DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

August 10, 2001

Number: **200149008**
Release Date: 12/7/2001

CC:PA:CBS:BR2
GL-114587-01
UIL 09.11.00-00
9999.98-00

MEMORANDUM FOR AREA COUNSEL SMALL BUSINESS - SELF EMPLOYED (AREA 2), GREENSBORO, CC:SBSE:2:GBO

FROM: Mitchel S. Hyman, Assistant Branch Chief, Branch 2 (Collection, Bankruptcy and Summonses)

SUBJECT:

By way of memorandum dated June 29, 2001, you asked for our review of the debtor's proposed Chapter 11 plan and disclosure statement involving an I.R.C. section 368 reorganization. We forwarded these documents to the office of Associate Chief Counsel (Corporate), and the following reflects their views.

The Plan

The plan provides that certain note-holders, who are the only unsecured creditors impaired under the plan, will receive the common stock of the reorganized debtor as well as stock warrants (options to purchase future issues of stock). However, the plan, on page 21, also provides that a small portion of stock and the warrants will be reallocated to the old common stock holders. This provision is written as follows:

> However, if the Effective Date occurs, the Holders of Allowed Senior Note-Related Claims shall be deemed to have reallocated and directed the Disbursing Agent to distribute pro rata to Holders of Old Common Stock (Class 7): (i) 40,000 shares of New Common Stock of the Reorganized Company and (ii) Warrants (the "Reallocation Provision").

The disclosure statement makes the following statements on pages 59-60 with regard to the federal income tax consequences to the reorganized debtors:

> COI income that is realized by the Reorganized Debtors will not be recognized under I.R.C. § 108. The Reorganized Debtors will be required to reduce certain tax attributes, such as net operating loss carryovers ("NOLs"), certain tax credits, and the tax basis of their assets, by the amount of the COI income that is realized as of the beginning of the tax year following the year in which the Effective Date occurs. It is not entirely clear whether the tax attributes that must be reduced as a result of COI income realized by the Reorganized

Company (the Reorganized Debtors included in such return being referred to herein as the “Consolidated Group”) are limited to tax attributes attributable to that particular Reorganized Debtor or include attributes of other members of the Consolidated Group. The Reorganized Debtors intend to take the position that attribute reduction is applied on a Debtor-by-Debtor basis. If the Internal Revenue Service were to successfully assert a contrary position, the Reorganized Debtors’ future Federal income tax liability could be significantly increased.

The Reorganized Company will under go an ownership change for purposes of I.R.C. § 382 as a result of consummation of the Plan, and, accordingly, the amount of the future income of the Reorganized Debtors that can be offset by their remaining NOLs and certain tax credit carryforwards will be subject to an annual limitation (the “Section 382 Limitation”). The Section 382 Limitation generally will be determined by multiplying the value of the Company’s equity before the ownership change, adjusted to reflect the increase in value arising from the reduction in indebtedness as a result of the Plan, by the long-term tax-exempt rate.

Discussion

[redacted]

[redacted]

With regard to the discussion of the federal income tax consequences of I.R.C. section 108 on pages 59-60 in the disclosure statement, we note that the position the reorganized debtor intends to assert is contrary to that of the Service. It is the Service’s position that, in the case of NOLs, the reduction of attributes of the members of a consolidated group is not done on a member-by-member basis, as apparently proposed by the debtors. In the case of a consolidated group, there is only one NOL, the consolidated NOL (“CNOL”). See United Dominion Industries, Inc. v. United States, -- U.S. –, No. 00-157 (June 4, 2001). [redacted]

With regard to the discussion of I.R.C. section 382 on page 59-60 of the disclosure statement, we note that the debtor will have to make an election under section

382(l)(5)(H) to have the tax consequences discussed.[1] Pursuant to Treas. Reg. section 1.382-9(i), such election must be made by the due date of the loss corporation's tax return for the taxable year which includes the change date.

If you have any questions, please contact the attorney assigned to this matter in Corporate at (202) 622-7930.

---

[1]Section 382(l)(5)(A) provides that section 382(a) shall not apply to any ownership change if, inter alia, the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case. Since is an old loss corporation and under the jurisdiction of the court in a title 11 case, then, pursuant to section 382(l)(5)(A), section 382(a) does not apply. However, section 382(l)(5)(B) provides that the pre-change losses of the old loss corporation which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to title 11 or similar case during a certain specified period. Thus, an old loss corporation applying section 382(l)(5) would have to reduce its NOL carryforward by such amount. As noted above, section 382(l)(5)(H) provides that a new loss corporation may elect not to have the provisions of section 382(l)(5) apply. Section 382(l)(6) provides that if section 382(l)(5) does not apply to an exchange of debt for stock in a title 11 or similar case, the value under section 382(e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.