

# “All Cash” D Reorganizations & Selected Issues under Section 108(i)

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# D Reorganizations

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# “D” Reorganization Requirements

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- The Distribution Requirement
  - The *stock, securities*, and other properties received by the target corporation (“T”), as well as T’s other properties, must be distributed to the T shareholders in pursuance of the plan of reorganization. I.R.C. §§ 354(b)(1)(B), 368(a)(1)(D).
- The “Substantially All” Requirement
  - The acquiring corporation (“Acq”) must acquire “substantially all” of T’s assets. I.R.C. § 354(b)(1)(A).
- The Control Requirement
  - T must transfer all or a part of its assets to Acq and, immediately after the transfer, T or T’s shareholders, must be in “control” of Acq.
  - “Control” as defined in section 368(a)(2)(H)(i) (referencing section 304(c)).
- The Continuity of Shareholder Interest (“COI”) Requirement
  - Not clear whether there is a COI requirement in an acquisitive “D” reorganization. *See* Treas. Reg. § 1.368-1(b) (“[r]equisite to a reorganization... [is] (except as provided in section 368(a)(1)(D)) a continuity of interest as described in [Treas. Reg. section 1.368-1(e)].”).
- The Continuity of Business Enterprise Requirement

# Topics to be Discussed

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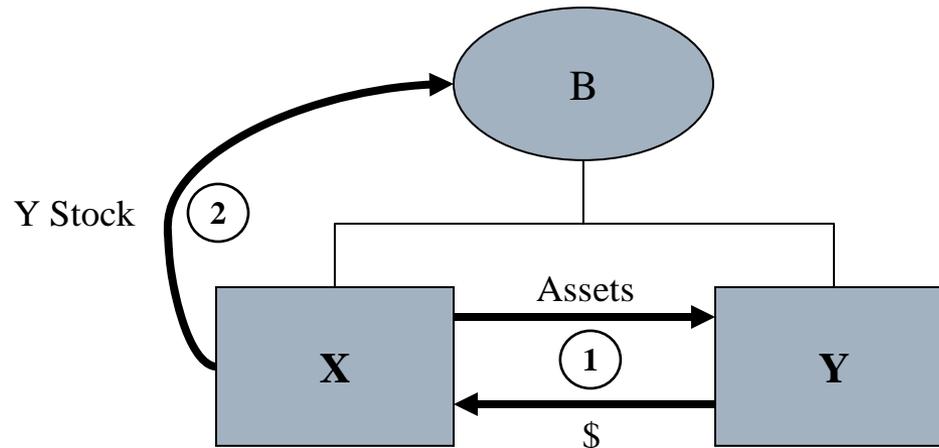
- “All Cash” D Reorganizations
  - Inaccessible basis in nominal share
  - Applicability of Treas. Reg. section 1.368-2T(l) to sections 354, 356, and 361
  - The nominal share when target has multiple classes of stock
  - Treatment of the nominal share in consolidation
- Continuity of Shareholder Interest
  - Does it apply to a D reorganization?
  - If so, how?
- Liquidation-Reincorporation
  - Status of “alter ego” doctrine in light of Treas. Reg. section 1.368-2(k)

# “All Cash” D Reorganizations

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## Rev. Rul. 70-240, 1970-1 C.B. 81

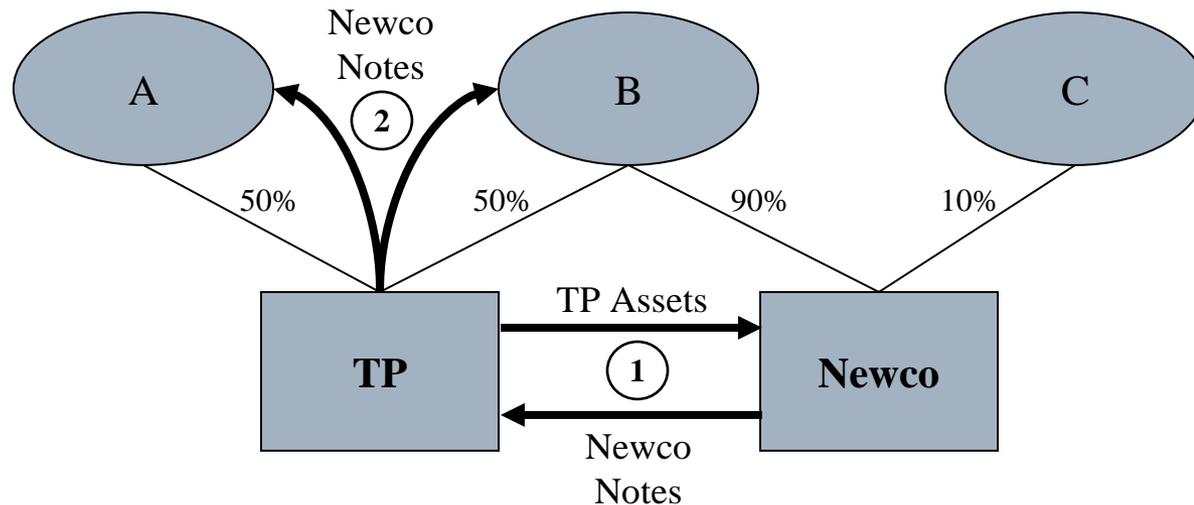
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- X transferred all of its operating assets to Y for cash in a value-for-value exchange and then liquidated.
- IRS concluded that actual issuance and distribution of Y stock is not necessary to satisfy the distribution requirement where the same person owns all of the stock of X and Y in identical proportions. Such an issuance would constitute a “meaningless gesture.”
- IRS also concluded that B’s receipt of the sale proceeds upon X’s liquidation was determined pursuant to section 356(a)(2).

## P.L.R. 200551018 (Sept. 15, 2005)

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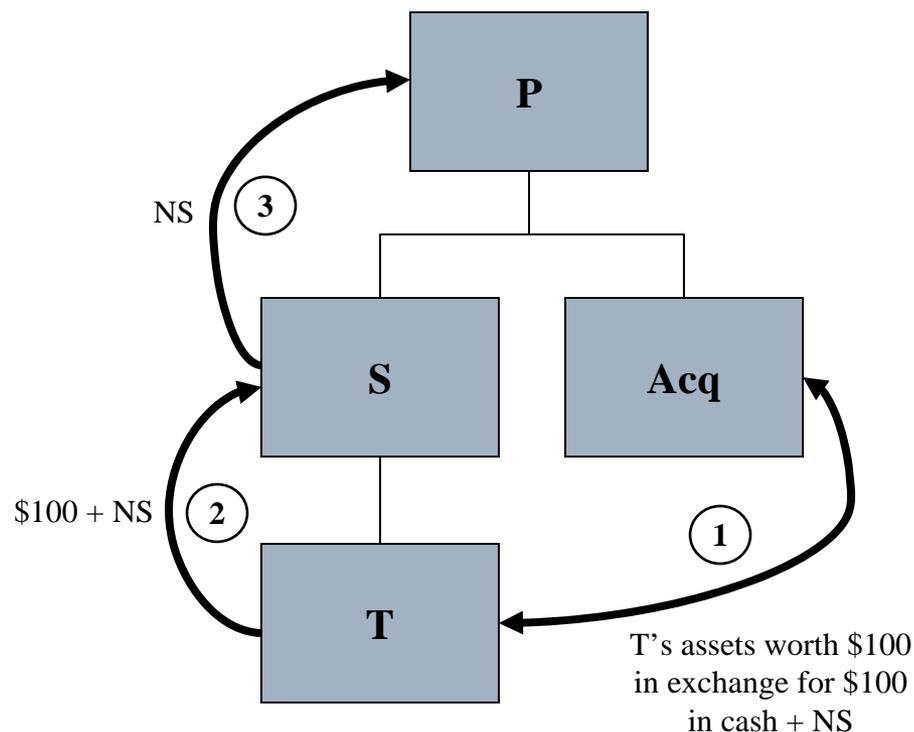
- TP represented that Newco Notes were indebtedness for federal income tax purposes.
- IRS ruled that Newco may amortize TP goodwill acquired from “purchase” of TP’s business under section 197.
- IRS implicitly determined that the transaction did not qualify as a D reorganization presumably because the distribution requirement was not satisfied.
  - Issuance of Newco stock would not have been a “meaningless gesture” because proportionate ownership of TP and Newco were not identical.

## Temp. Treas. Reg. Section 1.368-2T(l)

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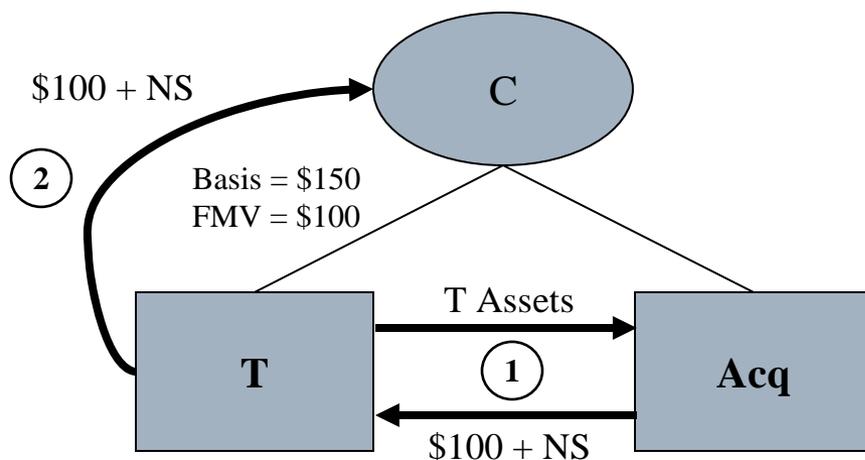
- If the *same person or persons* own, directly or indirectly, all of the stock of T and Acq in *identical proportions* then a transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the distribution requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding that there is no actual issuance of stock and/or securities of Acq.
- In such cases, Acq will be deemed to issue a *nominal share* (“NS”) of its stock to T in addition to the actual consideration exchanged for T’s assets.
- The NS of Acq stock will then be *deemed distributed* by T to T’s shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of T and Acq.
- Treas. Reg. section 1.368-2T(l) sunsets on December 18, 2009.

## Example 1: Treas. Reg. Section 1.368-2T(l) Mechanics



- Acq acquires T's assets in exchange for cash equal to the fair market value of T's assets followed by the liquidation of T whereby T distributes the cash to S1.
- Pursuant to Treas. Reg. section 1.368-2T(l)(2) (second sentence): Acq is deemed to transfer a NS of Acq stock (in addition to the cash actually transferred) in Step 1.
- NS deemed distributed to S in Step 2.
- Pursuant to Treas. Reg. section 1.368-2T(l)(2) (last sentence): NS deemed distributed to P in Step 3 in order to reflect the actual ownership of Acq stock.

## Example 2: Inaccessible Basis in Nominal Share



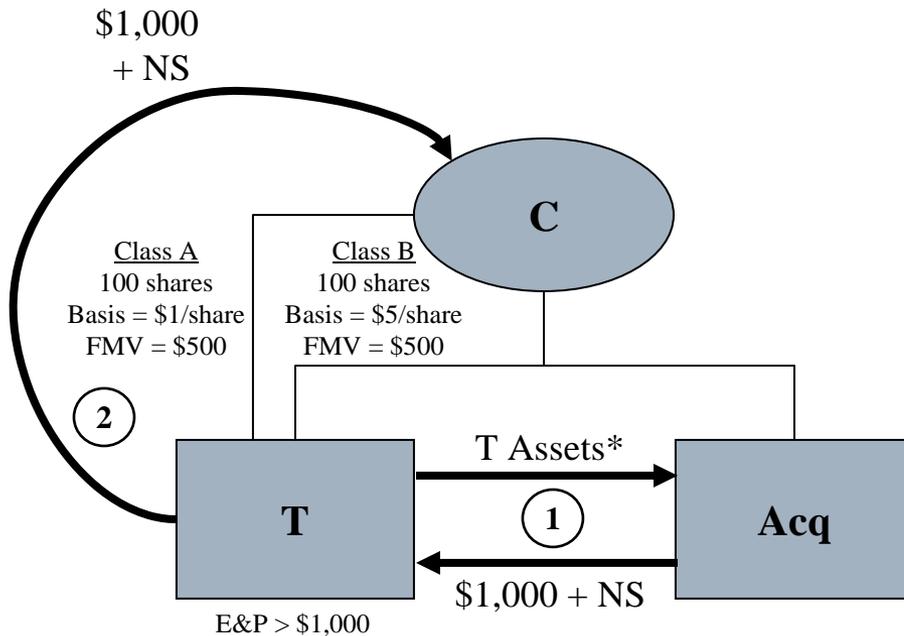
- Acq acquires T's assets in exchange for \$100 followed by T distributing the \$100 to C in complete liquidation.
- C's basis in the NS is \$50. I.R.C. § 358(a).
- Can C ever access the \$50 basis in the NS?
- If C is permitted to later access the \$50 basis in the NS, when is the appropriate time?
  - Upon C's disposition of all of its Acq stock?
  - Upon C's disposition of a "specifically identified" Acq share that contains a "nominal segment" with a \$50 basis under Treas. Reg. § 1.358-2?
  - Proportionately as C disposes of shares of Acq stock? If so, should C be treated as allocating its remaining \$50 of basis proportionately among its existing Acq shares?
- With respect to C's ability to recognize his built-in loss in his T stock, should there be a different result if instead T received \$99 in cash and one Acq share worth \$1?

# Applicability of Treas. Reg. Section 1.368-2T(l)(2)(i) to Sections 354, 356, and 361

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- Although Treas. Reg. section 1.368-2T(l)(2)(i) provides that a NS is deemed issued in an “all cash D reorganization,” the deemed NS issuance is for purposes of the distribution requirements under sections 368(a)(1)(D) and 354(b)(1)(B).
- Treas. Reg. section 1.368-2T(l)(2)(i) does not explicitly provide that the issuance of a nominal share should be deemed to occur for all purposes of sections 354, 356 and 361 (as well as Treas. Reg. section 1.1502-13(f)(3)).
- Section 368 is merely a definitional provision and does not address the tax consequences to Acq, T or the T shareholders in a reorganization.
  - Shareholder tax consequences determined under sections 354 and 356.
  - Corporate level tax consequences determined under section 361.

# Example 3: Treas. Reg. Section 1.368-2T(l) and Multiple Classes of Stock



- Neither Treas. Reg. section 1.368-2T(l) nor Rev. Rul. 70-240 addresses the consequences if T has multiple classes of stock outstanding.
- Under current law, C would recognize \$400 of dividend income under section 356(a)(2). See Rev. Rul. 74-515.
- Under Prop. Reg. section 1.354-1(d), is the Acq NS only issued in exchange for the Class A stock or the Class B stock? If so, which one?
  - If issued only in exchange for the Class A stock, C would: (1) with respect to the Class A stock, recognize \$400 of dividend income under section 356(a)(2); and (2) with respect to the Class B stock, either recognize (a) no gain or loss under sections 302(a) and 302(b)(3) (T goes out of existence), or (b) \$500 of dividend income under sections 302(d) and 301(c)(1) (if a successor concept is appropriate under these circumstances).
  - If issued only in exchange for the Class B stock, C would: (1) with respect to the Class A stock, either recognize (a) a \$400 capital gain under sections 302(a) and 302(b)(3) (T goes out of existence), or (b) \$500 of dividend income under sections 302(d) and 301(c)(1) (if a successor concept is appropriate under these circumstances); and (2) with respect to the Class B stock, recognize no gain or loss under section 356(a)(1).
- Alternatively, should NS be split into “segments”? If yes, the result should be the same as under current law.

\* T assets are worth \$1,000.

# “All Cash” D Reorganizations

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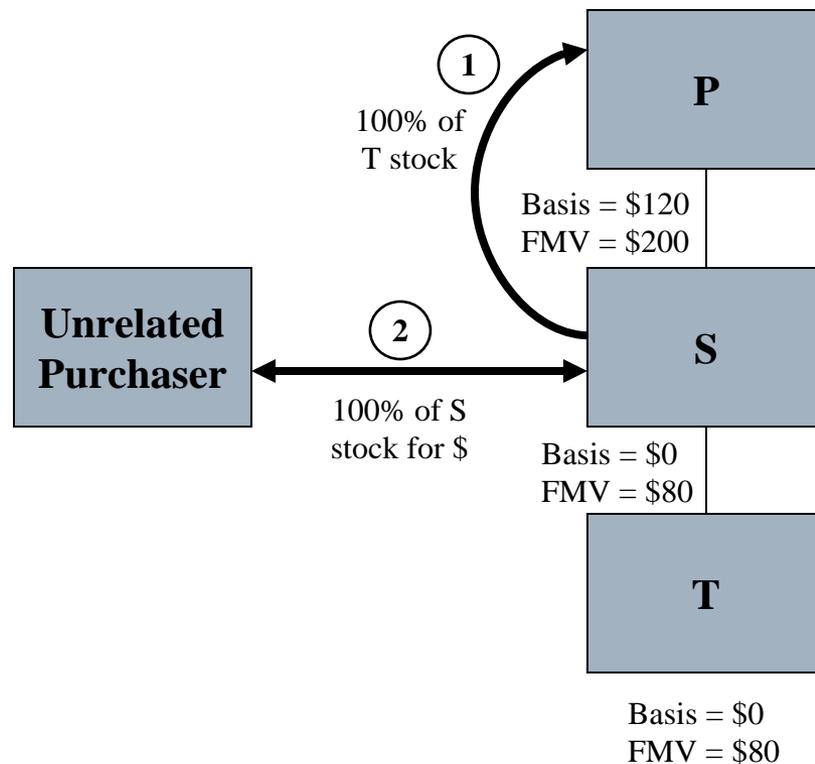
Treatment of the Nominal Share in  
Consolidation

# Treatment of the Nominal Share in Consolidation

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- Under Treas. Reg. section 1.1502-13(f)(3), a reorganization between members where T's shareholder ("S") receives boot that *results in the application of section 356* is recharacterized under the *Clark* fiction—in other words:
  1. T is treated as receiving solely Acq stock in exchange for T's assets;
  2. T is treated as distributing the fictional Acq stock (representing the boot), in addition to any actual Acq stock received in the exchange, to S followed immediately by;
  3. Acq redeeming S's fictional Acq stock in exchange for the boot whereby the redemption is treated as a *separate transaction* subject to sections 302(d) and 301.
- Does Treas. Reg. section 1.1502-13(f)(3) require the issuance of an Acq NS in addition to the Acq stock deemed issued under the *Clark* fiction? If so, is it also redeemed in Step 3 above?
- If an excess loss account ("ELA") attaches to a NS, does the requirement under Treas. Reg. section 1.368-2T(l)(2) that the NS be "further transferred through chains of ownership to the extent necessary to reflect the actual ownership of [T] and [Acq]" result in S having a deferred intercompany gain ("DIG") in an amount equal to the ELA?

## Example 4: Base Case—Consolidated Return Context



- P wishes to sell S but Unrelated Purchaser does not want T or T's assets.

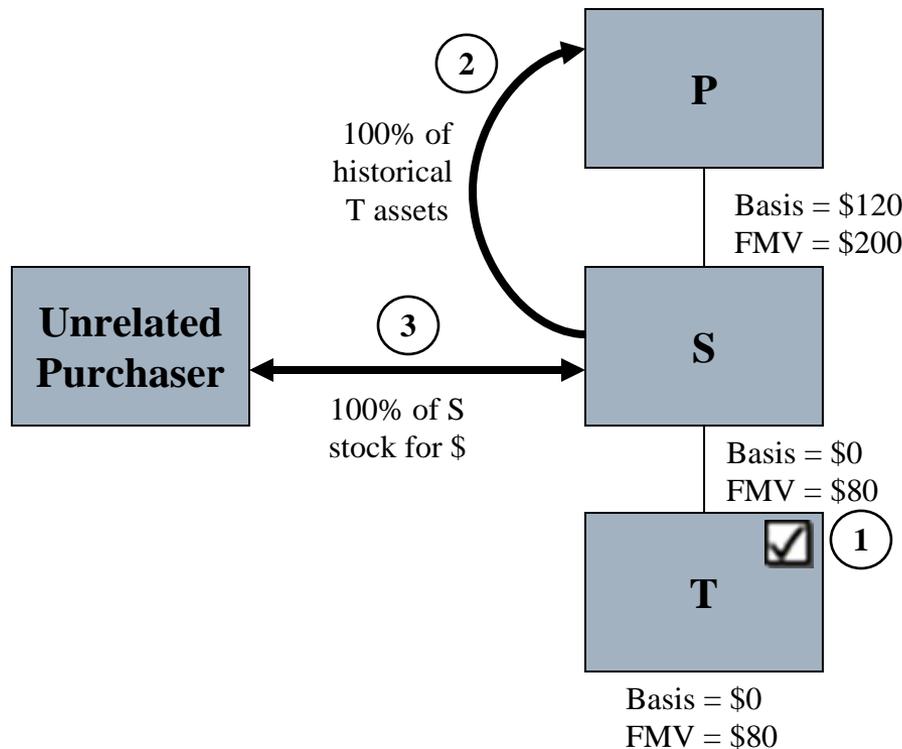
- Assuming distribution of T does not satisfy the requirements of section 355, the distribution of T to P by S results in (1) an S DIG of \$80 under Treas. Reg. § 1.1502-13(f)(2), and (2) a negative investment adjustment of \$80 under Treas. Reg. § 1.1502-32(b) resulting in P having a basis of \$40 in its S stock.

- P's subsequent sale of S to Unrelated Purchaser results in (1) the triggering of S's \$80 deferred intercompany gain under Treas. Reg. § 1.1502-13(d), and (2) P's basis in S is increased to \$120 under Treas. Reg. § 1.1502-32 resulting in no gain or loss on P's sale of the S stock.

- T's basis in its assets remains unchanged.

- **Result:** One level of tax was recognized and taken into account upon the sale of S and a second level of tax remains represented by the \$80 built-in gain in the historical T assets (i.e., no basis step up in the T assets).

# Example 5: Modified Base Case—Consolidated Return Context



- P wishes to sell S but Unrelated Purchaser does not want T or T's assets.

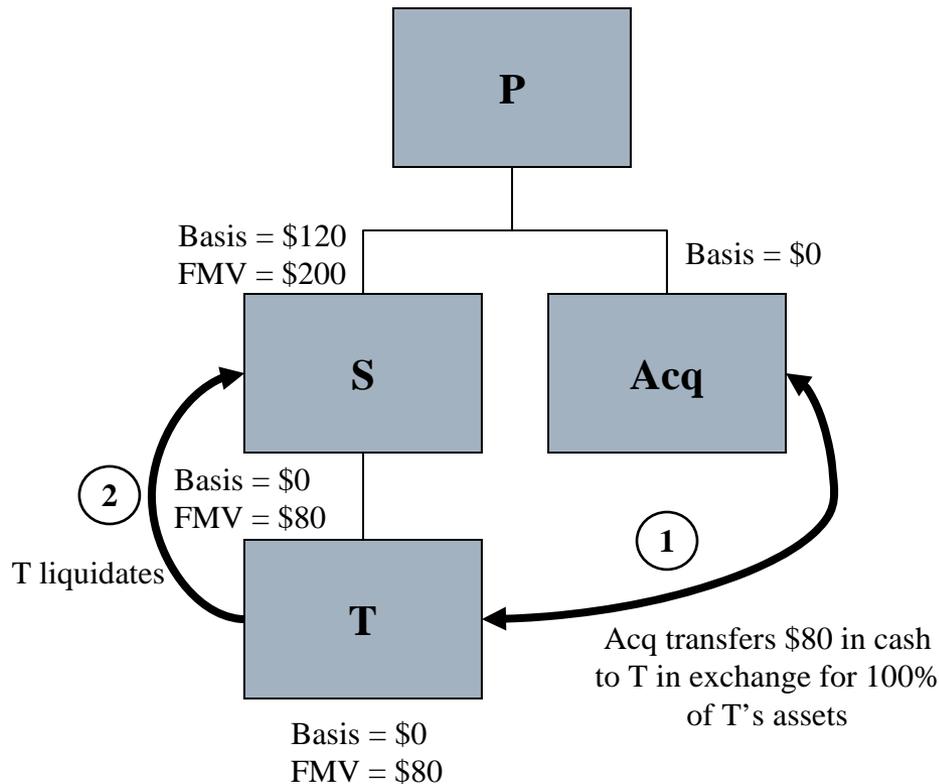
- T elects to be treated as a disregarded entity pursuant to Treas. Reg. §301.7701-3. S takes a carryover basis in T's assets. I.R.C. § 334(b). S's built-in gain in its T stock is eliminated.

- S distribution of 100% of T's historical assets results in (1) an S DIG of \$80 under Treas. Reg. § 1.1502-13(c), and (2) a negative investment adjustment of \$80 under Treas. Reg. § 1.1502-32(b) resulting in P having a basis of \$40 in its S stock. The FMV of P's S stock is now \$120. P takes a FMV basis in the historical T assets. I.R.C. § 301(c).

- P's subsequent sale of S to Unrelated Purchaser results in (1) the triggering of S's \$80 deferred intercompany gain under Treas. Reg. § 1.1502-13(d), and (2) P's basis in S is increased to \$120 under Treas. Reg. § 1.1502-32 resulting in no gain or loss on P's sale of the S stock.

- **Result:** One level of tax was recognized and taken into account upon the sale of S and P holds the T historical assets with an \$80 basis.

# Example 6: “All Cash” D Reorganization—Consolidated Return Context (Nominal Share Issued)



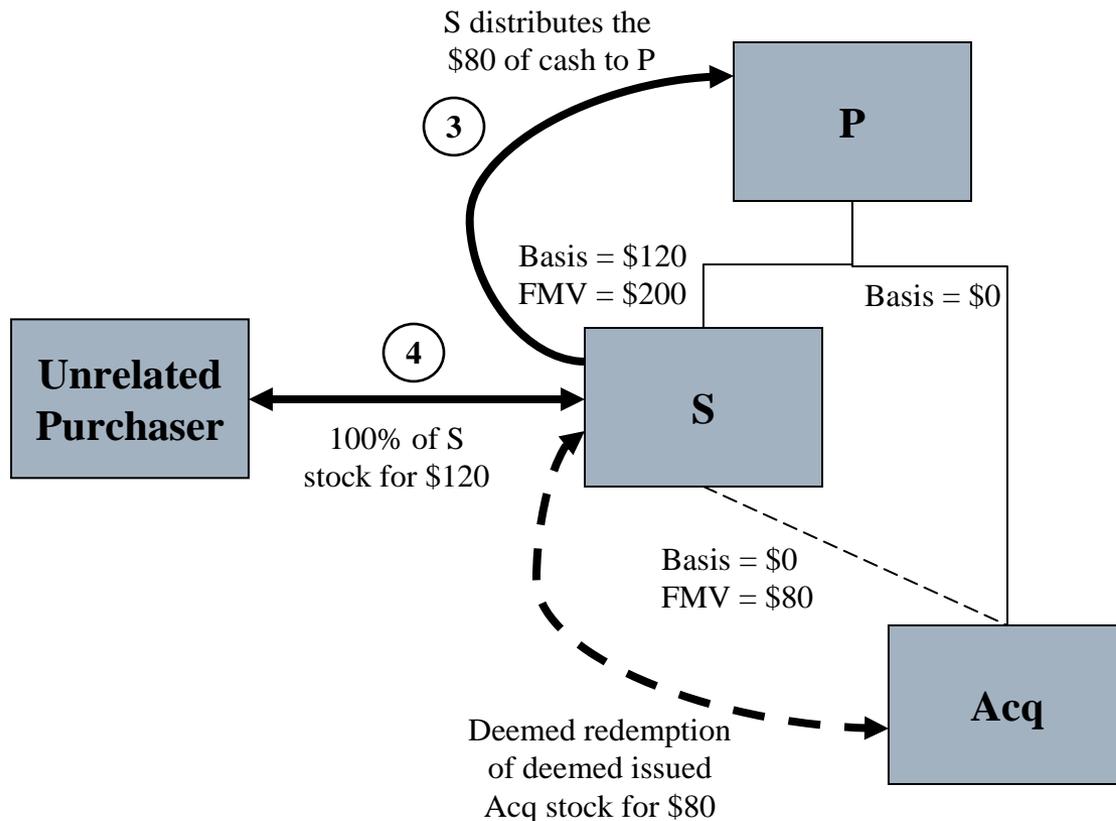
- Under Treas. Reg. § 1.368-2T(l), Acq deemed to issue a NS to T + \$80 in cash.

- Does Treas. Reg. § 1.1502-13(f)(3) apply to the transaction since the NS was only issued for purposes of section 368 (i.e., no mention of application to sections 354, 356, or Treas. Reg. section 1.1502-13(f)(3))?

- Assuming Treas. Reg. § 1.1502-13(f)(3) applies, S would be treated as (i) receiving an Acq NS + \$80 of Acq stock whereby S's basis in both “blocks” of stock is \$0 pursuant to section 358, followed by (ii) Acq redeeming the \$80 of Acq stock for \$80 treated as a section 301 distribution under section 302(d).

- Acq takes a \$0 basis in T's assets under section 362(b).

# Example 6 (Cont'd): “All Cash” D Reorganization— Consolidated Return Context (Nominal Share Issued)



- As a result of the deemed section 301 distribution, S’s basis in its Acq NS is reduced from \$0 to an ELA of \$80 under Treas. Reg. § 1.1502-32(b). P’s basis in its S stock would remain \$120. See Treas. Reg. § 1.1502-32(b)(3)(ii), (b)(3)(iii).

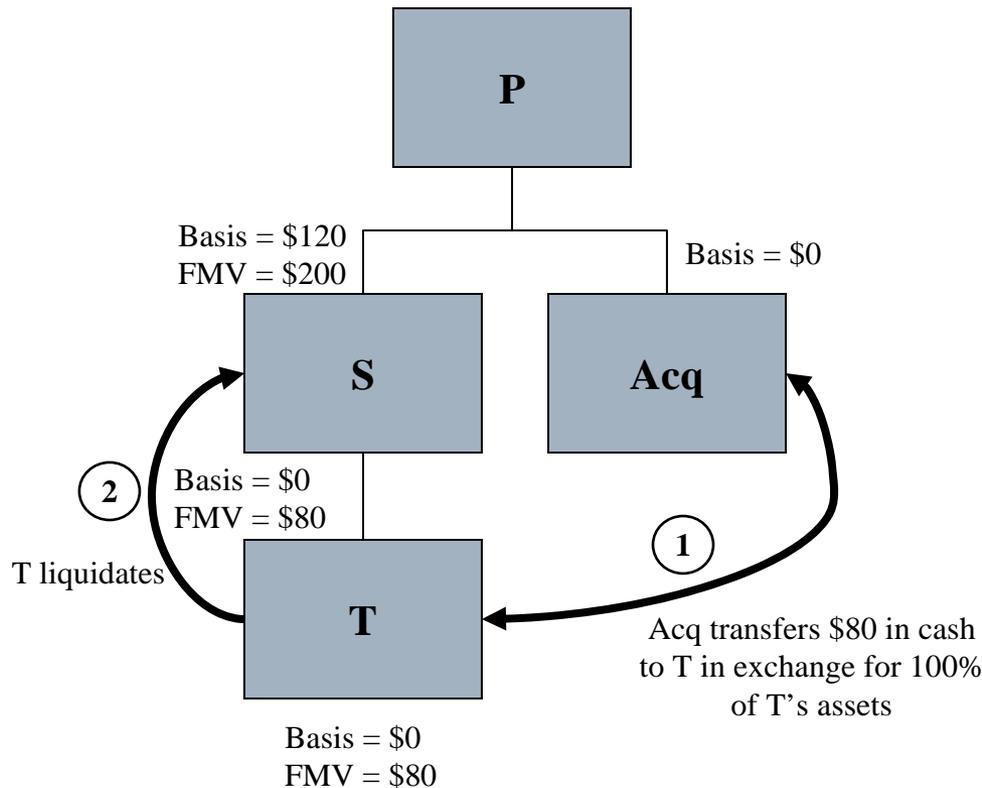
- Under Treas. Reg. § 1.368-2T(I)(2), S would be deemed to distribute the Acq NS to P thereby resulting in S having a DIG of \$80 under section 311(b).

- S’s distribution of \$80 in cash to P results in an \$80 decrease in P’s S stock from \$120 to \$40 under Treas. Reg. § 1.1502-32(b). The FMV of S is reduced to \$120.

- P’s sale of S to Unrelated Purchaser for \$120 (1) triggers S’s \$80 DIG under Treas. Reg. § 1.1502-13(d), and (2) increases P’s basis in its S stock from \$40 to \$120 under Treas. Reg. § 1.1502-32(b).

- **Result:** One level of tax was taken into account upon the sale of S and a second level of tax is preserved represented by the \$80 built-in gain in the historical T assets.

# Example 7: “All Cash” D Reorganization—Consolidated Return Context (Nominal Share *Not* Issued)

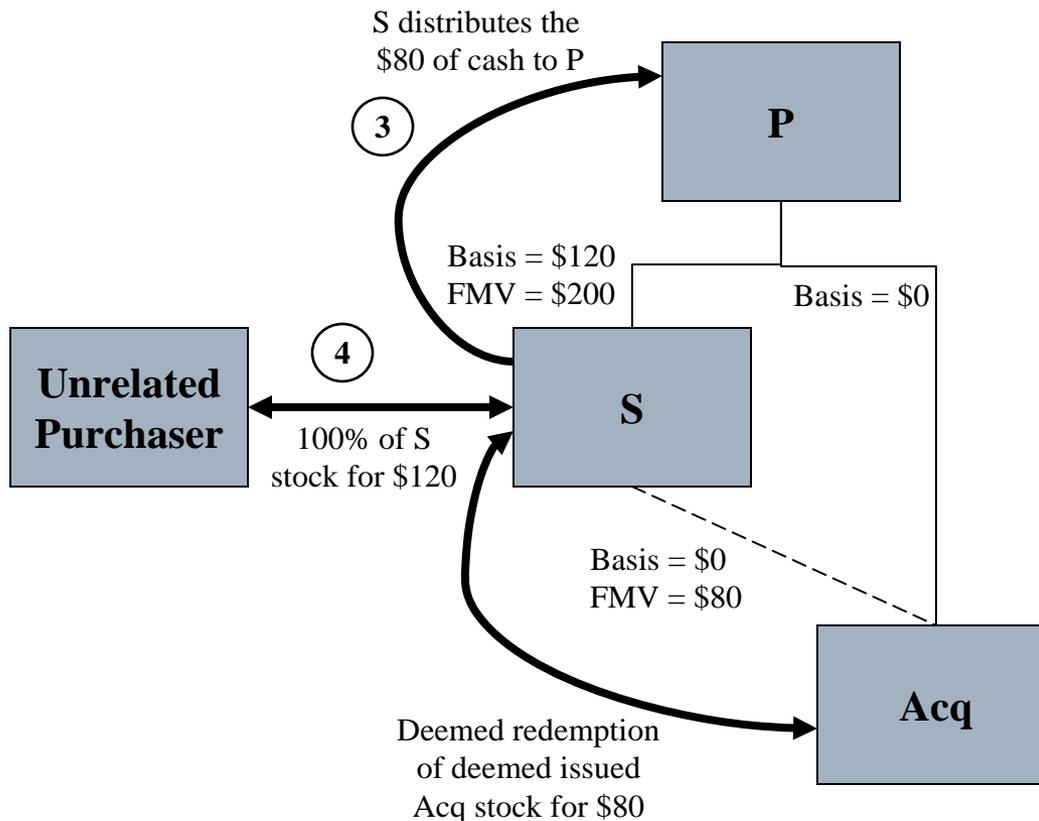


- Under this paradigm, the distribution requirement would be treated as satisfied notwithstanding that no Acq stock is issued in the transaction.

- Assuming Treas. Reg. § 1.1502-13(f)(3) applies, S would be treated as (i) receiving \$80 of Acq stock whereby S's basis in such deemed issued stock is \$0 pursuant to section 358 followed by (ii) Acq redeeming the \$80 of Acq stock for \$80 treated as a section 301 distribution under section 302(d).

- Acq takes a \$0 basis in T's assets under section 362(b).

# Example 7 (Cont'd): “All Cash” D Reorganization— Consolidated Return Context (Nominal Share *Not* Issued)



- As a result of the deemed section 301 distribution, a negative investment adjustment under Treas. Reg. § 1.1502-32 would create an \$80 ELA in Acq stock. Since S does not hold any Acq stock (nominal or otherwise), the \$80 ELA is presumably “allocated” to P’s historically held Acq stock (*see, e.g.* P.L.R. 200810015 (Mar. 7, 2008); P.L.R. 9815050 (Jan. 9, 1998)).

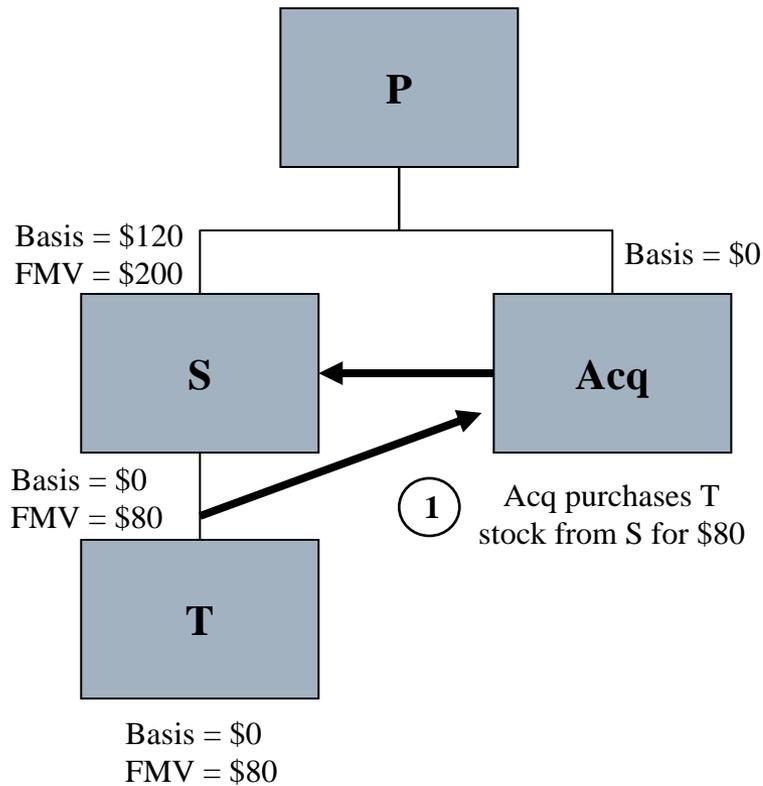
- S would *not* have an \$80 DIG because it had no S share for which to create an ELA and subsequently distribute to P. P’s basis in its S stock is increased by \$80 to \$200 under Treas. Reg. §§ 1.1502-32(b)(2)(ii) and (3)(ii).

- S’s distribution of \$80 in cash to P results in an \$80 decrease in P’s S stock from \$200 to \$120 under Treas. Reg. § 1.1502-32(b). The FMV of S is reduced to \$120.

- **Result:** Two levels of gain remain in the consolidated group (1) P’s \$80 ELA in its Acq stock, and (2) Acq’s \$80 built-in gain in the historical T assets. P could later liquidate Acq and eliminate the \$80 ELA.

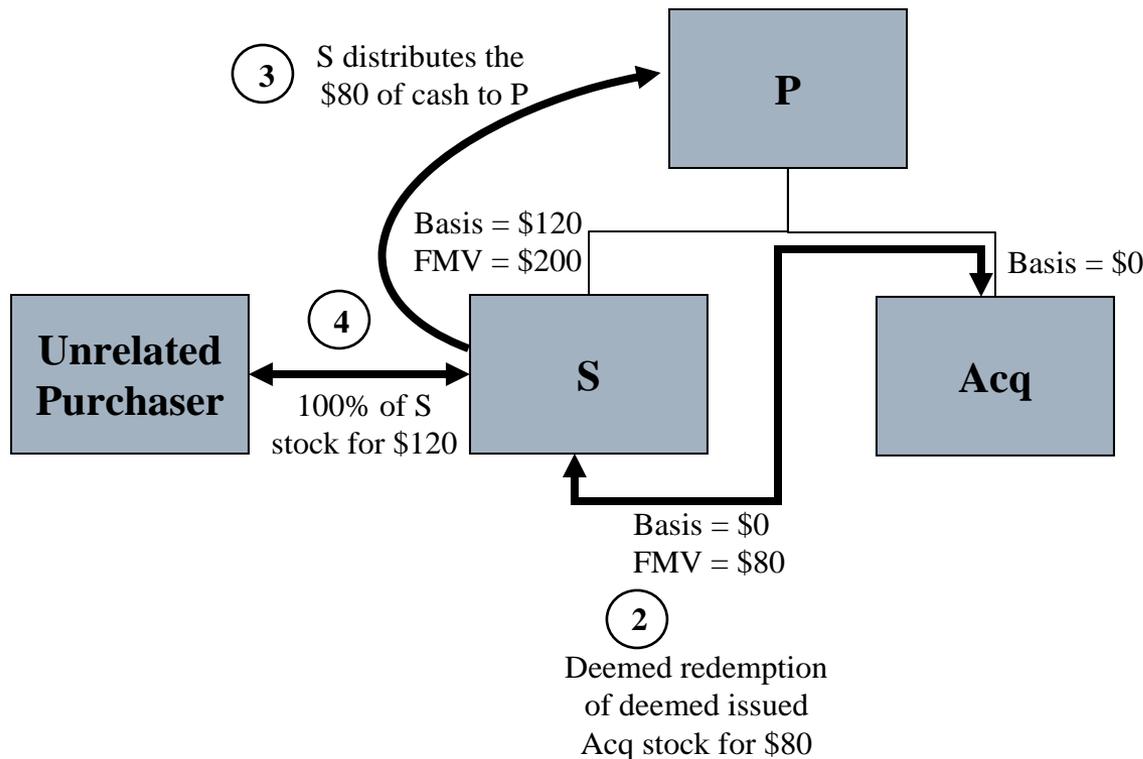
- **N.B.** If the liquidation is part of the same plan as the “all cash” D reorganization, transaction likely recharacterized as a taxable asset purchase by P followed by a section 332 liquidation of T into S. Result: S has \$80 DIG and P obtains an \$80 basis in the T assets.

# Example 8: Consolidated Section 304, Prior to Treas. Reg. Section 1.1502-80(b)



- Prior to 1991, sale was recast under section 304(a)(1) as if (1) S contributed the T stock to the capital of Acq and (2) S subsequently received \$80 in sale proceeds as a distribution in redemption of Acq stock.

## Example 8 (Cont'd): Consolidated Section 304, Prior to Treas. Reg. Section 1.1502-80(b)



- Assuming sufficient E&P, redemption would be treated as section 302(d) dividend, which would be eliminated from S's gross income under former Treas. Reg. section 1.1502-14(a).
- Although eliminated from gross income, the \$80 deemed dividend would increase S's E&P, resulting in P increasing its basis in the S stock to \$200 under former Treas. Reg. section 1.1502-32.
- Taxpayers argued that because S did not actually own any Acq stock, no corresponding negative basis adjustment was required as a result of the deemed redemption. *See Rev. Rul. 70-496 (basis disappears).*
- Upon distribution of \$80 sales proceeds to P, P would reduce its basis in the S stock to \$120 and recognize no gain or loss on the subsequent sale of S.
- **Response:** Since 1991, Treas. Reg. section 1.1502-80(b) has "turned-off" section 304 in consolidation.
- S's sale is now taxable, creating \$80 DIG which would be triggered upon sale of S. Acq also has \$80 stepped-up basis in T stock.

# Possible Treatment to “All Cash” D Reorganizations in Consolidation

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- Retain status quo (*see* Example 6).
  - Consistent with purpose of Treas. Reg. section 1.1502-80(b) (non-applicability of section 304)?
- NS only exists for purposes of satisfying the distribution requirements and sections 354, 356, and 361 (*see* Example 7).
- Turn off requirement under Treas. Reg. section 1.368-2T(l)(2) (last sentence) whereby the NS is *not* further transferred through chains of ownership to the extent necessary to reflect the actual ownership of T and Acq, thereby avoiding the creation of a DIG.
- Turn off Treas. Reg. section 1.368-2T(l) (and Rev. Rul. 70-240) rendering an “all cash” D reorganization in consolidation a taxable asset sale.
- Allow Treas. Reg. section 1.368-2T(l) to sunset.

# D Reorganizations

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Continuity of Shareholder Interest  
Requirement?

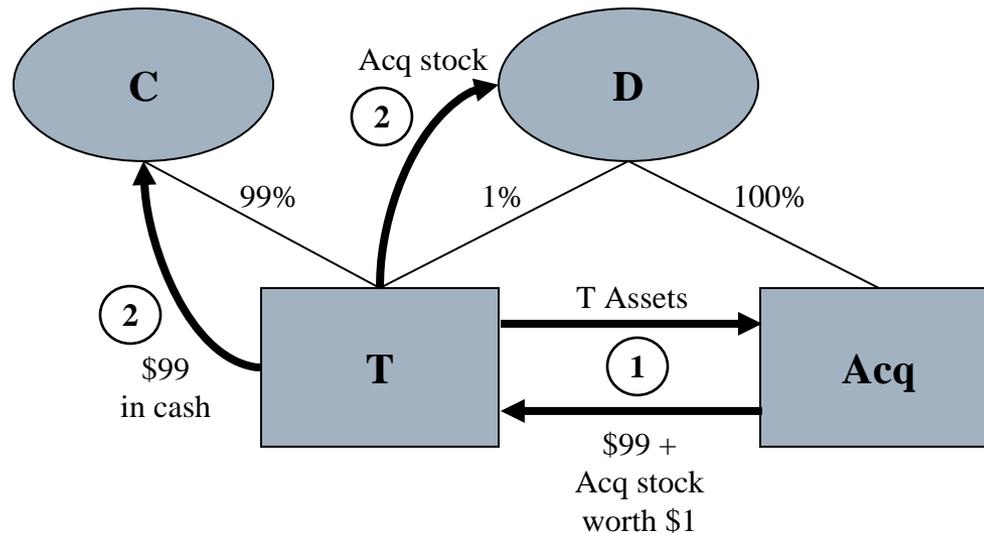
# Is there a Continuity of Shareholder Interest Requirement in a D Reorganization?

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- Treas. Reg. section 1.368-1(b) provides that “[r]equisite to a reorganization... [is] (except as provided in section 368(a)(1)(D)) a continuity of interest as described in [Treas. Reg. section 1.368-1(e)].”
  - Is the above exclusion limited to *divisive* D reorganizations?
  - Do the distribution requirements of sections 368(a)(1)(D) and 354(b)(1)(B) subsume the COI requirement?
    - Always or only when there is identical stock ownership in Acq and T?
    - If only when there is identical stock ownership in Acq and T, should attribution rules apply to make such a determination?

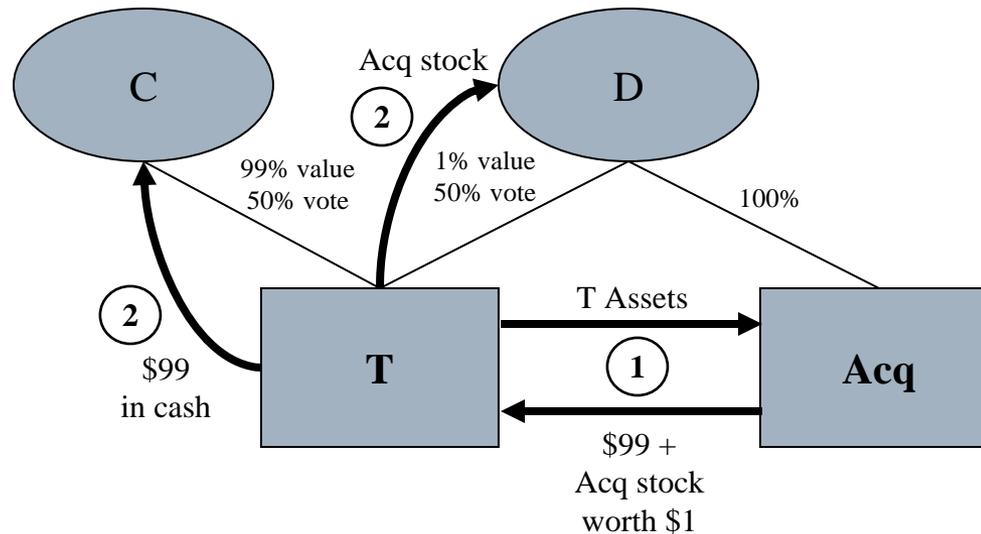
## Example 9: Minimal Qualifying Consideration

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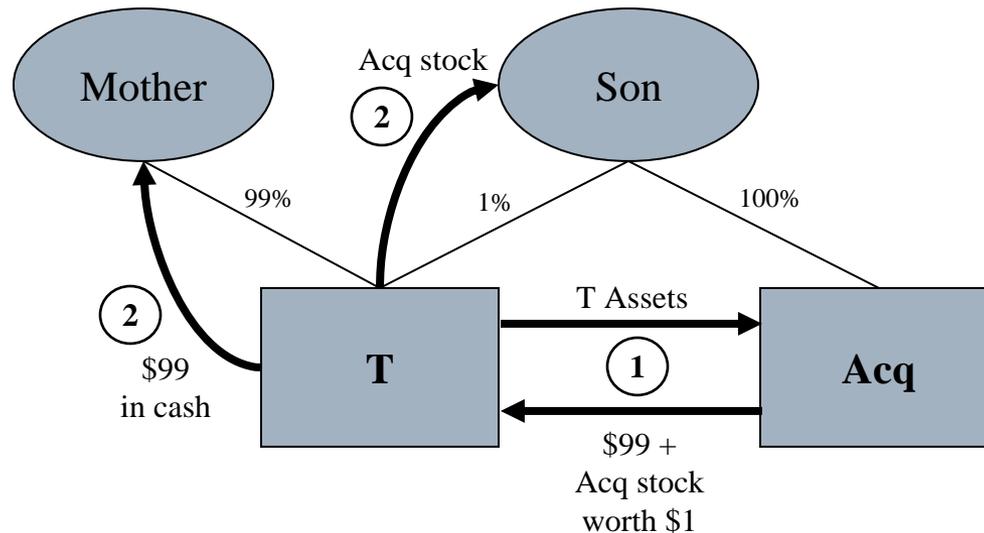
- D reorganization statutory requirements are satisfied.
- COI under Treas. Reg. section 1.368-1(e) is not satisfied (only 1% qualifying consideration issued).
- Is COI satisfied in the above transaction?

## Example 10: Same Person has Common Control under Section 304(a)(1) of T and Acq



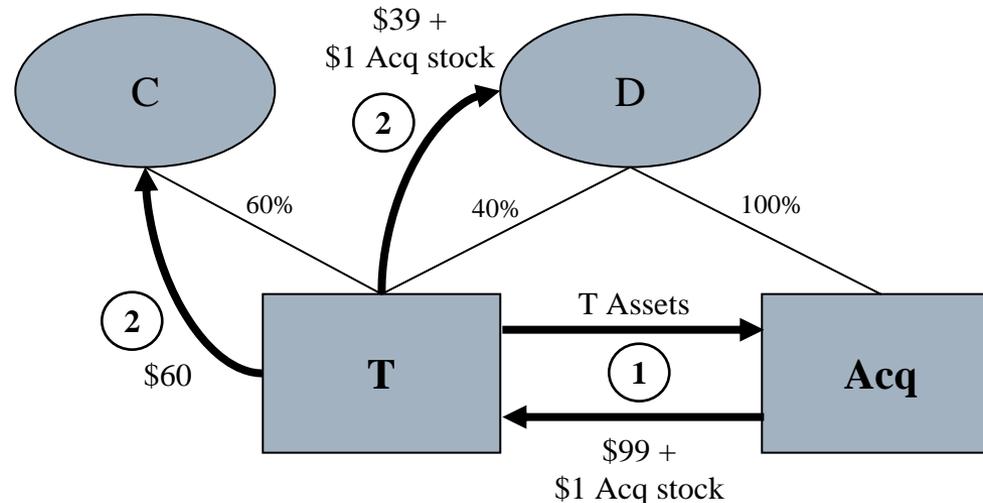
- D reorganization statutory requirements are satisfied.
- COI under Treas. Reg. section 1.368-1(e) is not satisfied (only 1% qualifying consideration issued).
- Is COI satisfied in the above transaction? *Cf.* Comments on Proposed and Temporary Regulations under Code Section 368(a)(1)(D), ABA Tax Sec. (2008), *reprinted in 75 Tax Notes (TA) 22* (Apr. 16, 2008).

# Example 11: Identical Stock Ownership of T and Acq Through Attribution



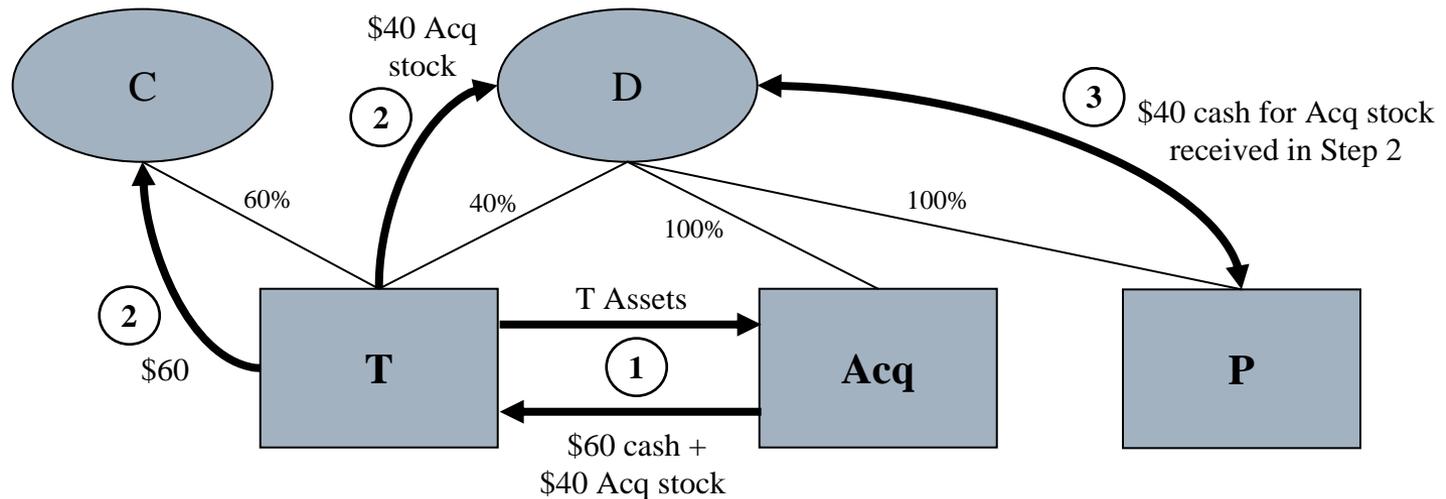
- D reorganization statutory requirements are satisfied.
- COI under Treas. Reg. section 1.368-1(e) is not satisfied (only 1% qualifying consideration issued).
- Is COI satisfied in the above transaction? *See* P.L.R. 9111055 (Dec. 19, 1990); *see also* Treas. Reg. § 1.368-2T(l)(2)(ii) (providing that an individual and all members of his family described in section 318(a)(1) shall be treated as one individual.”).

## Example 12: When Should Cash be Treated as Acq Stock for Purposes of the Continuity of Interest Requirement?



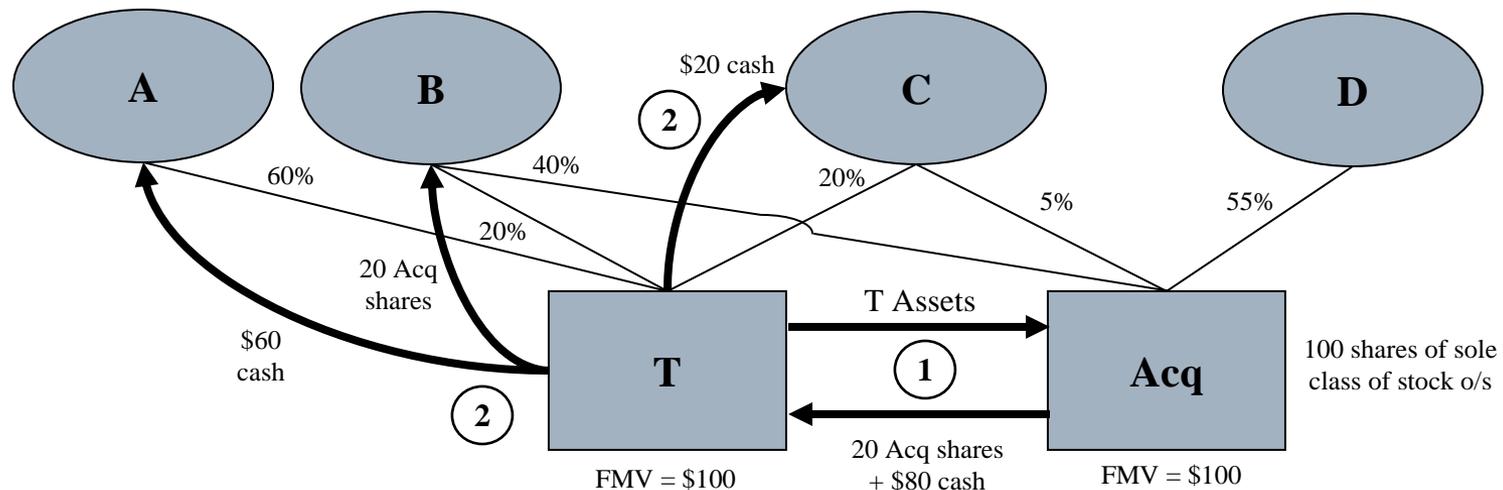
- D reorganization statutory requirements are satisfied (D owns 100% of Acq shares immediately after the transaction).
- COI under Treas. Reg. section 1.368-1(e) may be satisfied (“all facts and circumstances must be considered in determining whether, in substance, a proprietary interest in [T] is preserved.”).
- Is COI satisfied in the above transaction?
  - Possible Standard: To the extent a T shareholder receives non-qualifying consideration, such consideration shall be treated as qualifying consideration to the extent such shareholder’s percentage interest in T (based upon value) is the same or less than such shareholder’s percentage interest in Acq (based upon value) immediately prior to the transaction.
  - Under such a standard, COI satisfied.

# Example 13: Continuity of Shareholder Interest—Related Person Acquisition



- D reorganization statutory requirements are satisfied (D owns 100% of Acq shares immediately after the transaction).
- Steps 1 and 2 should be treated as a reorganization that satisfies the COI requirement (40% of the total consideration is qualifying consideration) notwithstanding Step 3. *See* Treas. Reg. § 1.368-1(e)(3) (related person acquisitions).

# Example 14: When Should Cash be Treated as Acq Stock for Purposes of the Continuity of Interest Requirement (Continued)?



- D reorganization statutory requirements are satisfied (B and C own 65 of 120 Acq shares outstanding immediately after the transaction).
- COI under Treas. Reg. section 1.368-1(e) is not satisfied (only 20% qualifying consideration issued).
- Is COI satisfied in the above transaction?
  - Under standard proposed in Example 12, COI failed (assuming 25% fails COI; B's 20 shares of Acq stock plus \$5 of the \$20 received by C).

# D Reorganizations

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Liquidation-Reincorporation

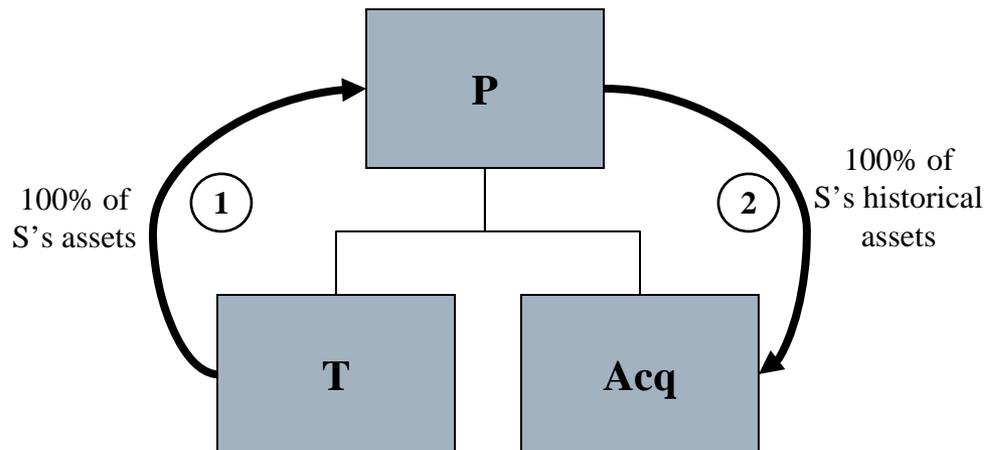
# Continued Vitality of Liquidation-Reincorporation Authorities

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- A transaction otherwise qualifying as a reorganization will not be disqualified or *recharacterized* as a result of a transfer of 100% of T's assets to a section 368(c)-controlled corporation provided Acq does not terminate its corporate existence in connection with the transfer. *See* Treas. Reg. § 1.368-2(k)(1), (2) (Ex. 1); *see also* Rev. Rul. 69-617, 1969-2 C.B. 57; *cf.* Treas. Reg. § 1.331-1(c) (possible recharacterization of liquidation followed by transfer of some or all of T's assets to Acq as either a (i) section 301 distribution from T where Acq is alter ego of T or (ii) D reorganization where boot is subject to section 356).

## Example 15: Form Respected/No *Alter Ego*

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- The above transaction should be treated as an upstream C reorganization followed by permitted transfer of T's assets by P to Acq pursuant to section 368(a)(2)(C). Treas. Reg. § 1.368-2(k)(1).
- The above transaction should *not* be recharacterized as a D reorganization. Thus, if P had retained some T assets, P's receipt of the retained T assets should not be subject to section 356.

# Section 108(i)

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## Overview of COD Deferral Provision

## COD Income – Debt Extinguishment Generally

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- General Rule: A debtor recognizes COD income upon the repurchase of a debt instrument for an amount less than its “issue price.”
  - For non-publicly traded debt issued for money, the issue price generally is the price paid by the initial purchaser of the debt.
  - For publicly traded debt, the issue price generally is the initial issue price to the public at which price a substantial amount of such debt is sold to the public.

# COD Income: Background

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- Included COD income
  - General rule: COD income included in gross income under section 61(a)(12).
- Excluded COD income
  - COD income excluded from gross income if an exception under section 108(a)(1) applies.
    - The discharge occurs in a title 11 case.
    - The discharge occurs when the taxpayer is insolvent (excluded only to the extent of the insolvency).
- Deferred COD income
  - New section 108(i)
  - Enacted under American Recovery and Reinvestment Tax Act of 2009.

## New Section 108(i): General Rules

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- Taxpayer may elect to defer COD income arising from a “reacquisition” of applicable debt in 2009 or 2010.
  - Additional guidance provided by Rev. Proc. 2009-37, including procedures for making the election and section 9100 relief procedures for late elections.
  - Applicable debt is:
    - Any debt issued by a C corporation or
    - Debt issued by an individual or pass-through entity (*e.g.*, a partnership) in connection with a trade or business.
    - In the case of an intercompany obligation, only an instrument for which COD income is realized under Treas. Reg. section 1.1502-13(g)(5).

## New Section 108(i): General Rules (continued)

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- Taxpayer may elect to defer COD income arising from a “reacquisition” of applicable debt in 2009 or 2010.
- A “reacquisition” includes:
  - An acquisition of debt for cash or property by the taxpayer or a related party,
  - A debt-for-debt exchange (including a significant modification of existing debt),
  - A debt-for-equity exchange, and
  - Forgiveness of debt.

## New Section 108(i): General Rules (continued)

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- COD income is deferred until 2014, at which point it is included ratably in the taxpayer's income over 5 years (*i.e.*, from 2014 through 2018).
- If COD income arises in a transaction in which debt remains outstanding, any discount will be treated as OID.
  - If COD income is deferred, OID also must be deferred and recognized in the same years as the COD income.
  - Matching of income and deductions – both timing and amount. As a result, COD income and OID should net to zero. Prior to the COD income deferral provision, the issuer would have recognized upfront COD income, which would be deducted over time as OID (a timing detriment to the issuer).
- In a transaction in which debt is retired at a discount, the COD income deferral election merely defers income recognition.

## New Section 108(i): Election

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- If an election is made to defer COD income under section 108(i), then exceptions to exclude COD income (*e.g.*, as a result of insolvency or bankruptcy) do not apply.
  - A protective election is available to claim deferral election in the event that bankruptcy and insolvency exclusion is not sustained.
- The election to defer COD income is made on a debt-by-debt basis (or with respect to a portion of a single debt instrument). Any COD income for which an election is not made can still qualify for exclusion under section 108(a).

## New Section 108(i): Election (continued)

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- Once made, the election is irrevocable.
- An election to defer COD income and any attendant OID deduction does not affect a taxpayer's E&P (with certain exceptions for RICs and REITs).
- The election to defer COD income may not always be the best choice for a taxpayer (*i.e.*, COD income exclusion with attendant tax attribute reduction may be preferable in certain circumstances).

## New Section 108(i): Acceleration Events

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- Deferred COD income may be accelerated upon certain events:
  - Bankruptcy filing;
  - Liquidation;
  - Assets or partnership interest dispositions; or
  - Business cessation.

# Section 108(i)

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## Issues in Consolidation

## Application of Section 108(i) to Intercompany Debt

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- Rev. Proc. 2009-37 provides that in the case of an intercompany obligation (as defined in Treas. Reg. section 1.1502-13(g)(2)(ii)), an applicable debt instrument only includes an instrument for which COD income is realized upon the deemed satisfaction pursuant to Treas. Reg. section 1.1502-13(g)(5).
- For intercompany obligations subject to Treas. Reg. section 1.1502-13(g)(3), the approach of the current consolidated return intercompany regulations is sufficient and section 108(i) is not necessary.

# Important Definitions

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- *Intercompany Transaction* -- Transaction between corporations that are members of the same consolidated group immediately after the transaction.
- *Intercompany Item* – S's income, gain, deduction, and loss, whether directly or indirectly, from an intercompany transaction.
- *Corresponding Item* – B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction.
- *Recomputed Corresponding Item* – Corresponding items that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those two divisions.

# Important Rules

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- *Matching Rule* – In general, reflects the application of the divisional treatment concept to produce the same result in a consolidated return as if the two members involved in the intercompany transaction were divisions of a single corporation. Generally, S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.
- *Acceleration Rule* – S's intercompany items and B's corresponding items are taken into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation (*e.g.*, B or S leaves the consolidated group or a non-member reflects any aspect of the intercompany transaction (typically the asset's basis)).

# Application of Section 108(i) to Non-Intercompany Debt Becoming Intercompany Debt

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- Generally, under Treas. Reg. section 1.1502-13(g)(5), when non-intercompany debt becomes intercompany debt, the debt is deemed satisfied for an amount determined under the principles of Treas. Reg. section 1.108-2(f).
  - If the debt has been acquired within the last 6 months, it is deemed satisfied for the holder's adjusted basis in the debt.
  - If the holder has acquired the debt outside the 6 month period, the deemed satisfaction amount is fair market value.

## Application of Section 108(i) to Non-Intercompany Debt Becoming Intercompany Debt (continued)

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- If upon the acquisition of a subsidiary, non-intercompany debt becomes intercompany debt; the debt is satisfied for FMV (outside the 6 month period) and the FMV of the debt is less than the adjusted issue price of the debt, then:
  - The issuer should recognize COD income.
  - The holder should recognize a capital loss.
  - Section 108(i) can apply to the COD income recognized by the issuer.
  - The application of the intercompany transaction regulations is not expressly addressed.

## Application of Section 108(i) to Non-Intercompany Debt Becoming Intercompany Debt (continued)

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- Based on Treas. Reg. section 1.1502-13, if a section 108(i) election is made, the capital loss recognized by the holder should be deferred and “matched” with the recognition of the COD income.
- What about the OID?
  - Generally, the intercompany item and the corresponding item offset in amount (and have the same character).
  - However, because section 108(i)(2) requires the OID deduction to be deferred, the OID income should also be deferred under the matching rule.

# Application of Section 108(i) Acceleration Rules to Section 332 Subsidiary Liquidations

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- As previously stated, the deferred COD income under section 108(i) is accelerated in certain circumstances, including a liquidation.
- Query whether this result is appropriate in the context of a consolidated group (*e.g.*, where a subsidiary with a section 108(i) election liquidates in a section 332 transaction into its parent)?

# Application of Section 108(i) Acceleration Rules to Section 332 Subsidiary Liquidations (continued)

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- General framework for Section 332 liquidations:
  - The parent corporation succeeds to the liquidated subsidiaries attributes under section 381 (*e.g.*, NOLs, E&P, capital loss carryovers, accounting methods, *bond discount*, etc.).
  - Section 381(c) does not provide an exclusive list of attributes. *See* *Dover Corp. v. Comm’r* 122 T.C. 324 (2004).
  - The parent corporation would be treated as the liquidating subsidiary’s successor for purposes of the intercompany transaction rules. *Treas. Reg.* § 1.1502-13(j)(2).

## Application of Section 108(i) Acceleration Rules to Section 332 Subsidiary Liquidations (continued)

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- Where the COD income deferral election is made with respect to a debt-for-debt exchange, one could argue that section 381(c)(9), which provides that the parent steps into the shoes of the liquidating subsidiary for purposes of OID accounting, should trump section 108(i)'s acceleration provision.
- This argument would be unavailable, however, where the COD income deferral arises in connection with an extinguishment of the debt.
- As a matter of policy, acceleration may be inappropriate; however, the literal language of section 108(i) may mandate acceleration in this context.

# Application of Section 108(i) Acceleration Rules to Section 332 Subsidiary Liquidations in a Consolidated Group

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- Even if the “section 108(i) acceleration rule” were to apply generally as a result of a section 332 liquidation, the consolidated return intercompany transaction regulations should apply to continue to defer the COD income where the liquidating subsidiary corporation (S) and its parent corporation (P) have historically filed a consolidated return.

## Example Applying the Intercompany Transaction Rules

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- Assume (i) P owns all the stock of S, (ii) P and S are members of a consolidated group, (iii) in 2009, S elects under section 108(i) to defer \$100 of COD income, and (iv) S liquidates into P in a section 332 transaction on December 31, 2009.
  - S's distribution of its assets to P in the section 332 liquidation is an intercompany transaction.
  - If the liquidation triggers the “section 108(i) acceleration rule,” then S has an intercompany item (its realized section 108(i) income recapture that directly or indirectly results from the intercompany transaction).

## Example Applying the Intercompany Transaction Rules (continued)

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- Assume (i) P owns all the stock of S, (ii) P and S are members of a consolidated group, (iii) in 2009, S elects under section 108(i) to defer \$100 of COD income, and (iv) S liquidates into P in a section 332 transaction on December 31, 2009.
  - P is a “successor person” to S as a result of the section 332 liquidation (which is a section 381(a) transaction) and succeeds to S’s intercompany item.
  - P’s corresponding item under section 332 is \$0 because P has no income, gain, deduction or loss from the liquidation or the property acquired in the liquidation.
  - The matching rule continues to apply, and the section 108(i) deferral continues through 2014, at which time, P would be required to annually recognize \$20 COD income (difference between P’s corresponding item of \$0 and the recomputed corresponding item of \$20) for five years.

# Broader Implications of Consolidated Intercompany Transaction Regulations

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- Continued deferral of COD income might apply in other contexts. For example, if S has a section 108(i) deferral election in place, and S sells substantially all of its assets to P, continued deferral of the COD income should be available (using the same reasoning applied to intercompany liquidations).