REPORT #768

TAX SECTION

New York State Bar Association

Report on Proposed Section 382(1)(5) Regulations

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July 28, 1993

Margaret Richardson
Commissioner Internal Revenue Service
1111 Constitution Avenue
Room 3000
Washington, D.C. 20224

Dear Commissioner Richardson:

Enclosed is a report of the Committee on Net Operating Losses dealing with proposed regulations under Section 382(1)(5) of the Code. The report strongly supports these regulations, which were pro-posed on May 10, 1993, and superseded substantially less liberal and more complex proposed regulations.

The new proposed regulations take a major step toward making the benefits of Section 382(1)(5) available to bankrupt corporations. The report makes certain suggestions consistent with the spirit of the proposed regulations. These include (1) eliminating the risk of adverse consequences if less-than-5% creditors participate in formulating the plan of re-organization in such a way as to make evident to the loss corporation that they have not held their debt for the requisite holding period; (2) expansion of the rules tacking the holding period of former and current holders of debt; and (3) modifying the effective date to permit taxpayers to rely on the old proposed regulations until their withdrawal and the new proposed regulations from the date of their proposal to the date final regulations are promulgated.

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We hope the report will be of help in finalizing the regulations. Please feel free to call the authors or myself if you have any questions.

Very truly yours,

Peter C. Canellos

cc: Leslie B. Samuels
Harry L. Gutman

enclosure

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July 27, 1993

New York State Bar Association Tax Section
Committee on Net Operating Losses

Report on Proposed Section 382(1)(5) Regulations

This Report[1] comments on the regulations proposed by the Internal Revenue Service (the "Service") on May 10, 1993 (the "Proposed Regulations"), dealing with section 382(1)(5) of the Internal Revenue Code of 1986 (the "Code"). The Proposed Regulations supersede the regulations proposed on September 3, 1991 (the "1991 Proposed Regulations").

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1 This Report was drafted by the following members of the Committee on Net Operating Losses: Robert A. Jacobs (co-chair), Reuven Avi-Yonah, Marjorie S. Elkin, Loretta J. Finger, Simon Friedman, Richard Stern and Linda Z. Swartz. Helpful comments were received from Stuart J. Goldring, Abraham Gutwein and Kenneth H. Heitner (co-chair).

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The Proposed Regulations provide meaningful and welcome guidance, removing a major obstacle facing loss corporations that seek to elect the special bankruptcy exception of Code §382(l)(5): How to determine which of the loss corporation creditors qualify as either (i) creditors who held their debt for at least 18 months before the date of the loss corporation's filing for bankruptcy ("Old and Cold Creditors"), or (ii) creditors whose debt arose in the ordinary course of the business of the loss corporation and who have held the debt from the time it was issued ("Trade Creditors").[2]

The Proposed Regulations generally provide that a loss corporation may treat a creditor as an Old and Cold Creditor if immediately after the ownership change the creditor is not either a 5-percent shareholder of the loss corporation, or an entity through which a 5-percent shareholder owns an indirect ownership interest in the loss corporation.[3] The Proposed Regulations provide that a creditor whose debt arose in the normal, usual or customary conduct of business of the loss corporation is a Trade Creditor.[4]

We commend the approach of the Proposed Regulations.[5] In particular, the presumption regarding Old and Cold Creditors is a

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2 To qualify for the Code §382(l)(5) exception, 50% by vote and value of the stock of the loss corporations must be owned by historic shareholders, and by virtue of the bankruptcy reorganization by Old and Cold Creditors and Trade Creditors immediately after the ownership change.

3 Prop. Reg. §1.382-9(d)(3).

4 Prop. Reg. §1.382-9(d)(2)(iv).

5 The Proposed Regulations frequently follows our recommendations in our Report on Suggested Bankruptcy Tax Revenue Rulings, reprinted in 50 Tax Notes 631 (February 11, 1991) (the "1991 Report"). See, e.g., proposed Bankruptcy Ruling 3.11 (5-percent presumption); proposed Bankruptcy Ruling 3.1 (exception for 5-percent entity whose sole asset is the debt of one title 11 debtor); proposed Bankruptcy Ruling 3.3 (tacking

bright line that will afford loss corporations welcome relief from the burden of establishing whether holders of widely held debt qualify as Old and Cold Creditors. We also believe reasonable the exceptions to the presumption, such as the rule that a 5-percent entity that undergoes an ownership change will not qualify as an Old and Cold Creditor if the debt constitutes over 25% by value of its gross assets.

The drafting of the Proposed Regulations could be somewhat improved. In particular, the rules regarding actual knowledge of stock ownership through 5-percent entities and the definition of 5-percent shareholders, both rely on cryptic references to other regulations. We suggest these concepts be expanded to clarify the cross-references.[6] At least, a repetition of the rule contained in the cross-referenced material would enable the reader to quickly grasp the principles being presented. More examples, in addition to the single one provided, would be helpful. We suggest the final regulations add as an example the case of a Trade Creditor whose indebtedness funded a capital expenditure of the loss corporation.[7] Presumably, a borrowing by the loss corporation to finance the takeover of a target corporation would not qualify as ordinary course indebtedness. If so, the regulations should so say. What then is the dividing line between losses incurred for capital expenditures that qualify for Trade Creditor status and those that do not?

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rules). In this Report we suggest implementing other proposed Bankruptcy Rulings that were not incorporated in the Proposed Regulations, such as proposed Bankruptcy Ruling 3.4 (foreclosure on debt held as collateral).

[6] See Prop. Reg. §§1.382-9(d)(3)(ii)(B),(C).

[7] See Prop. Reg. §1.382-9(d)(2)(iv).

As drafted, a 5-percent entity is any entity through which a 5-percent shareholder owns an indirect ownership interest in the loss corporation.[8] This definition is too broad because it would include an entity through which a 5-percent shareholder holds a minuscule percentage of the shares of the loss corporation if the 5-percent shareholder holds its five percent directly or through another entity.[9] Thus, if General Motors held some trade debt in a loss corporation, which it exchanged for 0.00001% of the loss corporation's stock, and a 5-percent shareholder of the loss corporation owned 100 shares of G.M. stock, G.M. would be a 5-percent entity and its status as an Old and Cold or Trade Creditor would have to be investigated. Instead, the definition should be amended to apply only to entities through which (and as a result of that holding) a 5-percent shareholder owns its ownership interest in the loss corporation. Alternatively, a 5-percent entity could be defined as any entity that would hold 5 percent of the loss corporation stock but for the rule that stock attributed from entities is not treated as owned by the entity from which it is attributed.[10]

Three specific parts of the Proposed Regulations should be improved before they are finalized: (i) The participation in the plan exception; (ii) the tacking rules; and (iii) the effective date provisions.

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[8] Prop. Reg. §1.382-9(d)(3)(i).

[9] The preamble to the Proposed Regulations indicates that only an entity that directly owns at least 5 percent of the loss corporation's stock after the ownership change should be considered a 5-percent entity.

[10] See Treas. Reg. §1.382-2T(h)(2)(i) (A).

(i) Participation in the Plan Exception.

The 1991 Proposed Regulations extended the presumption that widely-held debt was held by Old and Cold Creditors only to debt that was not held by S-percent beneficial owners on either the "plan date" (i.e., the date the plan of reorganization was approved) or the ownership change date. This rule was designed to prevent speculators from accumulating debt and selling it immediately before the change date, but after the Plan of Reorganization relying on Code §382(1)(5) had been approved, thus realizing the value of the Code §382(1)(5) treatment through the sales price of the debt.

The Proposed Regulations rightly conclude the burden of requiring the loss corporation to determine the ownership of its debt on two different dates is disproportionately large when compared to the potential advantages derived by speculators from the purchase and sale of debt, given that those speculators do not control the loss corporation after the ownership change. Thus, the Proposed Regulations require that the loss corporation determine the ownership of debt only on the change date. This approach enables the loss corporation to restrict its determination to creditors who actually become 5-percent shareholders in the reorganization.

The Proposed Regulations contain an exception to the general rule. Under this exception, the general presumption of Old and Cold Creditor status for creditors holding less than 5-percent debt does not apply to "indebtedness beneficially owned by a person whose participation in formulating a plan of reorganization makes evident to the loss corporation (whether or

not the loss corporation had previous knowledge) that the person has not owned the indebtedness for the requisite period."[11]

This standard is unclear and is unlikely to work well in practice. Presumably, the exception is intended to apply to those speculators who participate in the plan and thereafter sell out, reaping the benefits of the plan indirectly through the sale price of the debt. But these speculators will not hold the debt on the change date; the persons who buy the debt from them will not have participated in the plan, and the corporation may not know the debt holders had recently purchased their debt from speculators. Moreover, given this standard, it is unlikely speculators will participate in a plan in ways that will inform the loss corporations of their recent purchase of their debt.

The parenthetical phrase "whether or not the loss corporation had previous knowledge" indicates the Proposed Regulations recognize that even actual knowledge by a loss corporation that a less than 5 percent shareholder was not an Old and Cold Creditor generally does not rebut the presumption of Old and Cold Creditor status for small shareholders. This rule is a reasonable accommodation between the administrative burden on the loss corporation of determining the period for which debt was held and the holding period requirements of the statute. Nothing is gained, and clarity and simplicity are lost, by adding a participation in the plan exception to the general rule. We therefore recommend the participation in the plan exception be deleted and that all less than 5 percent shareholders be presumed to be Old and Cold Creditors.

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[11] Prop. Reg. §1.382-9(d)(3)(i).

(ii) The Tacking Rules.

Under the Proposed Regulations, a transferee of indebtedness in certain "qualified transfers" is treated as having owned the debt for the same period as it was owned by the transferor.[12] The enumerated transfer (e.g., transfers to related parties, loan syndications, and carryover basis transfers) are reasonable exceptions to the general rule, because the transfers involve non-abusive situations that commonly occur in corporate bankruptcies. Thus, the exceptions serve to simplify the operation of the Proposed Regulations without extending to abusive trading in troubled company debt. There are, however, certain additions that should be made to the list of qualified transfers to include other legitimate, non-abusive transfers.

Prop. Reg. §1.382-9(d)(5)(G) provides that a qualified transfer includes a transfer pursuant to a subrogation in which a bank or insurance company acquires a claim by reason of a payment to the claimant pursuant to a letter of credit or insurance policy. There is no reason this provision should be strictly limited to banks or insurance companies or to claims arising solely by virtue of a letter of credit or insurance policy. Transfers can arise from a variety of legitimate lending transactions involving a variety of financial institutions. One leading private letter ruling on the subject, PLR 9019036 (Feb. 9, 1990), held in this regard that:

> Any debt that arose out of the payment, pursuant to a guarantee, letter of credit, or similar security arrangement, of a debt incurred by [the loss corporation] at least 18 months prior to the Petition Date, will be treated as incurred at least 18 months prior to the Petition Date unless such guarantee,

12 Prop. Reg. §1.382-9(d)(5).

> letter of credit, or similar security arrangement had as a principal purpose the avoidance of the rule of section 382(1)(5)(E). Any debt that arose out of the payment, pursuant to a guarantee, letter of credit, or similar security arrangement, of a debt incurred by [the loss corporation] in the ordinary course of its trade of business, will be treated as incurred in the ordinary course of [the loss corporation's] trade or business unless such guarantee, letter of credit, or similar security arrangement had as a principal purpose the avoidance of the rule of section 382(1)(5)(E).

To guard against abuse while at the same time allowing legitimate transfers pursuant to subrogation agreements, Prop. Reg. §1.382-9(d)(5)(G) should be amended to provide that where a guarantee, letter of credit or similar security arrangement arises from the inception of a loan made by a transferee in the ordinary course of the transferee's trade or business,[13] a transfer of the claim against the loss corporation to the transferee pursuant to that guarantee, letter of credit or similar security arrangement will be treated as a qualified transfer. In addition, the final regulations should clearly state that any transfer pursuant to a guarantee, letter of credit or similar security arrangement that has been held by a transferee for 18 months before the date of the filing of the title 11 or similar case should also be treated as a qualified transfer, without regard to whether the guarantee, letter of credit or similar security arrangement arose from the inception of a loan and without regard to whether the transferee is engaged in the trade or business of making loans.

The list of qualified transfers should also include debt transferred in ordinary commercial factoring transactions. Where

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[13] This could be made more restrictive by requiring that the transferee be engaged primarily in the business of making loans and that the loan not have been made with a principal purpose of acquiring a security interest in the debt.

a manufacturer sells merchandise to a retailer on credit, the manufacturer frequently sells the debt (whether recourse or nonrecourse) to a factor, pursuant to a plan or arrangement in existence from the inception of the debt. Although the manufacturer, rather than the factor, is the technical lender in the ordinary course of the trade of business of the loss corporation, the described transaction is virtually the same as if the retailer borrowed money from the factor to pay the manufacturer. Given the historical development and culture of factoring practice, the regulations should provide that where a debt is factored in the ordinary course pursuant to a plan or arrangement to factor the debt from inception, the transfer of the debt to the factor should be treated as a qualified transfer. To ensure administrative certainty, the regulations might limit these qualified transfers to transfers to factors made within [30] days from the date the debt was incurred by the loss corporation.

(iii) The Effective Date

The Proposed Regulations apply to ownership changes occurring on or after the date the Treasury Decision adopting the Proposed Regulations is filed with the Federal Register. The preamble states the Service intends the final regulations will ensure that taxpayers are not disadvantaged by the withdrawal of the 1991 Proposed Regulations and requests comments on how to achieve this result.

We believe the appropriate way to ensure that taxpayers are not disadvantaged by the withdrawal of the 1991 Proposed Regulations is to permit taxpayers to rely on the 1991 Proposed Regulations for transactions occurring during the period following their issuance and prior to their withdrawal. Taxpayers

who have structured their transactions to conform with the 1991 Proposed Regulations should be allowed the favorable treatment they had a right to expect. In addition, taxpayers who do not qualify for favorable treatment under the 1991 Proposed Regulations should be allowed to argue based on general principles of law that they are entitled to favorable treatment under section 382(1)(5). Similar treatment should apply to taxpayers who rely on the Proposed Regulations, until the Proposed Regulations are withdrawn or modified.

This result is required by fairness and by the goal of allowing taxpayers certainty in structuring their transactions. As set forth in the preamble to the 1991 Proposed Regulations,

> [a]s a practical matter . . . interpreting section 382(1)(5)(E) to require that the loss corporation determine whether indebtedness was owned for the requisite period on a creditor-by-creditor basis would deny access to section 382(1)(5) to loss corporations with significant amounts of widely-held indebtedness. However, there is no indication that Congress intended to exclude these corporations from the benefits of section 382(1)(5).

The 1991 Proposed Regulations were proposed to be effective for ownership changes occurring after September 19, 1991. To deny taxpayers the benefit of the 1991 Proposed Regulations for ownership changes would be contrary to the intent of Congress. This Committee believes the number of taxpayers who have relied on 1991 Proposed Regulations is small, but that those few taxpayers that are affected be subjected to considerable hardship, should they not be able to so rely.

Similarly, given the length of time since the enactment of Code §382(1)(5), taxpayers that are currently reorganizing should be afforded the protection of a fixed set of rules on which they can rely to determine how best to structure their reorganizations. That protection would best be provided by a Service announcement that the Proposed Regulations can be relied upon until they are withdrawn or modified.