Real Estate/Bankruptcy Taxation

Hospitality and the Tax Man: Historical Hospitality Tax Issues in Distress

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Hospitality and the Tax Man: Historical Hospitality Issues in Distress

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TAX CONSIDERATION FOR LIQUIDATING TRUSTS AND FOREIGN ASSET REPORTING

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Liquidating Trusts

Introduction

- A liquidating trust is used as an alternative to liquidating through a post-confirmation entity.
- Used when assets are illiquid (for example, claims).
- Rev. Proc. 94-45 establishes a safe harbor for consistent tax treatment.
- IRS may issue PLRs to approve liquidating trusts.
- 5 year time limit.
- Taxed as grantor trusts with creditors deemed the beneficiary-owners.
- Transfers to the trust are deemed as *pro rata* distributions (based on the extent of the creditor's interest) to creditors.
- *Do not reflexively use liquidating trusts. Think about why you want to use one before you do.*

Basic Requirements of Liquidating Trusts

To fall within the safe harbor of Rev. Proc. 94-45 (whether or not a PLR is obtained)

- Trust assets must be valued at the time of transfer. Rev. Proc. 94-45(3.04) requires that all trust assets be valued in the plan, disclosure statement and trust agreement.
- These values must be used for all federal tax purposes.
- The trust arrangement must be extensively explained in the plan and disclosure statement.
- A trust indenture agreement must be drafted and ordinarily included with the disclosure statement.
- The trust cannot do anything other than liquidate and distribute assets of the trust – cannot operate a business except under very limited circumstances.
- *Use the checklist annexed to Rev. Proc. 94-45 to make sure you are meeting the requirements for qualification!*
- *Holywell Corp. v. Smith*, 503 U.S. 47 (1992)
  - Chapter 11 trustee was appointed pursuant to a confirmed plan of reorganization to liquidate and distribute debtors' assets. Debtors consisted of several corporations and an individual. All assets were transferred to one trustee with the debtors retaining a reversionary interest in surplus.

- The plan of reorganization was silent as to who would file returns and pay taxes on the liquidation of assets.
- The trustee took the position that he had no obligation to pay taxes or file returns.
- Looking at IRC § 6012, the Supreme Court (Thomas, J), held that the trustee was the assignee of the debtors' assets and thus: "must file the returns that the corporate debtors would have filed had the plan not assigned their property to the trustee." *Id*. at 54.
- *Holywell* only speaks to the need to file a return, not to the actual tax treatment of a liquidating trust. While the opinion contains language about duty to pay taxes, since the trust at issue did not qualify as a liquidating trust, *Holywell* has never been interpreted to change the pass-through treatment of a liquidating trust established pursuant to Rev. Proc. 94-45.
- The *Holywell* trust also contained a reversionary right for the debtors, which is highly unusual.

Tax Benefits of Liquidating Trusts

- Treated as a pass-through entity so gain/loss is recognized by creditor/beneficiaries – who usually have a loss to offset returns.
- No need to file a Form 1041 (or file a zero return).
- Allows for easy segregation of assets to be liquidated for the benefit of creditor/beneficiaries.

Tax Effect Not Often Considered

- On transfer of the assets from the DIP to the trust, a creditor may have to recognize phantom gain, if the assets are capable of valuation and the creditor's tax basis is insufficient to offset any gain.
- If the gross values of the assets transferred from the DIP to the trust are less than the gross issue price of the creditor's claims, the DIP may have to reduce tax attributes due to the realization of unrecognized COD income.
- Creditor/beneficiaries must take into account gain and loss from trust operations on a current basis.
- If the liquidating trust has net income for a given year, this income will be recognized *pro rata* by the creditor/beneficiary.
- Distributions of income to creditors must be made at least annually to conform to Rev. Proc. 94-45.
- Expenses of the DIP are not deductible by the liquidating trust.
- Liquidating trusts may typically only have a 5 year life span. Thus, if complex disputed claims are transferred to the trust and extensive litigation is required, procedural difficulties may arise.

What Happens if a Trust is Disqualified

- The arrangement may be treated as a "business trust" and taxed as a partnership, corporation or complex trust.
- If taxed as a corporation, the entity would have to pay taxes and file a tax return (Form 1120).
- If taxed as a partnership, the tax effects would continue to flow through to the creditor/owners, but the treatment would be different than under the trust rules:
    - The entity would file a tax return (Form 1065 – unless it is treated as a disregarded entity where there is only one creditor/owner).
- The arrangement may be taxed as a complex trust and would be responsible for taxes (IRC 641) and must file a tax return (Form 1041).
- Distributions from the DIP to the trust could be a taxable event to the DIP or the trust.
- The trust will be required to recognize gain or loss and, if applicable, pay taxes at the trust level.
    - Distributions from the trust to the creditor/beneficiaries would then be required to recognize gain on distributions received from the trust.
    - The trust cannot use DIP NOLs to shelter gains.
    - There would be no offsetting deduction for a bad-debt because the arrangement is no longer incident to a plan of arrangement of reorganization.

Consideration of Distributions to General Unsecured Creditors in the Wake of DBSD

Where a secured creditor wants to gift, but is precluded.

- Establishment of an extra-plan fund – i.e. an escrow or other arrangement, created by the secured creditors for the benefit of a junior class where there is a non-consenting intervening impaired class.
- Cannot likely qualify as a liquidating trust because it is not be establish pursuant to a plan of reorganization.
- Would be taxed as a business trust – most likely should be set up as a corporation.
- Not clear that such an arrangement is permissible under the Bankruptcy Code.

Foreign Asset Disclosure

Introduction

- U.S. taxpayers – including individuals and businesses – must file a disclosure of foreign bank accounts and assets in excess of $10,000.
- "Report of Foreign Bank and Financial Accounts" = FBAR
    - Bank and financial accounts
    - File FinCen Report 114
- "Foreign Account Tax Compliance Act" = FATCA
    - All other non-account assets
    - File Form 8938 – June by April 15th (starting 2016)
- Administered by FinCen and the IRS

Penalties for Failure to File

- Civil fraud penalties of 75% of the unpaid tax due to fraud
- Failure to file return penalties up to a maximum of 25% of the unpaid tax
- Failure to pay penalties up to 25% of the unpaid tax
- Accuracy related penalties of 20% of the underpayment attributable to negligence, substantial understatement, substantial overstatement of pension liabilities, or a substantial estate or gift tax valuation understatement
- Willful FBAR penalty of the greater of 50% of the highest aggregate value or $100,000, ***per year***
- Non-willful FBAR penalty up to $10,000 per account per year.

Offshore Voluntary Disclosure Program (OVDP)

- Disclose all facts related to the offshore accounts and income producing assets
- Agree to extend the limitations on assessment
- Provide copies of previously filed income returns for the past 8 years
- Provide amended returns for the last 8 years picking up excluded foreign income
- File complete and accurate returns and FBARs for the past 8 years
- All tax due on the unreported income
- An accuracy-related penalty of 20% of the tax due
- Delinquency penalties for failure to file and/or failure to pay
- Interest due on the tax and penalties
- FBAR penalty
    - For most individuals, the penalty is 27.5% of the highest aggregate balance of undisclosed foreign accounts and income producing assets over the last 8 years
    - There is a lower penalty available of 5% for those who have inherited accounts with little or no activity, or taxpayers who are foreign residents and were unaware that they were U.S. citizens
    - There is a lower penalty available of 12.5% for those with offshore accounts or assets that did not exceed $75,000 in any year under the OVDP
    - If the taxpayer qualifies for a streamlined program, the FBAR penalty is 5%

THE RISE AND FALL OF THE "GIFTING DOCTRINE"

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From the mid-1990's through early 2011, the "gifting doctrine" was a key tool used by debtors and secured creditors to garner support for plans of reorganization in Chapter 11 bankruptcy cases. The seminal decision on gifting can be found at *Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305 (1st Cir. 1993). Recent decisions from the Second and Third Circuits have narrowed or rejected the "gifting doctrine" and have signaled a sea change in the way in which Chapter 11 plans are negotiated and consummated. *See In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005); *Dish Network Corp. v. DBSD North Am., Inc. (In re DBSD North Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011). This change brings to the forefront certain tax considerations that will inform the development of plan-related strategies in Chapter 11 cases.

In *SPM*, following contentious negotiations regarding the reorganization of the Chapter 11 debtor, the Official Committee of Unsecured Creditors and Citizens Bank, the secured lender, entered into an agreement to cooperate in the restructuring and to share any proceeds they would receive in connection with a reorganization or liquidation of the debtor. *SPM Mfg. Corp.*, 984 F.2d at 1308. The First Circuit described the ensuing events as follows:

> After it became apparent that SPM could not be successfully reorganized, the bankruptcy court granted a motion by Citizens … to appoint a receiver with the power to negotiate a sale of all of SPM's assets…. On December 19, 1990, SPM's assets were sold to Heritage Albums, Inc. for a purchase price of $5,000,000.00. On December 21, 1990, a previously entered order went into effect granting Citizens relief from the automatic stay … and converting the case into a Chapter 7 liquidation proceeding…. On December 24, 1990, the Committee and Citizens filed a joint motion for "Entry of Order Requiring Delivery of Proceeds and Requiring

> Expedited Determination" which requested distribution of the sale proceeds to Citizens. The motion recited that the entire amount was subject to Citizens' security interest … and announced that, after receiving the $5 million and paying various administrative fees, "Citizens will distribute a portion of the net proceeds to … [counsel for the Committee] in accordance with its October 12, 1989 agreement with the Committee."

Id. at 1309 (internal citations omitted). The proposed distribution to the unsecured creditors jumped over a priority tax claim held by the IRS.

The Chapter 7 trustee and two individuals who were personally liable on the priority tax claim objected to the motion filed by Citizens and the Committee. The Bankruptcy Court granted a portion of the relief sought in the motion, authorizing the immediate distribution of the net sale proceeds to Citizens. However, the Bankruptcy Court rejected the sharing provision. The District Court affirmed the Bankruptcy Court order. The First Circuit reversed and approved the sharing arrangement. In arriving at its decision, the First Circuit observed:

> [T]he distribution scheme of section 726 (and, by implication, the priorities of section 507) does not come into play until all valid liens on the property are satisfied…. If a lien is perfected and not otherwise invalidated by law, it must be satisfied out of the assets it encumbers before any proceeds of the assets are available to unsecured claimants, including those having priority (such as priority tax creditors).

Id. at 1312 (internal citations omitted). The Circuit Court proceeded to find that the distribution scheme did not take anything away from the unsecured creditors because there would have been nothing left for unsecured creditors after Citizens received a distribution on its secured claim. *Id.* at 1312-13.

The First Circuit also examined the right of a creditor to do with a bankruptcy distribution what it wishes. According to the Court, "While the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors … creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including share them with

other creditors." *Id.*at 1313 (citations omitted). The Court also held, "[A]bsent some effect on the administration of the estate or diminution of estate property, neither the Code nor the Rules prohibit or discourage creditors from receiving cash from nondebtors in exchange for their claims." *Id.* at 1314. The precedent established by *SPM* formed the backbone of the "gifting" strategy utilized in countless cases that followed in order to achieve plan confirmation.

The first significant challenge to "gifting" occurred in the Third Circuit in *Armstrong*. At issue in that case was confirmation of a plan of reorganization that proposed to issue warrants for new stock to the debtor's equity holders before the debtor's creditors were paid in full To address a possible objection by the unsecured creditors, the plan proposed to issue the warrants to a class of asbestos personal injury claimants in the event of a cram down. The asbestos personal injury claimants would then transfer their rights to the warrants to the equity holders. . *Armstrong*, 432 F.3d at 509-10.

The Official Committee of Unsecured Creditors objected to confirmation of the plan as a violation of the absolute priority rule codified at Section 1129(b) of the Bankruptcy Code. The Bankruptcy Court issued proposed findings of fact and conclusions of law and recommended confirmation of the plan. The District Court denied plan confirmation, finding that "(1) the issuance of warrants to the equity interest holders violated the absolute priority rule, and (2) no equitable exception to the absolute priority rule applied." *Id.* at 511 (quoting *In re Armstrong World Indus., Inc.*, 320 B.R. 523 (D. Del. 2005)). The Third Circuit affirmed.

The Third Circuit adopted an unwavering approach to the absolute priority rule. According to the Court:

> The absolute priority rule, as codified, ensures that "the holder of any claim or interest that is junior to the claims of [an impaired dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. §

> 1129(b)(2)(B)(ii). The plain language of the statute makes it clear that a plan cannot give property to junior claimants over the objection of a more senior class that is impaired….

Id. at 513. The Court proceeded to distinguish *SPM* as follows:

> The District Court differentiated *SPM* from the current case in three ways: (1) SPM involved a distribution under Chapter 7, which did not trigger 11 U.S.C. § 1129(b)(2)(B)(ii); (2) the senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme; and (3) the distribution was a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others…. Similarly, *Genesis Health* involved property subject to the senior creditors' liens that was "carved out" for the junior claimants…. We adopt the District Court's reading of these cases, and agree that they do not stand for the unconditional proposition that creditors are generally free to do whatever they wish with the bankruptcy proceeds they receive. Creditors must also be guided by the statutory prohibitions of the absolute priority rule…. We conclude that the absolute priority rule applies and is violated by this distribution scheme.

Id. at 514 (internal citations omitted). Following the *Armstrong* decision, there was a real question as to whether unsecured creditors could effectively "gift" distributions under a Chapter 11 plan over the objection of creditors holding equal or lesser claims. *Armstrong* did not address the situation in which a secured creditor gave up a portion of its recovery on its secured claim for the benefit of the equity or a junior creditor interest.

The complete erosion of the "gifting doctrine" came with the Second Circuit's decision in *DBSD*. In that case, the Court considered a plan in which the equity received warrants and shares in the reorganized debtor before junior creditors were paid in full. The Court described the plan as follows:

> The plan provided that the holders of the First Lien Debt would receive new obligations with a four-year maturity date and the same 12.5% interest rate…. The holders of the Second Lien Debt would receive the bulk of the shares of the reorganized entity, which the bankruptcy court estimated would be worth between

> 51% and 73% of their original claims. The holders of unsecured claims … would receive shares estimated as worth between 4% and 46% of their original claims. Finally, the existing shareholder … would receive shares and warrants in the reorganized entity.

DBSD, 634 F.3d at 86. Sprint, an unsecured creditor, objected to confirmation and argued that the plan violated the absolute priority rule. *Id.*

The Bankruptcy Court overruled Sprint's objection and approved the plan, holding "that it would permit such gifting 'at least where … the gift comes from secured creditors, there is no doubt as to their secured creditor status, where there are understandable reasons for the gift, where there are no ulterior, improper ends … and where the complaining creditor would get no more if the gift had not been made.'" *Id.* at 87. The District Court affirmed. *Id.* at 88. The Second Circuit reversed, adopting a strict application of the absolute priority rule. According to the Court, "Absent the consent of all impaired classes of unsecured claimants … a confirmable plan must ensure either (i) that the dissenting class receives full value of its claim, or (ii) that no classes junior to that class receive any property under the plan on account of their junior claims or interests." *Id.* at 95. The Court proceeded to hold:

> The Code extends the absolute priority rule to "any property," … not "any property not covered by a senior creditor's lien." The Code focuses entirely on who "receive[s]" or "retain[s]" the property "under the plan," … not on who *would* receive it under a liquidation plan. And it applies the rule to any distribution "under the plan on account of a junior interest … regardless of whether the distribution could have been made outside the plan and regardless of whether other reasons might support the distribution in addition to the junior interest.

Id. at 97-98 (internal citations omitted) (emphasis in original).

The *DBSD* Court also distinguished *SPM*, employing an analysis similar to the one used by the Third Circuit in *Armstrong*. *Id.* at 98. The Court left open the possibility of settlements outside a plan when it made the following observation: "We need not decide whether the Code

would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside of the plan, for, on the present record, the existing shareholder clearly receives these shares and warrants 'under the plan.'" *Id.* at 95.

What's Left After DBSD:

Gifting plans appear to be dead after *DBSD*. Bankruptcy and restructuring practitioners have had to get creative in order to drive consensus in cases involving secured creditors that are undersecured and unsecured creditors that are out of the money. Following are some options for driving consensual plans following *DBSD*:

- Carve Outs
- Claims Trading
- Distributions Outside a Plan
- Strategic Contract Assumptions
- New Value Plans

In deciding whether to employ these strategies, it is important to consider the tax implications of each option.

SALE-RELATED TAX CONSIDERATIONS – TIMING IS EVERYTHING

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As with so many bankruptcy cases today, hotel and hospitality bankruptcies often end up in asset sales either pursuant to Section 363 of the Bankruptcy Code or pursuant to a Plan of Reorganization/Liquidation. When developing a strategy for these sale cases, the tax implications of the sale are a key issue. Front and center in that analysis is the stamp-tax exemption contained in Section 1146 of the Bankruptcy Code. Depending upon the value of the hotel/hospitality assets and the jurisdiction in which the property is located, the stamp-tax exemption could allow for a more substantial return to creditors in any given case. These materials are intended to provide an overview regarding the current state of the law on the stamp-tax exemption and will focus on a critical timing issue that has arisen on account of recent case authorities.

The Statute:

Section 1146(a) of the Bankruptcy Code provides: "The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp-tax or similar tax." 11 U.S.C. § 1146(a). Clearly, when a hotel or hospitality debtor sells some or all of its assets, it with make and deliver "an instrument of transfer." The controversial question that the cases routinely examine is whether the making or delivery of such instrument of transfer is "under a plan confirmed under section 1129" such that the transfer will not be subject to a stamp-tax or similar tax.

History:

Prior to 2008, an apparent circuit split had developed regarding the interpretation of the "under a plan confirmed" language in Section 1146(a) of the Bankruptcy Code. The following cases gave rise to that circuit split: (i) *In re Jacoby-Bender, Inc.*, 758 F.2d 840 (2d Cir. 1984); (ii) *NVR Homes, Inc. v. Clerks of the Circuit Courts of Anne Arundel County (In re NVR, LP)*, 189 F.3d 442 (4th Cir. 1999), cert. denied, 528 U.S. 1117 (2000); and (iii) *In re Hechinger Inv. Co. of Del.*, 335 F.3d 243 (3d Cir. 2003). To understand the current state of play, it is important to understand the historical backdrop created by these three cases.

The Second Circuit set the early standard with its decision in *Jacoby-Bender*. That case concerned a sale of the debtor's assets following confirmation of a plan of reorganization. The plan provided for funding through the sale of a building owned by the debtor. Following confirmation, the debtor sought an order authorizing the sale of the building and for the filing of the deed without payment of the transfer taxes. The City of New York objected and contended that the sale was not "under a plan confirmed" because the plan did not include sufficiently detailed information regarding the sale. The Second Circuit rejected the City's argument, taking an expansive view of the exemption set forth in Section 1146(a). According to the Court:

> [A]s the bankruptcy court found, "the plan's consummation depended almost entirely upon the sale of the building," the sale in turn depended upon the delivery of the deed. That the plan did not empower the debtor to make a specific sale or deliver a specific deed is irrelevant to our determination that the delivery of the deed took place "under" the plan within the meaning of section 1146(c)…. "[W]here, as here, a transfer, and hence an instrument of transfer, is necessary to the consummation of a plan, the plan seems implicitly to have 'dealt with' the transfer instrument."

Jacoby-Bender, 758 F.2d at 841-42.[1] For the Second Circuit, it was enough that the sale was necessary for "consummation" of the plan for the stamp-tax exemption set forth in Section 1146 to apply.

The Fourth Circuit was next to weigh in on the meaning of the phrase "under a plan confirmed" in Section 1146(a). In *NVR Homes*, the Fourth Circuit considered whether property sales by the debtor *prior to confirmation of a plan of reorganization* qualified for the stamp-tax exemption under the Code. The debtor argued that the sales qualified for the stamp-tax exemption because the sales were necessary to confirmation of the plan. Ostensibly following *Jacoby-Bender*, the Fourth Circuit distinguished between sales that were necessary to "consummation" of a plan and sales that were necessary to "confirmation" of a plan. The Fourth Circuit concluded that only post-confirmation sales qualified for the stamp-tax exemption set forth in Section 1146(a). In arriving at this decision, the Court observed:

> We must conclude that Congress, by its plan language, intended to provide exemptions only to those transfers reviewed and confirmed by the court. Congress struck a most reasonable balance. If a debtor is able to develop a Chapter 11 reorganization and obtain confirmation, then the debtor is to be afforded relief from certain taxation to facilitate the implementation of the reorganization plan. Before a debtor reaches this point, however, the state and local tax systems may not be subjected to federal interference.

NVR Homes, 189 F.3d at 458. With this decision, the timing issue began to take shape.

The Third Circuit took a much more restrictive view of the stamp-tax exemption in *Hechinger*. In that case, the debtor sought approval of property sales that closed prior to confirmation of a plan pursuant to Section 363 of the Bankruptcy Code. In the sale order, the debtor sough a declaration that the sales were exempt from transfer taxes pursuant to Section

[1] The stamp-tax exemption originally appeared in Section 1146(c) of the Bankruptcy Code. In 2005, Congress repealed subsections (a) and (b) of Section 1146, and the stamp-tax exemption was re-codified as Section 1146(a).

1146(a). The local taxing authorities objected. In a departure from the Second Circuit decision in *Jacoby-Bender*, the Third Circuit held that the sales must be explicitly authorized under a plan. The Third Circuit observed that "the most natural reading of the phrase 'under a plan confirmed' … is 'authorized' by such a plan." *Hechinger*, 335 F.3d at 252. In arriving at this decision, the Court relied upon two principles of construction: (i) that tax exemption provisions must be strictly construed; and (ii) that federal laws that interfere with a state's taxation scheme must be narrowly construed in favor of the state.

Checking the score card, we had the following competing precedents: (i) the Second Circuit authorized the stamp-tax exemption to the extent a sale is necessary for the "consummation" of a plan, regardless of whether the plan provides for the specific sale transaction; (ii) the Fourth Circuit would apply the stamp-tax exemption to sales only if the sales occurred post-confirmation; and (iii) the Third Circuit requires express authorization language in the plan before a stamp-tax exemption will apply.

Resolution:

In 2008, the United States Supreme Court addressed the Circuit Courts' disparate treatment of Section 1146(a) of the Bankruptcy Code when it decided *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008). In that case, the Bankruptcy Court approved a pre-confirmation sale of assets by the debtor along with a settlement that detailed the manner in which the sale proceeds would be distributed among the debtor's creditors. The sale order also provided that the transfer of assets was exempt from stamp-taxes pursuant to Section 1146(a). Subsequently, the debtor filed a plan that provided for distribution of the sale proceeds consistent with the prior order and settlement. The State of Florida objected to confirmation of the plan and sought a declaration that the transfer of property was not exempt from stamp-tax

liability under Section 1146(a). The Bankruptcy Court overruled the State's objection and held that the pre-confirmation sale was exempt from stamp-tax liability. Both the District Court and the Eleventh Circuit affirmed.

The Supreme Court reversed and held that a sale prior to confirmation of a plan does not fall within the stamp-tax exemption set forth in Section 1146(a) of the Bankruptcy Code. The Court observed that Section 1146(a) "specifies not only that a tax-exempt transfer be 'under a plan,' but also that the plan in question be confirmed pursuant to § 1129." *Id.* at 41. Similarly, the Court stated, "It was unnecessary for Congress to include in § 1146(a) a phrase such as 'at any time after confirmation of such plan' because the phrase 'under a plan confirmed' is most naturally read to require that there be a confirmed plan at the time of the transfer." *Id.* at 45. The Court ultimately quoted the following passage (referenced above) from the Fourth Circuit's decision in *NVR Homes*:

> Congress struck a most reasonable balance. If a debtor is able to develop a Chapter 11 reorganization and obtain confirmation, then the debtor is to be afforded relief from certain taxation to facilitate the implementation of the reorganization plan. Before a debtor reaches this point, however, the state and local tax systems may not be subjected to federal interference.

Id. at 52, quoting *NVR Homes*, 189 F.3d at 458.

Following the Supreme Court's decision in *Piccadilly Cafeterias*, some clarity had emerged. In the event a debtor proceed to close a sale prior to confirmation of a plan of reorganization, the sale would not qualify for the stamp-tax exemption set forth in Section 1146(a) of the Bankruptcy Code.

The Timing Issue Becomes More Complicated:

In 2009, the United States Bankruptcy Court for the Southern District of New York complicated the timing issue when it decided *In re New 118th, Inc.*, 398 B.R. 791 (Bankr.

S.D.N.Y. 2009). In that case, the Chapter 11 Trustee obtained authorization pursuant to Section 363 of the Bankruptcy Code to proceed with the sale of certain real property owned by the debtors. Subsequent to approval of the sale but prior to a closing of the sale, the Trustee filed a plan and disclosure statement. The plan noted the importance of the sale to its implementation and provided that the sale would be exempt pursuant to Section 1146(a) from various state and local taxes. The City objected to the tax exemption.

The Bankruptcy Court ruled that the stamp-tax exemption applied to the sale. As an initial matter, the Court observed that a transfer of real property does not occur under New York law until delivery of the deed. *Id.* at 794. Since Section 1146(a) refers to a transfer and not to a sale, the transfer does not occur until the debtor delivers the deed at closing. Since the closing had not occurred at the time of confirmation, the stamp-tax exemption would apply. In arriving at its decision, the Bankruptcy Court surveyed the decisions in *Jacoby-Bender*, *NVR Homes*, *Hechinger* and *Piccadilly Cafeterias*. Ultimately, the Bankruptcy Court concluded that the stamp-tax exemption would apply to a post-confirmation transfer of real property on a sale negotiated pre-confirmation. Specifically, the Bankruptcy Court held:

> [T]he post-confirmation delivery of the deed, and hence, the transfer, satisfies Piccadilly's "simple, bright-line rule." Furthermore, the Supreme Court's adoption of the NVR standard, and by extension, the reasoning of Jacoby-Bender, suggests that the § 1146(a) exemption applies to a post-confirmation transfer that follows a pre-confirmation sale if the transfer facilitates the implementation of the plan, or in the words of Jacoby-Bender, is necessary to the consummation of the plan.

Id. at 797. By way of further explanation, the Bankruptcy Court observed:

> This conclusion necessarily rejects the City's argument that § 1146(a) can never apply to a pre-confirmation sale under § 363. Piccadilly did not adopt such a rule and nothing in § 1146(a) requires the "sale" to occur post-confirmation. In fact, the word "sale" does not appear in § 1146(a). Instead, § 1146(a) is

> concerned with the "transfer" or the "making or delivery of an instrument of transfer."

Id. at 798-99.

Strategy Considerations:

Following the decisions in *Piccadilly Cafeterias* and *New 118th*, the timing of a transfer of property under state law should control the application of the stamp-tax exemption under Section 1146(a). However, the Bankruptcy Court's decision in *New 118th* is not binding upon other Bankruptcy Courts, leaving open the possibility that another Court could hold that a sale approved pursuant to Section 363 of the Bankruptcy Code pre-confirmation would not qualify for the exemption even if the sale closed post-confirmation. In any event, counsel and advisors to a debtor should consider the following when developing a strategy for sales of hotel and hospitality properties in connection with a Chapter 11 bankruptcy proceeding:

- Coordination of sale and plan processes whenever possible;
- Complications of sales of multiple properties;
- Complications of sales by multiple debtor entities;
- Economic impact on the estate of pre-confirmation sale(s).

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Tax Issues Related to the International Transaction: Know the Issues

Elizabeth A. Green and Troy Taylor

BakerHostetler

Hypothetical

- US-based Client owns major resort in Latin America for approximately 20 years.
  - Resort was purchased using low leverage, versus most domestic deals, which is typical of deals in higher risk foreign markets
  - Made substantial ongoing capital contributions to turn-around operations during and after 2008 crash. Due to low leverage, Client's equity was never out of the money, unlike almost all domestic deals. Walk-away was not prudent.
  - Resort has returned to profitability and Client wishes to liquidate some or all of its equity position and recoup its substantial investment

Restructuring Alternatives (1 of 2)

BakerHostetler

1) Asset Sale
   - Issue: Hotel and other fixed assets have depreciated substantially, eroding their tax bases. An asset sale is problematic for Client, due to high capital gains and transfer taxes in local jurisdiction.
2) Stock Sale
   - Issue: Stock sale is problematic for the Buyer because if assets' bases cannot be stepped-up in local jurisdiction, the financial impact of NPV of lost depreciation and tax basis (in the event Buyer were to flip the assets) would negatively impact purchase price.
3) Merger / Recapitalization
   - Issue: If merger/recapitalization alternative permits Newco to step-up asset bases, may have other issues such as increased time requirement, increased complexity of negotiations, disclosure issues, additional required approval and additional transaction costs.

Restructuring Alternatives (2 of 2)

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- Client was faced with balancing the payment of substantial capital gains (Asset Sale) vs. loss of purchase price (Stock Sale) vs. other complications (Merger)
- Generally speaking, in domestic transactions, tax issues don't drive the negotiations (don't let the tail wag the dog), but in foreign jurisdictions often the tax issues are the dog

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What Is the Level of Political Instability ?

- What is the chance of major changes in policy?
- Is there clarity on existing precedents?
- Is there inconsistency of application of the tax rules by taxing authorities?

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U.S. Tax-Free Reorganization Treatment (1 of 3)

One of the following seven types of corporate transactions must be met in order to qualify for tax-free reorganization treatment in the United States :

1) The statutory merger or consolidation, which looks to the corporate law of the state which will govern the effectiveness of the merger or consolidation

2) A stock-for-stock acquisition, i.e., the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)

3) A stock-for-asset reorganization, i.e., the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded

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Tax-Free Reorganization Treatment (2 of 3)

4) A divisive reorganization, i.e., a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

5) The recapitalization, whereby a single corporation reorganizes its own internal capital structure.

6) A transaction, whereby a corporation changes its identity, form, or place of organization, regardless of how the transaction is effected.

7) A transfer by a corporation of all or part of its assets to another corporation in a Title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355,

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Tax-Free Reorganization Treatment (3 of 3)

If a corporation meets any one of the above-mentioned definitions, no gain or loss is recognized by any corporation, which is a party to the reorganization or any shareholder in any corporation which is a party to the reorganization. Notice, however, that if anything additional is received other than the stock or securities permitted above, then that additional consideration will be subject to recognition of realized gain or loss 26 U.S.C. §§ 354(a)(1), 355(a), 361.

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What is the Local Tax Treatment of Asset Sale vs. Stock Sale vs. Merger

- Subject to capital gain, transfer tax, stamp/document taxes?
- Able to allocate purchase price among assets (basis step-up & allocation of goodwill to depreciable assets)
- Inherit tax liabilities and exposure to prior tax issues.
- Are tax consolidations permissible?
- Are there issues related to foreign ownership, exemptions for nationals, requirement for nationals in ownership structure?
- What is treatment of NOLs – can they be carried forward?
- Are there issues related to foreign ownership?

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Which Acquisition Vehicle is More Advantageous – Corporation vs. LLC vs. Trust (Other Considerations)

- What are the implications of local (intermediate) Holdco vs. Off-shore Holdco
  - Are there limitations/taxes on dividends to off-shore parent?
  - Limitations on deductions for other payments to off-shore parent?
- Are there any limitation on the deductibility of Interest?
  - Can interest from acquisition financing be deducted?
  - How is interest on Intercompany debt treated?
  - Are there limitations on payments to non-bank foreign lenders?
- What is the history of Tax authorities challenging the classification of the transaction based on the facts?
  - What is the likelihood and timing of an audit?
  - How is the audit appeal structured, and what is the likelihood of overturning an audit ruling? What will the cost of the process be?
  - How material are penalties and interest if the appeal is unsuccessful?

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