Update on Corporate Debt Restructurings

January 18, 2019

Bankruptcy, Debt Workouts and Tax Attributes
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Basics of Bankruptcy
Introduction to Bankruptcy Concepts

➢ Bankruptcy Code
  ▪ Title 11 of the U.S. Code
  ▪ The Bankruptcy Code will be cited as “B.C.” in this presentation

➢ Different Cases Appear Under Different Chapters of Title 11
  ▪ Chapter 7 (Liquidation)
  ▪ Chapter 11 (Reorganization)
  ▪ Chapter 13 (Individual)
Chapter 11 – Generally

- It is a protective mechanism whereby a Company receives relief from the collection efforts of creditors so that it can effect a financial reorganization.
- A Company in Chapter 11 operates as what is called a “Debtor-in-Possession”, with existing management typically remaining in control of day-to-day operations.
- Additional financing is almost always arranged by the Company in order to meet future obligations.
- Insolvency and fiduciary obligations
  - Generally, a business is insolvent when the sum of its debts is greater than the fair market value of its assets.
  - Operating a business in the “zone of insolvency” changes some of the relationships of the parties.
    - Members of the Board of Directors of a corporation are elected by shareholders. However, in an insolvent business, the obligation of the Board shifts to protecting and preserving value for creditors first, shareholders and others second.
Introduction to Bankruptcy Concepts

- **Chapter 11 versus Chapter 7**

  **Chapter 11**
  - Debtor typically retains control of business
  - Business continues to operate
  - Operations are restructured
  - Automatic stay put in place to help preserve value of the bankrupt estate
  - Company negotiates with creditors on pre-petition recoveries
  - Exception: “Liquidating 11”

  **Chapter 7**
  - Chapter 7 Trustee appointed to administer proceedings
  - Business ceases operations
  - Quick “fire” sale of Company assets
  - Proceeds from sales are distributed to creditors based on absolute priority

- The bankruptcy petition may be filed by either creditors or the company. An involuntary is filed by either three creditors with aggregate amount outstanding of more than $15,325 or by a single unsecured creditor with more than $15,325 outstanding.
Benefits of Chapter 11

- A Chapter 11 filing provides the Company a “time-out” from creditor obligations.
  - Automatic Stay
  - Management typically remains in control of operations as a Debtor-in-Possession
  - Allows Debtor to restructure obligations
  - Court protection allows for time to work with creditors and develop a Plan of Reorganization (exclusivity period)
  - Ability to reject unfavorable executory contracts
  - Ability to sell business assets
Detriments of Chapter 11

- Expensive
  - The bankruptcy process is “professional intensive.” In addition to its own counsel and advisors, the Debtor will also pay for various committees’ counsels, advisors, examiners and the U.S. Trustee.
- Drain on management’s time and energy
  - Increased and varied reporting required
- Strain on vendor and customer relationships
  - The Debtor should anticipate that suppliers will restrict, or cutoff completely, trade credit.
  - Customers will be uncertain about the future of the Company and may look to take their business to the competition.
  - Employee retention will become a challenge.
Pre-Petition versus Post-Petition

- At the time of a Chapter 11 filing, two time periods are established: pre- and post-petition.
- The date on which the goods are received, or services rendered, is generally the criterion used to determine whether an invoice is pre- or post-petition.
- Pre-petition (prior to filing) invoices
  - Pre-petition liabilities are generally frozen.
  - There are some exceptions.
- Post-petition (on or after filing) invoices
  - Payments to be made in accordance with established payment terms.
  - Receive limited protection in the form of elevated priority relative to other claimants.
Introduction to Bankruptcy Concepts

➢ Chapter 11 Timeline

- Pre-petition Planning
- File Chapter 11 Petition
- File Schedules & Statements
- File Plan of Reorganization & Disclosure Statement
- File Amended Plan of Reorganization & Disclosure Statement
- Confirm Plan
- Emergence/Consummation

- Obtain DIP Financing
- Business Plan Development
- Negotiate with Statutory Committees
- Claims Reconciliation
- Court and U.S. Trustee Supervision
Introduction to Bankruptcy Concepts

Plan of Reorganization

- The end goal of filing under Chapter 11 is to have a plan confirmed which restructures the Debtor’s debts, discharges its liabilities and affords the Debtor a fresh start.
- The Plan of Reorganization (“POR”) sets forth the rights of all classes of claimants, and how the Company plans to satisfy their claims.
  - The Plan of Reorganization is negotiated with all bankruptcy constituents
- The Debtor has 120 days to file a Plan of Reorganization, otherwise known as the period of exclusivity.
  - After 180 days any party-in-interest can file a plan.
  - In most cases, the period of exclusivity is extended at the request of the Debtor.
- A class of claims accepts a POR when votes to accept by the individual claimants in the class are at least:
  - One half the number of allowed claims in the class or
  - Two thirds the aggregate dollar amount of claims in the class
Introduction to Bankruptcy Concepts

- Impact on Debtor’s Tax Returns

- When a corporation files for bankruptcy protection, the vast majority of the rules contained in the I.R.C. and Treasury Regulations continue to apply to it without modification.

- The corporation is the same taxable entity after the filing that it was before. See I.R.C. §1399.

- The corporation’s taxable year does not close. Id.

- If the corporation was a member of an affiliated group filing consolidated returns before filing for bankruptcy, it will remain so afterward. See Rev. Rul. 63-104.
Introduction to Bankruptcy Concepts

- Understanding the Impact of Bankruptcy on the Statute of Limitations
  - Notice to Governmental Authorities
    - The Clerk of the bankruptcy court or designee notifies all real and potential taxing authorities that a bankruptcy filing has taken place. See B.C. § 342(a); Fed. R. Bankr. P. 2002.
    - As part of the Petition filing the Debtor must include a matrix of names and addresses of all real and potential creditors of the Debtor, including governmental authorities, to be notified so that all governmental authorities that may have a claim against the debtor's estate be put on notice.
  - When a taxing jurisdiction receives a notice that one of its taxpayers has filed for bankruptcy, that jurisdiction is in effect being put on notice that the normal rules governing the assessment and collection process are no longer in effect.
  - Instead, the taxing jurisdiction has become a potential creditor of the Debtor (like any supplier, lender or employee of the Debtor), and therefore must consider how to protect its interests in the case.
Introduction to Bankruptcy Concepts

- Understanding the Impact of Bankruptcy on the Statute of Limitations (continued)

- The first concern that a taxing jurisdiction will have is figuring out how much pre-petition tax it might be owed.

- The second concern is to submit its claim to the bankruptcy court before the bar date deadline, which is usually 180 days from notification.

- The result, in many cases, is an acceleration and intensification of the audit process experienced by the Debtor simply as a result of the bankruptcy filing. Many different jurisdictions — federal, state, and local — will at least consider the possibility of conducting an audit as a result of the bankruptcy filing, and (depending on whether a particular jurisdiction thinks some pre-petition taxes might be due) many audits may in fact be started. In a worst-case scenario, a large corporate debtor may find itself deluged with requests for audits specifically triggered by the filing itself.
Introduction to Bankruptcy Concepts

- Understanding the Impact of Bankruptcy on the Statute of Limitations (continued)
  - Like any other creditor, the IRS and other taxing authorities need to file proofs of claim against the debtor in accordance with the procedures set forth in the Bankruptcy Code and Rules if they are to preserve their rights to recover from the debtor in the case.
  - Also like any other creditor, the IRS and other taxing authorities need to file their proofs of claim before the applicable bar date set by the bankruptcy court. By statute, that date must be at least 180 days after the filing. See B.C. § 502(b)(9).
  - Claims not timely filed are permanently barred from collection.
  - The suspension of the IRS or states’ collection rights by the automatic stay results in a tolling of the applicable statute of limitations for collection only. See contradiction among B.C. § 362(b)(9) and I.R.C. § 6503(h).
  - The statute of limitations for assessment is not affected by the bankruptcy.
  - Governments can still asses tax and issue notice and demand for its payment, but collection actions and levying liens are stayed.
Introduction to Bankruptcy Concepts

Understanding the Impact of Bankruptcy on the Statute of Limitations (continued)

- Interest and Penalties on Pre-Petition Taxes
  - Accrual of interest post-petition on pre-petition taxes is not allowed.
  - Accrual of penalties post-petition on pre-petition taxes is not allowed if pecuniary in nature.

- Tax Refunds in Bankruptcy and Setoffs
  - Setoff of an income tax refund is permitted if it would be permitted outside of bankruptcy and if taxable years of overpayment and deficiency are both pre-petition years. See B.C. § 362(b)(26).
  - If setoff would not be permitted outside of bankruptcy due to a contest over the amount or legality of the deficiency, setoff will not be allowed. In this event, the governmental unit will be permitted to hold the refund pending resolution of the contest. See id.
Net Operating Losses – General and Change of Control Rules
For NOLs after December 31, 2017
- Carried forward indefinitely, but not carried back
- Can be used to offset 80% of taxable income

For NOLs before December 31, 2017
NOLs can be carried back two years and forward twenty years.
- 2% AMT toll charge on the use of NOLs
- NOLs carried back before attribute reduction

Limitations
- SRLY
- Sections 382 and 383
Net Operating Losses – General and Change of Control Rules

Section 382 – General Rules

➤ **Section 382 - NOLs, tax credits, and excess basis are limited after an ownership change**

➤ **Ownership change - more than 50% change in ownership (by value) over a rolling 3-year testing period. Examples:**
  – An ownership change occurs if creditors receive more than 50% of the stock of a debtor corporation.
  – An ownership change occurs if a third party acquires the stock of a majority shareholder of a debtor corporation.
  – An ownership change can occur if multiple small transactions cause a 50% change over a three year period.
Net Operating Losses – General and Change of Control Rules

Section 382 – General Rules

➢ Stock rules
  – Pure preferred stock – not counted.
  – Recharacterization rule – applies if it causes an ownership change.
  – Options – treated as stock if section 382 avoidance purpose and other tests met.

➢ Ownership rules
  – Ultimate human rule – broad upstream attribution.
  – Aggregation rule – group less than 5% shareholders together.
  – Segregation rule – break apart groups after merger, etc.
Net Operating Losses – General and Change of Control Rules

Section 382 – General Rules

- **General limitation**
  - The annual limitation =
    - i. the value of the stock of the corporation, times
    - ii. the long term tax-exempt rate published monthly by the IRS (2.51% for the month of December 2018)

- **Value of Loss Company**
  - Outside Bankruptcy: lower of value of stock before or after ownership change.
  - In Bankruptcy (section 382(l)(6)): lower of value of assets before or stock after ownership change.
  - In Bankruptcy (section 382(l)(5)): No limitation (with caveats).
Net Operating Losses – General and Change of Control Rules

Section 382 – General Rules

- **NUBIG/NUBIL**
  - FMV of assets less basis.
  - NUBIG rule - loss corporation can increase the section 382 annual limitation.
    - Gains recognized during 5-year recognition period.
  - NUBIL rule - deductions are subject to the section 382 annual limitation.
    - Losses (and depreciation) recognized during 5-year recognition period.
Net Operating Losses – General and Change of Control Rules

Section 382 – General Rules

➤ Notice 2003-65 – NUBIG/NUBIL Guidance
  – Alternative approaches for computing built-in gains and losses
  – Section 338 and 1374 approaches
  – Section 338 – foregone amortization
    – Applied by NUBIG taxpayers
  – Section 1374 – favorable built-in deduction rules
    – Applied by NUBIL taxpayers
Net Operating Losses – General and Change of Control Rules

Section 382 – Preserving Tax Attributes in Bankruptcy

➤ Potential Threats to Tax Attributes

– Greater than 50% change of stock ownership during bankruptcy. I.R.C. § 382.
  – Need an I.R.C. § 382 study prior to declaring bankruptcy and updated upon emergence.
  – A 50% or greater shareholder for the previous 3-year period
  – Holding the stock as of the close of the taxable year
  – Takes a return position that the stock is worthless to claim a loss.
– Use of attributes by profitable members of consolidated return group.
  – Tax sharing agreement
Potential Threats to Tax Attributes (continued)

- Acquisitions of claims against the Debtor.
  - Risks disqualification for avoiding I.R.C. § 382 attribute use limitations under I.R.C. § 382(l)(5).
  - Shareholders and qualified creditors must end up owning at least 50% of reorganized stock upon emergence.
  - Qualified creditors must have obtained their claims at least 18 months prior to bankruptcy in an ordinary business transaction.
  - Creditors trading the Debtor’s debt during bankruptcy may be fatal for tax attributes.
- Deconsolidation of subsidiary with outstanding preferred stock.
  - If preferred dividend payments are stopped, preferred stock will become common stock and trip more than 80% of value test for consolidation, causing deconsolidation.
  - Deconsolidation would trigger deferred intercompany gains, using up NOLs.
Net Operating Losses – General and Change of Control Rules

Section 382 – Preserving Tax Attributes in Bankruptcy

Possible Remedies by Debtor

- Request protective injunction from bankruptcy judge.
  - There are a variety of factual circumstances in which bankruptcy courts will reach out to protect a debtor's tax attributes from the potentially harmful actions of third parties.
  - Therefore, debtors facing real-world concerns about possibly suffering a loss of tax attribute value as a result of third-party action should seriously consider seeking an injunction to prevent that action from occurring.
- Make a protective election under I.R.C. § 382(l)(5)(H).
Net Operating Losses – General and Change of Control Rules

Section 382 – Preserving Tax Attributes in Bankruptcy

- Change of Ownership Attribute Limitations: Application of I.R.C. § 382(l)(5) and 382(l)(6)
  - Ordering
    - If debtor is eligible, IRC Sec. 382(l)(5) applies automatically, unless debtor elects out of it.
    - If debtor is ineligible, IRC Sec. 382(l)(6) usually applies to bankruptcy ownership changes.
  - I.R.C. § 382(l)(5)
    - Permits a corporation to avoid any limitation on use of its losses.
    - Requirements are stringent:
      - Applies only to bankruptcies.
      - Shareholders and creditors of corporation immediately before change must own at least 50% of corporation’s stock post-change.
      - Old and cold creditor – debt arose at least 18 months before filing related to ordinary course business.
      - Trading debt can be fatal.
Net Operating Losses – General and Change of Control Rules

Section 382 – Preserving Tax Attributes in Bankruptcy

- **Change of Ownership Attribute Limitations: Application of I.R.C. § 382(l)(5) and 382(l)(6)**
  - I.R.C. § 382(l)(5) (continued)
    - A second ownership change must not occur within 2 years following ownership change.
    - Must not have elected out of I.R.C. § 382(l)(5) treatment under I.R.C. § 382(l)(5)(H).
    - Must reduce pre-charge losses carried forward to post-change years to extent of certain pre-change interest accruals.
    - “Interest haircut”
    - Recompute NOLs to exclude interest paid/accrued during taxable year preceding ownership change and 3 prior taxable years on any debt converted to stock pursuant to bankruptcy case.
    - Must research state and local conformity issues related to I.R.C. § 382.
Net Operating Losses – General and Change of Control Rules

Section 382 – Preserving Tax Attributes in Bankruptcy

Change of Ownership Attribute Limitations: Application of I.R.C. § 382(l)(5) and 382(l)(6)

– I.R.C. § 382(l)(6)
  – Similar application of I.R.C. § 382 NOL utilization limitation.
  – Exception is that the value of the corporation is determined differently than under general case.
    – The value is the lesser of the corporation’s stock value immediately after the ownership change (not before) or the value of the corporation’s assets before the change
  – Anti-stuffing rules do not apply.
  – Corporation’s value includes any increase in value resulting from COD arising from G reorg or issuance of stock for debt.
Cancellation of Debt Rules
I.R.C. §108 provides that debt cancellation under Chapter 11 does not give rise to COD income.

- Doesn’t apply to intercompany transactions between members.
- COD occurring during the course of the bankruptcy, unrelated to court.
- Danger when COD occurs in disregarded entities, especially if parent is not in bankruptcy as well.
  - Must address state and local differences where entity is not deemed disregarded.
- Treatment of partner’s share of COD is excludable under I.R.C. §108(d)(6) only if the partner is in bankruptcy or insolvent.
Cancellation of Debt Rules

Computing COD Income

- COD doesn’t apply on compromises on amount of disputed debt.
- COD applies only to primary obligor on guaranteed debt.
- COD can’t exceed total discharged debt for joint obligors, but COD must be allocated to each entity in a rational matter.
  - No clear rules exist for allocation.
  - Important for state and local tax purposes and tax attribute use.
- Contribution of debt v. cancellation for stock
  - In capital contribution of debt, debtor is treated as having satisfied debt with amount equal to shareholder’s adjusted basis in debt (i.e., most likely no COD results)
  - If debtor issues stock in satisfaction of debt, debtor is treated as having satisfied debt with amount of money equal to FMV of stock (i.e., usually triggers COD)
Computing COD Income (continued)

- Debt modifications
  - COD arises to the extent issue price is less than amount of debt replaced
  - Original issue discount usually arises
- If debt is simply cancelled without any consideration, amount of COD income is amount of debt cancelled.
- For recourse debt, amount of COD income is the difference between FMV of property received, not including new debt or stock, and amount of debt.
- For nonrecourse debt where the property securing it is transferred in a foreclosure or similar transaction, no COD income, and property is deemed to be worth not less than the amount of debt.
- Unclear if debt of disregarded entity should be treated as nonrecourse debt of parent.
- FIN 48 issue
Cancelling of Debt Rules

- **Computing COD Income (continued)**
  - Exchange of debt for debtor’s stock, COD income is excess of amount of debt over FMV of stock.
  - Exchange of debt for new debt, COD income is excess of amount of old debt over issue price of new debt.
Cancellation of Debt Rules

- **Reduction of Tax Attributes and Asset Basis by COD – I.R.C. §1017**
  - The price exacted by I.R.C. § 108 for the bankruptcy COD income exclusion is reduction of the debtor's tax attributes to the extent of the COD income, generally in the following order:
    - NOL for the year of the discharge and NOL carryovers from prior years.
    - General business (I.R.C. § 38) tax credit carryovers at the rate of 33 1/3 cents of credit per dollar of COD income.
    - Minimum tax credit under I.R.C. § 53(b) available as of the beginning of the year following the year of discharge, also at the rate of 33 1/3 cents per dollar of COD income.
    - Net capital loss for the year of discharge and capital loss carryovers from prior years.
    - Basis of the debtor's assets.
    - Passive activity loss and credit carryovers (under I.R.C. § 469(b)) from the year of discharge at the rate of one dollar of loss and 33 1/3 cents of credit per dollar of COD income.
    - Foreign tax credit carryovers to or from the year of discharge, at the rate of 33 1/3 cents of credit per dollar of COD income.
Reduction of Tax Attributes and Asset Basis by COD – I.R.C. §1017 (continued)

– The sequence of the asset basis reductions is governed by IRC §1017 and the regulations thereunder, which specify that basis of the taxpayer's assets is reduced in the following order:
  – Real property used in a trade or business or held for investment, that secured the cancelled debt.
  – Personal property, other than inventory, accounts receivable, and notes receivable, used in a trade or business or held for investment, that secured the cancelled debt.
  – All other property used in a trade or business or held for investment, other than the types excluded above.
  – Inventory, accounts receivable, notes receivable, and dealer real estate.
  – Property not described above (i.e., not used in trade/business or held for investment).
Cancellation of Debt Rules

- **Reduction of Tax Attributes and Asset Basis by COD – I.R.C. §1017 (continued)**
  - **Liability Stop Rule**
    - The reduction in asset basis cannot reduce the debtor's aggregate remaining asset basis below the amount of its debt immediately after discharge. I.R.C. §§ 108(b)(2), 1017(b)(2).
    - Creates a permanent favorable book-to-tax difference.
Cancellation of Debt Rules

➢ Reduction of Tax Attributes and Asset Basis by COD – I.R.C. §1017 (continued)
  – Election to Reduce Depreciable Basis
    – Debtor taxpayer may elect under I.R.C. § 108(b)(5) to reduce the basis of its depreciable assets first.
  – Liability Stop Rule does not apply.
    – Not a problem if debtor has large amount of long-lived depreciable asset basis and soon to expire NOLs which may be used after emergence.
    – Not a problem if debtor will not have much debt upon emergence.
Cancellation of Debt Rules

➢ Reduction of Tax Attributes and Asset Basis by COD – I.R.C. §1017 (continued)
  – Time of Attribute Reduction
    – The reduction of attributes does not occur until after the end of the debtor's tax year in which the COD occurred, so those attributes are available to the debtor in determining the amount of its income, loss and tax liability for the year of discharge. I.R.C. § 108(b)(4)(A).
Cancellation of Debt Rules

- **Consolidated Return Rules**
  - COD income – Determined on a separate entity basis
  - Exclusion of COD income – Determined on a separate entity basis
  - Attribute reduction – part separate, part consolidated
    - First, reduce COD member’s separate tax attributes
    - Second, if subsidiary stock basis is reduced, reduce separate tax attributes of subsidiary
    - Third, reduce remaining consolidated tax attributes
Biographies
Patrick Hoehne

Managing Director

- Patrick Hoehne is a Managing Director with Alvarez & Marsal Taxand in San Francisco.
- Mr. Hoehne focuses on transactional and general corporate tax matters. He brings over 20 years of experience in private equity, corporate and individual tax and accounting matters, including mergers and acquisitions, tax planning and tax controversy matters.
- His background also includes tax due diligence and structuring, drafting opinion letters/ruling requests and preparing tax-related provisions in transactional documents.
- Mr. Hoehne has served corporate, private equity and individual clients in a wide range of industries, including technology, communications, entertainment, financial services, real estate investment trusts and public utilities.
- Before joining A&M, Mr. Hoehne worked with the transactional group at FTI Consulting and the mergers and acquisitions tax group with Ernst & Young. He assisted in numerous transactions, dispositions and reorganizations of both public and private businesses. Notably, he performed extensive tax and financial due diligence on a wide range of companies and clients, including private equity firms, corporations, and partnerships.
- Mr. Hoehne also worked at Wood & Porter, a tax law firm in San Francisco, representing individuals, partnerships and corporations in a variety of tax matters, and gained experience in the formation of entities, executive compensation, like-kind exchanges and the characterization of independent contractors for tax purposes. He regularly advised litigants about the tax treatment of damage awards.
- Previously, he was a manager with the audit and business consulting practices of Arthur Andersen. As an auditor, he performed and reviewed audit procedures, drafted financial statements and reviewed financial transactions. As a consultant, he prepared expert witness reports related to tax, accounting and financial aspects of civil litigation, and financial due diligence for his corporate and private equity clients. He was awarded a fellowship in Arthur Andersen’s Office of Regulatory and Legislative Affairs in Washington, D.C.
- Mr. Hoehne earned a J.D., with a specialization in business law and policy, from the UCLA School of Law. He also earned a bachelor’s degree in business administration, with a concentration in accounting, from California Polytechnic State University. He is admitted to practice law in California, where he also holds a CPA license.

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Lee Zimet

Senior Director

- Lee Zimet is a Senior Director with Alvarez & Marsal Taxand in Morristown. He is a graduate of New York Law School and has an LL.M in Taxation from New York University.
- Mr. Zimet specializes in the tax problems of bankrupt and insolvent corporations. During his over thirty-year career he has worked on some of the largest and most complex bankruptcies.
- In addition, he has a great deal of expertise in advising on section 382, subchapter C, and consolidated return issues. He speaks regularly at seminars on issues relating to M&A transactions.
- Mr. Zimet is a former chairman of the ABA Tax Section Bankruptcy & Workouts Committee and the NYSSCPA Bankruptcy & Financial Committee. He is also an adjunct professor at New York Law School’s LL.M program.
- He is currently renovating a 250-year old house with his wife Rozanne. Their family includes four cats and four dogs.

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