KIRKLAND **ALERT**

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IRS Rules Foreign Debt Discharge Excluded From Income if Recognized Under Chapter 15

In a private letter ruling obtained by Kirkland & Ellis LLP that is expected to be made public in February, the Internal Revenue Service has ruled for the first time that a debtor need not recognize as taxable income any cancellation of indebtedness income ("CODI") realized on debt cancelled via a non-U.S. bankruptcy proceeding. Under the facts of this ruling, a foreign taxpayer with U.S. operations realized CODI that could have been taxable in the United States. The debt was cancelled in a foreign bankruptcy proceeding, and that cancellation was then recognized in the United States by a proceeding under Chapter 15 of the U.S. Bankruptcy Code. Since Chapter 15 was enacted, tax practitioners have wondered whether Chapter 15 recognition would qualify a taxpayer for the "bankruptcy" exception under section 108 of the Internal Revenue Code. This ruling answers that question and provides yet another reason why taxpayers engaged in multinational operations that are involved in any sort of non-U.S. restructuring or insolvency proceeding should consider seeking recognition of such proceeding by a U.S. Bankruptcy Court under Chapter 15.

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While CODI is typically taxable to a borrower, Section 108 of the Internal Revenue Code provides that a taxpayer may exclude CODI if either (a) the cancellation occurs under the U.S. Bankruptcy Code, or (b) the amount of the CODI does not exceed the amount of the taxpayer's insolvency. The insolvency exception is frequently inadequate, because it is often uncertain whether the amount of the CODI exceeds the amount of the debtor's insolvency. As a result, taxpayers often seek to ensure that the CODI occurs in a bankruptcy case.

Chapter 15 is a provision of the Bankruptcy Code that provides for the efficient recognition of a foreign insolvency proceeding for U.S. purposes without requiring a costly and duplicative full-blown U.S. reorganization under Chapter 11. With Chapter 15 a debtor can negotiate a reduction of its debt obligations in a foreign proceeding and, so long as the foreign proceeding provided sufficient substantive and procedural protections to creditors, the foreign proceeding can be recognized by the U.S. court and the U.S. assets of the debtor will be protected from any creditors trying to circumvent the terms of the foreign restructuring. In its ruling, the IRS confirmed that a U.S. Bankruptcy Court's recognition and approval under Chapter 15 of a plan implemented in a foreign proceeding, even after the fact, meant that any CODI that arose pursuant to the restructuring was "pursuant to a plan approved by the court" and, therefore, eligible for exclusion under the bankruptcy exception of Section 108.

Private letter rulings do not constitute binding precedent and may only be relied upon by the taxpayers to whom they are issued. Nevertheless, this private letter ruling should provide comfort to U.S. taxpayers whose debt is cancelled in a foreign proceeding and who subsequently seek recognition of such proceeding under Chapter 15.

If you have any questions regarding the private letter ruling, Section 108 or Chapter 15 please contact the following Kirkland authors or your regular Kirkland contact:

James H.M. Sprayregen, P.C.
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/jsprayregen
+1 (312) 862-2481

Todd F. Maynes, P.C.
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/tmaynes
+1 (312) 862-2485

Adam Paul
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/apaul
+1 (312) 862-3120

Thad W. Davis
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/tdavis
+1 (312) 862-7013

Kon M. Asimacopoulos
Kirkland & Ellis International LLP
30 St Mary Axe
London EC3A 8AF
www.kirkland.com/kasimacopoulos
+44 20 7469 2230

Dr. Leo Plank
Kirkland & Ellis International LLP
Maximilianstrasse 11
80539 Munich
www.kirkland.com/lplank
+49 89 2030 6070

Neil McDonald
Kirkland & Ellis LLP
26th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
www.kirkland.com/nmcdonald
+852-3761-9111

Jeffrey D. Pawlitz
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/jpawlitz
+1 (312) 862-7347