Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LMSB:[redacted] TL-N-4512-00
[redacted]

date: FEB -2 2001

to: Manager, [redacted]
Attn: [redacted]

from: Associate Area Counsel, LMSB [redacted]

subject: **Request for Advisory Opinion**
Application of the Stock for Debt Exception
Taxpayer: [redacted]

We are writing in response to your request for our opinion regarding whether the stock for debt exception in former I.R.C. § 108(e)(10)(B) applies in this case.

ISSUES

1. Whether a claim that receives only cash can qualify for the stock for debt exception in former I.R.C. § 108(e)(10)(B), if the creditor holding that claim also holds a separate claim that receives stock.

2. Whether a single claim of an unsecured creditor who elects a distribution part in cash and part in stock is bifurcated into two claims in calculating the proportionality test of the stock for debt exception.

3. Whether prepetition interest that is disallowed in a plan of reorganization for purposes of distribution is included as part of the underlying claim in computing the proportionality test of the stock for debt exception or is, instead, treated as a separate claim not satisfied with a distribution of stock.

CONCLUSIONS

1. An analysis of whether the stock for debt exception applies is separately determined for each individual claim. A claim that receives cash only is not aggregated with other claims held by the same creditor for which the creditor receives stock.

2. A claim that is satisfied in part with a cash distribution and in part with a stock distribution remains one claim. The portion of this claim satisfied with a cash

distribution is not per se disqualified from the stock for debt exception.

3. The prepetition interest is an inherent part of the underlying claim. If the underlying claim is satisfied with a stock distribution, the prepetition interest on that claim should be considered part of that claim and included in the computation of the individual common stock ratio of the stock for debt exception.

FACTS

On [redacted], an involuntary petition under Chapter 11 of the Bankruptcy Code was filed against [redacted] or "the taxpayer") (now known as [redacted]. The taxpayer ultimately consented to the bankruptcy and an order for relief was entered on [redacted]. A Plan of Reorganization was confirmed in [redacted] of [redacted], with an effective date of [redacted].

[redacted] is a holding company that owns only stock of other corporations. All of subsidiaries held by [redacted] were wholly owned, except for [redacted]. The taxpayer filed consolidated returns for all relevant periods as parent of the controlled group. All of the taxpayer's subsidiaries, except [redacted] were also in bankruptcy and the cases were jointly administered.

There are three classes of debt that are relevant to the issues at hand designated as Class 5, Class 6, and Class 7 Debts in the taxpayer's bankruptcy. Class 5 Debts are a Bank Credit Agreement and Serial Zero Coupon Senior Notes. These debts were secured by stock in [redacted]'s wholly owned subsidiaries, rights to proceeds under an asset purchase agreement, and a note from [redacted], [redacted], and [redacted] payable to [redacted]. Class 6 consists of publicly issued Senior Subordinated Debentures, which are subordinated in payment to Class 5 Debts. Class 7 consists of publicly issued Subordinated Debentures, which are subordinated in payment to Class 5 and Class 6 Debts.

On its 10-K for the period ending [redacted], the taxpayer reported that it made distributions through its bankruptcy plan of reorganization, on the Class 5, Class 6, and Class 7 Debts as follows:

Claim:

Class 5:	Face Amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash	$ [redacted]		
	Senior Secured Notes	[redacted]		
	Senior Subordinated Notes	[redacted]		
	Class 1 Common Stock ([redacted] shares @ $[redacted])	[redacted]	$[redacted]	
	Excess surrendered			$ [redacted]
Class 6:	Face Amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash		$[redacted]	
	Excess surrendered			$[redacted]
Class 7:	Face amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash	$ [redacted]		
	Class 2 Common Stock ([redacted] shares @ $[redacted])	[redacted]	$ [redacted]	
	Excess surrendered			$[redacted]
Excess of Obligations Exchanged over Consideration Received				$[redacted]

The taxpayer's plan of reorganization provided that Class 5 creditors could elect one of, or a combination of, the following three types of distributions:

1. a new senior secured note with a face amount equal to [redacted]% of the creditor's Class 5 Claim, limited to an aggregate amount of $[redacted] (Type 1 Distribution);

2. cash equal to [redacted]% of the creditor's Class 5 Claim, limited to an aggregate amount of $[redacted] (Type 2 Distribution); or

3. a new senior subordinated note with a face amount equal to [redacted]% of the creditor's Class 5 Claim plus a proportionate share of [redacted] shares of Class 1 Common Stock and the right to purchase additional shares of Class 1 Common Stock at $[redacted] per share (Type 3 Distribution).

The plan of reorganization provided that each Class 6 Creditor was to receive cash equal to [redacted]% of the creditor's claim, plus the right to subscribe at a price of $[redacted] per share to any Class 2 Common Stock left after subscription by Class 7 creditors.

Class 7 creditors could elect from one or a combination of the following two options:

1. cash equal to [redacted]% of a creditor's claim, subject to an aggregate limit of $[redacted] (Type A Distribution); or

2. shares of Class 2 Common Stock equal to [redacted] times the amount of the creditor's Class 7 Claim, subject to an aggregate limit of [redacted] shares (Type B Distribution).

Each Class 7 creditor also had the right to subscribe to a proportionate amount of [redacted] additional shares of Class 2 Common Stock at $[redacted] per share. If the full [redacted] of additional shares were not fully subscribed by Class 7 Creditors, the remainder could be subscribed by Class 6 Creditors, as discussed above.

The plan of reorganization further provided that for purposes of distribution, the amount of the Class 5, Class 6, and Class 7 Claims were to be determined without including any unpaid default interest, unpaid interest on interest, or unpaid fees, cost, or expenses. The Class 5 Claims under the Bank Security Agreement would include accrued interest to the parent's petition date and Class 5 Claims under the Zero Notes would included accreted amounts on those claims up to the the parent's petition date. Class 6 and Class 7 Claims were determined without any

original issue discount or any accrued and unpaid interest, including prepetition interest.

A list of each Class 5, Class 6, and Class 7 creditor and the election made by the Class 5 and Class 7 creditors is attached hereto as Appendix I. Each creditor received distributions as shown in Appendix II.

In the analysis comparing distributions in the taxpayer's Chapter 11 case with hypothetical distributions in a Chapter 7 case, the taxpayer reported the following:

Class	Claim	Chapter 7 Recovery	Chapter 11 Recovery
Class 5	$[redacted]	$[redacted]	$[redacted]
Class 6	[redacted]	[redacted]	[redacted]
Class 7			

ANALYSIS

This case involves questions about the application of the stock for debt exception formerly found in I.R.C. §§ 108(e)(8) and (10). The stock for debt exception was repealed by the Omnibus Budget Reconciliation Act of 1993 for stock transfers after December 31, 1994. Pub. L. No. 103-66, § 13226(a). An exception to the repeal provides that the stock for debt exception continues to apply to any issuance of stock for indebtedness that occurred on or before December 31, 1994, or to bankruptcy or similar cases that were filed on or before December 31, 1993. Pub. L. No. 103-66, § 13226(a)(2)(B); Treas. Reg. § 1.108-2(e). The transfers here occurred prior to December 31, 1994. The stock for debt exception previously found at I.R.C. §§ 108(e)(8) and (10) before repeal is therefore the applicable law to answer the questions in this matter. References herein to the stock for debt exception and to provision of I.R.C. § 108 refer to the former provisions of the law, as it was in effect for the periods at issue.

Under I.R.C. § 108(e)(10)(A), the general rule is that a debt that is satisfied by the issuance of the debtor's stock is treated as having been satisfied with money equal to the value of the stock. The difference between the fair market value of the stock and the amount of the debt is income from the cancellation of indebtedness. An exception is provided to this general rule by I.R.C. § 108(e)(10)(B) for stock transfers in bankruptcy cases or, for an insolvent debtor, to the extent of the taxpayer's insolvency. This exception is known as the stock for debt exception.

The stock for debt exception does not apply if the stock issued is "disqualified stock" as defined in I.R.C. § 108(e)(10)(B)(ii). In addition, the shares issued must not be nominal or token. I.R.C. § 108(e)(8)(A). And the ratio that the fair market value of stock issued to an unsecured creditor bears to the canceled debt of that creditor that is exchanged for the stock must also be at least 50 percent of the same ratio computed for all unsecured creditors participating in the bankruptcy. I.R.C. § 108(e)(8)(B).

Disqualified Stock:

Disqualified stock is stock with a stated redemption price if there is a fixed redemption date or if either the issuer or holder has a right to redeem or require redemption at one or more times. The stock issued in the taxpayer's reorganization did not have any redemption rights, so it is not disqualified stock.

Nominal or Token Stock:

Whether the stock issued is nominal or token is a factual determination based on the relevant facts and circumstances. The determination of whether stock issued for unsecured indebtedness is nominal or token is made on an aggregate basis. Treas. Reg. § 1.108-1(b)[1]. For plans confirmed after May 17, 1994, the IRS has announced that stock will not be considered nominal or token if the stock issued to unsecured creditors equals at least 15% of the total stock of the corporation after bankruptcy. Rev. Proc. 94-26, 1994-1 C.B. 612.

After reorganization, the taxpayer had [redacted] shares of stock issued and outstanding, of which [redacted] were Class 1 shares and [redacted] were Class 2 shares. Of these shares, [redacted] shares [redacted] of Class 1 and [redacted] of Class 2) were issued to the Class 5 and Class 7 creditors in satisfaction

[1] Treas. Reg. § 1.108-1 was not promulgated until March 17, 1994, after the tax periods at issue. The effective date of the regulations, though, state that they apply to: 1) any issuance of stock for indebtedness made prior to December 31, 1994; and 2) to any issuance of stock for indebtedness in a bankruptcy or other insolvency case that was filed on or before December 31, 1993, pursuant to, (a) a bankruptcy plan confirmed after May 17, 1994, or (b) in a nonbankruptcy case, a workout in which the issuance of all stock for indebtedness occurred after May 17, 1994. Since the issuance of stock for indebtedness in this case occurred before December 31, 1994, the regulations are effective, even though they had not been promulgated at that time.

of debts. Through the plan of reorganization, creditors overall received [redacted]% of the total outstanding stock of the taxpayer, comprised of [redacted]% of the Class 1 stock and [redacted]% of the class 2 stock.

There are various arguments that can be made regarding the extent to which the Class 5 Claims are secured and how the distributions of cash, secured debt, unsecured debt, and stock should be allocated between the secured and unsecured portion of each claim. For example, in arguing that it should be entitled to deduct postpetition interest accrued on the Class 5 Claims, the taxpayer has taken the position that the Class 5 Claims are oversecured. Under this position, none of the stock issued to Class 5 Creditors would have been distributed in satisfaction of an unsecured debt. On the other hand, under the presumption in Treas. Reg. § 1.108-1(d)(6), a claim is considered secured only to the extent that consideration other than stock and unsecured debt is distributed for the claim. Under this presumption, all of the stock issued to Class 5 Creditors would have been distributed in satisfaction of unsecured claims.

It is clear that at least the [redacted] shares of stock issued to the Class 7 Creditors were issued in satisfaction of unsecured claims. This is [redacted]% of the aggregate amount of stock issued and outstanding after the reorganization. If only [redacted] of the [redacted] shares issued to Class 5 Creditors are deemed to be in satisfaction of unsecured liabilities, the 15% safe harbor provided in Rev. Proc. 94-26 would be satisfied.

Because the plan of reorganization in this case was confirmed prior to May 17, 1994, the effective date of Rev. Proc. 94-26, the 15% safe harbor does not apply in this case. However, even though it is not binding on the IRS, this Revenue Procedure does provide some guidance on what would be considered nominal or token for periods prior to its effective date. If the aggregate amount of stock issued for unsecured debt in this case exceeds 15%, an argument by the IRS that this amount is nominal or token would be subject to attack because of the Revenue Procedure.

As discussed in our previous memorandum regarding the deductibility of accrued postpetition interest, the taxpayer's position that the Class 5 Claims are oversecured is tenuous. The better position is that some part of the Class 5 Claims is unsecured. In Scenarios 1, 2, and 3 discussed below, applying various assumption regarding the allocation of distributions among Class 5 Debts, sufficient stock is allocated to unsecured Class 5 Claims to satisfy the 15% safe harbor in Rev. Proc. 94-26. Depending on the extent to which the Class 5 Claims are determined to be secured and the allocation of the distributions

between the secured and unsecured portions of these claims, an argument might be made that the stock issued in satisfaction of unsecured debts in this case was nominal or token. This argument, though, does not appear to be strong.

Proportionality Test:

To determine whether a disproportionately small amount of stock was issued for unsecured debt, the "individual common stock ratio" is compared to the "group common stock ratio." The stock for debt exception does not apply if the individual common stock ratio for a particular claim is less than one-half of the group common stock ratio. Treas. Reg. § 1.108-1(c)(1)(i).

The individual common stock ratio is defined as the ratio of the common stock issued for an unsecured indebtedness to the amount of the unsecured indebtedness allocated to that common stock. The amount of unsecured indebtedness allocated to the common stock is the amount of the indebtedness for which the common stock is issued reduced by other consideration transferred in exchange for the indebtedness. Treas. Reg. § 1.108-1(c)(1)(ii).

The group common stock ratio is defined as the ratio of the aggregate value of all common stock issued for unsecured indebtedness in the bankruptcy case to the aggregate amount of unsecured indebtedness allocated to that common stock. The amount of unsecured indebtedness allocated to the common stock is the aggregate amount of all unsecured indebtedness exchanged for stock or canceled in the bankruptcy case, reduced by the amount of other consideration issued for that indebtedness. Treas. Reg. § 1.108-1(c)(1)(iii).

The taxpayer takes the position that different claims held by the same creditor should be aggregated in applying the individual common stock ratio. In this case, four creditor who held Class 6 Claims also held Class 7 Claims. These creditors received no stock for their Class 6 Claims, but did receive stock for their Class 7 Claims. The taxpayer's position is that these Class 6 Claims qualify for the stock for debt exception because, when each creditor's Class 6 and Class 7 Claims are combined, these debts satisfy the proportionality test in the aggregate.

The individual common stock ratio must be determined on a claim by claim basis, not by aggregating all claims held by a particular creditor. The common stock ratio test is in I.R.C. § 108(e)(8), which is titled "Stock for Debt Exception Not to Apply in De Minimis Cases." The individual common stock ratio is designed to allow qualification for the stock for debt exception

only for claims that receive a meaningful proportion of the stock issued to creditors in the reorganization. Aggregating different claims held by one creditor could defeat this purpose by allowing the debtor the benefit of the stock for debt exception even in instances, as here, where no stock was issued to satisfy a particular claim.

Similarly, when the holder of a single claim elects to receive a combination of cash and stock, the claim is treated as a single claim. The portion of such a claim that is satisfied with a cash distribution is not a separate claim that automatically fails to qualify for the stock for debt exception. For example, in this case, a Class 7 creditor which elects to have its claim satisfied with a combination of Type A and Type B Distributions still has only one claim. This situation is similar to Debt 1 in the Example in Treas. Reg. § 1.108-1(c)(iv).

The Revenue Agent takes the position that a creditor electing different types of distributions (Class 7 Type A and Type B Distributions or Class 5 Type 1, Type 2, and Type 3 Distributions) should be looked at as having different claims. For example, the portion of a Class 7 Claim satisfied with a Type A Distribution would be disqualified from the stock for debt exception because no stock was issued for this portion of the creditor's claim. The individual stock ratio for the creditor's Type B Distribution would be calculated on the portion of the claim satisfied by that distribution alone, as if it were a claim separate from the portion satisfied with a Type A Distribution.[2] This also applies to a Class 5 Creditor who elects a combination of Type 1, Type 2, and Type 3 Distributions. While there is merit to this position, the better position is that a single claim held by one creditor that is satisfied with different types of distributions (at the creditor's election) should be combined in calculating the individual stock ratio for that claim.

The taxpayer did not include prepetition interest on the Class 6 and Class 7 Claims in its analysis of the cancellation of debt issues. We agree with the Revenue Agent that the claims for prepetition interest are included as part of the debts discharged in the bankruptcy under 11 U.S.C. § 1141(d)(1). As a debt discharged in the bankruptcy, this prepetition interest is included in the group common stock ratio and, to the extent that the stock for debt exception does not apply to the interest, it reduces tax attributes under I.R.C. § 108(b).

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[2] A copy of the Revenue Agent's position on this issue is attached hereto as Appendix III.

Since the confirmed plan of reorganization provided that the prepetition interest on Class 6 and 7 Claims would be disregarded for purposes of distribution, it could be argued that this interest was not satisfied by the issuance of stock. Under this argument, this prepetition interest could not qualify for the stock for debt exception, even if the underlying claim did qualify for the exception. Moreover, the prepetition interest would not be included in the individual stock ratio as a part of the claim satisfied by the issuance of stock.

The better position is that the prepetition interest is an inherent part of the underlying claim and is, therefore, included in the individual stock ratio and, if it qualifies, is subject to the stock for debt exception. A creditor's claim for prepetition interest is not a separate claim held by that creditor, but is an integral part of that creditor's underlying claim. The provision in the plan providing that nothing was to be distributed to the Class 6 and Class 7 Creditors for their prepetition interest does not alter the nature of the claim for interest.[3]

Since none of the Class 6 Claims (including the unpaid prepetition interest on those claims) received any stock in exchange for the debt, no Class 6 Claim can qualify for the stock for debt exception. The fact that some of the creditors holding Class 6 Claims also held Class 7 Claims and received stock for their Class 7 Claims is irrelevant to determining whether the stock for debt exception applies to the Class 6 Claims.

The only claims that can qualify for the stock for debt exception are the Class 5 Claims held by creditors receiving a Type 3 Distribution and the Class 7 Claims held by creditors receiving a Type B Distribution. Qualification of any particular claim depends of whether the proportionality test is satisfied for that claim.

The first step in calculating the ratios for the proportionality test is to determine the extent to which each debt is secured and unsecured. Secured debts are only considered secured under Treas. Reg. § 1.108-1(d)(6) to the extent of the value of property securing the debt. The remaining amount of the claim is considered unsecured. This is similar to the test for

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[3] Information received from the taxpayer indicates that the total unpaid prepetition interest was $[redacted] for the Class 6 Debt and $[redacted] for the Class 7 Debt. The taxpayer does not specify how this interest is allocated among the separate creditors in each class. For purposes of this memorandum, we assume that it is proportionately allocated and our calculations herein are based on this assumption.

determining whether a debt is secured for bankruptcy purposes. 11 U.S.C. § 506(a). In this case, the Class 5 Debts are nominally secured primarily by share of stock in the taxpayer's subsidiaries. Since these shares are not publicly traded, their value is not readily ascertainable and is further complicated by the entities' bankruptcies. Because the Class 5 Debts received significantly less than the amounts owed on those claims, it seems apparent that the security did not have sufficient value to fully secured the debts. The exact extent of the lack of value and how the distributions under the plan of reorganization should be allocated between the secured and unsecured portions of each claim, though, are not apparent.

Numerous argument can be made about the extent to which the Class 5 Claims are secured and about how distributions on those claims should be allocated between the secured and unsecured portions of each claim. This is primarily a factual determination. We address four possible scenarios below, based on the facts of this case.

Scenario 1

Under Treas. Reg. § 1.108-1(d)(6), absent strong proof to the contrary, the presumption is that the value of property securing a debt is the issue price of any new secured indebtedness plus the value of any other consideration (except for stock or unsecured indebtedness) received for the old debt. A court's determination of value in a bankruptcy proceeding is a factor to consider in determining value, but it is not controlling. Id. In this case, only Class 5 Claims had property securing their claims. Applying the presumption in Treas. Reg. 1.108-1(d)(6) to the Class 5 Claims results in secured and unsecured claims being allocated as follows:

Class	Secured	Unsecured
5	$[redacted]	$[redacted]
6	$[redacted]	$[redacted]
7	$[redacted]	$[redacted]
Total	$[redacted]	$[redacted]

The calculation of the secured and unsecured portion of each Class 5 Claim is shown on Table A.[4]

[4] Information provided by the taxpayer indicates that stock that should have been distributed to the [redacted] Series

The resulting group common stock ratio is [redacted]% computed as follows:

Stock issued for unsecured debt:
Class 5 $[redacted]
Class 7 [redacted] $[redacted]

Divided by:

Total unsecured debts $[redacted]
Less other consideration:
cash - class 6 [redacted]
cash - class 7 [redacted]
senior subordinated debt [redacted] [redacted]

Group Common Stock Ratio [redacted]%

Of the [redacted] Class 7 Creditors, [redacted] elected to receive only a Type A Distribution, receiving only cash in exchange for their claim. Since these creditors received no stock in exchange for their debt, the taxpayer is obviously not entitled to claim the benefits of the stock for debt exception for these debts. The taxpayer correctly reported the principal balance of these debts as amounts reducing tax attributes, but did not include any prepetition interest as part of these claims. As discussed above, the prepetition interest on these claims should also be included as amount reducing tax attributed under I.R.C. § 108(d). The 6 remaining Class 7 Creditors elected a combination of Type A and Type B distributions, receiving both cash and stock in exchange for their claims. Distributions to the 6 creditors who received stock for a portion of their claim are summarized as follows:

Claimant	Amount of Claim	Distribution	
		Cash	Stock
[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]

E claim was instead distributed to the [redacted] Series D claim. In the scenarios herein, we assume that this was in fact done. The Series D claim would thereby be paid $[redacted] more than the amount of the claim and $[redacted] of the Series E claim that would otherwise qualify for the stock for debt exception does not. In this situation, the taxpayer could argue that it is entitled to deduct postpetition interest on the Series D claim as an oversecured claim.

[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]

The individual common stock ratios for each Class 5 and Class 7 claim that received stock are shown in Tables B and C, respectively. The value of the stock received for the Class 5 Claims that elected to receive stock was more than [redacted]% of the group common stock ratio, so the Class 5 Claims satisfy the proportionality test. The Class 7 Claims that received stock also each received stock worth at least [redacted]% of the group common stock ratio, except for [redacted]. All of the Class 7 Claims other than the $[redacted] claim held by [redacted] satisfy the proportionality test.

Application of the presumption in Treas. Reg. 1.108-1(d)(6), however, leads to anomalous results in this case. Under the regulation, similarly situated creditors can have different proportions of their claim considered secured, depending on which type of distribution they elect for their claim. For example, [redacted] and [redacted] both hold notes with identical security and terms. However, [redacted]% of [redacted]'s claim is considered secured, while only [redacted]% of [redacted]'s claim is considered secured. Applying the regulation, creditors with identical claims in the same security could end up having different proportions of their claims deemed to be secured.

Under 11 U.S.C. § 1123(a)(4), either each claim within a particular class must be treated the same or the claims receiving less favorable treatment must agree to such treatment. Typically, to ensure compliance with this provision, Chapter 11 Plans provide for the same treatment of each claim within a class. The provisions of the Plan of Reorganization in this case allowing for claims within Class 5 to elect different types of distributions results in irregular allocations of the security to Class 5 claims when the presumption in Treas. Reg. §1.108-1(d)(6) is strictly applied as in this scenario.

Scenario 2

In the taxpayer's bankruptcy proceeding, the Chapter 7 analysis that is required to show that reorganization is in the best interest of creditors indicated that the Class 5 Claims would receive $[redacted] in a liquidation and that Class 6 and Class 7 Claims would receive [redacted]. Arguably, this, plus

the incongruous result under scenario 1, provide evidence that the presumption in Treas. Reg. 1.108-1(d)(6) does not reflect the proper value of the secured claims.

Apportioning the $[redacted] of assets securing the Class 5 Claims[5] proportionately among each Class 5 Claim results in an allocation as shown in Table D.

The distribution of secured and unsecured claims between Classes 5, 6, and 7 would be as follows:

Class	Secured	Unsecured
5	$[redacted]	$[redacted]
6	$[redacted]	$[redacted]
7	$[redacted]	$[redacted]
Total	$[redacted]	$[redacted]

The resulting group common stock ratio is [redacted]% computed as follows:

[5] The $[redacted] assumed in the scenario to be the value of the security is the amount the taxpayer used in its "best interest of creditors" analysis under 11 U.S.C. § 1129(a)(7) to show that the creditors were receiving at least as much as they would in a Chapter 7 liquidation. As the value in a liquidation, this amount most likely represents a forced sale value of the assets, rather than full fair market value, and would be reduced by the Chapter 7 Trustee's fees and other expenses of sale. This liquidation value is inappropriate for determining the extent to which a claim is secured when, as was done in this case, the debtor retains the collateral. See Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997). It could be argued that, as a liquidation value, the $[redacted] undervalues the security held by Class 5 creditors, or at a minimum sets a floor for the secured value.

Stock issued for unsecured debt:		
Class 5	$ [redacted]	
Class 7		$ [redacted]
Divided by:		
Total unsecured debts	$ [redacted]	
Less other consideration:		
senior secured notes	[redacted]	
cash - class 5		
cash - class 6		
cash - class 7		
senior subordinated debt		[redacted]
Group Common Stock Ratio		[redacted]%

The individual common stock ratios for each claim that received stock are as shown in Table E. Under this assumption, some of the percentages vary from those under Scenario 1, but the final result is essentially the same. The only difference is the claim held by [redacted]. All of the Class 5 Claims and Class 7 Claims that received stock satisfy the proportionality test.

Scenario 3

Another possible allocation would be to apply the presumption in Treas. Reg. § 1.108-1(d)(6) to the Class 5 Claims in the aggregate to determine the extent to which Class 5 is secured as a whole. The amount of the security could then be allocated to each individual Class 5 Claim on a pro rata basis. The allocation of security for the Class 5 Claims would be as shown in Table F. Applying the presumption in Treas. Reg. § 1.108(d)(1) to determine the extent to which claims are secured in the aggregate, then allocating that security pro rata amount the individual claims avoids the problem in Scenario 1 of similarly situated creditors being deemed secured to a different extent.

The resulting group common stock ratio under this scenario is [redacted]%, computed as follows:

Stock issued for unsecured debt:		
Class 5	$[redacted]	
Class 7		$[redacted]
Divided by:		
Total unsecured debts	$[redacted]	
Less other consideration:		
senior secured notes	[redacted]	
cash - class 5		
cash - class 6		
cash - class 7		
senior subordinated debt		[redacted]
Group Common Stock Ratio		[redacted]%

The individual common stock ratio for Class 5 Claims would be as shown in Table G. The individual common stock ratio for Class 7 Claims would remain the same as in Scenario 1 (Table C). The end result under Scenario 3 is the same as under Scenario 1; all of the debts receiving a stock distribution, except the Class 7 [redacted] debt, satisfy the proportionality test. This Scenario, though, eliminates the disproportionate allocation of security among Class 5 creditors.

Scenario 4

To support its deduction of postpetition interest that accrued on the Class 5 Claims, the taxpayer has argued that these claims were oversecured, even though they did not receive full payment. If the taxpayer were to prevail on this argument, the only unsecured claims would be the $[redacted] of Class 6 and Class 7 Claims. The group common stock ratio would be [redacted]%, computed as follows:

Stock issued for unsecured debt:		
Class 7	$[redacted]	$[redacted]
Divided by:		
Total unsecured debts	$[redacted]	
Less other consideration:		
cash - class 6	[redacted]	
cash - class 7		[redacted]
Group Common Stock Ratio		[redacted]%

Under this scenario, all of the Class 7 Claims that were satisfied with distributions of stock would meet the

proportionality test. None of the Class 5 Claims, though, would qualify for the stock for debt exception because the exception only applies to unsecured claims satisfied with a distribution of stock. The full amount of the Class 5 Claims that were discharged by the bankruptcy proceeding, including any postpetition interest that is allowed as a deduction, would be subject to attribute reduction under I.R.C. § 108(b).

Under each of these scenarios, the stock distributed in satisfaction of the unsecured portion of each Class 5 Creditor and, except for the claim held be [redacted] under Scenarios 1 and 3, each of the Class 7 Creditor satisfies the proportionality test. Based on the information available at this time, the most supportable of the four possibilities discussed in this memorandum is Scenario 3. If the assumption made in this memorandum turn out to be incorrect[6] or if additional facts become known, new computations may be necessary to determine the relevant common stock ratios.

It is questionable whether the liquidation analysis supporting Scenario 2 or the taxpayer's arguments supporting Scenario 4 rise to the level of "strong proof" necessary to overcome the presumption in Treas. Reg. § 1.108-1(d)(6) upon which Scenarios 1 and 3 are based. The best position, based on the evidence currently available, is that the presumption under Treas. Reg. § 1.108-1(d)(6) should be applied. The results under Scenario 1 are problematic because of the varied allocation of security amount identically situated creditors. The best result is to apply the regulatory presumption to the undersecured Class 5 Claims in the aggregate, but then allocate that security to each individual Class 5 Claim on a pro rata basis.

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[6] One assumption we made is that the stock issued by the taxpayer had a value of $[redacted] per share, as specified in the plan of reorganization. In another context, the taxpayer has taken the position that the Class 5 Debts were oversecured, arguing that the true fair market value of these shares was significantly higher than $[redacted] per share. If the fair market value of these shares was greater than $[redacted] per share, the common stock ratios will increase significantly. This could cause the Class 7 Debts to fail the proportionality test. An additional assumption in Scenario 2 is that the value of the security underlying Class 5 Claims was $[redacted]. As noted above, this arguably undervalues the secured portion and overvalues the unsecured portion of the Class 5 Claims. This value was used for the Class 5 secured claims in Scenario 2 because there does not appear to be any better evidence of the value of the security. If better evidence of the value of the security comes to light, the common stock ratios will change.

Various other scenarios could be constructed based on other assumptions of the value of the security underlying the Class 5 Claims. The key to unequivocally determining whether the proportionality test is satisfied for the claims in this case is to properly value the collateral securing the Class 5 Claims. This is essentially a valuation issue, which is factual.

The facts in this case do not support any definitive determination of the value of the assets securing the Class 5 Claims. If the value of the collateral cannot be resolved at the Exam level, it will most likely become necessary to obtain appraisals of the collateral underlying the Class 5 Claims to determine the portion of those claims that is properly classified as secured. Without appraisals or other evidence to provide strong proof of the value of the collateral, the presumption set forth in Treas. Reg. § 1.108-1(d)(6) should be applied.

If you have any questions regarding this matter, please feel free to contact me.

[redacted]
Attorney

APPROVED:

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