INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-110623-04, CC:FIP:B03

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Year 1 =

a =

ISSUES:

1. Whether Taxpayer is entitled to deduct the excess of the fair market value of the cash, notes and new common stock it transferred to certain creditors, pursuant to its Plan of Reorganization, over the amount of each creditor's claim.

2. Whether section 1032 of the Code otherwise bars a deduction of the excess amount.

CONCLUSIONS:

1. The Taxpayer is entitled to deduct under section 163 of the Code the excess of the fair market value of the cash, notes and new common stock it transferred to certain creditors, pursuant to its Plan of Reorganization, over the amount of each creditor's claim.

2. Section 1032 of the Code does not otherwise bar a deduction of the excess amount.

FACTS:

Taxpayer filed a voluntary petition on Date 1 to reorganize under Chapter 11 of the Bankruptcy Code. After reaching a consensus with its creditors, Taxpayer submitted a plan of reorganization (the "Plan" or "Plan of Reorganization"), which was approved by the Bankruptcy Court on Date 2, and became effective on Date 3 (the "Effective Date"). The Plan provided that, upon the Effective Date, all property and other assets of the bankruptcy estate would vest with the reorganized entity free and clear of all liens and other encumbrances not specifically contemplated by the Plan to survive or that were created or granted by the Plan. Likewise, all outstanding common stock and warrants were to be cancelled.

Under the Plan, certain classes of impaired[1] claims were allowed in full: Reset Notes, Credit Agreement Debt and Sale-Leaseback Rents, each of which we assume

[1] Under the Bankruptcy Code, Chapter 11 plans must designate classes of claims, specify the treatment of each class, and specify whether any class of claims is impaired under the plan. 11 U.S.C. § 1123(a). Generally, a class of claims is impaired under a plan unless it leaves unaltered the legal, equitable, and contractual rights to which each claimant in the class is entitled. 11 U.S.C. § 1124.

without concluding qualify as valid indebtedness for federal income tax purposes (the "allowed, impaired claims"). The total impaired claims submitted by holders of Credit Agreement Debt and Reset Notes represents the face amount of the debt plus accrued but unpaid interest. The Sale-Leaseback Rents arise in connection with a sale-leaseback transaction for which Taxpayer became liable as guarantor and represent accrued but unpaid rents owed by Taxpayer under a sublease agreement, which payments were required to be made directly to the lenders under the sale-leaseback transaction. None of these obligations represent trade debt and none survived the bankruptcy. None of Taxpayer's debt was convertible by its terms into Taxpayer common stock.

Distributions of cash, new debt and common stock were made in satisfaction of the allowed, impaired claims. The Plan stated that the cash, notes and new common stock were to be distributed to the creditors as of the Effective Date. The creditors were permitted to elect the relative amount of cash, notes, and new common stock they would receive upon cancellation of their old debt. Specifically, certain creditors were permitted to receive the "Tranche A Distribution" or the "Tranche B Distribution." For Tranche A and Tranche B Distributions, the value received was the sum of (i) cash; (ii) the issue price of notes; and (iii) fair market value of new common stock. A creditor electing the Tranche A Distribution received proportionately a greater amount of cash and notes and fewer shares of new common stock. A creditor electing the Tranche B Distribution received proportionately less cash and notes but significantly more shares of new common stock. The creditors were required to make their election no later than Date 4.

With respect to the Reset Notes, the holders had no choice with respect to the nature of their distribution (aside from their option to sell their claims to Reset Notes purchasers and receive cash in lieu of the Reset Notes distribution). For the Reset Notes distribution, the value received was the sum of (i) cash, and (ii) the issue price of the notes.

In addition, the Plan provides for the distribution of a certain amount of "cash on closing" in lieu of distributing Tranche A and Tranche B notes. The Bankruptcy Court also authorized Taxpayer to issue a shares of its new common stock to the Reset Note purchasers. These shares were in consideration of the Reset Note purchasers' agreement to transfer funds to Taxpayer in order to fund the distribution of cash to electing Reset Noteholders as provided in the Plan, their prior purchases of Reset Notes pursuant to a consent agreement and a shareholder agreement, and the satisfaction of their respective obligations under these agreements and a bank agreement.

The assets were distributed to the creditors on the Effective Date. Those creditors who accepted the Tranche A Distribution (primarily cash and notes) along with the Reset Notes holders (who received only cash and notes) received total distributions with a value less then their allowed claims. Those creditors who elected to take the

Tranche B Distribution (consisting primarily of stock) received distributions with a value in excess of their allowed claims.

On its Year 1 tax return, Taxpayer reported a net operating loss carryforward, a portion of which remained outstanding and was being used to offset income in the years under audit. When responding to the examining agent, Taxpayer asserted that it had made a mistake on its return for Year 1. Taxpayer asserted that it failed to deduct the excess[2] created when it settled a portion of its debt under the Tranche B Distribution, or it had miscalculated the required attribute reduction for the Tranch A Distribution. As a result, taxpayer made a claim to increase its net operating loss carryforward. The examining agent rejected the claim.

LAW AND ANALYSIS:

Issue 1

As discussed below, the excess payment represents a repurchase premium and is deductible under § 163.

Section 163(a) allows a deduction for all interest paid or accrued within the taxable year on indebtedness. In order for an interest deduction to be allowed, the interest expense must accrue on bona fide indebtedness. Tampa & Gulf Coast Railroad Co. v. Commissioner, 56 T.C. 1393, 1399-1400 (1971). Where a debt instrument is repurchased by an issuer for a price in excess of its adjusted issue price, the excess is deductible as interest for the taxable year in which the repurchase occurs. See § 1.163-4(c)(1). A premium paid for the early retirement of a bond issue represents an additional interest charge for the use of the bondholder's money.

A repurchase is not limited to an exchange for cash, but includes a reacquisition by money or its equivalent, including shares of stock in the issuing corporation. Clark Equipment Company v. United States, 912 F.2d 113 (6th Cir. 1990), cert. denied, 500 U.S. 941 (1991). See Duncan Industries v. Commissioner, 73 T.C. 266 (1979). See also Rev. Rul. 2002-31, 2002-1 C.B. 1023 (for purposes of § 249, a conversion is a repurchase and citing also to Treas. Reg. § 1.61-12(c)(2) and Treas. Reg. § 1.163-7(c).)

For purposes of federal income tax law, the act of filing a bankruptcy petition creates substantial uncertainty as to the allowability of a claim for postpetition interest. Accordingly, postpetition interest on prepetition unsecured debt generally is nondeductible. See In re West Texas Marketing Corp., 54 F.3d 1194 (5th Cir. 1995), cert. denied, 116 S. Ct. 523 (1995). See Beverly Hills Bancorp v. Hine, 752 F.2d 1334, 1339 (9th Cir. 1984). Although the liability for postpetition interest generally remains contingent while the debtor is in a Title 11 proceeding, this general rule may be lifted

[2] We assume without concluding that an "excess" was created when Taxpayer settled a portion of its debt under the Tranche B Distribution.

when or if a final order (including the terms of a confirmed plan) in the bankruptcy case requires the issuer to pay such postpetition interest. But see In re Dow Corning Corp., 270 B.R. 393 (E.D. Mich. 2001) (interlocutory order) (a Michigan bankruptcy court reached the opposite conclusion in a Chapter 11 case based on operation of the Bankruptcy Code). An award of postpetition interest may be allowed, however, when the bankrupt later proves to be solvent.

Under the facts of the instant case none of the allowed, impaired claims in issue represent trade debt. In addition, for the claims in issue, the total amount of the allowed claim was paid in full, which included the face amount of the debt and all accrued but unpaid prepetition interest on the debt. As a result, the excess payment could not have represented a repayment of principal or accrued, but unpaid prepetition interest. Therefore, under these facts, the excess amount represents a repurchase premium and is deductible under § 163.

Issue 2

Section 1032(a) provides that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation…." Treasury stock actually is the crux of § 1032: Congress enacted the section in 1954 to reject the result reached under pre-1954 case and regulatory law that required a corporation to recognize gain or loss if the corporation "deals in its own shares as it might in the shares of another corporation," even though the corporation would not recognize gain or loss on the disposition of newly-issued shares. See, e.g., Firestone Tire & Rubber Co. v. Commissioner, 2 T.C. 827 (1943).

This disparity of treatment between treasury shares and newly-issued shares gave rise to tax avoidance possibilities: a corporation expecting gain upon the disposition of treasury shares might avoid the gain by canceling the treasury shares and issuing new stock, whereas a corporation might produce a fictitious loss by purchasing its own shares and reselling them at a lower price. In 1954, Congress promulgated §1032 to alleviate uncertainty over the treatment of a corporation's stock transactions.[3]

Section 1.1032-1 of the Income Tax Regulations embodies the legislative history of §1032 by stating that the disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. It gives the example that the receipt of the subscription price of shares of its stock upon original issuance gives rise to neither

[3] Section 1032(a) was amended in 1984 to apply the same nonrecognition rule to gains and losses realized by a corporation on the lapse or acquisition of an option to buy or sell its own stock, including treasury shares.

taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock.

It is generally acknowledged that §1032 applies to an exchange of a corporation's stock for its debt, subject to §§61(a)(12) and 108, which provide that a corporation may have income from a cancellation of indebtedness on an exchange of its stock for its own debt (that is, cancellation of indebtedness income can be realized and recognized when debt is satisfied with stock of the debtor corporation, even though no gain is recognized on the issuance of stock). See preamble to §1.1032-3, 2000-1 C.B. 1151-1155. Similarly, therefore, the requirement set forth in the regulations under §1032 that the acquiring corporation transfer issuing corporation stock to acquire money or other property is satisfied where issuing corporation stock is used to satisfy acquiring corporation debt, subject to §§61(a)(12) and 108. See §1.1032-3.

Further, it is a well-established proposition that §1032 does not prevent a corporation from taking a deduction for an otherwise deductible expense that the corporation pays with its own stock, even if the stock is transferred in a §1032 exchange. See, e.g., Rev. Rul. 62-217, 1962-2 C.B. 59, Rev. Rul. 69-75, 1969-1 C.B. 52, §83(h) and Treas. Reg. §1.83-6 (all permitting deductions for services paid in stock in non-recognition exchanges under §1032); Duncan Industries, Inc. v. Commissioner, 73 T.C. 266 (1979) (borrower selling stock at a discount to lender as part of loan agreement allowed to amortize the amount of discount over the life of the loan as a cost of obtaining the loan); Rev. Rul. 75-348, 1975-2 C.B. 75 (corporation pledging to sell shares to charity at a price below fair market value could deduct excess of fair market value over agreed price as charitable contribution).

In this case, the excess amount represented a repurchase premium which is deductible under § 163. As long as the expense is otherwise deductible, § 1032 does not prevent the taxpayer from taking the deduction.

Other Issues

As set forth in the FACTS section, none of Taxpayer's debt was convertible by its terms into Taxpayer common stock. Therefore, none of the excess is attributable to a conversion feature and § 249 has no application.

It is undisputed that there was an "excess" amount paid on the allowed, impaired claims in issue. An issue was raised, however, with respect to the proper valuation of the stock used to determine the "excess." We ordinarily do not issue rulings or determination letters on matters in which the determination is primarily one of fact, such as the market value of property. See Rev. Proc. 2004-3, 2004-1 C.B. 114, at § 4.02(1). In the instant case, the determination of the fair market value of the stock is primarily a question of fact, and, therefore, is not an appropriate issue for determination.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.