INSOL INTERNATIONAL

FINANCIAL AND TAX CONSIDERATIONS FOR DISTRESSED COMPANIES AND THEIR CREDITORS

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International Association of Restructuring, Insolvency & Bankruptcy Professionals

Financial and Tax Considerations for Distressed Companies and their Creditors

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I am very pleased to introduce this important publication titled "Financial and Tax Considerations for Distressed Companies and their Creditors".

This is the first book INSOL International has published covering tax issues. The book aims to provide practical guidance to insolvency practitioners dealing with restructuring financially distressed companies, about the tax position in countries covered in the publication. We expect the book to be of assistance to practitioners before they consult the tax experts in those countries.

The first part of the book deals with the general insolvency considerations of a country and the latter part with the more specific tax issues. Each country chapter has an interesting collection of information that covers the insolvency laws and guidelines applicable in a restructuring, and also tax issues such as debt forgiveness, debt for equity swap or debt for debt swaps in restructuring plans. It also provides guidance on the various tax considerations that affect plans and discusses the practical difficulties that may be encountered and how they may be dealt with or avoided.

We have accepted that in most countries tax issues and tax treatments change constantly and that tax laws are changing sooner than some of the other laws. We decided however not to be deterred by these constant changes and move on to produce this book as INSOL's objective was wider.

I would like to congratulate Shinichiro Abe of Baker & Mckenzie, Japan for leading this project through to its publication. Shin has devoted a lot of his time to complete this publication to a very high standard and we sincerely appreciate his commitment to this project.

Sumant Batra
President
INSOL International

Foreword

Practitioners in the area of insolvency have to deal with a broad array of issues in finding solutions for their clients. They must wrestle not only with the insolvency law itself, but also with legal procedure, tax, and financial issues. Due to the complexity of insolvency, insolvency practitioners must be able to co-ordinate and work effectively with tax lawyers, public accountants, and other professionals if a company is to be successfully rehabilitated.

This book is the first publication in which INSOL has addressed tax and financial issues related to insolvency. Due to its scope, more than 2 years' time was required for its completion. It is hoped that this publication will give the reader a taste, from a financial point-of-view, of the overall procedures used to reorganize distressed companies in the contributors' 18 different jurisdictions.

I would like to extend my thanks to all of the contributors to this volume. In order to answer my questions, they were forced to draw on tax, tax planning, and business accounting knowledge in addition to their insolvency knowledge and experience. Special thanks go to my colleagues, Ryutaro Oka and Ken Tomura, who worked closely with me in researching and writing the Japan chapter and in editing all of the other chapters.

Shinichiro Abe
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AUSTRALIA

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

There are two principal types of insolvency laws which facilitate the rehabilitation of distressed companies in Australia. One is the Voluntary Administration regime under Part 5.3A of the Corporations Act (the Act) and the other is Schemes of Arrangement under Part 5.1 of the Act.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 Voluntary Administration

Voluntary Administration provides:

- For an insolvent company to transfer control of its property and business to a qualified insolvency practitioner promptly and economically; and
- A mechanism for the company to make an arrangement with its creditors without the need to make applications to the court for the purpose of convening meetings of creditors and obtaining approval of the arrangement.

Insolvency is determined on a cashflow test basis i.e., an inability of the debtor company to pay debts as and when they become due and payable.

The aim of Voluntary Administration is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

(a) Maximises the chances of the company, or as much as possible of its business, continuing in existence; or

(b) If it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

On being appointed, the administrator will take control of the business and property of the company and begin investigating its affairs. After giving the requisite notice to interested parties of the appointment, within eight business days the administrator is obliged to convene and hold a meeting of creditors at which the creditors may remove and replace the administrator, and / or decide whether to appoint a committee of creditors. The right to replace the administrator enables the creditors to take action where the directors of the company have appointed someone who may be sympathetic to them and their management, or where creditors simply prefer another administrator.

Following the meeting, the administrator must continue with the various investigations in order to decide whether the interests of the creditors would be best served by the formulation of a deed of company arrangement; or the termination of the administration; or the winding up of the company.

The administrator must then convene and hold another meeting of creditors; this second meeting is to be held within five business days before or after the end of what is called the convening period. The “convening period” is 20 business days beginning on the day after the administration began or 25 days during the Easter and Christmas holiday periods.

The court may extend the convening period during or after the period has expired and may be asked to do so if the administration is complex and more time is needed.

In convening this second meeting, the administrator must send to the creditors a notice, a report of the company’s affairs and a statement explaining the administrator’s opinion about what should happen to the company and the reasons for that opinion, and other information necessary to enable the creditors to make an informed decision. If a deed of company arrangement is proposed, the administrator must explain the details of it.

At the meeting, the creditors are able to decide whether:

- The company should execute a deed of company arrangement;

- The administration should end; or

- The company should be wound up.

If the first option is adopted, an administrator of the deed must be appointed. The administrator (ordinarily, this will be the administrator of the voluntary administration) must prepare an instrument specifying the terms of the deed. It is anticipated that the arrangement will form the basis of the company’s return to financial health and stability.

If the creditors decide at the meeting that the company is not able to be saved, and that their interests would be better served by its liquidation, they may resolve that it should be wound up.

There is a moratorium on creditors’ claims once a company enters administration, necessarily so in order to give the company, and its administrator, some “breathing space” in order to assess the company’s position. Substantial secured creditors have the option to either go along with the process, and thereby be bound for the moment from enforcing their security, or to take the option of appointing a receiver once the company enters administration.

Administrators have the benefit of taking action in foreign countries under the *Cross-Border Insolvency Act 2008* for the purposes of recovery of assets. Administrations are "collective proceedings" in terms of the application of the Model Law.

2.2 Schemes of Arrangement

The insolvency of a company, as determined on a cashflow test basis, can be dealt with by way of a scheme of arrangement between the company and its creditors that is entered into under Pt 5.1 of the *Corporations Act*. Such a scheme can bind all creditors of the company to an agreed arrangement as to payment of the company's liabilities. A scheme allows an arrangement to be implemented which would otherwise require the individual consent of every person affected by the scheme's operation. The court can order a meeting of the creditors or members concerned. If that meeting approves the scheme by a majority at least 75% in value, the court can order that the approved scheme bind all those creditors or members.

A creditors' scheme allows the company to respond to its insolvency by having the company's obligations to creditors deferred, compromised or extinguished. On the order of the court, the scheme will bind all creditors including those opposing the scheme. In particular, a court-approved scheme of arrangement can also overcome the requirement of pari passu distribution that applies in liquidations.

Since the introduction of voluntary administrations under Pt 5.3A of the *Corporations Act*, which provides an easier and more focused way for such agreements to be made, schemes for the purposes of restructuring debt have become infrequent. It has been suggested that Pt 5.1 is no longer needed in the insolvency context although in reality schemes have been used in large and complex administrations, HIH Insurance being a prime example.

The aim of a scheme of arrangement is to obtain a binding agreement whereby the legal rights of the creditors vis-à-vis the debtor company are modified or adjusted, with the consequence that there will be an ultimate benefit to the creditors which could not be obtained but for the arrangement. The nature of the modification of the rights of creditors depends on each set of facts and can be as varied as the parties determine.

Formal arrangements under Pt 5.1 are more appropriate for complex insolvency arrangements which involve a large number of creditors. The *Corporations Act* requires such arrangements to be sanctioned by the court. The legislation does not specify the circumstances in which a scheme can be conducted, but merely sets out the machinery for initiating the scheme, for securing the approval of the parties and court sanction and for administrative requirements during the life of an approved scheme.

QUESTION 3

3. **Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?**

Yes it is.

The most popular method in various plans is debt forgiveness, the purpose of which is to rehabilitate the debtor by decreasing excessive debt by abandoning a portion of the claims of creditors. This gives creditors an increased possibility of collecting their remaining claims as well as increasing the feasibility of rehabilitating the debtor.

Debt for Equity Swap (DES) is also a useful tool for debtors.

Debt for debt swap is a method used to increase the feasibility of rehabilitation of the debtor by financial creditors changing debts to subordinated debts. However, this method is not so common compared with the above two methods.

QUESTION 4

4. **Do you have any other methods to decrease existing debt and/or offer relief to the debtor?**

Yes we do.

The Voluntary Administration regime is very flexible. By application to the court, the administrator can obtain a significant extension of time to continue the company's moratorium against creditors' claims, before the meeting of creditors is convened to decide the fate of the company. The administrator's application may also include requests to amend certain classes of creditors' rights (e.g. leasehold creditors and retention-of-title creditors). In addition, at the meeting to determine the future of the company, creditors may resolve that the company enter into what is often called a 'Holding Deed' whereby the moratorium against creditors' claims is continued for an extended time until an agreed future event or date is reached (such as a general improvement in the market for the underlying assets and/or business).

The Scheme of Arrangement regime is significantly less flexible than the Voluntary Administration regime but in certain circumstances can be open to application to the court for relief or directions, if it is in the best interests of creditors generally or a class of creditors.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes', please list the names of the tax law which you consider. If the answer is 'no', please let us know why you do not have to consider tax issues.

Yes. The Income Tax Assessment Act 1997 (ITAA 1997) and the Income Tax Assessment Act 1936 (ITAA 1936) will be mainly considered.

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions 3 and 4.

As mentioned in question 3 above, debt forgiveness and DES are common ways of rehabilitating the debtor. Other methods which may be used to decrease existing debt and/or offer relief to the debtor include:

(i) "Debt parking" (a form of debt forgiveness), in which a creditor assigns its right to receive repayment to another person and either the new creditor is an associate of the debtor or the assignment occurred under an agreement or an arrangement to which the debtor and new creditor were parties;

(ii) Rescheduling debt payments, which broadly involves deferring the timing of repayments of interest and / or principal and may impact upon the characterisation of the loan as a debt interest for tax purposes; and

(iii) Selling distressed debt, in which case the tax implications will depend on the nature of the debt instrument.

The following is a discussion of the tax consequences for the debtor of obtaining a debt forgiveness and a DES.

6.1 Debt forgiveness

The implications of debt forgiveness for the debtor will typically depend on the characterisation of the forgiveness in the context of the debtor's business and / or the nature of the particular debt instrument.

The forgiveness of a debt does not ordinarily cause a debtor to realise any ordinary income or a capital gain, given the character of the debt as a liability as far as the debtor is concerned (in cases not involving financial institutions). However, the debtor may be required to make certain tax adjustments under the commercial debt forgiveness provisions contained in Schedule 2C of ITAA 1936.

(i) Commercial debt forgiveness provisions

The scope of a "commercial debt" for the purposes of these provisions encompasses any debt where interest or amounts in the nature of interest are allowable, or would be allowable, as a deduction to the debtor (even if no interest was in fact charged or if the interest deduction would have been prevented by a statutory restriction). Broadly, this means that the debt must be one where the interest is, or would be, an expense incurred for the purpose of gaining assessable income. It is expressly provided that an interest-free debt is still a commercial debt, provided interest would have been deductible had it been payable.

A commercial debt is treated as "forgiven" in a wide range of circumstances, including:

(a) Where the debtor's obligation to pay is released, waived or otherwise extinguished (other than by payment in cash) - this could include the situation whereby a debt is released by the creditor in return for the issue of shares in a debtor, that is, a DES;

(b) Where the debtor enters into an arrangement with the creditor with the result that the obligation to repay ends at some future time;

(c) Where the creditor assigns its right to receive repayment to another person and either the new creditor is an associate of the debtor or the assignment occurred under an agreement or arrangement to which the debtor and new creditor were parties - that is, debt parking; and

(d) Where a creditor subscribes for shares in a debtor company to enable it to repay the debt and the company applies all or part of the money in satisfaction of the debt - that is, a quasi-DES.

In each case it is necessary to make a calculation of the amount forgiven, based on the value of the debt that is forgiven less any consideration provided by the debtor. Special rules apply to calculate the value of the debt at the time it is forgiven. Once the amount forgiven has been calculated, a debtor must allocate that amount against the various classes of tax benefits. These classes, in order, are:

(a) Deductible prior year revenue losses;

(b) Deductible prior year net capital losses;

(c) The undeducted balances of various amortised expenditures (such as depreciation); and

(d) The cost bases of any capital gains tax (CGT) assets of the debtor owned at the beginning of the year.

As each class is fully eliminated, any excess is carried over to the next class and is applied in reduction of the items in that class. However, once those classes of tax benefits are exhausted any remaining forgiven amount is disregarded and does not give rise to an assessable gain for the debtor.

Particular rules apply for the calculation of the forgiven amount in relation to non-recourse debts, the assignment of debts and DESs and for the application of the forgiven amount in corporate group contexts.

(ii) Limited recourse debt

The limited recourse debt rules operate where limited recourse debt has been used to finance property for which capital allowance deductions are available, and the limited recourse debt arrangement is terminated without the debt being repaid in full. These circumstances effectively trigger a recapture of the capital allowance deductions by way of the inclusion of an amount in the debtor's assessable income.

(iii) Qualifying securities

Division 16E of the ITAA 1936 provides a mechanism whereby the issuer and holder of a qualifying security are taxed on an accruals basis with regard to the qualifying security. A "qualifying security" is, broadly, a security issued for a period that is reasonably likely to exceed 12 months, under terms whereby it is reasonably likely that the security will produce receipts (other than of periodic interest) which are in excess of the issue price of the security.

A transfer of a qualifying security or a "material variation" of the terms of the qualifying security may give rise to an assessable balancing adjustment for the issuer. While the forgiveness of a debt will not constitute a "transfer" for these purposes, it could trigger a material variation.

(iv) Taxation of financial arrangements provisions

Comprehensive new rules for the taxation of financial arrangements (TOFA) have recently been introduced and will apply from 1 July 2010, unless an election is made to apply the rules from 1 July 2009.

Broadly, where the TOFA rules apply, the overall gain/loss from a financial arrangement, such as a loan, will be assessable and deductible (subject to certain exceptions) and the assessable income/deductions will be spread over the term of the financial arrangement in accordance with prescribed timing methods. Where they apply, the TOFA rules generally override other provisions in the tax legislation relating to financial arrangements (such as the rules relating to qualifying securities mentioned above). However, where the commercial debt forgiveness rules in Schedule 2C to the ITAA 1936 apply, the gain which would be subject to the TOFA rules is reduced to the extent the gain is captured by Schedule 2C.

6.2 Debt for equity swap (DES)

A DES involves a debtor issuing shares to the creditor to replace and discharge the outstanding debt or part of it.

(i) Commercial debt forgiveness provisions

As mentioned in section 6.1 above, debt forgiveness is deemed to occur in both a DES situation (that is, where the debt is released by a creditor in return for the issue of shares in a debtor) and in a quasi-DES situation (that is, where a creditor subscribes for shares in a debtor company to enable it to repay the debt and the company applies all or part of the money in satisfaction of the debt). The amount forgiven is based on the notional value of the debt that is forgiven, less any consideration provided by the debtor and in quasi-DES circumstances, the "consideration" in respect of the forgiveness of the debt is calculated by reference to the market value of the shares subscribed for by the creditor.

(ii) Impact on ability to utilise tax losses

Distressed companies are likely to have tax losses. A company will be entitled to carry forward its tax losses if it passes the continuity of ownership test ("COT") or, failing that, the same business test. The COT looks to whether a company has maintained continuity of ownership at all times during the test period by reference to voting power, rights to dividends and rights to capital distributions. Failure to preserve continuity in any one of these aspects will result in failure of the test. The issue of new shares as part of a DES may trigger an ownership change for the purposes of the COT.

It may be that the equity is in a form which provides a preference for dividend distributions. The issuance of such shares would technically trigger an ownership change. Special rules have been proposed to ensure that the companies will not fail the COT because of special arrangements in place to make distributions of dividends and capital returns. However, these rules have not yet been introduced.

(iii) Tainting of a share capital account

The share capital tainting rules are integrity rules designed to prevent a company from making tax-preferred capital distributions from a share capital account to which the company has transferred profits. If a share capital account is tainted, distributions from that account are treated as fully assessable dividends rather than potentially non-assessable returns of capital. A company's share capital account is tainted if the company transfers an amount to its share capital from any of its other accounts. However, where the amount is transferred as a result of a DES, the share capital account will not be tainted.

A DES, for these purposes, is an arrangement under which a person discharges, releases or otherwise extinguishes the whole or part of a debt that the company owes to the person in return for shares (other than redeemable preference shares) in the company.

This exclusion for a DES will only apply to so much of the transferred amount that does not exceed the lesser of:

(a) the market value of the shares issued by the company; and

(b) the amount of the debt that is discharged, released or extinguished in return for the shares.

QUESTION 7

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7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

The main issues to consider are the availability and the amount of any tax deductions resulting from losses arising from a debt forgiveness or incurred under a DES. The types of deductions which may be available to the creditor in these circumstances are considered in the answer to question 8 below.

QUESTION 8

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8. If the plan includes the method mentioned in the above questions 3 and 4 and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of rel evant laws and their advantages for creditors.

The following is a discussion of the tax consequences for the creditor arising from a debt forgiveness or a DES. If the creditor is entitled to a tax deduction for the loss arising from the debt forgiveness or the DES, it will be an advantage for the creditor in that the deduction could potentially be offset against the creditor's assessable income (if any), thereby reducing its tax liability.

8.1 Debt forgiveness

The implications of debt forgiveness for the creditor (in particular, the availability of a deduction) will depend on the characterisation of the forgiveness in the context of the creditor's business and the nature of the particular debt instrument.

(i) Section 8-1 deduction

For a loss arising from a forgiven debt to be deductible under the general deduction provision, section 8-1 of the ITAA 1997, it must have been incurred in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income.

A loss from a bad debt will be "incurred" when the debt has been written off or when a creditor disposes of, settles, compromises or otherwise extinguishes the debt.

A financial institution, for example, would generally be expected to incur the loss in carrying on its money lending business.

The availability of a section 8-1 deduction is also dependant upon the loss not being of a capital nature. For example, a financial institution would generally be expected to hold loans on revenue account.

(ii) Section 25-35 deduction

Section 25-35 of the ITAA 1997 is the specific deduction provision for bad debts. The requirements for the deduction under this section are broadly as follows:

(a) A debt must exist;

(b) The debt must be bad;

(c) The debt must be written off as bad in the year of income in which the deduction is claimed;

(d) The debt must have been either:

  (i) Included in assessable income in that income year or a previous income year; or

  (ii) It is in respect of money lent in the ordinary course of a money lending business; and

(e) Where the lender is a company, it must also satisfy either the COT or the same business test.

Given the conditions required to be satisfied for section 25-35 to apply, a forgiven debt may be deductible under section 8-1 in circumstances where a deduction is not available under section 25-35.

(iii) Traditional and qualifying securities

For a "traditional security", section 70B of the ITAA 1936 provides that a loss on disposal or redemption of a traditional security may be an allowable deduction. However, section 70B(5) specifically denies a deduction for losses arising on the waiver or forgiveness of a traditional security. A "traditional security" is, broadly, a security that is not issued at a discount of more than 1.5%, does not bear deferred interest and is not capital indexed. A traditional security may be, for example, a bond, a debenture, a deposit with a financial institution or a secured or unsecured loan.

For a "qualifying security", a transfer or a "material variation" of the terms of the qualifying security may give rise to a deductible balancing adjustment. While the forgiveness of a debt will not constitute a "transfer" for these purposes, it could trigger a material variation.

(iv) CGT implications

In the alternative, a capital loss may be available under the CGT provisions. Capital losses are quarantined so that they may only be offset against capital gains and cannot be applied against other income. Generally, an entity will not be able to claim a capital loss in respect of a debt under the CGT provisions until either the debt has been disposed of, cancelled (generally, a legally enforceable forgiveness of a debt will constitute a cancellation) or a liquidator or administrator has made a valid declaration that the financial instruments have no value or have only negligible value. In respect of the latter event, a capital loss will only arise if the taxpayer chooses for the relevant provision to apply.

Further, any capital loss upon disposal of a debt must be adjusted to reflect the extent to which, if any, the forgiven amount of the debt has already been claimed as a deduction under section 8-1, section 25-35 or any other relevant provision.

(v) Taxation of financial arrangements provisions

As mentioned above, where the TOFA rules apply, a gain or loss from a financial arrangement, such as a loan, will be spread over the term of the financial arrangement in accordance with one of the various timing methods. The forgiveness of a loan may give rise to a balancing adjustment which could result in an additional deduction to the creditor.

8.2 Debt for equity swap

(i) Bad debt deductions for accrued interest

Where any accrued interest (up to the point in time the swap takes place) cannot be recovered, section 25-35 of the ITAA 1997 should be available to provide a deduction for the debt written off. This is on the basis that the accrued interest would have been included in the creditor's assessable income already or the debt is in respect of money lent in the ordinary course of a money lending business.

(ii) Section 63E deduction for remaining principal

The creditor may claim a deduction for "swap losses" arising from a DES under section 63E of the ITAA 1936 where the following conditions are met:

(a) Under an arrangement (defined very widely), a taxpayer discharges, releases or otherwise extinguishes the whole or part of a debt owed to the taxpayer in return for the issue by the debtor to the taxpayer of shares (other than redeemable preference shares) or units, in the debtor;

(b) The debtor is a company, trading trust or public unit trust; and

(c) The debt must have been either:

(i) Included in assessable income in any income year; or

(ii) It is in respect of money lent in the ordinary course of a money lending business.

A deduction under this provision is not available to the creditor where the debt is swapped for the issue of shares in a company other than the debtor.

The deductible loss is calculated as the difference between the amount of the debt and the "equity value" provided. The "equity value" of the shares or units is the greater of their market value and their value in the accounts of the creditor.

Under section 63F, the swap loss is reduced to the extent a deduction was previously allowed under section 8-1 or section 25-35 of the ITAA 1997 or under section 63E for the same loss.

If the creditor subsequently disposes of the equity received in lieu of the debt repayment, then:

(a) If the consideration is greater than the equity value, the difference is assessable income; or

(b) If the consideration is less than the equity value, the difference is a deductible loss.

Note however that where the TOFA rules apply, section 63E will not.

(iii) Traditional security provisions

A deduction under section 70B is not allowable for a loss on the disposal of a traditional security (that is, the debt being exchanged) if:

(a) The security was issued on the basis that the security will or may be:

(i) Disposed of or redeemed because of conversion into ordinary shares of the issuer (that is, the debtor) or a connected entity of the issuer;

(ii) Redeemed for ordinary shares in a company other than the issuer or a connected entity of the issuer; or

(iii) Disposed of to the issuer or a connected entity of the issuer in exchange for ordinary shares in a company other than the issuer or a connected entity of the issuer; and

(b) The disposal or redemption took place pursuant to a provision of the issue of the security that is listed in (a) above.

Similarly, no assessable gain will arise in the above circumstances. In the result, a DES may not give rise to an allowable deduction to the creditor under the "traditional security" regime. Rather, recognition of the loss may be deferred until the shares acquired on conversion or exchange are disposed of.

However, note section 70B continues to apply if the security is exchanged for shares that are not ordinary shares (e.g. preference shares), or if the disposal is to an entity other than the issuer (or a connected entity of the issuer) of the security (e.g. a sale into a secondary market), or if there is no conversion or exchange.

Note however that where the TOFA rules apply, the traditional security provisions will not.

(iv) CGT implications

Subdivision 130-E of the ITAA 1997 complements the above traditional security provisions by providing that the capital gain or loss on the disposal or redemption of an "exchangeable interest" is also disregarded.

Broadly, an exchangeable interest is a traditional security that is issued on the basis that it will or may be redeemed or disposed of to the issuer in exchange for shares in a company that is not the issuer (or a connected entity of the issuer).

The cost base and reduced cost base of the shares acquired on the exchange are modified. In particular, the first element of the cost base (and reduced cost base) of the shares will be the sum of:

(a) The cost base of the exchangeable interest at the time of disposal or redemption;

(b) An amount (if any) paid for the exchange; and

(c) An amount (if any) by which a capital gain from the exchange of the exchangeable interest has been reduced under section 118-20 (i.e. where the amount was assessable (or exempt) income under another provision).

The effect is that only the gain or loss on the ultimate disposal of the shares acquired from the exchange will be assessed under the CGT provisions.

QUESTION 9

9. Please tell us other pitfalls and/or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers to questions 6 and 8. In addition to the matters discussed in those answers, the following issues should be considered:

(i) Direct value shifts

For both a debt forgiveness and a DES, the direct value shifting rules must also be considered.

These rules were introduced to prevent schemes whereby value was shifted from one asset intended to be sold, to another asset that was either intended to be retained or was a non-taxable asset. The effect of this was to defer or eliminate a capital gain.

The direct value shifting rules apply where, under a scheme:

(a) There is a decrease in the market value of one or more equity or loan interests in a company and either:

   (i) Equity or loan interests in the company are issued at a discount to market value; or

   (ii) There is an increase in the market value of one or more equity or loan interests in the company; and

(b) The changes in market value and the issue of equity interests are reasonably attributable to things done under the scheme.

   The rules may apply to a DES where, for example, the debtor issues new shares at a discount as part of the swap arrangement and the issue of those shares decreases the market value of existing equity interests in the debtor.

If a direct value shift occurs as part of a DES, the rules may apply to modify the cost base of affected interests (that is, the other debt and equity interests in the debtor) to take account of material changes in market value that are attributable to the value shift. In addition, the holders of those other interests may also generate a capital gain in certain circumstances.

(ii) Unpaid PAYG liabilities

Companies have certain obligations to withhold and remit amounts to the Australian Taxation Office under the Pay-As-You-Go (PAYG) withholding regime in respect of the tax liabilities of third parties (for example, tax on employees' salaries and withholding tax in relation to dividends and interest paid offshore). Where a company withholds an amount under the PAYG regime (Withheld Amount) but fails to pay the Withheld Amount to the Australian Taxation Office within the time specified (Due Date):

(a) A person who is a director at any time during the period commencing on the day the Withheld Amount was withheld and ending on the Due Date is personally liable for a penalty equal to the Withheld Amount; and

(b) A person who becomes a director after the Due Date and the Withheld Amount is not paid to the Commissioner within 14 days of the person becoming a director, is personally liable for a penalty equal to the Withheld Amount.

These imposition of penalties on directors of distressed companies can interfere with the rehabilitation of a company.

The Australian Taxation Office is required to remit the penalty in certain circumstances (for example, if the company is placed under administration within a certain period) and there are defences to proceedings brought by the Australian Taxation Office under these provisions (for example, where the person took all reasonable steps to ensure that the directors complied with their obligations).

Penalties imposed under these provisions of the Tax Act are "parallel liabilities". Consequently, if the penalty is imposed on all the directors of a company, the payment of that penalty amount by any one of the directors will result in the other directors' liability for the penalty being discharged.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

On 5 November 2009, the Assistant Treasurer released for public consultation draft rewrites of certain parts of the ITAA 1936 for inclusion in the ITAA 1997 in a further step towards a single Income Tax Assessment Act. One of the parts proposed to be rewritten by the exposure draft legislation is Schedule 2C of the ITAA 1936 which governs the forgiveness of commercial debts. However, the rewrite into the ITAA 1997 reproduces the provisions in substantially similar terms.

BRAZIL

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

The Brazilian insolvency rules that govern the rehabilitation of distressed companies are set out in Law 11,101/05 " Bankruptcy Law", enacted on February, 2005. The Bankruptcy Law, however, does not apply to (i) *empresa pública*[1] and *sociedades de economia mista*[2]; and (ii) public or private financial institutions, credit unions, consortia, supplementary pension companies, health care plan companies, insurance companies, capitalization companies and other organizations legally equivalent to those listed above. For the legal entities referred to above other statutes shall apply[3].

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

The Bankruptcy Law provides for two different corporate reorganization procedures, (i) Judicial procedure; and (ii) Extrajudicial (out-of-court) procedure.

The Judicial reorganization shall be formally filed in court by the distressed company[4] and is subject to the judicial authority's approval. It ultimately aims at facilitating the overcoming of the company's economic and financial crisis along with the maintenance of its production sources, manpower, and of its creditors' rights. To have the request for reorganization processed by the court the debtor shall present, among other information, a statement of the material causes of the debtor's equity condition and the reasons for the economic and financial crisis; accounting statements for the last three financial years and those drawn up especially to support the petition, prepared in strict compliance with applicable corporation law; a full list of claims, assets and employees; as well as certificates demonstrating its regular standing (in case of a legal entity) and existing lawsuits and protests.

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1 *Empresa pública* is every company created by a specific statute whose capital stock belongs entirely to a Federal Unit or Federal Union.

2 *Sociedade de Economia Mista* is every company created by a specific statute controlled by Federal Unit or federal Union with private participation in the capital stock.

3 In case of insolvency, these entities are subject to specific bankruptcy and liquidation procedures. For example, Law 6,024/74 and Decree 1,477/76 provides that distressed financial institutions can be temporarily controlled by the Brazilian Central Bank, as well as be extra judicially liquidated if necessary.

4 That: (i) is not bankrupt; (ii) has not been awarded with a Judicial reorganization in the previous 5 years; (iii) if a mall venture, has not been awarded with the special reorganization procedure in the previous 8 years; and (iv) has not been convicted (including directors or controlling shareholder) of any bankruptcy crime.

Following a decision by the judicial authority for the reorganization to be processed, the distressed company (i.e. debtor) has to present its reorganization plan within a 60-day term describing the means through which it intends to pursue rehabilitation. In general terms, the plan shall include (i) the transactions to be implemented in order to achieve the recovery (any law ful alternative is acceptable, including, for instance, a change in the company's control or a partial sale of its assets, mergers, spin-offs, or leases of commercial establishments); (ii) a study of economical feasibility: and (ii) appraisal reports on economic financial situation, and debtor's assets.

If any creditor objects to the plan, it will then be subject to the Creditors General Meeting's scrutiny. The Creditors' General Meeting is to be formed by all creditors divided into three classes of creditors: (i) holders of labor-related credits and credits resulting from on-the-job accidents; (ii) holders of credits with *in rem* guarantee; and (iii) holders of general or special privileged credits, unsecured credits and subordinated credits. The plan has to be approved by each of the classes by (i) the holders of more than fifty percent of the amount of the credits attending at the General Meeting; and by (ii) the majority of the creditors attending the Meeting. Note, however, that the plan shall be considered approved by the class composed of the holders of labor-related credits and credits arising out of on-the-job accidents only if it has been approved by the majority of the creditors attending the General Meeting, no matter the amount of their credits. If successfully approved, the judicial authority confirms the reorganization plan.

Alternatively, a plan may be approved by the court if (i) the plan does not entail different treatment among the creditors of the class which rejected it; (ii) it has been approved by (A) the holders of more than fifty percent of the amount of credits attending the General Meeting, regardless of the class; (B) two classes of creditors (or one if there are only two classes); and (C) one third of the creditors of the class which rejected the plan.

After approval of the plan, the debtor will remain under judicial supervision for two years. If the plan is otherwise rejected by the Creditors General Meeting the debtor will formally be declared bankrupt[5].

The judicial recovery encompass all creditors, with the exception of (i) the fiduciary owner of real estate or personal property; (ii) the lessor under a commercial leasing agreement; (iii) the owner or committed seller of real estate whose respective agreements include an irrevocability or irreversibility clause; (iv) owner under a sale agreement with retention title; and (v) the creditor under an advance on export contract. Tax credits are also excluded from judicial recovery. However, Complementary Law No. 118, dated as of February 9th, 2005, provides for the repayment of tax debts on installments. The terms and conditions for the repayment, however, will need to be determined by future legislation.

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5 Under Brazilian law the term "bankruptcy" is reserved for liquidation. Thus, a company under reorganization is not in bankruptcy. Note, however, that courts might be a little bit flexible, not putting the debtor under liquidation immediately but allowing debtor and creditors to negotiate when there are substantial reasons to believe that the outcome of the negotiations will avoid liquidation.

It is worth mentioning that the debtor keeps possession of its assets, unless certain circumstances have occurred, such as fraud, crime conviction among others, and might legally be operational while undergoing rehabilitation as long as appropriately supervised by the appointed trustee.

The Bankruptcy Law also provides for an optional special procedure regarding to the rehabilitation of small ventures. Such entities might apply to a special instalment plan as to pay-off its debts (36 monthly instalments, with the first payment to be made within 180 days after filing the case; payments shall be done with monetary restatement plus a 12% interest rate per year). While this instalment plan is simpler than the ordinary rehabilitation plan, it only comprises unsecured credit rights.

In addition to the Judicial reorganization, the Bankruptcy Law allows for extra judicial reorganization plans[6] (including the totality or a part of the creditors' rights, labour and tax rights excluded), a novelty in Brazilian legislative history. Accordingly, distressed companies may privately negotiate with its creditors. The extra judicial plan must both be approved by creditors and further ratified by a judicial authority. To be approved the plan requires the vote of at least 3/5 of the holders of each kind of credit. Apart from the fact that private negotiations can always be more flexible than the rehabilitation rules set forth in legislation, another upside to the extra judicial reorganization is that its eventual failing (when debtor does not reach an agreement with its most relevant creditors) does not prevent the subsequent pursuing of the judicial reorganization.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Debt forgiveness (partial or full) and deadline extension are two of the most common and simplest methods through which corporate rehabilitation may be attained. A commonly found example of such liability renegotiation would be the adjustment of financial charges – banks and factoring creditors lowering their charges, an extremely useful tool in Brazil considering that our interest rates are among the highest in the world.

The debt for equity swap is also allowed by the Bankruptcy Law (either through share assignment or increase in capital stock). Nonetheless, this mechanism is not as used as the above described since it is always more troublesome to find credits interested in investing in a distressed company.

[6] If debtor: (i) has no pending Extrajudicial reorganization plan; and (ii) has not been already awarded with an Extrajudicial reorganization plan in the previous 2 years.

The use of debt for debt swap has increased, specially in more complex cases. One common example is the swap for debentures of different classes with different dates of maturity and guarantees.

The debt parking mechanism is also permitted in our legislation. The downside to such debt structure is that creditors: (i) that are partners, controlled, controlling, or associated to the debtor; (ii) that have partners or shareholders participating in the debtor with more than 10% of its capital stock; or (iii) in which the debtor or its partners participate with more than 10% of capital stock may be members of the Creditor's General Meeting, but without voting rights.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

Yes. Besides the methods described in item (3) above, the Bankruptcy Law allows for other kind of debt reliefs options, such as:

- Corporate reorganization (mergers, acquisitions, spin-offs, etc.); incorporation of a new entity with the special purpose of holding and transferring the debtor's assets to its creditors (safeguarding of debtor's assets); incorporation of a "creditors entity"; shifting in corporate control; partial sale of assets, etc.

Note that those methods are listed as examples in the Bankruptcy Law, meaning that any other legal debt relief mechanism agreed upon by and between debtor and creditors may be taken advantage of.

From a labour law standpoint, the reduction in wages, journey, and compensations in working schedule are also feasible as long as decided under labour collective agreements.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes. We do consider the Brazilian Tax Code[7], as well as our Income Tax Regulations[8] and other related laws[9] and regulations, both at the federal, the state and the municipal levels.

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

An important and controversial tax issue regarding the judicial rehabilitation is the mandatory presentation by the debtor of a "tax debt clearance certificate" (certificate issued by federal, state or municipal tax authorities certifying the non existence of tax debts pending payment) before confirmation by the judicial authority of the reorganization plan (as established in both the Bankruptcy Law and the Brazilian Tax Code).

This requirement has been questioned by the Brazilian taxpayers as some distressed companies may find it difficult to regularly pay all of their tax debts before engaging into a reorganization plan. Many jurists have disapproved reorganization plans conditioned on "tax debt clearance certificates". A legislative bill repealing such proviso (PL 7,636/06) was even proposed in our House of Representatives in 2006 (pending conclusion).

While taxpayers wait for the conclusion of the said legislative Bill, two routes might be pursued so that to circumvent the "tax debt clearance certificate" requirement.

(i) Enrollment in a tax debt installment plan; or

(ii) Challenging of such requirement and obtaining a favorable decision from the court.

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[7] Law 5,172/66.

[8] Decree 3,000/99.

[9] Such as Laws 9,718/98, 10,637/02, 10,833/03 (Social Contributions on Gross Revenues known as PIS and

Courts have been more inclined to decide that the presentation of a tax debt clearance certificate should not be required while pending legislation on the repayment of tax debts of companies under judicial reorganization. Furthermore, the need for a clearance certificate would be contrary to the main purpose of the bankruptcy law which is to reorganize the viable businesses.

One can say that the Brazilian Law does not provide for the application of specific tax methods on reorganization plans. In other words, most of the methods described in questions (iii) and (iv) above are governed by ordinary tax rules. Items 6.1 and 6.2 below are however subject to more favorable tax treatments.

6.1 Debt forgiveness

Normally, whenever a creditor grants debt forgiveness to a debtor, the realized gain (equal to the exonerated amount) must be included in the debtor's taxable income base for purposes of corporate taxation. Therefore, the debtor could be exposed to income tax (34% in Brazil) on such gain (in the rare cases where it is in a profitable position). On the other hand, the creditor may only be able to deduct the forgiven amount from its taxable income base if the debt has already expired (for more than 1 or 2 years, depending on the case), and when administrative or judicial charging procedures have already been filed.

Nevertheless, a creditor (of any sort) that forgives a debtor undergoing rehabilitation (either Judicial or Extrajudicial) is entitled to promptly deduct the exonerated amount from its taxable income base as an ordinary expense, which ends up enabling a more tax efficient scenario to negotiate debt forgiveness.

The exception to the above rules on deduction of forgiven amounts would be the disallowance of deductions by creditors that control, are controlled or associated to the debtor.

Note that our Tax Law does not establish a preclusive term for the offset of tax losses carryforwards (no carrybacks available in Brazil) previously incurred against current or future profits (regardless of whether or not a given company is under rehabilitation). However, a taxpayer may only offset tax losses carryforwards up to a 30% of annual taxable income in each calendar year.

6.2 Acquisition of establishment

As a rule, whenever one acquires an establishment from another and continues to explore the very same trade or business previously carried out by the seller, it becomes responsible for the tax liabilities eventually incurred by the seller.

The Brazilian Tax Code[10] excludes from that rule the acquisition of establishments in connection with judicial corporate reorganization plans. Put differently, if a beneficiary of a judicial reorganization plan sells an

[10] Such provision was put into effect by Complementary Law 118/05, enacted at the very same date of the Bankruptcy Law (February 9, 2005).

establishment, its associated tax liabilities are not transferred to the acquirer, but exclusively retained by the seller, unless the sale agreement states differently.

Note that the same rule does not apply in cases of extra judicial reorganization, where the purchaser of the commercial a establishment will succeed to the obligations of the debtor.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

The main tax benefit granted to creditors (regardless of the type of credit right they hold, or whether the reorganization plan is being pursued judicially or extra judicially) of a reorganization plan is the possibility of a prompt deduction of debt forgiveness amounts from its taxable income base. Therefore, creditor's attorneys should take into account (and balance) the prompt deductibility of the forgiven amount, and the possibility of further negotiating and actually receiving a higher portion of its credit rights.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

Both benefits described in items 6.1 and 6.2 (creditor tax benefits) are conditioned on appropriate confirmation of the reorganization plan by a court. Conversely, a complete accomplishment of such a plan by the debtors (in what regards all other creditors) is not a statutory requirement for the enjoyment of the tax benefits by a given creditor.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

As commented above, the forgiveness of a credit should be treated by the debtor as a taxable gain, what would trigger the assessment of corporate income tax, social contribution on net profits and the two contributions on gross revenues (PIS and COFINS). Thus, there is a strong possibility that the debt forgiveness results in the payment of taxes.

Since most companies under rehabilitation or reorganization carry book losses, there is the possibility that the shareholder acquires the debt from creditors with a discount (haircut) and subsequently offset the book losses against the accumulated losses, as provided for by our Income Tax Regulations. This procedure eliminates overall taxation.

One should note that this modality of debt forgiveness only works when the creditor is a shareholder of the company. Another possibility would be to grant one share to each creditor and proceed with the same structure.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

A Bill of Law (PL 5,082/09) is currently being analysed by our House of Representatives. This statute, if enacted, will empower the federal public attorney to strike deals and make concessions to the taxpayer as regards penalties, interest and other charges (with the intent to terminate litigation), while today each and every case must be formally tried by a judge.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

Please refer to question (10) above.

CANADA

QUESTION 1

1. **Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.**

The main insolvency* related laws are the Bankruptcy and Insolvency Act (BIA) and the Companies' Creditors Arrangement Act (CCAA). There is also the Farm Debt Mediation Act. There are various statutes in each province which address certain aspects of insolvency, for example, in Alberta there is the Landlords Rights on Bankruptcy Act.

QUESTION 2

2. **Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.**

Bankruptcy and Insolvency Act (BIA)

Part III of the BIA sets out the scheme for proposals. Division I governs corporate restructurings and Division II governs consumer proposals where aggregate debts do not exceed $250,000 (excluding debts secured by a principal residence). A proposal may be made by an insolvent person, a receiver, a liquidator of an insolvent person's property, a bankrupt or a trustee of the estate of a bankrupt corporate restructurings are noted below.

Generally, a proposal is a plan for a composition, extension of time or scheme of arrangement that a debtor company advances to its creditors. It permits an insolvent person to avoid bankruptcy or to annul a bankruptcy by making a proposal to creditors. There can be a variety of plans advanced in a proposal. Limits are really the level of creativity of the debtor and the necessity that the terms are acceptable to the creditors.

Recently, the BIA has been amended to facilitate debtors' negotiations on payment arrangements with the creditors.

* The definition of "insolvent" in Canada is as follows:
A person who has claims against him/her greater than or equal to $1,000, and:
a) who is for any reason unable to meet their obligations as they generally come due;
b) who has ceased paying current obligations in the ordinary course of business as they generally come due, or
c) the aggregate of whose property is not sufficient or if sold at a fairly conducted sale under legal process would not be sufficient to satisfy all of the debtors obligations both due and accruing.

The debtor remains in control of its business and assets, all actions by creditors are stayed (frozen) and the debtor is given time and an opportunity to address its insolvency by restructuring its financial affairs.

In order to commence the process under the BIA, a debtor either files with the official receiver a Notice of Intention to Make a Proposal (NOI) or a proposal. Generally, the NOI is filed as debtors have not developed a plan to advance to their creditors. Debtors choose the trustee to assist with the development of the proposal. Within 10 days after filing the NOI, the debtor must file a cash

flow statement with the official receiver. The cash flow sets out the debtor's anticipated receipts and disbursements generally over a 13 week period. If the debtor fails to file the cash flow within the prescribed time, the debtor is deemed to have made an assignment in bankruptcy. The cash flow statement must be reviewed for reasonableness by the trustee and must be signed by the trustee and the debtor. Any creditor can obtain a copy of the cash flow statement.

The trustee monitors the business of the debtor until a proposal is filed or the debtor goes into bankruptcy.

A proposal must be filed within 30 days after filing the NOI unless the debtor obtains from the Court an extension of time for filing a proposal. The Court can extend the time for filing a proposal up to periods of 45 days at a time, but the total period of extension cannot exceed five months after the initial 30 day period. If the proposal is not filed, the debtor is deemed to have made an assignment in bankruptcy.

Once a proposal is filed, it is sent to the creditors for their consideration. In order for a proposal to be accepted, two thirds in dollar value and over 50 in number of creditors in each class voting must vote in favour of the proposal. The vote is based on the number of creditors present and voting at the meeting either in person, by proxy or by mail. Creditors must file a proof of claim in order to be eligible to vote. The proposal must also be approved by the Court.

Distributions of funds in a proposal are made by the trustee. The maximum period over which a proposal can run is five years.

Companies' Creditors Arrangement Act (CCAA)

The CCAA allows for compromises or arrangements to be made by insolvent companies and its creditors. It is broader than the BIA and enables the company to meet the requirements of its creditors through refinancing, equity financing, sale of the business or sale of a portion of its assets.

The CCAA is restricted to larger corporations as they must have amounts owing to creditors in excess of $5 million. Companies who do not meet this debt threshold can utilize the BIA. The CCAA also allows the company to address its shareholders in addition to its creditors. Generally, large companies with a significant number of creditors and various layers of creditors use the CCAA to endeavour to restructure their financial affairs.

Under the CCAA, companies can ask the Court for protection from creditors while they prepare a plan of arrangement to present to their creditors. A monitor, who is an independent third party, is appointed by the Court and its duties are set out in the CCAA which includes monitoring the business, reporting to the Court from time to time, communicating with creditors, assisting the company with preparing its reorganization plan and preparing a report on the fairness of the plan.

The CCAA has many similarities to the BIA in that there is protection from creditors, cash flows are required, a plan is developed for consideration by creditors, creditors file proofs of claim and vote on the plan of arrangement (majority in number and two-thirds in dollar value are required for approval of the plan of arrangement) and the Court approves the plan of arrangement.

The CCAA is more flexible than the BIA. There is no specific time for when a plan must be filed, extensions of time for advancing a plan of arrangement are set by the Court, sanctioning of the plan by the Court is discretionary and if a plan under the CCAA is not accepted by the creditors, the company is not automatically bankrupt. However, it is quite likely if the plan is not accepted by the creditors the company will be placed into receivership or bankruptcy.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes. A key component of proposals under the BIA or the CCAA is the forgiveness of existing indebtedness in exchange for cash payments and / or for debt or equity in the debtor. Where the debt is forgiven, it is often in accordance with the payment of cash or other consideration over a period of time.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

There are occasions where it may be possible to extend the time for payment of debt or arrange a compromise of the debt on an informal basis. The difficulty with an informal arrangement is that it generally requires unanimity among the creditors. Moreover, creditors are not frozen or stayed from taking action against the debtor so one creditor can impact an informal reorganization or compromise of debt.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes', please list the names of the tax law which you consider. If the answer is 'no', please let us know why you do not have to consider tax issues.

Yes. The Income Tax Act (Canada) or ITA contains extensive legislation dealing with the taxation of debt forgiveness and other debt exchanges.

QUESTION 6

6. What are the issues (e.g. tax risk, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debt when the plan includes methods indicated in the above questions (3) and (4).

The Canadian forgiveness rules generally do not apply to a debtor who is bankrupt. However, where the forgiveness occurs on a proposal in bankruptcy or any other creditor arrangement act, this exclusion will not apply and the forgiveness rules noted below will have to be considered.

6.1 Debt forgiveness rules – general

The rules in the ITA will govern debt for equity swaps, debt-for-debt swaps and most arrangements with certain modifications. Specifically:

6.1.1 Debt for equity swap

Under the ITA, a debt for equity swap could result in a tax forgiveness. Specifically, the ITA will consider the debt to have been settled upon the exchange and will consider a payment to have been made by the debtor on the issuance of the shares equal to the fair market value of the shares. As a result, a "forgiven amount" will be deemed to have occurred to the extent of the difference between the principal of the debt and the fair market value of the shares that were issued. In addition, where a creditor already owns shares of the company at the time of the forgiveness, a payment will be deemed to have been made by the debtor on the forgiveness equal to the increase in the value of the creditor's shares as a result of the forgiveness. The forgiveness rules do not specifically deal with situations where a debtor contributes capital to the debtor which is used, in turn, to repay the debt (i.e., quasi-DES). Since the debtor is repaying some or all of the debt, the "forgiven amount" should be reduced but this is not clear.

6.1.2 Debt for debt swap

Under the ITA, where a debt is exchanged for another debt, a settlement will be deemed to have occurred at that time. However, the debtor will be deemed to have made a payment to the creditor equal to the principal amount of the new debt. Thus, if the principal of the new debt equals the principal of the old debt, no tax forgiveness will have occurred on the exchange. Where the debt is payable in a foreign currency, a foreign exchange gain or loss might result regardless of the absence of any forgiveness.

6.1.3 Distressed preferred shares

An exception to the rules relating to debt for equity swaps are distressed preferred shares (DPS) issued in exchange for debt that is settled. In the case of a DPS issuance, the rules relating to debt-for-debt swaps will apply such that the "forgiven amount" will not be based on the difference between the principal amount of the debt and the fair market value of the consideration issued but rather will be based on the excess of the principal amount over the paid-up capital of the DPS shares issued.

The DPS rules are quite complex and the parties will often seek an advance income tax ruling from the Canadian tax authorities before proceeding.

6.1.4 Debt parking

In certain cases, it may be desirable to have a major creditor dispose of its position to a person having a significant interest (in the debtor, thus allowing the creditor to realize its loss without providing for a formal forgiveness.
A creditor has a significant interest in a corporate debtor where the creditor, together with any person with whom the creditor deals not at arm's length, owns shares of the capital stock of the debtor having 25% or more of the votes or shares having more than 25% of the fair market value of all the issued shares of the corporation).

The ITA contains an extensive "debt parking" regime which may deem a forgiveness to have occurred where a creditor has realised its loss. For example, where a bank sells its position to a person having a significant interest in the debtor corporation, if the debt is sold at more than a 20% discount against the principal, the difference between the principal amount and the cost amount to the shareholder is treated as a "forgiven amount" to the debtor. The debtor may claim a 50% deduction upon repayments made on that debt.

6.2 Forgiven amount

When a debt is forgiven, the "forgiven amount" will reduce various tax attributes of the debtor, with the balance being included in income.

The first application of the "forgiven amount" is on a mandatory basis to the following attributes:

a) Non-capital (i.e. operating) losses of the taxpayer from prior years to the extent the losses would otherwise be deductible to the debtor during the year; and

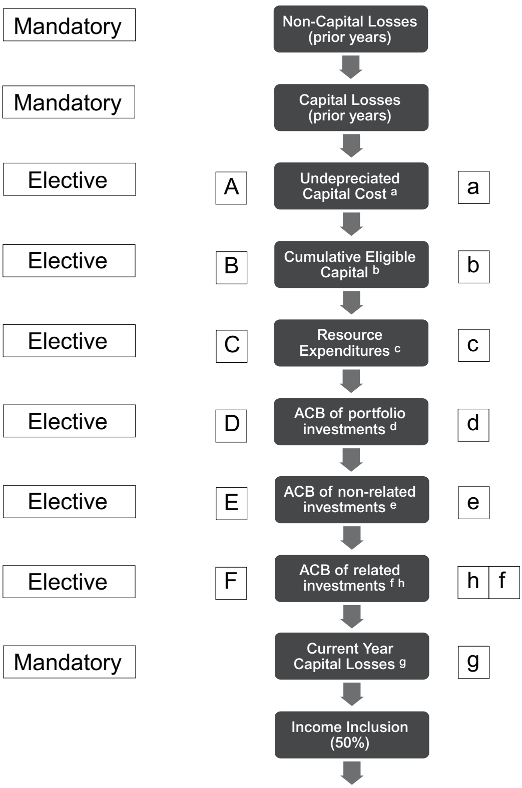
b) Capital losses from prior years to the extent the losses would be deductible in the year.

Any residual “forgiven amount” may then be designated to reduce the “elective” attributes in the order listed below. Failure to designate the application of the “forgiven amount” against each attribute to the maximum extent will prohibit application against the next attribute and may deny the ability to access certain planning tools to the debtor.

The remaining unapplied “forgiven amount” is then included in the taxpayer’s income at a rate of 50%.

The application of the “forgiven amount” is summarized in the following diagram:

Application of the forgiven amount*



* This diagram is for general information purposes. The application of a “forgiven amount” should be discussed with a tax advisor based on the relevant facts.[abcdefgh]

The debt forgiveness rules allow a debtor to mitigate the adverse impact of the 50% income inclusion to the debtor by utilizing the following:

a) Transfer of remaining forgiven amount - Instead of incurring the income inclusion on a forgiven amount, a taxpayer may elect to transfer the unapplied forgiven amount to an "eligible transferee" (generally, a related taxpayer) who may then apply the amounts against its tax attributes. In order to make this election, the debtor must have applied the forgiven amount against the attributed mentioned in (A) to (E) in the diagram to the maximum extent possible;

b) Insolvency deduction – The ITA requires a corporate debtor to claim a deduction where the expected income tax resulting from the income inclusion could render the taxpayer insolvent. The determination of insolvency is not based on a formal definition but is based on a calculation using the fair market value of the assets of the corporation at the end of the year of the forgiveness less certain liabilities, including the deemed tax liability on the income inclusion from the forgiven amount. The value of the net assets is increased by payments during the year for certain tax liabilities and amounts paid out as distributions to any person[i]; and

c) Five-year reserve – A corporate debtor may claim an annual reserve on the income inclusion such that it can be brought into the debtor's income evenly over a five-year period.

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[a] Undepreciated capital cost (unamortized tax cost of fixed assets) of depreciable property owned by the debtor immediately after the forgiveness.

[b] Cumulative eligible capital (i.e. unamortized tax cost of intangibles) immediately after the forgiveness. Since CEC represents 75% of the cost of the intangible, the ITA allows for $1 of a Forgiven Amount to be applied to reduce $0.75 of CEC.

[c] Resource Expenditures – these are the undeducted balances relating to expenses incurred for Canadian-based resource exploration or development.

[d] The adjusted cost base (ACB) or tax cost of capital properties owned immediately after the forgiveness other than:
i Shares and debts of a corporation where the debtor or a related person is a "Specified Shareholder", meaning
ii they own together more than 10% of the shares of any class of that corporation; and Interests in partnerships that are related to the debtor.

[e] The ACB of shares and debts of corporations owned immediately after the forgiveness where the debtor or a related person is a Specified Shareholder, other than shares and debts of related corporations.

[f] The ACB of shares and debts of corporations related to the debtor and interests in partnerships related to the debtor owned immediately after the forgiveness. The application against these assets will not avoid an income inclusion to the debtor where there are unapplied tax attributes in the related group.

[g] Where the Forgiven Amount has been applied to the fullest extent possible against the attributes in (A) to (D) above, the remaining balance will be deemed to be a capital gain in the year to the extent the taxpayer has other capital losses in the same year. This is useful since capital losses can only be applied to reduce income resulting from a capital gain.

[h] Where amounts have been applied to reduce assets under (F) above, that reduction may be effectively reversed and included in income if there are available tax attributes in the related group. This is meant to encourage debtors to elect to transfer a remaining forgiven amount to related taxpayers to utilize their tax attributes.

[i] This rule contains certain anti-avoidance provisions where the debtor has either transferred assets or become indebted in order to increase this deduction but only looks back to asset transfers and debt assumptions in the 12-month period prior to the end of the debtor's year in which the insolvency deduction is claimed. While there is no specific requirement to have designated the Forgiven Amount to the maximum extent against tax attributes, the Minister of Revenue may make designations against the attributes mentioned in (A) to (F) in the diagram to reduce the impact of the insolvency deduction.

6.3 Timing

The timing of tax forgiveness is important to consider since the circumstances and available tax attributes to a debtor may be significantly different at different times depending on the success of the plan. Under a proposal in bankruptcy or under creditor arrangement acts, the tax impact of the forgiveness will occur when the debt is truly settled. In many cases, the debt is only settled at the end of the arrangement when the debtor has met all the necessary terms. For example, where a proposal in bankruptcy has the debtor paying 30% of the debts over a three-year period (10% a year) the debts are generally deemed to have been forgiven only upon payment of the full 30% if the terms of the arrangement indicate that the debt will remain outstanding until final payment is received. However, where the plan specifically allows for debts to be partially settled as the debtor makes its periodic payments, the tax forgiveness rules would apply during the plan to the extent the debts are settled.

6.4 Foreclosures and seizures

In the context of a plan of arrangement, most gains from the forgiveness of debt would be treated as a Forgiven Amount but certain amounts may not. Specifically, if a secured creditor seizes an asset in satisfaction of their debt, or if an asset is surrendered to a creditor, the debtor is deemed to have disposed of the asset for proceeds of disposition equal to the principal amount of the debt extinguished as a result.

QUESTION 7

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7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

The main issue to consider is really the quantum of payment a creditor will receive under the plan of arrangement compared to any recovery in a bankruptcy. If the plan includes the distribution of shares, a creditor may consider the tax ramifications upon eventual disposition of those shares. Another consideration would be the possible survival of the debt and the potential for future business where the creditor is a supplier.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

In general, a creditor should be able to claim a loss on its debt upon the implementation of a plan on the basis that the consideration received is less than the cost amount of the original debt. A loss will not be available where the original debt was convertible under its original terms. Moreover, where the creditor is "affiliated" with the debtor, the loss may be denied based on certain stop-loss rules (For example, Canada has a general scheme which acts to deny losses where a property is disposed of at a loss and an "affiliated" party acquires within 30 days a property that is identical to the loss property or is a right to acquire such a property. In these cases, the loss is generally deferred until the time when the property is disposed of to a non-affiliated person. In addition, a loss can be denied where a financing loan was not made to gain or produce income. This can occur with respect to related-party financing where interest is not charged, although Canada will administratively allow the loss in certain circumstances).

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you rep resent a creditor.

As can be seen above, the debt forgiveness rules can result in favourable results if the timing of the forgiveness and the existence of tax attributes are considered. For example, if a forgiveness could be applied against the undepreciated cost of depreciable assets, it would avoid an immediate tax liability but will result in less depreciation expense available in future taxation years. Where depreciation expense can otherwise be accelerated, it might be beneficial to forego the application against the undepreciated cost of fixed assets and suffer the 50% income inclusion which can be amortized over 5 years under the reserve mechanism.

In structuring a plan, consideration must always be given to Canada's General Anti-Avoidance Rule (GAAR). The GAAR allows certain transactions to be recharacterized to remove a "tax benefit". For GAAR to apply, the tax benefit must result from an "avoidance transaction", which is a transaction, either alone or as part of a series of transactions, undertaken for non bonafide business purposes to obtain the tax benefit. Moreover, it must be determined that the avoidance transaction resulted in a "misuse or abuse" of the provisions of the ITA or the scheme of the ITA read as a whole.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No. The existing rules were introduced in 1994 as a result of problems with prior legislation. While the existing rules are quite complex, they provide a clear framework and as discussed above, they provide significant latitude to corporations with solvency issues to organize their affairs to reduce taxes in a time of need.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No

CAYMAN ISLANDS

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

The introduction of new insolvency legislation earlier this year meant that for the first time the Cayman Islands would now have their own set of detailed rules and procedures governing insolvency practice.

The Companies (Amendment Law) 2007 and the below rules and regulations govern insolvency practice in the Cayman Islands all of which came into effect on 1 March 2009. They are:

- The Companies Winding Up Rules 2008 (Amended 2010);
- The Insolvency Practitioner's Regulations 2008 (Amended 2010), and;
- The Foreign Bankruptcy Proceedings (International Cooperation) Rules 2008.

Prior to 1 March 2009, insolvencies in the Cayman Islands were governed primarily by the Insolvency Rules (1986) (UK) "to the extent that was practical to do so".

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 Overview of legislation

(a) The Companies (Amendment Law) 2007 and related rules and regulations govern insolvency practice in the Cayman Islands. Notable changes in respect of insolvency introduced in The Companies (Amendment Law) 2007 revision include the concepts of "shadow directors" and "fraudulent trading".

(b) The Companies Winding Up Rules 2008 (Amended 2010) represent the procedural rules for insolvency matters designed specifically for the Cayman Islands in relation to all proceedings commenced, and all steps taken in existing proceedings after 1 March 2009.

(c) The Insolvency Practitioners' Regulations 2008 (Amended 2010) defines criteria for official liquidators, including requirements in relation to professional qualifications, residency, independence and insurance.

(d) The Foreign Bankruptcy Proceedings (International Corporation) Rules 2008 make provisions to wind up a foreign company which has property located in the Cayman Islands, is carrying on business here, is the general partner of a Cayman Islands limited partnership, or is registered as a foreign company in the Cayman Islands.

2.2 Proceedings that facilitate the rehabilitation of distressed companies

There are a number of proceedings and / or mechanisms that facilitate the rehabilitation of distressed companies. One of the primary proceedings is the appointment of a provisional liquidator.

(a) Provisional Liquidation

A company may petition the court for a provisional winding-up order on an ex-parte basis if it is likely to become unable to pays its debts and it intends to present a compromise to its creditors. The court will assess the insolvency of a company using a cash flow test, not a balance sheet test. In making a provisional winding-up order, the court may grant the company certain relief such as a stay of proceedings while it works towards a compromise.

Pursuing a compromise or scheme of arrangement in this manner allows the company protection in much the same way as Chapter 11 in the US or Administration Order in the UK, from creditors during reorganisation from which it may emerge as a going concern.

(b) Schemes of Arrangement

Another mechanism to rehabilitate a distressed company is the provisions of the Companies Law that allow the Grand Court (the “Court”) to make orders enabling a company to pursue a compromise or an arrangement with its creditors or members (often called a “scheme of arrangement” or a “scheme”).

A scheme is a flexible, timely and cost effective form of corporate restructuring, which may be put forward in relation to a single company or a group of companies.

The scope for using a scheme of arrangement is wide; it can be used, for example, to reorganise the share capital of a company, to merge one company with another company or two or more companies under a new holding company or as part of a scheme of reconstruction or amalgamation, simplification of entitlements in liquidations etc. The timeline to completion of a scheme varies widely depending on the purpose and complexity of the scheme, appeals and the court schedule.

In order for a scheme of arrangement to be approved, a scheme must be supported by a majority in number representing at least 75% by value of the groups affected, whether shareholders, creditors or particular classes thereof.

Prior to the court meetings, every affected creditor or member must be provided with an explanatory memorandum outlining the provisions of the scheme, commercial effect and a timetable of principal events. Unlike Chapter 11 of the US Bankruptcy Code, the explanatory memorandum is not reviewed by the court prior to its distribution; instead its contents are the responsibility of the applicant of the scheme. Along with receiving the scheme documents, the affected parties are also notified of the date of the hearing of the petition, which will take place in an open court. Any affected party who voted is entitled to be heard on the petition.

After the scheme has been approved by the affected parties, the chairman of the meeting must prepare a detailed report outlining the results of the meeting that will allow the court to make a decision on whether to sanction the scheme or not. The court must be satisfied that the scheme is fair and may not approve a scheme that achieves the requisite votes if it considers the result to be unfairly prejudicial to an opposing minority.

(c) Other alternatives to winding up

The Companies Law provides for specific alternative orders by the court if the petition is presented on “just and equitable grounds”. The alternative orders include the following remedies:

(i) The company refraining from doing or continuing an act complained of by the petitioner;

(ii) Regulating the conduct of the company’s affairs in future;

(iii) Allowing civil proceedings to be brought on behalf of the company by the petitioner; or,

(iv) The purchase of shares of some members by other members, or the company itself.

These alternative orders provide options where there may be a dispute between contributories or oppressed minorities.

(d) Controllership

In the case of a Cayman Islands Monetary Authority (CIMA) regulated entity, CIMA may appoint a person to assume control of the affairs of the entity.

CIMA may appoint a “controller” if it is satisfied that:

(i) The entity is or likely to become unable to meet its obligations as they fall due;

(ii) The entity is carrying on or attempting to carry on business or is voluntarily winding-up its business in a manner prejudicial to its investors;

(iii) The business conducted by the funds is in breach of its licence;

(iv) The direction and management of the entity has not been conducted in a fit and proper manner; or,

(v) A director, manager or officer of the entity is not a fit and proper person to hold the respective position.

A person appointed as a controller has all the powers necessary, to the exclusion of any operator, to administer the affairs of the entity in the best interests of the investors and creditors of the fund.

QUESTION 3

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3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

The provisions of the Companies Law that allow a company to pursue a scheme with its creditors or members are very flexible in terms of providing a company a method to follow a proposed course of action. It is not the case that a scheme may only be used for distribution of assets on a winding up of a company. The applicant may pursue a scheme that fits their particular requirements, as the Companies Law does not prescribe the purposes or contents of a scheme, other than that there must be a compromise or an arrangement between the parties.

QUESTION 4

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4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

The Companies Law prescribes that the court, may either by the order sanctioning the compromise or by any subsequent order make provision for; (i) the transfer to the transferee company of the whole or any part of the undertaking and of the property or liabilities of any transferor company; or, (ii) the allotting or appropriation by the transferee company of any shares, debentures, policies, or other like interests in that company which under the compromise or arrangement are to be allotted or appropriated by that company to or for any person.

QUESTION 5

5. **Do you consider tax issues when you create your plan? If the answer is ‘yes,’ please list the names of the tax law which you consider. If the answer is ‘no,’ please let us know why you do not have to consider tax issues.**

The Cayman Islands is a tax neutral jurisdiction. As there is no corporate, income, property or inheritance tax then companies do not face any direct tax consequences. However; to the extent that the assets utilized in any scheme are foreign based, it may be appropriate to seek tax advice from attorneys in that jurisdiction.

QUESTION 6

6. **What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).**

This is not applicable as the Cayman Islands is a tax neutral jurisdiction.

QUESTION 7

7. **If you were the creditor’s attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?**

The main concern for the creditors’ attorney would be the taxation implications for the creditor in their home country where they are not resident in the Cayman Islands.

QUESTION 8

8. **If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the Court or executed by the debtor; does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.**

No, the Cayman Islands is a tax neutral jurisdiction.

QUESTION 9

9. **Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.**

None, the Cayman Islands is a tax neutral jurisdiction.

QUESTION 10

10. **Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?**

No. The Cayman Islands is a tax neutral jurisdiction.

QUESTION 11

11. **Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?**

No.

CHINA

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

At present, the Enterprise Insolvency Law of the People's Republic of China (EIL), which was promulgated by the Standing Committee of the 10th National People's Congress in August 2006 and took effect as of 1 June 2007, is the only law to govern the rehabilitation of distressed companies, and it provides a comprehensive guideline for the insolvency, reorganization and composition of distressed companies.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

Article 1 of the EIL outlines the purpose of the EIL. It sets out that the EIL aims to (a) regulate insolvency procedures; (b) fairly liquidate credits and debts; and (c) protect the lawful rights and interests of creditors and debtors. In addition, the EIL specifies two rehabilitation regimes: reorganization and composition.

Generally, a debtor may elect to file a petition of reorganization, composition or bankruptcy with the People's Court if it cannot pay the debts as they become due, while a creditor may file a petition of reorganization or bankruptcy with the People's Court. A creditor cannot initiate composition proceedings. Compared with composition, the option of reorganization is generally more advantageous for the rehabilitation of distressed companies.

2.1 Reorganization

(a) According to Article 2 of the EIL, where an enterprise is unable to pay off its debts and its property is not sufficient to pay off all its debts, or it is obviously insolvent, reorganization may be carried out in accordance with the provisions of the EIL.

(b) Under the EIL, the following persons may directly apply to the People's Court for a debtor's reorganization: (1) debtors; (2) creditors; (3) debtors' investors with more than 10% of the registered capital.

(c) Formulation and Approval of the Reorganization Plan (Reorg Plan).

The debtor or administrator shall submit the draft of the Reorg Plan to the People's Court and the Creditor's meeting will be held within 6 months from the date of the ruling by the People's Court on the reorganization of the debtor. The Reorg Plan can be implemented only after it is adopted by the creditor's meeting and is approved by the People's Court.

(d) Adoption of the Reorg Plan by creditors' meeting.

In order for a Reorg Plan to be voted at a creditors' meeting, the creditors shall be classified into different groups based on the following categories of credits and vote for the Reorg Plan on a group basis: (1) the creditors with secured rights against specific property of the debtor; (2) the salaries and medical and disability subsidies and pension expenses due to employees by the debtor, the basic pension insurance and basic medical insurance expenses due to the individual accounts of employees, and compensation that shall be paid to the employees as prescribed by laws and administrative laws and regulations; (3) the tax due from the debtor; and (4) ordinary creditors. Where over half of the creditors of the same voting group attending the meeting give consent to the Reorg Plan with the amount of debt represented exceeding two-thirds of the total amount of the debts of the same group, the Reorg Plan shall be deemed as being passed by this group. The plan is adopted when all groups pass the draft reorganization plan.

2.2 Composition

Under EIL, only the debtor may apply for a composition to the People's Court. In applying for a composition, the debtor shall put forward a draft of the Composition Plan (Comp Plan). The Comp Plan can be implemented only after it is adopted by the creditors' meeting and is approved by the People's Court. In order for a Comp Plan to be adopted, the Comp Plan shall be (1) adopted by over half of the creditors with voting rights present at the creditors' meeting and; (2) the amount of their debt must exceed two-thirds of the total amount of unsecured debt.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is common in China to use various forms of debt restructuring as mentioned above because, among other reasons, debt restructuring is less expensive than insolvency proceedings. The most popular method in various plans is debt forgiveness, which allows the debtor to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations. This gives creditors an increased possibility of collecting their remaining claims as well as increasing the feasibility of rehabilitating the debtor.

A Debt for equity swap (DES) is also a common tool in China. If a company runs into serious financial difficulties which are viewed as temporary but has great potential for financial improvement in the longer term, creditors will prefer a DES arrangement.

Debt for debt swap and debt parking are quite uncommon compared with the above two methods.

There is no regulatory restriction in China to prohibit the deployment of a debt parking scheme. However, debt parking arrangements are very uncommon in practice. From a tax perspective, the assignment between creditor to an associated party to the debtor must have a reasonable business purpose in order for the new creditor to claim a tax deduction for any expenses or costs it incurred to acquire the debt. On the other hand, for the debt forgiveness, the debtor will recognize the debt waiver as taxable income, and the creditor, if it is a related party to the debtor, would not be able to claim such debt forgiveness as a tax deductible cost.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

It may be possible to extend a debt repayment schedule or to forgive some or all of the incurred interest to decrease the total existing debt.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is ‘yes,’ please list the names of the tax law which you consider. If the answer is ‘no,’ please let us know why you do not have to consider tax issues.

Yes. We consider the PRC Enterprise Income Tax Law (EITL).

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

From a PRC tax perspective, debt reorganization can be classified as general debt reorganization and special debt reorganization. In a general reorganization, the debtor should recognize all the gains or losses resulting from debt reorganization in the current tax year when the reorganization takes place. Thus, any debt forgiven would be taxed in the current year, which can be a real obstacle to debt forgiveness. In a special reorganization, the debtor may elect to recognize the taxable income over a 5-year period. The following is a discussion of the tax treatment of general debt reorganization and special debt reorganization.

6.1 General debt reorganization

In general debt reorganization, the tax treatment under relevant transactions is outlined as follows:

(i) in a case of the debt repayment by means of the transfer of non-monetary assets, the transaction shall be viewed as two separate transactions - sale of non-monetary assets and debt repayment at fair market value of non-monetary assets; the creditor shall recognize the gains or losses resulting from the debt repayment by non-monetary assets;

(ii) in the case of a debt-for-equity swaps, the transactions shall be viewed as two separate transactions - debt repayment and equity investment, and the creditor shall recognize the gains and losses from the debt discharge;

(iii) the debtor shall recognize the gain from the debt reorganization based on the difference between the repaid debt and the tax basis of the debt; the creditor shall recognize the loss from the debt reorganization based on the difference between the debt repayment received from the debtor and the tax base of the claims.

6.2 Special debt reorganization

If taxable income realized out of debt reorganization accounts for more than 50% of the debtor's taxable income of the year, the debtor may allocate its taxable income from the debt reorganization equally over the following 5 years.

If a debt-for-equity swap occurs in a special debt reorganization, the tax basis of the equity investment shall be in line with the tax basis of the creditor's original claims where the debtor (the restructuring company) elects to postpone the recognition of the respective gains or losses from debt discharge and equity investment.

QUESTION 7

7. **If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?**

The eligibility for tax deduction would be a key concern for the creditor, in terms of any loss arising from the debt forgiveness. The losses arising from debt forgiveness are not tax deductible for creditors unless the debt forgiveness meets one of following conditions:

(i) debt forgiveness is determined in a confirmed Reorg Plan or Composition Plan;

(ii) debt forgiveness is made pursuant to certain mutual agreements accepted at a creditors' meeting under a reasonable standard of dealing with debt restructuring.

QUESTION 8

8. **If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.**

Not really, except that the creditor may be able to claim tax deductiosn for losses incurred from the debt reorganization plan, as discussed in question (7) above.

QUESTION 9

9. **Please tell us other pitfalls and/or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.**

Please see the answers stated in questions (6) and (7).

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

FRANCE

QUESTION 1

1. **Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.**

   French bankruptcy law is governed by the Business Safeguard Act *(Loi de Sauvegarde des Entreprises)* dated 26th July 2005, which came into force on 1st January 2006, and its application decree dated 28th December 2005. This Act has recently been modified with the Order dated 18th December 2008.

QUESTION 2

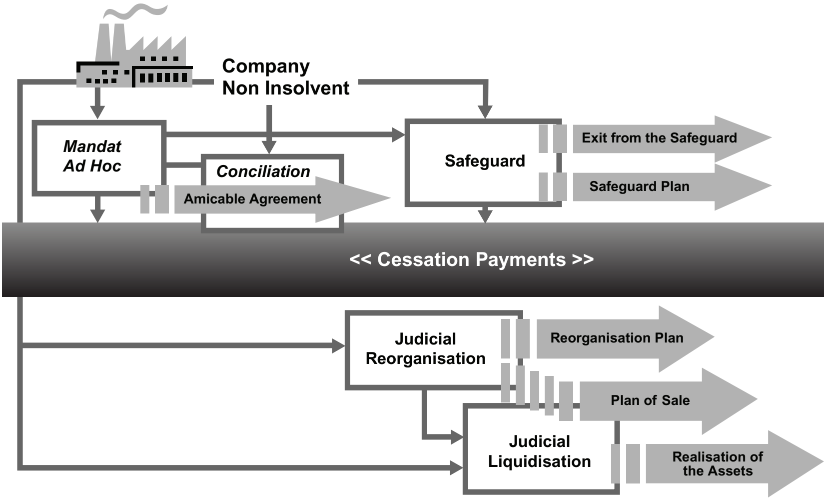
2. **Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.**

   The Business Safeguard Act has set out 5 different procedures dedicated to the amicable and judicial treatment of company difficulties.

   Amongst them, the safeguard procedure has recently been introduced by this Act.

   A distinction can be made between amicable proceedings e.g. mandat ad hoc and conciliation of judicial proceedings e.g. safeguard, judicial reorganisation, and judicial liquidation.

   The core criterion for proceedings governed by the Business Safeguard Act is the concept of default of payments. Default of payments by a debtor is characterised when the outstanding liabilities are greater than its available assets.



2.1 Amicable proceedings

(i) Mandat ad hoc

(a) Objectives of the procedure

Established by article L.611-3 of the commercial code, “Mandat ad hoc” is an amicable, flexible and confidential procedure with no set time limits, intended to allow a third party to assist a company in its negotiations so as to ensure its continuity.

(b) Instigation

This procedure is instigated by an order from the President of the Commercial Court at the sole initiative of the debtor, who must show that his company is not in default of payment.

The order names an independent receiver *(mandataire ad hoc)* who may have been nominated by the debtor.

(c) Principles

This procedure is confidential insofar as only the debtor, the independent receiver and the President of the Commercial Court are informed about its initiation. The absence of an opening judgment and publicity guarantees confidentiality.

Consequently, creditors who are informed about the instigation of proceedings within the context of negotiations are bound by the rules of confidentiality.

This procedure is flexible in that it is only regulated in part by the Business Safeguard Act (1 single article). Thus, its duration is not restricted by the Act and the mission of the independent receiver is freely determined by the presiding judge.

“Mandat ad hoc” may, therefore, result in the renegotiation of outstanding debts (terms of payment and / or cancellations) but equally any other objective convergent with preserving the continuity of the company.

It is specified that the debtor retains all of his powers without dispossession as a result of initiating the procedure.

(ii) Conciliation

(a) Objectives of the procedure

Established under article L.611 4 of the commercial code, conciliation is an amicable and confidential procedure up until ratification of the agreement. It has a set time limit, which has the purpose of “encouraging the conclusion of an amicable agreement intended to put an end to the company difficulties”.

Conciliation is particularly suitable for securing an investor with new money.

(b) Instigation

Conciliation is open to companies who can:

- Demonstrate that they are not in default of payments or that they have been for no more than 45 days.

- Justify a proven or foreseeable judicial, economic or financial difficulty.

This procedure is opened by an order from the President of the Commercial Court at the sole initiative of the debtor.

The order appoints a conciliator who may have been suggested by the debtor.

Before 2006, when the Business Safeguard Act came into force, a company, in default of payments had no other choice than to make a default of payments declaration with a view to initiating judicial reorganisation or liquidation proceedings. From now on, a company, despite being in default of payments (so long as this does not exceed 45 days), will be able to benefit from the amicable conciliation procedure.

(c) Confidentiality

On opening the procedure, only the debtor, conciliator and President of the Commercial Court are informed about the instigation of proceedings. The absence of an opening judgment and publicity guarantees confidentiality on opening the procedure.

This confidentiality may be lifted if the procedure is successful and on approval of the agreement reached with the creditors. This approval is actually delivered by a judgment subject to advertisement. However, the advertisement of the judgment only acknowledges the agreement and not the terms of the agreement (see below - d).

(d) Flexibility

This procedure is regulated more by the Act which makes it less flexible than “Mandat ad hoc”. The advantage is that the security of the approved agreement with conciliation is more significant than the agreement certified by the President of the Commercial Court as part of the “Mandat ad hoc”.

The Bankruptcy Safeguard Act regulates the conciliation process as follows:

- To instigate the process, the petitioner must demonstrate a proven or foreseeable judicial, economic or financial difficulty.
- The mission of the conciliator is set by the Act and not by the President of the Commercial Court: “To encourage the conclusion of an amicable agreement intended to put an end to the company difficulties”.
- In terms of the duration of conciliation, the Act provides a time limit of 4 months, renewable for 1 month.
- The Act provides for information from the state prosecutor’s office and from professional sources if the need arises.

Furthermore, conciliation does not automatically suspend legal proceedings or payments.

(e) Securing the agreement

In the event of an agreement reached with the creditors, the parties have two options: Presidential acknowledgement by means of an order or ratification by judgment.

The president’s acknowledgement is formalised by an order from the President of the Commercial Court who has received a certified declaration from the debtor testifying that he was not in default of payments at the time of the conclusion of the agreement or that the agreement has put an end to them.

Acknowledgement of the agreement gives him executory power.

The decision by the President of the Commercial Court is not subject to publication. Copies of the order will only be delivered to the parties and persons relying on them.

The presidential acknowledgement thus preserves the confidentiality of the agreement.

The decision by the President of the Commercial Court is not subject to appeal. It completes the procedure.

Approval of the agreement is granted on fulfilment of the following three conditions:

- The debtor is not in default of payments at the time of the conclusion of the agreement or the concluded agreement puts an end to them.

- The nature of the terms of the agreement assures the continuity of company activity.

- The agreement does not damage the interests of the non-signatory creditors.

Approval of the agreement is formalised by a Commercial Court judgment. This judgment is presented at the Court Clerk's office and advertised in the Official bulletin of Civil and Commercial Announcements *(Bodacc)*. On the other hand, it does not specify the terms of the agreement, which remains confidential.

The effects of the ratified agreement are as follows:

- Suspension of legal proceedings by the creditors party to the agreement.

- Joint obligors and securities of the company can benefit from the agreement.

- No potential deferring of the date of default of payments before the date of approval.

- Risk of unreasonable financial support is excluded.

- Establishment of a lien (new money lien) for the creditor who makes a financial contribution with the purpose of assuring the continuity of the company.

This concerns a statutory and general lien allowing payment by lien, for any debts originating prior to conciliation, in the event of subsequent judicial liquidation of the company.

2.2 Judicial proceedings

(i) Safeguard

(a) Objectives of the procedure

The safeguard procedure is the new element of the Business Safeguard Act dated 26th July 2005.

This new procedure, which previously had no weight in French law, was inspired by Chapter 11 of the U.S. Bankruptcy Code and is intended to encourage management of company difficulties prior to default of payments in order to optimise the chances of reversal.

This procedure is similar to judicial reorganisation prior to default of payments, but with some restrictions.

This procedure has had relative success since its conception, in that the number of safeguard procedures initiated is much lower than that of judicial reorganisation procedures.

(b) Instigation

The safeguard procedure may only be instigated at the debtor's initiative, on submission of a Declaration (DOPS) to the Court.

This declaration must demonstrate:

- That the company is not in default of payments.
- The difficulties that it is unable to overcome.

The Court then instigates a six month period of observation renewable once with the possibility of a second six month exceptional extension on request to the public State Prosecutor's Office (equivalent to an overall duration of eighteen months).

(c) Development of the procedure

The debtor continues to run his business with the help of a court-appointed administrator (no dispossession of the debtor in comparison with judicial reorganisation).

Instigation of the safeguard procedure removes the suspension of legal proceedings and the order denying payment of all former debts (those previously declared as liabilities).

(d) Safeguard plan

The purpose of the safeguard procedure is the renegotiation of company liabilities (terms of payment and debt forgiveness) with its creditors, within the framework of a safeguard plan.

For companies with more than 150 employees that have a turnover greater than twenty million Euros, negotiation with creditors is conducted within the context of creditor committees (credit institutions and suppliers).

The company can suggest terms of payment to its creditors (in or out of committee) as well as debt forgiveness in return for shorter payment terms.

The Court can impose terms of payment (maximum 10 years) on creditors that refuse the offers of settlement submitted to them. It cannot impose debt forgiveness.

The terms of payment and debt forgiveness negotiated as part of the plan are explained in (3).

The safeguard plan is adopted by a judgment.

(ii) Judicial reorganisation

(a) Objectives of the procedure

Judicial reorganisation is a procedure intended to protect a company owing money to its creditors so as to allow continuation of company activity, maintain employment and discharge liabilities.

(b) Instigation

Judicial reorganisation is open to companies that can demonstrate proven default of payments.

Instigation must be sought by the debtor within 45 days of the occurrence of the default of payments.

Furthermore, judicial reorganisation may be opened by a summons from the creditor or official referral from the Court.

The Court then initiates a six month period of observation renewable once with the possibility of a second six month period as an exceptional extension on request to the public prosecutor (equivalent to an overall duration of eighteen months).

(c) Organisation of the procedure

The opening judgment designates a court-appointed administrator who assists the debtor or takes his place running the company. The same judgment also nominates a judicial receiver whose function is to represent the creditors.

Initiation of the safeguard procedure removes the suspension of legal proceedings and the order denying payment of all former debts (those previously declared as liabilities).

Judicial reorganisation presents the opportunity to benefit from exceptional arrangements in respect of the French labour code as part of the redundancy procedure (shorter terms).

(d) Results of the procedure

The purpose of judicial reorganisation is to introduce a reorganisation plan allowing continuity of the company thanks to renegotiation of company liabilities (payment terms and debt forgiveness) with its creditors. If reorganisation of the company is not possible, third-parties will be able to make an offer of asset takeover with the Court.

The transfer plan offers the possibility of transferring the business to preserve the continuity of activity, maintain all or part of the workforce and pay off the creditors.

In the event that reorganisation of the company is not possible and no acceptable offer of transfer is reached, the Commercial Court declares liquidation.

(iii) Judicial liquidation

Judicial liquidation is initiated by a ruling from the Commercial Court in the event of proven default of payments and acknowledgement that company reorganisation is not possible. The same judgment nominates a court-appointed liquidator.

The purpose of judicial liquidation is to bring an end to the company's activities and realise the debtor's assets by total or separate assignment of his interests.

Judicial liquidation does not allow for renegotiation of liabilities with a view to continuity of the activity.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is.

(i) Debt forgiveness

Negotiation of debt forgiveness is the option used most often in the context of restructuring and especially within plans adopted in the judicial phase (safeguard or judicial reorganisation). In practice, the creditor accepts a partial payment of the debt (which will take place more quickly) in return for cancellation of the debt.

When a draft plan is submitted to the creditors, it can include 2 (or more) alternative options for the creditors: a short payment accompanied by debt forgiveness or payment of the whole debt over a duration not exceeding 10 years (the 1st payment to be made within 1 year and the annual repayment may be no less than 5% from the 2nd year onwards).

In accordance with French law, creditors in receipt of a draft plan has 2 options. Creditors who do not agree to discharge within the time limits will not be forced by the Court into discharging their debt by adopting the plan (creditors have 30 days to respond starting from the date of receipt of the settlement proposal). On the other hand, the Court can impose standard payment terms with regard to debts for future settlement, to longer terms stipulated between the parties before instigation of the procedure which may exceed the term of the plan (article L626-18 of the Commercial Code).

3 points should be acknowledged:

- The Business Safeguard Act has established creditor's committees as part of the safeguard procedure and judicial reorganisation. The committees are as follows:

  - Trade committee; and,

  - Credit institutions committee, (credit institution and any other entity with which the debtor has concluded a credit transaction, cf monetary and financial code and R626-55 of the commercial code).

    These committees are created by law for companies who have a turnover threshold of 20 million Euros and 150 employees and are optional below these thresholds.

    In the presence of the committees, the plan proposals addressed to the committees are not subject to the restrictions established above: it follows that these proposals may provide for a settlement of more than 10 years, as well as an annual repayment of less than 5% from the second year onwards.

    Cancellations may be imposed on the minority creditors of the same committee in the event of adoption of the draft Plan with a majority of 2/3 of the overall debts and adoption of the said Plan by the Court.

- According to French law, bond creditors are grouped together in a general assembly that deliberates, like a third type of creditor's committee, on the plan accepted by the creditor's committees (trade and credit institutions).

- Since the Business Safeguard Act came into force, Law 2009 - 179 17th February 2009 and the application decree of 6th April 2009, companies can apply, in certain circumstances, for cancellation of all or part of the debts from tax and social security authorities as part of conciliation, the safeguard procedure or judicial reorganisation (see below).

However, awarding of cancellations is subject to numerous conditions and does not apply to the totality of debts especially tax (such as indirect taxes like VAT).

The procedure for this type of restructuring of tax and social liabilities in the amicable phase (conciliation) or judicial phase (safeguard and judicial reorganisation), is as follows:

- Submission, within 2 months from the initiation of the proceedings, of the commission of the heads of the finance department (CCSF) by the company in the conciliation phase or the receiver in the judicial phase. This committee brings together the various public and semi-public creditors and is chaired by the Paymaster.

- The file must contain a certain number of financial elements (status of private debts, annual accounts, funds statement, forward budget etc.).

- With regard to the amount of debt remission solicited, as time limits for the verification of debts have not generally expired within 2 months, in practice a time limit for the presentation of the request for the development of the plan should be requested in practice.

The conditions for awarding cancellations are as follows: (art D626-15)

- The aim of clearing the debt is to facilitate the financial restructuring of the company in difficulty, the continuation of its economic activity and maintenance of employment. It cannot be applied for in the case of a non-viable company.

- "It must not present an unjustified economic advantage for the benefiting company".

- "The efforts of the public creditors are co-ordinated with those of the other creditors": thus, the CCSF will, therefore, take this into consideration.

- The efforts of the shareholders, managers and private creditors.

- The financial situation of the debtor and the prospects of his lasting recovery.

- The debtor's usual behaviour towards fiscal creditors.

- Any other efforts agreed to by these creditors regarding the assignment of the status of lien or non-settlement or cancellation of these indemnities or previously agreed payment terms.

(ii) Debt for equity swap

Creditors and especially the banks in France still demonstrate caution towards this remedy intended to restructure the debt. Nevertheless, several instances of debt for equity swap involving significantly sized companies have reached a conclusion within the context of amicable or judicial procedures (mainly safeguard).

This technique allows the company to restructure its debts by negotiating an appreciable reduction of its debts in return for which the creditors agree to acquire a stake in the company and in certain cases take control of companies.

This remedy is used infrequently in France.

(iii) Debt for debt swap

The debt for debt swap could be conducted under French Law.
The tax implication of debt for debt swap is comented in question 6.

(iv) Debt parking

Debt parking cannot be implemented under French law, in practice creditors would sell their receivables at a low price and recognize a loss.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

The practice of increasing the capital by debt incorporation also exists.

In the context of this type of debt restructuring, the current or new shareholders can decide to pay back certain debts at a price generally lower than the nominal value of the acquired debt. Secondly, these shareholders may decide to increase the capital by incorporating the acquired debts. The increase of capital will be freed by compensation with the amount of the acquired debt.

The operation requires the debt to be liquid and payable.

However, caution should be taken with regard to the assessment of the normal character of the payment which forms the offsetting process in terms of the said period (period between the default of payments set by the court and the opening judgment).

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Tax issues are not the main concern when working-out plans concerning the debtor who generally has a tax loss carry-forward enabling him to absorb any negative effects of the plan. The plan must however, take into account the tax issues of the creditors in order to obtain their agreement (see question 6). There is no specific tax regime applicable to companies subscribing to a plan, but they are subject to the general company tax provisions regulated by the French Tax Code (*CGI, Code Général des Impôts*).

(a) Articles 34 to 61; 205 to 248 deals with the taxation of profits.

(b) Articles 256-0 to 298 Septdecies deals with Value Added Tax.

A few rare provisions dealing with specific points provide for specific rules applying to companies that are subject to a plan:

- Possibility of obtaining early reimbursement of carry-back instead of 5 years (art.220 quinquiès 1 of the CGI).
- Possibility of transferring tax losses in case of breaking up of an integrated tax group which holding is subject to a plan (art.223 E of the CGI).

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

6.1 Tax losses

(i) Carry-forwards

Company tax loss carry-forwards cannot be transferred upon total or partial transfer, of a business, to the prospective purchaser of this business. This rule is particularly disadvantageous to companies subscribing to a plan who have little prospect of being able to use their tax loss carry-forward and it does not encourage the transfer of their activities to a prospective purchaser.

(ii) Carry-back option

French companies can opt to carry-back their tax losses according to the profits of the three previous tax years and record a tax net operating loss chargeable to the corporate tax for which they will be liable over the following 5 tax years. However, this option cannot be applied to tax losses recorded during the tax year of company liquidation, although, early settlement of the debt may be obtained (see above).

(iii) Company adherence to a tax group (art.223 A and following of the CGI)

Execution of the plan may lead to the cessation of a group or the company leaving the tax group and limit the possibilities of using tax losses, and indeed lead to the deneutralisation of operations made between companies belonging to the group (more valuable transfers, subsidies, debt forgiveness etc.).

6.2 Debt forgiveness

(i) The discharge of debts and debt forgiveness represent taxable products for the company benefiting from the plan, their total amount is incorporated into the tax year profits when the following takes place:

(a) The Court decision formally acknowledging the agreed discharge of debt within the framework of the plan or the imposition of standard terms of payment on creditors;

(b) Payment of the final settlement when the Court has given the creditors the option of being paid in a shorter term when they agreed to reduce the amount of their debts.

(ii) The payments made to creditors by the company benefiting from the plan under the application of a clause for return of better fortune constitutes a deductible charge from its taxable profit for the company, as far as the better fortunes clause has been expressly stipulated in the plan or a contract.

(iii) Value Added Tax

Cancellation of commercial debts by creditors will have the following implications:

(a) Debts corresponding to delivery of goods

The company must initially regularise the VAT deducted on receipt of the invoice and pay back the proportion of the VAT to the Treasury, that corresponds to the portion of the abandoned debt.

(b) Debts corresponding to provisions of services

The company has not been able to carry out the deduction of VAT corresponding to the outstanding amount of the debt, so the debt forgiveness has no impact.

6.3 Debt for debt swap / debt for equity swap

(i) Taxation of profits

Debt for debt swap or debt for equity swap has no impact on the taxable result of the company because they do not change the net situation of the latter, including when, subsequent to the debt for equity swap, the effects produced are immediately cancelled by negative charges on the carry-forwards of the company,

(ii) Value Added Tax

Debt for debt swap has no impact on VAT except when the swap is to be achieved by establishing negotiable loans (obligations and derivatives). This process will equate to payment of the commercial debt and will not call into question the VAT recovered on debts representative of goods and will allow the company to proceed with recovery of VAT on debts corresponding to services.

Debt for equity swap will be audited as the payment of the debt with the conditions mentioned in the previous paragraph.

(iii) DES vs Quasi-DES

The tax treatment applicable to DES and Quasi-DES would be the same; however, a Quasi-DES could not be implemented under French insolvency regulation.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

(i) The option of benefiting from a tax deduction on "losses" resulting from the implementation of the plan: no provision of the tax law allows the creditor of a company subscribing to a plan, to make tax provisions solely because the debtor is subject to a plan, only the final losses recorded on the commercial debts held by a company subject to a plan are tax deductible.

(ii) The option of fiscally deducting the final debt loss held by the company as soon as possible to avoid plans anticipating the possibility of being paid in a shorter time limit on condition of granting partial discharge of the debt (see 6.2 above).

(iii) The loss of the right to deduct fiscally the loss on the debt in the case of debt for equity swap, with the debt for equity swap being executed for the nominal value of the debt and the provision for depreciation subsequently constituted on the equity received not being subject to any tax deductions.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No particular advantage is provided for in favour of the creditor, article 39(8) of the General Tax Code (CGI) confirms the tax deductibility of the write-off of commercial debts granted to companies subject to a plan.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

The main points have been covered in the answers to the previous questions.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

Tax treatment of companies in difficulty could be improved as per the following points:

(i) To facilitate the transfer of tax losses to the prospective purchaser for companies subject to plans.

(ii) To stagger the taxation of profits resulting from the discharge of debt over several years.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

We are not expecting any significant changes in French tax legislation specifically concerning companies subject to plans.

GERMANY

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

There are two insolvency related laws in Germany. One is the German Insolvency Code (Insolvenzordnung, InsO) and the other is the Law Concerning the Contest of a Debtor's Transactions (Anfechtungsgesetz; AnfG). However, there are no guidelines which facilitate the rehabilitation of distressed companies.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 The German Insolvency Code (InsO)

(a) Article 1 of the InsO outlines the purpose of the InsO. Broadly, insolvency proceedings serve the purpose to collectively settle the claims of all creditors towards the debtor by disposing-off the debtor's assets and distributing the revenues or by agreeing on a differing regulation in an insolvency plan especially regarding the continuation of the company.

(b) According to the InsO, cases of bankruptcy are generally illiquidity and over-indebtedness. Illiquidity is defined as a situation in which the debtor is not able to timely balance liabilities due for payment. Over-indebtedness generally exists if the debtor's assets do not cover the existing liabilities anymore (based on a balance sheet according to German insolvency law). For the periods up to and including 2013 over-indebtedness is temporarily not regarded as reason for insolvency any more as long as a positive going concern prognosis can be made for the debtor. In contrast to the other scenarios mentioned above the debtor, however not the creditors can file for insolvency if illiquidity is pending, i.e. if the debtor will presumably not be able to pay its existing liabilities when due.

(c) The insolvency plan is an instrument which can be used for the restructuring of a company. The parties of the insolvency proceeding, the debtor and the creditors, have the possibility to depart from the normal way of disposing off the assets of the debtor. They can agree on a plan to keep the debtor's company alive and to restructure it. Thereby the special rights of the liquidator continue to exist. That means that in case of an insolvency plan the liquidator still is entitled to disencumber the company from long term contracts and continuing obligations, like lease agreements, supply agreements and especially employment agreements by using its extraordinary termination rights. This is one of the major advantages compared to a restructuring of a company outside an insolvency proceeding. In an insolvency proceeding some of the most important limitations for a restructuring of a company according to the German employment law including the Works Council Constitution Act as well as the collective bargaining law are partially suspended.

Both the liquidator and the debtor are entitled to submit the insolvency plan. The creditors' meeting can also mandate the liquidator to devise an insolvency plan. The insolvency plan has to comply with the statutory provisions. For the acceptance of the insolvency plan an approval by the majority of the creditors and the debtor is necessary. If the insolvency plan is accepted and no violation of process regulations exists the insolvency plan will be confirmed by the bankruptcy court. After the confirmed insolvency plan becomes valid the material consequences and effects agreed upon in the insolvency plan become effective and the bankruptcy court cancels the insolvency proceedings.

The insolvency plan consists of three parts, a descriptive part, a part in which the parties of the insolvency plan agree on certain measures, and the exhibits of the plan. In the descriptive part of the plan the current situation and the causes for the company's crisis are described. The second part includes the measures for the restructuring of the company, like a partial write-off or a debt-waiver by a bank to deleverage the debtor.

(d) In addition to the insolvency plan, another possibility to restructure the debtor in the course of an insolvency proceeding is the so called "debtor in possession" ("Eigenverwaltung") which can be issued by the bankruptcy court under certain circumstances. In case of a "debtor in possession" the administrative powers and the power of representation are not delegated to the liquidator but rather remain with the debtor despite the opening of the insolvency proceeding. The managing directors of the company have the opportunity to restructure the company without being reliant on a liquidator, as the bankruptcy court appoints a solicitor instead of a liquidator. The solicitor only reviews the economic and financial situation of the debtor and supervises the managing directors.

2.2 Out of court guidelines for multi financial institutions

There are no out of court guidelines for multi financial institutions.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is.

A very popular method in various restructuring plans is debt forgiveness (debt waiver) in order to rehabilitate the debtor by decreasing excessive debt. The idea is that creditors increase the possibility of collecting their remaining claims by abandoning a portion of their claims towards the company.

A debt for equity swap (DES) is also a useful tool for debtors and often occurs in practice in connection with debt forgiveness (debt waiver) by a shareholder. Before carrying out a DES it needs to be proved (e.g. by an external auditor) that the contributed receivable in exchange for newly issued shares (equity) is of sufficient value.

Debt for debt swaps are a method used to increase the feasibility of rehabilitation of the debtor by financial creditors changing debts to subordinated debts. So far, the main purpose of debt subordination was to avoid over-indebtedness according to German insolvency law, as in case of an appropriate subordination agreement the debt qualifies as equity for insolvency law purposes, but still as debt for German commercial and tax purposes. Yet, in a reaction to the financial crisis several temporary exceptions have been introduced to German insolvency law. As mentioned above for the period up to and including 2013 over-indebtedness is no longer a reason for insolvency as long as a positive going concern prognosis can be made for the company. For this reason, debt subordination (i.e. debt to debt swaps) has become less popular recently in restructuring cases where insolvency could already be avoided by preparing a positive going concern prognosis.

Debt parking in terms of a creditor assigning the right to receive repayment to another person, where the new creditor is an associate of the debtor or the assignment occurs under an agreement or an arrangement to which the debtor and the new creditor are parties, is generally possible in Germany. Nevertheless, it needs to be ensured that debt parking will be regarded as mere change of lenders by the German tax authorities. If, however, the German tax authorities regarded the debt parking as waiver of debt, cancellation of debt issues would likely occur. Hence, careful planning in advance is strongly recommended.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

The methods mentioned in (3) are most commonly used in practice. Further alternatives, which may under certain circumstances lead to the same results as debt forgiveness or DES, are:

- Assumption of debt
- Debt buy back

Both alternatives are explained in more detail in (6).

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes. We consider the various German tax laws, mainly the German Corporate Income Tax Law (CIT), the German Trade Tax Law (TT) as well as the German Income Tax Act (ITA).

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

The major tax risk resulting from any debt restructuring method is that taxable income is triggered and may lead to unfavourable cash tax payments.

However, distressed companies often have current tax losses or tax loss carry forwards (NOL) available. Taxable income can generally be offset against tax losses of the current year or with existing NOLs. The latter, however, would generally be subject to the restrictions of the German minimum taxation rules. The rules state that NOL up to an amount of €1 million can be wholly offset with taxable income. The remaining NOL can only be offset against 60% of the remaining taxable income. As a result there are often situations where tax has to be paid even though more NOL is available than taxable income is occurred.

The following is a brief summary of tax implications potentially arising upon the restructuring methods. Before actually implementing one of them the exact tax consequences would have to be thoroughly reviewed on the basis of the circumstances in the individual case.

6.1 Debt forgiveness

(i) Risk of taxable cancellation of debt income

From a German tax perspective debt forgiveness / debt cancellation generally triggers taxable income to the extent it does not qualify as a shareholder contribution. Hence, debt forgiveness by a third party should generally trigger taxable income in the amount of the waived claim. Debt forgiveness by a shareholder is treated as a tax free shareholder contribution only to the extent the waived receivable is considered to be of value (e.g. claim in the nominal amount of 100 is considered to be 40% of value, i.e. the worthless portion would be 60%). As far as the face value of the underlying liability exceeds the fair market value (FMV) the difference will be treated as taxable income (e.g., face value of 100, FMV of 40, this generally leads to taxable cancellation of debt with taxable income of 60).

(ii) Application for tax free recapitalisation gain

In order to minimize the tax burden from the cancellation of debt income it could be considered to file an application with the German tax authorities to treat potential cancellation of debt income as a tax free recapitalisation gain (Sanierungsgewinn).

Several prerequisites have to be met. Thus, it must, inter alia, be proven that the German entity requires recapitalisation in order to survive, it is generally possible to financially reorganise the company by recapitalisation measures, the debt waivers serve the purpose of recapitalisation and the creditor waives the debt with the purpose of rescuing and recapitalising the company. As the legal basis for the application are general tax rules for lowering taxes in highly unacceptable personal circumstances of the taxpayer, the decision to grant the application is in the whole discretion of the tax authorities.

Hence, it is recommendable to check in advance of an envisaged debt forgiveness / debt cancellation if the tax authorities would be willing to assume a tax free recapitalisation gain in the case at hand (request for a binding ruling with the German tax authorities). A positive ruling provided (for corporate income tax purposes), the existing debt could then subsequently be waived. However, for trade tax purposes (local tax) the German tax authorities' decision with respect to corporate income tax (federal tax) is not obliging. The respective local municipality authorities generally have the right to decide on their own whether to follow the German tax authorities' decision. Hence, the issue should also be discussed in advance with the responsible local municipality authorities.

(iii) Combination of debt forgiveness / debt cancellation with a debtor warrant

A debt forgiveness / debt cancellation could generally be combined with a debtor warrant (Forderungsverzicht mit Besserungsschein). As for the waiver the risk of taxable cancellation of debt income generally exists (for further details please see (i) above). Yet, an application for a tax free recapitalisation gain could also be filed (for further details please see (ii) above) in this case.

Due to the debtor warrant agreement the amount of debt originally waived would resurface if the agreed conditions occur, normally if the financial and economic situation of the debtor improves and the debtor is again able to repay the debt and interest thereon. Broadly, the resurfacing of the waived debt should lead to tax deductible expenses to the extent the original waiver triggered taxable income (before any potential requalification into a shareholder contribution).

6.2 Debt for equity swap (DES)

There are mainly two types of DES: (1) the creditor carries out a contribution in-kind by exchanging its claims (receivables) for equity (contribution in-kind DES); and (2) the creditor makes a capital contribution to the debtor in cash in order to settle the payable with the cash received (quasi-DES).

(i) Contribution in-kind DES

Under a contribution in-kind DES, creditors contribute their receivables to the capital of the debtor and receive debtor's shares in return. In case the FMV is below the face value of the receivable taxable cancellation of debt income is triggered (for further details please see comments in section 6.1). Additionally, the following issues would have to be considered:

(a) Risk of loss of NOLs (change of control rules)

Recapitalisation measures may constitute a change in ownership according to the German change of control rules concerning the future use of NOLs (current and carry forward). Broadly, any kind of direct or indirect change in ownership of more than 50% to one investor (or a group of related parties) within a five-year period leads to a loss of the entire NOL amount (between 25% and 50% on a pro-rata basis). The definition of a harmful share transfer in the law is broad (or any comparable act). Therefore, investors should consider the potential negative implications of these rules in all cases where they provide equity (of any type) to a German company which has NOLs itself or whose direct or indirect German subsidiaries have NOLs.

To this general rule the following exemptions exist according to recent changes to German tax law:

Recovery exemption

Share transfers in a corporate recovery operation are exempted from the general forfeiture rule. The recovery exemption is generally applicable for share transfers from 2008 onwards. The recovery operation must be aimed at preventing or remedying insolvency whilst preserving the basic structure of the business. The condition is met, if:

- The corporation concludes and follows a employer / works council agreement to protect current jobs; or

- The total employee remuneration paid in the five years after the share transfer equals at least 400% of the annual average for the five years prior to the change of shareholder (no inflation adjustment); or

- The corporation receives new capital from its shareholders by a contribution within a 12-month period after the change. These new assets should have a value of at least 25% of the gross assets as shown in the company's immediately preceding tax balance sheet. Waiver of existing debt by the new shareholder ranks as an injection of new capital, though only to the extent the debt had value. Any capital repayments or dividends from 2009 to 2011 reduce the contribution required to meet the 25% minimum.

Please note that only one of the conditions mentioned above needs to be fulfilled (not all 3 conditions cumulatively). Yet, please be aware that the exemption is also conditional on the company's operating an active business at the time of the change and on its remaining active in the same industry during the following five years.

Hidden reserve escape

Loss carry forwards are not to be curtailed on a change of shareholder (group internal or external) to the extent they are covered by hidden reserves / built-in gains in the company's net assets. The basic measure is the difference between the equity in the tax balance sheet of the company represented by the share transfer and the consideration paid. If there is no specific consideration for the transfer, or it was not at arm's length, a business valuation will be necessary. Qualifying hidden reserves are those ultimately taxable in Germany; thus assets held in a foreign permanent establishment will not qualify, and the same applies to investments in shares generally, given the exemption of the capital gain on a subsequent sale. This exemption is generally applicable for share transfers occurring from 1 January 2010 onwards.

Intra-group exemption

Share transfers within internal group reorganisations are exempted from the general forfeiture rule if the group / sub-group is being held by one single shareholder (holding company or natural person). This exemption is generally applicable for share transfers occurring from 1 January 2010 onwards. Applicability of this exemption needs to be checked thoroughly on a case by case basis.

(b) Real estate transfer tax (RETT)

In case of at least 95% change in ownership (direct or indirect) in a company owning German real estate, RETT would be triggered in the amount of 3.5% (in Berlin and Hamburg 4.5%) of a special tax value for RETT purposes. If the recapitalisation measures finally lead to a direct or indirect transfer of at least 95% in the shares of a company owning German real estate property, RETT would be triggered.

The following exemption has recently been introduced: Changes in ownership following a merger, spin-off or other form of corporate reorganisation governed by the German Reconstructions Act are to be exempt from RETT. This exemption does not apply to property acquired within five years prior to the transfer or sold within the following five years, or to the extent the shareholder in the land-owning entity reduces his holding during the same following five year period.

(ii) Quasi-DES

In case of a quasi-DES a equity contribution (cash injection) is made in order to enable the company to repay some of its existing debt. Please note that cash would have to be actually circulated in this scenario and the timing of steps is crucial in order to mitigate the risk that the German tax authorities disallow the structure and assume taxable cancellation of debt income. However, if structured appropriately a quasi-DES could help to reduce the company's leveraging without triggering taxable cancellation of debt income.

6.3 Assumption of debt

An assumption of debt may be a structuring alternative, depending on the individual circumstances, to avoid triggering taxable cancellation of debt income. It basically works as follows:

The assumption of debt is carried out by a group company further up the chain. Debt is subsequently converted into equity. According to a German Supreme Tax Court decision, taxable cancellation of debt income may be a voidable if structured correctly (careful and precise planning required).

It is inevitable to review in advance whether the numerous requirements to avoid taxable cancellation of debt income could actually be met in the case at hand. However, if structured appropriately an assumption of debt may be a useful instrument to deleverage the company without triggering taxable cancellation of debt income.

6.4 Debt buy back

In a debt buy back scenario the borrowing entity acquires its own liabilities, e.g. bank debt. The purchase price for these notes is often less than the face value of the underlying liabilities. As the acquired receivable and the corresponding debt will cease to exist shortly after the acquisition (otherwise the company would have a receivable and a payable towards itself), this transaction may help to decrease the leverage of the borrowing entity. Nevertheless, the transaction triggers a taxable gain in the amount of the difference between the purchase price for the receivable and the face value of the debt (e.g. purchase price for the receivable of 30, face value of the corresponding liability of 50 would lead to taxable income of 20).

For this reason, debt buy backs are often not carried out by the debtor itself, but rather by some other group company preferably located in a low tax country. Debt buy backs could alternatively be structured as so called “debt parking”, where the creditor assigns its right to receive repayment to an associate of the debtor. Careful structuring is necessary to avoid taxable cancellation of debt income in Germany (please see section 6.1). After a successful reorganisation of the company and a full repayment of the loan this group company, which acquired the loan receivable, would realise a taxable capital gain. If this acquisition company is directly or indirectly being owned by German shareholders this capital gain may be taxable in Germany due to the German anti-avoidance rules. Nevertheless, structuring may be available to mitigate this issue depending on the individual circumstances. Careful planning on a case by case basis in advance is indispensable.

6.5 Debt for debt swap

A debt for debt swap normally has no tax effects at the debtor. However, the new debt may have terms which could trigger income tax consequences. The following two special tax rules should be considered.

According to the German tax rules liabilities with duration of more than 12 months and without bearing interest have to be discounted with a rate of 5.5% p.a. for tax purposes. The effect is that the difference between the face value and the discounted value triggers taxable income at the debtor. This income will be reversed in the future when the discounted value increases every year. In case there is no defined duration of the debt the discount and consequently the taxable income is some 50% of the face value of the debt. Therefore, if the plan is to swap interest bearing debt into interest free debt the tax consequences should be carefully reviewed to avoid non beneficial tax consequences.

The second rule to be considered states that where debt has only to be repaid in case of future profits or income the debt is not considered for tax purposes as long as there is no repayment of the debt. When repaying the debt, expenses that can be deducted for tax purposes are recognised in the amount of the repayment. Therefore, careful tax planning is necessary in case the swapped new debt instrument provides for repayment of the debt depending on future profits or income.

QUESTION 7

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7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

One of the main issues from a creditor's perspective is to secure the tax deductibility of a (partly) debt forgiveness. Generally, debt forgiveness leads to a tax deductible expense for the creditor except to the extent the claim had not yet been written down before. If the creditor is a shareholder or a related party in terms of the German anti-avoidance rules the write down or write off of the claim is not tax deductible.

On the other hand, the creditor needs to avoid triggering taxable income at the level of the debtor (see 6.1 for further details).

QUESTION 8

8. **If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.**

We are not aware of any additional tax advantages for the creditors than the ones described in question (7).

QUESTION 9

9. **Please tell us other pitfalls and/or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.**

For the major considerations please see the answers regarding questions (6) and (7).

In some cases it can be beneficial to optimize tax deduction of interest at the debtor. In Germany, interest deduction is limited under the interest capping rules. The general rule provides that net interest expense (all interest expense less interest income) up to €3 million is fully tax deductible. However, if the net interest expense exceeds the €3 million threshold than the total net interest is only tax deductible by 30% of the tax EBITDA. The non tax deducted interest can be carried forward unlimitedly except a direct or indirect change in ownership of the debtor occurs.

The general rule has some exemptions and there might also be tax planning opportunities to optimize the tax deduction of the interest.

For both debtor and creditor the careful review of the interest capping rules and tax planning opportunities may provide significant benefit for cash flow planning purposes.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

The EU has begun an investigation into whether the new recovery exemption (whereby losses brought forward on acquisition could be preserved in certain distressed situations; for further details please see section 6.2) constitutes illegal state aid. Accordi

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

Please see answer to question (10).

HONG KONG

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

The law facilitating the rehabilitation of distressed companies in Hong Kong is very limited. It is a kind of scheme of arrangement under Companies Ordinance (Chapter 32 of the Laws of Hong Kong) to be entered into between the company and its creditors with the sanction of the Court. There is however no statutory moratorium available to distressed companies during the process of negotiation and the distressed companies are vulnerable to legal proceedings and assets enforcement, which make the rehabilitation process difficult. Other than that, the Hong Kong Monetary Authority (HKMA) issued guidelines jointly with Hong Kong Association of Banks in 1999 on standstill and work-outs for bankers in Hong Kong, which were primarily based on the London Approach. The HKMA guidelines, though not legally binding, recommended that bankers should try to take a supportive role when borrowers experience financial problems. The HKMA guidelines are quite helpful to distressed companies if the majority of their creditors are bankers.

Besides, a consultation on change of corporate rescue laws is now underway. The introduction of the process of Provisional Supervision (similar to the Administration in UK) may be probable subject to the consensus in the community and the necessary enactment procedures.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 Scheme of Arrangement

The whole process is governed pursuant to Section 166 of the Companies Ordinance, which is a very similar version of the Companies Act 1948 in UK. The distressed company needs to make an application to the Court and present the Court with the proposed scheme with creditors (and shareholders as well as the case may be). The submitted scheme must be supported by an explanatory statement setting out the relevant background and the justifiable rationale. With the initial approval by the Court, statutory court meeting(s) for creditors (and the shareholders) will be convened for their consideration of the proposed scheme.

The threshold in having the scheme approved in the respective creditors or shareholders meetings is two-folded: (i) It must be approved by more than three-quarters in values; and (ii) It must be approved by more than one half of the attendees present or represented by proxy in the meetings. In practice, it is however quite common that the lobbying work has long been commenced and completed before the submission of the proposed scheme to the Court so as to ascertain the wish and expectation of the creditors (and the shareholders). The statutory meetings are more or less a statutory process in approving the proposed scheme officially.

After the statutory court meetings, a report will be filed with the Court to advise the respective results. If the Court is satisfied with the conduct of the meetings, a sanction will be given and the scheme will form a binding arrangement between the company and its creditors (and shareholders).

2.2 Work-outs with lending banks

Pursuant to the spirit of the HKMA guidelines, the primary objective of the work-outs is to keep the distressed companies afloat during the assessment and review processes taken by the lending banks.

The distressed companies will be requested for operating and financial information for consideration by the lending banks, which aim at concluding workable solutions with the borrowers. The lending banks will be represented by a lead bank, which coordinates all the communications within the lending banks as well as with the distressed companies. Financial advisers or investigating accountants can be engaged to assist the retrieval and presentation of financial information. All the lending banks would primarily agree to an interim standstill period in order to give the distress companies some breathing space.

The distressed companies should then make proposals to the lending banks for consideration with or without the involvement of financial advisers or investigating accountants. The decision of the lending banks needs unanimity. They may accept, reject or counter-propose the distressed companies' proposal. For sizable work-outs involving large number of banks, a steering committee may be formed to deal with the matter.

In general, the work-outs arrangement will enhance the survival chance of distressed companies by offering them proper steps and procedures in negotiating with lending banks.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, all the methods are common in their repayment plans.

Debt forgiveness is quite common and it effectively reduces the excessive burden of the borrowers. Debt for equity swap is also welcomed by most creditors as they are given a chance to enjoy the future prospect of the restructured companies.

Debt for debt swap may also be used to provide further flexibility in the process of rehabilitation. Some creditors may have their debts rescheduled and rearranged so as to improve the recovery ratio and collaterals position. It also follows that some shareholders loans may need to be subordinated so as to obtain support from other ordinary creditors.

Debt parking is also possible, but its occurrence is dependent on the needs and skeleton of the restructuring exercise. Its tax implication would also depend on the parameters surrounding the arrangement and is primarily unique in every case.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

Creditors would normally prefer to follow the mechanism of scheme of arrangement or formal restructuring / rescheduling arrangement in relieving the debtor’s debt burden.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is ‘yes,’ please list the names of the tax law which you consider. If the answer is ‘no,’ please let us know why you do not have to consider tax issues.

Yes. The tax issues are governed by the Inland Revenue Ordinance (IRO) in Hong Kong.

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

As mentioned in (3) above, debt forgiveness, debt for equity swap and debt for debt swap are common ways of rehabilitating the debtor. The following is a general discussion of the profits tax consequences in Hong Kong from the perspective of the debtor in respect of each method.

6.1 Debt forgiveness

When a debtor obtains debt forgiveness from a creditor, a gain from waiver will generally be recognised in the profit or loss of the debtor.

The gains from waiver will be subject to profits tax under section 15(2) of the IRO if a tax deduction has been obtained by the debtor when the debt was incurred. In particular, section 15(2) of the IRO provides that in ascertaining the profits of a trade, profession, or business carried on in Hong Kong, where a deduction has been allowed for any debt incurred for the purposes of the trade, profession or business, then, if the whole or any part of that debt is thereafter released, the amount released shall be deemed to be a receipt of the trade, profession or business arising in or derived from Hong Kong at the time when the release was effected.

In addition, the waiver may be taxable under section 15(1)(c) of the IRO if it is considered to be a grant, subsidy or similar financial assistance in connection with the carrying on of a trade, profession or business in Hong Kong, other than sums in connection with capital expenditure.

The general charging provision, section 14, of the IRO provides that profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of the assessable profits arising in or derived from Hong Kong. The profits arising from the sale of capital assets are specifically excluded from the charge to profits tax. This exclusion is in practice extended to cover receipts of a capital nature not specifically provided for in the IRO. In respect of waiver of loan principal, one would generally take the view that any gains arising from the waiver to be capital in nature and should not be taxable under section 14 of the IRO. However, the gains will still be taxable if they fall within the scope of section 15(2) or section 15(1)(c) of the IRO discussed above.

6.2 Debt for equity swap and debt for debt swap

A debt for equity swap generally involves the debtor issuing its own shares to the creditor in exchange for the extinguishment of the debts. A debt for debt swap generally refers to the arrangement between the debtor and the creditor where the existing debt is refinanced by a new debt.

There is no specific provision in the IRO prescribing for the tax treatment under a debt for equity swap or a debt for debt swap transaction. The accounting treatment of a transaction will generally have an important bearing on the corresponding tax treatment of that transaction although the tax treatment does not necessarily follow the accounting treatment. As such, the tax consequences of the debt restructuring should be carefully examined by considering all the terms and conditions of the debt restructuring and the corresponding accounting treatment.

As a general comment, a debt for equity swap or a debt for debt swap should unlikely have any material tax impacts on the debtor if no gain or loss is recognised by the debtor. However, any gains from debt waiver recognised by the debtor as a result of the swap would generally be subject to profits tax if the gains fall within the scope of section 14, 15(2) or 15(1)(c) of the IRO discussed above.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues ?

The main tax issue from the perspective of the creditor is to consider whether any loss recognised in the profit or loss as a result of the debt restructuring discussed in (3) above would be tax deductible.

Section 16(1)(d) of the IRO provides for tax deduction in respect of bad debts incurred in any trade, business or profession subject to the satisfaction of certain conditions. To qualify for a tax deduction under section 16(1)(d), the first requirement is to prove to the satisfaction of the assessor that such debts have become bad during the basis period for the tax assessment year.

In addition, deductions under section 16(1)(d) are limited to:

(1) debts which have been included as a trading receipt in ascertaining the chargeable profits of the person claiming the deduction; or

(2) debts in respect of money lent, in the ordinary course of the business of the lending of money within Hong Kong, by a person who carries on that business.

It should be noted that expenditure of a capital nature or any loss or withdrawal of capital are specifically disallowed under section 17(1)(c) of the IRO. Therefore, any loss arising from waiver of loan principal would generally be considered as capital in nature and no tax deduction would be allowed unless the conditions under section 16(1)(d) of the IRO are satisfied.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

9. Please tell us other pitfalls and/or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers to questions (6) and (7).

Under a debt to equity swap, there will generally be a change in the shareholding of the debtor company as new shares are being issued to the creditor. If the debtor is a company which has tax loss, both the debtor and creditor should be aware of an anti-avoidance provision of the IRO as explained below.

In Hong Kong, tax loss is generally available to carry forward to set off against the future assessment profits of the company. While there is no time limit on the utilisation of the tax loss, there is an anti-avoidance provision in the IRO (section 61B) which empowers the Commissioner of Inland Revenue (CIR) to disallow the set off of tax loss if (i) the CIR is satisfied that any change in the shareholding in a company, as a direct or indirect result of which profits have been received or accrued to that company during any year of assessment; and (ii) the sole or dominant purpose of change of shareholding in a loss making company is to make use of its losses to obtain a tax benefit.

Section 61B would not be invoked if the CIR is satisfied that there are genuine commercial reasons for the change in shareholding and the “sole or dominant” purpose is not for the use of the tax losses to avoid or postpone or reduce tax liabilities.

For the sake of completeness, if the debtor needs to increase the authorised share capital for the purposes of issuing new shares to the creditor, this would attract a capital duty levied at 0.1% on the increase in authorised share capital, but capped at HK$ 30,000 per transaction.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

INDIA

QUESTION 1

1. Please list your country's insolvency related laws and guidelines that facilitate the rehabilitation of distressed companies.

In India, distressed companies are mainly governed by certain insolvency and restructuring regimes like winding up or liquidation of a company, scheme of arrangement between companies and its creditors and members (as provided in the Companies Act,1956), rehabilitation of distressed companies (covered under the Sick Industrial Companies Act,1985), restructuring of the corporate debts of viable corporate entities (Corporate Debt Restructuring guidelines), management takeover by secured creditors (in view of recent SARFAESI Act).

A brief outline of the respective regimes is provided below.

- The Companies Act, 1956

  Restructuring under these provisions can be under taken through either a merger & acquisition strategy, by following the procedure laid down under section 391-394 of the Companies Act, 1956. Also, a voluntary compromise arrangement between the company and the creditors can be entered under the provisions of the Companies Act, 1956 if a change in the capital structure (changing debt for equity or reducing equity) is warranted as part of the compromise. These methods, whether in whole or in part, can be categorized as corporate rescue mechanism primarily designed for restructuring of a company. The above schemes are carried out under the aegis of the High Courts having jurisdiction over the company in India.

- The Sick Industrial Companies (Special Provisions) Act 1985 (SICA)

  The Act involves restructuring of 'sick' or 'potentially' sick companies in certain specified industries. The Board for Industrial and Financial Reconstruction (BIFR) has been set up for the restructuring / rescue of sick companies under this Act. A sick industrial company has been defined under SICA, as an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

- The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI)

  The Act provides for the establishment of asset reconstruction companies (ARC), to undertake the management / realisation of non-performing loans acquired from secured creditors by taking over, changing the management, etc.

- Corporate debt restructuring (CDR) guidelines

  These have been issued by the Reserve Bank of India. The objective of the CDR framework is to ensure a mechanism for restructuring of corporate debts of viable corporate entities, outside the purview of BIFR, Debt Recovery Tribunal (DRT) and other legal proceedings. CDR applies only to multiple banking accounts, syndicates and consortium accounts.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 Arrangement between company and creditors governed by the Companies Act, 1956

The arrangement is governed by section 391-394 of the Companies Act, 1956, which provides for obtaining court approval for a scheme.

- The compromise arrangement can be proposed by any party (company, creditors, members, government, official liquidator) but has to be approved by creditors and members (majority in numbers and three-fourth in value) and confirmed by the Court, which has the power to supervise the implementation of such a compromise.

- On an application being moved before the Court, a meeting of the concerned creditors or / and members, whose rights would be affected by such compromise arrangement is called upon. The scheme of compromise or arrangement needs to be approved by majority in number representing 3/4 in value of the concerned creditors and / or members.

- The High Court is required to be satisfied that the applicant has disclosed all material facts relating to the company, such as the latest financial position of the company, the latest auditor's report on the accounts of the company, the pendency of any investigation proceedings in relation to the company.

- The company may also apply to the High Court for protection against actions by its creditors pending the approval of the scheme. The High Court may stay the commencement or continuation of any suit or proceeding against the company on such terms as the High Court thinks fit, until the application is finally disposed of.

- The Registrar is required to submit to the High Court a report that the affairs of the company have or have not been conducted in a manner prejudicial to the interests of its members or to the public.

- The High Court also gives notice of the application to the Central Government, and considers the representations, if any, made to it by that Government before passing any order.

- On being satisfied about the procedural aspects of the scheme and other related issues, the scheme is approved by the Court by an order and it becomes binding on all the creditors, members and the company.

- Thereafter, a certified copy of the order has to be filed with the Registrar within 30 days to make the order of the High Court effective.

If the High Court is satisfied that the compromise or arrangement sanctioned cannot be worked satisfactorily, with or without modifications, it may, either on its own motion or on an application by any person interested in the affairs of the company, make an order for winding up of the company.

Where such arrangement is proposed for reconstruction of the company (by way of merger, etc), all the properties and liabilities move to the new company and the shareholders acquire shares in the transferee company in lieu of their rights in the company proposed to be merged.

2.2 SICA for revival of sick industrial companies

The Indian government promulgated the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). The Board for Industrial and Financial Reconstruction (BIFR) was established as a quasi-judicial body under SICA to secure timely detection of "sick" industrial companies and to provide appropriate intervention. The process is applicable only to industrial companies that have been registered for not less than five years and have accumulated losses at the end of any year equal to or greater than their net worth.

- The board of directors of the company is required to file an application with the BIFR within 60 days from the date of finalisation of the audited accounts of the year in which the company has fallen sick.

- BIFR may conduct an inquiry into the sickness status of the company before admitting any reference, or upon receipt of information with respect to such company or upon its own knowledge as to the financial condition of the company. It may also appoint one or more persons to be special director(s) of the company, under its supervision, for safeguarding the financial and other interests of the company or in the public interest. The Board may also appoint an operating agency, usually the largest secured lender (a bank or financial institution), to enquire and submit a report with respect to matters specified in the order.

- The Board or the operating agency shall complete its inquiry within 60 days from commencement of the inquiry. If after making an inquiry, the BIFR is satisfied that a company has become a sick industrial company, it has two alternatives:

  Option 1- If the BIFR decides that it is practicable for a sick industrial company to make its net worth positive within a reasonable time, the Board can give time to the company to make its net worth exceed the accumulated losses.

Option 2 - If the BIFR decides that it is not practicable for the company to convert it to positive net worth (net worth to exceed accumulated losses) within a reasonable time and that it is expedient in the public interest, it can direct the operating agency to prepare a scheme providing for appropriate measures (viz. financial reconstruction, proper management, amalgamation, sale or other preventive measures, etc) in relation to such company. The operating agency shall prepare a scheme within a period of 90 days from the date of the order.

- The scheme prepared by the operating agency is examined by the BIFR. A copy of the scheme is also sent to the sick company. The BIFR also publishes the draft scheme in brief in daily newspapers, for suggestions and objections, if any.

- The scheme will thereafter be sanctioned by the BIFR and shall come into force on the date specified. A BIFR sanctioned scheme is binding on the members and creditors of the company. BIFR may also monitor periodically the implementation of the sanctioned scheme.

The government has recently inserted Part VI A in Chapter VIII under the Companies Act, 1956 where powers for revival and rehabilitation of sick Industrial companies have been delegated to the tribunal. Accordingly, for repealing SICA, Sick Industrial Companies (Special Provisions) Repeal Act, 2003, has been passed by the Parliament.

However, both the above provisions cannot be effective unless these are notified by the Government. Till the time the notification is pending, SICA continues to be the applicable law in relation to industrial sickness.

2.3 Securitisation and Reconstruction of Financial Assets Act

The Parliament enacted the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDBFI Act), followed by the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), to establish a separate mechanism for debt recovery to enable financial institutions to recover their non-performing assets (NPAs) and enforce security without intervention of the courts.

Under the provisions of the SARFAESI Act, a secured creditor has the right to enforce security interests if the loan is classified as an NPA, in accordance with guidelines issued by the Reserve Bank of India (RBI). In case of financing by multiple secured lender, the rights under SARFAESI can be exercised only after it is agreed upon by secured creditors representing not less than 3/4th in value of the amount outstanding, and such action is binding on all secured creditors.

A precondition to initiating action under SARFAESI is that an NPA must be backed by securities charged to financial institutions by way of hypothecation, mortgage or assignment— whether by the borrower or a third party.

Under the provisions of the SARFAESI Act, if a borrower fails to discharge its dues in full within a notice period of 60 days, then the financial institution may take recourse by taking possession of the security, and selling, leasing or assigning the right over the security and / or managing the same or appointing any person to manage the same.

2.4 Corporate debt restructuring (CDR) – RBI guidelines

The CDR mechanism was instituted according to guidelines issued by the RBI in August, 2001, for revival of viable corporates, which sometimes get into financial difficulty because of factors beyond their control and also due to certain internal reasons, as well as to minimise losses to banks and financial institutions and other stakeholders through an orderly and co-ordinated restructuring programme. Proposals under CDR entail extending the repayment period of loans, converting the un-serviced portion of interest into term loans and reducing the rate of interest on outstanding advances.

The CDR system has a three-tier structure: i) the CDR standing forum and its core group; ii) the CDR empowered group; and iii) the CDR cell. The CDR standing forum lays down policies and guidelines and monitors the restructuring. The empowered group decides the acceptable viability benchmark levels, and the CDR cell assists in all the functions.

The scheme covers only multiple banking accounts, syndication and consortium accounts of corporate borrowers with outstanding fund-based and non-fund based exposure of Rs 20 crores and above by the banks and financial institutions. There are two categories of debt restructuring under the system i.e. where accounts are classified as ‘standard’ and ‘substandard’ in the books of lenders and case where accounts are classified as ‘doubtful’ in the books of lenders. RBI has laid down different approaches for both the categories.

The broad steps to be followed are:

- All references for corporate debt restructuring by lenders or borrowers are made to the CDR Cell. It is the responsibility of lead institution / major stakeholder to the corporate, to work out a preliminary restructuring plan in consultation with other stakeholders and submit to the CDR Cell within one month.

- The CDR Cell prepares the restructuring plan in terms of the general policies and guidelines approved by the CDR Standing Forum and place for consideration of the Empowered Group within 30 days for decision.

- The Empowered Group can approve or suggest modifications but ensure that a final decision is taken within a total period of 90 days. However, for sufficient reasons the period can be extended up to a maximum of 180 days from the date of reference to the CDR Cell.

- The decisions of the CDR Empowered Group are final. If restructuring of debt is found to be viable and feasible and approved by the Empowered Group, the company would be put on the restructuring mode. If restructuring is not found viable, the creditors would then be free to take necessary steps for immediate recovery of dues and / or liquidation or winding up of the company, collectively or individually.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

There are certain insolvency and restructuring regimes (as discussed above) where all the interested parties viz. debtors, creditors and shareholders agree to compromise. In India, whether under the scheme of arrangement with creditors or in cases before the BIFR or under a CDR, creditors generally resort to forgiving part of their debt (which can be both principal or / and interest) or varying the terms thereof (viz. rate of interest, payment schedule, charge on assets as security, debt for equity swap (DES), etc).

The Indian laws and regulations do not have specific provisions in terms of debt parking. However in general practice, a creditor may assign his rights to receive repayment to another for mutually agreed consideration.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

No

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes, tax is an important imperative in any transaction and the implications under the Indian Income Tax Act, 1961 (IT Act) are considered.

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

As mentioned in (3) above, debt forgiveness and DES are common ways of rehabilitating a debtor in India. However, there are some tax issues that need to be examined for both the company as well as its creditors, before undertaking a restructuring plan.

The tax implications for the same are discussed below.

Debt forgiveness

- Remission of trading liability

  Where a creditor remits its liability which is in the nature of a trading liability for a company, gains realized by the company from such a remission is included in its taxable income as per the provisions of Indian tax laws.

- Waiver of financial loans

  The gains realised on a waiver of a loan (capital) need not be added to the income of a company, provided the same can be demonstrated to be capital receipt. Taxation for such a receipt has not been specifically provided for under the domestic tax law regime in India and can be the subject matter of litigation with tax authorities.

Debt for equity swap

DES does not have any tax implications for the company as the same only alters the capital structure with re-classification of debt as share capital. Consequentially, the ‘income flows’ from debt or equity would change i.e. interest payouts would be replaced by dividend and understandably the withholding (or tax) implications thereon. While there would be a tax withholding on interest payouts, dividend payments would require payment of a Dividend Distribution Tax at the rate of 16.995% by the company on the dividend distributed by the company. The value of shares issued by the borrower company to the lender would depend upon the negotiation between the two. Usually, in case the parties are unrelated, the fair value of such shares should be equal to the fair value of NPL debt (USD 40). However, the face value of shares may be higher or lower due to difference between net asset value as per books and fair value of the shares.

Quasi DES also only alters the capital structure of the company by issuing fresh capital to the creditor in the first transaction, and then repayment of debt liability by using the proceeds of the issue of capital in the second transaction.

Therefore quasi DES would also not have any tax implications for the company. However only the future income flow would change from interest payouts to dividend payouts and its tax implications, as mentioned above.

In case of debt for debt swap, creditors may agree to modify the terms of existing debt e.g. forgiving a part of debt (principal or / and interest) or varying rate of interest, payment schedule, charge on assets as security etc. In case part of the debt, in the nature of trading liability, is foregone, the amount of debt foregone may be treated as income in the hands of the debtor company, as discussed above.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

As a creditor's attorney, the tax issues which may be worth considering are tax deductibility of amounts foregone by the creditor.

The tax implications from the creditor's perspective for the methods discussed in (3) above have been set out below.

Debt forgiveness

- Remission of trading liability

  When a creditor foregoes a debt claim which is classified as a trading liability for a company, the loss arising to him may be tax deductible as bad debts under the provisions of the Indian tax laws. The important consideration for this tax deductibility is that such debt should already have been added to the taxable income of earlier years and the amount should be written off as irrecoverable by the creditor.

- Waiver of financial loans (including interest)

  Unless the creditor is in the business of money lending like a bank or financial institution, the principal portion of debt forgiven may not be allowed as a business deduction from the taxable income of such creditor.

  However, the amount of interest foregone is allowable as a deduction, provided the same has been offered as tax in earlier years.

Debt for equity swap

In case of DES, the creditor would be offered equity in exchange of debt. Though, there are no specific provisions in the IT Act, the swap may give rise to tax implications on the basis of value of equity shares. In case of trading liability or where the creditor is in the money lending business, difference between value of equity and debt may be taxed as business income in the hands of the creditor. In other cases, the difference may be taxed as income from other sources considering it as property received (equity) for inadequate consideration (debt) in terms of the proposed law[1].

DES is a more tax efficient option as against debt forgiveness (in case of financial loans), as in the former, there could be an opportunity to claim the amount of debt as cost of acquisition of shares and could thus be available as deduction from the income to be earned in future from sale of such shares, while in the latter, the cost would be a total loss for the creditor.

Assignment of right to receive repayment

In case the creditor transfers his right to receive repayment of the amount due from a debtor to a third party for a discounted consideration, the loss would be allowed as a deduction on account of bad debt, provided the liability qualifies as a trading liability. However, in the case of a financial loan, the loss would be allowed where a creditor is in the money lending business like banks, as discussed above.

QUESTION 8

8. **If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.**

The tax implications for the creditors in case of methods mentioned in questions (3) and (4) have been explained in answer to question 8.
In all these methods, the creditors do not have any specific tax advantages.

QUESTION 9

9. **Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.**

In continuation of answers to questions (5) and (6) above, there is also an issue for allowability of brought forward losses of the company or the debtor.

1 Effective from June 1, 2010 as per proposed amendment by Budget 2010

Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss can be carried forward indefinitely. Any change in beneficial interest in the shares of the company exceeding 51 per cent disqualifies the closely held company from the carry forward benefit. Thus, the DES plan needs to consider the above provisions so as to ensure that the resulting issue of equity does not disentitle the company from carrying forward its losses.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

The restriction on carry forward of tax losses for closely held companies where there is a change in specified percentage of shareholding should ideally exclude cases where the same is pursuant to execution of plans of corporate restructuring to take the company out of financial distress.

In the proposed new Direct Tax Code (DTC), this clause has not been included.

Further, even where the creditor is not in the money lending business, the waiver of the principal portion of debt can also be allowed as a deduction from taxable income. Loss of capital which otherwise could have also been lost in the normal business operations (where then the same would have been allowed as deduction from taxable income).

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

Please refer to the answer stated in question 10.

ITALY

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

The Law primarily regulating the bankruptcy and insolvency proceedings (Royal Decree March 16th 1942, n. 267, hereinafter Insolvency Law) has been recently reformed, amended and updated by the Decree n. 5 issued on January 9th 2006 and by the Decree n. 169, issued on September 12th 2007.

The main goal of this reform was to change the previous "liquidation" approach - where no options were available for managing a "distressed business restructuring" because the interest protected was to safeguard the position of the creditors in a formal and bureaucratic manner into a new "survival" or "restructuring" approach. The new approach would provide for the early start of the proceedings that will keep the value of assets not withstanding the distressed situation and that was considered the better way to satisfy the substantial interests of all the creditors and also the debtor companies.

In addition to this Royal Decree, other specific provisions regulate some aspects of the insolvency and restructuring proceedings of which the main are:

- Some articles of the Italian Civil Code that mainly regulate the voluntary liquidation of companies;

- Some articles of the Banking Law (Decree n. 385 issued on September 1st 1993), regulating the insolvency and reorganization of banking and financial institutions (not specifically discussed in this document); and

- The law regulating the extraordinary management and reorganization of large enterprises (i.e. businesses employing more than 200 employees (Decree Law n. 270 issued on July 8th 1999) or more than 500 employees (Decree Law n. 347 issued on December 23rd, 2003)).

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 The proceedings supervised by a court (or under a Public Authority control)

There are four important procedures that deal with insolvency.

a) Bankruptcy (*Fallimento)* – This is the general regime ruling the ways that entities are declared insolvent. Insolvency means inability to pay debts, even if the cause of such inability may be due to various reasons. The local judicial authority have to follow the bankruptcy procedure in order to segregate creditors into classes having different privileges as to their priority for being paid. Each category allows payment in equal portions based on available substance of the insolvent entity.

b) Creditors agreement (*Concordato preventivo*) – Even before the official declaration of an "insolvency" status, the distressed company may file a petition with the Court together with a plan where creditors might be divided in classes. For each class of creditors different percentage of satisfaction might be foreseen and each class of creditors must approve the plan.

   The actual feasibility of the plan prepared by the entrepreneur must be supported by an expert and supervised by a commissionaire appointed by the Court.

c) Restructuring agreements (*Accordi di ristrutturazione*) (art.182 bis of Insolvency Law) – This proceeding requires that credits representing at least 60% of the total amount agree on a settlement filed with the Court that provides the entire satisfaction This means that creditors that do not agree with the settlement have to be paid fully, while the creditors that agree with the settlement may be paid according to the settlement of the remaining creditors. In such case, no approvals are required by the classes of creditors like in the proceeding under b) above but similarly to it the settlement agreement must be supported by an expert who ensures that that the plan will allow the total satisfaction of the remaining creditors.

d) Administrative forced liquidation (*Liquidazione coatta amministrativa*) – This procedure is applicable to banks and other financial institutions, insurance companies and co-operatives. It is basically aimed at appointing a liquidator. Such office holder can be a lawyer, tax accountant or business person (by the statutory authority for each mentioned business sector) that will manage the procedure, liquidating the entity's assets and the payment of creditors, similarly to what happens in a bankruptcy procedure.

   Moreover the special proceedings aimed to avoid significant social impacts when a large company gets into a financially distressed position were introduced at the end of the '70 years, and amended in 1999 (by the above mentioned Decree Law 270), and in the 2003 (by Decree Law 347 issued in order to avoid the Parmalat bankruptcy proceeding). In such proceedings the role played by the Court has to be co-ordinated with special powers given to the Ministry of Industry that appoints a "Special Manager" whose objective is restructuring the company rather than liquidating. The special manager can be a lawyer, tax accountant or business person. For example, in the case of the fashion company *Ittierre*, managers that were appointed were: a tax lawyer, an accountant and a businessman.

2.2 Out of court (or Public Authority) control proceedings

In addition to the above mentioned procedures that remain under the control of a public body (the court or the competent sector authority) there are other forms of "private" management of temporary distressed situations.

Until now, such alternative forms have been largely preferred because they are more suitable to satisfy the needs of both creditors and the distressed entity. This is mainly due to the bureaucracy of the proceedings supervised by the public authorities including Bank of Italy in the banking sector, Consob in case of listed companies, ISVAP for the Insurance sector, Minister of economic deveplopment for entities established with the legal shape of co-operatives.

In addition to the traditional "liquidation" proceedings that were available prior to the introduction of the new insolvency law, a new form of restructuring (debt restructuring) has been introduced. This process might be considered half way between a private agreement and a proceeding supervised by the relevant authorities.

In general, even if the above mentioned reform of the insolvency law is going to change the scenario for restructuring distressed entities, the voluntary proceedings are still to be considered the best way to manage the business crisis by the creditors as well as the management and the shareholders.

In order to understand the Italian legislation on this issue better, we have to consider that, at this time, the recent insolvency reform cannot be considered fully tested and all the private and public players are still investigating about the degree of achievement of the goals that inspired the reform. It seems however, too early to evaluate if the goals (e.g. speed-up the proceedings and "reorganization" vs "liquidation" approach) will be eventually met.

The main types of voluntary reorganization proceedings are as follows:

a) Liquidation of the company

   This procedure is ruled by the Civil Code and is aimed at liquidating the company's assets, paying the creditors and distributing the remainder, if any, to shareholders.

   This solution is generally chosen when the continuation of the business is no longer profitable and when the assets are sufficient to satisfy all the creditors.

b) Settlement with creditors or "debt restructuring" (Art. 67 lett. d) of insolvency law).

   This voluntary proceeding might be composed of various agreements among creditors aimed at avoiding the bankruptcy consequences and obtain a higher percentage of receivables paid and allow the survival of the business. This settlement requires a restructuring plan certified by a qualified expert where it is demonstrated that by following the plan the company will end its distressed situation. An important characteristic of this procedure is that payments made under the plan are not subject to claw-back actions that instead affects payment to creditors based on regular agreements between creditors (who are supposed to know the critical financial troubles of the company and might foresee its insolvency). The claw-back can be activated only in the event that the distressed company starts a bankruptcy procedure within 1 year from a payment (except payments under the plan) to creditors under certain circumstances.

Common operations made in the context of the settlement with creditors are:

- The conversion of debt into capital or hybrid instruments (for example convertible bonds);
- The assumptions of company's debts from creditors (possibly followed by a debt forgiveness in favor of the distressed company); and
- The lease or the sale of the going concern to segregate the "good" business into a special purpose vehicle (allowing protection from bankruptcy procedures and excessive indebtedness).

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is.

3.1 Debt forgiveness

This is probably the most common method in reorganization plans: the decreased overall indebtedness may improve the likelihood of survival of the debtor.

3.2 Debt for equity swap (DES)

This is another useful tool for debtors. DES is mostly used in the Venture Capital turnaround market because it requires high specialization and high responsibility in the reorganisation management; in addition, another reason for a limited use of this tool out of venture capital context is the concern about the actual possibility to liquidate the investment by negotiating the equity due to the relatively small average size of Italian companies and of the Italian equity market. In any case the debt for equity swap does not involve any additional proceedings or public control (that would exist when a listed company is restructured).

3.3 Debt for debt swap

This is a quite common method used to increase the rehabilitation of the debtor by extending repayment terms and conditions and also introducing the subordination characteristic of the new debt. This may create a new environment to allow the debtor to enhance the overall debtor's financial reliability. However, this method seems more common than DES and less common than debt forgiveness and usually debt for equity and debt for debt swap are put together in a appropriate combination of initiatives aimed at reaching a balanced mix of equity and debt.

3.4 Debt parking

There are no special provision in the Italian law on Debt Parking transactions and in principle these transactions can be made (see question 6 for tax implications).

QUESTION 4

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4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

Some different methods exist to manage and facilitate the restructuring from a legal and corporate point of view. As we discussed before, the sale or the lease of a branch of business are often useful to carry on the reorganization of a distressed company by segregating the business that needs to be reorganized. As the activity of reorganization - as well as the activity to find a new investor interested in the business could involve a long period of time, the segregation of the profitable business into a special purpose vehicle might represent a critical issue. As a matter of fact it ensures the continuation of the profitable activities with minimal impact in terms of client relationships, quality of the profitable products and enhancing the possibility to give financial support. The ways to obtain such segregation are different, and each method has pros and cons. The lease of the business seems useful in view of a future disposal of the business to the lessee when the profitability will be demonstrated, while the contribution in kind of a profitable business into a new company may imply tax savings as it is a tax neutral (roll-over) transaction: when a profitable branch of the business has to be segregated into a separate vehicle (in order to keep it safe from the bad business), some corporate taxes could be applicable, as the disposal of the profitable business could create a taxable gain. Among tax free transactions (typically mergers, demergers, contributions in kind), the transfer of a business in exchange of shares of the receiving entity (often a Newco) is the most common tax free transaction; in other words it consists of an increase of capital of the entity (Newco) in exchange of the contribution in kind represented by the business.

On the contrary, when the business involves a licence that cannot be transferred, it makes sense for the non-viable activities to be transferred into a new and separate (bad) company, freeing the "viable" activities from the financial burden. In such circumstances the viable company has to become a guarantor against creditors for a new bad company. The maximum covered amount for the guarantee would be the value the bad business transferred.

QUESTION 5

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5. **Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.**

Yes. We have to consider the impact for creditors, for the distressed company (including its old and new shareholders), from different corporate, VAT, and indirect tax perspective.

In addition, there is the possibility to obtain from the tax authorities discounts as well as postponement of tax payments due in case of bankruptcy and reorganizations falling under the control of the court or other public authorities. In case of voluntary proceedings such negotiation would be theoretically possible, although it is more difficult as this is not specifically regulation by the law.

QUESTION 6

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6. **What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).**

In the Italian tax scenario, the main tax aspects of operations involving credits whose satisfaction is uncertain regarding the tax deductibility.

The Italian income tax rules allow the deduction of lost receivables under two circumstances:

a) The debtor is subject to an insolvency procedure regulated by a public authority. The proceedings which allow an automatic tax deduction of the loss are the ones under letters a), b) and d) described at point 2.1 and the procedure for the extraordinary management of large enterprises mentioned at point 1.

b) There are "certain" and "precise" elements that demonstrate that the credit is lost.

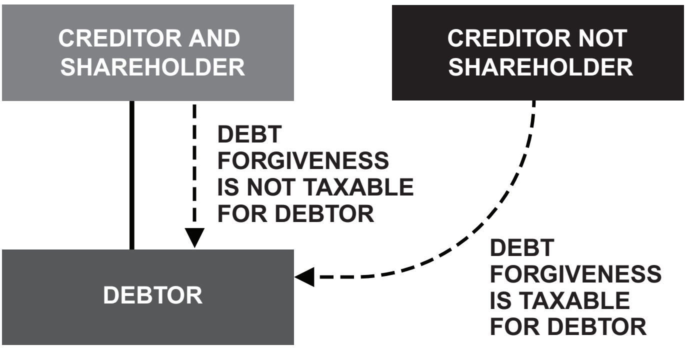
While the circumstance under 1) gives the creditor a safe context to deduct the loss, the ascertainment of the elements required under the second circumstance (i.e. as to whether the creditor has elements demonstrating the loss) is sometimes very difficult and usually the tax authorities try to disregard the tax deduction of credits supposed to be definitively not recoverable.

For example, losses generated by credits that are factorized attributing to the creditor the cash equivalent net of a commission or a discount, even if the operation occurred without recourse, cannot be considered automatically deductible and the tax authorities may consider a number of elements in this respect. In principle, to have a deductible loss, it is generally required that the creditor tried the available legal expedients to force the debtor to pay. For small credits the tax authorities admit the deduction of the loss when the cost for the forced collection (the expense needed to put in place legal actions against the debtor) is proportionally excessive.

In this respect, the choice of the most suitable operation to rehabilitate the financial position of a debtor might be influenced by the certainty about the tax deduction of the credit. For example, a creditor might be strongly inclined to end in a formal bankruptcy procedure as it ensures that its loss will be tax deductible, while otherwise (for example if a restructuring plan exist out of a publicly regulated insolvency procedure) he may be worried about the uncertainties as to whether the loss is deductible or not.

Also, debt parking transactions mentioned in question 3 falls under the tax requirement that losses generated by a transfer of a receivable must be accompanied by the attempt to recover it in all possible legal manners. In addition, at the time the new creditor forgives the debt, the tax consequences for the debtor are the ones described in the next para. 6.1.

6.1 Debt forgiveness and taxation for the distressed company



Income tax aspects may also affect the debtor: for example, irrespective of the tax treatment in the hands of the creditor, debts forgiven are taxable for the debtor as an extraordinary gain if the forgiver is not a shareholder. On the other hand credit forgiven becomes part of the investment in the company.

In fact, unless the debt forgiver is a shareholder, when a debtor obtains debt forgiveness from a creditor, the gain realized from the debt forgiveness must be included in the taxable income of the debtor and a tax exposure may consequently arise. However the gain, as well as any other corporate income profit, could be offset against available tax losses carried forward[1] or generated in the same fiscal year.

In order to avoid such impact a special tax structure can be considered; i.e. the debt forgiveness done by the shareholder on behalf of a controlled company, is not considered as a taxable gain (the amount will increase the tax cost of the participation); consequently if the distressed company credits might be acquired by the company A, and the distressed company debts are assumed by another company B, fully owned by A, then the forgiveness of debts done on behalf of B, would not be considered taxable as it would be done by the sole shareholder, and it would increase the participation cost in the accounting of A. Obviously such structure have to be tested and discussed in advance also taking into account the tax anti-avoidance legislation that basically requires a business purpose to put in place certain operations that generate tax benefits.

6.2 Debt-equity swap and taxation for the distressed company

Debt-equity swap are generally treated like contributions in exchange of shares and therefore the conversion per-se does not generate income tax consequences. The tax base of the receivable / loan is rolled-over and it is attributed by the creditor to the investment obtained in exchange.

Although the investment received in exchange of the receivable / loan may qualify for the participation exemption regime on investments (which implies for example that the possible write-off of investments is not deductible) a special provision allows financial institutions to keep the tax regime of receivable / loan irrespective of the actual nature of the asset held. This provision requires the submission of a ruling where the circumstances for the conversion are explained. The participation exemption regime might be disregarded if the tax authority shares the view of the applicant on the reasons and the mechanics of the restructuring.

6.3 Debt for debt swap and taxation for the distressed company

From a tax point of view the debt for debt swap does not have relevant tax issues / opportunity, as the new debt (most likely created by the issue of bonds), will be used in order to pay the old debt. If the new debt is interest bearing while the replaced debt was not, the debtor should consider that interest expense is generally deductible for income tax purposes to the extent of 30% of a tax parameter substantially similar to Ebitda. The remainder is not a deductible interest expense and could be carried forward without time limitations and deducted when there will be available Ebitda excess capacity.

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[1] As general tax rule, losses can be carried forward for 5 years, and cannot be carried back.

QUESTION 7

7. **If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?**

We should be mainly concerned of:

a) The likelihood of the tax deduction if a credit loss is involved;

b) The potential application of registration taxes on one or more operations included in the plan;

c) The potential cash out in the debtor's hand, potentially associated to income taxes generated by a debt forgiven that gives rise to a taxable gain; and

d) VAT applied (and presumably already paid to the VAT authorities) on unpaid receivables might be theoretically recovered when, at the end of the proceeding, there is certainty of the lost credit. The timing for recovering the VAT is associated to the timing of the procedure chosen.

QUESTION 8

8. **If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.**

No. The possible tax advantages follow the rules mentioned above.

It is worth noting that while the certainty to deduct a credit loss can be given only if the procedures mentioned at point 6 sub 1) are activated, plans approved by the Court under the context of the "restructuring agreements" mentioned at point 2.1 have more chances to be characterized by "certainty" and precise" requirements (which may allow the deduction of a credit loss as described at point 6) than plans made under "settlement with creditors" described at point 2.2 because the latter are not supervised by a public authority.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

The creation of a plan should take into consideration the tax consequences of the restructuring operations. Some perceivable tax issues may be generated in the following areas.

- Tax anti-abuse rules. The effect of obtaining a tax relief should be scrutinized in the light of the Italian legislation and case law in respect of tax abuse. In general, straightforward transactions made to achieve a business purpose do not risk criticism in this respect, while tax driven operations whose results might be reached by a more appropriate (although more tax expensive) route could be challenged by the tax authorities.

- Registration tax on deeds and securities. There is a quite sophisticated registration tax legislation applicable on restructuring deeds and guarantees that should be carefully evaluated.

- Potential effects on eligibility for tax benefits. Restructurings may change or limit requirements enabling the ability to keep certain favourable tax regimes in place (for example tax consolidation among companies belonging to the same group or the exemptions from withholding tax on interest paid might be jeopardized if regular voting rights are restricted or an holding period is not respected).

- If a “legal payment” occurs, an unwanted cash out effect may be generated. This happens, for example, when interest accrued overtime is forgiven by a non Italian lender in favor of an Italian borrower. As in many cases a withholding tax is due on interest payments to foreign lenders, a debt forgiveness might be considered a deemed payment followed by a cash contribution and therefore subject to withholding taxes.

- VAT credits can be refunded by the tax authorities on the basis of a suitable guarantee. The distressed situation could make it difficult to find a financial institution willing to grant such security.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

JAPAN

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

There are two types of insolvency laws which facilitate the rehabilitation of distressed companies in Japan. One is the Civil Rehabilitation Law (*Minji Saise Ho*) (CRL) and the other is the Corporate Reorganization Law (*Kaisha Kosei Ho*) (Reorg Law). The Out of Court Guideline for Multi Financial Institutions (Guideline), which relates to out of court workout for multi financial institutions (*Shiteki seiri no gaido rain*), is also a useful tool to rehabilitate distressed companies.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 The civil rehabilitation law and the corporate reorganization law

(a) Article 1 of the CRL outlines the purpose of the CRL. It says that the CRL shall, with respect to a debtor in economic difficulties: (a) aim to properly fix civil rights between the debtor and its creditors; and (b) aim to rehabilitate the business or economic livelihood of the debtor by establishing, etc. a rehabilitation plan which has the consent of a large number of its creditors and which has obtained approval from a court. The purpose of the Reorg Law is almost same as that of CRL except that the Reorg Law applies only to stock corporations.

Originally the CRL was made for the purpose of rehabilitating small to medium size companies, because the procedure is relatively simpler than that of the Reorg law, which was formed for big and / or listed companies. The cases, however, indicate that a lot of big and / or listed companies also file under the CRL. The reason for this is that the existing management of companies are entitled to retain their positions under the CRL procedure. This is called the Debtor in Possession (DIP) procedure, similar to Chapter 11 of the Bankruptcy Law of the United States. Under the Reorg Law, in principle the management is replaced and a trustee is appointed by the court. The trustee is a qualified lawyer and shall manage the business and administrate and dispose of the estate of the debtor. Therefore, the management of distressed companies like to keep their positions and tend to file under the CRL regardless of the size of the company.

(b) A significant difference between the above two procedures is that only unsecured creditors are bound under the CRL, whereas both secured and unsecured creditors are bound under the Reorg Law. Another difference, which is a practical difference executed at the Tokyo District Court, is that the time between an order by the courts for relief and the approval of a restructuring plan is six (6) months under the CRL and one (1) year under the Reorg Law. The reason of this time difference is that the procedure under the Reorg Law is more complex than that of under the CRL.

(c) Under the CRL, the rehabilitation plan (CRL Plan) is usually made by the debtors. The court has the power to transfer the case from the CRL to the Reorg Law if it thinks it proper. In order for a CRL Plan to be adopted at a creditors' meeting, the following requirements must be met: (1) consent to the CRL Plan is given by creditors who together possess half or more of the total amount of unsecured claims under the CRL Plan; and (2) a majority of the creditors present at the meeting consent to the CRL Plan. The court will confirm the adopted CRL Plan on the condition that: (1) the plan does not violate any laws; (2) the plan is likely to be implemented; (3) the plan has not been passed by an illegal act at the meeting; and (4) the plan is not in conflict with the general interests of creditors (e.g. best interests test).

(d) Under the Reorg Law, the restructuring plan (Reorg Plan) is usually made by debtors. Creditors are entitled to submit the Reorg Plan and they are often active either in submitting a substitute plan, or negotiating with the debtor and adding their opinions about the debtor's plan.

In order for a Reorg Plan to be adopted at a creditors' meeting, consent to the Reorg Plan must be given: (1) by creditors who together possess a majority of the total amount of unsecured claims under the Reorg Plan; and (2) by creditors who together possess three fourths (3/4) of the total amount of secured claims under the Reorg Plan. The court will confirm the adopted Reorg Plan on the condition that: (1) the plan does not violate any laws; (2) the plan is fair and equitable; (3) it is feasible to perform the plan; and (4) the resolution of the plan has been adopted in good faith and by fair means.

2.2 Out of court guideline for multi financial institutions

The Guideline was made in 2001 with reference to INSOL International a Statement of Principles as well as the "London Approach." The Guidline states that the debtor should obtain consent for its rehabilitation plan from all intended creditors, including creditors of financial institutions and major trade creditors, within the period decided at the first creditors' meeting, but not more than fourteen (14) weeks after submitting a standstill notice indicating that the rehabilitation procedure has begun. The debtor must file for commencement of the case under Japanese insolvency laws if it can not obtain the above consent within the specified period. This procedure has been used especially for distressed listed companies because: (1) the procedure is executed behind closed doors; and (2) a legal procedure triggers the delisting of the stock of the debtor.

Some of the requirements to adopt a restructuring plan under the Guideline are as follows: (1) feasibility of escaping from balance sheet insolvency (liabilities exceeding assets) in three (3) years; (2) possibility that operating earnings will have a surplus in three (3) years; (3) the right of the dominant shareholder of the debtor should vanish and the number of shares of the dominant shareholder should decrease or vanish whenever the debtor obtains debt forgiveness under the plan; and (4) the management of the debtor should be expelled whenever the debtor obtains debt forgiveness under the plan.

QUESTION 3

3. **Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?**

Yes, it is.

The most popular method in various plans is debt forgiveness, the purpose of which is to rehabilitate the debtor by decreasing excessive debt by abandoning a portion of the claims of creditors. This gives creditors an increased possibility of collecting their remaining claims as well as increasing the feasibility of rehabilitating the debtor.

Debt for equity swap (DES) is a useful tool for debtors. The Corporation Law provides that an investigation by a court-appointed inspector shall be needed before shares can be issued in exchange for a contribution in-kind without any outlay of cash. An investigation, however, is not required if the amount of money claims due, which are swapped for stocks, is less than the face value of the above claims. Also see the answers for question (10), below.

Debt for debt swap is a method used to increase the feasibility of rehabilitation of the debtor by financial creditors changing debts to subordinated debts. This gives the debtor breathing time, improves cash management, enhances its ability to pay back debts which are not subordinated, and restores its financial trustworthiness. The subordinated debts are construed to be capital, which affects improvement of its financial condition. However, this method is not so common compared with the above two methods.

QUESTION 4

4. **Do you have any other methods to decrease existing debt and / or offer relief to the debtor?**

While it may be possible to extend the time scheme for repayment, creditors especially financial institutions are very reluctant to agree such a kind of scheme because (i) cost of managing fee for these debts increase, and (ii) the guideline of Financial Service Agency allows only five (5) years at most to hold these debts (claims) after confirmation of the restructuring plan at the court.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes. We consider the Japanese Corporation Tax Law (CTL).

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

There are no statutory priority requirements for the Japanese tax purposes.

As mentioned in question 3 above, debt forgiveness and DES are common ways of rehabilitating the debtor. The following is a discussion of the tax consequences of obtaining debt forgiveness or a DES.

6.1 Debt forgiveness

When a debtor obtains debt forgiveness from a creditor, the gain realized from the debt forgiveness must be included in the taxable income of the debtor. Because of this, a tax exposure may arise unless the gain from the debt forgiveness less than the sum of: (1) losses carried forward (losses incurred within seven years prior to the current fiscal year); (2) losses incurred for the current fiscal year; and (3) loss incurred by the sale of fixed assets.

However, the use of "expired tax loss[1]" and the recognition of asset revaluation gain or loss is allowed in the following cases[2]: (1) order for relief under the Reorg Law; (2) order for relief under the CRL; and (3) certain out of court workouts which are equivalent to (2), e.g. Out of Court Workout for multi financial institutions.

The difference between the three cases is the scope of asset revaluation gain or loss and the priority of usage of expired tax loss and losses carried forward.

1 "Expired tax loss" means accumulated losses excluding loss carried forward incurred within seven years.

2 Even orders for relief both for the Special Liquidation procedures under the Corporations Law and for the bankruptcy proceedings under the Bankruptcy Law allow the utilization of expired tax loss, but the explanation is abbreviated here because we are discussing liquidation proceedings.

(i) The Corporate Reorganization Law

(a) Recognition of gain or loss on asset revaluation

As a general rule, the recognition of gain or loss on asset revaluation, executed at present value, is not allowed under the CTL. However, if a Reorg Plan is confirmed by the court, the assets are allowed to be revalued at fair market value and the recognition of gain or loss on revaluation is permitted.

Please note that under the CTL, the recognition of revaluation gain or loss is limited to the following assets: inventory, fixed assets, securities and deferred asset charges. Monetary claims are not the subject of revaluation.

(b) Expired tax losses and losses carried forward

If debt forgiveness is obtained, the utilization of expired tax losses is allowed under the CTL. In this case, in computing taxable income, the total amount of gain on debt forgiveness and the net revaluation gain is fully offset against the expired tax loss. The balance of gain, if it still exists, shall be offset against losses carried forward incurred within seven years.

(ii) Civil Rehabilitation Law

(a) Recognition of gain or loss on asset revaluation

As a general rule, the recognition of gain or loss on asset revaluation, executed at liquidation value, is not allowed under the CTL. However, the recognition of revaluation gain or loss is allowed when a CRL plan is confirmed. Strictly speaking, there are two methods of recognizing revaluation gain or loss under the CRL.

(i) Book entry method

Pursuant to this method, the recognition of asset revaluation loss for accounting purposes is required in order for such revaluation loss to be deductible for tax purposes.

The recognition of revaluation loss is allowed only for inventory and fixed assets. Although not expressly stated in the CTL, the recognition of revaluation loss on securities and deferred assets is permitted in practice. Please note that the recognition of revaluation gain is not allowed under this method.

(ii) Tax adjustment method

Pursuant to this method, recognition of revaluation gain or loss is allowed if a detailed statement and proof of the revaluation gain or loss is submitted with corporation tax returns.

The recognition of revaluation gain or loss is allowed on all assets except for: short term traded products; trading securities; redeemable securities; assets with unrealized gain or loss of up to 10 million yen (one half of share capital or 10 million yen, whichever is lower); and cash, deposits, loans, accounts receivables and other similar claims in the case of calculating revaluation loss.

(b) Expired tax loss and losses carried forward

The utilization of expired tax losses is allowed under the CTL if debt forgiveness is obtained in the CRL Plan. In the computation of taxable income, the order in which the expired tax losses and losses are carried forward would change depending on the method (i.e. book entry method or tax adjustment method) when the recognition of asset revaluation gain or loss is recognized.

(i) Book entry method

If the book entry method is employed in the recognition of asset revaluation loss, losses carried forward are first utilized until the amount of gain from debt forgiveness is reached for the purpose of computation of taxable income. The balance, if any, would be offset against expired tax losses. With regard to expired tax losses, please see the footnote 1.

(ii) Tax adjustment method

If the tax adjustment method is employed in the recognition of asset revaluation gain or loss, expired tax losses can first be utilized until the total amount of gain from debt forgiveness and the net revaluation gain is reached for the purpose of computation of taxable income. The balance, if any, would be offset against losses carried forward.

(iii) Certain out of court workouts (Out of court guideline for multi financial institutions)

The recognition of revaluation gain and loss and the utilization of expired tax loss are allowed if an out of court workout meets the following requirements:

(a) a plan is formulated in accordance with generally accepted guidelines for debt consolidation;

(b) the balance sheet is made by taking into account the value of the assets and liabilities, calculated using the guidelines in (a), above;

(c) the amount of debt forgiveness is determined taking into account the value of assets and liabilities in the balance sheet in (b), above, as well as the projected profits and losses in the plan; and

(d) more than two financial institutions, etc. admit the debt forgiveness.

All of these requirements are also adopted under the Out of Court Guideline for Multi Financial Institutions.

6.2 Debt for equity swap

There are two types of DES: (1) the creditor makes a contribution in-kind by exchanging its claims (receivables) for equity (contribution in-kind DES); and (2) the creditor makes a capital contribution to the debtor in cash and settles its receivables by receiving cash (quasi-DES). The following are the tax consequences of a DES.

(i) Contribution in-kind DES

In a contribution in-kind DES, creditors pay contribution in-kind in the form of receivables to the capital and receive debtor's shares in return. The contribution in-kind DES is subject to the rules for reorganizations under the CTL. If the DES falls within the category of a tax qualified contribution in-kind, assets and liabilities are deemed to be transferred at book value. However, in the case of a non-tax qualified contribution in-kind, the assets and liabilities are deemed to be transferred at fair market value.

The requirements for a tax qualified contribution in-kind are as follows:

TABLE: Tax qualified contribution in-kind (i.e. tax free contribution in-kind)

	Type 1	Type 2	Type 3
Shareholding relationship between transferor and transferee	**Group reorganization under 100% shareholding relationship**	**Group reorganization under 51-99% shareholding relationship**	**All other cases**
Requirement 1 Consideration	Consideration must be a share of transferee	Consideration must be a share of transferee	Consideration must be a share of transferee
Requirement 2 Employees	N/A	Retain at least 80% of transferee's employees	Retain at least 80% of transferee's employees
Requirement 3 Main Activities	N/A	Continue transferee's main business activities	Continue transferee's main business activities
Requirement 4 Business Relevancy	N/A	N/A	Transferred business must be related to transferee's business
Requirement 5 Business scale or management continuity	N/A	N/A	The size of transferred business compared with transferee's business must be within a 1:5 ratio
Requirement 6 Shareholding relationship	Must maintain 100% shareholding relationship	Must maintain 51-99% shareholding relationship	Continue to hold shares of transferee

DES is not usually a tax-qualified reorganization because only receivables are contributed. The exception is where the debtor is a wholly owned subsidiary of a creditor. This exception is not applied when a parent company (creditor) is a foreign company and its subsidiary (debtor) is a Japanese company.

The following explains the tax consequences of a tax qualified contribution in-kind DES and a non-tax qualified contribution in-kind DES:

(a) Tax qualified contribution in-kind DES

(i) Debtor

In a tax qualified contribution in-kind DES, no tax issue arises since the face value of the claim is converted to equity.

(ii) Creditors

In the case of a qualified contribution in-kind DES, since the book value of the receivables which are exchanged for shares becomes the acquisition cost of the shares, no gain should arise.

(b) Non-tax qualified contribution in-kind DES

(i) Debtor

In the case of a non-tax qualified contribution in-kind DES, the fair market value of the receivable is deemed to be contributed to the capital. For this reason, the difference between the face value of the claim of the debt (receivables) and its fair market value is treated as a gain from a forgiveness of debt. Therefore, a tax exposure arises unless the gain from the debt forgiveness is less than the sum of: (i) losses carried forward (losses arising during the past 7 years prior to the current taxable year); (ii) losses incurred for the current fiscal year; and (iii) the loss incurred by sale of fixed assets.

Note that the utilization of expired tax losses is allowed only in relation to the CRC, the Reorg law and certain out of court workouts (Out of Court Workout Guideline for Multi Financial Institutions).

(ii) Creditors

In the case of a non-tax qualified contribution in-kind DES, the claims (receivables) are deemed to be transferred at fair market value. For this reason, the fair market value of the claims constitutes the acquisition price of shares. The difference between the face value of the claims and its fair market value is treated as loss on the disposal of receivables. With regard to the requirements for tax deductibility of loss on disposal of receivables, please refer to the answers to question (7), below.

(iii) Quasi-DES

In a quasi-DES, creditors actually make a capital contribution in cash and receive cash in exchange for receivables. Since these transactions are generally treated as capital transactions, there is no tax exposure for either the creditors or the debtor.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

We should think about the amount of tax deduction resulting from losses arising from the debt forgiveness after plans are confirmed by the court.

The losses arising from the debt forgiveness, or a non-tax qualified DES, is not tax deductible for creditors unless the debt forgiveness, or non-tax qualified DES, meets one of following conditions:

(i) debt forgiveness is determined in a confirmed Reorg Plan or CRL Plan;

(ii) debt forgiveness is made pursuant to a certain private arrangement as follows:

(a) mutual agreements accepted at creditors' meetings under a reasonable standard of dealing with debt restructuring; or

(b) agreements which are equivalent to (a) with assistance of either administrative institutions or financial institutions, etc.; or

(iii) debt forgiveness is made in a written notice against debtors under the circumstance where repayments of the claims becomes difficult as a result of a prolonged period of balance sheet insolvency.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers regarding questions (6) and (7).

In addition to the matters discussed in those answers, we should consider that the amount of debt forgiveness is determined within the amount of revenue reserve, which should be minus (below zero). The revenue reserve consists of losses carried forward and expired tax loss. The debtor should pay corporation tax regarding a gain obtained by debt forgiveness of claims in the plan if creditors approve excessive debt forgiveness. In reality, creditors must be very reluctant to approve plans which will lead to debtors paying corporation tax while creditors are required to make sacrifices (e.g. debt forgiveness).

On the other hand, remaining debts after debt forgiveness and / or DES, etc. should be paid according to instalment plans made in the CRL or Reorg Plans. The term for instalment is determined under the CRL and Reorg Law: within ten (10) years for a CRL Plan and fifteen (15) years for a Reorg Plan. This means debtors should pay up within these terms. The easiest way to meet this condition is to obtain debt forgiveness from creditors as in as large an amount as possible. However, this treatment may incur the above corporation tax issue. To harmonize these two requirements and make plans would be difficult in the situation where debtors can pay back instalments only from gain, and the gain does not meet the amount required to pay each instalment. The debtors should consider a sale of business in this situation.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

Prior to the amendment of the CTL in 2006, there were many restructuring plans which used the method of DES. The reason for this was that a DES was treated as an exchange of face value of the claim of the debt (receivables) for the same amount of shares. Therefore, debtors did not realize a gain from a debt forgiveness. Creditors were willing to use the method of DES where they could not execute a large amount of debt forgiveness, but could still help the debtors to decrease the amount of claims. The creditors could get the up-side gain from the converted shares if the debtors became a healthy company again and the price of shares went up. In one case, a creditor got a huge amount of profit by selling shares which came from a DES. After the CTL changed in 2006, there was no advantage for debtors in executing a DES in the plans.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

MEXICO

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies

There is an insolvency law called "*Ley de Concursos Mercantiles* (LCM)."

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

The LCM provides for three stages:

- Preliminary stage to determine insolvency (called Visita)
- Conciliation stage
- Bankruptcy stage

The purpose of the first stage is to determine whether the merchant or company complies with the insolvency / illiquidity hypotheses provided for in the LCM as necessary to declare a *concurso mercantil*.

The following Articles explain the meaning of debtor's default which will be the requirement of *concurso mercantile*.

Article 10 - For the purposes of this Law, the general default to all obligations of a merchant referred to in the preceding article consists in the default to payment obligations to two or more different creditors and the existence of the following conditions:

i. That of the overdue obligations referred to in the preceding paragraph, those at least 30 days overdue represent at least 35% of the total aggregate sum of obligations payable by the merchant as of the date the insolvency lawsuit or petition was filed, and

ii. That, of the assets described in the following paragraph, those owned by the merchant are insufficient to cover at least 80% of the merchant's obligations due and payable as of the date of the lawsuit or petition.

The assets that must be applied for purposes of the provisions in section ii of this article will be the following:

a) Cash and demand deposits;

b) Term deposits and investments maturing within the 90 calendar days next following the date the lawsuit or petition is admitted in court;

c) Clients and accounts collectible maturing within the next 90 calendar days following the date the lawsuit or petition is admitted in court, and

d) Securities (i) the purchases and sales of which are regularly recorded in relevant markets; (ii) that may be sold within the ensuing 30 banking business days; and (iii) the appraisal value of which (as of the date of filing of the insolvency lawsuit or petition), is known.

The report by the Visitor (*visitador*[1]) and the expert opinions offered by the parties shall expressly refer to the requirements set forth in the foregoing sections.

Article 11 - It will be deemed that a merchant defaulted its obligations when any of the following is found:

i. Non existency or insufficiency of assets to garnish in an attachment of assets due to a default to an obligation or when attempting an attachment in aid of execution, regarding a judicial award against merchant with the authority of *res judicata*[2];

ii Default of its obligations to two or more different creditors;

iii. Hiding or being absent, without leaving a representative in charge of the management or operations that is able to comply with obligations;

iv. Under the same circumstances as above, the closing of the business address of the entity;

v. Resort to ruinous, fraudulent or fictitious practices to meet or avoid compliance of its obligations;

vi Default of money obligations resulting from an agreement entered into in terms of this Law, and

vii. In any other similar or analogous circumstances.

The first stage begins with a request to the Judge, to declare the merchant or company in *concurso mercanti.* This petition can be filed by the merchant, his / her / its creditors or the District Attorney.

During this stage, a review of the financial and economic situation of the merchant or company is carried out, which, the LCM calls the "verification visit". This verification is practiced by a specialist called "visitor".

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1 The role of the *visitador* is to act as an insolvency verification inspector, in charge of issuing a report to the insolvency court indicating if the merchant meets the legal requirements to be declared insolvent.

2 *Res Judicata* (a judged matter) means a matter settled by a final judgment.

The visitor has to be versed in accounting matters, therefore generally visitors are accountants. The visitor is designated by IFECOM. IFECOM notifies the court of the name of the person that was designated and the visitor files a motion with the court accepting to act as such.

Based on the Visitors report, and considering what is stated in the petition for *concurso mercantil*, as well as to express at this stage the merchant or the company, creditors and the District Attorney the judge will determine if the merchant or business is declared in *concurso mercantil*.

If the merchant or business is declared in *concurso mercantil*, the conciliation stage (second stage) commences. The purpose of this stage is to seek that the company and its creditors reach an agreement under which the merchant or the company will pay their debts.

The preparation and negotiation of an agreement between the parties, is assigned to a Conciliator (may be a lawyer, an accountant or other), who has to prepare a list of creditors acknowledged to be such, and determine the amount, type and level of preference of their claims.

Also during this stage, the merchant or company (except in some cases) will continue to operate its business under the supervision and in some cases requiring the express permission of the Conciliator. During this stage, payments of all claims are suspended, and no attachments of assets are allowed. The obligation of paying labor-related obligations continues regardless of the declaration of *concurso mercantil.*

In the event the merchant or company and its creditors fail to reach a Settlement Agreement the merchant will be declared bankrupt (third stage). In this stage, the objective is to sell all assets and rights of the merchant, in order to apply the proceeds of such sale to pay the liabilities to acknowledged creditors.

At this stage, management of the company goes to a specialist called a "trustee". The trustee may be a lawyer or an accountant. Best results are attained by having a lawyer and an accountant. Trustee is also appointed by the Court as mentioned above.

If the merchant is not declared to be in *concurso mercantil*, then the company will try to meet its obligations to creditors and employees on a regular basis or reach an out of court agreement if necessary.

QUESTION 3

3. Is it common in your country that companies use a method such as debt forgiveness, debt swap for shares?

It is possible, but not common. In general terms creditors may assign their credits to others, and creditors may forgive debts. From the tax point of view the creditor which forgives the debt may consider the debt-forgiveness as taxable income.

QUESTION 4

4. Is there any other method to diminish existent debt and / or to provide relief to the debtor?

There are many ways to extinguish the obligations or to make a change on such obligations.

This can be done by novation. (Art. 1991, 2213-2223 Federal Civil Code)

Novation is the process whereby a party changes an old obligation to a new one, e.g., getting a loan and applying the loan to pay the exisiting debt.

- Compensation (Art. 1991, 2185-2205 Federal Civil Code)

  The word compensation has nothing to do with any form of payment. Compensation, or offsetting of debts, is the result of both parties being creditors and debtors of each other. When that happens each credit is set off against the other, to simplify matters, and only one party will remain as debtor, for the balance.

- Confusion (Art. 1991, 2206-2208 Federal Civil Code)

  Confusion is the result of creditor and debtor becoming the same entity. e.g. a debtor buys a loan from the lender, creditor and debtor merge among them.

- Remitting (Art. 1991,2209-2212 Federal Civil Code)
- Remitting the debt is the same as forgiving it.
- Debt restructure
- Any other agreement between the merchant or the company and its creditors, if the same is lawful.

There are circumstances when the merchant or the company agrees to restructure its debts, or to request a waiver to reduce the total or partial payment for the same.

QUESTION 5

5. Do you consider tax issues when creating your plan? If the answer is 'yes', please list the names of the tax law you apply. If the answer is 'no', please let us know why not.

Yes. The relevant tax laws are:

- Income Tax Law (LISR)
- Business Tax at Single Rate Law (LIETU)
- Value Added Tax Law (LIVA)
- Domain or Property Transfer Law (LTD)

QUESTION 6

6. What are the issues (ie, fiscal risks, benefits, tips for overcoming the unfavorable tax treatment) considered in the plan? Please include the tax treatment for the debtor, where the plan includes methods indicated in the above questions (3) and (4).

- From the declaration of the *concurso mercantil* to the last date of the conciliation stage, to suspend the execution of administrative procedures for tax credits. However, tax authorities can continue the steps necessary for identifying and securing tax credits by the merchant.
- The tax credits will continue to cause updates, fines and accessories that are entitled under the applicable provisions; however, if the parties celebrate a Conciliation Agreement, this will cancel fines and accessories that may have accrued during the conciliation stage.
- In the stage of conciliation, the conciliator is required to submit to court a provisional list of credits by the merchant. The conciliator must accompany this list, all tax credits that are reported to the merchant by the tax authorities with the marking, if any, such authorities may continue with the verification procedures that apply.
- The merchant can ask the tax authorities waivers or authorizations in terms of the applicable requirements; they should be included in the Settlement Agreement.

A debt waiver is not deductible; a debt equity swap has no effect, because it is in fact payment of the debt (creditor ceases to be a creditor, and becomes a shareholder).

QUESTION 7

7. If you were the creditor's lawyer, what kind of issues would you consider when deciding whether to approve or reject the plan for tax issues?

The main consideration would be the effects it would have on financial statements and cash flow, as well as deduction for tax purposes that generate each of the alternatives and issues that could become a dispute.

QUESTION 8

8. If the plan includes the method outlined in previous questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, the creditor does not have any tax advantage? If so, list names of relevant laws and their benefits to creditors.

The only tax advantage is the cancellation of fines and surcharges.

QUESTION 9

9. Please tell us other risks and / or gaps in relation to tax issues should be considered when creating a plan for the debtor, or if you represent a creditor.

As mentioned in question 6, some considerations on the tax issues, would be if the taxpayer has tax credits, this will continue to cause updates, fines and accessories; and in case of conclusion of the Settlement Agreement, it will cancel the fines and accessories caused in the conciliation stage.

However, according to Article 144 of the Federal Tax Code, collection of IETU tax generated during the proceedings in bankruptcy, shall be suspended until he signs the agreement with creditors or is declared bankrupt. It is noteworthy however that the forgiveness of debt does not imply the cancellation or elimination of the obligation, but only the temporary suspension of tax collection. The same article provides that taxpayers, during the proceedings in bankruptcy, may apply for remission, even without a tax credit given by the tax authorities.

QUESTION 10

10. Do you have an opinion on the tax treatment they can or want to be included in the tax laws in your country in the future, which could facilitate the rehabilitation of companies in your country?

Forgiveness of certain taxes.

QUESTION 11

11. Do you expect changes in tax treatment with respect to distress companies in his country in the near future?

No.

NEW ZEALAND

QUESTION 1

1. **Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.**

New Zealand's company rehabilitation laws are contained in Parts 13-15A of the Companies Act 1993 (*Companies Act*).

QUESTION 2

2. **Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.**

There are three methods for rehabilitating companies under the Act – compromises, schemes of arrangement, and voluntary administration. The first two methods have now been largely overtaken by the newer voluntary administration procedure.

2.1 Voluntary administration

The voluntary administration regime of the Companies Act (part 15A) was introduced, from 1 November 2007, to maximise the chances of a company continuing trading or, if that is not possible, to provide a better return to creditors than an immediate liquidation of the company.

The New Zealand regime is largely based on the earlier Australian regime (Part 5.3A of the Corporations Act 2001 (Cth)) and adopts many of the recommendations of the Legal Committee of the Australian Companies and Securities Advisory Committee (CASAC), in the Committee's Corporate Voluntary Administration Final Report dated June 1998.

The administrator

A company's directors, secured creditors, liquidator or the Court may place the company into voluntary administration by appointing an administrator.

In most situations, the appointer can only appoint an administrator if the appointer considers the company is, or may become, insolvent and that an administrator should be appointed to produce a better recovery for creditors.

A secured creditor, with a charge over the whole, or substantially the whole, of the company's property can appoint an administrator if the charge has become, and is still, enforceable.

An administrator cannot be appointed if the company is already in administration, in liquidation or in the process of being wound up.

The administrator has control of the company's property and affairs.

Timetable of events

The company then enters a strict timetable where an administrator investigates the company's affairs and holds creditors' meetings. The administrator has extensive rights to obtain documents and information including examination of witnesses. The administrator must report any misconduct found to the Registrar of Companies.

Within five working days after the administration begins, the directors must provide the administrator with a statement of the company's position.

Within eight working days after the administration begins, the administrator must call and hold the first creditor's meeting. At this meeting the creditors determine whether to replace the administrator and whether to appoint a creditors' committee. The administrator must advertise the meeting within five working days before the meeting.

Within the convening period (twenty working days after the administrator's appointment, or a longer period if extended), the administrator must convene the watershed meeting. The administrator must provide written notice of the meeting to the company's creditors as well as an administrator's report on the company, the administrator's opinion on the creditors' options of future conduct, and the details of any recommended Deed of Company Arrangement (DOCA).

Within five working days of the end of the convening period, the administrator must hold the watershed meeting.

The administration's effect on company property

During a company's administration, there is an automatic moratorium under which the company is able to negotiate with creditors. The Companies Act places restrictions on, inter alia, the following actions:

- a person may not enforce a charge against the company's property without the leave of the administrator or court;

- a person may not bring or continue proceedings against the company or the company's property without the leave of the administrator or court; and;

- a person cannot enforce a guarantee of a liability of the company against a director of the company, or the director's spouse or relative. The purpose of this restriction is to ensure that the directors of a company will not be dissuaded from putting the company into administration.

The creditors' choice of next steps

At the watershed meeting, the company's creditors have a choice of only three options – approve a DOCA, resolve that the administration should end, or appoint a liquidator. A majority of creditors representing seventy five percent in value of the creditors or class of creditors voting are required to select an option. The administration comes to an end when the creditors make this choice.

The administration can also end if:

- so ordered by the Court because the Court is satisfied the company is solvent;
- the Court appoints a liquidator; or
- the watershed meeting is not held within the required time period.

Deed of Company Arrangement (DOCA)

The DOCA must specify, amongst other things, the company property available to pay creditors, the nature and duration of any creditors' moratorium, the extent to which the company will be released from its debts, the terms and conditions of paying creditors' claims and the circumstances in which the DOCA ends.

The deed must be executed by the company and the deed administrator.

The deed binds the company's creditors, the company, the company's directors, officers and shareholders and the deed administrator. A DOCA can release a company from debts owed to creditors bound by the deed. The deed binds secured creditors only to the extent that those creditors vote in favour of the DOCA.

The deed may be terminated by the Court, by a resolution of the creditors, or by the terms contained in the DOCA.

2.2 Compromises

Creditor compromises are covered by Part 14 of the Act. A company can enter a compromise with its creditors if the company is, or soon will be, unable to pay its debts. If the creditors are not unanimous, Part 14 provides a mechanism whereby certain majorities of creditors can bind the company.

A compromise can be conducted largely in private (with no need to advertise) and is the least expensive recovery method. However, there is no automatic moratorium preventing creditors from taking enforcement action against the company and there is no separate manager of the company's affairs.

2.3 Schemes of arrangement

The Companies Act also provides a Court approved scheme of arrangement (Part 15). This method provides flexibility although it once again provides no immediate moratorium to prevent creditors taking enforcement action.

A company, creditor or shareholder can apply to the Court for approval of a scheme of arrangement. If approved, the scheme will be binding on the company and any other person the Court considers appropriate (including dissenting creditors). The Court can also make orders concerning the transfer of property, issuing of securities, continuation of proceedings and the company's liquidation.

After receiving an application, the Court will initially make procedural orders covering such issues as the extent of information to be provided to creditors, the holding of creditors' meetings and the voting thresholds for scheme approval. A proposed scheme is usually required to have the support of 75% of a company's creditors by value and a majority in number.

After the meeting process, the applicant will then return to the Court for final approval. The scheme will be approved if the applicant has complied with any procedural requirements, the creditors have received fair notice and fair representation and an intelligent and honest business man might reasonably approve the scheme.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is. Although there has also been a series of moratoriums that finance companies have entered into in respect of loans advanced by retail investors (see answer to question 4).

Beside finance company moratorium, the most common approach would involve debt forgiveness, whereby the company is relieved from some of its obligations to the creditors with the intent that the company is then in a position to trade its way through its difficulties and return a greater amount to its creditors than would have been the case if the company was placed in receivership. Borrowers are generally more willing to forgiveness accrued interest and fees rather than forgive the principal component of the loans advanced to the company.

Debt for equity swap's are also considered by creditors. Rather than a simple debt forgiveness, it is possible for part of the debt owed by the company to be converted into an equity investment by the creditors. The equity held by creditors can take the form of preference shares that would see the creditors receiving a stipulated return on their equity investment prior to any distribution being able to be made to the other shareholders of the company. This mechanism can assist creditors to realise greater value in the event that the company successfully trades its way through its difficulties.

Debt for debt swap is generally less common (although it can form part of a moratorium arrangement, where rather than a simple deferral of repayment obligations, investors are offered a replacement security on different terms).

While this method can improve cash flow, often a key element of any plan is to improve the balance sheet of the company, and for this reason a debt for debt swap may not be as effective as the first two methods.

It is also permissible to enter into a debt parking arrangement where an associate of the debtor purchases the debt from the creditor for a discount, with the effect that the debtor no longer owes any amount to the original creditor.

QUESTION 4

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4. **Do you have any other methods to decrease existing debt and / or offer relief to the debtor?**

A number of finance companies that have raised funds from retail investors have entered into moratorium with their creditors to restructure the terms of the debt. These terms generally have involved a deferral in payment obligations in order to alleviate cash flow burdens on the finance company and allow it time to realise its assets in an orderly fashion.

Outside of retail investors, this approach has not been widely adopted.

QUESTION 5

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5. **Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.**

Yes. We consider the effect of the Income Tax Act 2007 (Tax Act) – which is the primary legislation that imposes income tax in New Zealand.

QUESTION 6

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6. **What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).**

The primary tax issue that needs to be considered by the debtor under any plan is how the financial arrangement rules apply to the plan. Although New Zealand does not generally have a capital gains tax, the financial arrangement rules seek to impose income tax and allow deductions by reference to the difference between the consideration provided and the consideration received under a financial arrangement.

The concept of financial arrangement is widely defined, and includes debt instruments. One exception is that shares are excluded from the financial arrangements rules. The rules apply to all New Zealand residents and to non-residents that carry on business through a fixed place in New Zealand.

In addition to taxing the difference between the consideration given and the consideration received, the financial arrangement rules also spread this income or expenditure over the term of the arrangement. Where a taxpayer applies IFRS accounting standards in preparing their financial statements, the IFRS methodologies for recognising income and expenditure over the term of the arrangement will (with some statutory amendments) determine how much income or expenditure will be recognised in any year during the term of the arrangement.

Notwithstanding that income and expenditure may have been spread based on accounting concepts, on maturity of the financial arrangement calculation is required to determine the final tax position of the debtor (called a base price adjustment). The base price adjustment is calculated as the difference between the consideration given and received that has not already been returned under the spreading method. In effect taxing the economic effect of the transaction, irrespective of any distinction between revenue and capital items. This base price adjustment can be triggered where a financial arrangement (debt) is replaced by an excepted financial arrangement (shares).

The tax issues arising for a debtor on a plan involving debt forgiveness, debt for equity swap, and debt for debt swap are discussed further below.

6.1 Debt forgiveness

Where a debtor is released from its obligation under a debt forgiveness plan, taxable income arises for the debtor company under the financial arrangements rules. This is because either:

1. in the case of a forgiveness of principal, the consideration received by the debtor (being the principal originally advanced) exceeds the consideration given by the debtor (being the reduced amount of principal repayable); or

2. in the case of a forgiveness of interest accrued, the spreading method under the financial arrangements rules will likely have already attributed this interest to an income tax period, and therefore the actual difference between the consideration given by the debtor and received by the debtor will be a lesser amount than that already spread under the financial arrangement rules.

The above calculations would occur on maturity of the debt instrument under the base price adjustment. However, in addition, the forgiveness of debt can cause income to arise during the balance of the term of the arrangement under the applicable IFRS spreading method. Depending on the accounting policies applicable to the debtor, the result is not necessary a simple spread to maturity calculation of the actual amount of the debt forgiven. In some instances, it is necessary to mark the financial arrangement to market. This can result in significant volatility in the amounts of income (and in some cases possibly expenditure) arising during the balance of the term of the arrangement as the market value of the debt can move significantly over the term of the arrangement, for example as a result of movements in reference interest rates.

In response to this issue, the Government has introduced concessional rules for defined 'creditor workouts' to allow the use of a straight line spreading method to avoid a debtor company being faced with a large tax liability immediately as a result of having entered into the plan. These rules do not remove the debt forgiveness income that can arise under such plans, but do remove the volatility that arose as a result of having to apply an IFRS spreading method to the compromised debt.

There is no ring fencing or other prohibition on the ability of the debtor company to use any available losses to shelter the income arising under the debt forgiveness plan. It is common for the debtor company to have accumulated tax losses in the trading period culminating in the need for a debt forgiveness plan; and in this situation the income tax arising from the debt forgiveness may not result in a cash tax obligation for the debtor company.

The financial arrangements rules also contain anti-avoidance rules that apply in situations where either a maturity is deferred through having a minimal amount remaining outstanding on a financial arrangement, or an associate of the debtor purchases all or part of a financial arrangement in order to avoid triggering debt forgiveness income for the debtor company (so called 'debt parking').

6.2 Debt for equity swap

There are several tax issues that a debtor company needs to consider when contemplating a debt for equity swap. The first is the application of the financial arrangements rules. As noted above, while debt is a financial arrangement, a share in a company is not. Accordingly, a debt for equity swap plan involves a debtor company ceasing to be subject to the financial arrangements rules in respect of some (and in extreme cases, all) of its debt.

This will generally trigger a base price adjustment for the debtor company in respect of that part of the debt that is converted into equity, and so require the debtor company to contrast the consideration it has received under the debt (being the principal originally advanced by the creditor) with the consideration given by the debtor company.

In a true debt for equity swap, the consideration given by the debtor company takes the legal form of equity which is issued in partial repayment of the debt. In this situation, the consideration given by the debtor company will be the market value of the equity issued. It is not sufficient to attribute a notional value to the equity on its issue (eg. one share will be issued in satisfaction of every $1 of debt to be converted). If the market value of the equity differs from the $1 attributed to it on issue then this difference will be brought to account under the financial arrangements rules.

This can pose difficulties for debtor companies that may be balance sheet insolvent. In this situation, arguably at least some of the equity has nil value until enough debt is converted so that the debtor company's assets exceed its liabilities. However, the counter argument to this is that even equity in an insolvent company has some value as it represents an opportunity to share in any future profits made by the company, should it survive its current difficulties.

Where there are real concerns about determining the market value of the equity to be issued (for example in a situation where a wholly-owned subsidiary is capitalising some of the debt owed to its parent), it may be preferable to have the debt for equity swap take effect in two stages. In the first stage the creditor contributes equity to the company by providing cash or cash equivalent value in return for the issue of shares.

The debtor company can then apply that cash or cash equivalent value in repayment of its debt obligation. When calculating the base price adjustment under the financial arrangements rules, the debtor company then has a certain cash value to attribute to the consideration given by it. It is important that the cash or cash equivalent value given by the shareholder represent real value received by the debtor company. For example, there may be issues where the creditor shareholder effects the transaction by way of journal entries without having the resources to actually fund an equity contribution of the required magnitude to the debtor subsidiary.

Where the creditor is a non-resident not carrying on business in New Zealand, the non-resident withholding tax effect of any debt to equity swap must also be considered. A debtor company will generally have an obligation to deduct with non-resident withholding tax (generally at 10%) or in the alternative pay approved issuer levy (at 2%, but only where the creditor is not an associate) on any interest paid to the non-resident creditor.

Payment under the withholding tax rules includes where an amount is credited to an account. Generally, a debt for equity swap will involve some crystallisation of accumulated interest, and this can trigger an obligation on the debtor company to pay non-resident withholding tax or approved issuer levy. This liability will not necessarily arise where the debt being converted to equity represents part of the principal of the debt, or an amount of interest that has already been capitalised (and therefore the debtor company has already accounted for non-resident withholding tax or approved issuer levy).

The debtor company also has to be cognisant of the implications of having some of its creditors as shareholders. The Tax Act contains rules that re-characterise debt as equity in certain circumstances. Where these rules apply, the debtor company is no longer entitled to a deduction for the 'interest' paid on the re-characterised debt, and repayments of the debt (including repayment of principle) can be taxed as a dividend paid by the debtor company. One such rule applies where funds are advanced by shareholders in proportion to their shareholding in the borrowing company. While in some debt for equity swaps it is arguable that this rule does not apply, as the debt existed prior to the creditors becoming shareholders, this is not always the case. In these circumstances it may be preferable to attach a conversion option to the balance of the debt as this will prevent that debt being treated as equity for tax purposes. Provided that the conversion option is at market, there should be no value attributable to the conversion option for tax purposes.

The debtor company also needs to consider the impact of introducing new shareholders on its ability to carry forward losses (and in such circumstances usually to a lesser extent, imputation credits). Under the Tax Act losses may only be carried forward by the debtor company where there is at least a 49% continuity of voting interests in the company from the beginning of the tax year in which the losses arose. It is often crucial that the debtor company remains entitled to carry forward losses it has accumulated in order to shelter any income that may arise under the financial arrangement rules because of the debt for equity swap. It is generally permissible to structure the equity to be issued to creditors to have limited voting rights in order to manage the continuity requirements.

Finally, where a debtor company is part of a New Zealand group of companies, the introduction of new shareholders may result in the debtor company ceasing to be a wholly owned member of that group of companies. In that situation,certain concessional rules regarding transactions between wholly-owned group members will cease to apply.

6.3 Debt for debt swap

A debt for debt swap raises similar issues under the financial arrangement rules for the debtor company. The debtor will be required to determine the market value of the debt issued by it in substitution for the existing debt in order to determine whether income (or less likely, expenditure) arises for it under the plan.

It is also worth noting, that debt instruments that bear interest calculated by reference to the profits of the debtor company are another category of debt that is re-characterised as equity for the purposes of the Tax Act. These instruments may be useful where, for commercial purposes it is preferable that the instrument continue to take the form of a debt, but for tax purposes it is preferable not to be subject to the continued application of the financial arrangement rules.

6.4 Debt parking

The financial arrangement rules contain provisions dealing with debt parking arrangements where a borrower's debt is purchased by an associate for less than 80% of its market value. For these purposes 'market value' is to be determined disregarding any factors associated with the creditworthiness of the borrower.

Under such an arrangement, the debtor is treated as having repaid the creditor an amount equal to the purchase price paid by the associate. The balance of the loan is treated as an amount forgiven by the creditor to the debtor and gives rise to debt forgiveness income for the borrower.

An interest-free loan is then deemed to exist between the borrower and its associate for the amount of the purchase price of the debt. Where the debtor ultimately repays the associate an amount in excess of this purchase price, the excess is income to the associate and deductible interest for the borrower.

QUESTION 7

7. If you were the creditor’s attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues ?

A creditor should consider the extent to which the arrangement raises the possibility of claiming a tax deduction under the financial arrangement rules; and whether they qualify to claim that deduction.

Any such deduction needs to be broken into two categories:

1. A reversal of interest income previously accrued by the creditor, which as a result of the plan will no longer materialise; and
2. A write-off of all or part of the principal originally advanced to the debtor company.

In the first case of a reversal of interest income previously recognised, all creditors will generally be entitled to claim a tax deduction for this amount. This deduction can arise either through a bad debt deduction for the interest income previously recognised by the creditor, or on calculation of a base price adjustment (where this adjustment is triggered in the year the interest income is reversed). These adjustments ensure that over the term of the arrangement the creditor only accounts for tax on the income representing the difference between the consideration originally given by the creditor to the debtor company and the consideration received from the debtor company in return.

Technically there is no deduction available under the financial arrangement rules for the second category – a write off of all or part of the principal. This is because under those rules the creditor is deemed to have received any amount that the debtor has been released from paying.

However, a bad debt deduction is available to a limited class of taxpayer for the principal that has been written off. In order to qualify for this bad debt deduction, the creditor must carry on a business that involves dealing in or holding financial arrangements similar to the arrangement with the debtor company and must not be associated with the debtor company.

In addition, the creditor should also consider the effect of the applicable spreading method under the financial arrangements rules to determine whether any further income or expenditure may arise during the remaining term of the debt.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers stated in questions (6) and (7).

In addition, the definition of financial arrangement is wide enough to include a series of arrangements (a so-called wider financial arrangement). It is possible for a wider financial arrangement to include an excepted financial arrangement.

Some care therefore needs to be taken in designing a plan such as a debt for equity swap or a debt for debt swap to identify whether a base price adjustment is triggered on the swap occurring, or whether income and expenditure has to continue to be spread over the term of the arrangement, which could continue until ultimate repayment / redemption of the swapped equity or debt instrument.

In the case of a wider financial arrangement, there can be difficulties in applying an IFRS spreading method as required by the Act.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

The financial arrangement treatment of debt instruments issued or held by rehabilitating companies has recently been amended to try and avoid rehabilitating companies deriving large amounts of income due to the accounting treatment and valuation of these financial arrangements.

However, further steps could be taken to simplify the treatment further. For example, a corporate may accrue losses under the financial arrangement rules leading up to it entering into a proposal with its creditors. If that proposal involves creditors taking a significant shareholding in the corporate, then the corporate may no longer have the ability to offset future income against its accrued losses (which are subject to forfeiture where a sufficient 49% continuity of voting rights is not maintained).

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

The tax treatment arising from the application of accounting principles to the calculation of income and expenditure during the term of a debt instrument under financial arrangement rules is subject to continuing review by the Government. It is possible that the financial arrangement rules will be amended to clarify and simplify their application to distressed debt situations.

RUSSIA

QUESTION 1

1. **Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and /or guidelines that facilitate the rehabilitation of distressed companies.**

   The main insolvency laws which facilitate the rehabilitation of distressed companies in Russia, include in particular:

   - The Federal Law of 26 October 2002 # 127-FZ On insolvency (bankruptcy) which is the general law with regard to bankruptcy (hereinafter – Law on Bankruptcy); and

   - In relation to banks and other credit institutions there is a special law - the Federal Law of 25 February 1999 # 40-FZ On insolvency (bankruptcy) of credit institutions.

QUESTION 2

2. **Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.**

   In accordance with Law on Bankruptcy, the bankruptcy procedure includes the following phases:

   - Supervision

   - Financial rehabilitation

   - External control; and

   - Bankruptcy proceedings.

   The first phase in the bankruptcy procedure is supervision. Other phases (if needed) are introduced after the phase of supervision by court resolution adopted based on a decision of the first creditors meeting, debtor's petition and opinion of the interim manager.

   The parties also can conclude an amicable agreement at any phase of the bankruptcy procedure, after the first creditors meeting has been conducted. If so, the bankruptcy procedure is terminated after court approval of the amicable agreement.

Supervision

Chapter IV of the Law on Bankruptcy, outlines the terms and conditions of the supervision phase.

The supervision is introduced by a court decision on the basis of an application for the initiation of bankruptcy procedures.

- The purpose of the supervision procedure is:
- To safeguard the debtor's property;
- To notify creditors of the introduction of the supervision phase;
- To register creditor's claims;
- To analyze the debtor's financial position; and
- To assess the possibility of the debtor's payment rehabilitation and reasonableness of introducing other bankruptcy phases.

At the supervision stage, a specially appointed interim manager summons the first creditors' meetings, the latter decides on further stages of bankruptcy procedure to be requested from the court (e.g. introduction of the "financial rehabilitation" phase).

During the supervision phase, the managing bodies of the debtor are allowed to adopt decisions and conclude transactions on behalf of the debtor subject to restrictions established by the Law on Bankruptcy and the court establishing the supervision phase.

Financial rehabilitation

Chapter V of the Law on Bankruptcy outlines the terms and conditions of the financial rehabilitation phase.

Financial rehabilitation may be introduced for the period of up to 2 years by court resolution upon request of the creditors' meeting. If the creditors' meeting does not support the introduction of the financial rehabilitation phase, such phase may be introduced by the court upon request of debtor's shareholders or third parties (where allowed by applicable law) provided the debtor's obligations included in payment schedule are secured with a bank guarantee.

At the stage of financial rehabilitation, creditors' claims must be satisfied in compliance with the debt payment schedule approved by the court. The debt payment schedule is obligatory for the debtor.

The debt payment schedule should stipulate that all unpaid debts included in the register of creditors' claims should be settled not later than one month prior to expiry of the rehabilitation period. The claims of first and second-tier creditors should be settled not later than 6 months after the introduction of financial rehabilitation. The claims of first-tier creditors include: compensation for physical and moral injury. The claims of second-tier creditors include severance and other outstanding employment payments and payments to authors of intellectual property. The debtor has the right to discharge its obligations ahead of schedule.

The debtor's obligations under the debt payment schedule may be secured by third parties.

At the financial rehabilitation stage, a special administrative manager is appointed by the court to manage the financial rehabilitation of the debtor. In particular, the administrative manager controls proper and timely execution of the financial debt payment schedule and rehabilitation plan. The managing bodies of the debtor are allowed to adopt decisions and conclude transactions on behalf of the debtor and under the supervision of the administrative manager subject to restrictions established by the Law on Bankruptcy.

A rehabilitation plan is drafted in case there is no security for fulfilment by the debtor of its obligations and is subject to approval by the creditors' meeting. The Law on Bankruptcy does not regulate the provisions which should be included in this plan. However, in practice, the plan usually includes such pro visions as the description of the debtor, sources of cash inflow, and other measures to regain the debtor's solvency. Such measures could be of a different nature (e.g. *economical* – diversion of production, sales of property, etc; *management* – introduction of optimal management structure, appointment of qualified managers, etc.; *financial* – identification of financial and investment sources, etc.; *informative* – additional product advertising, etc.). The provisions of the rehabilitation plan should not discriminate against any of the creditors included in the creditors' register. Moreover, the rehabilitation plan should comply with the debt payment schedule.

If the debtor fails to meet the debt payment schedule for a period of more than 5 days, the administrative manager must request repayment of the debts from the guarantors. If the guarantors discharge the debtor's obligations, the debt to guarantors is settled after the termination of bankruptcy proceeding or within the bankruptcy proceeding as claims of third-tier creditors. Alternatively, the debtor can request a creditors' meeting to amend the terms of the schedule. If the creditors meeting disagree with the requested amendments, it may request the court to cease the financial rehabilitation phase and introduce the "external control" phase or declare the debtor bankrupt and introduce bankruptcy proceedings (i.e., the sale of the debtor's assets for repayment of debts and liquidation of the debtor).

External control

Chapter VI of the Law on Bankruptcy outlines the terms and conditions of the external control phase.

External control is introduced by a decision of the creditors meeting and court approval for a period of up to 18 months.

At the external control stage, the authority of the managing bodies of the debtor are terminated and all management functions are performed by the external manager approved by the court; a moratorium on the settlement of creditors' claims included in the creditors' claims register is introduced.

During the external control phase, the external manager should prepare a plan for his external control and provide the plan to the creditors' meeting for approval not later than a month after his / her appointment. This plan should stipulate terms, timetable, associated costs and measures for the debtor's payment rehabilitation. The Law on Bankruptcy stipulates as examples the following measures for the debtor's payment rehabilitation:

- Changes in production profile;
- Closing down of unprofitable divisions;
- Disposal of a part of the property;
- Collection of accounts receivables;
- Cession of debt claims to a new creditor;
- Settlement of obligations via the property of the debtor's founders or of third parties;
- Increase of the debtor's share capital via the contributions of its founders or of third parties;
- Additional placement of the debtor's ordinary shares;
- Sale of shares in the debtor's property; and
- Substitution of the debtor's assets and other means.

The external control may be introduced for a period of up to 18 months. If the external control stage was preceded by financial rehabilitation stage, then the aggregate term of both stages may not exceed 2 years.

Bankruptcy proceedings

Chapter VII of the Law on Bankruptcy outlines the terms and conditions of the bankruptcy proceedings phase.

Bankruptcy proceedings are introduced by court resolution at request of the creditors' meeting when there is no possibility to succeed in the debtor's solvency rehabilitation and the debtor is declared bankrupt. The bankruptcy proceedings may be introduced after any of the previous stages of the bankruptcy procedure. The bankruptcy proceedings are introduced for a term of up to 6 months.

The bankruptcy proceedings phase mainly involves the valuation and disposal of the debtor's assets and satisfaction of the creditors' claims according to their priority in the register of the creditor's claims. For this purpose, a special bankruptcy manager is appointed. The authority of the managing bodies of the debtor is transferred to the bankruptcy manager.

At the bankruptcy proceedings stage, the creditors' meeting is entitled to adopt a decision to cease the debtor's business activities (e.g. goods production); the decision must be effected by the bankruptcy manager within 3 months following its adoption.

The court issues a resolution to complete (terminate) the bankruptcy proceedings after consideration of the report prepared by the bankruptcy manager on the results of the bankruptcy proceedings.

The court's resolution to terminate the bankruptcy proceedings serves as the grounds for the state registration of the debtor's liquidation in the Unified State Register of Legal Entities.

Amicable agreement

Within any phase listed above, an amicable agreement can be concluded between the debtor and creditors (their majority) provided the debt to the first and second tier creditors is fully repaid and all creditors having pledge rights against the debtor approved such agreement. The amicable agreement is subject to court approval and may include provisions as to the amount, order and terms of fulfilling the debtor's obligations. The Law on Bankruptcy provides that under an amicable agreement a debtor's obligations may be settled in one of the following ways:

- Compensation for release of the debt;
- Exchange of the debt for units / shares or other securities;
- Novation of obligations;
- Debt forgiveness; and
- Other measures that do not encroach on the rights of other creditors stated in the register of creditor's claims, and allowed by Russian law.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

As mentioned above, Russian law does not directly provide for methods to be included in the plan (please refer to our comments for question (2). However, some of them are mentioned as possible methods to be used under an amicable agreement.

Debt forgiveness

This is a method under which a creditor could forgive and thus terminate all or part of his claims to a debtor. Such forgiveness should not violate third parties' rights against the creditors' property. However, there is a risk that debt forgiveness could be treated as a gift. Since the Russian civil law expressly prohibits gifts between commercial legal entities, transactions considered as gifts may be recognized as null and void. Debt forgiveness is most commonly used for terminating debts owed to the parent company of a debtor. Russian court practice generally allows transfers of funds, debt forgiveness without consideration from the debtor as the donating party derives a certain benefit from such "gratuitous" transaction. When a parent company forgives debt to its subsidiary, the parent indirectly benefits by the increase in value of the net assets of the subsidiary and consequently the "real" value of its shares in the daughter company. The parent company in such case also avoids potential subsidiary's liability for the debt. Therefore, from that prospective debt forgiveness by a parent company to its subsidiary can be treated as "not a donation".

Debt for equity swap (DES)

This was considered as a risky option from a Russian legal perspective due to certain restrictions in the law until recent amendments to Russian corporate legislation were adopted. Since December 31, 2009 under Russian law the debt of a company owed to a shareholder or a third party can be converted into equity in such a company by way of increasing the amount of capital prescribed in the charter of the company. The Law on Bankruptcy prescribes the use of this method in an amicable agreement.

Debt for debt swap

This may be exercised in the following ways:

- As a debt novation when the parties replace a current claim by a new one under a new agreement (i.e. change of the subject of the contract) and may include different terms under the new claim (e.g. extended timetable or a new method for settlement of obligations). This option allows parties to be more flexible in settling the existing debt; or

- As debt set-off under claims of the same kind between the debtor and creditor provided that the payment period under the contracts was matured. Debt set-off may be performed in the amount of the lower debt. To perform debt set-off the implementation by one party is enough.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

Yes, the Russian Civil law provides for legal instruments such as a debt transfer, debt parking or a cession and compensation for release from an obligation.

To transfer the debt to a new debtor, the creditor's written consent is obligatory. Under a debt transfer, no amendments into the existing obligations are allowed. If the debt transfer is done on gratuitous basis (i.e. with no consideration to be paid by the previous debtor to the new one), there is a risk that such transaction could be treated as a gift which is prohibited between legal entities as mentioned in question 3.

The debt could also be terminated in exchange for compensation from the debtor (i.e. monetary payment, property transfer, etc.) for release from the debtor's initial (original) obligation. Compensation for release from an obligation is one of the grounds for terminating an obligation which is effected by providing any alternative type of a consideration (e.g. in-kind consideration) to the creditor. As compared to debt forgiveness, this method is always associated with the provision to the creditor of certain consideration for termination of the debt (not necessarily equal in value to original debt amount).

The details of such compensation must be agreed by the parties. If the compensation is less than the debt amount, the amount not repaid may be considered as debt forgiveness (please refer to our comments in question 3) or compensated in another way as additionally agreed by the parties. This option may not be very beneficial as in any case it results in an outflow of funds by the debtor.

Any specific mechanism such as debt parking is not provided for in the bankruptcy law. However, under general civil law rules a creditor may assign a receivable to another person by an appropriate assignment agreement (hereinafter – creditor's assignment). The debtor should be notified of such assignment. This mechanism does not involve the debt forgiveness since the obligation remains outstanding to the assignee.

QUESTION 5

5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes. We consider all issues under the Russian Tax Code.

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions 3 and 4.

6.1 Debt forgiveness

Profits tax - Forgiveness of debt is generally considered as the receipt of non-sales income by the debtor and therefore subject to Russian profits tax at the rate of 20%. However, free-of-charge receipt of property (including monetary funds) from an entity holding more than 50% of the charter capital of the recipient, is not subject to profits tax in Russia.

According to the clarifications issued by the Russian Ministry of Finance with respect to loan forgiveness, the income in part of the principal amount of a loan forgiven is deemed to be non-taxable, provided that the lender owns more than 50% of the debtor's capital. However, the forgiven liability to the extent of accrued interest is subject to profits tax at the general rate of 20%.

A creditor can not deduct the amount of the debt forgiven for profits tax purposes[1].

VAT - As a general rule, debt forgiveness should not be subject to Russian VAT as it is not deemed to be related to sale of goods, works or services under Russian law[2].

6.2 Debt for equity swap

Profits tax - Under the Russian Tax Code, contributions into the charter capital of a company, due to investment nature of the transaction, are not subject to profits tax[3]. Increase of charter capital should not be subject to profits tax either[4]. In case of a normal DES, the Russian thin capitalization rules would not apply to controlled debts converted as of the moment of such conversion.

VAT - Contributions to charter capital are also exempt from VAT in accordance with the Russian Tax Code[5].

6.3 Debt novation

Debt novation should result in no tax implications in Russia for the debtor or for the creditor if it is performed under the arm's length principle. However, further tax implications (i.e. tax implication after legal execution of debt novation) will depend on the form of the new contract to be concluded between parties in place of the loan / credit agreement being novated.

6.4 Debts' set-off

Debt set-off itself should not lead to tax implications in Russia for the debtor or for the creditor, if it is performed under the arm's length principle.

6.5 Debt transfer

In general, debt transfer should not lead to tax implications in Russia for the debtor or for the creditor. However, if a free debt is transferred from the debtor to a new debtor, Russian tax implications will similar to those for debt forgiveness will arise.

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1 Russian Tax Code, point 16, Article 270
2 Russian Tax Code, item 4, point 3, Article 39
3 Russian Tax Code, item 3, point 1, Article 251
4 Russian Tax Code, item 3, point 1, Article 251
5 Russian Tax Code, item 4, point 3, Article 39

6.6 Cession of debt claims to a new creditor

Under a cession agreement, the following Russian tax implications will arise:

- The creditor will be subject to 20% profits tax levied on the difference between the amount received from the new creditor and the amount of the debt[6]. No VAT implications should arise.

- The new creditor can deduct expenses associated with the cession agreement for profits tax purposes against its future income under this debt[7]. No VAT implications should arise at this stage.

- Cession of debt claims to a new creditor should not result in any Russian tax implications for the debtor.

6.7 Compensation for release from obligation

Compensation for release from obligation should not lead to tax implications in Russia for the debtor or for the creditor provided that it is performed under the arm's length principle[8]. The Russian Tax Code does not provide for the revaluation of debt. The amount of debt remains as stated in the supporting documents (i.e. the face amount). However, if the market value of in-kind compensation is lower than the face amount of the debt, the tax treatment of the amount not repaid will depend on how the parties agreed to settle the outstanding debt (e.g debt forgiveness or another option).

6.8 Creditor's assignment

No VAT implications should arise in case of initial creditor's assignment. Russian profits tax implications will depend on whether the debt is transferred to a new creditor at face value or at lower value.

If the creditor's assignment is executed at face value, no Russian profits tax implications should arise upon execution of the transaction.

If the debt is transferred to a new creditor at a value lower than the face amount of the debt, it is essential whether the creditor's assignment is executed before or after the due date for payment under the relevant agreement.

- If the debt is transferred before the due date for payment, the negative difference between the face amount of the debt and the creditor's assignment value should be considered as a loss for tax purposes. However, the deductible amount of such loss can be limited and subject to interest deductibility requirements prescribed by the Russian Tax Code.

- If the debt is transferred after the due date of payment, the respective negative difference should be considered as a loss deductible for profits

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6 Russian Tax Code, item 3, point 2.1, Article 268; Article 279
7 Russian Tax Code, point 3, Article 279
8 Russian Tax Code, item 10, point 1, Article 251

tax purposes as a non-sale expense. Such loss should be deducted in the following order: 50% of the amount of such loss may be deducted at the date of the creditor's assignment whereas the remaining 50% can be deducted on the expiry of 45 days after the date of the creditor's assignment.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject a plan as regards tax issues?

While choosing the appropriate method for debt settlement the following issues should be taken into account:

- Potential legal risks associated with different options (e.g. in case of debt forgiveness, DES when creditor exchanges its claims for the units / shares in the debtor, etc.);

- Potential profits tax and VAT implications under each option at the moment of its execution and their applicability by each party;

- Deductibility of interest expenses under the restructured loan at the level of the debtor;

- Tax treatment of interest income accrued under the restructured loan at the level of the creditor (e.g. potential tax treatment in case of debt novation); and

- Acceptance of the chosen option by each creditor since Law on Bankruptcy prescribes the use of the same method of settling debt for all creditors.

Please note if the creditor is a Russian taxpayer, which has outstanding bad debts, the taxpayer may choose whether:

- To deduct the respective amounts as non-sale expenses at the moment when they are treated as unrecoverable bad debts, which is evidenced by appropriate supporting document (e.g. court decision on bankruptcy of the respective debtor; documents confirming termination of 3 years from the initial date of payment, etc.) or

- To annually form a bad debt reserve for doubtful bad debts (except for interest related to credits / loans or other similar liabilities) in the manner prescribed by the Russian Tax Code, i.e.:

  - Bad debts exceeding 90 days may be fully included into the bad debt reserve based on the results of a specific analysis of the debtors;

- Bad debts within 45-90 days may be included into the bad debt reserve to the extent of 50% based on the results of a specific analysis of the debtors

- Bad debts under 45 days may not be included into the bad debt reserve.

The amount of additions to the bad debt reserve may be deducted for Russian profits tax purposes as a non-sales expense provided that it is properly documented. The amount of bad debt reserve can not exceed 10% of sales proceeds for the current period. A bad debt reserve may be offset by losses from unrecoverable bad debts recognised as such under the Russian Tax Code. If the amount of unrecoverable bad debts exceeds the amount of bad debt reserve formed by a taxpayer, the respective difference may be deducted as a non-sales expense proved that it is properly documented.

The respective policy should be reflected by the taxpayer in its tax accounting policy. However, formation of a bad debt reserve will allow a taxpayer a deferral effect for profits tax purposes by deducting losses related to outstanding bad debts earlier.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers regarding questions 6 and 7.

In addition to matters discussed in those answers, please note that settlement of the outstanding debt should be carefully structured. Thus, in practice, the Russian tax authorities try to challenge the taxable treatment of structured transactions that lack economic substance and are aimed only at tax evasion and receipt of an “unjustified tax benefit” (similar to a GAR provision, i.e., general anti-avoidance rule). If tax avoidance is unexpected, then even generally non-taxable methods of debt settlement could result in additional VAT and profits tax implications for the debtor and / or the creditor.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

SINGAPORE

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

Distressed companies in Singapore may be rehabilitated using the following provisions in the Companies Act, Cap. 50.

- Part VII - Arrangement, reconstruction and Amalgamations – relating to the use of Schemes of Arrangement
- Part VIIA - Judicial Management

The Companies Regulations, the subsidiary legislation of the Singapore Companies Act provide, amongst others, the rules relating to judicial management.

As for informal arrangement with creditors, whilst it is common, there are no statutory or formal guidelines on an out of court workout.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

2.1 Scheme of Arrangement and Compromise

A company in financial difficulty may enter into a scheme with its creditors or members. The mechanism is provided for in Sections 210 to 212 of the Singapore Companies Act.

One advantage of applying this statutory regime is that a unanimous consent of all creditors or members is not necessary. It allows a company to bind a dissenting minority representing less than 25% in value and 50% in number.

The process for initiating a scheme of arrangement begins with the preparation of the scheme, followed by an application to Court for leave to convene a scheme meeting. Unlike applying for a judicial management order, a company need not be insolvent to be qualified to apply for a scheme of arrangement. Whilst provisions in the Companies Act do not provide any details on the requirements to be included in a proposed scheme, a scheme should at least set out the objectives, the reason(s) for the need for the scheme and the likelihood of achieving the objective(s) having regard to the foreseeable business conditions.

It is advisable to have the comprehensive scheme documents in place to facilitate the Court to consider the proposed scheme. The Court may not grant leave to hold the scheme meeting if the company is hopelessly insolvent or where it is clear that the scheme cannot obtain the required support to approve the scheme. In the meantime, the applicant may seek to have all further actions or proceedings against the company be restrained except by leave of the Court or subject to such terms as the Court directs.

Once the Court grants leave to hold the scheme meeting, the company shall proceed to issue notice(s) summoning the meeting pursuant to the Court Order. Every notice shall be accompanied by a statement explaining the effect of the arrangement or compromise and in particular, any material interests of the directors in the scheme and its effects. At this stage, it is common for the company to engage its creditors to obtain feedback on the proposed scheme, and where agreeable, make amendments to the scheme.

If a majority in number representing 75% in value of the creditors or class of creditors or members or class of members present and voting either in person or by proxy at the meeting agrees to the proposed scheme, the arrangement or compromise, if approved by the Court, shall be binding on the parties who are subject to the proposed scheme.

The results of votes at the meeting(s) shall be reported to the Court. The Court may grant its approval subject to such alterations or conditions as it thinks just. The order shall take effect when a copy of the order is lodged with the Registrar of Companies.

2.2 Judicial Management

The laws and guidelines relating to judicial management are provided in Section 227(A) to 227 (X) of the Singapore Companies Act and the Companies Regulations.

A company in distress or any of its creditors may make an application to the Court for the company to be placed in judicial management.

Once an application is filed in Court, there will be an automatic stay of proceedings against the Company. Further, no winding up order can be made against the Company and the secured creditors cannot take steps to enforce their charges. A floating charge holder with the right to appoint receivers and managers may however veto the application. If a judicial management order is granted, a judicial manager who must be a public accountant, shall be appointed. During the period of judicial management, all powers conferred and duties imposed on the directors shall be exercised and performed by the judicial manager.

The judicial manager is required to convene a creditors' meeting within 60 days from the Court order (or such longer period as the Court may allow) and table a statement of proposal for consideration by the creditors.

The judicial manager is required to implement the proposal if it is approved by a majority in number representing more than 50% in value of those creditors present and voting at the meeting.

A judicial management order is only valid for 180 days but the Court may on the application of the judicial manager, extend this period.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

Yes, it is. A restructuring plan may apply one of the following methods or a combination of them.

Debt forgiveness (or compromise) - This is plausible when the assets of a company in distress are less than its liabilities

Debt for equity swap - This is more common when the company is a public listed entity and its shares can be freely traded / sold in the open market.

Debt for debt swap - A typical example is the simple conversion of a short term loan e.g. overdraft or trust receipt into a term loan. A more complicated swap example could be the issue of a low coupon rate secured loan stock attached with the right of conversion into equity with or without warrant.

QUESTION 4

4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

For a company which has sufficient assets to meet its liabilities and is facing a short term cash flow crunch, it may be possible to merely defer or re-schedule the terms of repayment. However, the creditors need to be convinced that by giving the indulgence, the financial position of the company will not be further deteriorated such that it adversely affects their chances of recovery.

Creditors who are entitled to claim for interest on outstanding debts may also be requested to either waive penalty interest or reduce the interest rate temporary to help the debtor to tie over the difficult period.

For an insolvent company, another possible method is “hiving down” its existing business and assets into a newly incorporated subsidiary. The existing company may be placed under liquidation thereafter and proceeds from the disposal of the subsidiary will be divided among the creditors in accordance to the liquidation laws.

QUESTION 5

5. **Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.**

The applicable tax laws are the Singapore Income Tax (Cap 134) and Goods and Services Tax Act (Cap 117A).

Whilst there may be tax implications arising from the different methods adopted in resolving the outstanding liabilities, it is not always a key factor being considered in a restructuring exercise.

QUESTION 6

6. **What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).**

There are tax implications on different restructuring plans adopted which may warrant consideration.

Debt forgiveness

The debt waived by a creditor may be brought to tax for the debtor if the amount is trade-related and had been claimed and allowed a tax deduction earlier.

Conversely, the waiver of a non-trade debt e.g. loan principal will not be taxable on the debtor.

As for Goods and Services Tax (GST), the debtor will need to return the input tax claimed from the Comptroller of GST if he is unable to pay the creditor.

Debt for equity swap

Any expenses incurred in connection with the conversion from debt to equity will not be tax deductible.

In addition, if the shares issue has given rise to a substantial change (i.e. more than 50%), in the shareholders of the debtor company, any unutilised capital allowances, losses and donations brought forward from past years will be disregarded, i.e. not allowed for set-off against future profits of the debtor company. However, the debtor company can apply for a waiver of the shareholding test and the Comptroller of Income Tax may grant the waiver if he is satisfied that the substantial change in shareholding is not for the purposes of deriving any tax benefit or obtaining any tax advantage (e.g. where the change was carried out for genuine commercial reasons as part of a company rescue package).

Debt for debt swap

Any expenses incurred in connection with the debt to debt swap will also not be tax deductible.

As a concession, the Comptroller of Income Tax may allow the deduction of interest payable on the refinancing loan if the debtor can establish that the refinancing has been effected for genuine commercial reasons, e.g. if the refinancing was necessary due to financial difficulties faced by the debtor who needs to restructure the loan in the interim. The onus is on the debtor to prove that the refinancing arrangement has been entered into for commercial reasons.

QUESTION 7

7. **If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?**

The portion of a trade debt which becomes irrecoverable following a debt forgiveness arising from formal insolvency procedures pursuant to either a Scheme of Arrangement or Judicial Management stands a better chance of being allowed a tax deduction. The creditor can also apply for bad debt relief from the Comptroller of GST for return of the output tax paid if certain conditions are satisfied.

However, there may be uncertainty if a debt waiver arises from an informal work-out and / or the parties are related, as the Comptroller may require the creditor to show proof that it has exhausted its means to recover the debt before allowing the deduction or bad debt relief.

In the case of debt for equity swap, a creditor may resist a plan if the issue price for the shares is higher than its market value. This is because while the receivable in the books of the creditor maybe regarded as fully realised, the actual amount recovered is lower. The shortfall in the recovery by the creditor due to lower market price will not be tax deductible.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No. A creditor may claim bad debt relief for an irrecoverable trade debt if he can prove to the tax authority that the debt is indeed bad. The fact that a plan involving debt forgiveness is confirmed by the Court merely gives an added evidence that the debt is bad, meaning that no automatic tax deduction occurs.

QUESTION 9

9. Please tell us other pitfalls and/or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see answers relating to questions (6) and (7) above.

In addition to the matters discussed in those answers, we should also consider the following:

(i) With regard to debt forgiveness, a trade debt waived by a related creditor may not rank for tax deduction for the creditor on the basis that the waiver of the debt was not incurred in the normal course of trade but to assist the related debtor which was in financial difficulty.

(ii) With regard to debt for equity swap, the debtor should be mindful as to whether the restructuring plan would result in a substantial change in shareholders, as this has implications on its eligibility to -

- carry forward its unutilised capital allowances, losses and donations for set-off against its future income;
- carry back its current year unutilised capital allowances and losses for set-off against its income of the preceding year(s); and
- transfer its current year unutilised capital allowances, losses and donations to another company within the same group for set-off against the other company's income.

(iii) Where there is a substantial change in the shareholders in situation (ii) above and the debtor has applied and is granted a waiver of shareholding test, the capital allowances, losses and donations which are granted the waiver can, however, only be deducted against the gains or profits derived from the same trade or business as that from which the capital allowances arose or in which the losses or donations were incurred.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No, but please see answer to question (11) below.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

A new income tax framework for qualifying amalgamations has been introduced for amalgamations that take place on or after 22 January 2009. It is aimed at minimising the tax consequences arising from qualifying corporate amalgamations where, amongst other conditions, the amalgamated company takes over all assets and liabilities of the amalgamating companies and the amalgamating companies cease to exist. Under the new tax framework, the intention is to ensure that most of the tax consequences of a continuing business will apply to the amalgamated company, i.e. the tax treatment of provisions, trading stocks, capital allowances, accruals etc. transferred to the amalgamated company from the amalgamating companies, will be ascertained on the basis that the businesses that have been taken over entirely have not ceased but continue in the amalgamated company, as part of the business (or enlarged business) of the amalgamated company.

The legislative provisions for this new tax framework are found in the new section 34C of the Income Tax Act [introduced by the Income Tax (Amendment) Act 2009 enacted on 29 December 2009]. Details of the new tax framework can be found in the e-Tax Guide “Tax Framework for Corporate Amalgamations” issued on 20 January 2010 by the Inland Revenue Authority of Singapore.

SOUTH AFRICA

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.

Chapter 6 of South Africa's new Companies Act 2008 "The new Companies Act" introduces a corporate rescue procedure which is an alternative to liquidation and which replaces the current judicial management system provided for in chapter 15 of our existing Companies Act 61 of 1973. The new Companies Act has already been approved by Parliament and is expected to become effective in mid 2010.

Chapter 6 is aimed at providing an insolvent company with a breathing space to enable it to trade back to solvency. Chapter 6 is structured so as to temporarily protect the company from the claims of its creditors so as to allow a business rescue practitioner to implement a business rescue plan which will result in a better return to creditors than they would have received had the company been placed into liquidation at the outset.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

A business rescue can be implemented either by way of a resolution adopted by the board of directors to voluntarily enter a business rescue or by way of a court application brought by a shareholder, creditor, registered trade union representing employees or the employees (defined in the new Companies Act as "affected persons") themselves.

In the former case, a board can pass such a resolution if it believes that the company appears to be reasonably unlikely to be able to pay all its debts as and when they fall due within the following six months, and that there is a reasonable prospect of rescuing it. In the latter case, an affected person must satisfy a court that the company is financially distressed, or that it has failed to pay over an amount in any employee related matters, or that it is just and equitable that the company be placed in business rescue.

A business rescue practitioner has to be appointed either within five days of a board filing a resolution to begin the business rescue process, or by a court simultaneously with it granting an order to place a company in business rescue. Once the business rescue practitioner, who can be a lawyer, accountant or other person qualified to act in terms of the applicable criteria, is appointed, he has ten business days in which to convene and preside over a meeting of creditors and also a meeting of employees or their representatives. The practitioner must also investigate the company's affairs, business, property and financial situation and then decide whether there is a reasonable prospect of the company being saved. Assuming the company can be saved and after consultation with all affected persons and the management of the company, the practitioner must prepare a business rescue plan for consideration and possible adoption at a second meeting of creditors and, if applicable, shareholders. A plan that is adopted is binding on the company, its creditors and every holder of the company's securities.

While a company is in business rescue, there is a moratorium on all claims and legal proceedings against it and the business rescue practitioner is afforded the right to cancel or suspend entirely, or in part, any contract (other than employment contracts) to which the company is a party at the commencement of the business rescue proceedings.

Although it is envisaged that business rescue proceedings must be implemented within three months from inception, provision has been made for the proceedings to be extended to make revisions to the business rescue plan or for any other good cause. If the proceedings have not ended within three months or such longer time as declared by court, the practitioner must deliver a report to court on the progress of the business rescue proceedings.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?

We refer to debt forgiveness as compromises in our jurisdiction. These are commonly effected by means of an agreement between the debtor and the creditor or in more complex cases by means of a court procedure utilising section 311 of the current Companies Act, No 61 of 1973. The new Companies Act also makes provision for compromises in section 155 thereof. Compromises have tax consequences (see below) and it is essential to consult with a tax expert.

The new Companies Act, as noted earlier, introduces a business rescue regime which broadly speaking contains elemts of both the chapter 11 bankruptcy proceedings in the US and administration in the UK. It is likely that the new business rescue regime will have a substantial impact on compromises and the like.

Debt for equity swaps is less common in our jurisdiction. If a commercial rationale exists, one could also effect a debt for debt swap in South Africa. Swaps of this nature amount to novations. These have complex legal consequences.

Debt parking can also occur in South Africa. As is the case elsewhere, this takes place when a creditor assigns its right to receive repayment to another person where:

- the new creditor is an associate of the debtor or the assignment occurred under an agreement or an arrangement to which the debtor and new creditor were parties. In either case, the creditor is taken to have forgiven the debt.

QUESTION 4

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4. Do you have any other methods to decrease existing debt and / or offer relief to the debtor?

As noted, a business rescue regime will shortly be introduced in South Africa. This is likely to have a substantial impact in dealing with financially troubled companies.

QUESTION 5

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5. Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.

Yes. One would need to consider the applicable provisions of the Income Tax Act, 1962 (which deals with issues relating to income tax, donations tax and capital gains tax), the Value-Added Tax Act, 1991 and the Securities Transfer Act, 2007.

QUESTION 6

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6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated above.

The answer would depend on the plan adopted and these are dealt with separately below.

6.1 Debt forgiveness (compromise)

6.1.1 The debtor

The tax implications that arise in consequence of debt forgiveness depend to a degree on whether the debtor is in an assessed tax loss position or not.

If the *debtor is in an assessed tax loss* position and any debt owed by that person is forgiven, then the debtor's assessed tax loss is required to be reduced by the amount of debt forgiven to the extent that the amount forgiven was used, directly or indirectly, to fund the acquisition of an asset and the debtor was allowed an income tax deduction in respect of the cost of acquiring that asset. For example, if a debtor acquires trading stock from a vendor on credit and the debt due is subsequently forgiven by the vendor, then any assessed tax loss of the debtor will be reduced by the amount of the debt forgiven on the basis that the debtor would have claimed an income tax deduction in respect of the cost of acquiring the trading stock. By contrast, if the debtor had acquired a trade mark on credit and the debt was subsequently forgiven, the debtor's assessed tax loss would not have been reduced by the amount of the debt forgiven as the debtor would not have been able to claim any income tax deduction in respect of the acquisition of the trade mark.

The provision dealing with the reduction of an assessed tax loss where the debtor has derived a benefit in consequence of the forgiveness of any indebtedness must be considered in conjunction with the claw-back (recoupment) provision that applies when any debtor is “relieved or partially relieved from the obligation to make payment of any expenditure actually incurred” by the debtor. As in the case above, the claw-back (recoupment) of expenditure will only arise if the debtor has claimed an income tax deduction in respect of that expenditure. However, this provision applies subject to the reduction in assessed tax loss provision - so that where the debtor is in an assessed tax loss position and any qualifying debt owing by the debtor is forgiven then the assessed tax loss will firstly be reduced by the amount of debt forgiven, and then to the extent that the assessed tax loss has been fully utilised, the excess debt amount will be clawed back (recouped) and treated as ordinary income in the hands of the debtor for income tax purposes.

If the *debtor is not in an assessed tax loss position*, then the claw-back (recoupment) provision will nevertheless still apply if the debt (expenditure) forgiven has previously been deducted by the debtor for income tax purposes.

In addition, where a debt has been forgiven, capital gains tax “CGT” will apply to so much of the debt as exceeds the amounts taken into account for purposes of the reduction of assessed tax loss and claw-back (recoupment) provisions discussed above. It follows that CGT implications will arise regardless of whether forgiveness of the debt has triggered any income tax implications or not. Where a debt owed by a person to a creditor is reduced or discharged for less than the face value of the debt, the debtor is in effect deemed to have disposed of an asset for proceeds equal to the amount of debt forgiven for CGT purposes. As the debtor would not have any base cost in respect of the debt, the full deemed proceeds will constitute a taxable capital gain in the debtor's hands. The resultant capital gain will accordingly be taxed in the hands of the debtor in accordance with the applicable inclusion rate (50% for corporate entities and trusts; 25% for individuals) and applicable normal tax rate (28% for corporate entities; marginal tax rate for individuals and 40% for trusts). The CGT provisions will not apply where:

(i) the debtor and creditor form part of the same “group of companies” as defined (certain anti-avoidance provisions apply that need to be considered);

(ii) the debtor is a company, the creditor and debtor are “connected persons” in relation to each other, and the debt is forgiven “in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence” of the debtor (certain anti-avoidance provisions apply that need to be considered).

Should the debt forgiveness form part of a transaction that meets the requirements of any of the so-called corporate rules (asset-for-share, amalgamation, intra-group, unbundling, liquidation, winding-up and deregistration), essentially provisions that provide roll-over relief, it is possible that the forgiveness of debt may not give rise to a tax effect.

Debt forgiveness will also trigger value-added tax “VAT” implications. The debtor (if a VAT vendor) will need to account for output tax (or reduce its input tax deductions) where any VAT owing to the creditor is forgiven and the debtor has previously deducted input tax in relation to the supply. The creditor in turn will be entitled to deduct as input tax the VAT amount of any debt forgiven.

6.1.2 The creditor

The creditor will in these circumstances generally only obtain *income tax* relief (deduction) for the debt written off if the loss can be said to have been incurred in the production of the creditor's income. Where a creditor has, for example, provided credit to a debtor in relation to the sale of trading stock, the creditor will be entitled to claim a deduction of any of the amount of the debt that is subsequently forgiven. By contrast, where a capital loan is made, for example, the creditor will only be entitled to claim income tax relief if the creditor is a so-called 'money lender’ – such as a financial institution whose business it is to lend money.

Where the debt forgiven does not qualify for income tax relief, the creditor will be entitled to claim a capital loss for CGT purposes. However, where the debtor and creditor are “connected persons” as defined, any capital loss arising in these circumstances will be “clogged”, that is, may only be set-off against any subsequent capital gain that is derived in consequence of a transaction between the debtor and creditor. This clogged loss may be carried forward.

6.2 Debt for equity swap

A debt for equity swap may be given effect to in two ways. Firstly, the creditor could make a contribution in a kind by exchanging (converting) its debt claims (receivables) for equity (contribution in-kind). Secondly, the creditor could make a capital contribution to the debtor in cash and the debtor would then settle the amount owing to the creditor by utilising the cash received. The following are the tax consequences that arise where either of these approaches is adopted.

(i) Contribution in kind

In a contribution in kind, creditors agree to exchange / convert the debt owing to them into equity capital of the debtor. The tax implications that arise in this instance are complex and unsettled. Our courts have held that where a loan or debt is exchanged (converted) into equity of the debtor, the debtor has derived a benefit as contemplated in the assessed tax loss provision discussed above. Thus, where the debtor has an assessed tax loss and any debt is exchanged (converted) into equity of the debtor, the debtor's assessed tax loss will be reduced by the value of the benefit derived. There is no certainty as to how this benefit is to be valued.

The issue also arises as to whether such a transaction avoids the claw-back (recoupment) provisions discussed above.

As regards CGT, a similar issue arises in that the CGT provisions will only be triggered if it can be said that in consequence of the debt for equity swap the debt owed by the relevant debtor has been “reduced or discharged” for an amount that is less than the “amount by which the face value of the debt has been so reduced or discharged”.

A further CGT issue that arises is: what is the “base cost” of the equity shares acquired by the creditor. In essence, a capital gain / loss is the difference between the “base cost” of an asset, and the proceeds derived in respect of the disposal of the asset. The “base cost” of an asset is, *inter alia*, the amount of expenditure incurred by the taxpayer in acquiring the asset. The creditor would need to be able to demonstrate that it has incurred expenditure in acquiring the debtor's equity shares. While our tax law recognises set-off, the expenditure incurred by the creditor in this instance may or may not be the face value of the debt forgiven.

(ii) Contribution in cash

What is envisaged here is that the creditor will make a capital contribution (subscribe for equity) equal to the face value of the debt. The debtor would then utilise the funds so received to repay the debt owing to the creditor.

The tax implications that arise in these circumstances are controversial.

This approach, it is commonly believed (albeit that there is another opposing view), does not trigger any of the adverse tax consequences discussed above (as payment of the debt will have been made) and provides certainty as regards the “base cost” of the equity shares acquired by the creditor for CGT purposes.

6.3 Debt for debt swap

A creditor may swap the debt owing by the debtor for debt owing to some third party.

As debt will constitute an "asset" for CGT purposes, and the exchange thereof for another asset (debt) trigger a "disposal" of such asset, CGT implications will arise on implementation of the debt for debt swap. However, provided the "base cost" (see above) of the asset (debt) swapped equals the "proceeds" derived in respect of the disposal thereof (the market value of the debt received in consideration for the swap), no actual CGT should be payable. However, if debt with a face value of, say R100 is swapped for debt with a face value (market value) of R80, the creditor disposing of the debt of R100 will incur a capital loss of R20. The new creditor will in turn have acquired debt with a face value of R100, but only have incurred "base cost" of R80 in relation to that debt.

QUESTION 7

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7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

The first issue would be to consider whether the plan triggers any of the adverse income tax consequences discussed above, that is, would the plan result in a reduction in the debtor's assessed tax loss, a claw-back (recoupment) of previously allowed expenditure and / or a CGT liability in the hands of the debtor without any corresponding CGT relief in the hands of the creditor?

Should the proposed plan give rise to any possible adverse tax consequences, I would then recommend that the attorney consider whether any of the so-called corporate rules can be applied so as to provide roll-over relief.

The attorney also needs to consider the VAT implications. These are often over looked as VAT is often thought of as "neutral". Not the case!

QUESTION 8

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8. If the plan includes the methods mentioned above and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

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9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Please see the answers stated in questions (6) and (7).

QUESTION 10

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10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

While there is recognition by the revenue authorities that the tax laws may need to be amended to accommodate the proposed new company law business rescue provisions, nothing has been proposed at this stage.

QUESTION 11

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11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

Yes. See answer to question 10 above.

UNITED KINGDOM

QUESTION 1

1. **Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.**

The law relating to corporate insolvencies is mainly contained in the Insolvency Act 1986 (England and Wales and Scotland), the Insolvency (Northern Ireland) Order 1989 and the Insolvency Rules 1986, the Insolvency (Scotland) Rules 1986 and the Insolvency Rules (Northern Ireland) 1991. In addition, there are scheme of arrangement provisions in the Companies Act 2006 (England and Wales, Scotland and Northern Ireland).

The processes are similar in England and Wales, Scotland and Northern Ireland, but the detail can vary. In particular, property law in Scotland differs from that in the rest of the UK and this can impact on insolvency procedures.

A Company Voluntary Arrangement (CVA) allows a company to enter into a binding arrangement with its creditors. The implementation of the arrangement is overseen by a licensed insolvency practitioner known as a supervisor. A CVA is a flexible process which may be used as a means of business rescue and / or as a mechanism for distributing funds to creditors.

A Scheme of Arrangement (under the Companies Act 2006 Part 26) is a process which enables a company to enter into a binding agreement with its members or creditors or any class of them. The involvement of the court is much greater than with a CVA. In particular, a Scheme of Arrangement must be sanctioned by the court.

Administration is a formal procedure where the affairs, business and property of a company are managed by a licensed insolvency practitioner.

QUESTION 2

2. **Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.**

Company Voluntary Arrangement (CVA)

A CVA is a composition in satisfaction of a company's debts or a scheme of arrangement of its affairs. It typically provides for debts to be partially repaid, but deemed to be settled in full and there is considerable flexibility to the form and content of the arrangement. A CVA cannot however alter the security rights or priority of a secured or preferential creditor without the creditor's consent.

The process starts with a proposal which is made by the directors of the company, unless the company is in administration or liquidation in which case the proposal is made by the administrator or liquidator as appropriate. The proposal sets out the proposed terms of the CVA and must deal with various matters specified in the Insolvency Rules 1986, Rule 1.3. The proposal must include the name and proposed functions of a licensed insolvency practitioner who will act as supervisor of the CVA in the event that it is approved.

At this stage, the directors (or administrator or liquidator) must also have identified a licensed insolvency practitioner to act as nominee. (In an administration or liquidation, the administrator or liquidator will often act as the nominee.) The nominee has a duty to decide whether meetings of the company's creditors and members should be summoned in order to consider and vote on the proposal.

The meetings of creditors and members decide whether to approve the proposal, with or without modifications. The proposal must be agreed by more than 50% in value of the members of the company voting in person or by proxy at their meeting and more than 75% in value of the creditors voting in person or by proxy. If the proposals are accepted by both meetings, the CVA takes effect. If the CVA is accepted only by the creditors' meeting, the CVA may still take effect unless the court orders otherwise on the application of a member.

Once the proposal has been approved, the supervisor monitors the implementation of the proposal. Once the terms of the CVA have been fulfilled, the CVA is completed. The CVA may be terminated (ie, be brought to an end prematurely) if the terms of the arrangement are not being adhered to and or it appears that they cannot be fulfilled.

Scheme of Arrangement

This is a process governed by the Companies Act 2006 (rather than the Insolvency Act 1986) and provides for a company to be able to make a binding arrangement with its members or creditors or any class of them, with the sanction of the court. A scheme of arrangement is sometimes used in conjunction with a reorganisation of the company. Unlike a CVA, the involvement of a licensed insolvency practitioner is not mandatory.

Voting members and creditors of the company are divided into classes and separate class meetings are held. For a scheme to be accepted it must be approved by more than 75% in number and value of the creditors, or class of creditors, or members, or class of members (as the case may be) voting in person or by proxy on the scheme.

Once the scheme has been sanctioned by the court, it is binding on all the creditors or members or class of them, as the case may be.

Administration

Administration is a process which places a company under the control of a licensed insolvency practitioner (the administrator). A company must be insolvent, or be likely to become so, in order to enter administration.

An administrator can be appointed by the company, its directors or creditors and is an officer of the court, even though he may not have been appointed by the court. He is also an agent of the company.

While a company is in administration, there is a moratorium on action by creditors. Broadly speaking, no legal proceedings or other enforcement action can be started or continued without the consent of the administration or the permission of the court.

The purpose of administration is to achieve one of the following three objectives (in hierarchical order):

1. Rescuing the company as a going concern;

2. Achieving a better result for the creditors as a whole than would be likely if the company were wound up (without first being in administration); or

3. Realising property in order to make a distribution to one or more secured or preferential creditors.

The administrator must pursue the first objective (rescuing the company as a going concern) unless he thinks either that it is not reasonably practicable to achieve that objective or that the second objective would achieve a better result for the company's creditors as a whole. The third objective can only be pursued if the administrator thinks that it is not reasonably practicable to achieve either of the first or second objectives.

The administrator is responsible for managing the affairs, business and property of the company while it is in administration and is given wide-ranging statutory powers to do this. These powers include the power to trade the business, sell or otherwise dispose of property of the company, borrow money, grant security over the company's property, establish subsidiaries and to transfer to subsidiaries the whole or any part of the business and property of the company. The administrator can also dismiss and appoint directors and call meetings of shareholders and creditors.

The administrator is required to prepare a detailed statement setting out proposals for achieving the purpose of administration. The proposals must be sent to creditors, shareholders and the Registrar of Companies as soon as reasonably practicable, but in any event within eight weeks of the company being placed into administration.

In some cases the administrator may be required to call a meeting of creditors to vote on the proposals. To be approved, the proposals require the consent of more than 50% in value of eligible creditors voting in person or by proxy on the proposals. It is possible for creditors to propose and vote on modifications to the proposals. If the proposals (with or without modifications) are not approved by creditors, the administrator must report the failure to obtain approval to the court. The court will then decide what should happen, which may include making an order to bring the administration to an end.

In some cases - broadly speaking, those where the administrator thinks either that all creditors will be paid in full or that there will be no funds available for unsecured non-preferential creditors other than by virtue of the prescribed part[1] - the administrator is not required to call a meeting of creditors. In such cases, the proposals are deemed approved once they have been sent out, unless creditors requisition a meeting to consider the proposals.

It should be noted that the administrator is able to exercise all of his powers before the proposals are put to creditors. In particular, it is established in case law that an administrator may, if necessary, sell the business and assets of the company before the proposals are approved.

The appointment of an administrator ceases to have effect at the end of one year from the date of appointment. The administrator's term of office may be extended, before it expires, for up to six months by creditor consent or for a specified period by order of the court.

QUESTION 3

3. Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swaps in their plans?

Lenders in the UK have a wide range of options, which are considered depending on the particular circumstances. Debt forgiveness, debt for equity swaps and debt for debt swaps are all used by banks to assist a company and allow rehabilitation. The tax consequences of these are complex and need to be considered for each case on its own merits.

Recently, we have seen a predominance of debt for equity swaps. Specific tax exemptions exist for debt for equity swaps if structured correctly.

Each of these methods potentially allows a company breathing space from its obligations under loans to build up a more robust financial position.

Debt parking, where the creditor assigns (or sells) its right to receive repayment to another person can apply in the UK. It has recently been seen predominately in a debt buyback situation where a company (or a member of its group) acquires debt from a third party creditor. This can give rise to UK tax implications e.g. a potential risk of a taxable credit in the debtor, and there have been recent changes in UK tax law that have impacted planning to mitigate tax risks (please see question 11 below).

1 The prescribed part is a proportion of floating charge realisations set aside for unsecured non-preferential creditors. It only applies in respect of floating charges created on or after 15 September 2003.

QUESTION 4

4. **Do you have any other methods to decrease existing debt and / or offer relief to the debtor?**

There are no other procedures that are typically used, but there is flexibility for companies to negotiate individual solutions with their creditors.

For example, it is becoming increasingly common for companies in distress to be acquired by its creditor and for groups to buy back debt that is trading on the open market at a discount. There are complex tax provisions that apply to this.

QUESTION 5

5. **Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.**

Yes, tax is frequently a key driver of the restructuring plan. In Liquidations (and Administrations), tax is an expense of the Liquidation (or Administration) and is generally payable in priority to the Liquidators (or Administrators) fees.

The law relating to UK corporate taxes is included in various Acts. These include the Income and Corporation Tax Act 1988 (ICTA), the Taxation of Chargeable Gains Act 1992 (TCGA), sundry Finance Acts (typically issued yearly) and the Corporation Tax Act 2009.

QUESTION 6

6. **What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).**

No tax issues are specifically required to be addressed in the plan. The key focus is to determine whether any steps in the plan give rise to tax charges and whether there is any planning available to mitigate the liability or potential risks.

However, as mentioned above, debt forgiveness, debt for equity swap, or debt for debt swap are common ways of assisting a company that is being rehabilitated.

We have outlined below some of the key tax issues from these transactions.

6.1 Debt forgiveness

A debt forgiveness (or debt waiver) can result in significant tax consequences and particular care is required to avoid triggering a tax charge where no additional cash has been received.

When a debtor is forgiven a debt by a creditor, the debtor will generally be taxed on the release in line with the accounting treatment. However, there are four exceptions:

- The release is part of a statutory insolvency arrangement (e.g. a CVA or scheme of arrangement).

- The release is in exchange for ordinary share capital of the debtor company (see 6.2 below).

- The debtor is in an insolvent insolvency process (insolvent Liquidation, Administration or Administrative Receivership).

- The debt is a connected party debt, irrespective of whether the debt arose as a loan or the debtor has claimed a deduction in computing the profits of a trade or property business. A connected party debt arises between two companies if either controls the other or both are controlled by the same person.

6.2 Debt for equity swap

The release of an inter-company debt in exchange for ordinary shares should not result in a taxable credit arising in the borrower. It is important that the shares are ordinary shares (not preference shares etc.) and the terms of the shares and wording of any legal documents are critical to avoid any unintended outcomes.

However, if equity being issued to a company outside the existing tax group (e.g. a bank), this can break the group for tax purposes and have significant wider impact on the group. For example, it can crystallise previously dormant tax charges (e.g. de-grouping charges that crystallise capital gains when an asset is transferred inter-group and the transferee leaves the capital gains group within 6 years of the transfer), it can prevent tax losses being surrendered to certain group companies that now fall outside the group etc.

If debt is released, there is a tax risk that the release could result in a taxable credit arising in the company. One approach to minimising this risk is to do a DES (in a prescribed manner) which can allow a debt release to be treated as non-taxable if the release is in exchange for the issue of ordinary shares. Under the quasi-DES on the basis the capital contribution is for the issue of shares and there is no release of debt (the debt is repaid) then generally a taxable credit does not arise.

6.3 Debt for debt swap

On a debt for debt restructuring the general rule is that tax treatment follows the debits and credits charged to the accounts. It is therefore critical that the accounting treatment (and accounting standards that will be followed) is determined in advance when the potential tax treatment is being considered.

Care must always be taken that any return on the debt is not linked to the company performance as there are rules that can treat such returns as a dividend and therefore make them non-deductible. This is particularly applicable to rehabilitation scenarios where lenders may build in an "upside" return if the company performance meets certain targets.

6.4 Debt parking

A deemed release of debt can occur where a company acquires a debt from an unconnected creditor and immediately after that acquisition the creditor is connected with the debtor company. This applies by virtue of acquiring shares at the same time as the debt. The deemed release is calculated as the amount that the pre-acquisition carrying value of the debt (being the carrying amount of the liability in the accounts of the debtor adjusted for any accrued amounts) exceeds the consideration which the connected creditor has paid for the debt.

There is an exemption to these rules which could apply where the purchaser of the debt acquired it in an arm's length transaction and the purchasing company was not connected with the debtor at any time during the three year period ending twelve months before the purchase. Debt buybacks often occurred this way through the use of a newly incorporated company to acquire the parked debt. However, this exemption has been addressed through draft legislation that could impact any groups considering a debt buyback on or after 14 October 2009. Please see section 11 below for further details.

QUESTION 7

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7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

We would need to consider:

- The availability of any tax deduction.
- The quantum of any such deduction.
- The timing of any such deduction.
- The type of tax loss generated.

- The income such a loss can shelter.

- If the creditor is a bank or moneylender there are specific rules that they would need to consider.

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

A tax deduction is generally available to a creditor on a debt forgiveness / loan waiver unless:

- The debt is a connected party debt; and

- The creditor company is not in an insolvent process (this is defined and includes Insolvent Liquidation, Insolvent Administration etc.).

A company is only in an "insolvent" process if at the time of appointment its assets were insufficient for the payment of its debts and other liabilities.

On a debt for equity swap or debt for debt swap, creditors not connected pre-swap can generally claim a tax deduction to the extent there is an impairment in the debt. Again, it is important that on a debt for equity swap ordinary shares are issued by the debtor and the wording of the legal documents is critical to avoid any unintended consequences.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

When considering a restructuring from the debtor's perspective, the first issue to consider would be whether the plan could crystallise a tax charge. This can arise in debt restructuring, for example, where there are acquisition of creditor rights by a connected company at an undervalue. In such circumstances this may be treated as a deemed release of a portion of the debt and be taxable on the debtor.

We would also consider whether tax attributes could be lost. For example, if the restructuring resulted in a change of ownership of the group and brought forward trading tax losses could be subject to more stringent conditions for future use.

The tax rules are extremely complex and are generally not drafted to directly address the actions and consequences of a Restructuring. Detailed tax advice should always be sought prior to any actions being undertaken.

When considering a restructuring from a Creditors perspective, consideration must be given as to whether the debtor and creditor could become connected for tax purposes or part of the same tax group e.g. after a debt equity swap. Being connected or part of the same group can have significant tax consequences.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

As noted in section 6 above, new draft debt buy-back rules could affect any groups considering a debt buy-back on or after 14 October 2009.

The current rules are that if debt is purchased at a discount by the debtor, the company will be taxed on the amount of the discount. If debt is purchased at a discount by a company connected with the debtor, the debtor will be taxed on the amount of the discount (under the “deemed release” rules). If the debt buyback fell within the exemption to these rules (and, recent debt buy-backs often occurred in this way) where there was a subsequent release of the debt following its purchase, no profit was brought into account for the debtor (under the connected party rules). A subsequent debt-for-equity swap would also have resulted in a tax-free buy-back.

The intention of the new draft debt buy-back rules is to ensure that any taxable credit arising on a debt buyback will be taxable immediately unless it falls within one of three exemptions. These are:

- Corporate rescue exception – This is only available in situations aligned to HMRC’s policy of “genuine corporate rescues”, by introducing various conditions e.g., must be a change of ownership of the debtor company, and it would have been reasonable to assume the company would have been insolvent but for the debt repurchase.

- Debt-for-debt exception - Where another group company buys back the debt and issues a new debt with same nominal value and “substantially” the same market value as old debt.

- Equity-for-debt exception - Where another group company buys back the debt and issues shares to lender (or another group company issues the shares).

However, there is a provision in the new legislation which means that even if the corporate rescue or debt for debt exceptions apply so that there is no taxable profit, any subsequent release of the debt, will result in the original debtor being taxed on the previously untaxed discount.

Any transactions carried out prior to 14 October 2009 should not be affected by the new changes as the draft legislation contains a grandfathering provision. There are also transitional provisions which may allow transactions entered into after 14 October 2009 and before 31 January 2010 to fall within the previous rules.

This draft legislation was issued on 9 November 2009.

UNITED STATES OF AMERICA

QUESTION 1

1. Please list your country's insolvency related laws (e.g., Chapter 11 of the U.S. Bankruptcy Code) and / or guidelines that facilitate the rehabilitation of distressed companies.[1]

The United States Constitution places bankruptcy under federal jurisdiction. The Bankruptcy Code is located in title 11 of the United States Code. Among other things, the Bankruptcy Code provides for reorganization or liquidation of a company under chapter 11 of the Bankruptcy Code or mandatory liquidation under chapter 7 of the Bankruptcy Code.

QUESTION 2

2. Please give a brief explanation of the above laws and guidelines, especially regarding procedures for creating the plan and requirements for creating and confirming the plan, if any.

The ultimate goal of a debtor-company in chapter 11 is to file and confirm a plan of reorganization or liquidation. A brief description of the plan process is set forth below.

The disclosure statement

A debtor is required to prepare and distribute a disclosure statement prior to solicitation of acceptance of its plan from creditors and equity security holders. The disclosure statement must contain adequate information regarding the assets, liabilities and affairs (income, projections, risks, etc.) of the debtor so as to enable the holder of a claim or interest to make an informed judgment about the proposed plan. It is the equivalent of a proxy statement under the U.S. securities laws and accordingly, is the basis for an exemption from certain aspects of U.S. securities laws for securities issued under a plan.

The plan

During the first 120-days after commencement of the chapter 11 case, only the debtor may file a proposed plan. That period of "exclusivity" may be extended by the court for cause to a date that is not more than 18 months after the date of the filing of the bankruptcy petition. The debtor has an additional 60 days after the filing of its plan to solicit acceptances of the plan from each impaired class of creditors. An impaired creditor is one whose legal rights are altered by the plan, and only impaired creditors may vote on the plan.

[1] The answers to questions 1 and 2 were provided by David F Heroy of Baker & McKenzie Chicago office.

If the debtor fails to file a plan within the fixed deadline, or if the plan is not accepted by the creditors within the deadline for soliciting acceptances, the debtor loses exclusivity and any party in interest may file its own plan.
The typical time from the filing of a chapter 11 case to confirmation of a plan is 18 months and sometimes up to two years or more in cases where the debtor's exclusive period has expired and competing plans are at issue.
This time can be shortened significantly with the use of a "prepackaged plan," discussed below.

Contents of a plan

A proposed plan must meet certain minimum requirements. For example, it must:

(a) designate all classes of claims and interests (substantially similar claims or interests must be categorized in the same class),

(b) specify which classes are impaired and not impaired,

(c) specify which classes are entitled to vote (only impaired classes are entitled to vote),

(d) specify the treatment of all classes,

(e) treat all members within a class equally,

(f) provide adequate means to implement the plan, and

(g) not contain any provisions that violate the Bankruptcy Code.

Plans can provide for a financial or operational overhaul of the debtor's business that includes sales of assets, modification or refinancing of secured and unsecured debt, assumption or rejection of contracts, releases in favor of the debtor's board of directors, management and professionals, amendments to the debtor's corporate charter, the cancellation of existing stock and issuance of new stock, and the swapping of debt for equity. If the debtor's business has been sold before a plan has been proposed, it can provide for distribution of the proceeds in a plan of liquidation.

Pre-packaged plans

Pre-packaged plans can provide a debtor the significant advantages of a chapter 11 case without the protracted delay and substantial expense often associated with a typical bankruptcy case. Usually, the plan and disclosure statement are filed immediately upon commencement of the chapter 11 case, after the debtor has solicited and obtained the necessary class acceptances that are then used at an expedited plan confirmation hearing typically held within 30 to 90 days of filing.

In a pre-packaged chapter 11 case the prospective debtor can negotiate the terms of a plan, acceptances and rejections before commencing a chapter 11 case. Typically, a committee of creditors is formed and counsel is retained to represent those creditors and negotiate the terms of the plan. The debtor may form more than one committee, for example one for bondholders and another for trade vendors. Once committee support is secured, the plan and disclosure statement are sent to impaired classes of creditors for approval with the support and recommendation of the committees. Pre-packaged plans can be utilized to obtain the approval of all classes but one or two rejecting classes that then could be "crammed down" (see discussion below) on an expedited basis.

Confirmation of the plan

In order for the bankruptcy court to confirm the proposed plan, a debtor must meet all of the requirements of section 1129 of the Bankruptcy Code. These requirements include establishing that:

(a) at least one impaired class has accepted the plan (without counting "insiders") and with respect to any non-accepting class, the requirements for a "cram-down" have been met (see below);

(b) that the plan meets the "best interests of creditors test" which requires in essence that each impaired class has either accepted the plan or receives no less than it would receive in a liquidation under chapter 7;

(c) that the plan is feasible (not likely to be followed by a liquidation or need for further reorganization);

(d) that the plan was proposed in good faith; and

(e) that the plan does not violate any provisions of the Bankruptcy Code.

Voting on the plan

With respect to an impaired class of creditors, the class is deemed to accept a plan if voting creditors that hold more than two-thirds in dollar amount and more than one-half in number of the claims in the class vote to accept the plan, excluding any votes not solicited or cast in good faith, as determined by the court on request of any party in interest.

Cram-down

Provided all of the requirements set forth in section 1129 of the Bankruptcy Code are met, the bankruptcy court may confirm a plan notwithstanding the rejection of the plan by one or more classes of impaired creditors provided the court determines the plan "does not discriminate unfairly" and is "fair and equitable" with respect to each impaired class that has not accepted the plan.

"Does not discriminate unfairly" generally means that similarly situated creditors must be treated similarly. For example, the treatment of general unsecured creditors must provide generally equivalent value for the rejecting, "crammed-down" class as for the other classes of general unsecured creditors.

The "fair and equitable" test for a plan cram-down differs for secured creditors, unsecured creditors, and equity holders. As the test is applied to unsecured creditors and equity holders, it requires that the class receives property of a value equal to the allowed amount of their claims or that junior classes or

interests receiving nothing on account of their claims or interests under the so called "Absolute Priority Rule" (discussed below).
With respect to secured creditors, the "fair and equitable" test generally requires that the creditor keep its lien, receive deferred cash payments totaling at least the allowed amount of its lien claim; and as of the effective date of the confirmed plan, the value of the payments to be made must have a present value equal to at least as much as the secured creditors' interest in the collateral. A plan may also be deemed fair and equitable with respect to secured creditors if it provides for deferred cash payments having a present value equal to the creditors' allowed secured claim within a reasonable time after confirmation of the plan (for example, from a proposed sale of assets contemplated in the plan).

The absolute priority rule

The absolute priority rule has been part of American bankruptcy jurisprudence since the Bankruptcy Act of 1898. To summarize, if a class is impaired and votes against confirmation of a proposed plan, then the class must be paid in full (including unpaid accrued interest), before any junior class of claims or interests may receive anything of value under the plan.

Accordingly, in cases where "old equity" wishes to retain an interest in the reorganized debtor despite paying creditors less than the full amount of their claims, the absolute priority rule can pose significant challenges. Under those circumstances, old equity holders must argue that a "new value exception" to the absolute priority rule applies and establish the following at confirmation:

- that they are making a new contribution in money or money's worth;
- that the contribution is reasonably equivalent to the value of the interest retained in the reorganized debtor; and
- that the new value contribution is necessary for implementation of a feasible plan of reorganization.

The effect of plan confirmation

Once the plan is confirmed by the bankruptcy court and becomes effective in accordance with its terms, the debtor's assets and liabilities are subject to the terms of the plan and all creditors and parties in interest are bound to the terms of the plan, regardless of whether they voted for the plan. Typically, the bankruptcy court retains jurisdiction to enforce the terms of the plan and resolve any disputes arising from the plan or that impact distributions to be made under the plan.

If a plan is not confirmed the debtor and/or other parties in interest may seek to propose an alternative plan, as the debtor's exclusive period to propose a plan will likely have lapsed by this point. Parties may also seek to convert the case to a chapter 7 mandatory liquidation if there is no reasonable prospect of reorganization.

QUESTION 3

3. **Is it common in your country for companies to use a method such as debt forgiveness, debt for equity swap, or debt for debt swap in their plans?**

Yes, one or all of these may be part of debt reorganization.

QUESTION 4

4. **Do you have any other methods to decrease existing debt and / or offer relief to the debtor?**

Yes. It is common for lenders and debtors to modify existing loan agreements to prevent a current default by the debtor. This may include a temporary waiver of certain covenants, an extension of the maturity date and / or a change in payment schedule. These modifications, however, often require the debtor to pay a fee, and may be accompanied by new covenants, higher interest rates and / or borrowing restrictions. These types of modifications may, under certain circumstances have significant federal income tax effects. These effects are further described in question 6.

QUESTION 5

5. **Do you consider tax issues when you create your plan? If the answer is 'yes,' please list the names of the tax law which you consider. If the answer is 'no,' please let us know why you do not have to consider tax issues.**

Yes. We consider the Internal Revenue Code (IRC). The rules in the IRC are interpreted by regulations issued by the Treasury Department (Regulations). Various state law statutes must also be considered in conjunction with the IRC (which is a compilation of federal statutes).

QUESTION 6

6. What are the issues (e.g., tax risks, benefits, tips for overcoming disadvantageous tax treatments) considered in the plan? Please include the tax treatment for the debtor when the plan includes methods indicated in the above questions (3) and (4).

6.1 Debt forgiveness

Debt forgiveness will result in a taxable discharge of indebtedness or "cancellation of debt" (COD) income to the debtor. Pursuant to the IRC and regulations issued to interpret the IRC, a taxpayer must generally recognize income on the discharge of indebtedness. Although "discharge of indebtedness" is not specifically defined by statute, case law has determined that the retirement of debt for less than its principal amount constitutes income to the debtor corporation (*U.S. v Kirby Lumber*, 284 U.S. 1 (1931)). Indebtedness includes any debt for which the taxpayer is liable or indebtedness subject to which the taxpayer holds recourse property. This includes expenses accrued (and deducted) by the company and accrued interest on debt which it is relieved from paying as a result of the debt forgiveness. Generally, the amount of COD income will be the stated principal amount of the debt forgiven. However, if the indebtedness in question was issued for less than its stated redemption price at maturity (*i.e.* debt with "original issue discount"), the amount of COD income will be determined based upon the issue price, adjusted for accrued original issue discount, instead of the stated principal amount. The IRC contains special rules relevant to debt restructuring transactions between members of a US consolidated group; the discussion below does not address such rules but rather focuses primarily on the rules relevant to transactions between debtors and creditors and that are not members of the same US consolidated group. Additionally, the discussion below does not identify special state tax rules that may be different from the relevant federal tax rules.

6.2 Repurchase at a discount

In the past, instead of receiving outright forgiveness of its debt from a creditor, a debtor would have a related party repurchase the debt from an unrelated creditor at a discount, effectively retiring that debt. The IRC now treats this as a repurchase by the debtor itself (IRC Section 108(e)(4)). This rule also applies to a so called "indirect acquisition," that is, when indebtedness is acquired by a holder in anticipation of becoming related to the debtor. Indirect acquisitions fall under this rule when the creditor becomes related to the debtor within six months of the acquisition of the debt, or in certain other "abusive" situations.

In a direct or indirect acquisition at a discount, the debtor's COD income is measured by reference to the amount of the holder's adjusted basis in the debt, which is generally the holder's purchase price for the debt. However, in an indirect acquisition where the debt is not acquired within six months of the acquisition date, the COD income is measured by reference to the fair market value of the indebtedness on the acquisition date.

The IRC has an intricate set of rules for determining who is “related” for purposes of Section 108(e)(4). These rules must be carefully applied to the facts of each situation.

6.3 Capital contribution of debt / debt for equity swap

If a shareholder of a corporation acquires outstanding debt of that corporation at a discount and Section 108(e)(4) (discussed immediately above) does not apply, the debtor corporation could still recognize COD income upon a subsequent capital contribution of that debt by the shareholder to the debtor corporation if the shareholder’s cancelling of the debt is related to its status as a shareholder.

The result of a shareholder / creditor contributing debt to the debtor corporation depends on whether the debtor issues stock in exchange for the debt contributed. When a corporation acquires its own debt as a contribution to capital (*i.e.,* no stock is issued to the contributing creditor), the debt is generally deemed satisfied (for purposes of computing the debtor corporation’s COD income) for an amount of money equal to the holder’s adjusted basis in the debt. (IRC Section 108(e)(6)). However, if the debtor corporation issues stock to a creditor in satisfaction of the debt, the debt will generally be deemed satisfied for an amount of money equal to the fair market value of the stock issued.

6.4 Debt for debt exchange

A financially distressed company may seek to renegotiate the terms of its debt with creditors. If the changes made to the terms of the debt are significant, the modification of debt may be treated as if the debtor issued a “new” debt instrument in cancellation of the “old” debt instrument (*i.e.*, debt for debt exchange) (IRC Section 1001). A modification which is deemed an exchange is a “taxable” transaction to both the debtor (*i.e.*, cancellation of indebtedness income can arise) and the creditor, unless a nonrecognition provision applies.

The IRC does not define what constitutes an “exchange” of property, but there is an extensive body of case law and Regulations that provide guidelines for determining when a modification will be considered an exchange of old debt for new debt. Under the Regulations, an alteration of the terms of a debt instrument is first tested to determine whether the change to the instrument is a “modification.” Once it has been determined that there is a modification, the modification is tested to determine whether it is a “significant modification.”

In general, the regulations provide that a modification occurs when there is an alteration of a legal right or obligation of the holder or issuer. However, an alteration occurring pursuant to the original terms of the instrument is generally not a modification, provided that the exercise of the waiver is unilateral.

Once a modification of a debt instrument has been deemed to have occurred, the taxpayer must determine if the modification is significant. A modification is significant only if, based on all the facts and circumstances, the legal rights or obligations being changed and the degree to which they are being changed are economically significant. A series of related modifications, each of which independently is not significant, may together constitute a significant modification.

The Regulations also contain the following specific rules for determining whether certain modifications are significant. These more specific rules cover, for example, changes in yield (including those resulting from the payment of modification fees to the lender), timing/amount of payments, obligor or security, the recourse nature of the debt.

If a significant modification has occurred, it will be viewed as a debt-for-debt exchange. For purposes of determining the amount of COD income arising in a debt-for-debt exchange, the debtor is treated as having satisfied the old debt instrument with an amount of money equal to the issue price of the new debt instrument.

If either the old debt or new debt is considered publicly traded, the issue price of the new instrument is the instrument's fair market value. The regulations have a broad definition of "publicly traded." It includes not only situations in which a debt instrument is traded on an established securities market but also situations in which the debt instrument is quoted by identifiable brokers on a quotation medium and other circumstances in which quotes on the debt instrument are readily available.

If, however, neither the old nor the new debt instrument is considered publicly traded, the issue price of the new debt will be its stated principal amount, provided the coupon rate of the new debt instrument is at least equal to the Applicable Federal Rate (AFR).

If a modification has been deemed to occur, the debt will also need to be tested to see whether it is still properly considered to be debt (as opposed to equity), and whether certain limitations on the deductibility of interest paid on the debt will apply. In addition, since the new debt will have an issue price that is less than the stated redemption price of the debt at maturity, it will likely be considered to have original issue discount (OID) equal to the difference between those two amounts. OID accrues over the life of the instrument creating an interest deduction for the issuer and an interest inclusion for the creditor. The interest amounts arising from OID may also be subject to limitations on deductibility.

6.5 Potential exclusion of COD

Relief is often available to a company if a discharge of indebtedness occurs in a title 11 bankruptcy case or when the company is insolvent. Congress prefers that financially troubled companies continue to operate rather than liquidate. In order to provide a "fresh start" to these companies, Congress provides for the deferral of tax liability resulting from the recognition of COD income. This deferral is accomplished by an exclusion of COD income from gross income and a corresponding reduction in certain tax attributes of the debtor corporation that otherwise could be used to offset future taxable income.

Pursuant to IRC Section108, COD income is excluded from gross income in full if the discharge of indebtedness is granted by or pursuant to a plan approved in a title 11 bankruptcy proceeding. If the company is not in a title 11 proceeding but is insolvent, IRC Section 108(a)(3) allows for a company to exclude the amount of discharge of indebtedness from income, but only to the extent of the taxpayer's insolvency. For tax purposes, insolvency is determined immediately before the discharge of indebtedness and is based on a balance sheet test – the excess of liabilities over the fair market value of assets. Fair market value includes intangible assets (including goodwill or going-concern value). Contingent liabilities are typically excluded for tax purposes until it can be shown that the taxpayer will likely be called on to pay the liability.

In order to recoup the loss in revenues caused by the current exclusion of COD from income, a company must reduce certain tax attributes that would otherwise be carried forward or that would generate deductions to offset future income. Taxpayers must reduce their attributes by the amount of COD income excluded from gross income after the determination of tax for the taxable year of discharge. If the amount of discharged debt excluded from income exceeds the tax attributes of a company in bankruptcy, the excess amount will permanently be excluded from taxation. This is also true with respect to insolvent taxpayers, except to the extent they become solvent during the debt restructuring.

6.6 Temporary election to defer COD recognition

Section 108(i), enacted in February of 2009, provides a temporary election that taxpayers can use to defer the recognition of all or a portion of the COD realized upon the "reacquisition" of certain debt instruments after December 31, 2008 and before January 1, 2011 (the "COD Deferral Election"). For repurchases occurring in 2009, any COD deferred is recognized as taxable income by the taxpayer ratably over the five years beginning in the fifth taxable year after the acquisition occurs (*i.e.*, beginning in 2014 for a calendar year taxpayer). For repurchases in taxable year 2010, the income is taken into account ratably over the five years beginning with the fourth taxable year after the repurchase (*i.e.,* also beginning in 2014 for a calendar year taxpayer).

The term "reacquisition" includes not only the purchase of the debt by the issuer, but also the exchange of the debt instrument for another debt instrument, including a deemed exchange resulting from a significant modification. If a taxpayer elects the COD Deferral Election, any resulting OID deductions are deferred for the same period of time as the COD is deferred for.

A taxpayer that avails itself of the COD Deferral Election may not also avail itself of the bankruptcy or insolvency exceptions to the inclusion of COD in gross income with respect to the portion of COD that it chose to defer. However, with the availability of a partial election, a taxpayer may balance the amount of COD it chooses to defer, and how much it would like to remain eligible for exclusion.

QUESTION 7

7. If you were the creditor's attorney, what kind of issues would you mainly consider when deciding whether to approve or reject the plan regarding tax issues?

An understanding of the tax consequences for creditors is extremely important if the financially troubled company wishes to obtain the cooperation of creditors in the restructuring. Also critical from a continuing creditor's perspective (whether continuing as a creditor or shareholder of the company) is the impact of the plan on the debtor's tax attributes, as discussed below. Hence, prospective modeling of a debtor's post-restructuring cash taxes costs can be critical.

Consequences of a taxable exchange to a creditor

Debt swaps will be "taxable" in nature if either the old or new debt instrument does not qualify as a "security." A creditor will recognize gain or loss on the exchange equal to the difference between the adjusted issue price of the new debt plus the fair market value of other property received as compared to the creditor's adjusted basis in the old debt.

The courts apply a facts-and-circumstances approach to determine whether a debt instrument is a "security." The landmark decision, *Camp Wolters Enterprises Inc. v. Commissioner* 22 T.C. 737 (1954) held that "Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation, and continuing interest… compared with the similarity of the note to a cash payment." Generally, a debt instrument with a maturity of 10 years or more will qualify as a "security," whereas a debt instrument with less than 5 years may not qualify as a "security," but this rule should not be applied in all situations. Each fact pattern must be examined independently to determine whether the instrument in question constitutes a security.

Consequences of a tax-free exchange to a creditor

An exchange of an old debt instrument for new debt pursuant to a plan of reorganization can qualify as a tax-free recapitalization (*i.e.,* a Type "E" reorganization) if both the old and new debt instruments qualify as a "security."

In a tax-free recapitalization, typically the creditor recognizes no gain or loss on the exchange but may recognize taxable income to the extent accrued but previously unpaid interest is satisfied by the debtor corporation. If property other than stock or securities of the debtor (boot) is received in the exchange, creditors may be required to recognize gain. The amount of gain recognized is equal to the lesser of gain realized in the exchange (*i.e.,* any gain inherent in the old debt) and the fair market value of the boot received. The excess of the principal amount of a new security received over the principal amount of the old security surrendered (if any) is generally treated as boot to a creditor. (IRC Section 354).

A creditor will take a substituted tax basis in a new debt instrument equal to the tax basis in the old debt instrument when the new debt is received in exchange for the old debt pursuant to a tax-free reorganization. However, where boot is also received, the boot will take a fair market tax basis and the new debt instrument's substituted tax basis will be (1) decreased by such amount allocated to the boot and (2) increased by any gain recognized by the creditor in the exchange. (IRC Section 358)

QUESTION 8

8. If the plan includes the method mentioned in the above questions (3) and (4) and the plan is confirmed by the court or executed by the debtor, does the creditor have any tax advantage? If yes, please list the names of relevant laws and their advantages for creditors.

No.

QUESTION 9

9. Please tell us other pitfalls and / or loopholes regarding tax issues you should consider when you create a plan for the debtor or when you represent a creditor.

Debtor's considerations

Bankrupt companies are provided relief from COD income at the cost of a reduction in tax attributes as set forth in IRC Section 108(b). The first attribute reduced pursuant to the ordering rules is any net operating loss (NOL) carryforward. Generally, if a corporation generates taxable income from operations or from the sale of the company's business assets, any NOL for the current year (arising from other sources), as well as any NOL carry-forward from prior years is available to offset the income generated. However, the availability of NOL carry-forwards may be limited in two situations: (1) the NOLs have been completely eliminated as a result of the attribute reduction arising from avoiding COD income in bankruptcy or insolvency (discussed above); or (2) the company undergoes or has undergone an "ownership change."

IRC Section 382 imposes an annual limitation on the utilization of NOLs after a corporation undergoes an "ownership change." An ownership change occurs if immediately after any "owner shift" or an "equity structure shift," the percentage of stock of the loss corporation owned by one or more 5 percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or any predecessor) owned by such shareholder(s) at any time during the testing period. In general, the identification of 5 percent shareholders, the determination of each shareholder's percentage ownership, and the computation of the aggregate increase in percentage ownership is made by reference to the fair market values of each class of stock or other equity interest on each testing date. The "testing period" is generally defined as the three-year period ending on the testing date. A testing date arises any time an "owner shift" or "equity structure shift" occurs. An "owner shift" is any change in the respective ownership of stock held by a 5 percent holder before or after the change. A 5 percent shareholder can be any individual, a public group, or entity. An "equity structure shift" is generally defined as tax-free reorganization governed by § IRC 368, other than a divisive Type "D," a Type "G" or a Type "F" reorganization.

If an ownership change and a debt restructuring occur simultaneously during a year, the Regulations provide an election that allows the company to allocate income for the year based on a closing of its books, so that COD income can often be treated as prechange income.

The annual limitation on the use of pre-ownership change losses is generally equal to the value of the loss corporation before the ownership change multiplied by the long-term tax-exempt debt rate. The value of a loss corporation for purposes of computing the annual limitation is generally the fair market value of the corporation's stock immediately before the ownership change. The valuation of the loss corporation includes "plain vanilla" preferred stock, even though such classes of stock are not considered when testing for an ownership change.

As stated above, any NOLs that survive the attribute reduction may be further limited by the IRC Section 382 limitation if an ownership change occurs in the debt restructuring. Creditors are generally deemed to acquire control of an insolvent or bankrupt company no earlier than the time a bankruptcy court confirms a plan of reorganization. Under the Regulations, the confirmation of a plan in bankruptcy is seen as creating an option which is not deemed exercised for purposes of determining a IRC Section 382 ownership change until the time the plan becomes effective. As such, the IRC Section 382 ownership change resulting from an exchange of stock for debt pursuant to a confirmed bankruptcy plan occurs on the effective date of the plan.

Special rules for corporations in chapter 11 bankruptcy

IRC Section 382(l)(5) and 382 (l)(6) provide two special NOL limitation rules that allow distressed companies in Chapter 11 bankruptcy limited use of their NOLs following an ownership change. The rules of IRC Sections 382(l)(5) and 382 (l)(6) are mutually exclusive, thus if the requirements of IRC Section 385(l)(5) are not met or the loss corporation elects out of the rule, Section 382(l)(6) applies.

IRC Section 382(l)(5) sets forth a special exception to the IRC Section 382 limitation if the distressed company's shareholders and qualified creditors own at least 50 percent (value and voting power) of the loss corporation stock (or stock of a controlling corporation also in bankruptcy) immediately after an ownership change as a result of being shareholders or qualified creditors immediately before the change. In such case, in lieu of the annual IRC Section 382 limitation, the loss corporation's NOL and other attributes are scaled back for two items and the residual tax attributes can be used without limitation. The NOL is reduced for interest deducted in the year in which the ownership change occurs on or before the change date and in the prior three taxable years with respect to debt exchanged for stock pursuant to the bankruptcy reorganization. Additionally, the NOL is reduced by the COD excluded by virtue of the attribute reduction rules as discussed in question 6.4.

A “qualified creditor” is defined as the beneficial owner, immediately before the ownership change, of qualified indebtedness of the loss corporation. Indebtedness is “qualified” if it (1) has been owned by the same beneficial owner for the 18 months prior to the date of bankruptcy filing or (2) arose in the ordinary course of the loss corporation’s trade or business and has been held by the creditor at all times. The applicability of the special bankruptcy exception is often an issue because of the uncertainty of whether creditors receiving stock in the plan of reorganization qualify as historic and continuous creditors. This concern is most evident where the debt is publicly traded and there is active trading. Because of the problem of identifying ownership of widely-held debt, this provision may be unavailable for loss corporations with significant amounts of publicly held debt.

In determining ownership of indebtedness, a special rule allows a loss corporation to treat indebtedness not owned by the original creditor as still being owned by a qualified creditor if the beneficial owner is not, immediately after the exchange of stock for debt (1) a 5 percent shareholder or (2) an entity through which a 5 percent shareholder owns an indirect ownership interest in the loss corporation.

Generally, upon a bankruptcy filing by a debtor corporation, many unsecured creditors of the debtor corporation seek to sell their claims against the debtor in an attempt to reduce possible future losses. However, the selling or trading of claims prior to the ownership change can jeopardize the potential benefits afforded by IRC Section 382(l)(5) in that it may eliminate qualified creditor status (i.e. those purchasing claims from the original creditors prior to the ownership change are not considered qualified creditors immediately before the ownership change for purposes of IRC Section 382(l)(5), unless the special rules in the preceding paragraph apply). Where significant amounts of NOL are at issue, debtors may attempt to prohibit or restrict the trading of claims among large creditors who would become 5 percent-or-more shareholders in the bankruptcy reorganization.

While the Bankruptcy Code does not expressly provide a method to prohibit the trading of claims, it may be within the power of the court to prohibit such trading in the interest of preserving a valuable asset of the debtor’s estate in the form of a NOL carry-forward. Under 11 USC § 105, the court has the authority to enjoin actions that threaten the integrity of a debtor’s estate. Additionally, pursuant to the same rule, the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of title 11.

The Court of Appeals for the Second Circuit has held that a debtor’s NOL carry-over is valuable property of the bankruptcy estate protected by the automatic stay provisions of the bankruptcy code and the court’s broad equitable and injunctive powers (*See* Jean Morris, *Imposition of Transfer*

Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case to Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend, 77 Am. Bankr. L.J. 285,289 (2003). Although there are no published opinions where a court has enjoined the transfer of a creditor's claim (as opposed to an interest holder's stock) to preserve a possible NOL, it appears the bankruptcy courts routinely are issuing such injunctions with regard to both debt and equity securities in unpublished orders.

The least restrictive approach to this issue is to establish a procedure by which the debtor corporation may continuously monitor claims trading and preserve its ability to seek injunctive relief until such time as it appears that additional trading could jeopardize the NOL. Additionally, the debtor may seek an agreement with the creditors to achieve the same result.

As with claims trading, the debtor corporation with significant NOL carry-overs may attempt to prohibit or restrict the trading of its stock for the two-year period following the effective date of the bankruptcy plan to prevent an ownership change. As stated above, if a corporation experiences an ownership change within two years of the effective date of the plan its annual IRC Section 382 limitation (and therefore its NOL) is reduced to zero.

IRC Section 382(l)(6) governs the determination of the annual limitation in a title 11 or similar case where the special rules of Section 382(l)(5) do not apply either expressly or by election. General Section 382 provisions provide that the equity value of a loss corporation is the value of its stock immediately before the ownership change for purposes of computing the IRC § 382 limitation. Under IRC Section 382(l)(6), the equity value of the corporation may be increased to reflect any increase in value due to the conversion of debt into stock (debt for equity swap) by reason of a bankruptcy reorganization. Treasury Regulations under IRC Section 382(l)(6) provide that the value of a loss corporation will be the lesser of (1) the value of the stock corporation's stock immediately after the ownership change (the "stock value" test) or (2) the value of the corporation's assets (determined without regard to liabilities) immediately before the ownership change (the "asset value" test).

The purpose of this rule is to allow an increase in the value of a loss corporation's stock due to a conversion of debt into stock, both directly through the issuance of stock in exchange for debt and indirectly when stock is issued for cash and the cash is used to retire debt.

The tax consequences of using IRC Section 382(l)(5) versus IRC Section 382(l)(6) should be evaluated in light of the particular facts and circumstances. Assuming both are available, certain comparisons are noteworthy. First, the annual IRC § 382 limitation is a limitation on the future use of tax attribute utilization (assuming taxable income in the future) whereas IRC Section 382(l)(5) reduces tax attributes but does not limit the future rate of NOL utilization. Second, the drawback of Section 382(l)(5) is that, unlike the general § 382 limitation, it imposes a § 382 limitation of zero if there is a second ownership change within two years of the first ownership change.

For discussion of creditor considerations see the answer to question 7.

QUESTION 10

10. Do you have any opinion regarding tax treatment that can or will be included in tax laws in your country in the future which might facilitate rehabilitating companies in your country?

No.

QUESTION 11

11. Do you expect any changes in tax treatment regarding rehabilitating distressed companies in your country in the near future?

No.

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