**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

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to:
Large & Mid-Size Business)
Strategy, Research & Program Planning
Ogden, Utah

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Office of Associate Chief Counsel (Corporate)

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subject: Bankruptcy Plan

This Chief Counsel Advice responds to your request for assistance. This memorandum may not be used or cited as precedent.

LEGEND:

Debtor =

Reorganized Debtor =

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Disclosure Statement =

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We have examined the Disclosure Statement regarding the bankruptcy plan of Debtor, under which Debtor will be succeeded by Reorganized Debtor. Debtor files a consolidated return with its subsidiaries (together, the Debtor Group). This memorandum highlights some issues that the Service might encounter on audit of Debtor or Reorganized Debtor in the future.

1. Cancellation of debt income – attribute reduction

A major issue will be whether any of Debtor's net operating losses (NOLs) will survive the bankruptcy and be available to Reorganized Debtor.

Section 108(a)(1) of the Internal Revenue Code excludes from gross income cancellation of debt (COD) income if the discharge occurs in a title 11 (i.e., Bankruptcy Code) case. However, as a price for this income exclusion, § 108(b) requires that the amount of the excluded income be applied to reduce seven specified tax attributes of the taxpayer. Generally, under § 108(b)(1), net operating losses (NOLs) are the first attribute to be reduced. However, § 108(b)(5) allows the taxpayer to elect to reduce the basis of depreciable assets under § 1017 before other attributes are reduced. We note that the Disclosure Statement at b states that the Debtor Group has consolidated NOL carryforwards of approximately X dollars, and anticipates that the bankruptcy reorganization will result in excluded COD income of Z dollars, a larger amount than X dollars.

When the bankruptcy plan becomes effective, Debtor will be succeeded by Reorganized Debtor, a different taxpayer. The bankruptcy reorganization appears likely to qualify as a reorganization under § 368(a)(1)(G), under which a corporate reorganization includes a transfer by one corporation of assets to another corporation in a title 11 (bankruptcy) case if stock or securities of the transferee corporation are distributed in a transaction described in § 354, 355, or 356. In a "G" reorganization, the NOLs, and certain other tax attributes of Debtor are carried over to Reorganized Debtor under § 381(c), and the basis of Debtor's assets that are acquired by Reorganized Debtor will have the same basis as in the hands of Debtor under § 362(b).

On July 18, 2003, the Internal Revenue Service published Temporary Regulation § 1.108-7T, on the reduction of tax attributes due to discharge of indebtedness. T.D. 9080, 2003-40 I.R.B. 696. The temporary regulations specify that the tax attributes that pass to the successor corporation under § 381(c) are the attributes as reduced under § 108, and the basis of assets that are transferred to the successor corporation reflect the basis reductions required under § 108(b)(2)(E) or (b)(5). These temporary regulations are effective for discharges of indebtedness occurring after July 17, 2003. Because the discharge of indebtedness in the case of Debtor did not occur before the plan was confirmed on Date J, a date after July 17, 2003, these temporary regulations apply to Debtor[1].

On September 4, 2003 (with amendments on December 1, 2003 and March 15, 2004) the Service published Temporary Regulations § 1.1502-28T, which provide that a consolidated group reduces tax attributes under § 108(b) on a consolidated basis, so that potentially the tax attributes of all members may be reduced. T.D. 9089, 2003-43 I.R.B. 906, amended by T.D. 9098, 2003-52 I.R.B. 1248 and T.D. 9117, 2004-15 I.R.B. 721. The temporary regulations require in general that the consolidated tax attributes attributable to the debtor member, and attributes in certain separate return years of the debtor member, are reduced first. Any remaining COD income is applied to reduce consolidated tax attributes and certain separate return year attributes attributable to other group members. The tax attribute of a member's property basis is generally reduced only for the member realizing COD income. If the property whose basis is reduced is the stock of another group member (such as a lower-tier subsidiary), a "look-through" rule provides for a reduction of NOLs and other tax attributes of the other group member. The temporary regulations generally apply to discharges of debt of a consolidated group member that occur after August 29, 2003 and therefore would apply to Debtor's bankruptcy discharge. The Disclosure Statement (prepared before the Service issued the regulations described above) stated that the taxpayer will contend that the reduction of tax attributes occurs on a separate corporation basis.

Under § 1.1502-19 and § 1.1502-19T, a debt discharge of a subsidiary in bankruptcy may trigger an inclusion of income from an excess loss account (a "negative basis" in the stock of a subsidiary that can result under consolidated return rules) to the extent of the amount discharged that, generally speaking, exceeds the reductions in tax attributes under § 108 or § 1017. § 1.1502-28T(b)(6)(ii) requires that this inclusion of an excess

1 These temporary regulations were finalized by T.D. 9127, May 11, 2004, 2004-24 I.R.B. 1042, with certain modifications. The modifications apply to discharges of indebtedness occurring on or after May 10, 2004.

loss account be included on the group's tax return for the taxable year that includes the date on which the subsidiary realizes excluded COD income.

2. Application of § 382 to losses of Debtor

Section 382 generally limits the amount of tax attributes that a corporation may use following an ownership change. The general limitation is computed as the value of the loss corporation (i.e., the value of its stock) multiplied by the long-term tax-exempt rate for the month in which the ownership change occurs (for example, 4.58 percent for ownership changes occurring in April 2003). This limitation applies to net operating loss carryovers from tax years before the ownership change, and also to "built-in" losses of assets at the time of the ownership change if the corporation has an overall "net unrealized built-in loss" (§ 382(h)(1)(B)).

Because the stock of a bankrupt corporation generally has no value, the general rule of § 382 would produce a §382 limitation of zero, and Reorganized Debtor would not be able to use any of the losses (other than to offset recognized built-in gains). However, § 382(l)(5) provides a special rule for title 11 (bankruptcy) cases that makes the general § 382 limitation inapplicable to cases to which the special rule applies. The rule requires that either the old shareholders or certain "qualified creditors" hold at least 50 percent of the new loss corporation's stock (determined under the rules of § 1504(a)(2)). This tax benefit comes at the price of decreasing the losses by eliminating the effect of interest deductions on debt that was converted into stock in the bankruptcy plan, for the taxable year of the ownership change and the 3 preceding taxable years. A "qualified creditor" under § 382(l)(5)((E) and Treas. Reg. § 1.382-9(d) holds debt that was held by the creditor at least 18 months before the date of the filing of the bankruptcy case, or arose in the ordinary course of the trade or business of the corporation and has been held at all times by the same beneficial owner.

The Service on audit will need to determine whether enough of the creditors receiving stock are "qualified creditors" so that the taxpayer qualifies for § 382(l)(5) relief. Note that c of the Disclosure Statement describes an order that the Debtor obtained from the Bankruptcy Court to allow the Debtor to object to certain acquisitions of creditor's claims in order to avoid reducing the proportion of creditors who are qualified creditors. The Service should also verify that a sufficient proportion of qualified creditors (preferably 50 percent) retained their stock in Reorganized Debtor for a reasonable (not transitory) period of time after the bankruptcy plan is consummated.

The Service will also have to verify that there was no second ownership change for Reorganized Debtor within two years of the consummation of the bankruptcy plan. Under § 382(l)(5)(D), if the corporation underwent such a second ownership change, the benefits of § 382(l)(5) for the first ownership change are disallowed and, further, the corporation's § 382 limitation after the second ownership change is zero.

If the Debtor goes through the bankruptcy reorganization but does not qualify for § 382(l)(5) relief[2], § 382(l)(6) provides that the § 382 limitation will apply but provides that the value of the old loss corporation under § 382(e) will reflect the increase in value (if any) of value of the old loss corporation resulting from the surrender or cancellation of creditor's claims in the transaction. See Reg. 1.382-9(j), (k), and (l) for rules on determination of the value of the old loss corporation for this purpose.

A taxpayer to which § 382(l)(6) applies is subject to the "continuity of business enterprise" rule of § 382(c), under which the § 382 limitation will be zero if the new loss corporation does not continue the business enterprise of the old loss corporation at all times during the two-year period after the ownership change date. The test used is the business continuity test used for corporate reorganizations under Treas. Reg. § 1.368-1(d). Under that regulation, business continuity is satisfied if the acquiring corporation continues the target corporation's historic business or uses a significant portion of the target's historic assets in a business. The bankruptcy documents suggest that this requirement is likely to be met, but it should be verified in audit.[3]

The Service will also need to ascertain whether there may have been an ownership change before the bankruptcy plan is consummated. An earlier ownership change would be subject to the full force of the § 382 limitation, and since Debtor probably would have no value, all of its losses would become unusable to it or Reorganized Debtor even if the later bankruptcy would be eligible for either § 382(l)(5) or (l)(6) relief. The Debtor is concerned that such a prior ownership change could occur. The disclosure Statement at e describes an order obtained from the Bankruptcy Court that prohibits any person or entity from acquiring any class of equity interest that would cause the party to acquire f percent (an amount less than 5 percent) or more of that class of equity interest. The apparent purpose of that order is to avoid creating more "5-percent shareholders" for purposes of possibly triggering an ownership change under § 382(g).

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2 Section 382(l)(5)((H) allows a taxpayer who is eligible for § 382(l)(5) relief to elect to have § 382(l)(6) apply (instead of § 382(l)(5), but the Disclosure Statement at d indicates that Debtor is not likely to make that election but expects to use § 382(l)(5) to preserve use of its losses.

3 A limitation related to "continuity of business enterprise", but one which we doubt will apply to this case, is in Reg. § 1.269-3(d). Under that regulation, an acquisition in connection with an ownership change to which § 382(l)(5) applies is presumed to be a transaction with the principal purpose of evasion or avoidance of federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and after the bankruptcy case. The trade or business does not have to be the historic trade or business, however. Since the bankruptcy documents indicate that Debtor during the bankruptcy and Reorganized Debtor afterwards will continue to conduct its historic business or a similar business, we do not think that this presumption will make § 269 applicable to this case if § 382(l)(5) applies.

3. Alternative Minimum Tax

There is a special adjustment relating to ownership changes under § 382 in the alternative minimum tax (AMT) provisions. Section 56(g)(4)(G) provides that, for purposes of determining "adjusted current earnings," if there is an ownership change under § 382 and there is a net unrealized built-in loss under § 382(h), then the adjusted basis of each corporate asset immediately after the ownership change is its proportionate share of the fair market value of the assets of the corporation as determined under § 382(h) immediately before the ownership change. The effect of this change is to limit deduction for losses on asset dispositions reflecting "built-in" losses from the AMT "adjusted current earnings" base. This provision has no exception for the bankruptcy discharge rule of § 382(l)(5) discussed above, and CC:IT&A, which has jurisdiction over the AMT provisions, confirmed that that the provision applies whether or not the bankruptcy rule applies under the regular tax. Therefore, this limit on "built-in" losses will apply for AMT "adjusted current earnings" purposes even though the losses may be allowed for regular tax purposes. See Treas. Reg. § 1.56(g)-1(k) for more details on the application of this special rule.

In addition, § 56(d) recomputes net operating losses and limits their allowance to 90 percent of the taxpayer's alternative minimum taxable income.

4. Forgiveness of Intercompany Obligations

The Disclosure Statement at h describes the proposed substantive consolidation of part of the Debtor Group (other than M and its subsidiaries) under the Bankruptcy Code, which would, among other things, eliminate intercompany claims within the group. The Disclosure Statement at i describes the settlement of a dispute concerning an intercompany note between the Debtor and M.

Although Treas. Reg. § 1.1502-13(g) currently addresses the area, the Service's Priority Guidance Plan for 2003-2004 calls for the issuance of new guidance regarding transactions involving obligations of consolidated group members. Also, the treatment of the discharge of intercompany obligations in bankruptcy cases is currently uncertain. For example, equitable subordination of an intercompany obligation in a bankruptcy case suggests that the intercompany obligation should be characterized as equity. However, under § 385(c), the taxpayer may not be free to recharacterize the obligation as equity. Please contact Corporate with regard to any issues in this area.

5. Reorganization of international businesses of Debtor.

On Date K, Debtor applied to the Bankruptcy Court for permission to reorganize certain foreign subsidiaries of Debtor. While the motion before the court described several transactions that might have international tax ramifications, we did not have basic information as provided in the Plan of Reorganization to make a recommendation for a motion before the Bankruptcy Court. Nevertheless, we will describe the transactions and the instances where taxable gain might be recognized by the Debtor group.

The first type of transaction involves a U.S. corporate member of the Debtor consolidated group transferring stock of a foreign subsidiary to a Country N holding company. A check-the-box election under Reg. § 301.7701-3 (effective Date L) was previously made, causing these foreign corporations to be treated as disregarded entities for federal income tax purposes. A disregarded entity's assets and liabilities are treated as the assets and liabilities of its single owner. Because the corporate entity is disregarded for tax purposes, the U.S. transferor is treated as transferring the assets (and not the stock) of the foreign subsidiary to the foreign holding company. These transactions appear to qualify as nonrecognition exchanges under § 351.

Although the transactions may qualify generally for nonrecognition under § 351, these transfers of assets by a U.S. corporation to a foreign corporation are subject to § 367(a), which taxes gain on certain types of assets. Trade or business assets are generally not subject to tax, with the exception of certain assets such as inventory, installment obligations, accounts receivable, and foreign currency. For the time the foreign subsidiary is treated as a disregarded entity for tax purposes (and hence a foreign branch), any net operating losses of that specific foreign subsidiary which were deducted by the Debtor consolidated group would be recaptured as income to the extent of the built-in gain in all of the assets of the foreign subsidiary (including trade or business assets). Losses may also be recaptured under § 1503(d). In addition, if the foreign corporation has intangible property, this property is taxed under § 367(d).

We counted s of these transactions, which we believe to be substantial. However, we have no information as to the type of assets in these foreign corporations and the built-in gain in these assets. Moreover, it is important to note that the transfer of most trade or business assets (a large category of assets) are not subject to tax under § 367(a). However, if the foreign subsidiaries have valuable intangibles or were incurring losses after 2001 (and therefore were subject to the loss recapture rules), then income under § 367(a) and (d) would be implicated. Also, if the Debtor consolidated group has capital and ordinary losses, these losses could very well offset any § 367 income. If these transactions occur before the bankruptcy discharge occurs and before an ownership change under § 382 occurs, the losses may be available because neither attribute reduction nor § 382 would limit use of the losses.

Another type of transaction we noted is where a U.S. corporate member of the Debtor consolidated group transfers stock of a foreign subsidiary to the Country N holding company, and the foreign subsidiary liquidates into the Country N holding company. This transaction is commonly recast as a § 368(a)(1)(D) or (G) reorganization, as if the assets and liabilities of the foreign subsidiary were transferred directly to the foreign holding company in exchange for holding company stock and the foreign subsidiary distributes the holding company stock to its shareholder in liquidation.

If the liabilities of the foreign subsidiary exceed of the adjusted basis of the foreign subsidiary's assets, in the § 351 or § 368(a)(1)(D) transactions described above, such excess is generally recognized as gain to the foreign subsidiary under § 357(c) and included directly in the income of the Debtor consolidated group as subpart F income. We do not know whether § 357(c) is triggered in any of these transactions, however, because we do not know the amount of debt in relation to the adjusted basis of assets of the foreign subsidiaries. Moreover, even if there is § 357(c) gain included in the income of Debtor, the Debtor group may very well have losses (for the period before the bankruptcy discharge and any ownership change) which offset such income.

There are t transactions where the stock of a foreign subsidiary is transferred to the Country N holding company by a U.S. corporate member of the Debtor consolidated group in a nonrecognition exchange. This stock transfer is different from the prior transactions above, because the foreign subsidiary has not elected disregarded status (so the stock, as opposed to the assets, of the foreign subsidiary are transferred to the foreign holding company) and the foreign subsidiary does not liquidate into the holding company (hence, it is not recast as a § 368(a)(1)(D) or (G) reorganization).

Under § 367(a), gain on the transfer of foreign stock by a U.S. corporation to a foreign corporation in a nonrecognition exchange is generally included in income, unless the U.S. transferor enters into a gain recognition agreement (commonly called a GRA). The GRA is filed with the taxpayer's return for the year of the transaction and allows an exception from gain recognition if the Country N holding company (the transferee) does not dispose of the foreign stock for five years. If the Country N holding company disposes of the foreign stock in a subsequent nonrecognition exchange (which occurs here in some cases) then the GRA must be modified so that the new transferee does not dispose of the foreign stock within the 5-year period. We are assuming that the Debtor group will enter into GRAs with respect to these types of transactions. Therefore, we do not have a problem with these transactions.

If you have any questions regarding the non-international issues in this memorandum, please contact the Office of Associate Chief Counsel (Corporate) at (202) 622-7750. If you have any questions regarding the foreign issues, please contact the Office of Associate Chief Counsel (International) at (202) 622-3800.

Please notify Chief Counsel when the account for Debtor is assigned and pulled.