



Business Distress and Tax Consequences

2023 U.S. Cross-Border Tax Conference

June 5–7, 2023

Lead through Complexity



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Cross-Border Section 382

Brief overview of Section 382 and unique issues in the context of foreign corporations

01

Section 7874 & Cross-Border Restructuring



Section 7874 Overview

- Section 7874 and the corresponding regulations are the U.S.’s “anti-inversion” rules.
 - These are meant to deter certain “expatriation” transactions in which non-U.S. corporations acquire substantially all of the assets of a U.S. trade or business where the same shareholders there is significant overlap in ownership because of their tax avoidance potential.
- Inversion transactions may take many different forms. This may include a stock inversion, asset inversion, or a combination of the two.
- For a transaction to be considered an inversion, two statutory tests must be met.
 - Each test is subject to additional rules as provided in the relevant regulatory guidance.
 - These tests include:
 - i. the Acquisition Test, and
 - ii. the Ownership Test.
 - A further test, the Substantial Business Activities Test, if satisfied, may be used as an exception to the Ownership Test.

When Does Section 7874 Apply?

Section 7874 applies if pursuant to a plan (or series of related transactions):

- A foreign corporation completes a domestic entity acquisition (DEA);
- The ownership percentage is at least 60 percent (as measured by vote or value); and
- The foreign acquiring corporation's expanded affiliated group (EAG) does not have substantial business activities in the foreign acquiring corporation's country of formation (very rarely the case that the EAG would have substantial business activities).

Consequences

- If the ownership percentage is at least 60%, but less than 80%, then the foreign acquiring corporation is respected as a foreign corporation for U.S. tax purposes, but foreign acquiring shareholders, U.S. target, and U.S. persons related to U.S. target are subject to adverse U.S. tax regimes.
- If the ownership percentage is at least 80%, then the foreign acquiring corporation is a domestic corporation for all purposes of the Code.

Important Definitions Under Section 7874

Domestic Entity Acquisition

- The foreign acquiring corporation directly or indirectly acquires substantially all of either the properties directly or indirectly held by a U.S. corporation or the properties of a U.S. partnership's trade or business.
- Always consider the “multiple domestic target rule” and “multiple foreign acquirer rule.”

Ownership Percentage

- Measures the equity interest in the foreign acquiring corporation that the former owners of US target receive “by reason of” their U.S. target stock or partnership interests.
- Section 7874 regulations include a series of complex rules that adjust the numerator and/or denominator of the ownership fraction.

The Creditor Rule Under Section 7874

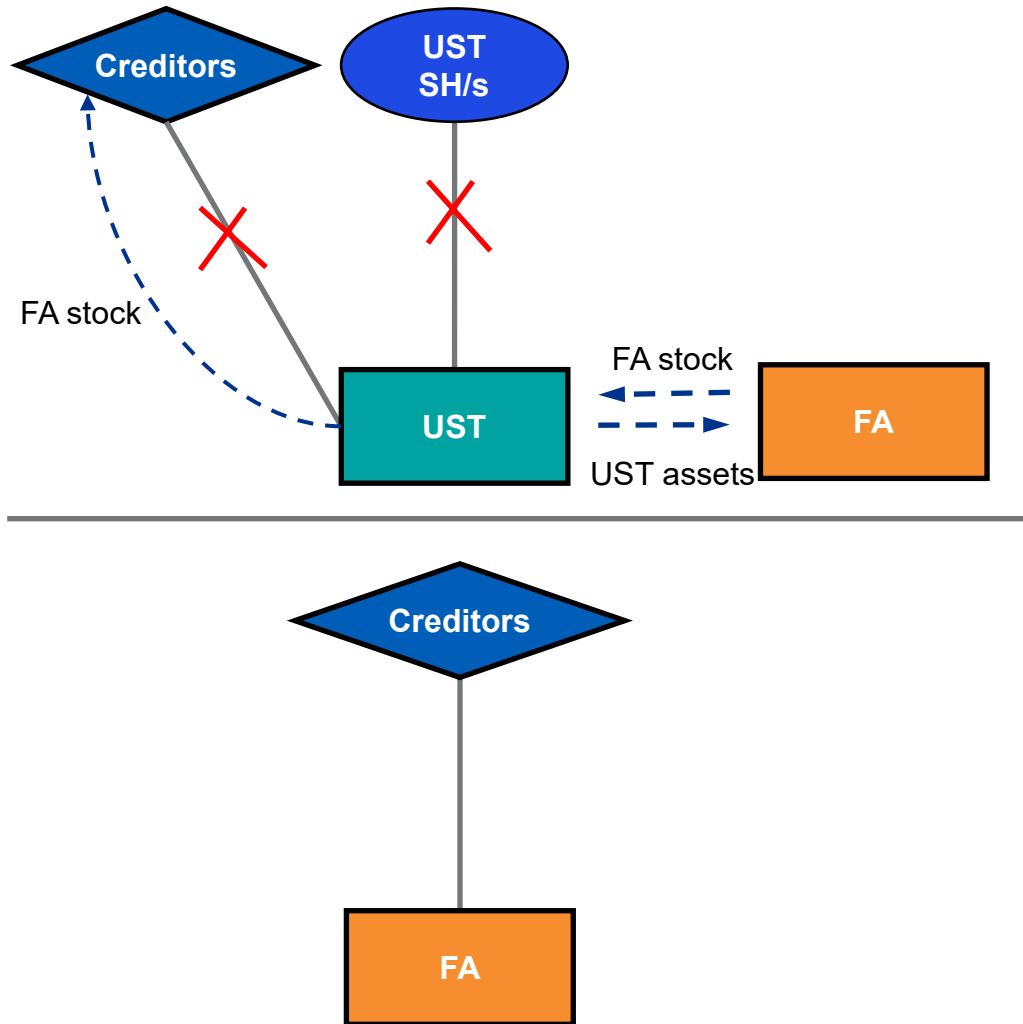
Overview of the Creditor Rule

- Applies for the determination of the appropriate treatment of companies that are insolvent or bankrupt.
- If applicable, a creditor of a domestic corporation is treated as a shareholder.

Specifically, the regulation provides:

For purposes of section 7874, **if, immediately prior to the first date properties are acquired as part of a domestic entity acquisition**, a domestic corporation is in a title 11 or similar case (as defined in section 368(a)(3)), or the liabilities of the domestic corporation exceed the value of its assets, then each creditor of the domestic corporation shall be treated as a shareholder of the domestic corporation and any claim of the creditor against the domestic corporation shall be treated as stock of the domestic corporation.

Example: The Creditor Rule



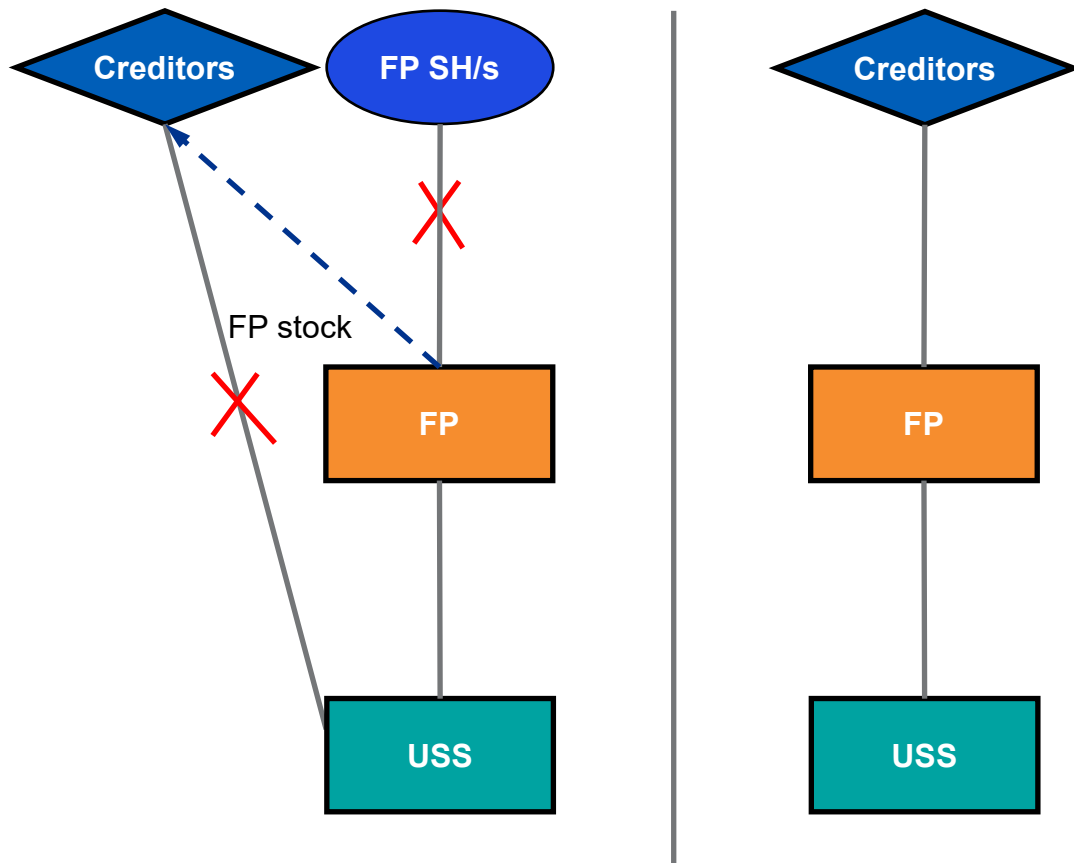
Facts

- UST is insolvent.
- FA acquires substantially all of UST's assets in exchange for FA stock, which is transferred to the Creditors in satisfaction of the debt.
- The existing shares of UST are cancelled.

U.S. Federal Tax Considerations

- FA's acquisition of substantially all of the assets of UST constitutes a domestic entity acquisition.
- Does the Creditor Rule apply to treat the Creditors as shareholders of UST and the FA stock as "by reason of" stock?

Example: The Creditor Rule & the Acquisition Test



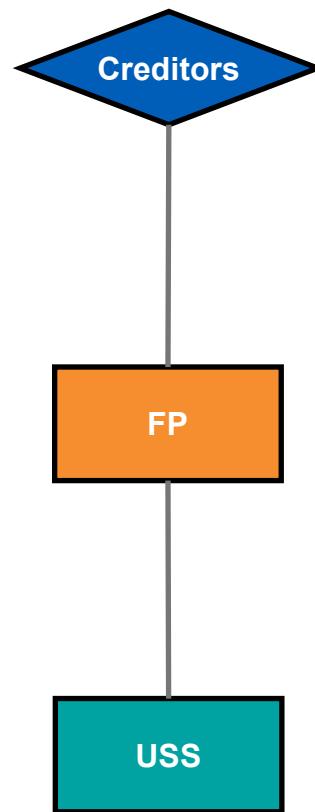
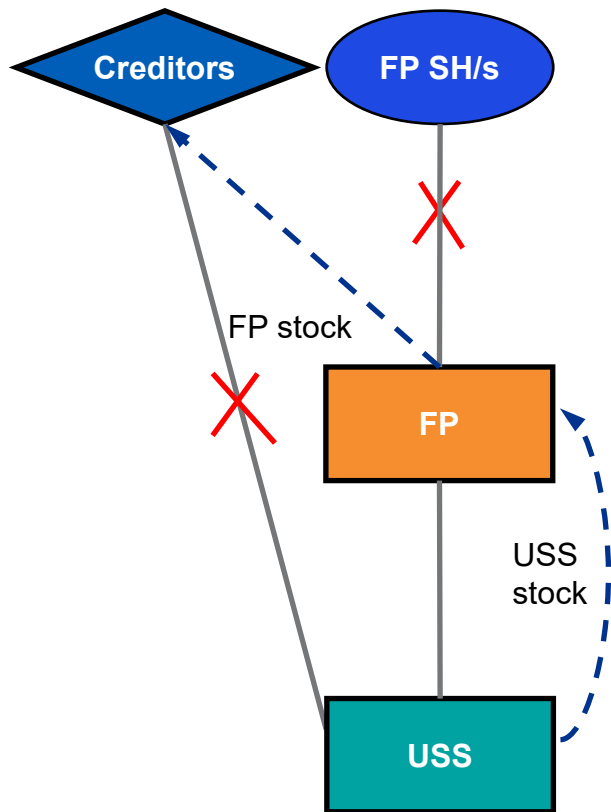
Facts

- USS is insolvent.
- The sole asset of FP is the stock of USS.
- FP transfers 100% of its stock to the creditors of USS in satisfaction of the debt.
- The existing shares of FP are cancelled.

U.S. Federal Tax Considerations

- There is no domestic entity acquisition of USS by FP, but for the application of the Creditor Rule or a broad interpretation of Reg. Section 1.7874-2(c).
- Does the Creditor Rule apply, such that the extinguishment of the USS debt in exchange for the FP shares is a domestic entity acquisition of USS?

Example: Section 7874 & Historic Ownership



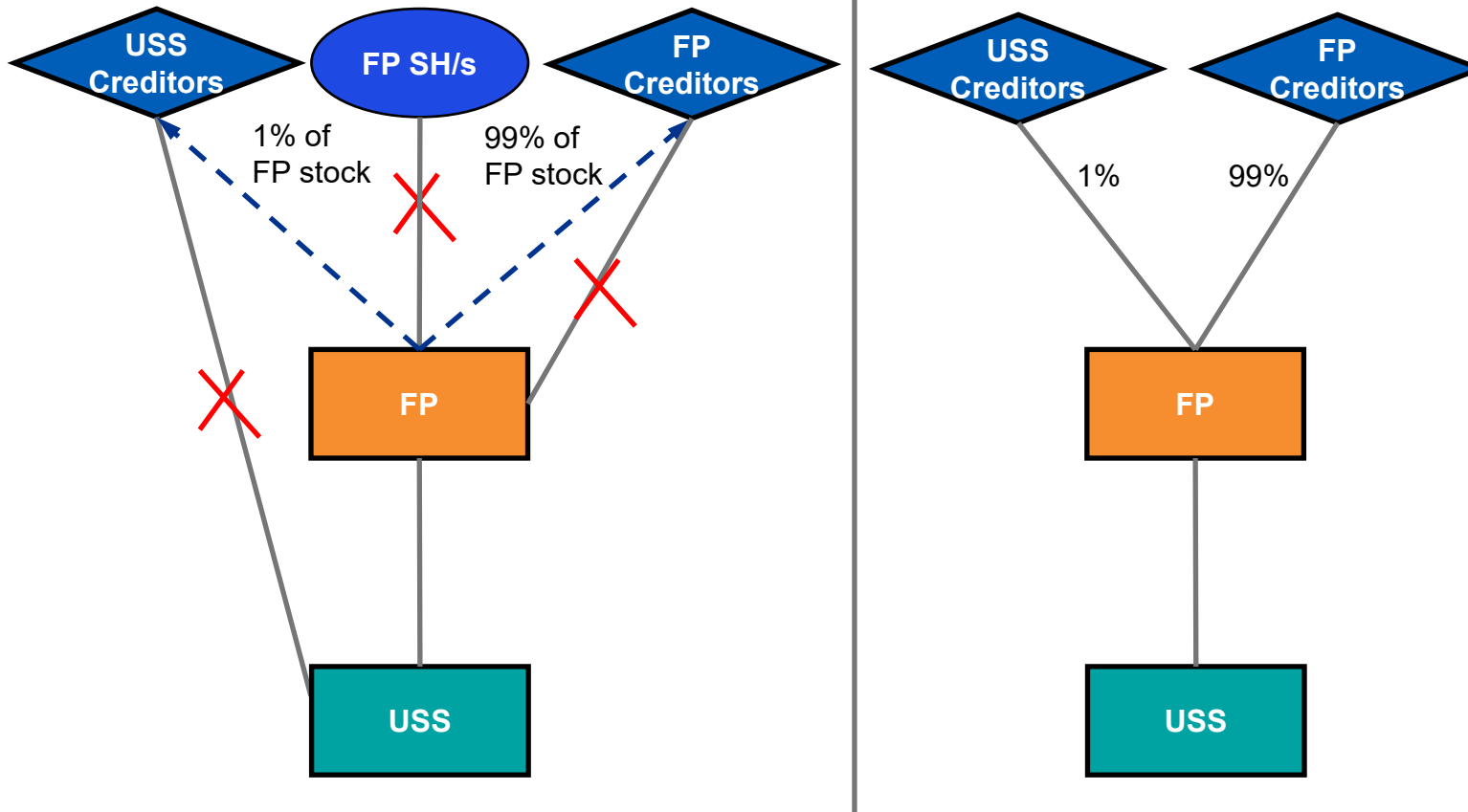
Facts

- Assume the same facts as the prior example, except that as part of the restructuring, USS issues stock to FP.

U.S. Federal Tax Considerations

- Assuming the Creditor Rule can only apply if there otherwise is a domestic entity acquisition, does USS's issuance of shares in the restructuring constitute a domestic entity acquisition for purposes of Section 7874 even though FP has historically owned all of the outstanding stock of USS?

Example: The Creditor Rule & Multiple Creditors



Facts

- FP and USS are insolvent.
- The creditors of both USS and FP exchange their debt in USS and FP, respectively, in exchange for 1% and 99%, respectively, of FP stock.

U.S. Federal Tax Considerations

- If the Creditor Rule applies regardless of whether there is a domestic entity acquisition, is the Ownership Test satisfied?
- For purposes of the Ownership Test, it is likely that all of the stock of FP issued to FP creditors is excluded from the Ownership Fraction. See Reg. Section 1.7874-4(c), (h).

02

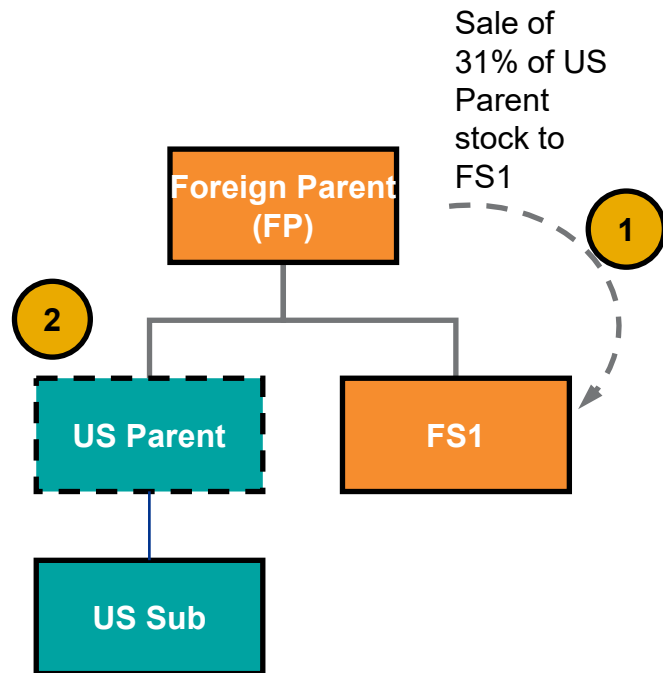
Granite Trust
Planning: A Case
Study



Granite Trust Planning - Overview

- Generally, a complete liquidation of a corporate subsidiary is treated as a taxable exchange of the corporation's assets in exchange for its stock under Sections 331 and 336.
- If a corporation is 80% owned by a corporate shareholder, a complete liquidation of a solvent corporate subsidiary is generally tax-free under Sections 332 and 337.
- Post-1998, a lower threshold of stock ownership could still give rise to an upstream C reorganization.
 - “Substantially all the assets”
 - See Rev. Proc. 77-37, *amplified by* Rev. Proc. 86-42
- Self-help is available -- Granite Trust

Granite Trust in the News: Bausch Health



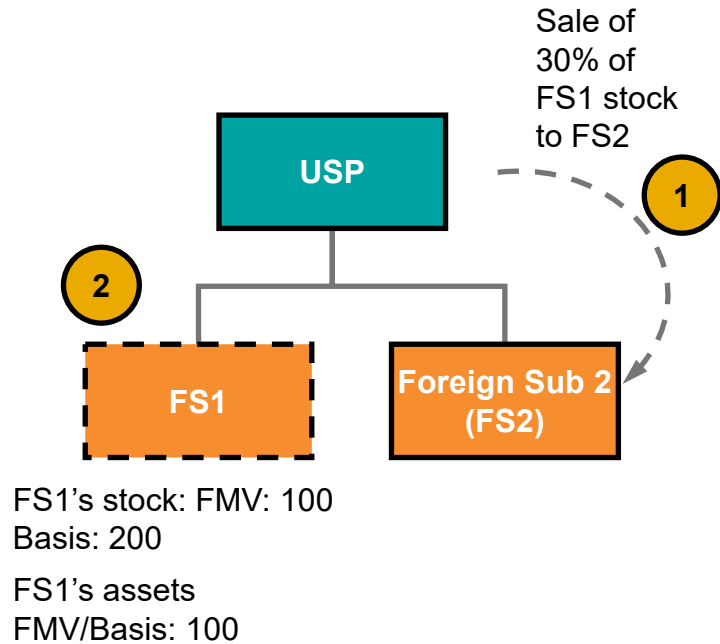
Facts

- Step 1: FP sells 31% of its US Parent stock to FS1.
- Step 2: Following the sale, US Parent liquidates under local law and distributes its assets pro-rata to its shareholders, FP and FS1.

U.S. Federal Tax Considerations

- No US tax benefit from any loss in the stock of the US Parent.
- Section 336 – taxable sale of US Sub.
- Based on public statements made by Bausch Health, it appears that the IRS was taking the position that US Parent's liquidation was a Section 368(a)(1)(C) reorganization (C Reorganization) of US Parent into FP because FP acquired substantially all of US Parent's assets solely in exchange for voting stock.

Example: Base Case - *Granite Trust*



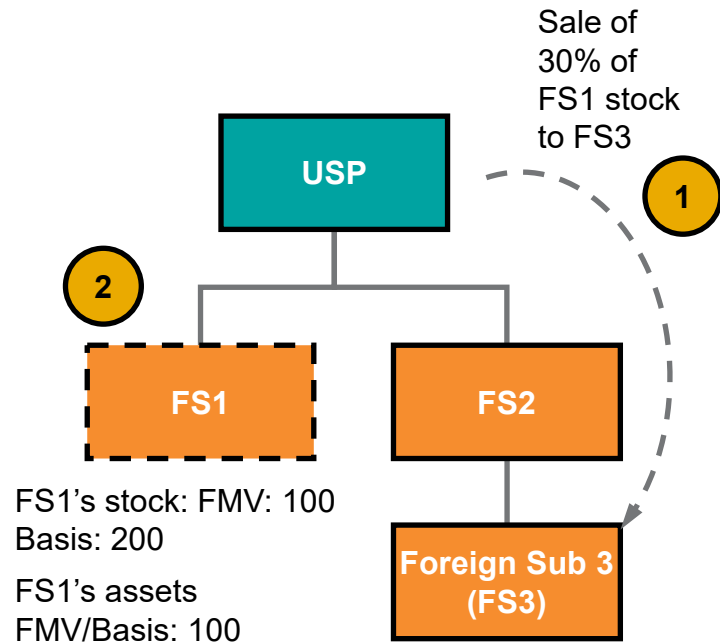
Facts

- Step 1: USP sells 30% of its FS1 stock to FS2.
- Step 2: FS1 makes a CTB election to be treated as a flowthrough entity for tax purposes.

U.S. Federal Tax Considerations

- Application of Section 304 to the cross-chain sale
- Capital loss: 70

Example: Base Case - *Granite Trust* with Basis Hop



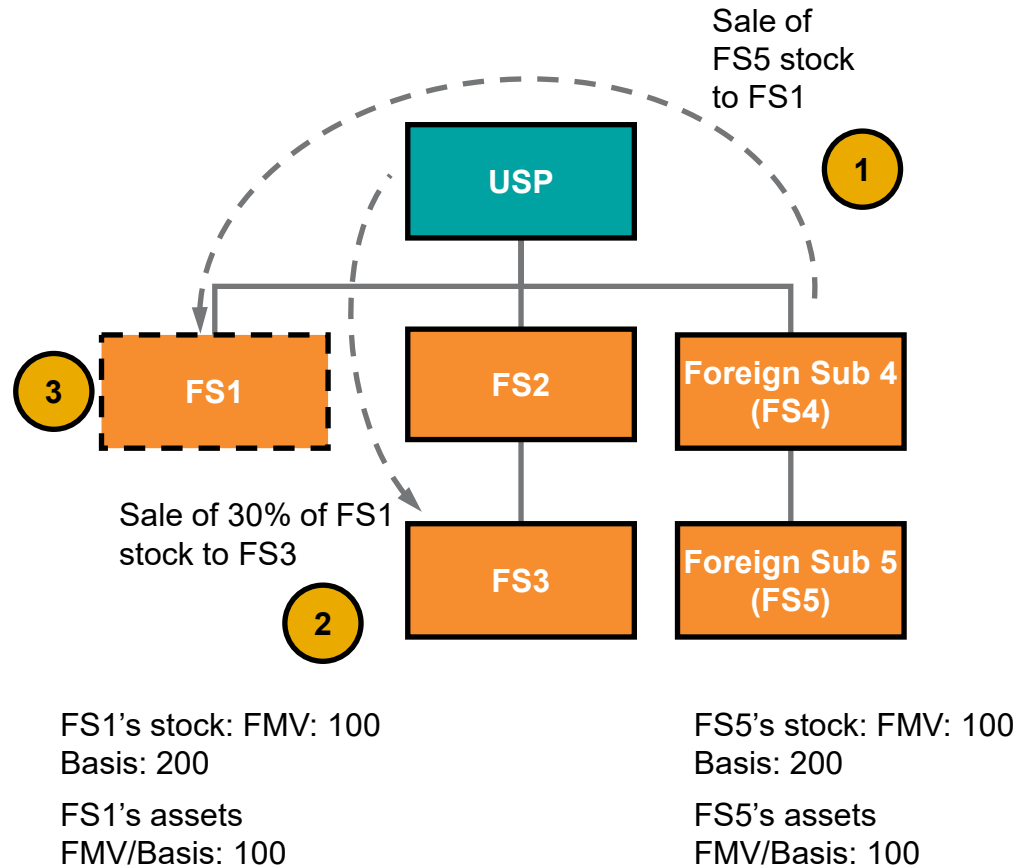
Facts

- Step 1: USP sells 30% of its FS1 stock to FS3, a subsidiary of FS2.
- Step 2: FS1 makes a CTB election to be treated as a flowthrough entity for tax purposes.

U.S. Federal Tax Considerations

- Sale of FS1 may result in dividend equivalent treatment under Section 304
- Potential position that the dividend equivalent transaction results in “basis hop” – 30 of basis from the sold shares “hops” to the 70% retained shares
- Capital loss: 100 (if no E&P)

Example: *Granite Trust* with Super-Charged 304 Basis Hop



Facts

- Step 1: FS4 sells all of its FS5 stock to FS1.
- Step 2: USP sells 30% of its FS1 stock to FS3.
- Step 3: FS1 makes a CTB election to be treated as a flowthrough entity for tax purposes.

U.S. Federal Tax Considerations

- Step 1: Sale of FS5 stock may result in dividend equivalent treatment under Section 304, leading to potential position that FS5's stock basis of 100 jumps to the FS1 stock
- Step 2: Potential position that 30 of basis from the FS1 shares sold hops to the 70% FS1 retained shares
- Step 3: Capital loss: 200 (if no E&P)

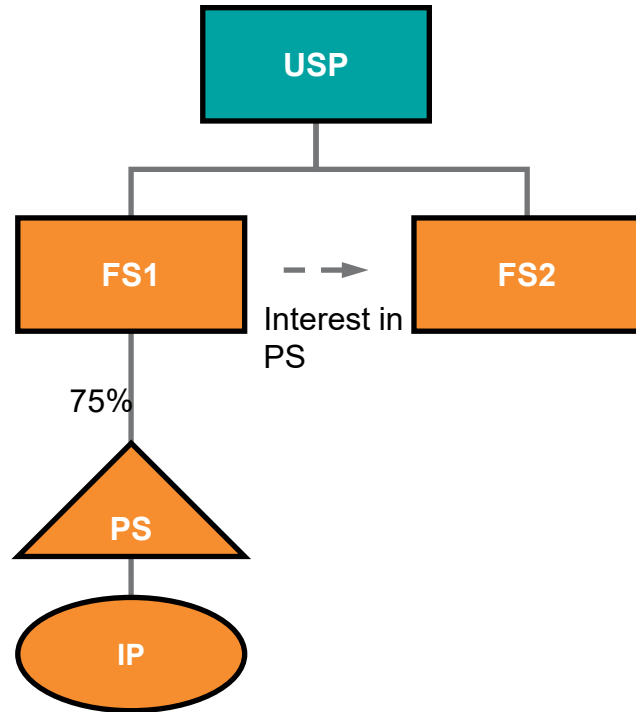
Example: Super-Charged Basis Hop – Considerations

- Potential position in favor of Section 304 basis hopping based on current guidance.
 - If possible, consider only selling shares with lowest basis as a safeguard.
- Consider how much stock to sell:
 - A sale of 21% would be enough to fail Section 332 and trigger a taxable transaction under 331.
 - To avoid potential recharacterization as an upstream C Reorganization of FS1 into USP, a sale of at least 25% of FS1's stock would be advisable; 30% market practice. See Rev. Proc. 77-37, *amplified by* Rev. Proc. 86-42.
 - Consider recent developments in the Bausch Health audit, where Bausch Health disposed of 31% of its subsidiary stock to a foreign corporation prior to the liquidation, and the IRS argued that the liquidating subsidiary engaged in an upstream C into its 69% shareholder.
- With respect to the sale of FS5, consider the application of Section 269 or listed transaction status.

Example: Super-Charged Basis Hop - Considerations (Cont'd)

- International considerations:
 - If there is E&P:
 - Potential application of section 1059 (relating to extraordinary dividends).
 - Application of section 304(b)(6).
 - Sourcing of the dividend equivalent distribution (i.e., PTEP first).
 - Section 961 basis consequences.
 - Sourcing of the loss under Section 865 and related anti-abuse provisions in Reg. 1.865-2(b)(4).

Potential Use of Capital Loss: Cross-Chain Sale of IP



Facts

- FS1 and FS2 are wholly owned by USP. FS1 owns a majority stake in PS, with the remaining interest owned by an unrelated third party. PS has significant built-in gain in its IP.
- FS1 sells its 75% interest in PS to FS2.

Considerations

- Section 754 election
- Can Section 1239 apply to the sale of PS interests on an aggregate versus entity theory?

Potential Use of Capital Loss: Cash Repatriation

- Distributions from CFCs in excess of basis – Section 301(c)(3)
- Consider competing benefits of making distributions from CFCs with Section 965(b) PTEP in excess of stock basis
 - Capital gain under Section 961(b)(2) to the extent of excess
 - See *FedEx v. United States*, No. 20-cv-02794 (W.D. Tenn. 2023) – foreign tax credits (FTCs) related to repatriated earnings from profitable CFCs that had been offset by losses from other CFCs.
 - Potential for reversal on appeal
 - *Sysco Corp.* case on same issue docketed in Tax Court
 - Application to post-repat years (current law Section 960(b))

03

Worthlessness



Loss deductions

- Intercompany Debt
 - Section 166: ordinary deduction for wholly worthless business debt
 - Section 166(a)(2): ordinary deduction for partially worthless business debt upon chargeoff
- Stock
 - Worthless stock deductions ordinarily capital under Section 165(g)(1)
 - Loss may be ordinary under Section 165(g)(3) in the following circumstances:
 - Domestic corporate shareholder
 - Ownership requirement met (80% vote and value)
 - More than 90% of corporation's aggregate "**gross receipts**" for all taxable years from non-passive sources
 - Sources other than: royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from the disposition of stocks or securities.
 - Consider the power of Section 381 to move (or replace) receipts for a holding company

Common stock may be worthless even if preferred has value



Section 165(g) Worthless Securities - Overview

- Section 165(g) provides the rules applicable to deductions for worthless securities.

“Security”

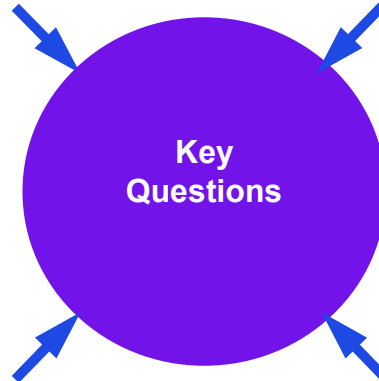
Section 165(g)(2)

- A share of stock in a corporation; a right to subscribe for, or to receive, a share of stock in a corporation; or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

Timing of Worthlessness

General rule:

- Became worthless during the year (i.e., must have prior worth, but no worth by year end)
- An **identifiable event** is required (unless there is hopeless insolvency)
- **Affiliated corporations:** Reg. section 1.1502-80(c)



Amount of Loss

Adjusted Basis

- Additional rules set forth for affiliated corporations in Reg. sections 1.1502-32, -36
- For foreign corporations, consider sections 965 and 961

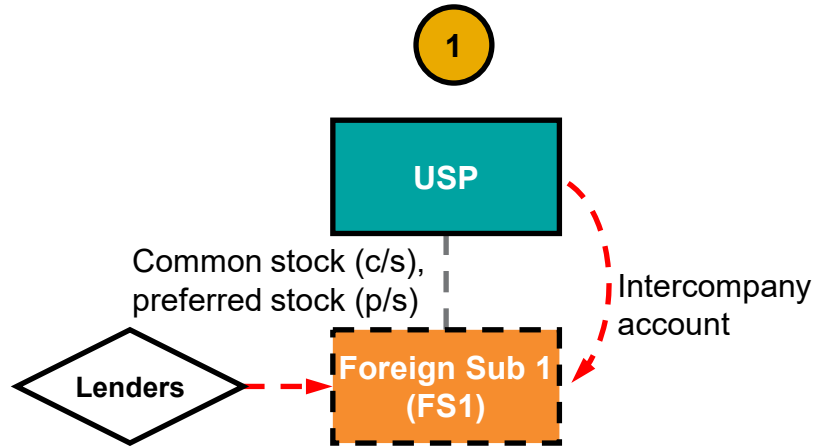
Burden of proof

Character of Loss

Capital vs. Ordinary

- Affiliation Exception
 - Ownership Test
 - Gross Receipts Test

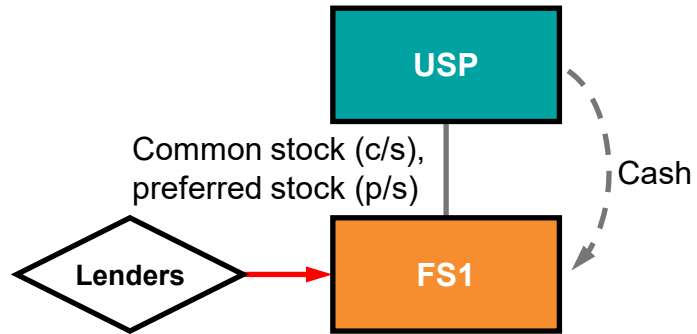
Example: Life-Cycle of FS1 – Initial Formation



Facts

- USP looking to invest 100m into a new line of business through a CFC (by purchase or formation)
- Ultimate value could end up anywhere between 5 and 500m

Example: Life-Cycle of FS1 – Ongoing cash needs



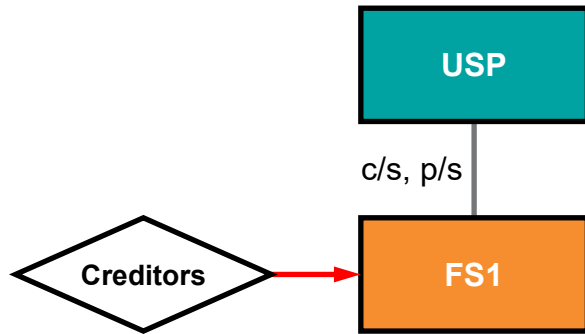
Facts

- Cash infusions are required to maintain FS1 operations

Options to consider

- Cash contribution
- Advance through ongoing intercompany account
- Establish new, senior debt facility

Example: Life-Cycle of FS1 – No recovery, but business need to make whole certain FS1 creditors



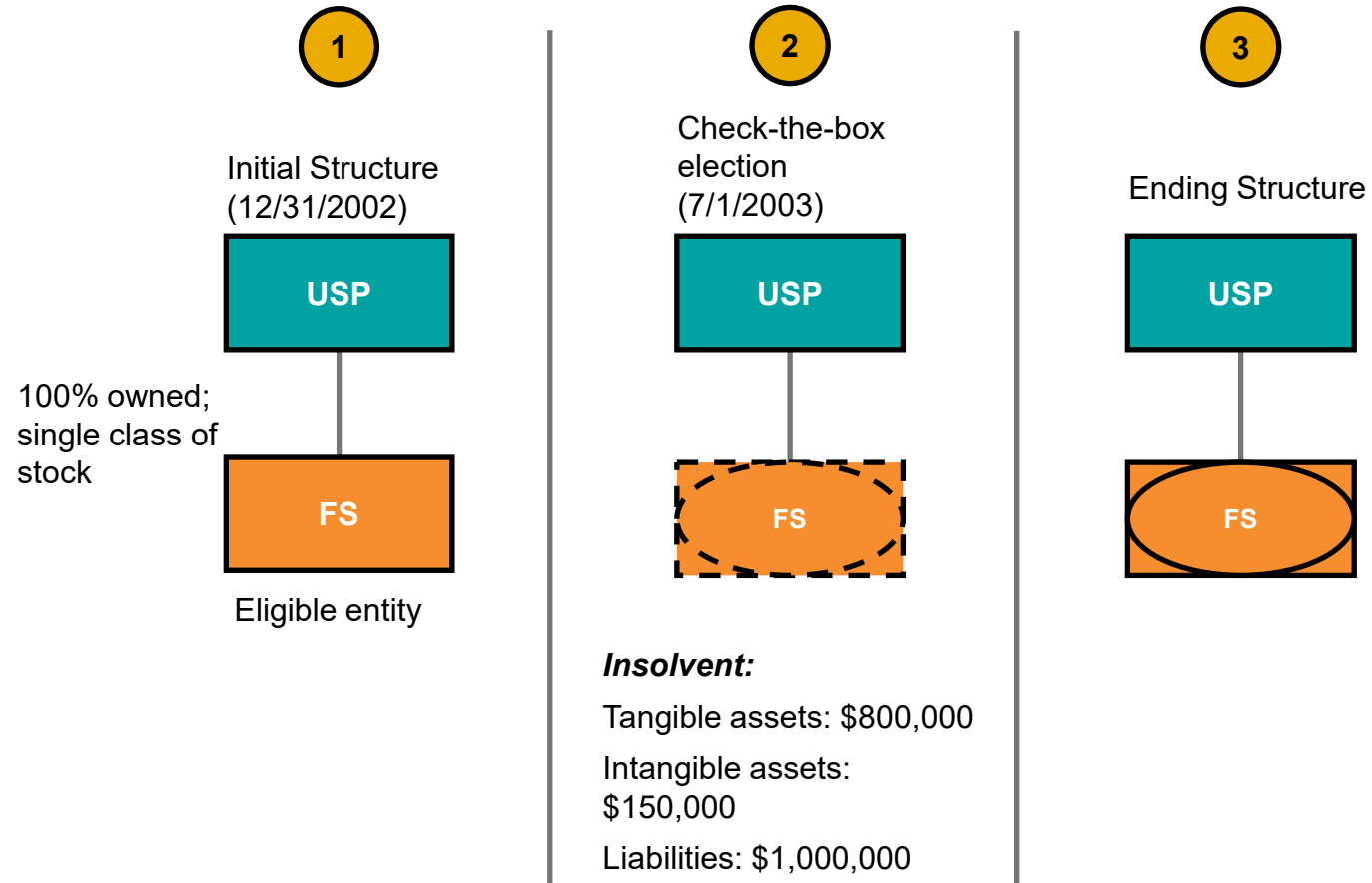
Facts

- USP implications from implosion of FS1
 - Reputational
 - Intangible value

Considerations

- Can USP pay FS1 creditors directly?
- Compare *Baker Hughes v. United States*, 943 F.3d 255 (5th Cir. 2019) (payments made to troubled subsidiary to prevent its liquidation held not to give rise to a Section 162 deduction), with *Lohrke v. Comm'r*, 48 T.C. 679 (1967) (payment made by shareholder directly to corporation's creditors held deductible under Section 162).
- Can USP sell FS1 to local management for a nominal amount to avoid liquidation costs
 - E.g., employee protection rules, reputational damage, implications for other credit in the group

Rev. Rul. 2003-125



Rev. Rul. 2003-125

- Holding
 - Check-the-box (CTB) election of an insolvent subsidiary gives rise to a worthless stock deduction under Section 165(g)
 - Insolvent = FMV of assets (including off-balance sheet assets) < liabilities
 - Deemed liquidation is an identifiable event
 - FS creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under Sections 165 or 166
 - Other Relevant Considerations
 - Consider if common stock is worthless where there are multiple classes of stock
 - Evaluate tax cost/benefit of taxable asset sale (including impact of excess debt)
 - Consider impact of asset sale on stock basis in consolidated setting or where asset gain/loss gives rise to GILTI items
 - Consider FTC consequences

04

Cross-Border Section

382



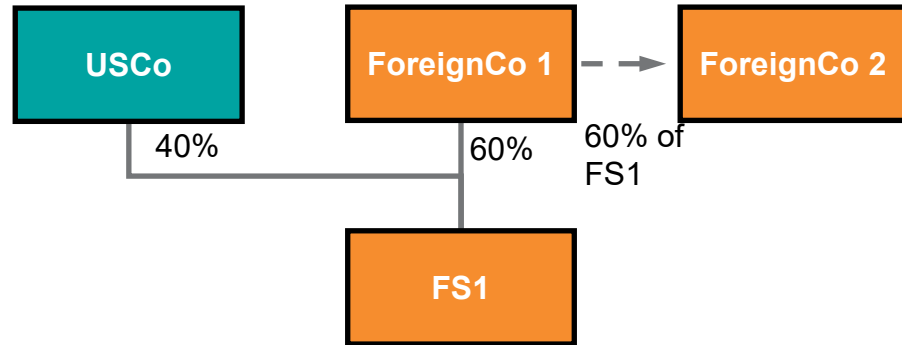
Section 382 and CFCs

- Sections 382 and 383 impose an annual limitation on a corporation's ability to utilize certain tax attributes, including NOLs, if the corporation (a loss corporation) has experienced an ownership change of more than 50 percent of its stock during a testing period.
- A loss corporation is generally a corporation with one or more of the following:
 - an NOL carryover to or NOL for the ownership change year
 - net unrealized built-in loss (NUBIL)
 - for taxable years beginning after December 31, 2017, a disallowed business interest expense carryforward under section 163(j). Section 382(k)
 - Certain tax credit carryovers
- Applicable to CFCs: "Section 382, by its terms, applies to the disallowed BIE [business interest expense] carryforwards of foreign corporations regardless of whether they have ECI." 86 Fed. Reg. 5496, 5508 (Jan. 19, 2021).
- Section 382 was intended to prevent trafficking in tax losses (e.g., NOLs, built-in-losses) that are used to offset income (the Anti-Loss Trafficking Policy) and to preserve the function of the NOL carryover provisions as an averaging system (the Averaging Policy).

Section 382 and CFCs – Ownership Shifts

- Section 382 applies in the case of an ownership change, which is a change in ownership by 5% shareholders of more than 50 percentage points of the stock (by value) in a loss corporation over a testing period (generally three years)
 - Identity of a 5% shareholder is generally not relevant
 - By contrast, in the CFC context the identify of a shareholder is relevant as only certain shareholders will include certain CFCs items as income
 - Less-than-5% shareholders (small shareholders) are generally aggregated and treated as a 5% shareholder

Example: CFC Ownership Shift – Sale to ForeignCo2



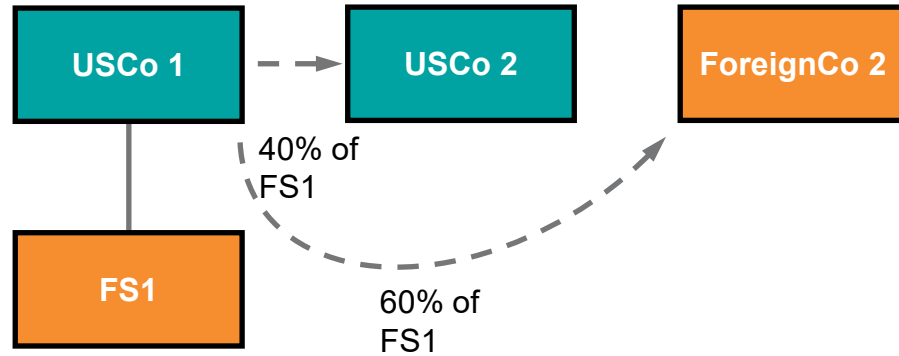
Facts

- USCo owns 40% of FS1, a foreign loss corporation that is a CFC. ForeignCo, an unrelated foreign entity, owns 60% of FS1. ForeignCo wholly owns a US subsidiary (not depicted).
- ForeignCo1 sells its 60% interest in FS1 to ForeignCo2, an unrelated party. ForeignCo2 also owns a wholly owned US subsidiary (not depicted).

U.S. Federal Tax Considerations

- Should Section 382 apply where USCo's interest as FS1's 10% U.S. shareholder has not changed? Consider the Anti-Loss Trafficking Policy and Averaging Policy.

Example: CFC Ownership Shift – Sale to US and Foreign Buyers



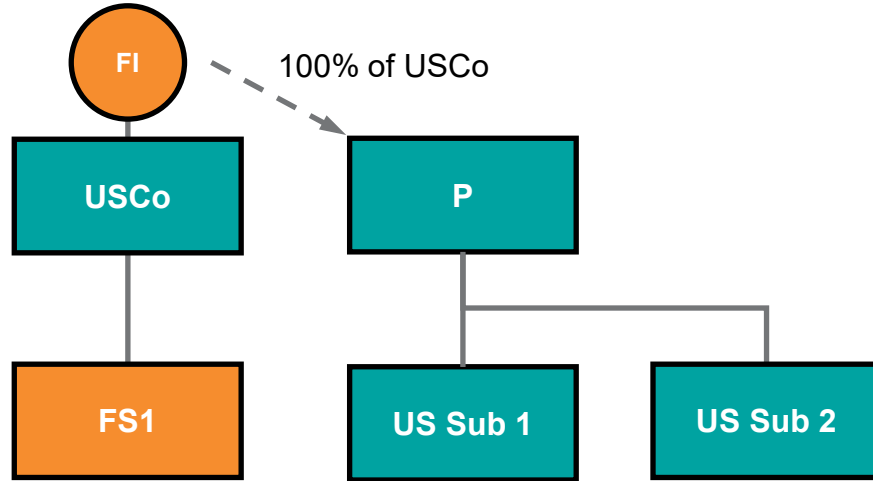
Facts

- USCo owns 100% of FS1, a foreign loss corporation that is a CFC. USCo 1 sells 40% of FS1 to USCo 2 and 60% of FS1 to ForeignCo2. ForeignCo 2 wholly owns a U.S. subsidiary.

U.S. Federal Tax Considerations

- Which entity could benefit from acquiring FS1's attributes? Impact on Section 382 ownership shift analysis?
- Impact to FS1's U.S. tax attributes arising from ForeignCo2 acquisition of 60% of FS1?

Example: CFC Ownership Shift – Sale to Consolidated Group



Facts

- FI is a foreign individual that wholly owns USCo, which in turn wholly owns FS1, a foreign loss corporation. FI sells 100% of USCo to P and USCo joins P's consolidated group.

U.S. Federal Tax Considerations

- FS1's U.S. tax attributes could potentially offset items generated by other CFCs owned by P's consolidated group.
- Indirect ownership change of FS1 implicates potential Anti-Loss Trafficking Policy concerns underlying Section 382.

Section 382 and CFCs – Valuation of CFCs

- The Section 382 limitation is the value of the old loss corporation multiplied by the long-term tax-exempt rate.
- Section 382(e)(3) states: “Except as otherwise provided in regulations, in determining the value of any old loss corporation which is a foreign corporation, there shall be taken into account only items treated as connected with the conduct of a trade or business in the United States.”
- Reg. Section 1.952-2(b)(1): “...the taxable income of a foreign corporation for any taxable year shall, subject to the special rules of paragraph (c) of this section, be determined by treating such foreign corporation as a **domestic corporation** taxable under section 11 and by applying the principles of section 63.”
- For loss corporations that are members of a controlled group, Reg. Section 1.382-8 provides for an automatic adjustment to their stock value to avoid duplication. Thus, the value of CFC stock directly held by a member of the controlled group is reduced by the stock value owed by such member immediately after the ownership change and is deemed “restored” to the value of the member shareholder.
- The CFC may make an election to not restore full or partial value. See Reg. Section 1.382-8(h)(2).

Section 382 and CFCs – Limitations

- Unlike income of a domestic corporation, CFC income is subject to tax at different effective tax rates.
 - ECI (CFC income) taxed at 21%
 - Subpart F income (US shareholder inclusion) taxed at 21%
 - GILTI (US shareholder inclusion) taxed at 10.5% rate (post-Section 250 deduction).
- Should any Section 382 limitation calculation method for CFCs take into account the difference in effective tax rates?
- Should grouping of multiple CFCs be allowed if acquired in the same transaction?
- Consider whether the separate return limitation year (SRLY) limitation rules would be turned off in the event of an ownership change.

Q&A



A person wearing a red jacket and a wide-brimmed hat stands in the center of a slot canyon. The canyon walls are illuminated with a gradient of purple and blue light, creating a dramatic, ethereal atmosphere. The rock surfaces show distinct horizontal layering and wavy patterns. The sky above is a deep blue with some light clouds.

KPMG

Thank you!



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