Report on Application of Treasury Regulation Section 1.382-2T(f)(18)(iii) with Respect to Distressed Debt

Report No. 1255

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I. Introduction

This report[1] of the Tax Section of the New York State Bar Association discusses the potential application of Treasury Regulation Section 1.382-2T(f)(18)(iii) to trading in "distressed debt" instruments.

Treasury Regulation Section 1.382-2T(f)(18)(iii) is titled "Treating Interests Not Constituting Stock as Stock." The regulation provides that, in certain instances, an instrument that would not otherwise constitute stock for federal income tax purposes will be treated as stock for purposes of determining whether a corporation has undergone an "ownership change" within the meaning of Section 382.[2] In general, the regulation may treat a non-stock ownership interest as stock if the interest offers the holder a "significant participation in the growth of the corporation"[3] and certain other requirements are met. As drafted, the regulation could be read as applying to distressed debt instruments because the likelihood that such a debt instrument will ultimately be repaid may depend upon the future growth of the corporation.

This report makes recommendations on the application of Treasury Regulation Section 1.382-2T(f)(18)(iii) to trading in distressed debt. Part II of this report summarizes our

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[1] The principal author of this report is Russell Kestenbaum, with substantial assistance from Drew Batkin, Randy Clark and Joanna Grossman. Significant contributions were made by Stuart Goldring and Andrew Needham. Helpful comments were received from Vadim Mahmoudov, William McRae, Jodi Schwartz, Ansgar Simon and Eric Sloan. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] Unless otherwise indicated, "Section" and "I.R.C. §" references are to the Internal Revenue Code of 1986, as amended (the "Code") and "Treasury Regulation Section" and "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder.

[3] Treas. Reg. § 1.382-2T(f)(18)(iii)(A).

recommendations with respect to the application of Treasury Regulation Section 1.382-2T(f)(18)(iii) to trading of distressed debt. Part III provides background on the relevant Code and Treasury Regulations. Part IV summarizes the relevant authorities. Part V of the report describes certain issues with respect to application of the regulation to transfers of distressed debt instruments and our recommendation.

Although the potential types of instruments to which Treasury Regulation Section 1.382-2T(f)(18)(iii) applies (i.e., "[a]ny ownership interest[s]" in a corporation that are not stock[4] but offer a "potential significant participation in the growth of the corporation") is broad and amorphous, this report addresses only debt instruments that were not treated as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) when originally issued (or, except as noted herein, deemed issued). While there is no fixed definition of what constitutes a debt instrument for federal income tax purposes, when this report addresses a debt instrument, it assumes that the instrument, at the time it was issued, was properly treated as a debt instrument under the prevailing statutory and common law and administrative pronouncements.[5] We note, however, that many of the issues raised in this report that support eliminating the potential application of Treasury Regulation Section 1.382-2T(f)(18)(iii) with respect to a debt instrument that was not treated as stock for Section 382 purposes when issued may apply to other instruments or rights not denominated as debt.

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[4] Treasury Regulation Section 1.382-2T(f)(18)(iii) incorporates the definition of "stock" in Treasury Regulation Section 1.382-2T(f)(18)(i), which, in turn, incorporates by reference the definition of stock in Treasury Regulation Section 1.382-2(a)(3)(i), which defines the term stock to mean "stock other than stock described in section 1504(a)(4)." Section 1504(a)(4) describes what is often referred to as "plain vanilla" preferred stock, or stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock. Treasury Regulation Section 1.382-2(a)(3)(i) further provides that "stock that is not described in section 1504(a)(4) solely because it is entitled to vote as a result of dividend arrearages shall be treated as [1504(a)(4) stock]."

[5] *See, e.g.*, I.R.C. § 385; *John Kelley Co. v. Comm'r*, 326 U.S. 521 (1946); *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3d Cir. 1968); Notice 94-47, 1994-1 C.B. 357.

II. Summary of Recommendations

For the reasons discussed in this report, we recommend that the Treasury Department ("Treasury") and Internal Revenue Service ("IRS") revise Treasury Regulation Section 1.382-2T(f)(18)(iii) to provide that an instrument properly treated as debt for federal income tax purposes at the time of its original issuance will not be treated as stock under the regulation solely as a result of the transfer of such debt at a time when, due to deterioration in the issuer's financial condition, the likelihood that the instrument will be repaid is based in significant part on the future growth of the issuer's business. More specifically, we recommend that a determination of whether a debt instrument should be treated as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) be made only at the time the debt instrument is issued (or deemed issued, except as provided below) for federal income tax purposes. We believe that extending the regulation to potentially treat distressed debt as stock upon transfer would be inconsistent with the legislative history and purpose of Section 382, as well as the general principle of tax law that the character of an instrument is determined on the date of issue. We also believe that administering such a rule would make it very difficult for corporations to determine whether they have, or are likely to undergo, an ownership change.

In addition, we recommend than any revisions to the regulations consistent with the above also provide that a deemed exchange under Treasury Regulation Section 1.1001-3(e) of an instrument properly treated as debt at original issuance will not cause the modified debt to be considered stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) merely because the financial condition of the issuer has deteriorated.

III. Background

Section 382, added to the Internal Revenue Code in 1954, was intended to address a Congressional concern that corporate acquirors were "trafficking in . . . loss carryovers" of target corporations.[6] The IRS had an existing weapon against such trafficking in the form of Section 269. Section 269, however, depended (and continues to depend) on subjective determinations of the purpose of an acquisition.[7] Section 382 was intended to provide an objective test for when the use of an acquired corporation's net operating losses ("NOLs") and certain built-in losses should be limited.

As enacted in 1954, the Section 382 limitation directly reduced the net operating losses of the acquired corporation. In contrast, the current version of Section 382 limits the amount of income that may be offset by losses incurred prior to an ownership change. In general, the annual amount of any such losses that may be carried forward to a post-ownership change year is equal to the value of the acquired corporation's stock immediately before the ownership change, multiplied by the long-term tax exempt rate (the "Section 382 limitation").[8] If the Section 382 limitation for a taxable year exceeds the post-ownership change taxable income of the corporation, the unused limitation is added to Section 382 limitation for the subsequent taxable year.[9]

The trigger[10] of the Section 382 limitation is an "ownership change" in the "stock" of a "loss corporation."[11] The statute generally defines a "loss corporation" as "a corporation that is entitled to use a net operating loss carryover or having a net operating loss for the taxable year in

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[6] H.R. REP. NO. 1337, 83d Cong., 2d Sess., at 42 (1954).

[7] See I.R.C. § 269.

[8] I.R.C. § 382(b)(1).

[9] I.R.C. § 382(b)(2).

[10] The House version of the provision that became Section 382, passed on December 17, 1985 in H.R. 3838, actually includes the term "trigger." As enacted, that term is not used.

[11] I.R.C. § 382(a).

which the ownership change occurs."[12] The two elements of the trigger for the Section 382 limitation are addressed below.

A. Ownership Change

An ownership change occurs if, "immediately after any owner shift involving a 5-percent shareholder or any equity structure shift, the percentage of the stock of the loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points, over the lowest percentage of stock of the loss corporation (or any predecessor corporation owned by such shareholders at any time during the testing period)."[13] The "testing period" is generally "the three year period ending on the date of any owner shift involving a 5-percent shareholder or equity structure shift."[14]

For this purpose, a 5-percent shareholder is a person that owns (directly or indirectly) 5 percent or more of the loss corporation's stock measured by value.[15] An owner shift is "any change in the respective ownership of the stock of a corporation [where] such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change."[16] An equity structure shift is generally any reorganization within the meaning of Section 368.[17]

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[12] I.R.C. § 382(k)(1).

[13] I.R.C. § 382(g).

[14] I.R.C. § 382(i). The testing period is shortened in certain cases, including where a prior ownership change has occurred and where all the relevant losses arose after the general three year testing period began. I.R.C. § 382(i)(2), (3).

[15] I.R.C. §§ 382(k)(7), (k)(6)(C), (l)(3).

[16] I.R.C. § 382(g)(2).

[17] I.R.C. § 382(g)(3)(A). Certain reorganizations under Section 368 are excluded, such as reorganizations described in Section 368(a)(1)(F) or divisive reorganizations described in Section 368(a)(1)(D) or (G). I.R.C. § 382(g)(3)(A)(i)(ii).

B. <u>Meaning of "Stock"</u>

Section 382(k)(6) provides that "stock" for purposes of the Section 382 limitation means, except as provided by regulations, any stock other than stock described in Section 1504(a)(4). Stock is described in Section 1504(a)(4) if it is (1) not entitled to vote, (2) is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent," (3) has limited redemption and liquidation premium rights, and (4) is non-convertible.[18] The Conference Report to the Tax Reform Act of 1986 indicates that Congress understood the reference to Section 1504(a)(4) to mean that in certain cases, such as where preferred stock "carries a dividend materially in excess of a market rate," preferred stock would be taken into account as stock for this purpose.[19]

Section 382(k)(6)(B) directs the Secretary to prescribe regulations as necessary to treat "warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock and to treat stock as not stock." The Conference Report noted two types of stock that should *not* be treated as stock for this purpose, namely, preferred and common stock where, at the time of issuance or transfer, "the likely percentage participation of such stock in future corporate growth is disproportionately small compared to the percentage value of the stock as a proportion of total stock value," and preferred stock that fails to qualify as Section 1504(a)(4) stock solely because it is voting stock."[20]

C. <u>Policies of Current Section 382</u>

In the 1954 version of Section 382, the statute provided two restrictions on the use of any NOL carryover. First, any carryover was completely disallowed where a change in stock

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[18] I.R.C. § 1504(a)(4).

[19] H.R. REP. NO. 841, 99th Cong., 2d Sess., at II-173 (1986) (Conf. Rep.).

[20] *Id.*

ownership occurred and the old trade or business of the corporation was not continued.[21] Because this limitation included a factual element, i.e., whether the old trade or business of the corporation was discontinued, this provision resulted in extensive litigation.[22] Second, any tax-free reorganization that resulted in the previous owners holding less than 20 percent of the stock of the reorganized company resulted in a proportionate reduction of the carryover.[23] Notably, neither limitation required a showing of a tax avoidance purpose, a requirement that has limited the effectiveness of Section 269 as an effective curb on trafficking in NOLs.

Prior to the Tax Reform Act of 1986,[24] Congress considered Section 382 to be ineffective at carrying out its intended purpose, which was "restricting the function of carryforwards to that of an averaging device."[25] The staff of the Senate Finance Committee submitted a proposal in 1983 to revise Section 382. The proposal included three stated goals:

> "(1) to provide for tax neutrality on the disposition of corporations that possess favorable tax carryover characteristics (i.e., to eliminate both incentives and disincentives for the acquisition); (2) to limit the use of corporate tax benefits generated under one set of owners to the income attributable to the particular pool of capital that generated those benefits; and (3) to provide objective rules that could be applied and administered with greater certainty."[26]

Consistent with the above goals, Congress retained the objective triggering rules of Section 382 as they existed in the 1954 tax code, because measuring "changes in a loss corporation's stock ownership continues to be the best indicator of a potentially abusive

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[21] 1954 Code § 382(a).

[22] BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14-60 (7th Ed. 2006 with Supplement).

[23] 1954 Code § 382(b).

[24] P.L. 99-514, 100 Stat. 2085.

[25] H.R. REP. NO. 426, 99th Cong., 1st Sess., Pt. 3, at 256 (1985).

[26] Bittker and Eustice, *supra* note 22, at 14-61.

transaction."[27] The objective trigger of changes in stock ownership "rejects" the subjective-intent based carryover limitations imposed by Section 269.[28]

D. Introduction of Temporary and Proposed Regulations

On August 5, 1987,[29] Treasury issued temporary regulations under Section 382.[30] The regulations set forth general rules regarding ownership changes.[31] While maintaining the statutory definitions of "owner shift" and "equity structure shift,"[32] the regulations clarified the application of the Section 382 limitation by introducing the term "testing date," i.e., the date on which an owner shift or equity structure shift occurs.[33] The regulations also set forth the general rule for the calculation of increases in percentage ownership on a testing date[34] and provided rules for determining the applicable testing periods.[35]

The definitional provisions of the regulations include a definition of "stock."[36] For purposes of determining whether an ownership change occurred, the regulations specifically excepted stock not described in Section 1504(a)(4) stock "solely because it is entitled to vote as a

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[27] H.R. REP. NO. 426, 99th Cong., 1st Sess., Pt. 3, at 256 (1985).

[28] New York State Bar Association Tax Section Report 1198, Report on the Treatment of Fluctuations in Value under Section 382(l)(3)(C), 14-15 (Dec. 22, 2009).

[29] T.D. 8149 (Aug. 5, 1987). The following references to sections of the temporary regulations are to the temporary regulations as proposed in 1987. Certain provisions of the regulations introduced in 1987 have become final and are embodied in Treasury Regulation Section 1.382-2(a).

[30] The proposed and temporary regulations were addressed in a February 22, 1988 New York State Bar Association Tax Section Report (88 TNT 42-37), supplementing an earlier report on the House version of the statute that became Section 382 (86 TNT 98-54).

[31] Temporary regulations issued after the date of enactment of Section 7805(e)(2) expire three years from the date of their issuance. Treasury Regulation Section 1.382-2T(f)(18)(iii) was introduced prior to enactment of Section 7805(e)(2), with the result that the temporary regulations are not subject to the sunset provisions.

[32] Treas. Reg. § 1.382-2T(e).

[33] Treas. Reg. § 1.382-2T(a). A "testing date" could also be triggered by certain option transfers.

[34] Treas. Reg. § 1.382-2T(c).

[35] Treas. Reg. § 1.382-2T(d).

[36] Treas. Reg. § 1.382-2T(f)(18). After introduction of the definition by the temporary regulations, certain definitional concepts for "stock" became final in Treasury Regulation Section 1.382-2(a)(3)(i).

result of dividend arrearages."[37] The regulations also introduced rules for determining when an interest that would otherwise constitute stock for purposes of Section 382 should not be considered stock and rules for determining when an interest that would not otherwise constitute stock should be considered stock for that purpose.

Under the temporary regulations, an interest that would otherwise be stock for purposes of Section 382 would *not* be treated as stock where,

> (A) as of the time of issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation,
>
> (B) treating the interest as not constituting stock would result in an ownership change, and
>
> (C) the amount of the pre-change loss (determined as if the testing date were the change date and treating the amount of any net unrealized built-in-loss as a pre-change loss) is more than twice the amount determined by multiplying (1) the value of the loss corporation (as determined under section 382(e)) on the testing date, by (2) the long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.[38]

Conversely, the temporary regulations provide that an ownership interest that would not otherwise be stock for purposes of Section 382 would be treated as stock where,

> (A) as of the time of its issuance or transfer to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), such interest offers a potential significant participation in the growth of the corporation,
>
> (B) treating the interest as constituting stock would result in an ownership change, and
>
> (C) the amount of the pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying (1) the value of the loss corporation (as determined under section 382(e)) on the testing date, by (2) the long-term

[37] Treas. Reg. § 1.382-2T(f)(18)(i). This stock, however, remains included in the calculation of the value of the corporation under Section 382(e). *Id*. This portion of the definition became final and can be found at Treasury Regulation Section 1.382-2(a)(3)(i).

[38] Treas. Reg. § 1.382-2T(f)(18)(ii).

> tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.[39]

The conjunctive components of the regulation treating certain non-stock interests as stock are discussed, in turn, below.[40]

1) *"As of the time of issuance or transfer to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), . . ."*

Consistent with the mechanical concept of the testing date created by the temporary regulations, this component provides the appropriate time for testing the character of the interest in question.

This component additionally provides an objective test of which issuances or transfers need to be tested. Only transfers that involve an actual 5-percent shareholder or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock are tested. The test for when an instrument that is issued or transferred to a potential 5-percent shareholder involves an objective comparison of what the interest-holder's relative ownership of the tested corporation's stock would be if the interest in question were treated as stock.

2) *" . . . such interest offers a potential significant participation in the growth of the corporation . . . "*

The temporary regulations do not define "significant participation in the growth of the corporation" even though it is a key component of both Treasury Regulation Section 1.382-2T(f)(18)(ii) and (iii). Similar terms appear elsewhere in the Code and regulations, including the definition of Section 1504(a)(4) stock, which cannot "participate in corporate growth to any

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[39] Treas. Reg. § 1.382-2T(f)(18)(iii).

[40] The portion of the temporary regulation treating certain stock interests as non-stock for purposes of Section 382 is beyond the scope of this report.

significant extent," and the definition of "preferred stock" under Treasury Regulation Section 1.305-5(a). However, neither the temporary regulations nor the preamble thereto reference those sections.

Section 382 directs the Secretary to prescribe regulations as necessary to treat "warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock."[41] The preamble to the temporary regulations, without providing an example of what it means to "significantly participate in corporate growth", states that, "a financial instrument that *generally is treated as debt* for federal income tax purposes nevertheless may be treated as stock under the temporary regulations if such debt offers a potential significant participation in the growth of the loss corporation."[42] Other references in the Code and Treasury regulations to participation in corporate growth address instruments that already constitute stock for federal income tax purposes,[43] and thus do not provide guidance as to how a debt instrument could so participate.

The absence of a clear definition of what it means to "significantly participate in corporate growth" undermines the goal of objectivity in the application of Section 382. Not only is it unclear how an instrument that is debt for federal income tax purposes could participate in corporate growth, it is also unclear as to how much participation is necessary before it is "significant."

3) *". . . Treating the interest as constituting stock would result in an ownership change . . ."*

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[41] I.R.C. § 382(k)(6). Under this authority, Treasury and the IRS promulgated Treasury Regulation Section 1.382-4(d) with respect to when options and similar instruments will be treated as stock for Section 382 purposes.

[42] T.D. 8149 (January 1, 1987) (emphasis added).

[43] *See*, *e.g.*, I.R.C. § 1504(a)(4); Treas. Reg. § 1.305-5(a).

Consistent with the goal of objectivity in Section 382, this component requires an objective (i.e., quantifiable) comparative analysis of alternatives. If the issuance or transfer of a non-stock interest in a loss corporation, even if treated as stock, would not result in an ownership change, the interest will not be treated as stock.

4) *" . . . The amount of the pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying (1) the value of the loss corporation (as determined under section 382(e)) on the testing date, by (2) the long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs."*

This component must, almost by definition, meet the goals of objectivity of Section 382. There are two subsets of this component, each of which requires objective inputs. The first input, the amount of pre-change losses, is a cumulative balance that the loss corporation will have already taken into account, both for purposes of current year deductions and for purposes of calculating any NOL carryover from prior years. The second input is a calculation of the Section 382 limitation.[44] This was, as discussed above, an objective measurement by design.

This component is determined by dividing one input by another -- if the pre-change losses are not more than twice the Section 382 limitation, any non-stock interest of the loss corporation will not be treated as stock.

IV. <u>Relevant Authorities</u>

The only specific authority addressing the application of Treasury Regulation Section 1.382-2T(f)(18)(iii) is in the form of a several private letter rulings and a field service advice. Following is a discussion of those rulings.

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[44] *See* I.R.C. § 382(b)(1).

Private Letter Ruling 200938010[45] addresses whether a payment-in-kind instrument ("PIK Facility") is subject to re-characterization as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) where the issuer of such instrument experiences deteriorating financial health resulting in transfers of interests in the PIK Facility at significant discounts to its stated principal amount. The common parent of an affiliated group that files consolidated returns ("Parent") had previously issued common stock, owned entirely by a non-U.S. parent, and preferred stock, owned by two funds (the "Funds"). In Year 1, Parent formed a U.S. subsidiary (the "Sub") contributing Euros in exchange for (i) common stock of the Sub and (ii) shareholder loans (treated as equity for federal income tax purposes). Additionally, Sub borrowed funds in exchange for payment-in-kind notes (the "PIK Notes") from a consortium of lenders.

In Year 2, Sub converted into a disregarded entity for federal income tax purposes. After the conversion, Sub entered into the PIK Facility and used the cash proceeds to repay the PIK Notes. Because Sub was disregarded as separate from Parent, the PIK Facility was treated as an obligation of Parent for federal income tax purposes. Parent had no other outstanding debt at the time the PIK Facility was issued, and Parent's financial projections as of the time the PIK Facility was issued indicated that Parent would be able to satisfy all of its obligations on the PIK Facility as such obligations came due. In addition, the PIK Facility did not entitle its holders to any voting rights, right to dividends or liquidation proceeds. Finally, holders of the PIK Facility had no control or influence over the management of Parent.

The ruling states that, as of the date of the ruling request, Parent was in poor financial condition as a result of market conditions and industry competition. At such time, it was unclear

[45] Sept. 18, 2009.

that Parent's common and preferred stock had any value. In addition, it was believed that transfers of interests in the PIK Facility were being made at significant discounts.

On the basis of the facts presented in the ruling request, the IRS ruled that the PIK Facility should *not* be characterized as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii). Moreover, the IRS further ruled that interests in the PIK Facility would not be treated as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) for periods after the ruling was issued, so long as (i) Parent was not actively involved in placing the PIK Facility with potential acquirers, (ii) the PIK Facility was not issued or transferred to any person that would own more than 50% of the PIK Facility, and (iii) no material change to the terms of the PIK Facility were made.

While no reasoning is provided, the IRS position in the ruling may recognize the difficulty in tracking transfers of, and the likely absence of abuse with respect to, minority interests in debt unless the issuer is involved in the transfer.

In *Private Letter Ruling 200445020,*[46] the IRS considered whether creditor claims against a debtor entity received pursuant to a bankruptcy restructuring should be characterized as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii). The ruling was requested by a domestic corporation (the "Taxpayer"), the common parent of a consolidated group (the "Group") for federal income tax purposes. Taxpayer had both domestic and foreign affiliates and was involved in a wide range of related businesses.

After voluntarily commencing Chapter 11 proceedings, Taxpayer filed a bankruptcy plan (the "Plan") and related disclosure statement. Although filed under Chapter 11, the Plan was a "plan of liquidation" in that it preserved the economic rights of the various creditor

[46] Nov. 5, 2004.

constituencies and Taxpayer's shareholders during the period following the effective date of the Plan while the Group liquidated its assets and made distributions in accordance with the relative priorities of claims and equity interests. Specifically, although the Plan estimated that valid creditor claims would exceed recoveries, the Plan provided that if Taxpayer's creditors were paid in full, any remaining value would be distributed to Taxpayer's preferred shareholders and, after the preferred shares were paid in full, distributions would be made to Taxpayer's common shareholders. The ruling notes that, for non-tax reasons, on the effective date of the Plan, each class of Taxpayer stock would be replaced with a newly issued class of stock with the same priority and entitlement to distribution as was the case prior to re-issuance. The newly issued stock was then issued to one of several trusts, with the beneficiaries of the trusts being the persons that previously held the shares of stock. The trusts were intended to be treated as grantor trusts for federal income tax purposes. Thus, while the shares of Taxpayer stock were recapitalized and transferred to new owners, the trusts, on the effective date, the beneficial owners of the shares remained the same as they were immediately before the effective date.

The IRS ruled that the exchange of the existing Taxpayer stock for new stock and the issuance of that new stock to the trusts does not give rise to an owner shift under Section 382(g). Citing Treasury Regulation Section 1.382-2T(f)(18)(iii), the IRS further ruled that any interests received by the various creditors of Taxpayer would not be treated as stock for purposes of Section 382.

This ruling is significant because although the Plan acknowledged that the debt claims would likely exceed recoveries and that the stock was therefore unlikely to receive any distributions, the IRS still concluded that the effective date of the Plan was not a proper time for treating creditor claims as stock under Section 382.

In *Field Service Advisory 199910009*,[47] the IRS considered a fact pattern whereby a taxpayer was affirmatively claiming that Treasury Regulation Section 1.382-2T(f)(18)(iii) caused certain of its debt to be treated as stock for Section 382 purposes. The taxpayer at issue ("X") purchased assets in a leveraged buyout. As a part of the leveraged buyout, X borrowed funds from a lender ("Lender") pursuant to a loan agreement (the "Loan Agreement"). The Loan Agreement identified three different loans: a term loan, a fixed rate loan, and a revolving facility. In conjunction with the loan agreement/leveraged buyout, Lender also received a warrant to purchase shares of X.[48]

On Date 2, X and Lender made certain modifications to the Loan Agreement, including amendments related to the permitted debt ratios of X, compensation of employees, Lender enforcement rights with respect to certain matters (including submission of financial statements, certain asset sales and other notice requirements), and X's right to issue additional stock to certain individuals. On Date 3, a second amendment to the Loan Agreement significantly altered the payment terms of the various loans, including the conversion of a certain amount of the fixed rate loan and revolving facility to additional principal of the term loan, the rescheduling of principal payments on the term loan, the extension of the term loan maturity date, and the forgiveness of a portion of the principal on the term loan. In addition, the number of shares subject to the warrant was increased. The FSA notes that the second amendment constituted a significant modification of the loans under Section 1001. At the time of the second amendment on Date 3, X was insolvent.

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[47] Mar. 12, 1999.

[48] The FSA separately considers what facts are necessary to determine whether the warrants issued should be treated as stock for purposes of Section 382(k)(6)(B)(ii).

X argued that the total outstanding non-revolving loans owed to Lender (i.e., the term loan and fixed rate loan) should be treated as stock as of the date of the second amendment for purposes of determining whether an ownership change occurred. X argued that the second amendment modifications were made because of X's financial difficulties, and that if X had been required to liquidate on the date the second amendment was made, it would not have had sufficient value to satisfy its liabilities. As a result, X argued that Lender had a vested interest in the growth of X; it was reliant on such growth to ensure its debt claims would be repaid in full.

The FSA rejected X's argument, concluding that the loans should not be re-characterized as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii). In its analysis, the IRS focused on the question of whether the first part of the regulation was met; whether the loans provided the "potential for significant participation in the growth of X . . . " to the Lender. The IRS rejected X's insolvency argument, refusing to accept that a borrower's insolvency automatically provides the potential for significant participation in corporate growth to the Lender. The FSA states that, if X's position that insolvency could trigger recharacterization of debt as stock for Section 382 purposes were correct, "possibly every lender to a debtor that subsequently became insolvent or bankrupt would be considered as automatically having a potential for significant participation in the growth of the debtor. This cannot be correct."

The IRS acknowledged that although an exchange of debt for stock or warrants may offer participation in the growth of the debtor company, "it may be more appropriate to take the position that the [Lender] is not participating in the growth of the company" when the parties modify the terms of the debt instrument to facilitate repayment. In the instant case, the loans were modified to increase the likelihood of repayment. Moreover, the FSA noted that the interest rates on the loans were consistent with the treatment of the instruments as debt for purposes of Section 382. The IRS also assumed that, for the Lender to agree to a modification of the debt, X would have been expected to have sufficient assets and future cash flows to meet its payment obligations under the modified loans. Consequently, the IRS held that "it would be difficult for X to argue that Lender has the potential to offer significant participation in the growth of X, and that the debt is stock for purposes of Treasury Regulation Section 1.382-2T(f)(18)(iii)."

The IRS noted that a definite conclusion as to whether debt is stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) could be dependent upon such facts and circumstances as: "the reasonableness of the credit risk, the reasonableness of the projections of earnings and cash flow that X used at the time of the debt modification, the percentage of projected income and cash flow that X was required to commit to debt service, the security provided for the debt, the market interest rates on similar types of debt, the terms of the warrant and the likelihood of exercise of the warrant."

It is worth noting that, in claiming that the modified loan should be treated as stock for Section 382 purposes, X contended that the value of the loan should be treated as part of X's equity value for purposes of determining its Section 382 limitation. Rather interestingly, the IRS noted that, even if the modified debt constituted stock for purposes of Treasury Regulation Section 1.382-2T(f)(18)(iii), it did not follow that the value of the debt would be taken into account in determining the value of X's stock for the purpose of determining the limitation under Section 382. The IRS noted that a deemed exchange of the debt for new stock could be treated as a contribution to capital which is properly excluded from the value of X's stock under Section 382(l)(1)(A).

Private Letter Ruling 9441036[49] considered whether new subordinated notes and debentures issued as part of the restructuring of a distressed borrower should be characterized as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii). The taxpayer ("Taxpayer") was a domestic corporation engaged in the ownership and operation of multiple stores. Prior to the transactions at issue, Taxpayer had issued voting common stock, non-voting preferred stock, subordinated notes, two series of subordinated debentures and a warrant. In an effort to reduce its debt, Taxpayer sold certain stores and operations and negotiated with its senior lenders for additional credit and modifications to the existing senior loans.

Taxpayer offered to exchange all of the two classes of its existing debentures for new debentures (the "New Debentures"), common stock, and cash. Taxpayer also issued new subordinated notes (the "New Subordinated Notes") for its existing subordinated notes. The ruling notes that Taxpayer could not represent whether it was solvent at the time the New Debentures and New Subordinated Notes were issued. However, Taxpayer represented that it would have sufficient assets from project cash flows related to future earnings and proceeds of anticipated debt financing to satisfy its obligations with respect to the New Debentures and the New Subordinated Notes regardless of whether there was future growth with respect to the Taxpayer's assets.

Citing Treasury Regulation Section 1.382-2T(f)(18)(iii), the IRS held that the New Subordinated Notes and the New Debentures were not stock for Section 382 purposes when those instruments were issued. The IRS also held that the New Subordinated Notes and the New Debentures would not be subject to re-characterization as stock for purposes of determining an

[49] Oct. 14, 2004.

ownership change after the restructuring date unless they are reissued or transferred to (or by) a 5-percent shareholder.

This ruling provides little, if any, insight into the IRS's position with respect to Treasury Regulation Section 1.382-2T(f)(18)(iii). While it notes that Taxpayer could not represent whether it was solvent at the time the new debt was issued, it does not state that Taxpayer was in fact insolvent. Also, the fact that Taxpayer expected to be able to service the debt in accordance with its terms, an extremely important factor in determining whether a new instrument is debt for tax purposes, should almost certainly lead to a conclusion that such debt was not expected to participate in the issuer's growth to a significant extent.

There are certain other authorities that, while not specifically addressing the application of Treasury Regulation Section 1.382-2T(f)(18)(iii), are helpful in thinking about whether treating distressed debt as stock for Section 382 purposes is appropriate. In *Helvering v. Alabama Asphaltic*,[50] the Supreme Court held that the creditors of an insolvent corporation stepped into the shoes of the old shareholders upon instituting bankruptcy proceedings. Alabama Rock Asphalt Inc. ("OldCo") was a subsidiary of a corporation in receivership as of 1929 ("Parent"). Stockholders of Parent financed OldCo in exchange for unsecured notes (the "Noteholders"). Given the poor financial health of OldCo and its inability to satisfy the payment obligations under the Notes, the Noteholders developed a plan of reorganization providing for the formation of a new corporation ("Alabama Asphaltic") to acquire all of the assets of OldCo. Stock of Alabama Asphaltic was issued to the Noteholders and other creditors in satisfaction of their claims against OldCo. The Noteholders instituted involuntary bankruptcy proceedings in 1930, and the plan of reorganization was effected.

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[50] 315 U.S. 179 (1942).

Alabama Asphaltic sought a carryover basis in the assets acquired from OldCo. The Court thus considered whether there was continuity of interest as between OldCo and Alabama Asphaltic, concluding that it was "immaterial that the transfer shifted ownership of the equity from the stockholders to the creditors of [OldCo]."[51] As of the date of the institution of bankruptcy proceeds, the debtors had "effective command over the disposition of the property."[52] Consequently, when "the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority."[53]

In *Helvering v. Southwest Consolidated Corporation*,[54] the Court addressed whether bondholders of an insolvent corporation may be treated as stockholders for purposes of qualifying a transfer of the insolvent corporation's assets to a new corporation as a reorganization for federal income tax purposes. The taxpayer ("Southwest") was a successor to Southwest Gas Utilities Corporation ("Utilities"). Utilities defaulted on payments on certain of its outstanding bonds. Members of a bondholder committee subsequently became directors of Utilities and, within a short time thereafter, assumed control of Utilities. Pursuant to a plan, Utilities' assets were transferred to Southwest in exchange for Southwest stock, warrants and an assumption of certain debt of Utilities. Most of the Southwest stock received was transferred to the bondholders, a small percentage of stock and warrants were transferred to unsecured creditors, and warrants were transferred to the preferred and common stockholders of Utilities.

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[51] *Id*. at 183.

[52] *Id*.

[53] *Id*. at 184.

[54] 315 U.S. 829 (1942).

Southwest argued that the transaction was a reorganization, allowing it to acquire a high carryover tax basis in the transferred assets. The statute governing reorganizations in effect at the time of the transfer included the requirement that the transferor (Utilities) or its stockholders, or both, be in "control" of the transferee corporation (Southwest). The statute defined control as ownership of at least 80 percent of the voting stock and 80 percent of the shares of non-voting stock. The Court held that the transfer did not qualify as a reorganization because Utilities' creditors were not its stockholder for purposes of determining whether Utilities or its stockholders received control of Southwest.

Subsequently, Congress added Section 368(a)(1)(G) providing tax-free reorganization treatment with respect to certain transactions involving corporations in a title 11 or similar case. The legislative history to the legislation providing for G reorganizations states Congress' intent that rules be developed for purposes of measuring continuity of interest in a G reorganization by treating the senior most class of creditors that receives stock as well as all junior classes of creditors as holding a proprietary interest in the corporation for purposes of determining whether the continuity of interest requirement is met.[55] Regulations providing the standard for when creditor claims will be treated as a proprietary interest for continuity purposes were finalized in 2008.[56] The final regulations are generally viewed as taxpayer favorable in that they make it easier to satisfy the continuity of interest requirement in connection with a work out of an insolvent corporation. Citing the legislative history accompanying the introduction of G reorganizations, the preamble to the Treasury Decision issued with the final continuity regulations noted that "[t]he expansion of the application of the G reorganization rules to

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[55] S. REP. NO. 1035, 96th Cong., 2d Sess., at 36-37 (1980).

[56] Treas. Reg. § 1.368-1(e)(6).

reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress' intent to facilitate the rehabilitation of troubled corporations."[57]

The Court's decision in *Alabama Asphaltic*, together with introduction of G reorganizations and the subsequent continuity of interest regulations that apply to reorganizations in bankruptcy, could be viewed as support for treating certain debt claims as stock for Section 382 purposes at some point. However, given the purpose behind those rules, to facilitate tax-free restructurings of financially troubled companies, we do not believe those authorities should be interpreted in a manner that supports treating distressed debt as stock for Section 382 purposes solely because the debt is transferred at a time when a purchaser is looking to growth in the company for a return on its investment.[58]

Finally, recently issued Treasury Regulation Section 1.1001-3(f)(7) provides that a significant modification to the terms of a debt instrument will not cause the new debt instrument to be treated as other than debt solely as a result of a deterioration in the financial condition of the issuer. Specifically, Treasury Regulation Section 1.1001-3(f)(7)(ii) provides:

> in making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account. For example, any decrease in the fair market value of a debt instrument (whether or not the debt instrument is publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument.

[57] T.D. 9434 (Dec. 11, 2008).

[58] *See also* Treas. Reg. § 1.1001-3(c)(6) which provides that a modification to debt associated with a chapter 11 plan occurs only on the effective date of the plan, and Treas. Reg. § 1.1001-3(e)(4)(i)(G) which provides that a filing of a bankruptcy petition does not cause a change in obligor for Section 1001 purposes.

The preamble to the proposed regulation notes that it was always intended that the credit condition of an issuer of modified debt not be taken into account in determining whether the modified instrument is debt or something other than debt for tax purposes. The preamble notes that

> any decrease in the fair market value of a debt instrument (whether or not publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the issuer and not to a modification of the terms of the instrument. Consistent with this rule in the proposed regulations, if a debt instrument is significantly modified and the issue price of the modified debt instrument is determined under § 1.1273-2(b) or (c) (relating to a fair market value issue price for publicly traded debt), then any increased yield on the modified debt instrument attributable to this issue price generally is not taken into account to determine whether the modified debt instrument is debt or some other property right for U.S. federal income tax purposes.[59]

V. Recommendation – Treasury Regulation Section 1.382-2T(f)(18)(iii) Should Not Apply to Distressed Debt

A. Scope of Report – Limited To Distressed Debt

As noted in the introduction, the recommendations in this report are intended to apply only to distressed debt instruments that were not treated as stock under Treasury Regulation Section 1.382-2T(f)(18)(iii) when issued (or, except as noted herein, deemed issued).

B. Treasury Regulation Section 1.382-2T(f)(18)(iii) Should Not Apply to Distressed Debt

We recommend that Treasury and the IRS revise Treasury Regulation Section 1.382-2T(f)(18)(iii) to make the rule inapplicable to a debt instrument issued by a corporation if the debt instrument was not treated as stock for Section 382 purposes when originally issued. More specifically, we believe that if, at the time of issuance a debt instrument was not subject to Treasury Regulation Section 1.382-2T(f)(18)(iii) because it did not offer significant participation in the future growth of the corporation, the debt instrument should not be retested for significant

[59] T.D. 9513 (Jan. 6, 2011).

participation on a subsequent transfer merely because subsequent deterioration in the issuer's financial condition causes the debt to decline in value. For the same reason, we also recommend that the same debt instrument should not be retested on these grounds following a deemed exchange under Treasury Regulation Section 1.1001-3(e).

Our recommendations are based on several factors, including (i) the absence of any evidence that Congress intended that Section 382 apply to transfers of distressed debt, (ii) the likely impairment of a loss corporation's ability to benefit from the Section 382(l)(5) and (l)(6) exceptions to Section 382 with respect to ownership changes occurring in bankruptcy, (iii) the difficulty of monitoring transfers of debt and (iv) the difficulty in defining when debt is sufficiently "distressed" to be treated as stock for Section 382 purposes.

Congress Did Not Express an Intent to Treat Distressed Debt as Stock for Section 382 Purposes

Meaning of Stock – Section 382(k)(6) defines stock as stock other than Section 1504(a)(4) preferred stock. In addition, the statute specifically authorizes Treasury to prescribe regulations to treat "warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interests as stock"[60] and to prescribe regulations to treat stock as not stock for purposes of Section 382.[61] The statute includes no specific delegation to treat other types of non-stock instruments as stock.

Nor does the legislative history to Section 382 suggest that Congress intended to treat distressed debt as stock for purposes of testing whether an ownership change has occurred. Specifically, the conference agreement to the 1986 Act provides as follows:

> Under grants of regulatory authority in the conference agreement, the conferees expect the Treasury Department to publish regulations disregarding, in appropriate cases, certain

[60] I.R.C. § 382(k)(6)(B)(i).

[61] I.R.C. § 382(k)(6)(B)(ii).

> stock that would otherwise be counted in determining whether an ownership change has occurred, when necessary to prevent avoidance of the special limitations. For example, it may be appropriate to disregard preferred stock (even though voting) or common stock where the likely percentage participation of such stock in future corporate growth is disproportionately small compared to the percentage value of the stock as a proportion of total stock value, at the time of the issuance or transfer. Similarly, the conferees are concerned that the inclusion of voting preferred stock (which is not described in section 1504(a)(4) solely because it carries the right to vote) in the definition of stock presents the potential for avoidance of section 382. As another example, stock such as that issued to the old loss company shareholders and retained by them in the case of *Maxwell Hardware Company v. Commissioner*, 343 F.2d 716 (9th Cir. 1969), is not intended to be counted in determining whether an ownership change has occurred.
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> In addition, the conferees expect that the Treasury Department will promulgate regulations regarding the extent to which stock that is not described in section 1504(a)(4) should nevertheless not be considered stock. For example, the Treasury Department may issue regulations providing that preferred stock otherwise described in section 1504(a)(4) will not be considered stock simply because the dividends are in arrears and the preferred shareholders thus become entitled to vote.[62]

The legislative history is consistent with the language in Section 382(k)(6), which focuses on treating stock as not stock in certain situations. It is clear that Congress was concerned with abusive situations where instruments denominated as stock are issued to potentially avoid an ownership change but those instruments do not represent a substantial economic interest in the corporation as well as situations where preferred stock that otherwise would not be treated as stock for 382 purposes based on its economic terms might be treated as stock because of a voting right. Nowhere in the Code or legislative history is it suggested that Congress was concerned with a situation where an instrument not treated as stock under general tax principles should be treated as stock for Section 382 purposes as a result of changes in the value of the instrument.

The lack of Congressional focus on non-stock instruments does not foreclose the possibility that Congress thought there could be situations where an instrument labeled as debt

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[62] H.R. REP. NO. 99-841, 99th Cong., 2d Sess., at II.173-74 (1986) (Conf. Rep.).

should be treated as stock for purposes of determining whether an ownership change has occurred. However, no specific rule is necessary to address any such concern with respect to a newly issued instrument as it is clear that an instrument may be evaluated at issuance to determine whether it is properly characterized as stock for tax purposes.

Lack of Congressional intent to treat distressed debt as stock for Section 382 purposes is also apparent in Section 382(g)(4)(D). Section 382(g)(4)(D) provides that if a person owning 50% or more of the stock in a loss corporation treats the stock as becoming worthless in a taxable year and the stock is held by such person at the end of that year, the stockholder will be treated as having acquired the stock on the first day of the next taxable year and as having not owned the stock during any prior period, thus causing a Section 382 ownership change of the loss corporation. If common stock in a corporation is treated as worthless in a taxable year, at least some of the corporation's debt will be distressed and therefore subject to treatment as stock under Section 382 if our recommendation is not adopted. A rule that is written and has been understood to look solely to the ownership of actual stock in a corporation for purposes of determining if an ownership change has occurred notwithstanding that the stock is worthless suggests that distressed debt should not be taken into account in testing whether an ownership change has occurred.[63]

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[63] It could be argued that the reference to stock in Section 382(g)(4)(D) is intended to include any instrument treated as stock for Section 382 purposes, whether by statute or through regulations. Not only would such an interpretation make the provision almost impossible to administer, it would also significantly narrow its scope as compared to the case where it only applies to actual stock. For example, Section 165 only allows a worthless debt deduction on debt that is completely worthless. If a Section 165 loss is claimed on wholly worthless debt, it would be difficult to argue that the debt is stock on the theory that it shares in the growth of the company.

Treating Distressed Debt as Stock Could Severely Limit a Debtor's Ability to Utilize Section 382(l)(5) or (l)(6)

If an ownership change occurs, an annual limitation is placed on the loss corporation's ability to use its NOL carryforwards and certain built-in losses in an amount equal to the product of (i) the "applicable federal long-term tax exempt rate" in effect for the month of the ownership change and (ii) the equity value of the corporation *immediately before* the ownership change. The equity value of a debtor that is in bankruptcy will often be zero or quite low since it is usually insolvent. As a result, if an insolvent corporation undergoes an ownership change either before filing for bankruptcy or during the term of its bankruptcy case but prior to implementing a bankruptcy plan, the general Section 382 limitation will severely limit the corporation's ability to utilize its NOLs and other tax carryforwards. There are two special exceptions to the general ownership change loss limitation rule, both of which may apply in respect of an ownership change that occurs pursuant to a bankruptcy plan. These exceptions are commonly referred to as the (l)(5) and (l)(6) exceptions (corresponding to their locations in Sections 382(l)(5) and 382(l)(6) of the Code, respectively).

382(l)(6) Exception - The "(l)(6) exception" applies if an ownership change occurs as a result of an exchange of outstanding debt for newly issued equity in a plan of reorganization in a bankruptcy case and the company either does not qualify for the (l)(5) exception or it makes an election not to apply the (l)(5) exception. If the (l)(6) exception applies, a reorganized debtor's ability to use pre-effective date NOLs, and certain effective date built-in losses that are recognized after the bankruptcy plan effective date, to offset post-effective date taxable income is limited to an annual amount equal to the product of (i) the fair market value of the reorganized debtor's outstanding stock *immediately after* the ownership change resulting from implementation of the plan and (ii) the applicable federal long-term tax-exempt rate.

382(l)(5) Exception - The "(l)(5) exception" automatically applies if, immediately following the ownership change of a loss corporation pursuant to a plan of reorganization in bankruptcy, the shareholders and "qualified creditors" of the debtor own, as a result of their status as shareholders or qualified creditors, at least 50% of the reorganized debtor's stock. For this purpose, a qualified creditor generally includes (i) a creditor who held its claim continuously during the period beginning 18 months prior to the filing of the bankruptcy case and (ii) a creditor holding a claim that arose in the ordinary course of the debtor's business, but only if the creditor has continuously held that claim since its inception. Regulations under Section 382(l)(5) allow the loss corporation to presume that certain creditors are qualified creditors for purposes of determining whether the corporation qualifies for the (l)(5) exception. If the (l)(5) exception is applicable, no limitation is placed on the reorganized debtor's ability to use its pre-effective date tax losses. However, the reorganized debtor is required to reduce its NOL carryforward by the interest the debtor previously deducted with respect to the debt that is converted into equity. In addition, if the (l)(5) exception applies and the reorganized debtor undergoes another ownership change within two years of the bankruptcy plan effective date, the debtor will lose its ability to use its remaining pre-effective date NOLs and certain built-in tax losses from that subsequent ownership change date forward.

Consistent with other provisions of the Code that reflect a tax policy of facilitating reorganizations of financially troubled companies,[64] the (l)(5) and (l)(6) exceptions clearly reflect Congressional intent that corporations reorganizing through a bankruptcy proceeding receive some relief from the often harsh impact of Section 382. Bankruptcy reorganizations that result in the application of the (l)(5) or (l)(6) exception generally result from a corporation's creditors

[64] *See, e.g.*, I.R.C. § 108(a) (excluding from taxable income cancellation of debt income of a corporation that is insolvent or in bankruptcy) and I.R.C. § 368(a)(1)(G) (providing for tax-free reorganization treatment for certain restructurings pursuant to, among other things, a Chapter 11 plan of reorganization).

exchanging their debt obligations for all or most of the corporation's equity. Applying Treasury Regulation Section 1.382-2T(f)(18)(iii) to trading in debt obligations of a corporation could result in a Section 382 ownership change either prior to or following the filing of a bankruptcy petition. If such an ownership change occurs, the debtor would not be able to benefit from the (l)(5) or (l)(6) exceptions, frustrating the purpose of those provisions.

In providing that the (l)(5) exception applies only where qualified creditors (and/or shareholders) receive a majority of the company's equity, Congress contemplated that there could be substantial acquisitions of debt instruments prior to an ownership change resulting from a restructuring of debt into equity. By including a provision limiting application of the (l)(5) exception where there is significant trading in company debt before the bankruptcy plan is implemented but not including any similar rule in testing qualification for the (l)(6) exception, it can be inferred that Congress was not concerned with transfers of distressed debt causing an ownership change prior to an actual exchange of debt for equity.

Inability to Monitor Transfers of Debt

A significant practical reason for not treating debt instruments as stock for purposes of determining whether an ownership change occurs is that, even if the debt instruments that may be subject to this treatment are identifiable, there is generally no certain mechanism available for tracing who beneficially owns debt instruments and how much each holder owns. These, of course, are necessary elements of determining (i) whether a person beneficially acquires a corporation's debt instrument, (ii) whether that person is or would be a 5% holder of the corporation (including as a result of the acquisition of debt treatable as stock), and (iii) whether an acquisition of debt treated as stock, along with all other acquisitions and dispositions of stock and interests treated as stock for purposes of determining an ownership change under Section 382(g), is sufficient to trigger an ownership change of the issuer.

Although, anecdotally, most if not all debt instruments issued within the U.S. by domestic corporations are issued in "registered form" in accordance with the requirements of Section 163(f), many such instruments are held in "street name" for the beneficial owners. The IRS acknowledges that issuers and, indeed persons further down the chain of ownership, often do not and will not know the identities or percentage holdings of a debt issuance.[65]

In formulating the Section 382 temporary regulations, Treasury and the IRS recognized the challenges of determining whether widely held equity interests changed hands and were held by 5% holders. To alleviate the burdens of determining whether there are 5% holders and how many, the regulations allow a loss corporation to "rely on the existence or absence of filings under [SEC] Schedules 13D and 13G as of a date to identify the corporation's shareholders (both individuals and entities) who have a direct ownership interest of five percent or more."[66] Rule 13-1(d) under Regulation 13D compels any person who acquires beneficial ownership of more than 5% of a class of equity securities required to be registered under Section 12 of the Securities and Exchange Act of 1934 to file a Schedule 13D or 13G with the SEC within 10 days after the acquisition. There is no such filing requirement for debt. Accordingly, for any debt issuance that may be held through a clearing organization or by a broker in street name, there would be no

[65] *See, e.g.*, IRS Audit Technique Guide http://www.irs.gov/businesses/small/article/0,,id=185747,00.html ("The use of the DTC in debt offerings as a clearing agency along with its system of record keeping of debt securities fits the definition of registered form per regulation section 5f.103-1(c) <u>regardless that it has no knowledge of the actual beneficial owners of debt securities</u>. This is true because the direct participants who hold an interest in the global note of the issuer, maintains a record of beneficial owners of the debt securities.") (Emphasis added.) Cf. Private Letter Ruling 9613002 (Mar. 29, 1996) (the IRS ruled that a debt issuance was in registered form for purposes of Section 163 despite that the debt was nominally in bearer form, because it was held by a foreign clearing organization that could not transfer the instrument and would keep a register of participations).

[66] T.D. 8149 (August 11, 1987); Treas. Reg. § 1.382-2T(k)(1)(i).

effective manner for the issuer, the holders, or the government to determine whether the requirements of Treasury Regulation Section 1.382-2T(f)(18)(iii) are satisfied.

Difficulty in Establishing Standards for Treating Debt as Equity

In addition to the issues noted above in support of our recommendation that debt not be treated as stock for Section 382 purposes simply because of a deterioration in the financial condition of the issuer that effectively ties a transferee's return to the future growth of the company, we believe that there would be tremendous difficulties in determining when such a debt instrument should be treated as stock. It is easy enough to say the proper time is when the debt has become distressed, but to define what it means to be distressed for Section 382 purposes is not so simple. It would likely be very difficult to establish an objective definition of distressed for this purpose and any subjective test would make an already complicated section that has many issues open to interpretation and gives rise to significant expenditures by companies and requests for rulings much more burdensome.

For the reasons noted above, we believe that the existing regulation should not apply to debt instruments that trade at a value well below their adjusted issue price as a result of a deterioration in the financial condition of the issuer. However, if our recommendation to eliminate Treasury Regulation Section 1.382-2T(f)(18)(iii) as it applies to an instrument properly treated as debt for tax purposes is not adopted and Treasury and the IRS are of the view that the regulation can apply to "distressed debt," consistent with the fairly mechanical application of Section 382, we recommend that clear objective standards be established in determining whether debt may be treated as stock for Section 382 purposes on the date of a transfer.[67]

[67] Without a clear understanding of the potential instruments that may be treated as stock and the potential circumstances under which those instruments may be treated as stock, corporations, shareholders, and creditors cannot take precautionary steps to avoid unintentionally causing an ownership change, nor can they determine whether to report whether one has occurred. *See Versata Enterprises Inc. v. Selectica, Inc.,* No. 193, 2010 (Del.

A rule that looks to the trading price of a debt instrument is probably not appropriate as debt trading at a significant discount to its face amount will not always arise because of a deterioration in the financial condition of the issuer that effectively makes the holder of the debt instrument the equivalent of an equity investor from an economic perspective. There are many reasons why debt may trade at a discount to its face amount. While the discount may reflect deterioration in the issuer's credit quality, it may also be attributable to fluctuations in interest rates, the term of the debt instrument, the non-economic terms of the instrument (i.e., financial covenants) or a combination of more than one of those factors. There may be a very limited market in an issuer's debt that results in trading prices at discounts to face value that do not accurately reflect the likelihood that the instrument will be repaid. Because differences between the trading price of a debt instrument and its face amount may exist for many reasons other than because of a deterioration in the financial condition of the issuer, if, notwithstanding our recommendation Treasury Regulation Section 1.382-2T(f)(18)(iii) is applied to transfers of instruments properly treated as debt for tax purposes, a clear standard established so that corporations and debt holders can determine whether a particular issue is properly treated as stock for Section 382 purposes should look beyond trading prices.

Different approaches are possible for determining whether debt would be distressed for purposes of the Regulation. We considered whether to recommend that the Regulations determine whether debt is distressed based on whether the instrument's yield increased by a specified multiple as compared to its yield at original issuance where the increase is not attributable to changes in the terms of the instrument since original issuance. A trigger based on

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Oct. 4, 2010) (the Delaware Supreme Court found that it was a valid exercise of a corporation's board of directors' discretion to adopt a shareholder's rights plan that was designed to protect its NOLs from limitation that would result from an ownership change). Ill defined regulations could also lead to unnecessary, costly and likely imprecise monitoring of debt trading, or overbroad preventative trading restrictions that reduce a debt instruments' liquidity.

a large enough increase in yield may minimize the likelihood that changes in market interest rates on a fixed rate debt instrument would cause the debt instrument to be distressed. While an objective test based on significant changes to a debt instrument's yield could provide a clear standard for determining the status of a debt instrument, it may be very difficult to determine a yield threshold that makes sense for different issuers in different industries. In addition, it may be difficult to reliably determine yield on a debt instrument that does not trade with sufficient regularity. With regard to yield, we note that the legislative history to Section 382 provides that in certain circumstances, section 1504(a)(4) stock might not be disregarded as stock for ownership change determination purposes if it "carries a dividend rate materially in excess of a market rate . . . ."[68] Presumably, the concept being addressed is that an excessive dividend rate signals that the purported plain vanilla preferred stock economically represents a more speculative investment in the issuer's prospects. Analogously, one would presume that any debt instrument that provides lenders potential significant participation in corporate growth must offer a yield (stated interest plus original issue discount or market discount) significantly in excess of the prevailing market rates either when issued or at a later date when transferred by one holder to another.

We note that in our recent report on distressed debt,[69] we recommended a definition of distressed debt for general tax purposes, including for purposes of determining when a holder may cease to accrue interest, OID and market discount. That report includes an extensive discussion of why it is difficult to define when debt is distressed and offers some recommendations, understanding that any such definition would not be perfect. Given the

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[68] See H.R. REP. NO. 841, 99th Cong., 2d Sess., at II-173 (1986) (Conf. Rep.).

[69] New York State Bar Association Tax Section Report 1248, Report on the Taxation of Distressed Debt, November 22, 2011.

difficulty in defining when debt is sufficiently distressed to allow a holder to cease accruing interest, OID or market discount, the report generally recommendsthat debt should be treated as distressed if there is no reasonable expectation that the holder will recover the principal amount (or, if lower, the adjusted issued price) of the debt. In an effort to provide greater certainty to taxpayers, the report also proposes several safe harbors based upon objective criteria. While we reiterate our recommendation that Treasury Regulation Section 1.382-2T(f)(18)(iii) not apply to distressed debt, if Treasury and the IRS determine to apply the regulation to distressed debt, the safe harbor standards recommended in our recent report should be considered.

C. <u>Application of Treasury Regulation Section 1.382-2T(f)(18)(iii) to Deemed Exchanges</u>

As discussed in Section B above, we believe Treasury Regulation Section 1.382-2T(f)(18)(iii) should not treat distressed debt as stock if the debt instrument was not treated as stock upon issuance. In support of our recommendation, we noted that in the ordinary course, it is difficult for the issuer of a debt instrument to track the ownership of its debt, and even more difficult to determine whether and when transfers of the debt during periods of financial distress would cause an ownership change. We also noted that treating distressed debt as stock is inconsistent with the purpose of Sections 382(l)(5) and (l)(6).

We acknowledge that identifying the ownership of debt is not as difficult when the debt instrument being tested for participation results from a "significant modification" under Treasury Regulation Section 1.1001-3(e). Because the issuer is a party to the modification, it will often be able to determine the actual ownership of its debt at that time and may even be able to put a mechanism in place to monitor future transfers. In determining whether to agree to a modification, the issuer can also take into account the possibility that such a modification may cause an ownership change, thereby minimizing any potential benefit associated with Sections

382(l)(5) and (l)(6) should the issuer subsequently reorganize in bankruptcy. Nonetheless, we believe that if a debt instrument undergoes a significant modification under Treasury Regulation Section 1.1001-3(e), a deterioration in the issuer's financial condition following the date of issue should not cause the modified instrument to be treated as stock for Section 382 purposes. This approach is consistent with recently issued Treasury Regulation Section 1.1001-3(f)(7), which provides that a change in the financial condition of an issuer from the date of original issuance until the date of the significant modification is not taken into account in determining whether the modified instrument is treated as debt or equity for federal income tax purposes. This regulation effectively views the modified instrument as if it were issued at the time the original instrument were issued.

We believe that it is appropriate to apply the same principle to Treasury Regulation Section 1.382-2T(f)(18)(iii) and therefore not take the issuer's financial condition into account at the time of the modification. The new Section 1001 regulation, which Treasury and the IRS view as a clarification of law in effect at the time the regulation was issued, seeks to encourage the modification of a debt instrument where the modification does not include equity-like terms by providing that the instrument will not lose its debt characterization simply because the issuer could not support the modified debt based on its financial condition on the date of the modification. It would appear contrary to Treasury and the IRS's purpose in promulgating the new Section 1001 regulation to adopt a contrary rule for Section 382 purposes.

Adopting a standard similar to Treasury Regulation Section 1.1001-3(f)(7) in determining whether a debt instrument resulting from a significant modification of existing debt is stock for Section 382 purposes would not, of course, allow taxpayers to avoid the potential application of Treasury Regulation Section 1.382-2T(f)(18)(iii) if the modifications include terms that allow the holder to participate in the future growth of the issuer without regard to changes in the issuer's financial condition. For example, a change in the stated interest rate of a debt instrument to an equity-like rate or an extension of the maturity date of the modified instrument may, under certain circumstances, argue in favor of treating the modified instrument as stock for Section 382 purposes.