

IRS Releases Final Creditor Continuity of Interest Regulations by Amy S. Elliott

The IRS December 11 finalized a portion of the March 2005 proposed "no net value" regulations regarding the continuity of interest requirement in the context of insolvency reorganizations.

Dec. 12, 2008

The IRS December 11 finalized a portion of the March 2005 proposed "no net value" regulations regarding the continuity of interest (COI) requirement in the context of insolvency reorganizations.

The regulations (T.D. 9434) clarify the extent to which interests held by creditors of an insolvent target corporation are included in the determination of COI. (For the proposed regs, REG-163314-03, see Doc 2005-4832 or 2005 TNT 46-5. For T.D. 9434, see Doc 2008-26044.)

"The regulations provide welcome guidance in an area that has quickly become a top priority for many tax advisers and their clients in the current financial crisis," said Joshua T. Brady, a partner with Ivins, Phillips & Barker.

The release of these regulations "may also encourage non-bankruptcy workouts, which may, in turn, hasten the recovery of the insolvent corporations," said Joseph M. Spitzenberger, a partner in Grant Thornton LLP's national tax office.

Satisfying the COI requirement is necessary for a reorganization to qualify for nonrecognition treatment under reg. section 1.368-1. COI is met when a substantial part -- generally interpreted as at least 40 percent -- of the value of the proprietary interest in the target corporation is preserved in the reorganization.

These final regulations set forth taxpayer-favorable rules for the determination of COI in reorganizations involving the issuance of stock to creditors occurring inside and outside of bankruptcy proceedings. Under the regulations, the claims of creditors of an insolvent target corporation are treated as proprietary interests in the target corporation as long as the creditors receive more than a de minimis amount of acquiring corporation stock.

"Under common-law rules of *Alabama Asphaltic*, creditors had to take affirmative action to enforce their claims prior to the reorganization in order for them to be considered to hold a proprietary interest in the target corporation. The final regulations now clarify that no such pre-reorganization enforcement actions are necessary," Brady said. (See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).)

The regulations clarify that when senior claims of creditors are treated as proprietary interests in the target corporation, the senior claims and all junior claims are treated as proprietary interests in the target corporation for COI purposes. When the senior claims are satisfied with a mixture of cash and stock, the value of the senior claims is calculated by averaging the treatment of all such senior claims.

Also, the regulations added a de minimis rule that requires more than a de minimis amount of acquiring corporation stock be exchanged for the creditors' proprietary interests in order to count for COI and possibly qualify for nonrecognition. This rule "is essentially an anti-abuse rule preventing reorganized companies from issuing a de minimis amount of stock to senior creditors in order to intentionally break continuity of interest," Brady said.

Tax Analysts Information

Code Section: Section 368 -- Corporate Reorganizations

Section 368(a)(1)(G) -- Bankruptcy Reorganizations

Jurisdiction: United States

Subject Area: Corporate taxation

Deferral of taxes

Mergers and acquisitions

Bankruptcy and insolvency

Author: Elliott, Amy S.

Institutional Author: Tax Analysts

Tax Analysts Document Number: Doc 2008-26105

Tax Analysts Electronic Citation: 2008 TNT 240-6

www.taxanalysts.com