Schulte Roth & Zabel

18th annual private investment funds seminar

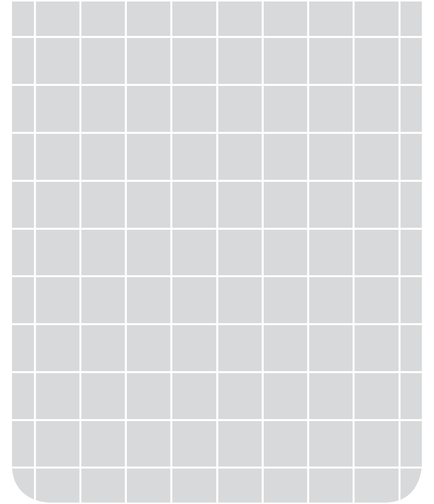
Tuesday, January 13, 2009

Tax Aspects of Investments in Distressed Situations

Philippe Benedict, Dominique Padilla Gallego, Kurt Rosell and Shlomo Twerski

1. About the Speakers
2. Overview of Section 382: The Effects of an Ownership Change on NOLs
3. Recent Developments Relating to Cancellation of Debt (COD) Income
4. Additional Materials
5. PowerPoint Presentation

About the Speakers



Philippe Benedict
919 Third Avenue
New York, NY 10022
212.756.2124
philippe.benedict@srz.com

Philippe Benedict is a partner in the Tax Group at Schulte Roth & Zabel LLP. His practice concentrates on the tax aspects of investment funds, mergers & acquisitions, international transactions, real estate transactions and financial instruments.

Philippe is a graduate of the New York University School of Law, where he received a J.D. in 1990 and an LL.M. in 1993. During law school, he was a staff member of the *Journal of International Law and Politics* and a recipient of a Gruss Fellowship. He received his B.S. in 1985 from Adelphi University.

Dominique Padilla Gallego
919 Third Avenue
New York, NY 10022
212.756.2332
dominique.gallego@srz.com

Dominique Padilla Gallego is a partner in the Tax Group at Schulte Roth & Zabel LLP. She focuses her practice on U.S. federal income tax matters related to investment funds, financial products and structured finance transactions.

Dominique was awarded an LL.M. in International Taxation from New York University School of Law; received a J.D., *cum laude* and valedictorian, from Ateneo de Manila University in Manila, Philippines; and obtained her undergraduate degree, *summa cum laude*, from De La Salle University in Manila, Philippines. Dominique is a recipient of the AT&T Asia Pacific Leadership Award. Prior to joining SRZ, Dominique was an associate at Sidley Austin. She is a member of the New York State Bar Association, the American Bar Association and the Integrated Bar of the Philippines.

Kurt F. Rosell
919 Third Avenue
New York, NY 10022
212.756.2099
kurt.rosell@srz.com

Kurt F. Rosell is a partner in the Tax Group at Schulte Roth & Zabel LLP. His practice focuses on the tax aspects of mergers and acquisitions; leveraged buyout and other private equity transactions; taxation of international transactions; formation of private equity funds; executive compensation; and bankruptcy and work-out transactions.

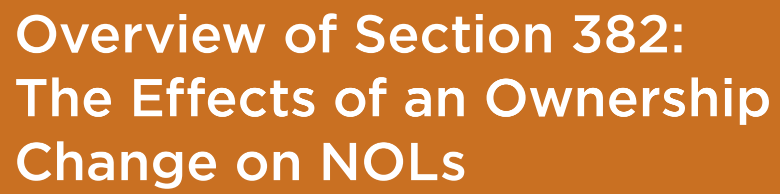
Kurt earned his LL.M in Taxation from the New York University School of Law in 1992; his J.D. from Columbia University School of Law, where he was a senior editor of the *Columbia Law Review* and a Harlan Fiske Stone Scholar, in 1985; and his B.A., *magna cum laude* and Phi Beta Kappa, from Wake Forest University in 1982. He is listed in *The Best Lawyers in America* and *Super Lawyers*.

Shlomo C. Twerski
919 Third Avenue
New York, NY 10022
212.756.2510
shlomo.twerski@srz.com

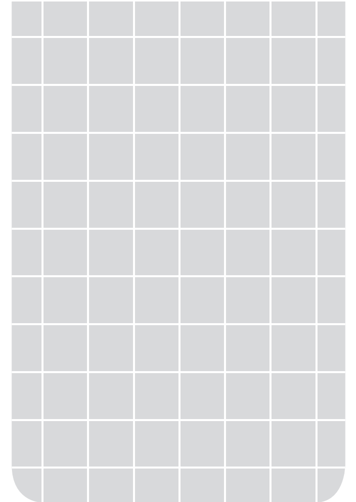
Shlomo C. Twerski is a partner in the Tax Group at Schulte Roth & Zabel LLP. His practice focuses on the tax aspects of:

- Onshore and offshore investment funds
- Private equity partnerships
- Real estate and corporate transactions
- Restructurings and workouts
- Securitizations
- Existing and emerging financial instruments

Shlomo is a 1983 graduate of Hofstra University School of Law, where he was an articles editor of the *Hofstra Law Review*. He is a member of the Tax Section of the New York State Bar Association and regularly speaks on tax issues.



Overview of Section 382: The Effects of an Ownership Change on NOLs



> Overview of Section 382: The Effects of an Ownership Change on NOLs

Kurt Rosell and Misti Bridges

I. Section 382: General Overview

A. Prevention of Loss Trafficking

B. Applies Upon an "Ownership Change"

C. Imposes a Limitation on the Use of Pre-Change and Built-In Losses

D. Can Carryover Unused Limitation

E. Built-In Gains Help with Limitation

F. Special Rules in Bankruptcy Cases

II. "Ownership Change" Defined

A. An ownership change occurs if, immediately after any owner shift involving a 5% shareholder or any equity structure shift:

1. The percentage of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points *over*

2. The lowest percentage of stock of the loss corporation owned by those shareholders at any time during the testing period

III. Ownership Change

A. Need ownership increase of more than 50 percentage points

B. Measure change as of the close of a "testing date"

IV. Testing Date Triggers

A. Owner Shifts—any transfer by a 5% shareholder of loss corporation stock

1. Includes taxable purchases and dispositions, tax-free exchanges under §351, redemptions, stock issuances, and debt conversions

B. Equity Structure Shift—any tax-free reorganization except for divisive D and G reorganizations and F reorganizations

C. Overlap—equity structure shifts are also owner shifts but do not require transfers by 5% shareholders

V. Measuring an Ownership Change

A. Only look at increases of 5% shareholders; if 5% shareholder's interest decreased or remained the same, ignore it

B. Must aggregate all increases of 5% shareholders to see if the increase exceeds 50 percentage points

VI. Examples of How to Measure Ownership Changes

A. Example 1

Shareholder A has owned 30 out of 100 shares in Corporation for many years. Shareholder A buys 30 more shares of Corporation from the general public. Shareholder A's ownership increase for §382 purposes is a 30 percentage point increase (from 30% to 60%). If there are no other transfers during the testing period, Corporation has not experienced an ownership change.

B. Example 2

Assume the same facts as above, except that Shareholder A sells 20 of his original 30 shares on Date 1 and purchases 55 shares on Date 2 (and Date 2 is within three years of Date 1). A's ownership increase for §382 purposes is 55 percentage points (comparing lowest 10% to highest 65%). Corporation has experienced an ownership change.

VII. Public Trading

A. Public Trading Rule

1. Daily public trading of stock should not trigger an ownership change. All shareholders who own less than 5% can freely trade their stock except to a 5% shareholder.

VIII. Testing Period

A. Generally, the testing period is the three-year period ending on the day of any owner shift or equity structure shift.

B. No requirement that related transactions cause the 50+ percentage point increase; likewise, related transactions outside of the testing date are irrelevant.

C. Shorter testing period where Corporation previously experienced an ownership change.

IX. 5% Shareholder

A. Defined

1. In measuring ownership changes, only look at 5% shareholders.

2. A 5% shareholder is any person (or entity) holding 5% or more of the loss corporation's stock at any time during the testing period.

3. 5% is measured by value of loss corporation stock.

B. Aggregation

1. In determining who is a 5% shareholder, certain persons' stock holdings may be aggregated and treated as held by an entity. If the entity would hold 5% or more of the stock, the entity is a 5% shareholder.

2. An "entity" includes a group of persons who have a "formal or informal understanding among themselves to make a coordinated acquisition of stock." A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members.

3. Query: Should investment funds managed by same manager that typically invest side-by-side be treated as an entity for §382 purposes and their interests in loss corporation aggregated in determining whether they are a 5% shareholder?

4. Answer: PLR 200605003 (Feb. 3, 2006; attached). SRZ obtained a ruling that such funds did not constitute an "entity" for §382 purposes, and thus their interests were not aggregated for purposes of determining 5% shareholder status. The ruling is fact-specific, though.

5. Aggregate all persons/entities owning less than 5% and treat as a single 5% shareholder (so-called public shareholder).

6. Complex segregation rules.

7. Rules of convenience and presumptions can help.

   (a) For example, public companies may rely on SEC filings to identify their shareholders.

C. Constructive Ownership Rules

1. §318 attribution rules generally apply in determining who is a 5% shareholder for §382 purposes, with modifications.

X. "Loss Corporation" Defined

A. Generally, a loss corporation is any corporation entitled to use an NOL carryover or which incurs a NOL in a year in which a testing date occurs.

B. Also includes a corporation with a NUBIL and certain other tax attributes.

XI. §382 Limitation

A. If ownership change occurs, pre-change year losses can offset post-change year income only up to a certain amount (such amount is the "§382 limitation amount").

B. Pre-change losses generally are: NOL carryforwards to change year plus change year NOL allocable to the pre-change period.

XII. Calculating §382 Limitation

Annual limitation on pre-change year losses equal to:

Value of Loss Corporation X Long-Term Tax-Exempt Rate (5.4% as of 12/08)

A. Value of Loss Corporation is FMV of its stock

1. For public company, use mean stock price on change date times number of shares outstanding

2. Determined *immediately before* ownership change

3. Must reflect redemptions in connection with change

4. Beware of anti-stuffing rule-can't contribute new capital in anticipation of ownership change

5. Special rules apply in bankruptcy context

XIII. Carryover of Unutilized §382 Limitation

A. To extent §382 limitation exceeds the current year income, taxpayer can carry forward excess §382 limitation to next year.

B. Carryover of excess §382 limitation amount is available as long as the pre-change losses are available.

XIV. Continuity of Business Requirement

A. Corporation must continue the business that generated the pre-change losses for two years after ownership change.

B. If fail to continue loss business, §382 limitation generally is reduced to zero; lose all pre-change losses.

C. §382 adopts continuity definition in reorganization provisions:

Must continue historic loss business OR use significant portion of loss corporation's assets in new business.

XV. NUBIGs & NUBILs

A. When corporation has a NUBIG, built-in gains recognized in recognition period increase §382 limitation for such taxable year.

B. When corporation has a NUBIL, built-in losses recognized in recognition period are subject to §382 limitation as if such losses were pre-change losses.

C. NUBIG/NUBIL effect on §382 limitation is only during "Recognition Period."

D. "Recognition Period" is five-year period beginning on change date.

XVI. Computing NUBIGs & NUBILs

A. Generally, take aggregate adjusted bases of all assets and compare to aggregate FMV of assets. If bases are higher than FMV, then NUBIL. If bases are lower than FMV, then NUBIG.

B. Determine immediately before ownership change

C. Ignore NUBIG or NUBIL if either does not exceed the lesser of:

1. $10 million or

2. 15% of the FMV of assets (excluding cash, receivables and certain marketable securities)

XVII. Establishing NUBIG/NUBIL Amounts

A. Burden on taxpayer to establish NUBIG/NUBIL amounts

B. Taxpayer should get an appraisal of assets at time of ownership change

C. Safe Harbors—Notice 2003-65

1. §1374 Approach (S corporation approach)

2. §338 Approach

XVIII. Bankruptcy Proceedings §382(l)(5)

A. §382(l)(5) bankruptcy exception

1. Corporation must be under Title 11 bankruptcy jurisdiction and

2. Continuing shareholders and "qualified creditors" of corporation must own at least 50% of corporation immediately after the ownership change.

(a) "Qualified Creditors" are (i) old and cold creditors (18 months prior to Title 11 filing) or (ii) trade creditors that have continuously held such debt.

(b) Assume continuous ownership of debt if former debtholder will not be a 5% shareholder or an entity through which a 5% shareholder owns an indirect interest in the corporation immediately after the ownership change (absent actual knowledge to contrary).

B. No continuity of business requirement

1. Beware of §269 though (need more than insignificant amount of active trade or business)

C. "Toll Charge" for (l)(5)

1. Loss corporation must reduce its NOL carryovers but such NOL carryovers are fully deductible against post-change income.

2. Toll charge equals:

(a) Denial of interest deductions during three taxable years preceding the taxable year of the ownership change AND during part of change year ending on change date.

3. Recalculate NOL carryover as if no deduction allowed for the denied interest deductions.

D. §382 Limitation reduced to zero where second ownership change within two years

E. Debtor can elect out of §382(l)(5)

1. Debtor may want to elect out where ownership change in next two years is foreseeable

F. In order to avoid subsequent ownership changes, Bankruptcy Court may impose trading restrictions on corporation stock prior to reorganization and post-reorganization (so-called Trading Order).

1. Trading Orders typically restrict the trading of a bankrupt corporation's stock by shareholders holding a certain percentage of stock (usually something slightly less than 5%).

2. See example of Trading Order in materials.

XIX. Bankruptcy Proceedings §382(l)(6)

A. §382(l)(6) relief

1. Available for bankrupt corporations that cannot qualify for (l)(5) or elect out of (l)(5) treatment.

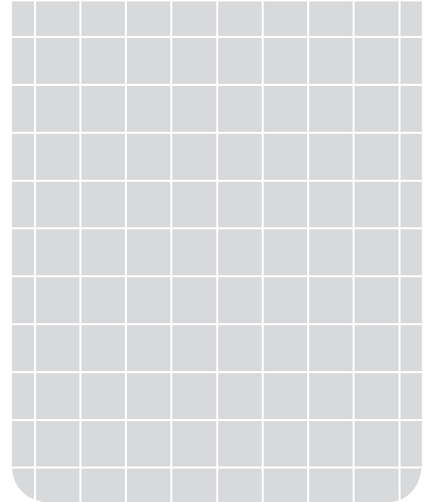
2. Value of corporation for §382 Limitation is increased by surrender or cancellation of creditor claims even if such cancellation does not occur immediately before the ownership change.

3. Relief preserved even if second ownership change within two years.

XX. Recent Change Re: Banks

A. Notice 2008-83 provides that after an ownership change of a bank, losses on loans and bad debts (including a deduction for a reasonable addition to a reserve for bad debts) are not treated as built-in loss items or deductions attributable to periods before the change date for §382 purposes.

Recent Developments Relating to Cancellation of Debt (COD) Income



> Recent Developments Relating to Cancellation of Debt (COD) Income

Dominique Padilla Gallego and Audrey Wei

I. Background: Income from Discharge of Indebtedness

A. Section 61(a)(12) sets forth the general rule that gross income includes income from discharge of indebtedness.

1. Section 108(a) lists certain exceptions, including that gross income does not include income from discharge of indebtedness in the context of a bankruptcy filing, or to the extent that the debtor is insolvent.

B. In calculating the amount of income arising for discharge of indebtedness, Section 108(e)(8) provides:

1. If a corporation transfers stock to a creditor in satisfaction of debt, then the corporation is deemed to have satisfied the debt with the fair market value ("FMV") of the stock.

2. If a partnership transfers a partnership interest to a creditor in satisfaction of debt (partnership debt-for-equity exchange), then the partnership is deemed to have satisfied the debt with the FMV of the partnership interest.

II. Proposed Regulations Clarifying the Application of Section 108(e)(8) to Partnerships[i]

A. Valuation of partnership debt-for-equity interest

1. The proposed regulations permit the use of liquidation value as a proxy for FMV in a partnership debt-for-equity exchange, provided the following requirements are met:

(a) The partnership determines and maintains capital accounts in accordance with Treas. Reg. Section 1.704-1(b)(2)(iv) capital accounting rules;

(b) The creditor, the partnership and its partners treat the FMV of the debt as equal to the liquidation value of the transferred interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(c) It is an arm's-length exchange; and

(d) The partnership and persons related thereto do not repurchase the transferred interest as part of a plan whose principal purpose is avoidance of COD income.

2. The proposed regulations define "liquidation value" as the cash that a creditor/new partner would receive for the transferred interest if, immediately after transfer, the

partnership sold all of its assets (including all its intangibles) for cash equal to the FMV of those assets, and then liquidated.

3. Hypothetical:

   (a) AB partnership ("AB") owes $1,000 to C.

   (b) C cancels the debt in exchange for an interest in AB.

   (c) The debt's FMV is $700.

   (d) AB determines and maintains its partners' capital accounts according to Treas. Reg. Section 1.704-1(b)(2)(iv).

   (e) Under Treas. Reg. Section 1.704-1(b)(2)(iv)(b), C's capital account is increased by $700, which is the liquidation value of C's debt-for-equity interest.

   (f) All parties treat the FMV of the debt as being equal to the liquidation value of C's debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange.

   (g) AB does not redeem C's interest, directly or indirectly, as part of a preconceived plan.

   (h) Conclusion: Because all four requirements in the proposed regulations are met, the deemed FMV of C's interest, for the purpose of determining AB's COD income in respect of satisfying the $1,000 indebtedness, is $700.

B. Non-recognition treatment under Section 721

1. The proposed regulations also provide for non-recognition treatment under Section 721 from the standpoint of the creditor.

   (a) Therefore, if a creditor contributes partnership indebtedness to a debtor partnership in exchange for debtor's partnership interest, then the creditor does not recognize any income or loss.

2. The explanations to the proposed regulations further provide that:

   (a) Section 722 should apply to a partnership debt-for-equity exchange so that the creditor's basis in the interest equals the debt's adjusted basis, and

      (i) Therefore, if the liquidation value of the interest is less than the outstanding principle balance of indebtedness, then the creditor does not recognize any loss in the exchange; rather, the creditor's basis in exchanged interest will be increased by the adjusted basis of indebtedness.

   (b) Section 721 should apply to a partnership debt-for-equity exchange so that the creditor's holding period in the partnership interest includes the creditor's holding period in the debt under Section 1223(1).

C. Exception for unpaid rent, royalties, and interest

1. The regulations provide that the non-recognition treatment will not apply to:

(a) unpaid interest (including accrued original issue discount),

(b) unpaid rent, or

(c) unpaid royalties.

D. Practical Implications

1. In certain situations, parties to an arm's-length exchange of debt for a partnership interest will have more certainty concerning the tax treatment of the exchange.

2. If the amount of outstanding debt exceeds the value of partnership interest received, no loss is recognized by a creditor in a debt-for-equity exchange.

III. Exclusion of Income: Non-Corporate Entities and Contribution to Capital[ii]

A. Partnerships and other non-corporate entities have taken the position that an exclusion of income is available in the case of contributions to capital under Section 118(a), which generally provides that "in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer," and/or under an alleged "common law contribution to capital doctrine."

B. A Coordinated Issue Paper to all industries clarified that:

1. Section 118 does *not* apply to non-corporate entities; <u>and</u>

2. There is no common law contribution to capital doctrine for non-corporate entities.

C. Therefore, if a third party/non-owner contributes (for nothing in exchange) to the capital of a non-corporate entity (e.g., partnership), then such amounts are includable in the gross income of the recipient.

D. Practical implications

1. Partnerships and other non-corporate entities should not take the position that capital contribution-type debt discharges by third parties are excludable from income without any tax to them, either by reason of Section 118 or any common law contribution to capital doctrine.

IV. Final and Temporary Regulations on Section 6050P Information Reporting Requirements[iii]

A. Under Section 6050P and existing regulations, any "applicable entity" that discharges indebtedness of any person of at least $600 must file an information return (Form 1099-C) and furnish an information statement to such person.

B. An "applicable entity" covers an executive, judicial or legislative agency, and an applicable financial entity.

C. An “applicable financial entity” includes: (1) a financial institution described in Section 581 (banks) or Section 591(a) (savings institutions), (2) a credit union, (3) a federal executive agency and (4) an organization, a significant trade or business of which is lending money.

D. The regulations deem a discharge of indebtedness to have occurred if and only if an “identifiable event” occurs. An “identifiable event” includes the expiration of a “non-payment testing period.”

E. In defining “non-payment testing period,” the regulations provide that there is a rebuttable presumption that an identifiable event has occurred if a creditor has not received a payment from a debtor at any time for 36 months (the “36-months rule”). However, the presumption that an identifiable event has occurred may be rebutted by the creditor if (1) the creditor has engaged in significant, bona fide collection activity, or (2) the facts and circumstances indicate that the debt has not been discharged.

F. Prior to the issuance of the final and temporary regulations, every “applicable entity” must comply with the “36-months rule.”

G. The final and temporary regulations provide that only (1) financial institutions, (2) credit unions and (3) federal executive agencies must comply with the “36-months rule.”

H. Key Rationale and Effect

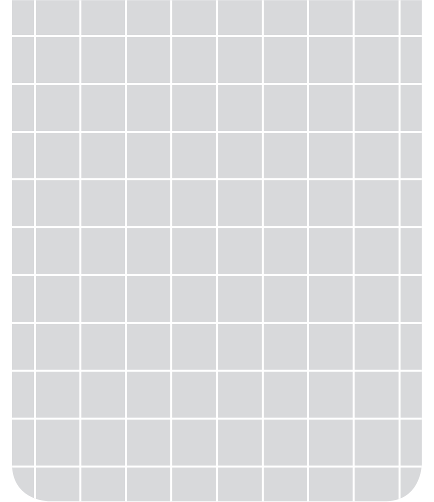
   1. To avoid premature information-reporting of cancellation of indebtedness income.

   2. To protect debtors from receiving information returns that prematurely report cancellation of indebtedness income.

---

[i] Reg-164370-05/RIN 1545-BF27/Tax Analyst Doc 2008-23074
[ii] LMSB4-1008-051/Tax Analyst Doc 2008-24495
[iii] TD 9430/RIN 1545-BH99/TD 9430/Tax Analyst Doc 2008-23679

Additional Materials



IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	:	**Chapter 11**
WASHINGTON MUTUAL, INC., et al.,[1]	:	**Case No. 08-12229 (MFW)**
Debtors.	:	**(Jointly Administered)**
		Re: Docket No. 155

FINAL ORDER PURSUANT TO SECTIONS 105(a) AND 362 OF THE BANKRUPTCY CODE ESTABLISHING NOTIFICATION PROCEDURES AND APPROVING RESTRICTIONS ON CERTAIN TRANSFERS OF INTERESTS IN THE DEBTORS' ESTATES

Upon the motion, dated October 24, 2008 (the "Motion")[2] of Washington Mutual, Inc. ("WMI") and WMI Investment Corp. ("WMI Investment"), as debtors and debtors in possession (collectively, the "Debtors"), pursuant to sections 105(a) and 362 of title 11 of the United States Code (the "Bankruptcy Code"), seeking entry of a final order (the "Final Order") to establish notification procedures and approve restrictions on transfers of certain equity interests in WMI, as more fully described in the Motion; and the Court having jurisdiction to consider the Motion and the relief requested therein pursuant to 28 U.S.C. §§ 157 and 1334; and consideration of the Motion and the relief requested being a core proceeding pursuant to 28 U.S.C. § 157(b); and venue being proper before this Court pursuant to 28 U.S.C. §§ 1408 and 1409; and due and proper notice of the Motion having been provided to the Notice Parties; and it appearing that no other or further notice need be provided; and the Court having entered an

[1] The Debtors in these chapter 11 cases along with the last four digits of each Debtor's federal tax identification number are: (i) Washington Mutual, Inc. (3725); and (ii) WMI Investment Corp. (5395). The Debtors' principal offices are located at 1301 Second Avenue, Seattle, Washington 98101.

[2] All capitalized terms not expressly defined herein shall have the meaning ascribed to them in the Motion.

interim order granting the relief requested in the Motion on November 7, 2008 (the "Interim Order"); and the Court having reviewed the Motion and having heard the statements in support of the relief requested at the hearing on the Motion; and the Court having determined that the relief sought in the Motion pursuant to this Final Order is in the best interests of the Debtors, their creditors and all parties in interest; and the Court having determined that the legal and factual bases set forth in the Motion establish just cause for the relief granted herein; and upon all of the proceedings had before the Court and after due deliberation and sufficient cause appearing therefore, it is FOUND that:

1. The consolidated net operating tax loss carryforwards ("NOLs") and certain other tax attributes (together with NOLs, the "Tax Attributes") of WMI and its subsidiaries are property of the Debtors' estates and are protected by the automatic stay prescribed in section 362 of the Bankruptcy Code;[3]

2. Unrestricted trading of certain equity interests in WMI during the pendency of the Debtors' bankruptcy cases could severely limit the Debtors' ability to utilize the Tax Attributes for purposes of title 26 of the United States Code (the "Tax Code"), as set forth in the Motion;

3. The notification procedures and restrictions on transfers of WMI's common stock, certain classes of preferred stock and options to acquire such stock are necessary and proper to preserve the Tax Attributes and are therefore in the best interests of the Debtors, their estates, and their creditors;

[3] This Order does not affect the rights, titles, and interests, if any, of WMB or WMBfsb or FDIC or JPMorgan Chase & Co. with respect to the Tax Attributes; provided, however, that the foregoing shall not excuse JPMorgan Chase & Co. from any of the restrictions, requirements or procedures on or regarding acquisitions, dispositions and other transfers contained in this Order to the extent any of the foregoing would be otherwise applicable to JPMorgan Chase and Co.

4. The relief requested in the Motion is authorized under sections 105(a) and 362 of the Bankruptcy Code; and

5. On November 7, 2008, the Court entered the Interim Order (i) establishing notification procedures and approving restrictions on transfers of certain equity interests in WMI, and (ii) scheduling a final hearing. This Final Order will supersede the Interim Order.

THEREFORE, IT IS:

ORDERED that the Motion is granted on a final basis; and it is further

ORDERED that the provisions of this Final Order shall be effective, *nunc pro tunc*, to the date of the Motion; and it is further

ORDERED that all objections to the Motion not previously withdrawn are overruled; and it is further

ORDERED that any acquisition, disposition or other transfer in violation of the restrictions set forth herein shall be null and void *ab initio* as an act in violation of the automatic stay prescribed in section 362 of the Bankruptcy Code and pursuant to this Court's equitable power prescribed in section 105(a) of the Bankruptcy Code. For purposes of this Final Order, any trades made before the entry of the Interim Order shall not be subject to this Final Order; and it is further

ORDERED that the following procedures and restrictions shall apply to trading in WMI Stock (as defined below) and are approved:

(1) Notice of Substantial WMI Stock Ownership. Any person or entity that beneficially owns, at any time on or after the filing date of the Motion, WMI Stock in an amount sufficient to qualify such person or entity as a Substantial Equityholder (as defined below) shall file with the Court, and serve upon the Debtors, Debtors' counsel, the Creditors' Committee's counsel, and counsel to Washington Mutual, Inc. Noteholder Group, a Notice of Substantial Stock Ownership (a "Substantial Ownership Notice"), in the form attached hereto as Exhibit "1," specifically and in detail describing the WMI Stock ownership of

such person or entity, on or before the date that is the later of: (a) ten (10) days after the entry of the Court's order or (b) ten (10) days after that person or entity qualifies as a Substantial Equityholder. At the holder's election, the Substantial Ownership Notice to be filed with the Court may be redacted to exclude such holder's taxpayer identification number and the number of shares of WMI Stock that such holder beneficially owns.

(2) Acquisition of WMI Stock or Options. At least twenty (20) calendar days prior to the proposed date of any transfer of equity securities (including Options, as defined below, to acquire such securities) that would result in an increase in the amount of WMI Stock beneficially owned by any person or entity that currently is or becomes a Substantial Equityholder or that would result in a person or entity becoming a Substantial Equityholder (a "Proposed Equity Acquisition Transaction"), such person, entity or Substantial Equityholder (a "Proposed Equity Transferee") shall file with the Court, and serve upon the Debtors, Debtors' counsel, the Creditors' Committee's counsel, and counsel to Washington Mutual, Inc. Noteholder Group, a Notice of Intent to Purchase, Acquire or Otherwise Accumulate WMI Stock (an "Equity Acquisition Notice"), in the form attached hereto as Exhibit "2," specifically and in detail describing the proposed transaction in which WMI Stock would be acquired. At the holder's election, the Equity Acquisition Notice to be filed with the Court may be redacted to exclude such holder's taxpayer identification number and the number of shares of WMI Stock that such holder beneficially owns and proposes to purchase or otherwise acquire.

(3) Disposition of WMI Stock or Options. At least twenty (20) calendar days prior to the proposed date of any transfer of equity securities (including Options to acquire such securities) that would result in a decrease in the amount of WMI Stock beneficially owned by a Substantial Equityholder or that would result in a person or entity ceasing to be a Substantial Equityholder (a "Proposed Equity Disposition Transaction" and together with a Proposed Equity Acquisition Transaction, a "Proposed Equity Transaction"), such person, entity or Substantial Equityholder (a "Proposed Equity Transferor") shall file with the Court, and serve upon the Debtors, Debtors' counsel, the Creditors' Committee's counsel, and counsel to Washington Mutual, Inc. Noteholder Group, a Notice of Intent to Sell, Trade or Otherwise Transfer WMI Stock (an "Equity Disposition Notice"), in the form attached hereto as Exhibit "3," specifically and in detail describing the proposed transaction in which WMI Stock would be transferred. At the holder's election, the Equity Disposition Notice to be filed with the Court may be redacted to exclude such holder's taxpayer identification number and the number of shares of WMI Stock that such holder beneficially owns and proposes to sell or otherwise transfer.

(4) Objection Procedures. The Debtors and the Creditors' Committee shall have fifteen (15) calendar days after the filing of an Equity Acquisition Notice or an Equity Disposition Notice (the "Equity Objection Deadline"), as the case may be, to file with the Court and serve on a Proposed Equity Transferee or a

Proposed Equity Transferor, as the case may be, an objection to any proposed transfer of WMI Stock described in such Equity Acquisition Notice or Equity Disposition Notice on the grounds that such transfer may adversely affect the Debtors' ability to utilize the Tax Attributes (an "Equity Objection") as a result of an "ownership change" under section 382 or section 383 of the Tax Code.

a) If the Debtors or the Creditors' Committee file an Equity Objection by the Equity Objection Deadline, then the Proposed Equity Acquisition Transaction or the Proposed Equity Disposition Transaction shall not be effective unless approved by a final and nonappealable order of this Court.

b) If the Debtors or the Creditors' Committee do not file an Equity Objection by the Equity Objection Deadline, or if the Debtors and the Creditors' Committee provide written authorization to the Proposed Equity Transferor approving the Proposed Equity Acquisition Transaction or the Proposed Equity Disposition Transaction, as the case may be, prior to the Equity Objection Deadline, then such Proposed Equity Acquisition Transaction or the Proposed Equity Disposition Transaction, as the case may be, may proceed solely as specifically described in the Equity Acquisition Notice or the Equity Disposition Notice. Any further Proposed Equity Transaction proposed by the Proposed Equity Transferor or Proposed Equity Transferee, as the case may be, shall be the subject of additional notices as set forth herein and an additional twenty (20) calendar day waiting period.

(5) Unauthorized Transactions in WMI Stock or Options. Effective as of the date of the Motion and until further order of the Court to the contrary, any acquisition, disposition or other transfer of WMI Stock in violation of the procedures set forth herein shall be null and void *ab initio* as an act in violation of the automatic stay under sections 362 and 105(a) of the Bankruptcy Code.

(6) Definitions. For purposes of this Final Order:

a) Substantial Equityholder. A "Substantial Equityholder" is any person or entity that beneficially owns at least:

(i) 80,700,000 shares of WMI's common stock ("WMI Common Stock") (representing approximately 4.75% of all issued and outstanding shares of WMI's common stock); or

(ii) 4.50% of the total number of outstanding shares of WMI's 7.75% Series R Non-Cumulative Perpetual Convertible Preferred

Stock, as of the date immediately prior to the date of filing of the Equity Acquisition Notice or the Equity Disposition Notice;[4] or

(iii) 4.75% of the total number of outstanding shares of any of the following classes of WMI preferred stock: Series I Perpetual Non-Cumulative Fixed-to-Floating Rate; Series J Perpetual Non-Cumulative Fixed Rate; Series L Perpetual Non-Cumulative Fixed-to-Floating Rate; Series M Perpetual Non-Cumulative Fixed-to-Floating Rate; and Series N Perpetual Non-Cumulative Fixed-to-Floating Rate;

b) Beneficial Ownership. "Beneficial ownership" (or any variation thereof of WMI Stock and Options to acquire WMI Stock) shall be determined in accordance with applicable rules under section 382 of the Tax Code, the U.S. Department of Treasury regulations ("Treasury Regulations") promulgated thereunder and rulings issued by the Internal Revenue Service, and, thus, to the extent provided in those rules, from time to time shall include, without limitation, (i) direct and indirect ownership (*e.g.*, a holding company would be considered to beneficially own all stock owned or acquired by its subsidiaries), (ii) ownership by a holder's family members and any group of persons acting pursuant to a formal or informal understanding to make a coordinated acquisition of stock and (iii) in certain cases, the ownership of an Option to acquire WMI Stock;

c) Option. An "Option" to acquire stock includes any contingent purchase, warrant, convertible debt, put, stock subject to risk of forfeiture, contract to acquire stock, or similar interest regardless of whether it is contingent or otherwise not currently exercisable; and

d) WMI Stock. "WMI Stock" shall mean WMI Common Stock, the 7.75% Series R Non-Cumulative Convertible Preferred Stock, and any of the following classes of WMI preferred stock: Series I Perpetual Non-Cumulative Fixed-to-Floating Rate; Series J Perpetual Non-Cumulative Fixed Rate; Series L Perpetual Non-Cumulative Fixed-to-Floating Rate; Series M Perpetual Non-Cumulative Fixed-to-Floating Rate; and Series N Perpetual Non-Cumulative Fixed-to-Floating Rate. For the avoidance of doubt, by operation of the definition of beneficial ownership, an owner of

---

[4] Because the Series R has conversion rights, the application of a lower percentage (4.5% rather than 4.75%) allows a cushion for the reduced number of shares of preferred stock that may be outstanding as of the actual acquisition or disposition of the shares that are the subject of the Equity Acquisition Notice or the Equity Disposition Notice.

an Option to acquire WMI Stock may be treated as the owner of such WMI Stock.

and it is further;

ORDERED that any person or entity acquiring, disposing of or transferring WMI Stock in violation of the restrictions set forth herein, or failing to comply with the Equity Acquisition Notice or Equity Disposition Notice requirements, as may be the case, shall be subject to such sanctions as the Court may consider appropriate pursuant to this Court's equitable power prescribed in section 105(a) of the Bankruptcy Code; and it is further

ORDERED, that in the event that the transfer agent executes a transfer as instructed, the transfer agent, solely in its capacity as transfer agent, shall not incur liability to any party, solely with respect to such action, in the event such transfer is determined to be in violation of this Order;

ORDERED that the notice substantially in the form annexed hereto as Exhibit "3" is approved; and it is further

ORDERED that the Debtors shall (1) serve notice of the entry of this Final Order substantially in the form annexed hereto as Exhibit "4" (the "Final Procedures Notice") by facsimile, electronic mail or overnight mail on the Notice Parties, (2) post the Final Procedures Notice on the website established by the Debtors' claim agent, Kurtzman Carson Consultants, LLC, at http://www.kccllc.net, (3) submit a notice of the entry of this Final Order for publication on the Bloomberg newswire service, and (4) cause the Final Procedures Notice to be published once in each of The Wall Street Journal (National Edition) and The New York Times (National Edition); and it is further

ORDERED that, upon receipt of the Final Procedures Notice, (i) any transfer agents shall send the Final Procedures Notice to all holders of WMI Stock registered with the

transfer agent, (ii) any registered holder shall, in turn, provide the Final Procedures Notice to any holder for whose account the registered holder holds WMI Stock, and (iii) any holder shall, in turn, provide the Final Procedures Notice to any person or entity for whom the holder holds WMI Stock; and it is further

ORDERED that nothing herein shall preclude any person or entity that desires to purchase or transfer any WMI Stock from requesting relief from this Final Order in this Court subject to the Debtors' rights to oppose such relief; and it is further

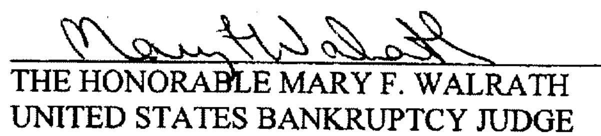
ORDERED that notice of the Motion as provided therein shall be deemed good and sufficient notice of the Motion; and it is further

ORDERED that the requirements set forth in this Final Order are in addition to the requirements of Bankruptcy Rule 3001(e), applicable securities, corporate, and other laws, and do not excuse compliance therewith; and it is further

ORDERED that the Court shall retain jurisdiction with respect to any matters, claims, rights or disputes arising from or related to the implementation of this Final Order; and it is further

ORDERED that the relief granted in this Final Order is intended solely to permit the Debtors and the Creditors' Committee to protect, preserve and maximize the value of the Tax Attributes. Accordingly, except to the extent the Final Order expressly conditions or restricts trading in equity interests in the Debtors, nothing in this Final Order or in the Motion shall or shall be deemed to prejudice, impair or otherwise alter or affect the rights of any holders of interests in the Debtors, including in connection with the treatment of any such interests during the pendency of the Debtors' bankruptcy cases.

Dated: November 18, 2008
Wilmington, Delaware



THE HONORABLE MARY F. WALRATH
UNITED STATES BANKRUPTCY JUDGE

Private Letter Rulings

Private Letter Ruling 200605003, 02/03/2006, IRC Sec(s). 382

UIL No. 382.00-00

Limitation on net operating loss carryforwards bankruptcy petition entities.

Headnote:

Funds, consisting of small, large and foreign investor funds together, aren't entity under Reg § 1.382-3 (a)(1) , as long as purported transferee or transferor complies with stated procedures and co. complies with stated prompt enforcement requirements and continues to seek enforcement against purported transferee or transferor at end of co.'s taxable year.

Reference(s): Code Sec. 382;

Full Text:

Number: **200605003**

Release Date: 2/3/2006

Index Number: 382.00-00

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text], ID No. [Redacted Text]

Telephone Number: [Redacted Text]

Refer Reply To: CC:CORP:1

PLR-139276-05

Date: October 28, 2005

Legend:

Company =

date 1=

date=*2*

date 3=

date=*4*

date 5=

State=

a =

b=

c=

d=

Manager =

Small Investor Fund =

Large Investor Fund =

Foreign Investor Fund =

General Partner =

Individual =

Country =

Dear [Redacted Text]:

This letter responds to your letter dated July 22, 2005, requesting rulings under section 382 of the Internal Revenue Code (Code). Submissions dated August 8, September 23, and October 24, 2005, supplement the original letter. The relevant information in the letter and supplements is summarized below.

Company is the common parent of an affiliated group of corporations filing a consolidated return. Company is a loss corporation. The stock of Company is widely held and publicly traded on an over-the-counter market using what are known as "pink sheets."

On *date 1* (more than three years ago), Company and subsidiaries filed voluntary bankruptcy petitions in the United States Bankruptcy Court for the District of *State*(Bankruptcy Court). On *date 2* (while Company was a loss corporation), Company filed a motion with the Bankruptcy Court requesting the Bankruptcy Court to impose trading restrictions on Company stock. The restrictions were intended to

give Company the ability to prevent an ownership change by limiting owner shifts in Company stock. The Bankruptcy Court imposed the requested restrictions by interim order effective *date 3*and by final order effective *date 5*.

The restrictions relate to acquisitions or dispositions of Company stock involving any person (Restricted Owner) that owns or comes to own at least *a* percent (greater than 4 but less than 5 percent) of Company stock. Ownership for this purpose takes into account the constructive ownership rules of section 382 and the regulations thereunder. Under the interim and final orders, any person that is or becomes a Restricted Owner is required to notify Company of the person's status as such. Also, any person intending to acquire Company stock is required to notify Company if the proposed acquisition (Purported Acquisition) would either (i) cause any person to become a Restricted Owner or (ii) incr ease the percentage of stock owned by any Restricted Owner. In addition, any person intending to dispose of Company stock is required to notify Company if the proposed disposition (Purported Disposition) would either (i) cause any person to cease to be a Restricted Owner or (ii) decrease the percentage of stock owned by any Restricted Owner. Within a specified time of receiving notice of a Purported Acquisition or Disposition (Purported Transaction), Company may object to the transaction. If Company objects in accordance with the order, any Purported Transaction is not effe ctive unless approved by an order of the Bankruptcy Court.

Shortly before *date 3*, three private investment funds under common management (Funds) began to acquire Company stock. The Funds informed Company that as of *date 4* (while the interim order was in effect), the Funds owned in the aggregate *b* percent (greater than 5 percent) of Company stock. The Funds also informed Company that each Fund individually owned less than *a* percent of Company stock (taking into account the constructive ownership rules of section 382 and the regulations thereunder).

Company was concerned that the Funds together might be an entity under Treas. Reg. § 1.382-3(a)(1). If the Funds together were an entity, the acquisitions of Company stock would result in an owner shift under section 382(g)(2) and Treas. Reg. § 1.382-2T(e)(1). In addition, if the Funds together were an entity, one or more of the acquisitions would be Purported Acquisitions. Thus, Company considered objecting to the acquisitions as in violation of the interim order. Ultimately Company agreed that if the Funds together were not an entity, Company would not object to the acquisitions.

The Funds consist of Small Investor Fund (Small), Large Investor Fund (Large), and Foreign Investor Fund (Foreign). Small and Large are *State* limited partnerships, and Foreign is a *Country* corporation. General Partner is the general partner of Small and Large and the sponsor of Foreign. General Partner owns a *c* -percent interest in each Fund's net profits. General Partner is owned by Individual and persons or entities affiliated with Individual, such as family members, trusts for the benefit of family members, and the like. Individual and affiliates own limited partnership interests in the Funds equal to approximately *d* percent (less than 10 percent) of the total capital interests in the Funds.

Manager is an LLC that serves as manager and investment advisor of the Funds. Individual and affiliates own Manager.

Each Fund is organized to attract specific types of investors. No Fund shares an investor with any other Fund. The Funds qua lify for exemption from registration under the Investment Company Act of 1940. Each Fund's specific exemption depends on the type of investor it attracts.

Each Fund has the same investment objecti ves. Thus, in virtually every case Manager decides to invest each Fund's assets in the same stock or security. Moreover, Manager invests the same percentage of each Fund's total assets in that stock or security. That is, Manager invests based on the percentage of each Fund's assets to be invested in a particular issuer's stock or security; Manager does not invest based on the percentage of an issuer's stock or security to be acquired by one or more of the Funds. Manager acts in accordance with its fiduciary duty to the Funds. However, even in the absence of a fiduciary duty, M anager would use this investment approach because each Fund has the same investment objectives.

In addition to serving as investment advisor to the Funds, Manager also serves as investment advisor to other private investment funds. The investment objectives of these other funds differ from that of the Fu nds. Thus, for example, none of these other funds owns Company stock.

The Funds represent as follows:

(a) The Funds:
(i) did not acquire any Company stock for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the total outstanding stock of Company,
(ii) have not acquired equity interests in any other issuer for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the equity interests of that issuer, and
(iii) have not indicated to investors in the Funds that the Funds would acquire equity interests in any issuer for the purpose of the Funds' accumulating ownership of any particular minimum percentage of the equity interests of any issuer.
(b) The Funds:
(i) did not acquire any Company stock for the purpose of changing or influencing the control of Company,
(ii) have not acquired equity interests in any other issuer for the purpose of changing or influencing the control of that issuer, and
(iii) have not indicated to investors in the Funds that the Funds would acquire equity interests in any issuer for the purpose of changing or influencing the control of any issuer.

In the event of a Purported Transaction, Company may seek to compel certain actions related to Company stock acquired or disposed of in the Purported Transaction (Prohibited Company Stock), as described in (I) through (III) below.

(I) Within 30 business days of learning of a Purported Transaction, Company will notify the Bankruptcy Court and the person engaging in the Purported Transaction that the transaction is in violation of the order.
(II) In the event a person (Purported Tr ansferee) acquires Prohibited Company Stock in a Purported Acquisition:
(i) Within 30 business days of learning of the Purported Acquisition,

Company will demand that the Purported Transferee sell the

Prohibited Company Stock in an arm's length transaction using the "pink sheets" if possible. If the Purported Transferee does not sell the Prohibited Company Stock within 30 days of the demand, Company will institute legal proceedings to compel the sale.

(ii) If the amount realized by the Purported Transferee on the sale reduced by related costs (net pr oceeds) exceeds the Purported Transferee's basis in the Prohibited Company Stock, then
a. After selling the Prohibited Company Stock, the Purported Transferee will promptly donate the net proceeds from the sale minus its basis in the Prohibited Company Stock, together with any distributions received on the Prohibited Company Stock while the order is in effect, to one or more organizations described in section 501(c)(3). If the Purported Transferee received the Prohibited Company Stock by gift or inheritance, its basis for this purpose shall be the fair market value of the Prohibited Company Stock at the time received.
b. The Purported Transferee will promptly notify the Bankruptcy Court and Company, in a certificate signed by a person authorized by the Purported Transferee, of the number of shares of Prohibited Company Stock sold, the date of each sale, the price at which each share was sold, the related costs of each sale, the basis of each share sold, the date on which each share was acquired, the gain recognized on each sale, the amounts received as distributions while the order is in effect, the fair market value of the share at the time

received if received by gift or inheritance, and the section 501(c)(3) organizations to which net proceeds minus basis, together with distributions, were donated.

(iii) If the net proceeds from the sale do not exceed the Purported Transferee's basis in the Prohibited Company Stock, then:

a. After selling the Prohibited Company Stock, the Purported Transferee will promptly donate any distributions received on the Prohibited Company Stock while the order is in effect, minus costs related to the sale, to one or more organizations described in section 501(c)(3). If the Purported Transferee received the Prohibited Company Stock by gift or inheritance, its basis for this purpose shall be the fair market value of the Prohibited Company Stock at the time received.

b. The Purported Transferee will promptly notify the Bankruptcy Court and Company, in a certificate signed by a person authorized by the Purported Transferee, of the number of shares of Prohibited Company Stock sold, the date of each sale, the price at which each share is sold, the related costs of each sale, the basis of each share sold, the date on which each share was acquired, the loss, if any, recognized on each sale, the amounts received as distributions while the order is in effect, the fair market value of the share at the time received if received by gift or inheritance, and the section 501(c)(3) organizations to which distribution minus costs related to the sale were donated.

(III) In the event a person (Purported Transferor) disposes of Prohibited Company Stock in a Purported Disposition (including a disposition by a Prohibited Transferee selling Restricted Company Stock before demand by Company, and any other Purported Disposition):

(i) If the net proceeds from the Purported Disposition exceed the Purported Transferor's basis in the Prohibited Company Stock, upon receiving notice from Company the Purported Transferor will promptly donate the net proceeds from the sale minus its basis in the Prohibited Company Stock, together with any distributions received on the Prohibited Company Stock while the order is in effect, to one or more organizations described in section 501(c)(3), and will promptly notify the Bankruptcy Court and Company as provided in (II)(ii)b., above.

(ii) If the net proceeds from the Purported Disposition do not exceed the Purported Transferor's basis in the Prohibited Company Stock, upon receiving notice from Company the Purported Transferor will promptly donate any distributions received on the Prohibited Company Stock while the order is in effect, minus costs related to the sale, to one or more organizations described in section 501(c)(3), and will promptly notify the Bankruptcy Court and Company as provided in (II)(iii)b., above.

Based on the foregoing, we rule as follows:

1. The Funds together are not an entity within the meaning of Treas. Reg. § 1.382-3(a)(1).
2. Provided that:

(i) the Purported Transferee or Transferor complies with the procedures described in (I) through (III) above, or

(ii) Company complies with the prompt enforcement requirements described in (I) through (III) above and is continuing to seek enforcement against a Purported Transferee or Transferor at the end of a taxable year of Company,the person acquiring Prohibited Company Stock in the Purported Transaction will not be treated as having acquired ownership of that stock for purposes of section 382 and the regulations thereunder.

3. Should a court or other adjudicative body issue a final order declaring the restrictions in the Bankruptcy Court's interim or final orders unenforceable *ab initio*, then for purposes of section 382 and the regulations there under ownership of Prohibited Company Stock will be treated as having been acquired by a person in a Purported Transaction on the date actually acquired.

The ruling contained in this letter is based on facts and representations submitted by the taxpayer and accompanied by a pena lties of perjury statement executed by an appropriate party. This Office has not verifi ed any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides

that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of the taxpayers involved for any relevant taxable year. Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Martin Huck

Assistant Chief, Branch 1

Office of the Associate Chief Counsel (Corporate)
END OF DOCUMENT -
© 2008 Thomson Reuters/RIA. All rights reserved.

Notices

Notice 2008-83, 2008-42 IRB 905, 10/01/2008, IRC Sec(s). 382

Limitation on NOL carryforwards and certain built-in losses following ownership change—built-in losses and gains—bank bad loans and bad debt.

Headnote:

Any deduction allowed after Code Sec. 382(g); ownership change to bank on loan losses or bad debts won't be treated as built-in loss or deduction attributable to any period before change date.

Reference(s): ¶ 3825.25(20); Code Sec. 382;

Full Text:

1. Overview

The Internal Revenue Service and Treasury Department are studying the proper treatment under section 382(h) of the Internal Revenue Code (Code) of certain items of deduction or loss allowed after an ownership change to a corporation that is a bank (as defined in section 581) both immediately before and after the change date (as defined in section 382(j)). As described below under the heading Reliance on Notice, such banks may rely upon this guidance unless and until there is additional guidance.

2. Treatment Of Deductions Under Section 382(h)

For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.

3. Reliance On Notice

Corporations described in section 1 of this notice may rely on the treatment set forth in this notice, unless and until there is additional guidance.

4. Scope

This notice does not address the application of any provision of the Code other than section 382.

The principal author of this notice is Mark S. Jennings of the Office of Associate Chief Counsel (Corporate). For further information regarding this notice contact Mark S. Jennings on (202) 622-7750 (not a toll-free call).

END OF DOCUMENT -

© 2008 Thomson Reuters/RIA. All rights reserved.

110TH CONGRESS
2D SESSION

S. ______

To amend the Internal Revenue Code of 1986 with respect to the proper tax treatment of certain indebtedness discharged in 2009 or 2010, and for other purposes.

IN THE SENATE OF THE UNITED STATES

Mr. ENSIGN introduced the following bill; which was read twice and referred to the Committee on

---

A BILL

To amend the Internal Revenue Code of 1986 with respect to the proper tax treatment of certain indebtedness discharged in 2009 or 2010, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. PROPER TAX TREATMENT OF CERTAIN FINAN-**
4 **CIAL INDEBTEDNESS DISCHARGED IN 2009**
5 **OR 2010.**
6 (a) IN GENERAL.—Section 108(a)(1) of the Internal
7 Revenue Code of 1986 (relating to exclusion from gross
8 income) is amended by striking "or" at the end of sub-
9 paragraph (D), by striking the period at the end of sub-

1 paragraph (E) and inserting ", or" and by adding at the
2 end the following new subparagraph:
3 "(F) the indebtedness discharged is appli-
4 cable financial indebtedness which is discharged
5 after December 31, 2008, and before January
6 1, 2011.".
7 (b) APPLICABLE FINANCIAL INDEBTEDNESS.—Sec-
8 tion 108 of such Code is amended by adding at the end
9 the following new subsection:
10 "(i) DEFINITIONS AND RULES RELATING TO APPLI-
11 CABLE FINANCIAL INDEBTEDNESS.—For purposes of sub-
12 section (a)(1)(F)—
13 "(1) APPLICABLE FINANCIAL INDEBTED-
14 NESS.—The term 'applicable financial indebtedness'
15 means indebtedness—
16 "(A) which was originally issued by a cor-
17 poration, or by a partnership engaged in a
18 trade or business (other than a trade or busi-
19 ness of trading in stocks or securities for the
20 partnership's own account), and
21 "(B) which is—
22 "(i) indebtedness originally issued or
23 syndicated by a financial institution (as de-
24 fined in section 582(c)(2) without regard
25 to subparagraph (C) thereof) or a deposi-

1 tory institution holding company (as de-
2 fined in section 3(w)(1) of the Federal De-
3 posit Insurance Act (12 U.S.C.
4 1813(w)(1)),
5 ''(ii) indebtedness which—
6 ''(I) constitutes a security within
7 the meaning of the Securities Act of
8 1933, and
9 ''(II) was originally issued pursu-
10 ant to a registration statement that
11 was declared effective under such Act
12 or pursuant to an exemption from, or
13 in a transaction not subject to, the
14 registration requirements of such Act,
15 or
16 ''(iii) indebtedness that is traded on
17 an established market (within the meaning
18 of section 1273(b)(3)).
19 ''(2) APPLICABLE DISCHARGES.—Subsection
20 (a)(1)(F) shall only apply to a discharge of applica-
21 ble financial indebtedness if such discharge is by
22 reason of—
23 ''(A) the acquisition of the indebtedness by
24 the issuer of the indebtedness,

1 "(B) the acquisition of the indebtedness of
2 the issuer by a person related, or who becomes
3 related, to the issuer of the indebtedness from
4 a person who is not related to the issuer, or
5 "(C) the significant modification of the in-
6 debtedness (within the meaning of section
7 1001).
8 For purposes of subparagraph (B), the determina-
9 tion of whether a person is related to another person
10 shall be made in the same manner as under sub-
11 section (e)(4).".
12 (c) COORDINATION OF EXCLUSIONS.—Section
13 108(a)(2) of such Code is amended—
14 (1) by striking "and (E)" in subparagraph (A)
15 and inserting "(E), and (F)", and
16 (2) by adding at the end the following new sub-
17 paragraph:
18 "(D) FINANCIAL INDEBTEDNESS EXCLU-
19 SION TAKES PRECEDENCE OVER INSOLVENCY
20 EXCLUSION UNLESS ELECTED OTHERWISE.—
21 Paragraph (1)(B) shall not apply to a discharge
22 to which paragraph (1)(F) applies unless the
23 taxpayer elects to apply paragraph (1)(B) in
24 lieu of paragraph (1)(F).".

1 (d) EARNINGS AND PROFITS.—Section 312(l) of such
2 Code is amended by adding at the end the following new
3 paragraph:

4 "(3) DISCHARGE OF CERTAIN FINANCIAL IN-
5 DEBTEDNESS.—The earnings and profits of a cor-
6 poration shall not include income from a discharge
7 of indebtedness to which section 108(a)(1)(F) ap-
8 plies.".

9 (e) OTHER SPECIAL RULES.—

10 (1) TREATMENT AS MARKET DISCOUNT
11 BOND.—For purposes of the Internal Revenue Code
12 of 1986, any indebtedness acquired in a transaction
13 described in section 108(i)(2)(B) of such Code (as
14 added by subsection (b)), or received pursuant to an
15 exchange arising from a transaction described in sec-
16 tion 108(i)(2)(C) of such Code (as so added), shall
17 be treated as a market discount bond (within the
18 meaning of section 1278(a)(1) of such Code) having
19 market discount equal to the amount (if any) which,
20 but for section 108(a)(1)(F) of such Code (as added
21 by subsection (a)), would have been includible in
22 gross income by reason of the discharge of such in-
23 debtedness in any such transaction.

24 (2) ACQUISITIONS BY FOREIGN PERSONS.—Any
25 interest (or original issue discount) paid or accrued

1 after December 31, 2008, and before January 1,
2 2011, on indebtedness which is described in section
3 108(a)(1)(F) of such Code by reason of the acquisi-
4 tion of such indebtedness by a foreign person or by
5 a partnership (or other pass-through entity) in
6 which a foreign person is a partner (or other profits
7 or capital owner) shall not be subject to sections
8 871(h)(3), 881(c)(3)(B) or 881(c)(3)(C) of such
9 Code.

Proposal to Suspend Discharge of Indebtedness Rules

Present Law

Taxable income includes the amount of any discharge from indebtedness, including, generally, the difference between the amount of a corporation's indebtedness and the amount paid by that corporation to acquire or retire that indebtedness. See Section 61(a)(12) of the Internal Revenue Code of 1986 (the "Code") and United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

The purchase of indebtedness of an issuer by a person "related" to that issuer (from an "unrelated" person) is treated as if the issuer had itself repurchased such indebtedness, so that if the related-person purchase is for less than the amount of the indebtedness, the issuer will have taxable discharge of indebtedness income. Section 108(e)(4) of the Code.

If a "related person" purchases the indebtedness of an issuer, such indebtedness is treated as reissued by the issuer in the amount of the price paid by the "related person" for such indebtedness. Treas. Reg. § 1.108-2(g)(1). If, for example, the "related person" purchased that indebtedness at a discount from its original issue price, then the issue price of the new indebtedness will be lower than its initial issue price. Such new indebtedness will then be treated as issued with original issue discount, or OID, which must be accrued currently and taken into income by the related-person holder of the indebtedness for U.S. federal income tax purposes. The issuer of the reissued indebtedness is treated as accruing OID deductions for U.S. federal income tax purposes. However, even were such OID to be fully deductible by the issuer as it accrued, the issuer would have discharge of indebtedness income in the year of the deemed repurchase of the debt under Section 108(e)(4), but would only over time benefit from the OID deductions. In addition, a number of Code provisions may apply to require the deferral of such OID deductions, or their disallowance. These include the so-called applicable high-yield debt obligation or AHYDO rules of Section 163(e)(5) and (i) of the Code, the earnings stripping rules of Section 163(j) of the Code and the rules for the potential deferral of interest or OID owed to related persons, or related foreign persons, under Sections 163(e)(3) and 267 of the Code.

Non-U.S. persons generally are not subject to U.S. federal income or withholding tax on interest payments from U.S. issuers under the portfolio debt rules of Sections 871(h) and Section 881(c) of the Code. However, the portfolio debt rules do not apply if the non-U.S. person holder of the debt is a 10% owner of the issuer. Under attribution rules, persons not directly owning equity of the issuer may be treated as owning such equity for purposes of this rule.

Reasons for Change

The proposed changes would enhance the President's and Congress's program to provide relief to the credit markets through the purchase of troubled assets.

The proposed changes would encourage the private sector to participate in the purchase of distressed debt. By reducing the tax costs to corporations of repurchasing their debt

at a discount, corporations and their shareholders would be encouraged to repurchase debt. Such repurchases would have several beneficial consequences for the credit markets. First, corporations that deleverage by purchasing their debt will strengthen their balance sheets and thus be better positioned to withstand the effects of an economic downturn. Second, as a significant amount of the debt of corporations is held by troubled financial institutions, encouraging purchases of debt from such financial institutions will provide the same enhancement to the credit market that the Emergency Economic Stabilization Act of 2008, or EESA, seeks to provide but will do so without direct government funding.

Under present law, the purchase by the issuer or a person "related" to that issuer of the issuer's debt results in taxable income to the issuer in the amount of the cancellation of indebtedness, which is not matched by an equivalent tax benefit to the issuer, because of timing differences and deduction disallowance and deferral rules. This is a strong disincentive to such purchases, in an environment where such purchases could be expected to serve the purposes of the EESA and have crucial benefits for financial institutions with troubled balance sheets and for the credit environment generally. Temporarily waiving the rule for cancellation of indebtedness could thus aid the resolution of the credit crisis. This waiver should apply not only to an issuer's direct purchase of its own indebtedness, but also a "related" person's purchase of the issuer's indebtedness. Section 108(e)(4) of the Code was enacted because purchases of indebtedness by a person related to the debtor were viewed as essentially similar transactions to purchases by issuers themselves, which should have the same tax effect. H.R. Rep. No. 833, 96th Cong., 2d Sess. 9, 16 (1980). Thus, any waiver of the impact of cancellation of indebtedness in this crisis should apply to "related" party debt purchases, as well as purchases by issuers directly.

These waivers would represent a temporary suspension of the discharge of indebtedness rule in response to, and with the intention to ameliorate, a severe economic crisis. A similar approach was adopted recently with the enactment of the temporary waiver of taxation of discharge of indebtedness income resulting from the discharge of "qualified principal residence indebtedness" under the Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142), originally intended to apply to such discharges occurring after December 31, 2006 and prior to January 1, 2010, and extended by EESA to apply prior to January 1, 2013.

Improving the market for distressed debt assets by expanding the group of potential purchasers is another way to hasten the resolution of this credit crisis. One additional source of purchasers are non-U.S. persons. To the extent that the portfolio debt rules do not apply to distressed debt assets, this is a powerful disincentive for non-U.S. persons to acquire such assets, because of the dramatic reduction in yield resulting from the application of the 30% U.S. federal withholding tax that will apply to non-portfolio debt. Temporarily suspending the exemption from the portfolio debt rules for purchasers of debt who are owners of 10% of the equity of the issuer can also be expected to increase the market for distressed debt. This also should aid the balance sheets of banks and troubled financial institutions and help address the credit crisis.

While a suspension of the rules relating to debt repurchases could result in a loss of tax revenue, any such loss would further aid the stabilization of the credit markets and the deleveraging of corporations in advance of an economic downturn.

Explanation of Provisions

The proposed Code amendments would suspend the application of the tax rules applicable to cancellation of certain types of indebtedness as a result of the acquisition of such indebtedness by the issuer or by a person “related” to the issuer. Section 108 and certain ancillary Code provisions would be amended accordingly.

The proposed Code amendments would apply to indebtedness issued by an entity conducting a trade or business, so that personal indebtedness and indebtedness issued by an entity not conducting a trade or business would not be affected by the change. The amendments would apply to purchases of indebtedness by the issuer (or a related person with respect to the issuer) so as to directly target the deleverage effect and the relief of troubled financial institutions discussed above. Under the proposal, the exclusion from gross income would not result in reduction of any tax attributes of the issuer of the indebtedness. Indebtedness acquired by a related person that is addressed by the new rule would not be treated as newly issued as a result of such acquisition, under Treas. Reg. § 1.108-2(g) or otherwise, and so no new original issue discount would result from the transaction.

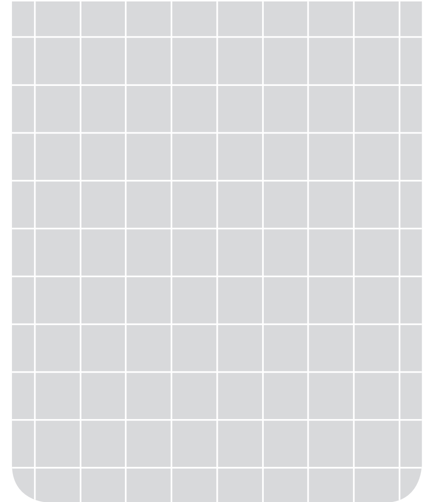
The proposed Code amendments would also suspend the exemption to the portfolio debt provisions for debt purchased by non-U.S. persons that are 10% or more owners of the issuer, under guidelines to be established by the Secretary of the Treasury.

Effective Date

The recommendations contained herein would apply to debt purchases on or after January 1, 2008 and prior to January 1, 2013.

IRS Circular 230 Notice Requirement. This communication is not given in the form of a covered opinion, within the meaning of Circular 230 issued by the United States Secretary of the Treasury. Thus, we are required to inform you that you cannot rely upon any tax advice contained in this communication for the purpose of avoiding United States federal tax penalties. In addition, any tax advice contained in this communication may not be used to promote, market or recommend a transaction to another party.

PowerPoint
Presentation

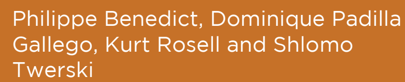


SchulteRoth&Zabel

18th annual private investment funds seminar

Tuesday, January 13, 2009

Tax Aspects of Investments in Distressed Situations



Philippe Benedict, Dominique Padilla Gallego, Kurt Rosell and Shlomo Twerski

© 2009 Schulte Roth & Zabel LLP

Distressed Investments

existing **losses**

Distressed Investments

existing **assets**

"Entity" Definition

"An entity includes a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock."

investments in distressed assets

© 2009 Schulte Roth & Zabel LLP |

CIRCULAR 230 NOTICE. THE FOLLOWING NOTICE IS BASED ON U.S. TREASURY REGULATIONS GOVERNING PRACTICE BEFORE THE U.S. INTERNAL REVENUE SERVICE: (1) ANY U.S. FEDERAL TAX INFORMATION CONTAINED HEREIN IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING U.S. FEDERAL TAX PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER; AND (2) EACH TAXPAYER SHOULD SEEK ADVICE ON PARTICULAR TRANSACTIONS BASED ON THE TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty whatsoever as to the accuracy or completeness of the information. Distribution of this information is not intended to create, and its receipt does not constitute, an attorney-client relationship between SRZ and you or anyone else.

Electronic mail or other communications to SRZ (or any of its attorneys, staff, employees, agents or representatives) resulting from your receipt of this information will not, and should not, be construed to create an attorney-client relationship. No one should, or is entitled to, rely in any manner on any of this information. Parties seeking advice should consult with legal counsel familiar with their particular circumstances.

The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.