



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
June 2, 2000

Number: **200040003**
Release Date: 10/6/2000
CC:DOM:FS:CORP

UILC: 368.05-00
368.14-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ASSISTANT DISTRICT COUNSEL CC:
ATTN:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Bankruptcy Reorganization and Recapitalization

This Field Service Advice responds to your memorandum dated March 23, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Holdings =
Sub =

Date =

\$a =
\$b =
\$c =
\$d =
\$e =

x =

x% =
y% =

z% =

ISSUES:

(1) Whether, on the Pre-Effective Date, Holdings' transfer of its assets to Sub in exchange for a note and stock, followed by the distribution of such note and stock pursuant to the liquidation of Holdings, qualifies as a tax-free reorganization within the meaning of I.R.C. § 368(a)(1)(G).

(2) Whether, on the Effective Date, the stock issued by Sub in exchange for various notes and claims, and the warrants issued by Sub in exchange for various notes, qualifies as a tax-free recapitalization within the meaning of I.R.C. § 368(a)(1)(E).

CONCLUSION:

We do not have enough information to analyze the restructuring. In the last section of this memorandum, we have provided a list of questions. Once we have the answers to these questions, we can begin to analyze the restructuring.

FACTS:

On Date, Holdings and Sub filed a disclosure statement in connection with a Prepackaged Joint Consolidated Plan of Reorganization (the "Plan").

On the day immediately preceding the consummation of the Plan (the "Pre-Effective Date):

- Holdings shall transfer all of its assets to Sub as follows: (1) cash in the approximate amount of \$a in exchange for an x-year senior unsecured note issued by Sub (the "Holdings Loan") and (2) the one outstanding share of Old Sub Common Stock (which share shall be canceled) in exchange for one newly-issued share of Interim Sub Common Stock (the "Holdings Stock Exchange");
- Holdings will organize a trust (the "Trust") whose beneficiaries will be: (1) the Banks as holders of the Holdings Guaranty Claims, (2) the y% Noteholders and (3) the holders of the Holdings General Unsecured Claims. The interests in the Trust of the beneficiaries will be equal to their respective pro rata share of the aggregate allowed amount of the claims of each such beneficiary;
- Holdings shall dissolve and transfer its assets as follows: (1) the one share of Interim Sub Common Stock pledged to the Banks pursuant to the Holdings Guaranty and Pledge Agreement will be distributed to an agent of the Banks

and (2) the Holdings Loan will be distributed to the Trust for the benefit of: (a) the Banks as holders of the Holdings Guaranty Claims, (b) the y% Noteholders and (c) the holders of the Holdings General Unsecured Claims.

- Pursuant to the Plan, the following will be canceled: (1) the intercompany notes and other instruments evidencing claims of Sub or any of its subsidiaries against Holdings (the “Holdings Intercompany Claims”) and (2) the Holdings’ issued and outstanding shares of common stock, warrants and options (collectively, the “Holdings Equity”). The holders of the Holdings Intercompany Claims and of the Holdings Equity will receive no distribution and retain no property on account of such claims or interests under the Plan.

On the Effective Date, Sub will issue:

- term notes in the aggregate principal amount of \$e, and shares of common stock (“New Common Stock”), to the Banks as holders of the Senior Secured Bank Claims;
- shares of New Common Stock distributed to (a) the Trust in respect of the Holdings Loan and (b) the x% Noteholders;
- shares of New Common Stock with a value, as of the Effective Date, equal to the amount of the Holdings Loan, to the Banks (as holders of the Holdings Guaranty Claims), the y% Noteholders and the holders of Holdings General Unsecured Claims, as beneficiaries of the Trust holding claims under the Holdings Loan;
- Series A Warrants and Series C Warrants (to purchase a specified percentage of the shares of New Common Stock) to the z% Noteholders.
- New Common Stock, Series A, Series B (to purchase a specified percentage of the shares of New Common Stock) and Series C Warrants to the x% Noteholders.

The Plan also provides for the cancellation of the intercompany notes and other instruments evidencing claims of Holdings or any of Sub’s subsidiaries against Sub (the Sub Intercompany Claims”), the Old Sub Common Stock and the Interim Sub Common Stock. The holders of the Sub Intercompany Claims and the holders of the Old Sub Common Stock will receive no distribution and retain no property on account of such claims or interests under the Plan.

Taxpayer’s Position

The taxpayer takes the position that the transactions occurring on the Pre-Effective Date (the “Downstream Merger”) should be treated as a reorganization within the meaning of I.R.C. § 368(a)(1)(G). The taxpayer also takes the position that the transactions occurring on the Effective Date (the “Recapitalization”) should be treated as a reorganization within the meaning of I.R.C. § 368(a)(1)(E).

In that case, the taxpayer argues that the tax consequences to the holders of securities of Sub and Holdings are as follows:

- Holders that received no consideration for their securities should recognize long-term capital loss in an amount equal to their aggregate tax basis of such securities, unless they had previously recognized such loss.
- Holders that received new securities in exchange for their securities should not recognize any income, gain or loss on such exchange. These holders will have an aggregate basis in the new securities equal to their aggregate basis in their securities. The holding period of the new securities will include the holding period of their securities.

In that case, the taxpayer also argues that the tax consequences to Sub and Holdings are as follows:

- Holdings will not recognize any income, gain or loss in connection with the Downstream Merger.
- Holdings and Sub will realize, in the aggregate, income from the cancellation of indebtedness (“COD income”) in an amount equal to the excess of (a) the sum of the adjusted issue prices of the various notes retired pursuant to the restructuring plus the amount of the Holdings General Unsecured Claims minus (b) \$e plus the aggregate fair market value as of the Effective Date of the New Common Stock and Warrants.
- Under I.R.C. § 108(a), any COD income realized will be excluded from the gross income of both Holdings and Sub.
- Except as provided in the next paragraph, pursuant to I.R.C. § 108(b), Sub will be required to reduce certain Federal income tax attributes, including net operating loss carryovers and the basis of Sub’s assets, by the amount of the COD income excluded by reason of I.R.C. § 108(a).
- Under I.R.C. § 1017(b)(2), the basis reduction described above is limited to the excess of the aggregate basis of Sub’s property immediately after the restructuring minus the aggregate liabilities of Sub immediately after the restructuring. Amounts not applied to reduce basis under the immediately

preceding sentence will be excluded permanently from Sub's gross income and will have no further tax effect.

- Sub estimates that, as a result of the application of the rules described in the two immediately preceding paragraphs, approximately \$d of COD income will be applied to eliminate Sub's consolidated net operating loss carryovers, approximately \$c of COD income will be applied pro rata to reduce the basis of Sub's assets (other than inventory and accounts receivable) under I.R.C. § 1017(b)(2) and the balance of the COD income realized in the restructuring will be excluded permanently from gross income.
- If the Downstream Merger does not qualify as a tax-free reorganization within the meaning of I.R.C. § 368(a)(1)(G), then Holdings could be required to recognize income to the extent of its excess loss account in the stock of Sub. That amount is approximately \$b.

LAW AND ANALYSIS

As a threshold matter, we note that, even if the Downstream Merger and Recapitalization each qualify as a tax-free reorganization (as contended by the taxpayer), it is the position of the Service that the taxpayer would have cancellation of indebtedness ("COD") income. Rev. Rul. 77-437, 1977-2 C.B. 28. In other words, the status of each exchange as taxable or tax-free may matter for other reasons, but it has no bearing on the COD issue. The taxpayer has COD income in either case. Nevertheless, because Holding and Sub are in title 11, I.R.C. § 108 applies to exclude such COD income from the gross income of both Holding and Sub. I.R.C. § 108(a)(1)(A). Of course, Holding and Sub must apply I.R.C. § 108(b) to reduce (or eliminate) their tax attributes.

We do not have enough information to analyze other issues arising out of the restructuring. In the next section of this memorandum, we have provided a list of questions. Once we have the answers to these questions, we can begin to analyze the restructuring.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

1 [REDACTED]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

Please call if you have any further questions.

By: _____
STEVEN J. HANKIN
Special Counsel (Corporate)
Field Service division

cc: CC:
CC: