



Weil

Tax in Distressed Situations
UNITED STATES

The consequences and treatments described herein relate solely to U.S. federal income tax consequences and do not purport to address state or local income tax consequences.

GENERAL

1. Does debt have a specific meaning for tax purposes?

The classification of an instrument as debt or equity affects numerous US tax law provisions. Some provisions of the relevant US tax law may expand what constitutes "equity." There are many cases that have established a list of factors that assist taxpayers in making a determination as to whether an instrument is "debt" or "equity" for US tax purposes.

These factors include but are not limited to:

- *Name or label:* The issuance of a stock certificate indicates an equity contribution; the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness;
- *Fixed maturity date:* The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same would indicate that repayment was in some way tied to the fortunes of the business, indicative of an equity advance;
- *Source of payments:* If repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital but if repayment is not dependent upon earnings, the transaction is indicative of a loan to the corporation;
- *Right to enforce payments:* The presence of creditor rights favors loan treatment;
- *Participation in management (as a result of the advances):* If a stockholder's percentage interest in the corporation or voting rights increase as a result of the transfer, it will contribute to a finding that the instrument is equity;
- *Status in relation to regular corporate creditors:* Whether the advance has a status equal to or inferior to that of regular corporate creditors is of some import in any determination of whether taxpayer is dealing as a shareholder or a creditor;
- *Intent of the parties:* It is relevant whether the parties intended, at the time of the issuance of the instrument, to create a debtor-creditor relationship. The intent of the parties, in turn, may be reflected by their subsequent acts; the manner in which the parties treat the instrument is relevant in determining its character;
- *Identity of interest between creditor and stockholder:* Advances made by stockholders in proportion to their respective stock ownership is often cited in support of equity treatment in combination with other factors. A sharply disproportionate ratio between a stockholder's percentage interest in stock and debt is, however, strongly indicative that the debt is bona fide;
- *Thinness of capital structure in relation to debt:* Thin capitalization is very strong evidence of a capital contribution where (1) the debt to equity ratio is initially high, (2) the parties realized the likelihood that it would go higher, and (3) substantial portions of the funds are used for the purchase of capital assets and for meeting expenses needed to commence operations;
- *Ability of corporation to obtain credit from outside sources:* If a corporation is able to borrow funds from outside sources at the time an advance is made, the transaction has the appearance of a bona fide indebtedness. If no reasonable creditor would have loaned funds to the corporation at the time of the advance, an inference arises that a reasonable shareholder would likewise not so act;
- *Use to which advances were put:* A corporation's use of cash advances to acquire capital assets or to expand its operations, e.g., by acquiring an existing business, is also often cited in support of equity treatment in combination with other factors;
- *Failure of the debtor to repay:* The failure of a corporation to repay principal amounts on the due date and a lender's failure to pursue creditor-like remedies in the face of such failure to repay, together, raise the specter that an instrument may be treated as equity; and
- *Risk involved in making advances:* A reasonable expectation of repayment by the provider of an advance when the advance is made suggests that the advance is debt.

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The US Internal Revenue Code of 1986, as amended (the “**Code**”), also grants to the US Department of the Treasury (the “**Treasury**”) broad regulatory authority to classify corporate instruments as either US debt or stock. Treasury finalized regulations in 2020. The relevant “debt/equity” regulations provide that the IRS may recast related-party debt instruments as equity interests in certain circumstances. These regulations focus on covered debt instruments issued between members of the same “expanded group”, which is defined as a group of corporations connected through stock ownership with a common parent corporation if the parent owns directly or indirectly 80 percent vote or value of at least one of such other corporations and 80 percent vote or value of each of such other corporations is owned directly or indirectly by such group of corporations. Certain exceptions apply to the application of these rules, including issuances by foreign corporations or certain issuances by cash pool headers.

2. Do derivatives have a specific meaning for tax purposes?

While derivatives do not have a specific meaning for US tax purposes, a derivative is generally understood to be a financial instrument or other contract that derives its value from an underlying asset, index or interest rate. Derivative taxation can vary widely, depending on the type of derivative (e.g., option, futures contract, forward contracts, or swap); the underlying asset or index (stock, bond, commodity, digital asset, or currency index); the holding period of the derivative product or the underlying asset (if any); and the tax status of the taxpayer (e.g., investor, trader, dealer, or hedger). For instance, the character of gains and losses on derivative transactions as capital or ordinary, is generally based on the status of the taxpayer (i.e., investors and traders generally receive capital gain or loss on their transactions, while dealers and business hedgers generally receive ordinary tax treatment).

3. Generally, are intra-group debts treated differently to external debt for tax purposes?

Intra-group debt is generally treated consistently with arm's length/external debt. To be so treated, the terms of the intra-group debt would need to be those which would otherwise be made at arm's length. To the extent no such arm's length terms exist, interest may be imputed and transfer pricing rules may apply. Limitations on the deductibility of interest generally apply, whether the debt is external or internal.

If debt exists between members of a US consolidated tax group, certain special other rules apply. Please see Q&A 1 above relating to further rules that may impact the debt/equity characterization of any intra-group debts.

4. Does it make a difference if debt is owed by a partnership or other pass through entity in distress to third parties versus to its partners?

Yes. If debt is owed to third parties by a partnership or pass-through entity, a debt/equity analysis should be undertaken with respect to such debt. The partnership tax rules are complex, including with respect to identifying what constitutes partnership liabilities and how such liabilities affect the basis of partnership assets.

If recast or treated as equity, any third party holders would likely be viewed as partners. The US tax consequences to such holders may vary depending on how they hold the 'debt' and what activities the partnership or pass-through entity conducts. If it conducts a US trade or business, non-US 'debt' holders may be subject to US tax and filing obligations.

DEBT IMPAIRMENT

1. What are the key tax considerations on a debt impairment for the creditor?

Creditors could consider a partial bad debt deduction and, in the event the debt is entirely worthless, a full deduction. If a partial bad debt deduction is considered, special considerations apply with respect to validating the absence of recovery on the debt and accompanying book charge off. A partial bad debt deduction is not allowed with respect to certain corporate debt. In addition, a partial bad debt deduction entitles the holder to an ordinary loss whereas a later exchange or restructuring of the debt might result in a capital loss.

2. What are the key tax considerations on a debt impairment for the debtor?

For considerations relating to debt impairment for the debtor, please see below.

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DEBT AMENDMENT, REFINANCING AND NOVATION

1. What are the key tax considerations on a debt amendment?

Significant Modification/Cancellation of Debt Income. Under the relevant US tax rules, changes in the terms of a debt instrument will be treated as an "exchange" of the original debt for the modified debt if the terms of the modified instrument differ "materially either in kind or in extent" from the original terms - referred to as a "significant modification." Even slight changes could be considered "significant" for this purpose (e.g., a change in yield of a fixed rate or variable rate debt instrument by more than 25 basis points). If the amendment results in an "exchange" there can be meaningful potential tax consequences to both the debtor and the creditor. If a modification constitutes a significant modification, the issuer is deemed to have issued a new debt instrument in satisfaction of the existing debt instrument. If a borrower is deemed to have issued a new debt instrument at an issue price less than the adjusted issue price of the existing debt instrument, the borrower generally has cancellation of debt income ("CODI") in an amount equal to such excess. For example, if an existing debt instrument issued at par undergoes a significant modification and trades at 60% of the face amount immediately after the modification, the issuer could recognize CODI in an amount equal to 40% of the face amount, as further explained below.

When determining whether the terms of the modified instrument differ significantly from the original debt, there are a variety of rules which may be applicable.

For those types of modifications not covered by any of the separate rules, the regulation tests such modifications on a collective basis under a general "economic significance" standard, based on all facts and circumstances. There are five general types of changes covered by separate rules:

- changes in yield (but only for certain debt instruments);
- changes in timing of payments;
- additions or deletions of co-obligors, changes in security or credit enhancement, and changes in priority;
- changes in the nature of a debt (such as changes in the recourse nature or debt equity status of a debt); and
- changes in customary accounting or financial covenants.

In some of these cases, the regulation provides a bright-line rule or safe harbor and, in others, a specially crafted, yet general, standard for determining whether the modification is "significant." Notwithstanding that a change in terms would fall within one of the separate rules of the regulation, a change must be tested under the general "economic significance" standard if it is (i) effective only upon the occurrence of a substantial contingency or (ii) in the case of a change in obligor, security, or recourse/nonrecourse status, effective on a substantially deferred (although not contingent) basis.

Thus, a critical consideration in amending a debt instrument is whether the terms of the amendment materially differ from the original terms, as "exchange" treatment can give rise to disparate outcomes for debtors and creditors.

Key Elements of "Exchange" Treatment: New Issue Price. The potential consequences of "exchange" treatment, such as the recognition of CODI for the borrower, gain or loss for the creditor and the determination of original issue discount ("OID"), depends in significant part upon the issue price of the "new" debt instrument. The "issue price" of a "new" debt instrument deemed issued in exchange for an existing debt instrument is generally equal to:

- The fair market value of the new debt instrument, if the new debt instrument is "publicly traded" (which is often the case, as explained below);
- The fair market value of the existing debt instrument, if the existing debt instrument, but not the new debt instrument, is publicly traded; or

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- The stated principal amount of the new debt instrument (or, in certain circumstances, its stated redemption price at maturity), if neither the new debt instrument nor the existing debt instrument is publicly traded.
 - If the non-publicly traded debt does not provide for adequate stated interest, then the issue price is determined by discounting all payments due under the terms of the debt (including interest and principal) at the applicable federal rate.

As such, a key consideration in this analysis is whether the debt is considered publicly traded (which, under the relevant regulations, does not require a formal market; indicative or firm quotes can be sufficient).

Potential Exchange Gain or Loss. Creditors may have a taxable gain or loss on an exchange of debt. For example, gain may arise if the creditor has previously written down the debt for tax purposes or acquired the debt at a discount and the issue price of the "new" debt is higher than the creditor's tax basis. If the debt is not publicly traded such that its issue price would generally be its stated principal amount (assuming adequate stated interest), the potential for "phantom" income is great since the actual fair market value of the new debt may be substantially less than the issue price of the debt. As discussed below, it is possible in the case of a corporate borrower that the exchange might constitute a so-called "tax-free" recapitalization. Otherwise, the installment method of accounting may provide some relief in particular cases. In addition, in appropriate circumstances, the "doctrine of uncollectability" may arguably provide some assistance. Under case law, income is not accruable where the debtor is insolvent and real doubt exists as to the collectability of the related obligation. Accordingly, in the case of an insolvent debtor, a creditor arguably might be able to compute gain or loss on an exchange by reducing the new debt's principal amount by the amount likely to be uncollectible (rather than by using the new debt's adjusted principal amount). As a practical matter, however, uncollectability may be difficult to establish where an underlying premise of the restructuring is the expectation or hope that the restructured obligation would ultimately be paid in full. Regulations provide some relief through the potential ability to claim a partial bad debt deduction in respect of the new debt (as described further herein), other than with respect to corporate debt that is subject to a wholly-worthless security rule.

Conversely, a creditor might recognize a loss where, for example, the "issue price" of the new debt is determined based on its fair market value and the creditor has a high tax basis. In addition, where there is unpaid interest, the allocation rules may allocate a portion of the "new" debt to the accrued interest, creating ordinary income and exacerbating any loss (which loss may be a capital loss). This similarly would be of concern in the gain context where the interest would be taxed at ordinary income rates but the gain potentially would be taxed at capital gain rates.

Tax-Free Recapitalization. In the case of a corporate borrower, the creditor's exchange might be considered a tax-free recapitalization in which gain or loss is generally not recognized (see below, Debt for Equity Exchange, Q&A 1). This possibility is subject to understanding the tax classification of the issuer and whether the debt (both existing and amended) is a "security" and whether they have other consideration received in the exchange under the relevant US tax rules. The determination of whether a debt constitutes a "security" for these purposes depends on an original evaluation of the nature of the debt, including whether the holder is subject to a material level of entrepreneurial risk. Experientially, instruments with original weighted average maturities of 10 years or more usually will be considered securities whereas instruments with original weighted average maturities of 5 years or less usually will not. The status of instruments which have an original maturity of between 5 and 10 years is unclear.

OID. If the face amount (or, if not all the interest payments are required to be made in cash, the stated redemption price at maturity) of the deemed newly issued debt instrument resulting from a significant modification exceeds the issue price of such debt instrument (determined as discussed above), the debt instrument may be treated as issued with OID for US tax purposes. Such OID is generally equal to the CODI (as calculated above) that is currently includible as income. OID is generally deductible by the borrower over the term of the new debt instrument, though such deductions may be subject to significant limitations. From the creditor's perspective, OID generally has to be included in income as it accrues, subject to reduction or offset if the holder's tax basis is greater than the debt's issue price.

Potential recharacterization as debt or non-debt. The status of a deemed newly issued debt instrument as "debt" for tax purposes is required to be re-tested as of the date of the deemed issuance. Accordingly, modifications to an existing debt instrument can result in the

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recharacterization of that debt instrument as equity for US tax purposes. However, as long as the borrower on the debt instrument remains the same, and no co-borrowers are added or removed from the debt instrument, any deterioration in the financial condition of the borrower is generally ignored between the original issue date of the debt instrument and the date of the significant modification is ignored for this purpose.

Modifying Debt of Foreign Subsidiaries. In addition to debt restructuring by US borrowers, a US parent of a foreign borrower subsidiary may consider repurchasing or modifying existing debt of such subsidiary. A foreign subsidiary owned more than 50% by a US shareholder (or shareholders) is generally considered to be a controlled foreign corporation ("CFC"). If the repurchase or modification (as discussed above) of the CFC's debt gives rise to CODI at the level of the CFC, such CODI may cause the CFC's US shareholder to recognize additional income under the complex rules governing "global intangible low-taxed income" ("GILTI").

Generally, a US shareholder's GILTI is the amount of its CFCs' net income in excess of 10% of the CFCs' adjusted basis in its tangible depreciable assets (a 10% deemed tangible income return amount). A US shareholder is subject to US tax on GILTI regardless of whether the US shareholder receives any distributions from its CFCs. Corporate US shareholders are allowed a deduction equal to 50% of their GILTI and foreign tax credits for 80% of foreign taxes paid on that GILTI in that year (without a carryback or carryforward). However, the manner in which this 50% GILTI deduction and foreign tax credits must be taken into account by a US shareholder may significantly reduce the benefit to such US shareholder of any net operating loss ("NOL") carryforwards or carrybacks.

- If a debt repurchase or modification results in CODI to the CFC (applying the same rules discussed above), a US shareholder of such CFC may be required to include additional GILTI corresponding to such CODI in the absence of offsetting tested losses from other CFCs.
- If CODI recognized by an insolvent CFC is excluded from taxable income by reason of such insolvency, how the CFC's various tax attributes may be affected is unclear, but if the CFC is required to reduce tax basis in its depreciable tangible property, such a reduction could increase potential GILTI inclusions in future years by decreasing the 10% deemed tangible income return amount.
- If CODI caused by a debt repurchase or modification is not subject to current foreign taxation, such event may result in a timing mismatch such that the GILTI arising from the CODI is included in a US shareholder's income currently while foreign taxes may not be paid until a later year, and therefore the associated foreign tax credit does not arise.
- A US shareholder in an overall net loss position or with NOL carryovers for the taxable year in which CODI is recognized by a CFC could be losing the benefit of the 50% deduction for GILTI and NOL carryovers, as well as foreign tax credits related to that GILTI.
 - Because general US tax rules apply to CFCs in a similar fashion as to US corporations, the concerns relating to limitations on deductibility of OID (including any OID on an applicable high yield debt obligation) that may be created in a debt modification or a related party purchase could apply to CFCs in the same way as discussed above.

2. Does the deferral of any payments of interest or repayments of principal trigger tax consequences?

The deferral of interest payments or repayments of principal generally is not expected to result in a significant modification/deemed exchange of the debt unless it is a "material" deferral. A deferral is generally not considered "material" if the deferral extends for the lesser of five years or 50% of the original term of the debt, with the period beginning on the original due date of the first scheduled payment that's deferred. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amount of the payments that are deferred, and the time period between the modification and the actual deferral of payments. Even if the deferral of interest payments or repayments of principal do not trigger a deemed exchange under general tax principles, the deferral may result in a recomputation or recalculation of OID.

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3. What are the key tax considerations on a debt refinancing?

The key US tax considerations relating to a debt refinancing are consistent with those set forth above regarding the tax considerations of an amendment or modification of a debt instrument.

An additional consideration in a refinancing is whether the refinanced debt is fungible with the original debt. Specific rules are provided to determine whether fungibility exists.

4. Does rolling up interest or satisfying interest through issuing “payment in kind” notes give rise to any tax consequences?

Payment in kind (“PIK”) interest accrues during the applicable accrual period and is then “paid in kind” through either the issuance of additional debt instruments or an increase in the principal of the existing debt (usually the latter).

PIK interest is accounted for under the OID rules for inclusion into income. Under these rules, a creditor is required to report the appropriate PIK interest as income in the current year, regardless of its method of accounting. Therefore, a cash method creditor holding a PIK note is required to include current interest into income regardless of when it receives cash payment.

In addition, issuers of PIK notes may be subject to the applicable high yield debt obligation rules, which may cause either a deferral or permanent disallowance of interest/OID deductibility. Issuers often include “PIK” catch-up provisions in credit agreements to prevent such rules from applying.

5. Does the novation of debt by a debtor to another group company trigger any adverse tax consequences?

The tax consequences of such a novation depend in part on the recourse/non-recourse nature of the debt. The substitution of a new obligor of recourse debt generally would be expected to result in a significant modification and thus a deemed exchange of the debt. In contrast, if the debt is non-recourse, the substitution of a new obligor generally would not be expected to give rise to a significant modification. The tax consequences also depend on the reason for the novation - such as whether the novation constitutes a deemed contribution/distribution, and whether the companies file a single consolidated US tax return.

6. Are there any specific tax considerations to bear in mind where the security / guarantee package is amended as part of the debt amendment / refinancing?

The US tax considerations relating to amending the security or guarantee package are different depending on whether a debt is recourse or non-recourse. A modification altering collateral or guarantees, or adding or deleting a co-obligor, to recourse debt is a significant modification if it results in a “change in payment expectations.” A change in payment expectations occurs if there is (a) a substantial enhancement of the borrower’s capacity to service the debt instrument and that capacity was primarily speculative prior to, and is adequate after, the modification, or (b) a substantial impairment of the obligor’s capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

- **Recourse Debt.** A change in collateral or other credit enhancement is a significant modification if it results in a change in payment expectations.
- **Nonrecourse Debt.** In the case of nonrecourse debt, a change in the collateral by a substantial amount or any form of credit enhancement generally is a significant modification except in two limited circumstances relating to the substitution of collateral. A substitution of collateral is not a significant modification if (i) the collateral is fungible in nature (such as government bonds or securities of a particular type and credit quality) or (ii) the substitution is of a similar commercially available credit enhancement contract. Improvements to the collateral would not result in a significant modification.

CFC Pledge. Under prior law, US borrowers were generally reluctant to look to its non-US subsidiaries to provide material credit support, given a risk of doing so was that such guarantee or pledge could result in a taxable deemed dividend. Changes in 2019 alleviated this concern for most corporate US borrowers, who are now able to take advantage of a dividend received reduction for any such deemed dividend, provided that (i) certain holding period requirements are met, (ii) the dividend is not a “hybrid dividend,” or (iii) the dividend is not US source.

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Fund Guarantees. As private equity funds look to restructure a portfolio company's debt, obtain a waiver of financial covenants with respect to existing portfolio company debt, or have a portfolio company borrow incremental amounts, lenders may ask the fund to guarantee the portfolio company's debt. The existence of a fund guarantee raises the issue, often referred to as the *Plantation Patterns* issue, of whether the fund (not the portfolio company) should be viewed as the true borrower of the debt for US tax purposes.

If the fund is treated as the borrower, tax-exempt investors in the fund could recognize unrelated business taxable income as a result of the fund being treated as borrowing money to make an investment in a portfolio company. However, this should only occur if the fund is treated as the borrower and the fund recognizes income in respect of its investment in the portfolio company during the tax year in which the fund is viewed as the borrower, or if the fund sells its investment in the portfolio company at a gain and the fund was treated as the borrower within the 12-month period ending prior to the sale.

If the fund is treated as the borrower for US tax purposes, the fund may recognize income when the portfolio company repays all or a portion of the debt from its cash flow or when the portfolio company refinances its debt in the future without a fund guarantee, as the repayment or refinancing could be treated as a distribution of cash from the portfolio company to the fund. In such a case, the fund would recognize income, and have a withholding obligation with respect to its non-US investors, to the extent the deemed distribution is treated as a dividend from a corporation for US tax purposes.

Because the incurrence of such taxable income can violate covenants in fund agreements or side letters and given the other issues noted above, it is important to carefully consider whether providing a fund guarantee creates any tax issues for the fund's investors. If a fund guarantee is added midstream, the debt may be treated as significantly modified and deemed reissued or the fund could be treated as assuming the debt of the portfolio company if the fund guarantee causes the fund to be treated as the borrower.

DEBT RELEASES

1. Does the release of debt trigger taxable income for the debtor? If so are there any reliefs or exemptions?

In general, a debtor will recognize CODI to the extent the consideration received (if any) is less than the adjusted issue price of the debt. The requirement of current inclusion of CODI is subject to several exceptions.

The two principal exceptions apply to insolvent or bankrupt debtors.

- Bankruptcy Exclusion: CODI arising from discharges of debt occurring in a title 11 case is excluded from income. To take advantage of the bankruptcy exclusion, the taxpayer must be under the jurisdiction of a US bankruptcy court and the discharge must be granted by the court or pursuant to a plan approved by the court.
- Insolvency Exclusion: CODI arising from the cancellation of debt that occurs while the debtor is insolvent is excluded from income only to the extent the debtor is insolvent.
 - The term "insolvent" means the amount by which the taxpayer's liabilities exceed the fair market value of its assets, as determined immediately before the debt is cancelled. Special rules have developed for taking certain types of debt into account under the insolvency exception.

In each case, the exclusion is not unlimited in scope. The relevant release of debt, while excluded from taxable income, may result in reduction of current year losses and other tax attributes. Special rules relating to these exclusions apply in the context of US consolidated tax groups.

2. Does the release of debt trigger any withholding or indirect tax? If so are there any reliefs or exemptions?

A release of debt itself is generally expected to be treated as taxable income of the borrower; however, no US withholding tax is generally expected to arise from such release. Varying withholding tax consequences may arise from other transactions relating to a broader restructuring of debt, including in connection with exchanges of debt. Partnership CODI that is effectively connected taxable income allocable to foreign partners is subject to US withholding tax. For further potential risks, see below regarding the acquisition of distressed debt.

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3. Can a creditor claim a deduction in respect of any debt that is released?

It depends. Several specific conditions must be met in order for a creditor to claim a deduction.

Worthless Securities. In general, if a "security" becomes worthless during the creditor's taxable year, the creditor may be entitled to a loss for the security. A "security" for this purpose (which differs from a "security" for purposes of potential tax-free recapitalization treatment discussed in the prior section, see Debt Amendment, Refinancing and Novation, Q&A 1), includes stock or stock rights. It also includes any bond, debenture, note, or certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. The loss is deemed recognized as a sale or exchange of the worthless security on the last day of the creditor's taxable year. The character of the loss depends on whether the security is a capital asset in the hands of the creditor. If so, the loss is capital; if not, the loss is ordinary.

Unlike the case with a bad debt deduction (discussed below), no deduction may be taken for a partially worthless security. The creditor has the burden of demonstrating that the security is worthless and that it became worthless in the taxable year the deduction is claimed. The test for determining worthlessness has often been expressed as a two-part test: (i) the security has no current liquidating value and (ii) the security has no future value. The second prong can be established either by (i) pointing to an identifiable event, such as bankruptcy, cessation of business, liquidation, or other specific event, or (ii) showing that the liabilities are so greatly in excess of its assets and the nature of its assets and business is such that there is no reasonable hope that continuation will result in any recovery on the security.

Bad Debt. For debt that is not a "security" for worthlessness purposes, a creditor can sometimes claim a bad debt deduction. The indebtedness giving rise to the deduction must be a "bona fide" debt for US tax purposes. A bona fide debt is generally defined as a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money, and the amount of the deduction cannot exceed the creditor's tax basis in the debt. The distinction between business bad debts and non-business bad debts is described in Q&A 4, below.

4. Is the position different if the debt being released is a trade debt?

Yes. In the case of taxpayers other than corporations, the rules governing deductibility of a bad debt deduction depend on whether the bad debt is a business or nonbusiness bad debt. Debts of corporations are always treated as business bad debts.

A nonbusiness bad debt is deductible as a short-term capital loss, whereas a business bad debt is entitled to an ordinary deduction. In addition, a creditor may not take a deduction with respect to a nonbusiness bad debt that is only partially worthless. A nonbusiness bad debt is defined as a debt other than: (i) one created or acquired in connection with the creditor's trade or business; or (ii) the loss from the worthlessness of which was incurred during the operation of the creditor's trade or business. To qualify as a business bad debt under (ii), the debt must, at the time of the worthlessness, be proximately related to the taxpayer's trade or business. A partial bad debt deduction for a business debt must be supported by a comparable write-off on the books of the company.

If a creditor claims a bad debt deduction and later recovers all or a portion of the debt, a portion of the recovered amount may be includible in the creditor's income for the year of the recovery.

5. Does the release of an uncalled guarantee obligation trigger any adverse tax consequences? Is the position different if the guarantee has been called?

As to whether the release of a guarantee obligation results in any adverse tax consequences with respect to the underlying debt, see above regarding the change in collateral/guarantee package (see, Debt Amendment, Refinancing and Novation, Q&A 6).

Generally speaking, a guarantor's liability is secondary, meaning they are not responsible for a debt unless the primary debtor fails to perform their obligation. Thus, the guarantor should not have CODI from the release of a guarantee. This should similarly be the case even if the release of the guarantee happens after the debt has been called.

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6. Do any adverse tax consequences arise on the release of liabilities owed under a derivative contract?

First, as stated above, (see, General, Q&A 2), the character of gains and losses on derivative transactions is capital or ordinary, based on the characterization of the taxpayer. Investors and traders generally receive capital gain or loss on their transactions, while dealers and business hedgers generally receive ordinary tax treatment.

Second, whether the taxpayer has held the capital asset for the long-term holding period (more than one year) or the short-term period (one year or less) determines the tax treatment of the sale or exchange. Long-term capital gains get favorable tax treatment, while short-term gains are taxed at ordinary income rates.

Other potentially relevant rules may apply in the case of a derivative instrument, particularly in the event that a derivative instrument is treated as equity ownership for US tax purposes. Such potential characterization would need to be considered based on the instrument.

DEBT FOR EQUITY EXCHANGE

1. What are the key tax considerations on a debt-for-equity exchange for the creditor?

One significant consequence of a debt-for-equity exchange to a creditor is the potential for gain or loss. This risk is reduced in the corporate context, where the possibility for “tax-free” recapitalization treatment exists. The US tax consequences to the creditor in such instance depend, in part, on whether the old debt instrument is a “security” for this purpose. If the instrument is a “security” as discussed earlier (see Debt Amendment, Refinancing and Novation, Q&A 1, Tax-Free Recapitalization), then the exchange may qualify for recapitalization treatment. If an exchange so qualifies, no loss would be able to be recognized by such holder and no gain would be recognized if solely stock or securities of the same debtor corporation are received. Interest income may be recognized to the extent any consideration received is allocable to accrued but unpaid interest (and possibly accrued OID). The proper allocation of amounts received in a debt exchange between principal and interest is unclear, although the applicable legislative history indicates that all parties should be bound by their explicit allocation of property received in an exchange between principal and accrued interest or OID on the original debt.

If the instrument is not a security, then the creditor will recognize gain or loss equal to the difference between the fair market value of the stock received and its adjusted basis in the old debt.

In connection with a debt-equity exchange, new debt may also be issued. If it is part of a tax-free recapitalization, the creditor will still not be able to recognize any loss. However, a creditor may be required to recognize gain where it has previously written down the debt for tax purposes or acquired the debt at a discount, such that it has an economic gain, if the new debt does not constitute a security or if the principal amount of the new debt security received exceeds the principal amount of the old debt.

2. What are the key tax considerations on a debt-for-equity exchange for the debtor?

Of great concern for the debtor is the potential for CODI. In general, the debtor realizes CODI equal to the difference between the adjusted issue price of the debt and the fair market value of the stock transferred or issued, unless an exception applies (see Debt for Equity Exchange Q&A 1, above). Similar to a stock-for-debt exchange, a debtor partnership has COD income equal to the difference between the adjusted issue price of the debt and the fair market value of the partnership interest.

For partnerships, the regulations provide a valuation safe harbor if certain conditions are satisfied. Specifically, under the safe harbor, the partnership and the creditor may value the partnership interest transferred to the creditor based on the liquidation value of the transferred partnership interest. Non-recognition treatment will generally apply to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership. However, the non-recognition provisions applicable to partnerships do not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness of unpaid rent, royalties, or interest that accrued on or after the beginning of the creditor's holding period for the indebtedness.

TAX IN DISTRESSED SITUATIONS – UNITED STATES

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3. Where warrants or similar instruments are issued as part of a debt restructuring does this trigger any adverse tax consequences?

Warrants are sometimes treated simply as another piece of consideration, or under certain circumstances, like additional equity in considering the tax consequences at an exchange of old debt. When warrants or similar instruments are issued along with new debt, consideration should be given to the investment unit rules. These rules generally provide for an allocation of relative value to set the issue price of the underlying debt. Any amounts allocated to the warrant component of the investment unit generally informs the discount on the underlying debt.

4. What are the key tax consequences of capital contributions by a parent company into its subsidiary?

If the creditor is an existing shareholder of the debtor corporation, the creditor might contribute the debt to the capital of the debtor. In this instance, the debtor generally realizes CODI equal to the amount by which the adjusted issue price of the debt exceeds the shareholder's tax basis in the debt. The remaining portion of the cancelled debt is treated as a tax-free contribution to capital. The shareholder/parent company should be entitled to an upward adjustment to its tax basis in the stock of the debtor corporation equal to its tax basis in the debt.

FEES AND TRANSACTION COSTS

1. Is there any adverse tax impact in respect of common restructuring fees, for example, consent fees?

Adverse tax impacts could arise in respect of the receipt of fees by a creditor, including when such fees are issued in common restructuring transactions.

In general, when fees are issued, there is a concern that such fees may constitute a payment of services. How the fees are paid and what the fees are paid for, as a factual matter, impacts this analysis. If a non-US creditor is treated as receiving a fee for services from a US issuer, there is risk that receipt of the payment could give rise to taxable income in the US and a resulting tax filing obligation. Other fees may result in interest income or OID which, if not excluded under applicable exceptions (e.g., portfolio interest exemption), may result in some withholding tax leakage.

Other fees, including potentially consent fees, may be treated as additional consideration in connection with a debt exchange. However, as noted above, the treatment of any such fees is in large part predicated on the facts relating to the payment of such fees.

Furthermore, any such fees could trigger a significant modification of the debt and, thus, have major implications beyond the fee itself. The nature and amount of such fees would need to be examined under the relevant tests for determining whether a significant modification has occurred, including ascertaining whether the debt is publicly traded in order to assess the potential exposure.

2. Are transaction costs deductible for tax purposes and is any VAT recoverable?

Transactions costs may be deductible for US tax purposes. The nature of the deductibility depends on the nature of the cost and whether such cost is inherently facilitative to the transaction or whether the deduction was incurred in connection with the taxpayer's trade or business.

In bankruptcy, a debtor may have relief from certain transfer taxes under the US bankruptcy code to the extent the transfers are pursuant to a confirmed bankruptcy plan.

DEBT ENFORCEMENT

1. Aside from insolvency proceedings, what are the key methods of enforcement and their tax impact?

The key enforcement proceedings depend on whether the debt is recourse or non-recourse. If non-recourse, the collateral is able to be recouped. If recourse, the creditor has rights under law against the specific debtor (in addition to any collateral).

TAX IN DISTRESSED SITUATIONS – UNITED STATES

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2. If the enforcement results in the creditor taking ownership of equity or assets, what are the key tax considerations to bear in mind?

The tax consequences that result from a creditor taking ownership of equity or assets will vary based on the structuring of such transaction, the type of entity (e.g., partnership v. corporation) and, if a corporation, whether such corporation is a member of a US consolidated group.

One key consideration is the limitations relating to the availability of NOLs and other tax attributes after a change of control under Section 382 of the Code (see below, Debt Enforcement, Q&A 4).

3. Are any specific tax considerations arising on payments or transferring security under guarantees as opposed to the debt?

The treatment primarily depends on the arm's length nature of the guarantee and the existing relationship between the entities. For example, payment by a guarantor generally gives rise to a right of subrogation. If there is a waiver of such right or other intention not to enforce the right of subrogation, the payment might be viewed as a deemed contribution if the guarantor is the parent or a deemed distribution if the guarantor is the subsidiary. Otherwise, to the extent the guarantor makes a payment on the guarantee and is not reimbursed, a bad debt deduction might be available (see, Debt Release, Q&A 3). There is a question under judicial authority whether the guarantor can claim an interest deduction to the extent it makes a payment of interest on the guaranteed debt.

If a payment is made with respect to the *incurrence* of a guarantee that is paid, then such payment may be subject to US taxation, including if a guarantee or guarantee fee is deemed provided among related parties or a guarantee is made by a subsidiary. In some non-US jurisdictions, a foreign subsidiary that guarantees debt of a US parent may be deemed to receive a guarantee fee from the US parent, which could be subject to tax in that non-US jurisdiction. In addition, there may be good non-US reasons to require the US parent to pay the guarantee fee directly to the foreign subsidiary (e.g., to set the rate based on a transfer pricing determination, instead of permitting a taxing authority to impute a rate). This could create knock-on US effects – the guarantee fee may be treated as Subpart F income or GILTI for the US parent. Any US tax arising from a guarantee made by a subsidiary CFC to a US shareholder could be potentially mitigated by the availability of the Section 245A dividends received deduction. However, such rules are complex and contain many exceptions which, if applicable, may jeopardize the availability of such dividends received deduction (e.g., hybrid dividends, dividends from US sourced E&P, nimble dividends, short holding periods, etc.) If a payment is made on the debt by the borrower itself, no such consequences would be expected to arise. As noted above, a guarantor has secondary liability and generally steps into the shoes of the primary holder should they not pay.

4. Are there any adverse tax consequences arising from a change of control or break of a tax group?

Where an exchange also involves the issuance to lenders or others of stock or options to acquire stock (including warrants), a corporate debtor may be concerned about Section 382 of the Code and the ability to use its NOL carryforwards and certain other tax attributes against its current and future income (including CODI). Section 382 of the Code may apply to limit the use of the corporation's NOLs and other tax attributes after a change of control.

Section 382 of the Code applies to limit the use of NOLs and certain other losses and credits of a corporation following a greater than 50-percentage point change in stock ownership of the corporation during a three-year period (i.e., an "**ownership change**"), generally disregarding trading between less than 5 percent shareholders.

Where an "ownership change" occurs midyear, any current year net income or loss is generally allocated on a pro-rata basis between the prechange and postchange portions of the year, regardless of when in the year it is recognized. If the corporation has current year net income due to pre-change CODI, a portion of any CODI recognized would be allocable to the postchange portion of the year and might not be fully offset by the debtor's prior year losses, unless the corporation makes an interim closing of the books election. As opposed to the pro-rata default allocation, where the debtor elects to do an interim closing of its books as of the change date, any net income recognized on or before the date of the ownership change can be offset by the debtor's prior year losses, subject to any other applicable limitations. However such pre-change portion will be subject to the Section 382 limitation.

TAX IN DISTRESSED SITUATIONS – UNITED STATES

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A corporate debtor that undergoes an ownership change pursuant to a confirmed plan in a US bankruptcy (or similar) case may obtain favourable treatment under Section 382 of the Code if its pre-existing shareholders and so-called "old and cold" creditors receive or retain 50% of the vote and value of the reorganized company's stock. For this purpose, an "old and cold" creditor is one that (i) has held its debt since at least 18 months before the bankruptcy, (ii) holds debt incurred in the ordinary course of the debtor's business and has held the debt since its inception, or (iii) in certain circumstances where the creditor has not held the debt for the requisite length of time, the creditor acquires less than 5% of the reorganized company's stock.

Certain considerations can also arise when a member is deconsolidated from its US consolidated tax group. For instance, deconsolidation can give rise to the trigger of an excess loss account (i.e., negative basis) in the stock of the relevant departing member. The amount of such excess loss account may be taxable income to the US consolidated group that is not otherwise excluded under the CODI exclusions described earlier herein (see, Debt Release, Q&A 1). In addition, a deconsolidation include the potential triggering of certain intercompany items of income, gain or loss which were deferred by reason of the application of the US consolidated group rules. Other potential rules under the US consolidated group rules may apply so as to limit the deconsolidating member's tax attributes to the extent of the lesser of the parent of the consolidated group's stock loss and the deconsolidating member's built-in inside loss.

The portion of a consolidated NOL attributable to a departing subsidiary will be determined after any consolidated attribute reduction resulting from any member's excluded CODI.

5. Where equity / assets are indirectly transferred as part of an enforcement, does that trigger adverse tax consequences?

An enforcement transaction can result in adverse US tax consequences to both the debtor and creditor when such assets or equity are transferred. Such tax consequences largely depend on the manner in which such equity or assets are transferred. For instance, this can occur in a tax-free transaction or in a taxable transaction and can result in a loss or reduction of valuable tax attributes, which the debtor (or creditor) may otherwise use on a go-forward basis.

6. Is any claw back permissible where a distressed company pays taxes for which a solvent shareholder is liable?

Under US tax law, there are no such clawbacks.

ACQUISITION OF DEBT

1. Does the acquisition of a creditor's interest in distressed debt trigger any adverse direct tax consequences for the debtor?

A repurchase and retirement by a company of its debt at a discount will generally result in taxable income to the company in the form of taxable CODI or, if the insolvency or bankruptcy exception discussed above is applicable, a reduction in tax attributes (see Debt Release, Q&A 1). The amount of CODI is typically the difference between the principal amount of the debt repurchased (or its accreted value, if applicable) and the repurchase price. The incurrence of CODI can create a cash tax liability which may be payable if the company does not otherwise have losses or other deductions that can be used to offset this income. If the issuer is a partnership or other entity taxed as a partnership, CODI can create a cash tax liability for the partners of the issuer unless current deductions of the issuer, or other losses or deductions of such partners, can be used to offset this income. A company also incurs CODI if a person "related" to the company purchases the debt at a discount.

Generally, a corporation is related to a stockholder that holds more than 50% of its stock. Similar rules apply in the case of debt issued by a partnership. However, the rules governing relatedness are complex and include stock ownership attribution rules as well as rules governing entities under common control. In the case of a related-party purchase, the purchased debt is generally treated as having been acquired by the company for the price paid by the related party and reissued to the related party for the same amount. The deemed reissuance of the debt at a discount results in the "new" debt being issued with OID.

TAX IN DISTRESSED SITUATIONS – UNITED STATES

The consequences and treatments described herein relate solely to U.S. federal income tax consequences and do not purport to address state or local income tax consequences.

2. Does the acquisition of distressed debt trigger any adverse withholding or indirect tax consequences for the debtor?

Generally no. As indicated in the preceding Q&A, CODI can arise on a related party purchase. However, partnership CODI that is effectively connected taxable income allocable to foreign partners is subject to US withholding tax. The obligation that the US tax rules imposes on a partnership to withhold tax on effectively connected COD income allocable to foreign partners creates a serious practical dilemma in the debt restructuring context. A myriad of other US withholding tax consequences may apply to the extent the distressed debt is treated as equity for US tax purposes. Such consequences are outside the scope of this Q&A, however, should be carefully considered when evaluating the acquisition of distressed debt.

3. What are the key tax considerations for the purchaser of a creditor's interest on the acquisition of distressed debt?

A purchaser's tax considerations depend on whether the purchaser is related to the issuer of the debt or not. Complex rules are used to determine whether an issuer and a debt purchaser are treated as related. In a simple case, a private equity partnership that owns more than 50 percent of the stock of a corporate portfolio company would be treated as related to the company. However, in certain situations, a purchaser can directly own less than 50 percent of the issuer and still be considered related under complex attribution rules.

If the purchaser is not related to the issuer, the purchaser is treated as having acquired debt at a "market discount." Unlike with OID, the market discount rules do not require the holder to accrue market discount into income while holding the debt unless an election to do so is made. Nonetheless, if the debt is retired or sold for more than the purchase price of the debt, the holder must treat the market discount then accrued as ordinary income rather than capital gain. Payments of principal before maturity on debt acquired with market discount can also give rise to the recognition of ordinary income by the holder. Limitations apply to the deductibility of interest expense incurred on indebtedness incurred to purchase or carry market discount debt. Note that, under limited circumstances, taxpayers may take the position that the market discount rules do not apply to speculative debt purchased at a very deep discount.

If the purchaser is related to the issuer, the acquired debt held by a related party is generally treated as immediately exchanged for new debt issued by the portfolio company to the related debt holder (with an issue price equal to the price paid by the purchaser). As such, the existence of this "new" debt would have tax ramifications for both the holder and the issuer:

- The "new" debt is generally treated as having been issued with OID equal to the discount upon purchase. The holder would have to include the OID in its taxable income over the remaining life of the debt.
- If the holder of the "new" debt is not a U.S. person, withholding may be required on the payment of interest and the eventual payment of accrued OID.
- For the holder and issuer, the tax consequences of the repayment or settlement of the "new debt" depend, among other things, on whether or not the principal amount is paid in full.

4. Are there any particular beneficial regimes accessible to a purchaser of a distressed debt portfolio?

There are no beneficial regimes in the US to purchasing a distressed debt portfolio. However, certain non-US lenders may be entitled to the portfolio interest exemption.

INSOLVENCY PROCEEDINGS

1. What are the key insolvency procedures?

Insolvency procedures can be 'in-court' or 'out-of-court,' depending.

2. What are the key tax considerations arising upon entry into an insolvency procedure?

In general, the entry into an insolvency procedure (whether a receivership, foreclosure or bankruptcy) is not a taxable event for US tax purposes. The debtor's status as a corporation or partnership continues unchanged. The tax year of the corporation or partnership upon entry into an insolvency procedure would similarly not change.

TAX IN DISTRESSED SITUATIONS – UNITED STATES

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However, a debtor corporation may seek to adopt measures to prevent an “ownership change” and other events from occurring that could adversely impact the company’s NOLs and other tax attributes. In some instances, restrictions on trading and NOL motions are made with the bankruptcy court to protect any valuable tax attributes. Out of court, certain debtors may implement an NOL poison pill, which serves to deter any potential buyer of debtor stock from doing so, as such buyer would, in theory, be immediately diluted by operating of the poison pill.

3. Does entry into an insolvency procedure impact tax groupings?

Under US tax rules, the entry into an insolvency procedure itself is generally not expected to impact tax groupings (e.g., a member of a consolidated group generally does not become deconsolidated from the US consolidated group by reason of the entry into an insolvency procedure).

While the entry into an insolvency procedure itself is not expected to give rise to a change in tax groupings, there may be other effects to US tax groupings as a result of certain events that may occur as a result of the emergence from bankruptcy. This could include, among other things, the deconsolidation of a member of a US consolidated group or under anti-inversion rules under Section 7874, which treat creditors as shareholders in certain such instances, which can drastically effect the tax consequences under Section 7874 and the regulations thereunder and may result in unanticipated consequences without proper awareness and planning, to the extent no internal group restructuring or other exception is available.

If a subsidiary of a consolidated group leaves the group upon emergence from bankruptcy, there can be many tack on effects relating to such departure.

4. Are there any specific tax set offs available in an insolvency?

The bankruptcy or insolvency exceptions to CODI are available. The application of such exceptions is described in an earlier Q&A (see Debt Release, Q&A 1). To the extent either such exception applies, current year losses and tax attributes would be reduced.

5. Is the tax authority a preferential creditor in an insolvency?

Yes. In the bankruptcy or insolvency context, certain tax claims of the government are afforded priority before certain other classes of claims can be repaid.

6. Are directors or other managers personally liable for tax debts in an insolvency?

Generally, no. However, there are certain excise taxes and employment taxes for which personal liability may be imposed on directors and/or managers. As a general matter, directors or managers do not have personal liability for US federal income taxes.

Outside of bankruptcy, there is a statute - commonly referred to as the “insolvency priority statute” - that may result in personal liability to a director and/or manager to the extent such director and/or manager knows of (or as reason to know of) a government’s debt, and at a time when the company is insolvent, violates the statutory priority of the government’s debt. In such case, as a means of enforcement, the director and/or manager may be personally liable to the extent of the proscribed payment.

MEET THE AUTHORS OF OUR JURISDICTIONAL GUIDES

WEIL CONTACTS

London



Jenny Doak
Partner, Tax
London
+44 20 7903 1060
jenny.doak@weil.com



Stuart Pibworth
Counsel, Tax
London
+44 20 7903 1398
stuart.pibworth@weil.com



Anna Ritchie
Associate, Tax
London
+44 20 7903 1348
anna.ritchie@weil.com

United States



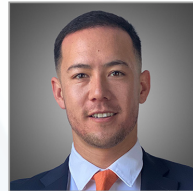
Devon Bodoh
Partner, Tax
Washington, D.C.
+1 202 682 7060
devon.bodoh@weil.com



Stuart Goldring
Partner, Tax
New York
+1 212 310 8312
stuart.goldring@weil.com



Joseph Pari
Partner, Tax
Washington, D.C.
+1 202 682 7001
joseph.pari@weil.com



Grant Solomon
Associate, Tax
Washington, D.C.
+1 202 682 7029
grant.solomon@weil.com

France



Edouard de Lamy
Partner, Tax
Paris
+33 1 4421 1571
edouard.delamy@weil.com



Benjamin Pique
Partner, Tax
Paris
+33 1 4421 9831
benjamin.pique@weil.com

MEET THE AUTHORS OF OUR JURISDICTIONAL GUIDES

LOYENS & LOEFF CONTACTS

The Netherlands



Bartjan Zoetmulder

Partner – Tax Adviser
T +44 20 7826 3071
M +44 7879 607 977
bartjan.zoetmulder@loyensloeff.com
(Currently on assignment in London)



Bart Wingen

Senior Associate – Tax Adviser
T +31 20 57 85 730
M +31 6 10 89 60 57
bart.wingen@loyensloeff.com



Aziza Tissir

Senior Associate – Tax Adviser
T +31 10 22 46 593
M +31 6 53 42 48 78
aziza.tissir@loyensloeff.com



Jacqueline Kleijn

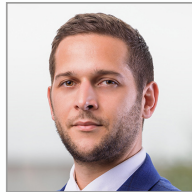
Associate – Tax Adviser
T +31 10 224 61 66
M +44 7736 381 775
jacoline.kleijn@loyensloeff.com
(Currently on assignment in London)

Luxembourg



Pierre-Antoine Klethi

Partner – Tax Adviser
T +352 466 230 429
M +352 6 91 96 31 57
pierre-antoine.klethi@loyensloeff.com



Kévin Emeraux

Senior Associate – Tax Adviser
T +352 466 230 570
M +352 6 91 96 32 24
kevin.emeraux@loyensloeff.com



Enxhi Basho

Associate – Tax Adviser
T +352 466 230 647
M +352 6 91 96 32 21
enxhi.basho@loyensloeff.com



Victoria Hodireva

Associate – Tax Adviser
T +312 057 853 27
M +352 6 91 96 31 84
victoria.hodireva@loyensloeff.com

Switzerland



Beat Baumgartner

Partner – Attorney at Law
T +41 43 434 67 00
M +41 79 93 06 352
beat.baumgartner@loyensloeff.com



Pascal Hammerer

Senior Associate – Tax Adviser
T +44 207 826 3070
M +41 79 878 62 03
pascal.hammerer@loyensloeff.com
(Currently on assignment in London)

Belgium



Aldo Engels

Counsel – Attorney at Law
T +32 2 743 43 92
M +32 496 13 76 21
aldo.engels@loyensloeff.com



Benno Daemen

Senior Associate – Attorney at Law
T +32 2 773 23 67
M +32 497 32 99 02
benno.daemen@loyensloeff.com



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