DEBT EXCHANGES©

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DEBT EXCHANGES[*]

I. INTRODUCTION

This article focuses on one of the crucial issues in any debt restructuring—whether changes to the terms of outstanding debt typically sought by lenders would constitute a deemed exchange of the debt pursuant to section 1001[1] and the corresponding Treasury regulations.[2] The first part of the article discusses the regulations. The second part of the article discusses the adverse tax consequences to debt holders of a deemed debt exchange under the regulations, including the collateral effects of a possible recharacterization of the modified debt as equity. The third part of the article discusses the tax consequences if modified debt is subject to the original issue discount ("OID") rules. Finally, the article discusses strategies to avoid the pitfalls commonly associated with debt exchanges.

II. DEEMED EXCHANGES OF DEBT

A. Regulations

Many of the modifications commonly sought by lenders to the terms of troubled debt would cause a deemed exchange of the debt; in many cases, a single modification would be sufficient to cause a deemed exchange. However, several provisions in the regulations represent a significant extension of case law and rulings insofar as the regulations would trigger a deemed exchange of debt where no exchange would otherwise occur.[3] Proposed

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1 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury regulations promulgated thereunder.

2 Treas. Reg. § 1.1001-3, added by T.D. 8675, 1996-2 C.B. 60 (June 26, 1996).

3 *See generally* New York State Bar Association, Tax Section, *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation*

regulations were issued on December 2, 1992, in response to the Supreme Court's decision in *Cottage Savings Association v. Commissioner*[4] that a deemed exchange of property occurs if the "legal entitlements" of the exchanged properties are not identical, which decision significantly lowered the threshold for deemed exchanges.[5] The proposed regulations, with certain changes, were finalized on June 26, 1996, effective for any alteration of the terms of a debt instrument on or after September 24, 1996.[6]

1. Modifications

The regulations employ a two-part test to determine whether a deemed exchange occurs when debt is modified. Under this test a specific change to a debt instrument triggers a deemed exchange if the change constitutes a "modification," and the modification is "significant."[7] As a threshold matter, it is important to note that although the modifications made to debt in a workout context where debt is in default often address unique issues, the Internal Revenue Service (the "IRS") has generally

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Act of 1990 Affecting Debt-for-Debt Exchanges, 51 TAX NOTES 79 (Apr. 8, 1991).

[4] 499 U.S. 554 (1991).

[5] Prop. Treas. Reg. § 1.1001-3, 57 Fed. Reg. 57,034 (Dec. 2, 1992); *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). For background on the proposed regulations, *see* Lawrence H. Brenman, *Tax-Oriented Investments: Proposed Regulations Regarding Debt Modification Issued in Response to Cottage Savings Decision*, 10 J. PARTNERSHIP TAX'N 175 (1993); Richard M. Lipton, *IRS Issues Proposed Regulations on Debt Modifications*, 71 TAXES 67 (1993); Linda Z. Swartz, *Troubled Real Estate Partnerships: What Options Are Available to Foreign Lenders?*, 12 J. PARTNERSHIP TAX'N 196 (1995).

[6] Treas. Reg. § 1.1001-3, added by T.D. 8675, 1996-2 C.B. 60 (June 26, 1996).

[7] Treas. Reg. § 1.1001-3; *see also* Priv. Ltr. Rul. 1999-50-022 (Sept. 16, 1999) (holding that an investor that exchanges a pool of securities matching in number and type the securities represented by a specified number of units in an investment trust is not considered to have materially altered its ownership position in the securities, and is not required to recognize gain or loss with respect to the securities for purposes of section 1001).

treated the context in which modifications are made as irrelevant.[8] This past practice is continued in the regulations, which provide that a deemed exchange may not be avoided simply because the borrower is insolvent or bankrupt.[9] The regulations broadly define a modification as any change in a legal right or obligation of the issuer or holder of the debt instrument, with some exceptions.[10]

A change that occurs pursuant to the original terms of a debt instrument is not a modification.[11] An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result

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[8] Priv. Ltr. Rul. 84-51-012 (Aug. 23, 1984) (constructive sale of notes under section 1001 where maturity date and interest rate of notes were materially and involuntarily altered by the New York State Emergency Moratorium Act); *supplementing* Priv. Ltr. Rul. 80-52-023 (Sept. 25, 1980). By contrast, some courts have treated troubled debt restructurings more liberally than they have restructurings in the absence of economic distress. *See, e.g.*, *Mutual Loan & Savings Co. v. Commissioner*, 184 F.2d 161 (5th Cir. 1950); *Newberry v. Commissioner*, 4 T.C.M. (CCH) 576 (1945). Moreover, the IRS Chief Counsel stated in 1977 that "as a matter of policy" the IRS will not litigate the issue of whether a deemed debt exchange has occurred when involuntary changes are made to a debt instrument that is in default, unless the bonds were acquired "in contemplation of realizing a gain from the change in terms." G.C.M. 37,002 (Feb. 10, 1977). Although the IRS has not retracted this General Counsel Memorandum, it is doubtful whether it continues to represent the IRS' position in light of the regulations.

[9] *See* Treas. Reg. § 1.1001-3(c)(6)(iii) (providing that a "modification" occurs upon the effective date of a plan of reorganization in a Title 11 or similar case if a change in a term of a debt instrument occurs pursuant to such plan); *see also* Treas. Reg. § 1.1001-3(c)(4), (d), Ex. 13.

[10] Treas. Reg. § 1.1001-3(c)(1)(i); *see also* Priv. Ltr. Rul. 2011-39-003 (Sept. 30, 2011) (subsidy payments made by loan servicer on behalf of borrower who was a member of the armed services were not a modification because subsidy payments were an arrangement between the borrower and the loan servicer that did not change the mortgage owners' legal relationship with the borrower).

[11] Treas. Reg. § 1.1001-3(c)(1)(ii).

of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

The following alterations, however, are modifications even if the alterations occur by operation of the terms of a debt instrument:

- An alteration that results in the substitution of a new obligor,[12] the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse);[13]

- An alteration that results in an instrument or property right that is not debt for federal income tax purposes unless the alteration occurs pursuant to a holder's option under the terms of

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12 However, under regulations issued under section 1001, an exchange or assignment of derivatives (including notional principal contracts) by a dealer or clearing organization to another dealer or clearing organization generally is not a taxable event, even if a third party's consent is required. Treas. Reg. § 1.1001-4(a)(1)-(2). If, however, the terms of the derivative instrument are otherwise modified, the assignment may result in a taxable exchange under section 1001. Treas. Reg. § 1.1001-4(a)(3); *see also* Marie Sapirie, *Proposed Regs Address Derivative Contract Assignments*, TAX NOTES (July 25, 2011).

13 Treas. Reg. § 1.1001-3(c)(2)(i). Note that the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. Treas. Reg. § 1.1001-3(f)(6)(i); *see also* Priv. Ltr. Rul. 2000-47-046 (Aug. 30, 2000) (parent obligor's removal of subsidiary as co-obligor on conduit loans securing industrial revenue bonds ("IRBs") was a modification occurring by operation of the terms of the IRBs where the loan terms allowed the removal of the subsidiary as co-obligor without the consent of the holders of the IRBs; change-in-obligor exception did not apply because neither the parent nor the subsidiary were considered obligors with respect to the IRBs, which are obligations of the issuing state or local governments or agencies).

the instrument to convert the instrument into equity of the issuer;[14] and

- An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument, unless:
  - The option is unilateral; and
  - In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.[15]

An option is unilateral only if, under the terms of the instrument or under local law, (i) at the time the option is exercised, or as a result of the exercise, there is no right of the other party to alter or terminate the instrument or put the instrument to a person related to the issuer;[16] (ii) the exercise of the option does not require the consent or approval of the other party, a person related to the other party or a court or arbitrator; and (iii) the exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a *de minimis* amount, a specified amount, or an amount that is based on a formula that uses objective financial information.[17]

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[14] Treas. Reg. § 1.1001-3(c)(2)(ii).

[15] Treas. Reg. § 1.1001-3(c)(2)(iii).

[16] It should be noted that this is an absolute test—even an economically insignificant right of the other party to alter the instrument may prevent the option from being unilateral. Obviously, a *de minimis* exception in this regard would be welcome. *See also* Priv. Ltr. Rul. 2011-49-017 (Dec. 9, 2011) (no significant modification after unilateral option resulting in mandatory tender by holders; in accordance with bond terms because the mandatory tender was not equivalent to a holder's right to alter or terminate the bonds).

[17] Treas. Reg. § 1.1001-3(c)(3).

An issuer's failure to perform its obligations under a debt instrument is also not a modification.[18] An agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for more than two years following the issuer's initial failure to perform, and any additional period during which the parties conduct good faith negotiations or during which the issuer is in a Title 11 or similar case.[19]

Although a change in the currency denomination of a debt instrument is generally considered a modification, Treasury regulations provide an exception for a change in denomination to the euro.[20] The advent of the euro, on January 1, 1999, as the single currency of participating members of the European Union[21] initially raised concerns that the conversion of the national currencies of those members ("legacy currencies") to the euro would be a taxable exchange.[22] Responding to those concerns, the IRS issued temporary, and then final, regulations providing nonrealization treatment for the conversion of a legacy currency to the euro.[23] The regulations apply broadly to a change in rights and

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[18] Treas. Reg. § 1.1001-3(c)(4)(i).

[19] Treas. Reg. § 1.1001-3(c)(4)(ii). A Title 11 case means a case under Title 11 of the United States Code relating to bankruptcy. In addition, for this exception to apply, the taxpayer must be under the jurisdiction of the court and the discharge of indebtedness must be granted by the court or be pursuant to a plan approved by the court.

[20] Treas. Reg. § 1.1001-5.

[21] Only eleven members of the European Union initially participated in the conversion of their national currencies to the euro. The eleven members were: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. Today, eighteen of the twenty-eight member states of the European Union have adopted the euro as their official currency.

[22] *See, e.g., Deloitte & Touche Joins Microsoft and Others in Seeing Euro Conversion as "Non-Event,"* 98 TNT 93-35 (Apr. 30, 1998).

[23] Treas. Reg. § 1.1001-5(a); T.D. 8776, 1998-2 C.B. 6 (July 29, 1998) (temporary regulations); T.D. 8927, 2001-1 C.B. 807 (Jan. 10, 2001) (final regulations).

obligations denominated in a legacy currency if the change results solely from the conversion of the legacy currency to the euro.[24] For example, a change in the currency denomination of a bond from French francs to euros as a result of the conversion of the franc to the euro is not a "modification" under the section 1001 regulations.[25]

If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification.[26]

A modification is tested when the parties agree to a change, even if the change is not immediately effective.[27] The regulations provide exceptions for a change in a term that is agreed to by the parties but is subject to reasonable closing conditions or that occurs as a result of bankruptcy proceedings.[28] In these cases, a modification occurs on the date the change in the term becomes effective.[29] Thus, if the conditions do not occur (and the change in the term does not become effective), a modification does not occur.

2. Significant Modifications

As stated above, a modification must be "significant" to trigger a deemed exchange. The regulations describe categories of modifications that generally would be considered significant and add a general rule for types of modifications for which specific rules are not provided.[30] Under this general rule (the "general significance rule"), a modification is significant if, based on all the facts and circumstances, the legal rights or obligations being

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[24] Treas. Reg. § 1.1001-5(b) (effective for tax years ending after July 29, 1998).

[25] Treas. Reg. § 1.1001-5(b).

[26] Treas. Reg. § 1.1001-3(c)(5).

[27] Treas. Reg. § 1.1001-3(c)(6)(i).

[28] *See* Treas. Reg. § 1.1001-3(c)(6)(ii), (iii).

[29] Treas. Reg. § 1.1001-3(c)(6)(ii), (iii).

[30] Treas. Reg. § 1.1001-3(e).

changed and the degree to which they are being changed are economically significant.[31]

When testing a modification under the general significance rule, all modifications made to the instrument (other than those for which specific bright-line rules are provided) are considered collectively. Thus, a series of related modifications, each of which independently is not significant under the general significance rule, may together constitute a significant modification.[32] The general significance rule also applies to a type of modification for which specific rules are provided if the modification is effective upon the occurrence of a substantial contingency.[33] Moreover, the general significance rule will apply to certain types of modifications that are effective on a substantially deferred basis.[34]

a. Changes in Yield

The regulations provide that a change in yield is significant if the change exceeds the greater of 25 basis points or 5% of the original yield on the instrument. This bright-line rule is limited to fixed rate and variable rate debt instruments. Because of the difficulties in developing appropriate mechanisms for measuring changes in the yield of other debt instruments (for example,

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31 Treas. Reg. § 1.1001-3(e)(1).

32 Treas. Reg. § 1.1001-3(e)(1); Rev. Rul. 81-169, 1981-1 C.B. 429 (holding that reduction in interest rate, extension of maturity and elimination of sinking fund requirement, "taken together," constituted a material modification); Priv. Ltr. Rul. 98-44-021 (Oct. 30, 1998) (modifications of the terms of bonds involving interest, repayment, security, and redemption rights conferred legally distinct entitlements sufficient to trigger a deemed exchange under section 1001); FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS stated that a significant modification due to a change in yield can result from a change in either the amount or timing of payments); *but see* Priv. Ltr. Rul. 98-19-043 (May 8, 1998) (ruling that a proposed modification of notes did not constitute a significant modification because each step in the series of modifications did not alter the legal rights and obligations of the parties to any economically significant degree).

33 Treas. Reg. § 1.1001-3(f)(1)(ii).

34 Treas. Reg. § 1.1001-3(f)(1)(iii).

contingent payment debt instruments), the regulations provide that the significance of changes in the yield of those other instruments is determined under the general significance rule, described above.[35] A commercially reasonable prepayment penalty generally is not taken into account in determining the yield of the modified instrument.[36]

Example 1: ABC Corp. issues to L a debt instrument bearing a 10% annual interest rate at par. ABC Corp. and L agree to a modification of the debt instrument that reduces the yield to 9.25%. The 75 basis point reduction in yield is a significant modification because it exceeds 50 basis points (*i.e.,* the greater of 25 basis points or the product of 5% and the original yield of 10%). To avoid a significant modification from a change in yield, the yield should not be reduced below 9.5%.

b. Changes in Timing and Amount of Payments

A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in

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[35] Treas. Reg. § 1.1001-3(e)(2)(i). Under the prior proposed regulations, a change to the terms of a debt instrument that caused the annual yield of the instrument to change by more than 0.0025% (25 basis points) constituted a significant modification. Three separate tests were used to determine whether alterations in the terms of a debt instrument caused such a change in the yield of an instrument. First, any change of more than 25 basis points in the stated interest rate of a debt instrument that provided for current interest payments was a significant modification. Second, a change in the index, formula, or other mechanism that was used to determine the interest rate on a variable rate debt instrument was a significant modification only if the change could reasonably be expected to affect the annual yield on the debt instrument by more than 25 basis points. Third, any other change to a debt instrument that changed the yield on the instrument by more than 25 basis points was a significant modification. Prop. Treas. Reg. § 1.1001-3(e)(1); *see also* FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed regulations were outstanding, the IRS stated that a change in yield that causes a significant modification can result from a change in either the amount or timing of payments).

[36] *See* Treas. Reg. § 1.1001-3(e)(2)(iii)(B).

the material deferral of scheduled payments.[37] The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. 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 amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

The regulations allow the deferral of payments within a safe-harbor period (the lesser of five years or 50% of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period.[38] The terms of an instrument are determined without regard to options to extend the original maturity and deferrals of *de minimis* payments.[39] If the safe-harbor period exceeds the actual deferral period, the excess remains a safe-harbor period available for any subsequent deferral of payments on the debt instrument.[40]

Example 2: On January 1, 1988, ABC Corp. issued to L a debt instrument scheduled to mature on December 31, 1996, with an option to extend the maturity to December 31, 2000. L allows ABC Corp. to refinance the debt and extends the maturity to December 31, 1997. The one-year extension is not a significant modification because it falls within the safe-harbor period (*i.e.*, the lesser of (i) five years or (ii) 50% of the original term of eight years, without regard to the option to extend the maturity four years), which, in this case, is four years. Because the deferral period of one year is less than the safe-harbor period, ABC Corp.

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[37] Treas. Reg. § 1.1001-3(e)(3)(i). The regulations do not address acceleration of payments, which presumably would be a modification, but not a significant modification. Query whether the sale of coupon rights back to the issuer would be treated simply as prepayments or as a modification of the entire debt instrument. Such a sale may also be treated as a bond-stripping transaction under section 1286. *See* James M. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737, 771-73 (Apr. 29, 2002).

[38] Treas. Reg. § 1.1001-3(e)(3)(ii).

[39] Treas. Reg. § 1.1001-3(e)(3)(i).

[40] Treas. Reg. § 1.1001-3(e)(3)(i).

and L may agree to a further extension of up to three years without triggering a deemed exchange. Notably, the 3-year unused portion of the safe-harbor period exceeds the safe-harbor period of ½ year calculated based on the new term of the instrument (lesser of five years or 50% of one year).

The proposed regulations had provided four rules for determining whether a change in the timing or amount of payments results in a significant modification. First, such a change was a significant modification if it materially deferred payments due under an instrument.[41] Second, an extension of the maturity date beyond the lesser of (i) five years or (ii) 50% of the original term of the instrument was a significant modification.[42] Third, the prepayment or forgiveness of a portion of a debt instrument was generally not a significant modification unless such prepayment or forgiveness caused more than a 25 basis point change in the instrument's yield.[43] Fourth, the addition or deletion of a put or call right with significant value when added or deleted was a significant modification.[44]

If the terms of any debt instrument issued on or after August 13, 1996 are modified to defer one or more payments in a manner that does not cause a deemed exchange under section 1001, then solely for purposes of the OID rules under sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the modification date for an amount equal to the instrument's adjusted issue price on that date.[45] As a result, a deferral of interest payments that is not a significant modification under section 1001 could nevertheless cause a non-OID instrument to be reissued as an OID instrument if interest payments cease to constitute "qualified stated interest."[46]

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[41] Prop. Treas. Reg. § 1.1001-3(e)(2)(i).

[42] Prop. Treas. Reg. § 1.1001-3(e)(2)(ii).

[43] Prop. Treas. Reg. § 1.1001-3(e)(2)(iii), (g), Ex. 3.

[44] Prop. Treas. Reg. § 1.1001-3(e)(2)(iv).

[45] Treas. Reg. § 1.1275-2(j).

[46] *See* Section IV below for a more detailed description of the OID rules.

c. Changes in Obligor or Security

A change in the obligor on a nonrecourse debt instrument is not a significant modification.[47] The regulations provide that a change in the obligor on a recourse instrument is a significant modification unless the change results from a tax-free reorganization or liquidation, or from a transaction in which the new obligor acquires substantially all of the assets of the original obligor.[48] Each exception must meet the following requirements: (i) other than the substitution of a new obligor, the transaction must not result in any alteration that would be a significant modification but for the fact that it occurs by operation of the terms of the instrument (a "significant alteration"); and (ii) the transaction must not result in a change in payment expectations.[49]

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[47] Treas. Reg. § 1.1001-3(e)(4)(ii).

[48] Treas. Reg. § 1.1001-3(e)(4)(i). *See* Priv. Ltr. Rul. 2007-42-016 (October 19, 2007) (ruling that substituting the guarantor as the primary obligor and releasing the borrower from liability was a significant modification).

[49] Treas. Reg. § 1.1001-3(e)(4)(i)(B),(C),(E). *See, e.g.,* Priv. Ltr. Rul. 97-11-024 (Mar. 14, 1997) (ruling that in a tax-free spinoff under section 355, the substitution of the controlled corporation for the distributing corporation as obligor was not a significant modification; the transaction was an acquisition of substantially all the assets of distributing corporation under Treas. Reg. § 1.1001-3(e)(4)(i)(C), it did not result in a significant alteration, and payment expectations did not change); *see also* Priv. Ltr. Rul. 2007-09-013 (March 2, 2007) (ruling that there was not a significant modification of the debt of a company that converted from a corporation to a limited liability company and was partially acquired by a third party because under state law there was no change in the creditors' rights against the company or the company's obligations under state law and each step of the transaction where a new obligor was substituted qualified for an exception under Treas. Reg. § 1.1001-3(e)(4)(i)(B) or (C)); Priv. Ltr. Rul. 2010-10-015 (Mar. 12, 2010) (ruling that there was not a significant modification of the debt of a subsidiary that converted into an LLC as part of its parent's reorganization, because the transaction would not affect the legal rights or obligations between the debt holders and the subsidiary or otherwise result in a change in payment expectations).

The regulations also provide that the filing of a petition in a Title 11 or similar case does not by itself result in the substitution of a new obligor.[50] The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor and the collateral securing the instrument continues to include the original collateral.[51] The substitution of a new obligor is also not a significant modification if the acquiring corporation becomes the new obligor pursuant to a section 381 transaction, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.[52] An election under section 338, following a qualified stock purchase of an issuer's stock, does not result in the substitution of a new obligor.[53]

A change in payment expectations occurs if there is a substantial enhancement or impairment of the obligor's capacity to meet its payment obligations under the instrument and the enhancement or impairment results in a change to an adequate capacity from a speculative capacity or vice versa.[54] There is no change in payment expectations, however, if the obligor has at least an adequate capacity to meet its payment obligations both before and after the modification.[55]

The regulations apply the payment expectations test to determine whether the addition or deletion of a co-obligor is a significant modification.[56] Similarly, the regulations provide that

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[50] Treas. Reg. § 1.1001-3(e)(4)(i)(G).

[51] Treas. Reg. § 1.1001-3(e)(4)(i)(D). In a recent Chief Counsel advice memorandum, the IRS confirmed this result, holding that no significant modification occurred when California dissolved various redevelopment agencies and substituted successor agencies as obligors for the previous agencies' tax-exempt bonds. *See* A.M. 2012-004 (May 23, 2012).

[52] Treas. Reg. § 1.1001-3(e)(4)(i)(B).

[53] Treas. Reg. § 1.1001-3(e)(4)(i)(F).

[54] Treas. Reg. § 1.1001-3(e)(4)(vi)(A).

[55] Treas. Reg. § 1.1001-3(e)(4)(vi)(B). An obligor's capacity includes any source for payment, including collateral, guarantees or other credit enhancement.

[56] Treas. Reg. § 1.1001-3(e)(4)(iii).

whether certain other modifications are significant is determined by reference to whether the modifications result in a change in payment expectations. Those modifications include: (i) for recourse debt, the release, substitution, addition, or other alteration of the collateral for, a guarantee on, or other form of credit enhancement; and (ii) for both recourse and non-recourse debt, a change in the priority of a debt instrument.[57]

A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument generally is a significant modification even if the modification does not result in a change in payment expectations.[58] If the collateral is fungible, however, or is in the form of a commercially available credit enhancement, a substitution of the collateral is not a significant modification. Improvements to the property serving as collateral for a nonrecourse debt also do not give rise to a significant modification.[59]

Example 3: DH Partnership ("DHP") owns the Taj Mahal Hotel, which has a fair market value of $500,000 and is subject to a $1,000,000 nonrecourse bank loan. With the bank's consent, DHP exchanges the Taj Mahal for a new hotel with a fair market value of $500,000. The substitution of collateral is a significant modification even though the new collateral is worth the same amount as the old collateral.

Example 4: Assume the same facts as in Example 3 except that instead of exchanging the Taj Mahal for a new hotel, DHP renovates the Taj Mahal, increasing the hotel's fair market value to

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57 Treas. Reg. § 1.1001-3(e)(4)(iv)(A), (v).

58 Treas. Reg. § 1.1001-3(e)(4)(iv)(B). It is not clear whether the term "substantial amount of" qualifies only the collateral for a nonrecourse debt or also the guarantee or other credit enhancement for the debt. Arguably, only an alteration of a substantial amount of a guarantee on or credit enhancement for a nonrecourse debt should trigger a deemed exchange, and a fungibility concept should apply so that a substitution of a guarantor that produces an equally valuable guarantee (*e.g.,* same credit quality) should not be a significant modification.

59 Treas. Reg. § 1.1001-3(e)(4)(iv)(B).

$600,000. The improvements to the collateral are not considered a significant modification of the nonrecourse debt.

d. Changes in the Nature of a Debt Instrument

A modification to a debt instrument that causes the instrument not to be treated as debt is a significant modification.[60] Unless there is a substitution of a new obligor or the addition or deletion of a co-obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.[61]

Under the proposed regulations, the change of a debt instrument from nonrecourse to recourse or recourse to nonrecourse was a significant modification.[62] However, the final

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[60] Treas. Reg. § 1.1001-3(e)(5)(i).

[61] Treas. Reg. § 1.1001-3(e)(5)(i).

The preamble to the 1996 final regulations explained that for purposes of Treasury regulation section 1.1001-3, "unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt." T.D. 8675 (June 25, 1996). However, the actual language of the final regulations limits this qualification only to a modification under paragraph (e)(5)(1), and thus the qualification does not literally apply to a modification that would be treated as significant under any of the other subsections of Treasury regulation section 1.1001-3.

The government recognized this confusion, and recently issued final Treasury regulations clarifying that any deterioration in the financial condition of the issuer is generally not taken into account to determine if the modified instrument is debt (unless there is a change in obligor), even if the modification is treated as significant under the other provisions of Treasury regulation section 1.1001-3. Treas. Reg. § 1.1001-3(f)(7)(ii)(A).

[62] Prop. Treas. Reg. § 1.1001-3(e)(4)(iv). Under the proposed regulations, each of the following changes was a significant modification: (i) changing a fixed rate instrument to a variable rate or contingent payment instrument; (ii) changing a variable rate instrument to a fixed or contingent rate instrument; (iii) changing a contingent payment instrument to a fixed rate or variable rate instrument; or (iv) changing the currency in which payment under the debt instrument is made. Prop. Treas. Reg. § 1.1001-3(e)(4)(ii).

regulations limit this rule to changes from substantially all recourse to substantially all nonrecourse, or vice versa.[63] If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under the general significance rule.[64] The regulations also provide two exceptions. First, a defeasance of a tax-exempt bond permitted by the terms of the instrument generally is not a significant modification.[65] Second, a modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations.[66] If the collateral is fungible, substitution of collateral with new collateral of a similar type and value is not considered a change in the original collateral.[67]

Although much of the regulations turn on the distinction between recourse and nonrecourse debt, the regulations do not define the terms "recourse" and "nonrecourse." In some cases, such as a loan to a special purpose vehicle that is secured by all of the entity's assets, the distinction may be without meaning.[68] If form governs, taxpayers may essentially be able to elect the classification of such debt by characterizing it as one or the other

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The final regulations lack these bright-line rules, and so the significance of any change in method of calculating payments is determined under the general significance rule.

63 Treas. Reg. § 1.1001-3(e)(5)(ii)(A).

64 Treas. Reg. § 1.1001-3(e)(5)(ii)(A).

65 Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1). The defeasance will not be a significant modification if it occurs pursuant to the terms of the indenture for the original bonds and the issuer places in trust government securities or tax-exempt government bonds reasonably expected to provide interest and principal to cover payment obligations under the bonds.

66 Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

67 Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

68 For a discussion of the meaning of the terms "recourse" and "nonrecourse" in the context of debt of disregarded entities, *see* Terence Floyd Cuff, *Indebtedness of a Disregarded Entity*, 81 TAXES 303 (Mar. 2003).

in the loan documents.[69] Another example of this blurred distinction is a recourse loan to a disregarded entity. Such a loan should not be considered a nonrecourse loan to the entity's owner where the rights of the parties under state law do not change.[70] Hopefully, additional guidance will be forthcoming on the pivotal recourse-nonrecourse question. In the absence of guidance, the recourse or nonrecourse nature of a loan should not be affected by limited exceptions that are unlikely to apply, such as nonrecourse loan provisions allowing recourse to the borrower in cases of fraud or misapplication of funds, or local law requiring a lender that forecloses on collateral for a secured recourse loan to waive any right to a deficiency judgment.

B. Comparison of Regulations and Case Law/Rulings

1. Increased Principal Amount

The IRS generally has not viewed an increase in the principal amount of debt attributable to accrued, unpaid interest as causing a deemed exchange. The regulations, by contrast, treat capitalization of accrued but unpaid interest as a deemed exchange if the capitalization changes the yield on the debt instrument by more than the greater of 25 basis points or 5% of the original yield on the instrument.[71] This issue often arises in debt restructurings, where it is common for accrued but unpaid interest payments to be

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[69] For arguments in favor of allowing taxpayers to choose classification of debt, *see* James M. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (Apr. 29, 2002).

[70] *See* Priv. Ltr. Rul. 2006-30-002 (June 28, 2006) (conversion of old parent of consolidated group into a limited liability company owned by new parent does not result in modification of nonrecourse debt issued by old parent where holders' legal rights against old parent with respect to payment and remedies and old parent's obligations and covenants to the holders were unchanged under state law); Priv. Ltr. Rul. 2003-15-001 (Sept. 19, 2002) (same).

[71] Treas. Reg. § 1.1001-3(e)(2).

capitalized and added to the principal amount of the restructured debt.[72]

2. Change from Annual Pay to Monthly Pay

Debt is often modified in restructurings to change annual arrears interest payments to monthly advance payments. In most cases, a change from annual pay to monthly pay without a corresponding decrease in interest rate will cause more than a 25 basis point increase in the annual yield of the debt. Before the regulations were adopted, the IRS took the position that a more than *de minimis* change in yield caused a deemed exchange.[73] Under the regulations, the change from annual to monthly pay (without a reduction in interest rate) will cause a deemed exchange of the debt, since any change of more than 25 basis points (or 5% of the original yield, if greater) in the annual yield of a debt instrument causes a deemed exchange.[74] This type of change is often engendered by the borrower's use of funds earmarked for debt service to satisfy more immediate cash needs.

3. Forbearance of Remedies

While lenders often continue to reserve their right to charge default interest after a borrower's failure to make its annual interest payment has matured into a default, a debt restructuring may

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72 *See* FSA 2000-06-003 (Feb. 11, 2000) (U.S. corporation liable for withholding tax for accrued but unpaid interest when interest was contributed as paid in capital by the foreign parent).

73 *See, e.g.*, Rev. Rul. 89-122, 1989-2 C.B. 200 (holding that reduction in annual interest rate from 10% to 6.25% constituted a material modification); Rev. Rul. 87-19, 1987-1 C.B. 249 (holding that waiver of right to receive increase in interest rate from 7% to 8.56% resulted in a deemed exchange); TAM 91-27-003 (Mar. 18, 1991) (holding that 87.5 basis point reduction constituted a material modification under section 1001); Priv. Ltr. Rul. 88-34-090 (June 3, 1988) (assuming for ruling purposes that 20 basis point change in yield constituted a material modification). *But see* Priv. Ltr. Rul. 89-32-067 (May 17, 1989) (ruling that a less than 12.5 basis point change in yield did not constitute a material modification); Priv. Ltr. Rul. 88-35-050 (June 8, 1988) (ruling that reduction in yield by less than 3 basis points was *de minimis*).

74 Treas. Reg. § 1.1001-3(e)(2)(ii).

include a waiver of the right to charge such default interest. Under case law and the IRS' ruling position, the forbearance of remedies (including a waiver of the current payment of interest continuing to accrue) generally does not cause a deemed exchange.[75] Under the regulations, a party's waiver of a right under an instrument will cause a deemed exchange unless the waiver is unilateral and, in the case of an option exercisable by a holder, the exercise does not result in a deferral of, or reduction in, any scheduled payment of interest or principal.[76] Absent a written or oral agreement to alter other terms of the instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right is not a modification unless and until the forbearance remains in effect for a period that exceeds two years following the issuer's initial failure to perform, and any additional period during which the parties conduct good faith negotiations or during which the issuer is in a Title 11 or similar case.[77]

4. Extension of Maturity Date

Almost every restructuring includes some extension of the maturity date on the debt. Under case law and IRS rulings predating the regulations, an extension of maturity did not cause a deemed exchange of the debt.[78] Under the regulations, an

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75 Priv. Ltr. Rul. 89-20-047 (Feb. 17, 1989); *see also West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1952), *acq.*, 1952-2 C.B. 3; *Motor Products Corp. v. Commissioner,* 47 B.T.A. 983 (1942), *aff'd*, 142 F.2d 449 (6th Cir. 1944), *acq.*, 1946-1 C.B. 3; *Farmers Trust Co. v. Hoey*, 52 F. Supp. 665 (S.D.N.Y. 1942), *aff'd*, 138 F.2d 1023 (2d Cir. 1943).

76 *See* Treas. Reg. § 1.1001-3(c)(2)(iii).

77 *See* Treas. Reg. § 1.1001-3(c)(4).

78 *See* Rev. Rul. 73-160, 1973-1 C.B. 365; *see also* Priv. Ltr. Rul. 90-43-060 (Aug. 1, 1990); Priv. Ltr. Rul. 88-48-033 (Sept. 1, 1988); Priv. Ltr. Rul. 88-29-028 (Apr. 20, 1988); Priv. Ltr. Rul. 87-53-014 (Oct. 2, 1987); Priv. Ltr. Rul. 87-42-032 (July 20, 1987); Priv. Ltr. Rul. 87-31-011 (May 1, 1987); Priv. Ltr. Rul. 87-08-017 (Nov. 21, 1986); Priv. Ltr. Rul. 85-34-064 (May 28, 1985); Priv. Ltr. Rul. 83-46-104 (Aug. 18, 1983). In a 1989 private ruling, deferral of interest payments was permitted under a net cash flow workout where deferred interest bore interest on a compound basis. Priv. Ltr. Rul. 89-20-047 (Feb. 17, 1989) (citing *Motor Products Corp. v.*

extension of the maturity date on the debt is a significant modification if it results in the material deferral of scheduled payments.[79] The regulations allow the deferral of payments during a safe-harbor period (the lesser of five years or 50% of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period.[80] Thus, meaningful extensions of the term of debt will be severely curtailed under the regulations. In particular, there may be virtually no ability to extend maturity under the regulations where debt being restructured has already been refinanced for only a short term. Moreover, even if a deferral does not trigger a deemed exchange of the debt, deferring interest may transform non-OID debt into OID debt.[81]

5. Changes in Obligor or Collateral

The IRS has not viewed the addition of a guarantee as triggering a deemed exchange.[82] Although there is no authority regarding the release of a guarantee, such a release should not trigger a deemed exchange according to the IRS' view. Under the regulations, the release of a guarantee of nonrecourse debt generally causes a deemed exchange of the debt instrument, whereas the release of a guarantee of recourse debt causes a deemed exchange of the debt instrument if the modification results in a change in payment expectations.[83] Lenders often agree to

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Commissioner, 47 B.T.A. 983 (1942), *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944) and *West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1942), *acq.*, 1952-2 C.B. 3).

79 Treas. Reg. § 1.1001-3(e)(3)(i).

80 Treas. Reg. § 1.1001-3(e)(3)(ii).

81 *See* Treas. Reg. § 1.1275-2(j).

82 Priv. Ltr. Rul. 85-34-064 (May 28, 1985).

83 Treas. Reg. § 1.1001-3(e)(4)(iv); *see also* Priv. Ltr. Rul. 2000-47-046 (Aug. 30, 2000); Priv. Ltr. Rul. 1999-04-017 (Oct. 29, 1998) (parent's assumption of indirect subsidiary's debt was not a significant modification because the assumption did not cause a change in payment expectations); Priv. Ltr. Rul. 2000-47-046 (Aug. 30, 2000) (removal of subsidiary as guarantor was not a significant modification because the subsidiary's earnings and assets would continue to provide parent with payment capacity, causing no change in payment expectations).

release guarantees of either interest or principal in connection with a debt restructuring, generally because the guarantees are of little practical value due to the fact that the guarantors (often related parties) are also in financial distress. A change in an amount of nonrecourse debt collateral that is not substantial generally will not result in a deemed exchange under either IRS rulings[84] or the regulations.[85]

C. Potential for Equity Recharacterization

1. Basis for Recharacterization

Recharacterization of modified debt as equity consequent to a deemed debt exchange carries with it a host of adverse tax consequences for borrowers and for foreign lenders. This issue arises because the regulations provide that a deemed exchange occurs if and when a restructured debt instrument no longer qualifies as debt for tax purposes.[86] The implication of this provision is that modified debt is subject to equity recharacterization under general debt-equity principles even under circumstances where the form of a debt instrument is not recast as equity. Further, the issue presents itself under the regulations whenever the value of the collateral securing a loan is less than the outstanding principal amount of debt being restructured, and there is a change in obligor(s) under the restructured debt. As a practical matter, either the IRS, or the borrower as the withholding agent for foreign lenders, could treat modified debt as equity of the borrower following a deemed debt exchange.

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[84] *See* Priv. Ltr. Rul. 98-01-047 (Oct. 3, 1997) (reducing the principal amount of U.S. Government obligations to be delivered as substitute collateral to obtain the release of a lien on real property from 125% to 100% of the outstanding balance of mortgage loan was not a significant modification because the amendment did not release a substantial amount of collateral and the obligation to repay the entire mortgage loan remained fully secured).

[85] Treas. Reg. § 1.1001-3(e)(4)(iv).

[86] Treas. Reg. § 1.1001-3(e)(5). *See also* FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS stated generally that new instruments issued in debt exchanges may have to be retested under debt-equity principles).

The retesting contemplated by the regulations is a clear departure from current law; the IRS has not historically attempted to recharacterize a deemed exchanged debt instrument as equity solely because the value of the collateral securing the debt has declined since the issue date. Nevertheless, IRS representatives stated shortly after the proposed regulations were released that they were considering whether it is proper to retest debt under general principles after a deemed debt exchange when the debt would continue to qualify as debt but for the decline in value of the collateral.[87] The IRS has carved out these circumstances from re-testing under the regulations, but only when the obligor remains the same on the restructured debt. Consequently, it is not clear why a change to (or addition of) an affiliated obligor provides a proper basis for retesting debt.

Where the IRS seeks to challenge the tax treatment of modified debt, its character as debt or equity presumably would be determined under all of the relevant facts and circumstances at the time of the deemed debt exchange.[88] For an instrument to be debt, facts must exist to support a reasonable expectation that the debt will be serviced in accordance with its terms, which terms include stated dates for the payment of principal and interest.[89] The factors relevant in determining whether an instrument satisfies this standard and qualifies as debt include (i) the intent of the parties to create a debtor-creditor relationship,[90] (ii) the expectation of the ability of the borrower to obtain funds from operations or outside sources to service the debt, (iii) the ratio of debt to equity in the capital structure of the borrower, (iv) the risk involved in the loan,

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[87] *See Official Details Treasury, IRS Thinking Behind Proposed 'Cottage Savings' Regulations*, Daily Tax Report (BNA), at G4, 5 (Mar. 5, 1993).

[88] *See* I.R.C. § 385(b).

[89] *See, e.g., Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957).

[90] *See, e.g., Cerand & Co., Inc. v. Commissioner*, T.C. Memo 2001-271 (2001) (inadequate evidence to support a finding of true debtor-creditor relationship where there were no debt instruments or signed agreements, no fixed maturity date or repayment schedule, and repayments were inconsistent and appeared dependent on financial success); *see also* FSA 2000-03-001 (Jan. 21, 2000) (holding taxpayer to its chosen form and refusing to recharacterize foreign parent loans to U.S. subsidiaries as equity rather than debt).

and (v) the source of payments on the loan.[91] Courts applying these factors have historically held that even advances to an insolvent borrower may be respected as debt when the creditor had a "genuine expectation of repayment," notwithstanding current financial problems of the borrower.[92]

One Tax Court Memorandum opinion highlights the Tax Court's continued reluctance to adopt the IRS position of testing each of several subsequent loans between the same borrower and lender separately and without regard to the long-standing debtor-creditor relationship.[93] In *Foretravel, Inc. v. Commissioner*, the Tax Court was presented with the IRS argument that the latter part of a series of loans between related parties was in substance capital contributions as a result of the borrower's increasingly poor financial condition.[94] The Tax Court refused to examine each advance separately under general debt-equity principles, terming that approach "artificial."[95] Instead, the court examined the series of advances together and held that each of the loans constituted debt, notwithstanding the borrower's poor financial condition.[96]

Where lenders ease the payment terms of debt instead of making further advances, this same intent to continue the debtor-creditor relationship exists. Absent an expectation of eventual repayment of the debt on the restructured terms, a creditor would have a strong economic incentive to force a sale of the collateral in order to terminate its relationship with the borrower. Lenders engaging in this calculus do not view themselves as equity holders,

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[91] *See Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Laidlaw Transportation, Inc. v. Commissioner*, T.C. Memo 1998-232 (1998); *Nestle Holdings, Inc. v. Commissioner*, T.C. Memo 1995-441 (1995); *see also* I.R.C. § 385(b) (listing debt-equity factors which could be taken into account in issuing regulations).

[92] *See, e.g.*, *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536, 552 (1968); *American Processing and Sales Co. v. United States*, 371 F.2d 842, 856-57 (Ct. Cl. 1967); *Drachman v. Commissioner*, 23 T.C. 558, 562-63 (1954).

[93] *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995).

[94] *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995).

[95] *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995).

[96] *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995).

but they may need to refocus their approach to loan restructurings if the IRS proceeds with equity recharacterization. If the IRS fails to respect the parties' continued debtor-creditor relationship after a deemed debt exchange, foreign lenders may be particularly reluctant to engage in debt restructurings. Faced with uncertainty as to whether modified debt is in fact treated as equity, increasing numbers of such lenders may seek to foreclose on their collateral, which would in turn prompt borrowers to seek protection of the automatic stay from foreclosure in bankruptcy.

To date, the IRS has offered no explanation as to why a deemed exchange of debt that includes a change (or addition) of an obligor provides an appropriate occasion for retesting debt under general debt-equity principles; retesting debt upon a deemed exchange clearly contravenes the "once debt, always debt" principle that has historically been a basic tenet of debt-equity treatment.[97] This is particularly true in light of the fact that the value of collateral for debt typically will have fallen below the outstanding principal amount of the debt it secures by the time the debt is restructured. As a result, a re-examination of whether the debt is still good debt would commonly yield a negative answer due solely to the effect of reduced collateral value on the borrower's debt-equity ratio. While it is certainly appropriate to give due weight to the value of collateral when debt is originally incurred, this factor should be accorded little, if any, weight in the context of restructuring troubled borrowers' debt where a long-standing debtor-creditor relationship exists.

Moreover, sustaining equity recharacterization in the context of a deemed debt exchange requires either that the parties' historical debtor-creditor relationship be ignored, or the implicit conclusion that collateral always constitutes a wasting asset. As discussed above, the Tax Court has refused to separate individual loans from the historical relationship of the parties. Moreover, the cyclical nature of real estate values is one example that contravenes the conclusion that the value of collateral will not subsequently increase; lenders may quite reasonably expect eventual principal repayment of restructured debt as their collateral

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[97] *See, e.g.*, *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *see generally* William T. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 499-503 (1971).

value increases. In light of the continuing debtor-creditor relationship that typically underlies a debt restructuring, any IRS attempt to recharacterize modified debt as equity on the basis of a decline in collateral value should fail. The exclusion of this factor from the retesting equation (absent the substitution of a new obligor) in the final regulations[98] is a welcome signal that the IRS agrees with this conclusion. However, limiting the exclusion to exchanges where the obligor does not change significantly limits troubled issuers' reorganization options.

Equity recharacterization also stands in curious contrast to the treatment of "equity-flavored debt" elsewhere in the Code. In sections 163(e) and (h), for example, an issuer's deduction for OID on high yield debt instruments is deferred until interest is paid, and in cases where the debt instrument most resembles equity, a portion of the interest deduction is disallowed.[99] Similarly, the "earnings-stripping" rules in section 163(j) disallow an issuer deduction for interest paid on equity-flavored debt held by foreign and tax-exempt persons, but the rules do not recharacterize the underlying debt instrument as equity. Finally, the contingent debt regulations clearly contemplate that obligations qualify as debt even where the repayment of some portion is at best uncertain. In none of these cases, however, is the actual debt instrument in question recharacterized as equity. Ultimately, the best reason for retaining debt or equity status may be the far-reaching consequences of recharacterizing that status.

2. Consequences to Borrowers

The provisions in the regulations give no hint as to the type of equity interest a lender would be deemed to hold in a borrower if and when debt is recharacterized as equity. A threshold question is whether recharacterization would cause part or all of a lender's note to be treated as equity. In other contexts courts have bifurcated notes into part debt and part equity, and such bifurcation

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[98] Treas. Reg. § 1.1001-3(e)(5) (providing that any deterioration in the financial condition of the obligor between the issue date of the unmodified debt instrument and the modification date is not taken into account unless there is a substitution of a new obligor or an addition or deletion of a co-obligor).

[99] *See* discussion in Section IV.I regarding high yield debt instruments.

would certainly be appropriate in the context of a deemed debt exchange to the extent Treasury is determined to proceed with equity recharacterization.[100]

Other crucial questions will obviously include whether lenders will be treated as holding an equity interest in the borrower, or whether the lender will be treated as holding a direct interest in the borrower's asset in the case of single-asset borrowers. A third possibility is that the type of equity interest will depend on the classification of the borrower. Since the asset of a single-asset partnership borrower would typically have collateralized the borrower's obligation under the loan, equity recharacterization would be tantamount to a foreclosure on the borrower's collateral. Moreover, even if the IRS determines that a lender will take an equity interest in the borrower rather than an interest in the collateral, that interest may be tantamount to a direct interest in the asset in the case of certain single-asset borrowers.

For example, since the outstanding balance due on recharacterized debt would typically exceed the value of the sole asset of a partnership borrower, the lender could theoretically be viewed as acquiring 100% of the equity interests in the borrower partnership. Under those facts, one would assume the partnership would terminate for tax purposes,[101] leaving the lender holding a direct interest in the partnership asset(s). If the lender is instead treated as acquiring less than 100% of the equity interests in a single-asset partnership, query whether the other partners would be treated as relieved of their share of the partnership debt now treated as equity, and if so, whether the potential deemed distribution of cash and additional cancellation of indebtedness income ("COD") could cause the non-lender partners to recognize additional phantom income for tax purposes.[102]

A panoply of issues would also arise in connection with the recharacterization of debt of a borrower with multiple assets (often

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[100] *See, e.g.*, *Pleasant Summit Land Corp. v. Commissioner*, 863 F. 2d 263 (3d Cir. 1988).

[101] A partnership terminates for tax purposes if 50% or more of the total interest in partnership capital and profits is sold or exchanged within a 12-month period. I.R.C. § 708(b)(1)(B).

[102] *See* I.R.C. § 731.

corporate), where a lender might presumably be treated as holding a deemed equity interest in the borrower entity after an equity recharacterization. For example, would the lender's priority rights under the deemed equity instrument dictate that the lender receive a preferred interest in the borrower entity? If so, a number of additional issues would arise. For example, within affiliated groups of corporations, it is often the subsidiaries, rather than the common parent corporation, who are the borrowers. As a threshold matter, a deemed preferred stock interest in a borrower subsidiary would typically be worth less than its liquidation value (which might reasonably equal the stated redemption price of the modified debt instrument), and the lender might be required to accrete the liquidation "premium" on the deemed preferred stock under section 305. Ironically, this result could obtain even under circumstances where a deemed exchange of non-publicly traded debt would not produce OID (or COD).

Additional and perhaps more serious consequences could result if the IRS argues that a deemed equity interest in a borrower subsidiary would constitute participating preferred stock for purposes of section 1504(a)(4)(C). In that case, unless such stock was nevertheless treated as section 1504(a)(4) stock, the subsidiary could be treated as deconsolidated from its common parent. Although such a conclusion is not compelled by the applicable legislative history, and it is not supported by case law, the IRS may be no less likely to make such an argument than to recharacterize debt as equity.[103] Deconsolidation would trigger a host of negative tax consequences for the borrower's affiliated group, including (i) triggering of deferred gains with respect to the borrower subsidiary's stock or assets, (ii) triggering excess loss accounts with respect to such subsidiary's stock, and (iii) precluding other group members' future use of such subsidiary's net operating losses ("NOLs").

With regard to a borrower subsidiary's NOLs (which would typically have been funded in part by interest expense attributable to the recharacterized debt), query whether a deemed equity interest would also constitute participating preferred stock that

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[103] *See* New York State Bar Association, Tax Section, *Report on Section 305 Proposed Regulations*, 94 TNT 219-10, n.5 (Nov. 8, 1994).

would be considered stock for purposes of section 382.[104] Since the lender's "participating preferred stock" interest would logically include most of the value of the borrower subsidiary, the deemed issuance of such stock could logically be thought to trigger an ownership change for the borrower subsidiary. Such an ownership change would typically impose significant limitations on the use of the subsidiary's NOLs in light of the probable low value of the subsidiary's assets at the time of a deemed debt exchange.

3. Consequences to Foreign Lenders

If restructured debt retains its character as non-contingent debt after a deemed exchange, foreign lenders would have no significant adverse U.S. tax consequences. Most foreign lenders could continue to treat interest paid as portfolio interest not subject to U.S. withholding tax (as long as the interest on the modified debt is not contingent),[105] and a foreign lender would not be subject to U.S. tax on gain attributable to the deemed debt exchange (and losses could not be used to shelter U.S. income) unless the lender is otherwise currently engaged in a related U.S. trade or business or separately subject to U.S. tax.[106] Lenders have historically relied on a U.S. trade or business exception for trading in stocks or securities (as opposed to loan origination activity) to achieve this result.[107] More recently, however, commentators have

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[104] *See* I.R.C. § 382(k).

[105] *See* I.RC. §§ 871(h)(4) and 881(c)(4) (certain contingent interest does not qualify as portfolio interest).

[106] *See* I.RC. §§ 871(a) & (b), 881(a), and 882(a); *see also* Treas. Reg. § 1.1441-2(b)(2)(i). *But see Sun Capital Partners III LP v. New England Teamsters and Trucking Industry*, No. 12-2312 (1st Cir. 2013) (First Circuit concluded foreign investors may be engaged in a U.S. trade or business by reason of the general partner's activities for ERISA purposes), *cert. denied* No. 13-648 (Mar. 3, 2014).

[107] I.R.C. § 864(b)(3)(A). Securities are defined for purposes of this safe harbor as "any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." Treas. Reg. § 1.864-2(c)(2)(i).

See e.g., New York State Bar Association, Tax Section, *NYSBA Members Seek Guidance on Tax Issues Arising From Economic Downturn*, 2008 TNT 162-14 (Aug. 20, 2008); *see also* Robert voiced concern that the IRS could view deemed exchanges of troubled loans as loan origination activity, causing a foreign lender restructuring its debt holdings to become engaged in a U.S. trade or business and thus subject to U.S. income taxes.[108]

On the other hand, if restructured debt is treated as equity in a partnership, foreign lenders will experience a myriad of adverse tax consequences. As a threshold matter, if restructured debt is treated as deemed equity in a borrower partnership, lenders would be treated as partners in the partnership. Under such circumstances, interest payments received by foreign lenders in their capacity as partners could be recharacterized for U.S. tax purposes as guaranteed payments for the use of capital.[109] In that case, the lenders' tax consequences would then depend on (i) whether the partnership is engaged in a U.S. trade or business, and (ii) whether such deemed guaranteed payments are characterized as interest income or as a distributive share of partnership income; support exists for each characterization.[110]

Cassanos, *An Alternative Approach to the Offshore Lender's Dilemma*, 2009 TNT 2-63 (Jan. 5, 2009).

108 The New York State Bar Association has asked the IRS to provide guidance on whether restructuring debt could cause a foreign person to become engaged in a U.S. trade or business. *See, e.g.*, New York State Bar Association, Tax Section, *NYSBA Members Seek Guidance on Tax Issues Arising From Economic Downturn*, 2008 TNT 162-14 (Aug. 20, 2008) ("We are concerned that the trading exception . . . may not apply if the foreigner originates loans and that the creation of a new debt instrument pursuant to a deemed exchange of debt under 1001 might be treated as a loan origination that disqualifies the taxpayer from the Section 864(b)(2) safe harbor."); New York State Bar Association, *NYSBA Members Recommend Projects for IRS Guidance Priority List*, 2009 TNT 127-11 (July 7, 2009).

109 The lenders could also be separately treated as having the right to a distributable share of partnership profits.

110 *See* Treas. Reg. § 1.707-1(c) (guaranteed payments for use of capital generally treated as a partner's distributive share of the partnership's ordinary income); Priv. Ltr. Rul. 87-28-033 (Apr. 13, 1987) (guaranteed payments made by a partnership to a real estate investment trust retain the underlying character of the partnership's income, *i.e.*, rental income, for purposes of determining the nature of the income in recipient's hands); Priv. Ltr. Rul. 86-39-035 (June 27, 1986) (same). *But see Miller v. Commissioner*, 52 T.C. 752 (1969)

If the partnership is not engaged in a U.S. trade or business,[111] guaranteed payments received by lenders not otherwise doing business in the U.S. should not be treated as effectively connected income under either characterization. In that case, if guaranteed payments are treated as interest payments, the portfolio interest exception to withholding, and reduced withholding under treaties, should continue to apply.[112] Guaranteed payments also could be treated as rental income in accordance with the nature of the partnership's income, in which case such payments would be subject to a 30% U.S. federal withholding tax as fixed and determinable annual or periodic income.[113] Although such payments could qualify for treaty-based reduced withholding, reduced withholding for rental income payments may not be available under many treaties.[114]

(guaranteed payments treated as earned income); *Carey v. United States*, 427 F. 2d 763 (Ct. Cl. 1970); G.C.M. 38,133 (Oct. 10, 1979) (guaranteed payments treated as interest); G.C.M. 36,702 (Apr. 12, 1976) (same).

[111] *See* Rev. Rul. 88-3, 1988-1 C.B. 268 (determination of whether a taxpayer is engaged in a U.S. trade or business is highly factual and IRS will generally not rule on this issue in advance).

[112] *See* I.R.C. §§ 871(a)(1)(A); 881(a)(1).

[113] *See* I.R.C. §§ 871(a)(1)(A); 881(a)(1).

[114] For example, if guaranteed payments were treated as real property rental income, the U.S. withholding tax on such payments probably could not be reduced under the interest provisions of the United States-Japan tax treaty because the treaty provides no relief for real property rental income. *See* Convention Between the Government of the United States of America and the Government of Japan for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 6, 2003, U.S.-Japan, Senate Treaty Doc. No. 108-14, at 11 ("U.S.-Japan Tax Treaty"). Income from the rental of tangible personal property, by contrast, may be eligible for reduced withholding under the "Royalties" or "Business Profits" article of an applicable tax treaty if the income is not attributable to a permanent establishment of the foreign partner in the source country. *See, e.g.*, U.S. Model Income Tax Treaty (1981) at art. 7(1) (exempting business profits from source-State taxation if not connected to a permanent establishment in such source-State), (5) (defining business profits to include income derived from rental of tangible personal property); *see generally* Richard Anderson, *Analysis of United States Income Tax Treaties*, ¶ 4.02[4][a], [b].

By contrast, if the partnership borrower is engaged in a U.S. trade or business, deemed guaranteed payments that are characterized as a distributive share of the partnership's income would be income effectively connected with the partnership's U.S. business. Query whether the IRS would assert that such payments would properly be subject to withholding under section 1446(a) as effectively connected income allocable to foreign partners under section 704, although such a position could be disputed in light of the fact that guaranteed payments are not allocated pursuant to section 704.[115] Were section 1446 withholding to apply, partnerships could be required to withhold tax before such guaranteed payments are made.[116] This result would prove particularly harsh for borrower partnerships lacking sufficient cash flow to timely service its restructured debt, a/k/a equity, let alone pay withholding tax under section 1446 (not to mention the interest and penalties occasioned by late payment of the withholding tax).

Moreover, if restructured debt is treated as equity in a partnership owning real estate, a foreign lender's receipt of proceeds from a sale or repayment of its debt may be subject to U.S. tax by attribution to such lender's deemed equity interest in the partnership.[117] Under section 897, a foreign lender could be subject to 10% withholding on repayments of principal treated as payments in redemption of the lender's deemed partnership interest, because proceeds received from the sale or redemption of a foreign partner's interest in a U.S. partnership owning real property are treated as taxable proceeds from the sale of such foreign person's interest in the partnership's real property.[118]

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115 *See* I.R.C. §§ 1441(a); 1446(b)(2)(A). Presumably withholding would be required under either section 1441 or section 1446.

116 Section 1446(a) requires withholding on guaranteed payments on the earlier of the date a payment is made, or 3 months and 14 days after a guaranteed payment is due. *See* Rev. Rul. 89-17, 1989-1 C.B. 269.

117 *See* Treas. Reg. § 1.897-1(d)(1). Gain would be subject to U.S. tax at generally applicable rates, and a purchaser of the debt generally would be required to withhold 10% of the amount paid for the debt as a prepayment of the tax. I.R.C. § 1445(e)(5).

118 *See* I.R.C. § 897(g). An interest in a partnership (i) in which U.S. real property interests represent 50% or more of the value of its direct or indirect gross assets, and (ii) in which U.S. real property interests plus any cash represent 90% or more of the value of its

III. TAX CONSEQUENCES OF DEBT EXCHANGES

A. Borrower Tax Consequences of Debt Exchanges

A borrower will recognize COD income upon certain actual or deemed debt-for-debt exchanges if the issue price of the new debt is less than the adjusted issue price of the old debt.[119] This results because the new debt issue price is treated as the amount paid for the old debt.[120] Specifically, the borrower will recognize COD income in any exchange where the issue price of the new debt plus the fair market value of any property, stock and cash received in satisfaction of the old debt is less than the adjusted issue price of the old debt.[121]

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gross assets, is treated as entirely a U.S. real property interest for purposes of section 1445. By contrast, for section 897(g) purposes, such a partnership interest is treated as a U.S. real property interest only to the extent that gain on the disposition is attributable to U.S. real property interests. Temp. Treas. Reg. § 1.897-7T(a).

[119] The adjusted issue price of a debt instrument is its issue price, increased by the portion of any OID previously includible in gross income of any holders and decreased by the portion of any bond premium previously included in the gross income of the borrower. I.R.C. §§ 1272(a)(4); 108(e)(3). *See* Section IV below for a more detailed description of the OID rules.

[120] *See* I.R.C. § 108(e)(10) (issue price of debt instrument issued in satisfaction of debt is determined under section 1273 or 1274); *see also* FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS position was that COD income in debt exchanges is properly measured based on the respective issue prices of the debt instruments, even for debt exchanges occurring prior to the effective date of section 108(e)(10) or its predecessor).

For a thorough history of I.R.C. § 108(e)(10), as well as a discussion of certain tax issues that arise in the case of "hung" bridge loans, *see* Charles Morgan, *Bridge Loans—Confronting Tax Issues Triggered by the Recent Economic Downturn*, 7 J. *TAX'N FIN'L PRODUCTS* 4 (2009).

[121] *See* I.R.C. § 61(a)(12); Treas. Reg. § 1.61-12(c)(3); Rev. Rul. 77-437, 1977-2 C.B. 28. Section 61(a)(12) codifies the rule of *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), that a debtor recognizes taxable income upon a satisfaction of its indebtedness for less than its adjusted issue price because the satisfaction of a liability

If neither the old debt nor the new debt is publicly traded, and the new debt bears "adequate stated interest," the new debt issue price will equal its stated principal amount (for debt instruments governed by section 1274) or its stated redemption price, *i.e.*, the adjusted issue price of the old debt, and no COD income will be recognized.[122] The avoidance of COD income under these circumstances is the sole remaining exception to COD recognition in connection with an exchange of debt for property after the repeal of the stock-for-debt exception to COD income in 1993. By contrast, if an issuer exchanges non-publicly traded debt for non-publicly traded *contingent payment* debt, the issuer will ordinarily recognize COD income because the issue price of such a non-publicly traded contingent payment debt instrument does not include any amounts that are contingent.[123]

If either the old or new debt is publicly traded, the issue price of the new debt will be the trading price of the debt, *i.e.*, the fair market value of the property.[124] If the modified debt is treated as equity, the borrower's tax consequences would be the same as on a deemed exchange of publicly traded debt—the borrower

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at a discount enriches the debtor and should therefore be treated as income. *Cf.* TAM 98-22-005 (Jan. 16, 1998) (wholly owned subsidiary did not realize COD income upon cancellation of its debt to its parent).

For the purpose of determining the issue price of a new debt instrument, proposed regulations that address when property is "publicly traded" have interpreted the term expansively. 76 Fed. Reg. 1101 (Jan. 7, 2011) (issuing proposed Treasury regulation 1.1273-2(f) and defining "publicly traded"). Although this definition has been narrowed to some degree in the final regulations, *compare* Prop. Treas. Reg. § 1.1273-2(f) (2011), *with* Treas. Reg. § 1.1273(f), this definition still increases the number of debt-for-debt exchanges at a discount that produce COD income (since such a new debt instrument's issue price will more often be less than that of the retired debt instrument), *see* Robert Willens, *Debt Instruments: When Is a Debt Instrument "Traded on an Established Market"?*, 30 TAX MGMT. WEEKLY REP. 398 (Apr. 4, 2011).

[122] I.R.C. §§ 1274(a)(1); 1273(b)(4).

[123] *See* Treas. Reg. § 1.1274-2(g). *See* Section IV.H below for a detailed discussion of the contingent payment debt instrument rules.

[124] I.R.C. § 1273(b)(3).

would recognize COD income equal to the difference between the outstanding balance on the old debt and the fair market value of the equity received, *i.e.*, the fair market value of the property.[125] This result would presumably obtain without regard to whether COD would have been avoided if the debt were not recharacterized as equity.

As discussed below in Section IV.B., the Treasury Department recently issued proposed regulations that would significantly expand the definition of publicly traded debt instruments.[126] The proposed regulations, if finalized, will likely increase the scenarios where borrowers realize COD income.[127]

If the debt is discharged in a Title 11 case, the taxpayer is not required to recognize the COD income.[128] If the debt discharge occurs when the taxpayer is insolvent, the taxpayer is not required to recognize the COD income to the extent of its insolvency.[129] A taxpayer is considered insolvent if and to the extent its liabilities exceed the fair market value of its assets, as determined immediately prior to the debt discharge at issue.[130] The extent to which contingent liabilities are taken into account in determining solvency is unclear, other than in the Ninth Circuit, which has held that contingent obligations constitute a liability for these purposes only when it is "more likely than not" that the taxpayer will be required to pay such liability.[131]

Any taxpayer that excludes COD amounts from gross income because of the Title 11 or insolvency exception is required

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[125] I.R.C. § 108(e)(8). *See* Section II.C.2 for a detailed discussion of the collateral consequences to an issuer when debt is recharacterized as equity.

[126] 76 Fed. Reg. 1101 (Jan. 7, 2011).

[127] *See generally*, Lee Sheppard, *Treasury Marks to Bid*, 2011 TNT 11-1 (Jan. 18, 2011).

[128] I.R.C. § 108(a)(1)(A).

[129] I.R.C. §§ 108(a)(1)(B) and (a)(3).

[130] I.R.C. § 108(d)(3).

[131] *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), *aff'g*, 109 T.C. 463 (1997). *See also* Raby and Raby, *Measuring Assets and Liabilities for DOI Purposes*, 1999 TNT 189-34 (Sept. 29, 1999).

to reduce its tax attributes to the extent of the excluded amount.[132] A taxpayer may elect to first reduce the basis of depreciable property.[133] Otherwise, the tax attributes will be reduced in the following order: (i) NOLs;[134] (ii) general business credit;[135] (iii) minimum tax credit;[136] (iv) capital loss carryovers;[137] (v) basis of assets;[138] (vi) passive activity loss and credit carryovers;[139] and (vii) foreign tax credit carryovers.[140] Attributes are reduced after tax is determined for the taxable year of the debt discharge.[141] As a result, NOLs may be used to shelter operating income (including

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132 I.R.C. § 108(b)(1).

133 I.R.C. § 108(b)(5). The section 108(b)(5) election must be made on the taxpayer's tax return for the year of the debt discharge. I.R.C. § 108(d)(9).

134 Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year in the order in which the loss arose, will be reduced by a dollar for each dollar excluded. I.R.C. §§ 108(b)(2)(A), (b)(3)(A), (b)(4)(B).

135 Any general business credit carryover to or from the taxable year of a debt discharge is reduced in the order it would be used against taxable income, by 33 1/3 cents for each dollar excluded. I.R.C. §§ 108(b)(2)(B), (b)(3)(B), (b)(4)(C).

136 The amount of any minimum tax credit available under section 53(b) as carryover from the year of the debt discharge will be reduced by 33 1/3 cents for each dollar excluded. I.R.C. §§ 108(b)(2)(C), (b)(3)(B), (b)(4)(A).

137 Net capital losses from the taxable year of discharge, and any capital loss carryovers, from the year of discharge and then in the order in which they arose are reduced by a dollar for each dollar excluded. I.R.C. §§ 108(b)(2)(D), (b)(3)(A), (b)(4)(B).

138 The basis of the property of the taxpayer is reduced by a dollar for each dollar excluded. I.R.C. §§ 108(b)(2)(E), (b)(3)(A).

139 Any passive activity losses or credit carryovers that have been suspended under the passive activity loss rules are reduced by 33 1/3 cents for each dollar excluded for credit carryovers. I.R.C. §§ 108(b)(2)(F), (b)(3)(B).

140 Foreign tax credit carryovers to or from the taxable year of the discharge in the order in which they arose are reduced by 33 1/3 cents for each dollar excluded. I.R.C. §§ 108(b)(2)(G), (b)(3)(B).

141 I.R.C. § 108(b)(4)(A).

COD income not excluded under an exception) in the year the debt is discharged.

A partnership borrower is not taxable on any COD income it recognizes upon a debt restructuring.[142] Instead, the borrower generally is required to allocate its income or gain among its partners in proportion to the partners' shares of the canceled debt under section 752.[143] Revenue Ruling 92-97 provides that other allocations of COD income will also be respected if the allocations have (or are deemed to have) "substantial economic effect" under the rules of section 704(b) and the corresponding Treasury regulations. While the application of the section 752 rules and the "substantial economic effect" test are less than clear in a workout context, most allocations of COD income in accordance with a partnership's governing documents should be respected, provided the allocations in those documents would otherwise pass muster with the IRS. Partnership COD income that is effectively connected taxable income allocable to foreign partners is subject to U.S. withholding tax; foreign corporate partners currently are subject to U.S. withholding tax at a 35% rate.[144]

The obligation that section 1446 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. Where an investor is willing to invest new money in an insolvent U.S. partnership in exchange for a

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[142] I.R.C. §§ 61(a)(12); 1001.

[143] Rev. Rul. 92-97, 1992-2 C.B. 124.

[144] I.R.C. § 1446(a), (b)(2)(B). Regulations under section 1441 provide that a lender is not required to withhold tax on COD income that is triggered when the lender forgives a loan to a foreign borrower. Treas. Reg. § 1.1441-2(d)(2); T.D. 8804, 1999-12 I.R.B. 5 (Mar. 22, 1999). By cancelling a debt, the lender is not considered to have "custody or control" over money or property of the borrower from which a withholding tax liability could be satisfied, even if the lender receives payment from the borrower in partial satisfaction of the loan. COD income of a partnership, however, is still governed by section 1446, which requires withholding on a foreign partner's allocable share of the partnership's effectively connected taxable income. *See* Treas. Reg. § 1.1446-1; T.D. 9200, 2005-23 I.R.B. 1158 (May 13, 2005) (final regulations effective for partnership years beginning on or after May 18, 2005).

partnership interest, a portion of the funds will go to the IRS to pay the withholding tax relating to the COD income allocable to the partnership's foreign partners. This situation is frequently unacceptable to a prospective investor who expects that the entirety of its investment will be used to rebuild the business.[145]

Regulations provide limited relief from this dilemma.[146] The regulations permit a foreign partner who meets the so-called "good driver" requirement[147] to certify to the partnership that it has deductions and losses from prior years that it reasonably expects to be available to reduce its U.S. income tax liability on its allocable share of effectively connected income from the partnership.[148] If the foreign partner properly provides the requisite certification, the partnership may consider certain partner-level deductions in computing its withholding obligation with respect to the certifying partner.[149] A partnership that reasonably relies on such certification is not liable for penalties if it is later determined that the certificate is defective or if the partnership subsequently

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[145] As discussed below, the foreign partner may not qualify for the section 108(a) insolvency exclusion since the insolvency exception is determined at the individual partner level. I.R.C. § 108(d)(6); *see Marcaccio v. Commissioner*, T.C. Memo 1995-174 (1995).

[146] Treas. Reg. § 1.1446-6; T.D. 9394, 2008-21 I.R.B. 988 (Apr. 29, 2008).

[147] Treas. Reg. § 1.1446-6(b). A foreign partner may satisfy the "good driver" requirement by providing (i) valid documentation to the partnership to which a certification is submitted, (ii) that it has timely filed or will file a U.S. federal income tax return in each of the partner's preceding three taxable years, and (iii) that it has timely filed or will file a U.S. income tax return for the taxable year in which certification is provided to the partnership.

[148] Treas. Reg. § 1.1446-6(c)(1)(i). A foreign partner may also certify that its investment in the partnership is (and will be) the only investment or activity that will give rise to effectively connected items for the foreign partner's taxable year. Treas. Reg. § 1.1446-6(c)(1)(ii). A partnership that receives this certificate is not required to pay section 1446 withholding tax with respect to any such partner if the partnership estimates that the annualized section 1446 tax will be less than $1,000. Treas. Reg. § 1.1446-6(c)(1)(ii).

[149] Treas. Reg. § 1.1446-6(c)(1)(i).

receives an updated certificate; however, the partnership remains liable for the substantive section 1446 tax liability.[150]

Each partner may shelter its allocable share of COD income or gain with any available losses. In addition, a bankrupt or insolvent partner could qualify for the section 108(a) exception to the inclusion of COD income since the bankruptcy or insolvency exception is determined at the partner level for partnerships.[151] However, this exclusion is limited to the amount by which the taxpayer is insolvent.[152] For these purposes, insolvency is defined as "the excess of liabilities over the fair market value of assets."[153] There has been significant uncertainty regarding the extent to which contingent liabilities are taken into account in determining solvency. The Ninth Circuit has held that a contingent obligation constitutes a liability for these purposes only when it is "more likely than not" that the taxpayer will be required to pay such liability.[154]

Partners who avoid COD income recognition under the Title 11 or insolvency exception must reduce tax attributes by the amount of avoided COD income.[155] Solvent partners other than C corporations may also elect to exclude COD income attributable to the cancellation of "qualified real property business indebtedness."[156] Partners making this election must reduce basis

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150 Treas. Reg. § 1.1446-6(d)(2).

151 I.R.C. § 108(d)(6).

152 I.R.C. § 108(a)(3).

153 I.R.C. § 108(d)(3).

154 *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), *aff'g* 109 T.C. 463 (1997). *See also* Raby and Raby, *Measuring Assets and Liabilities for DOI Purposes*, 1999 TNT 189-34 (Sept. 29, 1999).

155 I.R.C. § 108(a)(2).

156 I.R.C. § 108(c). Qualified debt generally includes debt incurred or assumed in connection with the acquisition or substantial improvement of real property used in a trade or business, and secured by such real property. I.R.C. § 108(c)(3). Debt incurred or assumed before January 1, 1993 will constitute qualified debt if it is simply secured by real property used in a trade or business at the time the debt is incurred or assumed. I.R.C. § 108(c)(3)(B); *see also* TAM 2000-14-007 (Dec. 13, 1999).

in their depreciable property by the amount of COD income excluded.[157] The amount of COD income that a partner may exclude under the election is limited to a partner's aggregate basis in its depreciable real property immediately prior to the COD income-producing event.[158]

Example 5: Sumi, a Japanese company, and Venture Co., a U.S. corporation, are 50% partners in the SV Partnership ("SV"), a U.S. real estate development business. In 1988, SV issues to L an 8-year $1,000 nonrecourse note secured by an office building in lower Manhattan. L syndicates the note, a substantial amount of which was first sold to the public at $700. When SV encounters financial difficulties in 1996, the noteholders agree to extend the maturity of the debt for five years, triggering a deemed exchange. The old debt is publicly traded at $800. Unlike SV, Sumi and Venture Co. are solvent.

Because the old debt is publicly traded, the issue price of the new debt is $800. SV has $200 of COD income ($1,000 adjusted issue price of old debt - $800 issue price of new debt). Sumi and Venture Co. will each recognize their allocable share of COD income flowing through from SV and neither can benefit from the section 108(a) exclusion because they are each solvent in their individual capacities. SV must withhold tax at a rate of 35% on the COD income allocable to its foreign corporate partner, Sumi, because the COD income is effectively connected with the conduct of U.S. trade or business.

The noteholders recognize $100 of gain ($800 issue price of new debt - $700 tax basis in old debt) and must accrue $200 of OID in income ($1,000 stated redemption price at maturity of new debt - $800 issue price of new debt) over the 5-year term of the new debt, regardless of their regular method of tax accounting. SV will be entitled to a corresponding deduction for OID.

In the consolidated return context, COD income may be triggered if an intercompany obligation is transferred outside the consolidated group. Final regulations generally provide that if a creditor member sells an intercompany obligation to a nonmember,

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157 I.R.C. §§ 108(a)(1)(D); 1017.

158 I.R.C. § 108(c).

the following sequence of events is deemed to occur immediately before, and independent of, the actual transaction: (i) the debtor is deemed to satisfy the obligation for cash in an amount equal to the obligation's fair market value; and (ii) the debtor is deemed to immediately reissue the obligation to the original creditor for the same cash amount. The debtor and the creditor are then treated as engaging in the actual transaction with respect to the new obligation.[159] For transactions in which it is appropriate to require

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[159] Treas. Reg. § 1.1502-13(g)(3)(ii).

The deemed satisfaction-reissuance model generally does not apply to intragroup and outbound transactions in the following situations: (i) a transfer and assumption of debt in an intragroup or nonrecognition transaction to which any of sections 361(a), 332, 337(a), or 351 (subject to certain exceptions) apply; (ii) the debtor's obligations under the intercompany obligations are assumed in connection with the debtor's sale or other disposition of the property (other than solely money) in taxable intercompany transactions; (iii) the obligation becomes an intercompany transaction by reason of an exception to the application of the rules on the acquisition of debt by a person related to the debt for acquisitions by securities dealers; (iv) the amount realized is from reserve accounting under section 585; (v) the transaction is a certain type of intercompany extinguishment transaction; (vi) the transaction is a routine modification of an intercompany obligation; (vii) the transaction is an outbound distribution of a newly issued intercompany obligation to a non-member shareholder or non-member creditor in a transaction to which section 361(c) applies; or (viii) the members of a departing intercompany obligation subgroup become members of another consolidated group immediately after the transaction and neither the creditor nor debtor recognize any income, gain, deduction or loss with respect to the intercompany transaction. Treas. Reg. § 1.1502-13(g)(3)(i)(B).

However, an anti-abuse rule prevents the application of these exceptions if the intercompany transaction is engaged in with a view to shifting items of built-in gain, loss, income or deduction from the obligation from one member to another member in order to secure a tax benefit that the group or its members would not otherwise enjoy. Treas. Reg. § 1.1502-13(g)(3)(i)(C).

For transactions occurring in consolidated return years beginning prior to December 24, 2008, Treasury regulation section 1.1502-13(g) provided a similar deemed satisfaction-reissuance model, but did not separate the deemed transaction from the actual transaction.

this deemed satisfaction and reissuance, the intercompany obligation generally is deemed satisfied and reissued for its fair market value.[160] Similarly, if an intercompany obligation is transferred outside the group because the creditor or debtor leaves the group, the obligation is deemed satisfied for cash in an amount equal to the debt's fair market value immediately before the member leaves the group and is then deemed reissued for cash equal to the debt's fair market value.[161] COD income would arise if the sale price for the debt, or the fair market value of the debt at the time the creditor or debtor leaves the group, was less than the adjusted issue price of the original debt.[162] In computing consolidated taxable income, any COD income of the borrower would be offset by a corresponding ordinary deduction for the creditor.[163]

COD income may also arise if an obligation that is not an intercompany obligation becomes one. If, for example, a third party lender joins the consolidated group of the borrower, the following sequence of events is deemed to occur immediately before, and independent of, the actual transaction: (i) the debtor is deemed to satisfy the obligation for cash in an amount equal to the obligation's fair market value; and (ii) the debtor is deemed to immediately reissue the obligation to the original creditor for the same cash amount.[164] All attributes from the deemed satisfaction

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[160] Treas. Reg. § 1.1502-13(g)(3)(ii).

[161] Treas. Reg. § 1.1502-13(g)(3)(ii).

[162] Treas. Reg. § 1.61-12(c)(2); Treas. Reg. § 1.1502-13(g)(7), Ex. 2. The new debt that is deemed issued will have OID if its face amount exceeds the sales price or fair market value of the original debt, as the case may be. *See* Treas. Reg. § 1.1502-13(g)(7), Ex. 2.

[163] *See* Treas. Reg. § 1.1502-13(c), (d) (providing "matching" and "acceleration" rules to ensure that the intercompany items of one member and the corresponding items of another member are taken into account to produce the same effect on consolidated taxable income as if the members were divisions of a single corporation).

[164] Treas. Reg. § 1.1502-13(g)(5).

The deemed satisfaction-reissuance model excepts inbound transactions if: (i) the obligation becomes an intercompany obligation by reason of an exception to the application of the rules on acquisition of debt by a person related to the debt for acquisitions by of the debt are determined on a separate entity basis, rather than by treating the borrower and lender as divisions of a single corporation, notwithstanding the fact that the deemed satisfaction occurs after the lender joins the borrower's consolidated group.[165] As a result, if the debt is deemed satisfied for less than its adjusted issue price, the lender's loss may be a capital loss even though the borrower's corresponding amount of COD income would be ordinary.

Two temporary provisions were enacted to provide relief from COD income recognition to certain taxpayers. First and foremost, Congress enacted section 108(i), which permitted a taxpayer to defer recognition of COD income when the taxpayer or a related person "reacquires" an "applicable debt instrument" in 2009 or 2010 pursuant to the American Recovery and Reinvestment Act.[166] At the taxpayer's election, the COD income could be deferred until 2014 and then included ratably over a period of five years.[167] Once made, the election is irrevocable.[168] Generally, a taxpayer that elects to defer COD income through section 108(i) may not benefit from any other COD exclusions, including the Title 11 and insolvency exclusions, with respect to the same debt instrument, or portion thereof, to which the election

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securities dealers; or (ii) the members of a departing intercompany obligation subgroup become members of another consolidated group immediately after the transaction and neither creditor nor debtor recognizes any income, gain, deduction or loss with regard to the intercompany obligation. Treas. Reg. § 1.1502-13(g)(5)(i)(B).

For transactions occurring in consolidated return years beginning prior to December 24, 2008, Treasury regulation section 1.1502-13(g) provided a similar deemed satisfaction-reissuance model, but did not separate the deemed transaction from the actual transaction.

[165] Treas. Reg. § 1.1502-13(g)(6)(i)(B).

[166] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009); I.R.C. § 108(i)(1).

A related person is a person that would be related to the taxpayer under section 108(e)(4). I.R.C. § 108(i)(5)(A).

[167] I.R.C. § 108(i)(1); I.R.C. § 108(i)(3)(A).

[168] I.R.C. § 108(i)(5)(B)(ii).

applies, for the tax year in which the election is made or any subsequent tax year.[169]

Section 108(i) defines an applicable debt instrument as a debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person.[170] An applicable debt instrument is "reacquired" if the debtor, or a related person to the debtor, "acquires" the debt, which is defined to include an acquisition (i) for cash, (ii) in exchange for another debt instrument (including an exchange resulting from a modification of the debt instrument), (iii) in exchange for corporate stock or a partnership interest, and (iv) as a contribution to capital. A debt instrument is also treated as acquired if it is completely forgiven by the holder.[171]

As discussed below, Revenue Procedure 2009-37 provides both additional guidance on theoretical questions the statute did not address and procedures for making the election.[172] More specifically, an election is generally made on an instrument-by-instrument basis, and a taxpayer may make a partial election for only a portion of COD income realized with respect to one or more instruments.[173] Revenue Procedure 2009-37 confirms that a taxpayer that makes a partial section 108(i) election and defers only a portion of COD income realized with respect to a debt instrument may exclude from income the remaining portion of COD income under another applicable COD exclusion, such as the insolvency exception.[174] In addition, if a taxpayer elects to defer COD income under section 108(i), OID deductions in respect of the debt instrument issued to reacquire an applicable debt

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[169] I.R.C. § 108(i)(5)(C).

[170] I.R.C. § 108(i)(3)(A). A debt instrument is defined to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a)(1). I.R.C. § 108(i)(3)(B).

[171] I.R.C. § 108(i)(4)(A), (B).

[172] Rev. Proc. 2009-37, 2009-2 C.B. 309.

[173] I.R.C. § 108(i)(5)(B)(ii); Rev. Proc. 2009-37, 2009-2 C.B. 309.

[174] Rev. Proc. 2009-37, 2009-2 C.B. 309.

instrument[175] will be deferred until the five-year period during which the taxpayer takes the COD income into account, and then be included ratably during that five-year period.[176]

An election under section 108(i) to defer COD income is made by including with the taxpayer's income tax return for the tax year in which the debt instrument is acquired a statement that provides (i) the name and any applicable taxpayer identification numbers of the issuer(s) of the debt instrument; (ii) a general description of the debt instrument; (iii) a general description and the date of the reacquisition transaction(s) generating the COD income; (iv) the amount of COD income resulting from the reacquisition and the amount of COD income the taxpayer is electing to defer; (v) in the case of a partnership or S corporation, a list of partners or shareholders, respectively, that have a deferred amount, their identifying information, and each partner's or shareholder's deferred amount or share of the deferred amount; (vi) in cases in which a new debt instrument is issued or deemed issued in exchange for the debt instrument, the issuer's name, taxpayer identification number, a general description of the new debt instrument and whether the new debt instrument has OID, a schedule of the OID that the issuer expects to accrue each taxable year on the instrument and the amount of OID that the issuer expects to defer each taxable year; and (vii) any other information required by the IRS.[177] A taxpayer that makes a section 108(i) election must also provide an information statement with its income tax returns beginning with the taxable year following the taxable year in which the taxpayer makes the election.[178] Partnerships, S corporations, and certain foreign corporations

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[175] If the proceeds of a debt instrument are used directly or indirectly by the issuer to reacquire an applicable debt instrument of the issuer, the debt instrument will be treated as issued for the applicable debt instrument. If only a portion of the proceeds are used, the OID deferral rule will only apply to that portion of the debt instrument. I.R.C. § 108(i)(2).

[176] If the OID accruals during the five year deferral period exceed the deferred COD income, the OID deductions are disallowed in the order the OID is accrued. I.R.C. § 108(i)(2).

[177] I.R.C. § 108(i)(5)(B)(i)(II); Rev. Proc. 2009-37, 2009-2 C.B. 309.

[178] *See* Rev. Proc. 2009-37, 2009-2 C.B. 309 (providing a description of, and the time and manner for reporting, the additional information).

making a section 108(i) election are subject to additional reporting requirements.[179]

Any COD income deferred by a partnership must be allocated among (and subsequently recognized by) the partners holding partnership interests immediately before the debt is discharged in the same manner as those amounts would have been included in the partners' income under section 704 if the COD income were immediately recognized.[180] Revenue Procedure 2009-37 provides that a partnership that makes a partial section 108(i) election may specify whether deferred or currently realized COD income is to be allocated to each partner.[181] Any decrease in the partner's share of partnership liabilities resulting from the debt discharge is only taken into account at that time to the extent it would not cause the partner to recognize gain under section 731; any excess amount subsequently taken into account by the partner at the same time, and to the extent remaining, in the same amount, as the deferred COD income is recognized.[182] Practitioners have voiced concern that the rules for allocating deferred COD income, particularly in a partnership situation, are somewhat ambiguous. For example, it remains unclear how section 108(i) applies to tiered partnerships, how partial transfers or redemptions of interest will be treated, and whether any amounts of deferred COD allocated to the partners in a partnership should be reflected in the partners' capital accounts.[183]

Any COD income that is deferred under section 108(i) will be accelerated if the taxpayer (i) dies, (ii) liquidates or sells substantially all of its assets, or (iii) ceases to do business, or if similar circumstances occur, to the taxable year in which the event occurs, or in the case of a Title 11 proceeding, the day before the petition is filed.[184] In the case of a pass-through entity, including a partnership, the COD income is also accelerated if there is a sale,

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[179] *See* Rev. Proc. 2009-37, 2009-2 C.B. 309.

[180] I.R.C. § 108(i)(6).

[181] Rev. Proc. 2009-37, 2009-2 C.B. 309.

[182] I.R.C. § 108(i)(6).

[183] *See* Jenks *et al*., *Expert Commentary on the New COD Deferral Election*, Collier on Bankruptcy Taxation, 2009 Supplement.

[184] I.R.C. § 108(i)(5)(D)(i).

exchange, or redemption of an interest in the pass-through entity.[185]

The second temporary provision enacted by Congress was an exception to the taxation of COD income arising from a taxpayer restructuring the debt on its principal residence or upon a foreclosure of its principal residence.[186] This exception excluded from COD income recognition "qualified principal residence indebtedness" discharged in calendar years 2007 through 2013 as a result of a decline in the value of the residence or the financial condition of the taxpayer.[187] "Qualified principal residence indebtedness" is up to $2 million of acquisition indebtedness with respect to the taxpayer's principal residence.[188] Any excluded qualified principal residence indebtedness will reduce the taxpayer's basis in its principal residence, although not below zero.[189]

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[185] I.R.C. § 108(i)(5)(D)(ii).

[186] I.R.C. § 108(a)(1)(E); H.R. REP. NO. 110-356, at 56 (2007).

[187] The exception does not apply to debt discharged on account of services performed for the lender or any other factor not directly related to the decline in the value of the residence or the financial condition of the taxpayer. I.R.C. § 108(a)(1)(E), as amended by the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007), and extended by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008); I.R.C. § 108(h)(3).

If a portion of a discharged loan is not qualified principal residence indebtedness, section 108(a)(1)(E) applies only to the extent that the amount discharged exceeds the non-qualifying portion of the loan (as determined immediately prior to the discharge). I.R.C. § 108(h)(4).

[188] I.R.C. § 108(h)(2). Acquisition indebtedness includes any debt incurred to acquire, construct or substantially improve the taxpayer's principal residence if the debt is secured by the residence, as well as any refinancing of that debt to the extent of the prior debt. I.R.C. § 163(h)(3)(B).

Principal residence has the same meaning as when used in section 121. I.R.C. § 163(h)(5).

[189] I.R.C. § 108(h)(1).

B. Holder Tax Consequences of Debt Exchanges

A holder will generally recognize gain or loss in connection with a debt exchange if its basis in the old debt does not equal the issue price of the modified debt, except in the case of a corporate issuer where the exchange qualifies as a tax-free recapitalization under section 368(a)(1)(E).

1. Tax-Free Debt Exchanges

A deemed or actual exchange of debt can qualify as a tax-free reorganization only if the issuer of the debt is a corporation and the original and modified debt instruments each qualify as a "security" for federal income tax purposes.[190] Although the term "security" is not defined in the Code, stock and debt instruments due more than 10 years from the date of issuance are generally thought to constitute securities. However, the precise limits are unclear and an instrument with an original term of as little as five years (or even less) may also qualify.[191]

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190 I.R.C. § 368(a)(1)(E).

191 *See, e.g.*, *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737, 750-53 (1954), *aff'd*, 230 F.2d 555 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956) (notes maturing in 5 to 9 years held to be securities); *Commissioner v. Freund*, 98 F.2d 201 (3d Cir. 1938) (mortgage bonds maturing serially over 6 years held to be securities); *George A. Nye v. Commissioner*, 50 T.C. 203, 212-14 (1968), *acq.*, 1969-2 C.B. 25 (10-year promissory notes held to be securities); *D'Angelo Assocs., Inc. v. Commissioner*, 70 T.C. 121, 134 (1978) (short-term notes may be considered securities when the stated maturity is unrealistic or ignored by the parties); *Prentis v. United States*, 273 F. Supp. 460 (S.D.N.Y. 1967) (notes with six-month term qualified as securities because they were part of a plan for delayed issuance of preferred stock); Priv. Ltr. Rul. 2001-39-009 (June 27, 2001) (expressing no opinion on whether debt having a term of less than ten years is a security for federal tax purposes, in ruling that no gain or loss will be recognized by holders on the exchange of old debt constituting securities for new debt constituting securities, IRS cautioned that it expressed no opinion on whether debt having a term of less than ten years is a security for federal tax purposes); *cf. Bradshaw v. United States*, 683 F.2d 365 (Ct. Cl. 1982) (installment notes payable over 2½-6½ years did not constitute securities); Martin Lipton & George A. Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975).

In Revenue Ruling 2004-78, the IRS found that an exchange of long-term debt for a two-year debt instrument in a merger was tax free in a reorganization under section 368(a)(1)(A). The ruling noted that although most authorities hold that a two-year note is not a security, this treatment is not appropriate when a note is issued by an acquirer in a reorganization in exchange for target debt that bears the same terms (other than the interest rate). In such a case, the ruling holds that the acquirer note represents a continuing interest in the target, and accordingly, treatment of such a note as a security is consistent with the intent of the reorganization provisions of the Code.[192]

If a debt exchange constitutes a tax-free recapitalization, holders of debt securities who receive new securities generally will not recognize gain, subject to two exceptions discussed below, and holders generally may not recognize a loss on the exchange.[193]

First, holders must recognize income to the extent that the value received for accrued interest exceeds the amount of accrued interest previously included in the holder's income for federal

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It has been argued that the IRS should treat even short-term debt of troubled issuers as "securities" because the legislative history to section 368(a)(1)(E) illustrates Congress's desire to "encourage legitimate reorganizations required to strengthen the financial condition of a corporation," *see* Los Angeles County Bar Association Taxation Section Corporate Tax Committee, *Restructuring the Debt of Financially Troubled Companies*, BNA DAILY TAX REPORT (May 9, 2003) (arguing that imposing tax on a deemed or actual modification of even short-term debt of a troubled issuer contravenes Congressional purpose by discouraging private debt restructurings and increasing the likelihood of bankruptcies that are more costly to the parties and to the economy).

[192] Rev. Rul. 2004-78, 2004-2 C.B. 108. The scope of this ruling is unclear. The context of the ruling was a two-year note with only one substantive change in terms (the interest rate) in a reorganization under section 368(a)(1)(A). Query whether a note with a maturity of less than two years, a note with more than one change in its terms or a note exchanged in any other tax-free reorganization would qualify as a security. For an excellent discussion of the implications of this ruling, *see* Simon Friedman, *Debt Exchanges after Rev. Rul. 2004-78*, 105 TAX NOTES 979 (Nov. 15, 2004).

[193] I.R.C. § 354(a)(1).

income tax purposes.[194] Such value may be received in the form of new debt in a deemed debt exchange, or new debt, cash or property in an actual debt exchange. 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.[195] A holder that previously included amounts in income, as interest paid on the debt instrument, that exceed the amount of cash and other property the holder receives as allocable to interest on an exchange of the debt instrument may deduct such unpaid interest, generally either as a loss or, in the case of certain holders such as banks, as an adjustment to a reserve for bad debts.[196]

The possibility of holders recognizing losses with regard to over-accruals of interest is highlighted by the IRS' position that holders must continue to accrue OID even when the issuer's financial condition is so poor that there is no reason to expect that the debt instrument will be redeemed in accordance with its terms.[197]

In a second requirement, holders who also receive property other than new securities in a debt exchange will recognize gain to the extent of the lesser of (i) the fair market value of the other property received, or (ii) the holder's actual gain on the exchange determined by comparing the value of all property received with the holder's adjusted tax basis in the debt exchanged.[198] Although the "dividend within gain" rule of section 356(a)(2) applies to debt exchanges, it does not operate to transform the gain into a dividend.[199]

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[194] I.R.C. § 354(a)(2)(B); *see also* I.R.C. §§ 483; 1274.

[195] *See* H.R. REP. NO. 96-833, at 33 (1980).

[196] *See generally* I.R.C. §§ 165; 166.

[197] TAM 95-38-007 (June 13, 1995); FSA 2000-18-017 (Jan. 13, 2000). *See* Section IV.C.2 below for a discussion of OID accrual in cases of doubtful collectibility.

[198] I.R.C. §§ 354(a)(2)(A); 356(d)(2)(B).

[199] Rev. Rul. 71-427, 1971-2 C.B. 183.

The meaning of the term "principal amount" has been a matter of some debate in the context of tax-free reorganizations. The definition of principal amount is important because the principal amount of debt instruments exchanged by a holder acts as a ceiling on the amount of securities that can be received tax free by the holder in a recapitalization.[200] In the case of a debt instrument that bears "adequate stated interest," principal amount should mean all amounts due under the instrument other than qualified stated interest.[201] Where a debt instrument lacks adequate stated interest, however, the definition of principal amount is less clear. This lack of clarity results because the definition of principal amount predates, and is inconsistent with, the OID regime. The New York State Bar Association (the "NYSBA") has recommended that the principal amount rule be replaced with a modified version of the rule that was proposed (but not enacted) in the 1991 Tax Bill which compared the "issue price" of the new debt instrument to the "adjusted issue price" of the debt instrument being exchanged to determine a holder's gain.[202] However, the NYSBA recommendation would sensibly limit the gain a holder would be required to recognize to either (i) the difference between the fair market values of the two debt instruments, or (ii) the gain that would be recognized under the current principal amount rule.

A holder's aggregate basis in a security received in a tax-free debt exchange (other than any amount received for interest) will equal the holder's basis in the modified debt instrument (other than basis attributable to accrued interest), reduced by the amount of cash and the fair market value of other property received for such debt instrument (other than property received for accrued interest), and increased by the amount of gain recognized on the exchange.[203] The holding period for a new debt instrument received in a tax-free debt exchange will include the period the holder held the original debt instrument, provided the debt

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[200] I.R.C. § 356(d).

[201] *See* Treas. Reg. § 1.1274-2(b)(1).

[202] New York State Bar Association, Tax Section, *Report on Excess Principal Amount of Securities under Section 356*, 95 TNT 31-25 (Feb. 15, 1995).

[203] I.R.C. § 358.

instrument was held as a capital asset on the date of the exchange.[204]

Under current law, the holder in a debt-for-debt exchange that constitutes a recapitalization or other reorganization recognizes gain only to the extent of the fair market value of property it receives, other than stock or securities in a corporation that is a party to the reorganization.[205] This includes the excess of the principal amount of the new debt over the principal amount of the old debt.[206] In 1999, the Clinton Administration proposed to change the amount of gain that holders would recognize in a debt-for-debt exchange that constitutes a reorganization.[207] Under that proposal, rather than the difference in principal amounts, the excess of the issue price of the new debt over the adjusted issue price of the old debt would generally constitute recognized gain. If either of the debt instruments were publicly traded, however, a holder's recognized gain would be capped by the excess of the issue price of the new debt over the fair market value of the old debt. The effect of the cap would be that no gain would be recognized in a debt-for-debt exchange that is a reorganization involving publicly traded instruments, because presumably the fair market value of the old debt would equal the fair market value of the new debt in such cases. At the time, commentators accepted the proposal and supported expanding the application of the proposal beyond the realm of reorganizations.[208]

2. <u>Taxable Debt Exchanges</u>

Neither an exchange of debt characterized as a security for debt not so qualified (or vice versa), nor an exchange of debt

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[204] I.R.C. § 1223(1).

[205] I.R.C. § 356(a).

[206] I.R.C. § 356(d)(2)(B).

[207] STAFF OF JOINT COMMITTEE ON TAXATION, 106TH CONG., DESCRIPTION OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 54-622 (Comm. Print 1999), at 213-15.

[208] *See, e.g.,* New York State Bar Association, Tax Section, *Report on Proposed Legislation to Amend the Market Discount Rules of Sections 1276-78*, 1999 TNT 124-36 (June 22, 1999).

issued by a non-corporate entity qualifies as a tax-free recapitalization. Thus, for example, any deemed or actual exchange of debt that includes at least one non-security will be a taxable event for the holders. In the event of such a taxable exchange, holders will generally recognize gain or loss equal to the difference between a holder's adjusted tax basis in its debt and the holder's "amount realized" on the exchange.[209] If the amount realized is greater than the holder's adjusted tax basis in its debt, the holder will recognize taxable income as a result of the exchange.[210]

Two sets of authorities govern taxable exchanges. Unless another specific rule applies, section 1001 provides that a holder's amount realized will equal the sum of cash received and the fair market value of stock and other property received.[211] Without differentiating between cash and accrual method taxpayers, the regulations under section 1001 clarify that the amount realized in a taxable exchange of debt is the instrument's issue price, as determined by reference to the OID rules.[212] Thus, under section 1001, issue price serves as a proxy for fair market value when calculating the amount realized in a taxable exchange.

A debt instrument's issue price depends on the circumstances under which the debt instrument is issued.[213] If it is publicly traded, a debt instrument's trading price serves as a reliable proxy for its fair market value and, in turn, its issue price.[214] By contrast, the issue price of non-publicly traded debt that provides for adequate stated interest is the debt instrument's

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209 I.R.C. § 1001(a), (c); Treas. Reg. § 1.1001-1(g).

210 I.R.C. § 1001(a). This result may occur, for example, where a holder had accrued interest income not yet reported on the cash method of tax accounting, when all or a portion of the debt had been deducted by the holder as a bad debt, or when a holder acquired the debt (usually after issuance) at a deep discount.

211 I.R.C. § 1001(b).

212 Treas. Reg. § 1.1001-1(g)(1) (citing Treas. Reg. §§ 1.1273-2 (for publicly traded debt instruments) and 1.1274-2 (for debt instruments that are not publicly traded)).

213 *See* Section IV.B below for a more detailed discussion of issue price.

214 *See* Treas. Reg. § 1.1273-2(b)(1).

stated principal amount.[215] If, however, the instrument does not provide for adequate stated interest, its issue price will generally be its imputed principal amount.[216] Under limited circumstances, when a debt exchange constitutes a "potentially abusive situation," an anti-abuse rule treats the amount realized as the fair market value (rather than the issue price) of the instrument.[217]

In most transactions, the exchange of money or property for a debt instrument occurs on a single date; in a small subset of transactions, however, the taxpayer will receive payments over more than one year. The installment sale rules under section 453 apply to such transactions[218] unless the taxpayer opts out of the installment sale method when reporting his sale.[219] Regulations issued under section 453 indicate that, when a taxpayer opts out, the amount realized on the sale will vary depending on the taxpayer's accounting method. Specifically, a cash method taxpayer's amount realized is the fair market value of the obligation, while an accrual method taxpayer's amount realized is the amount due under the installment obligation, less any interest or OID payable.[220] This distinction between cash and accrual method taxpayers, however, appears to be at odds with the section 1001 regulations, which specifically note that the amount realized should be determined by reference to the issue price of a debt instrument.[221]

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[215] I.R.C. § 1274(a)(1); Treas. Reg. § 1.1274-2(b)(1).

[216] I.R.C. § 1274(a)(2); Treas. Reg. § 1.1274-2(b)(2); *see also* Rev. Rul. 89-122, 1989-2 C.B. 200; Rev. Rul. 79-292, 1979-2 C.B. 287. The imputed principal amount is the sum of the present values of each payment due under the instrument. I.R.C. § 1274(b)(1).

[217] I.R.C. § 1274(b)(3)(A).

[218] Very briefly, section 453 generally requires that, when a taxpayer sells or transfers property under certain limited conditions and one or more payments are to be received in a later taxable year, the taxpayer may defer recognition of a portion of the profits on the sale. I.R.C. § 453(a), (c).

[219] I.R.C. § 453(d).

[220] Treas. Reg. § 15A.453-1(d)(2)(ii).

[221] Treas. Reg. § 1.1001-1(g)(3).

The textual inconsistency between the regulations results in some ambiguity where installment sales are concerned. Practically speaking, however, the ambiguity exists only with respect to those transactions that are subject to the installment sale rules but are not reported on the installment sale method. In such cases, as the regulations under section 1001 were finalized more recently,[222] the government may be expected to apply the rule under Treasury regulation section 1.1001-1(g)(3), which would determine both cash and accrual method electing holders' amounts realized by reference to the issue price of the instrument.

The calculation of a holder's amount realized will produce a surprising result for accrual basis holders of non-publicly traded debt acquired at a discount shortly before a taxable deemed or actual debt exchange. These holders will be treated as receiving property with a value equal to the imputed principal amount of such debt, even though the holder recently purchased the debt at a much lower value. As a result, such a recent purchaser would recognize a significant amount of phantom taxable gain in connection with a deemed exchange of the debt.

A different, more beneficial result would obtain for the same holder if the new debt deemed issued is treated as issued under "potentially abusive" circumstances as a result of the recent sale of the old debt.[223] In that case, the amount realized on the deemed exchange is computed with reference to the fair market value of the newly issued debt.[224] Curiously, where an investor purchases a note at a deep discount and immediately restructures the debt, the application of the usually detrimental "potentially abusive" rules would benefit the purchaser by reducing the amount realized on the deemed exchange of the old debt instrument from its imputed principal amount to the instrument's lesser fair market value. Of course, the potentially abusive rules would not provide relief to longtime holders of debt, such as banks, whose low basis in debt of troubled issuers is attributable to a partial write down of the debt.

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[222] *Compare* T.D. 7768 (Feb. 4, 1981) (implementing regulations under section 453).

[223] I.R.C. § 1274(b)(3)(B)(ii)(I); Treas. Reg. § 1.1274-3(a)(2)(i).

[224] I.R.C. § 1274(b)(3)(A).

A tax deduction for partial worthlessness of the old debt would soften the blow of phantom gain recognition. To be entitled to a tax deduction, however, the holder must charge off the uncollectible portion of the debt from its books during the taxable year.[225] If the holder charged off a portion of the debt in a prior year, a second charge-off during the taxable year of gain recognition is not possible unless the holder restores the prior charge-off by increasing its basis in the debt. Although the phantom gain increases the tax basis of the debt, regulatory and accounting principles do not allow a corresponding increase in basis for book purposes.[226] Cognizant of this problem, the IRS issued regulations under section 166 in conjunction with its issuance of regulations under section 1001.[227] Under the regulations, a holder required to recognize gain due to a significant modification of a debt instrument is allowed a deemed charge-off of the debt during the taxable year of gain recognition if the holder claimed a deduction for partial worthlessness in a prior year.[228] The deemed charge-off is the amount by which the tax basis of the debt exceeds the greater of the debt's fair market value or net book value, and is limited to the gain recognized as a result of the significant modification.[229] It should be noted, however, that because the regulations require a prior charge-off, they do not help holders that have a low basis in the old debt because they acquired the debt at a discount (rather than at par) and so did not take the requisite bad debt deductions for partial worthlessness.[230]

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225 Treas. Reg. § 1.166-3(a)(2).

226 *See* T.D. 8767, 1998-1 C.B. 5 (Jan. 28,1998) (preamble to the final regulations); T.D. 8676, 1996-30 I.R.B. 4 (June 24, 1996) (preamble to the temporary regulations).

227 *See* Treas. Reg. § 1.166-3(a)(3) (effective Sept. 23, 1996).

228 Treas. Reg. § 1.166-3(a)(3)(ii)(A). The regulations apply only if (i) a significant modification of a debt instrument results in gain recognition under Treasury regulation section 1.1001-1(a), and (ii) debt was previously charged off and deducted by the taxpayer, satisfying the requirements of Treasury regulation section 1.166-3(a)(1) and (2).

229 Treas. Reg. § 1.166-3(a)(3)(iii).

230 *See* T. D. 8763, 1998-1 C.B. 5, 6 (Jan. 28, 1998) (rejecting commentators' requests to allow a deemed charge-off for debt

A holder's adjusted tax basis in a debt instrument will generally be its cost (which, in the case of a note purchased with a foreign currency, will be the U.S. dollar value of the purchase price on the date of purchase),[231] increased by (i) the amount of any OID,[232] (ii) market discount (or acquisition discount, in the case of a short-term debt instrument) included in the holder's income with respect to the debt instrument, and (iii) the amount, if any, of income attributable to *de minimis* OID included in the holder's income with respect to the debt instrument, and reduced by (x) the amount of any payments on the debt instrument that are not qualified stated interest payments,[233] and (y) the amount of any amortizable bond premium applied to reduce interest income attributable to the debt instrument.[234] The tax basis of property (including new debt) received by a holder in an exchange of debt will equal the portion of the fair market value of such property that was included in the holder's amount realized on the exchange.[235] For purposes of this rule, the tax basis of new debt received in an exchange is generally the issue price of such new debt.[236] The holding period for property received in the exchange will begin on the day following the exchange.[237]

The character of any gain or loss recognized by a holder in a debt exchange as capital or ordinary, and, in the case of capital gain or loss, as short term or long term, will depend on a number of factors, including: (i) the tax status of the holder of the debt instrument; (ii) whether the holder is a U.S. financial institution;[238]

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acquired at a discount and for which a prior owner claimed a deduction for partial worthlessness, including debt purchased at a discount by one member of a consolidated group by another member).

[231] Treas. Reg. § 1.988-2(b)(5)(ii), (9), Exs. 4 and 5.

[232] Treas. Reg. § 1.1272-1(g).

[233] Treas. Reg. § 1.1272-1(g).

[234] Treas. Reg. § 1.171-1(b)(2).

[235] Treas. Reg. § 1.1012-1(a).

[236] Treas. Reg. § 1.1012-1(g).

[237] I.R.C. § 1223(1).

[238] Section 582(c) provides that the sale or exchange of a bond, debenture, note or certificate, or other evidence of indebtedness by a

(iii) whether the debt instrument is a capital asset in the hands of the holder; (iv) whether the debt instrument has been held for more than one year; (v) the extent to which the holder previously claimed a loss, bad debt deduction, or charge to a reserve for bad debts with respect to the debt instrument; and (vi) whether, in the case of certain debt instruments for which no election was made to currently include market discount in income, the difference between the holder's basis in the debt instrument immediately after it was acquired and the amount of the debt instrument that exceeded any then unaccrued OID (by more than the *de minimis* amount).[239]

In the case of a holder whose note constitutes a capital asset, the gain required to be recognized on a debt exchange generally will be classified as a capital gain under the rules discussed above, except to the extent of interest.[240] Any capital gain recognized by a holder will be long-term capital gain with respect to those notes held for more than one year, and short-term capital gain for notes held for one year or less.[241] However, holders of original notes that constitute market discount obligations will be required to treat as ordinary income any gain recognized upon the exchange of their old notes to the extent of the market discount accrued during the holder's period of ownership, unless the holder elected to include such market discount in income as it accrued.[242]

Any additional gain recognized by the holder would be characterized in accordance with the general rules described above. Any accrued market discount not treated as ordinary income upon an exchange of old notes for new notes in which gain or loss is not recognized in whole or in part should carry over to the new notes received in the exchange.[243] On disposition of such new notes, any

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bank or certain other financial institutions shall not be considered the sale or exchange of a capital asset. Accordingly, any gain recognized by such holders will be ordinary income.

239 I.R.C. § 1276(a)(1).

240 I.R.C. § 1271(a)(1).

241 I.R.C. § 1222(1), (3).

242 I.R.C. § 1276(a).

243 I.R.C. § 1276(c)(2)(A), (d)(1)(B).

gain recognized generally would be treated as ordinary income to the extent of the amount of accrued market discount carried over.[244] The statutory provision governing the character of gain on notes attributable to market discount applies only to bonds with a term of more than one year.[245] However, the IRS has taken the position that the portion of the amount realized on the sale of customer notes with a term of a year or less that is attributable to accrued market discount is also ordinary income.[246] With respect to the accretion of market discount, the IRS has held that market discount on a customer note with a term of 12 months or less could be treated as accruing ratably each day, or under any other method of accounting that would clearly reflect income.[247]

IV. ORIGINAL ISSUE DISCOUNT RULES

A. General Rules

The basic rules governing OID are contained in sections 1271 through 1275 of the Code and the final regulations issued in 1994 (the "OID Regulations"), which expand and illustrate the rules provided by the Code. The section 988 rules apply in conjunction with the OID rules to securities denominated in a foreign currency. The OID Regulations also include an anti-abuse rule that permits the IRS to apply or depart from the regulations discussed below as it deems necessary to ensure a reasonable result in light of the purposes of the OID-related sections of the Code.[248]

A debt instrument (sometimes referred to below as a "note") is treated as issued with OID (sometimes referred to below

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[244] I.R.C. § 1276(a).

[245] I.R.C. § 1278(a)(1).

[246] TAM 2001-20-001 (Jul. 28, 2000) (citing to *United States v. Midland Ross Corp.*, 381 U.S. 54 (1965) (holding that gain on the sale of a note attributable to OID was equivalent to interest and taxable as ordinary income)); *see also* S. REP. NO. 98-169, at 155 (1984) (legislative history finding that OID and market discount are economically equivalent for a noteholder).

[247] TAM 2001-20-001 (Jul. 28, 2000).

[248] *See* Treas. Reg. § 1.1275-2(g).

as a “discount note”) if the excess of the note’s “stated redemption price at maturity” over its issue price is greater than a *de minimis* amount.[249] The “stated redemption price at maturity” of a note is the sum of all payments provided by the note other than payments of “qualified stated interest.”[250] A “qualified stated interest” payment includes any payment of stated interest on a note that is unconditionally payable at least annually at a single fixed rate (or at certain floating rates) that appropriately takes into account the length of the interval between stated interest payments.[251] Notes with an interest holiday, “cash flow” notes, and “zero coupon” notes that do not pay interest, are examples of notes that do not have qualified stated interest.

If the terms of any debt instrument issued on or after August 13, 1996, are modified to defer one or more payments in a manner that does not cause a deemed exchange under section 1001, then solely for purposes of the OID rules under sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the modification date for an amount equal to the instrument’s adjusted issue price on that date.[252] As a result, a deferral of interest payments that is not a significant modification under section 1001 could nevertheless cause a non-OID instrument to be reissued as an OID instrument if interest payments cease to constitute “qualified stated interest.”

B. Issue Price

Generally, the issue price of a note is the first price at which the note is sold.[253] As a result, the issue price of a note will depend on whether the note is issued for cash or property, and in the latter case, whether the notes are publicly traded. In the case of

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[249] I.R.C. § 1273(a); *see also* FSA 1999-665 (Aug. 9, 1993) (IRS rejected the proposition that OID deductions on a nonrecourse debt instrument should be limited to the amount by which the fair market value of the collateral securing the debt exceeds the adjusted issue price of the debt under the proposed section 1001 regulations).

[250] Treas. Reg. § 1.1273-1(b).

[251] Treas. Reg. § 1.1273-1(c).

[252] Treas. Reg. § 1.1275-2(j).

[253] I.R.C. § 1273(b)(1).

notes issued (in part or solely) for cash, the issue price of a note is the amount of consideration received from a purchaser by the issuer.[254] The same rule essentially applies in the case of publicly traded debt that is issued in exchange for property (including outstanding debt). Where debt is exchanged for other debt, the issue price of the new debt will be the fair market value (the trading price) of the debt if either the debt or the property for which it is issued (including outstanding debt) is publicly traded.[255]

Under previous regulations, a debt instrument issued in a debt-for-debt exchange was considered publicly traded if, at any time during the 60-day period ending 30 days after the exchange,[256] the debt fell in any one of four categories.[257]

On September 13, 2012, the Treasury Department issued final regulations that significantly expanded the definition of publicly traded debt instruments.[258] Under the current regulations, a debt instrument will be treated as publicly traded if at any time during the 31-day period ending 15 days after its issue date:

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[254] I.R.C. § 1273(b)(1).

[255] I.R.C. § 1273(b)(3)(A), (B); Treas. Reg. § 1.1273-2(b)(1), (c)(1).

[256] Treas. Reg. § 1.1273-2(f)(1).

[257] The four categories that the previous regulations provided were: (i) any debt listed on a national securities exchange, interdealer quotation system, or foreign exchange or board of trade, (ii) any debt traded on a "contract market" as determined by the Commodities Futures Trading Commission, (iii) any debt appearing on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions, and (iv) any debt for which price quotations are readily available. *See* New York State Bar Association, Tax Section, *Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273 and Related Issues*, 2010 TNT 61-24 (Mar. 31, 2010) (updating and supplementing New York State Bar Association, Tax Section, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273*, 2004 TNT 159-7 (Aug. 17, 2004)), for an excellent analysis of these categories and recommendations for regulatory changes.

[258] T.D. 9599, 2012-40 C.B. 417 (Sept. 13, 2012).

- the sales price for an executed purchase or sale of the debt instrument appears on a medium that is available to persons that regularly purchase or sell debt instruments or to persons that broker purchases or sales of debt instruments, or[259]

- one or more "firm" price quotes are available for the debt instrument from at least one identified broker, dealer, or pricing service, and the quoted price is substantially the same as the price for which the property could be purchased or sold,[260] or

- one or more "indicative" price quotes are available for the debt instrument from at least one broker, dealer or pricing service.[261]

As indicative, or "soft," price quotes are available for almost all debt instruments, the regulations treat almost all debt instruments as publicly traded, subject to a "*de minimis*" exception described below.[262]

Under the final regulations, the classification of a quote, a firm quote, or an indicative quote is dependent on the definition of a "price quote."[263] Because the final regulations do not define price quote, the NYSBA has suggested that the Treasury Department clarify that (i) a mere valuation or estimate is not a price quote, and (ii) a price quote cannot exist absent an actual quote to buy or sell property. [264]

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[259] Treas. Reg. § 1.1273-2(f)(1), (f)(2).

[260] Treas. Reg. § 1.1273-2(f)(1), (f)(3).

[261] Treas. Reg. § 1.1273-2(f)(1), (f)(4).

[262] *See Treasury Expands Definition of Publicly Traded Debt Instruments*, 2011 TNT 5-H (Jan. 7, 2011).

[263] The regulations provide that a price quote meeting certain requirements is a firm quote. All price quotes that are not firm quotes are indicative quotes. Treas. Reg. §1.1273-2(f)(4).

[264] New York State Bar Association, Tax Section, *Comments on Final "Publicly Traded" Regulations under Section 1273 of the Code*, 2012 TNT 220-30 (Nov. 12, 2012).

The final regulations provide that the sales price or price quote is presumed to be the fair market value of the debt instrument.[265] However, if only an indicative price quote is available and a taxpayer determines that the quoted price or average of quotes materially misrepresents the fair market value of a debt instrument, the taxpayer may use any method that provides a reasonable basis to determine the fair market value of the property, so long as the taxpayer's method more accurately reflects the value of the property than the quoted price.[266] Although the regulations appear to permit issuers and holders to reach different determinations as to whether an indicative quote (mis)represents fair market value and to use different methods to determine fair market value in that situation, the issuer's determination of public trading and fair market value is binding on all holders, provided that the issuer makes its determination available to holders in a commercially reasonable fashion within 90 days of the debt instrument's issuance. Further, the final regulations impose a "reasonable diligence" standard on issuers in determining the existence of firm or indicative quotes.[267] Holders can report inconsistently with an issuer's binding determination only if they disclose their differing determination on a timely filed tax return.[268]

Even though a sales price or firm quote can also misrepresent the fair market value of the property in certain circumstances, the final regulations do not permit a means for taxpayers to challenge such material misrepresentations. Accordingly, the NYSBA asked the Treasury Department to confirm that taxpayers may rebut the presumption that a sales price

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[265] Treas. Reg. § 1.1273-2(f)(5)(i).

[266] Treas. Reg. § 1.1273-2(f)(5)(ii).

[267] *See* Treas. Reg. § 1.1273-2(f)(9). The NYSBA has asked the Treasury Department to clarify that the issuer's obligation only applies where the existence of a firm or indicative quote is relevant for U.S. federal income tax purposes. *See* New York State Bar Association, Tax Section, *Comments on Final "Publicly Traded" Regulations under Section 1273 of the Code*, 2012 TNT 220-30 (Nov. 12, 2012).

[268] *See* Treas. Reg. § 1.1273-2(f)(9).

or firm quote reflects the fair market value of property in those cases.[269]

The regulations provide an exception to the publicly traded debt rules for "small debt issues." A debt instrument is treated as part of a small debt issue if the stated principal amount of the issuance that includes the debt instrument does not exceed $100 million.[270]

An anti-abuse rule in the regulations provides that if trading of a debt instrument is temporarily restricted and a purpose for the trading restriction is to avoid publicly traded treatment, the debt instrument will be treated as publicly traded regardless of whether the issuer or a third party imposed the temporary trading restriction.[271] Notably, the final regulations do not require a principal purpose of tax avoidance. Additionally, a sale or price quotation that purposefully causes a debt instrument to become publicly traded or materially misrepresents the value of the debt instrument will be disregarded.[272]

If neither an existing debt instrument nor any debt instrument issued in a debt-for-debt exchange is publicly traded, the issue price of the newly issued debt instrument will generally be its stated principal amount if the note bears "adequate stated

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[269] New York State Bar Association, Tax Section, *Comments on Final "Publicly Traded" Regulations under Section 1273 of the Code*, 2012 TNT 220-30 (Nov. 12, 2012).

[270] Treas. Reg. § 1.1273-2(f)(6). Although Treasury will consider whether a debt instrument whose outstanding principal amount has been reduced should qualify for the small issue exception, early indications from the government suggest that the exception may not apply. *See* Lee A. Sheppard, *Walli Defends Proposed Issue Price Regs*, TAX NOTES (May 16, 2011). Government officials have indicated, however, that they would not object to borrower prepayments on debt instruments in order to reduce the outstanding principal balance below the $100 million threshold. *See* Amy S. Elliot, *Walli OK with Paydowns to Meet Small Issue Exception in Debt Issue Price Rules*, 2012 TNT 241-1 (Dec. 14, 2012).

[271] Treas. Reg. § 1.1273-2(f)(7)(i).

[272] Treas. Reg. § 1.1273-2(f)(7)(i).

interest."[273] If a non-publicly traded note does not bear adequate stated interest, its issue price will generally be its imputed principal amount.[274] Such imputed principal amount equals the present value of all payments due under the note (including interest), using a discount rate equal to the applicable federal rate ("AFR") in effect when the note is issued.[275]

Notwithstanding the above described rules, a debt instrument will have a fair market value issue price if it is issued under "potentially abusive" circumstances.[276] Because this test is fact-based, it is easily subject to challenge by the IRS. The OID regulations provide several examples of potentially abusive circumstances, including, for example, the issuance of a debt instrument with clearly excessive interest, as determined in light of the issuer's creditworthiness, among other factors.[277] An issuer's determination as to whether a debt instrument has been issued in a potentially abusive situation is binding on all holders, absent disclosure by a holder taking a contrary position.[278]

Some notes that bear stated interest and are issued at par may nevertheless bear OID. For example, a note may bear OID where, among other things, (i) the note bears interest at a floating rate (a "Floating Rate Note") and provides for a maximum interest rate or a minimum interest rate that is reasonably expected as of the issue date to cause the yield on the note to be significantly less (in the case of a maximum rate) or more (in the case of a minimum rate) than the expected yield determined without the maximum or minimum rate, as the case may be;[279] (ii) the note is a Floating

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[273] I.R.C. § 1274(a)(1); Treas. Reg. § 1.1274-2(b)(1).

[274] I.R.C. § 1274(a)(2), (c)(1)(D); Treas. Reg. § 1.1274-2(b)(2).

[275] I.R.C. § 1274(b)(1), (2); Treas. Reg. § 1.1274-2(c).

[276] I.R.C. § 1274(b)(3)(A); Treas. Reg. § 1.1274-2(b)(3).

[277] Treas. Reg. § 1.1274-3(b)(3). Other examples of potentially abusive circumstances include a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or any other situation involving a recent sales transaction, nonrecourse financing or financing with a term in excess of the usual life of the property. Treas. Reg. § 1.1272-3(a).

[278] Treas. Reg. § 1.1274-3(d).

[279] Treas. Reg. § 1.1275-5(b)(3).

Rate Note that provides for significant front-loading or back-loading of interest;[280] or (iii) the note bears interest at a floating rate in combination with one or more other floating or fixed rates.[281] Many notes issued in workouts have both fixed and floating interest rate components. For example, a restructured note may provide for both the payment of interest at a fixed rate over the term of the note and also for the payment of additional interest at a floating rate that increases over time. Such a floating rate is designed to effect a "cash sweep" of available borrower funds, which are typically projected to increase over time as the borrower's fortunes improve.

Investment units, which are comprised of debt and other property, are often received by lenders in debt restructurings. The issue price of such an investment unit is determined according to the above described rules as if the investment unit were a debt instrument. The resulting issue price is then allocated between the debt instrument and other property based on their relative fair market values.[282]

C. OID Accrual Rules

Holders of notes that mature more than one year from the date of issue may be required to include OID in gross income before the receipt of cash attributable to such income, without regard to the holder's method of accounting for tax purposes.[283] The amount of OID includible in such holder's gross income is the sum of the "daily portions" of OID with respect to a note for each day during the taxable year or portion of the taxable year in which

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280 Treas. Reg. § 1.1275-5(c)(4).

281 In general, the Treasury regulations are very flexible in permitting various combinations (and even inversions) of fixed and floating rates, as long as the latter are "qualified." *See* Treas. Reg. § 1.1275-5(a)(3), (c)(1), (3). Thus, a Floating Rate Note may be most likely to bear OID when the variability of floating rates is exaggerated through multipliers, and/or compressed through the use of caps and floors. The same is true of notes with floating rates in combination with fixed rates. *See* Treas. Reg. § 1.1275-5(b)(1), (2).

282 I.R.C. § 1273(c)(2); Treas. Reg. § 1.1273-2(h)(1).

283 I.R.C. § 1272(a)(1), (2)(C); Treas. Reg. § 1.1272-1(a)(1).

the holder holds such note ("accrued OID").[284] The daily portion of accrued OID is determined by allocating to each day in any "accrual period" a *pro rata* portion of the OID allocable to that accrual period.[285] Under the OID Regulations, accrual periods with respect to a note may be any set of periods (of varying lengths) selected by the holder as long as (i) no accrual period is longer than one year and (ii) each scheduled payment of interest or principal on the note occurs on either the first day or final day of an accrual period.[286]

The amount of OID allocable to an accrual period equals the excess of (a) the product of the note's adjusted issue price at the beginning of the accrual period and the note's yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period) over (b) the sum of any payments of qualified stated interest on the discount note allocable to the accrual period.[287] The "adjusted issue price" of a note at the beginning of the first accrual period is the note's issue price, and at the beginning of any accrual period thereafter is (x) the sum of the issue price of such note, the accrued OID for each prior accrual period (determined without regard to the amortization of any acquisition premium or bond premium, which are both discussed below), and the amount of any then accrued, unpaid qualified stated interest on the note, less (y) any prior payments on the note other than qualified stated interest payments.[288] The adjusted issue price at the beginning of such accrual period is reduced by the amount of any payment that is made on the first day of an accrual payment period (other than a payment of qualified stated interest).[289]

Where a portion of the initial purchase price of a note is attributable to interest that accrued prior to the note's issue date, the holder may elect to decrease the issue price of the note by the amount of pre-issuance accrued interest if the first stated interest

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284 I.R.C. § 1272(a)(1).

285 I.R.C. § 1272(a)(3); Treas. Reg. § 1.1272-1(b)(1)(iv).

286 Treas. Reg. § 1.1272-1(b)(1)(ii).

287 I.R.C. § 1272(a)(3); Treas. Reg. § 1.1272-1(b)(1)(iii).

288 I.R.C. § 1272(a)(4); Treas. Reg. § 1.1275-1(b).

289 Treas. Reg. § 1.1272-1(b)(4)(iv).

payment on the note will equal or exceed the amount of pre-issuance accrued interest and will be made within one year of the note's issue date.[290] If a holder so elects, a portion of the first stated interest payment will be treated as a return of the excluded pre-issuance accrued interest rather than as an amount payable on the note.[291]

Under the OID Regulations, any reasonable method may be used to determine the amount of OID allocable to a short initial accrual period, assuming all other accrual periods are of equal length, provided that the amount of OID allocable to the final accrual period equals the excess of the amount payable at the maturity of the note (other than any final payment of qualified stated interest) over the note's adjusted issue price as of the beginning of such final accrual period.[292] In addition, if an interval between payments of qualified stated interest on a note contains more than one accrual period, the amount of qualified stated interest payable at the end of such interval is allocated *pro rata* (on the basis of their relative lengths) between the accrual periods contained in the payment interval.[293]

In general, if the excess of a note's stated redemption price at maturity over its issue price is *de minimis*, such excess constitutes "*de minimis* OID."[294] Under the OID Regulations, unless a holder elects to treat all interest as OID, such a note will not be treated as issued with OID,[295] and a holder of such a note will recognize capital gain with respect to such *de minimis* OID as stated principal payments on the note are made.[296] The amount of capital gain with respect to each such payment will equal the

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[290] Treas. Reg. § 1.1273-2(m)(1).

[291] Treas. Reg. § 1.1273-2(m)(2).

[292] Treas. Reg. § 1.1272-1(b)(4)(ii), (iii).

[293] Treas. Reg. § 1.1272-1(b)(4)(i)(A). *De minimis* OID is an amount equal to .0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date. Treas. Reg. § 1.1273-1(d)(2).

[294] Treas. Reg. § 1.1273-1(d).

[295] Treas. Reg. § 1.1273-1(d)(1).

[296] Treas. Reg. § 1.1273-1(d)(5)(i), (ii).

product of the total amount of the note's *de minimis* OID and a fraction, the numerator of which is the amount of the principal payment made and the denominator of which is the stated principal amount of the note.[297]

1. OID Accrual on Short-Term Debt Instruments

Special rules apply with respect to OID on notes that mature one year or less from the date of issuance ("short-term notes"). In general, a cash basis holder of a short-term note is not required to include OID in income as it accrues for tax purposes, although such a holder may elect to do so.[298] However, accrual basis holders and certain holders, including banks, regulated investment companies, dealers in securities,[299] and electing cash basis holders who so elect[300] are required to include OID[301] in income as it accrues on short-term notes on either a straight-line basis or under the constant yield method (based on daily compounding), at the election of the holder.[302] In the case of a holder that is not required (and does not elect) to include OID in income currently, any gain realized on the sale or retirement of short-term notes will be ordinary income, generally to the extent of the OID accrued on a straight-line basis through the date of sale or retirement.[303] Holders who are not required and do not elect to include OID on short-term notes in income as it accrues will be required to defer deductions for interest on borrowing allocable to short-term notes in an amount not exceeding the deferred income until the deferred OID income is realized.[304]

Any holder of a short-term note can elect to apply the rules in the preceding paragraph taking into account the amount of

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297 Treas. Reg. § 1.1273-1(d)(5)(i).

298 I.R.C. §§ 1283(c)(1)(A); 1281(a)(1), (b)(1)(A); 1272(a)(2)(C); Treas. Reg. § 1.1272-3(a).

299 I.R.C. § 1281(b)(1).

300 Treas. Reg. § 1.1272-3(a).

301 I.R.C. § 1283(c)(1)(A); Treas. Reg. § 1.1272-3(c).

302 I.R.C. § 1283(b), (c)(1)(B).

303 I.R.C. § 1271(a)(4)(A), (D).

304 I.R.C. § 1282(a).

"acquisition discount," if any, with respect to the note (rather than the OID with respect to such note).[305] Acquisition discount is the excess of the stated redemption price at maturity of the short-term note over the holder's purchase price therefor.[306] Acquisition discount will be treated as accruing on a ratable basis or, at the election of the holder, on a constant-yield basis.[307] For purposes of determining the amount of OID subject to these rules, the OID Regulations provide that, although no interest payments on a short-term note are qualified stated interest,[308] such interest payments are included in the short-term note's stated redemption price at maturity.[309]

2. OID Accrual in Cases of Doubtful Collectibility

Under case law and IRS rulings, accrual method creditors may discontinue accruing interest where there is no reasonable expectation that the income will be collected.[310] By contrast, with respect to OID, the IRS has taken the questionable position that creditors must continue to accrue OID income despite the doubtful collectibility of such income.[311] The IRS has taken the position

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305 I.R.C. § 1283(c)(2).

306 I.R.C. § 1283(a)(2).

307 I.R.C. § 1283(b).

308 Treas. Reg. § 1.1273-1(c)(5).

309 Treas. Reg. § 1.1273-1(b).

310 *See, e.g.*, *Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937); *European American Bank and Trust Co. v. United States*, 20 Cl. Ct. 594 (Ct. Cls. 1990), *aff'd*, 940 F.2d 677 (Fed. Cir. 1992); Rev. Rul. 80-361, 1980-2 C.B. 164 (referring to interest that becomes uncollectible).

311 TAM 95-38-007 (June 13, 1995); FSA 2000-18-017 (Jan. 13, 2000). However, citing bankruptcy law disallowing claims for post-petition interest (including OID), the IRS has issued internal guidance stating that holders are not required to include (and the issuer cannot deduct) post-petition interest and OID on pre-petition unsecured debt where the issuer has filed for bankruptcy. IRS Litigation Guideline Memorandum (May 6, 1996), 2000 TNT 121-83 (June 22, 2000).

Similarly, the market discount rules do not contain a doubtful collectibility exception and there is no case law that provides for one.

that the "no reasonable expectation of payment" exception should be strictly construed and interest income must be accrued until the loan becomes uncollectible.[312] In addition, the IRS has indicated that the OID provisions are intended to match the holder's income with the issuer's deductions, and cites legislative history stating that the borrower on an OID instrument is deemed to pay annual interest, which the lender is deemed to receive and then relend to the borrower.[313]

The IRS' argument with respect to the mismatch potential if holders need not accrue OID can easily be rebutted in light of the fact that the "doubtful collectibility" exception to the accrual of stated interest income creates the same mismatch potential as OID. In fact, an IRS official has publicly acknowledged that the disparity between requiring matching OID accruals and allowing nonaccrual of coupon interest in doubtful collectibility cases is a policy question that will eventually need to be addressed.[314]

Further, the IRS' reliance on the payment-then-relending construct in the legislative history appears misplaced. Another passage in the legislative history to the OID provisions indicates

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As a result, commentators have suggested that taxpayers could be required to take the market discount into account as ordinary income currently, and if the loan is not repaid, receive a capital loss at a later date that would not offset the earlier ordinary income, resulting in both timing and character mismatches. *See* Lee Sheppard, "News Analysis: Neither a Dealer Nor a Lender Be, PART 4 – Vulture Fund Self-Help," 2008 TNT 220-5 (Nov. 17, 2008); *see also* New York State Bar Association, Tax Section, *Guidance on Economic Downturn Issues*, 2008 TNT 162-14 (Aug. 20, 2008).

The IRS is aware of practitioners' concerns and has publicly described as "high priority" the development of regulations addressing the accrual of discount on distressed debt. *See* Lee A. Sheppard & Amy S. Elliott, *Distressed Debt Issues Redux*, 142 TAX NOTES 153 (Jan. 13, 2014).

312 Rev. Rul. 2007-32, 2007-21 I.R.B. 1278; Rev. Rul. 80-361, 1980-2 C.B. 164.

313 *See* TAM 95-38-007 (June 13, 1995) (citing H.R. REP. NO. 98-432, at 1034 (1984)); FSA 2000-18-017 (Jan. 13, 2000) (same).

314 Lee A. Sheppard, IRS's Solomon Offers Updates on Debt Exchange Regs, Spin-offs, 69 TAX NOTES 531 (Oct. 30, 1995).

that the construct is used only to provide a *theoretical* basis for the issuer's deduction, the holder's income inclusion, and the economic accrual or compounding of interest.[315] Numerous other provisions in the legislative history clearly state that OID is to be treated as interest for tax purposes, providing ample evidence of Congress' intent[316] that OID be treated as interest for all federal income tax purposes, including section 451 and the accrual method regulations thereunder. The author believes that the authorities stating that the accrual method requirements are not satisfied where interest collection is doubtful should also apply for purposes of accruing OID income.[317]

As noted above, the foregoing argument may also be employed to prevent insolvent issuers from deducting OID. Although early cases held that an issuer of a debt obligation can

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315 *See* H.R. Rep. No. 99-87, at 4, n.4 (1985) ("The premise of the OID rules is that, for federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually to the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the 'economic accrual' of interest, or interest 'compounding.'").

316 *See* H.R. Rep. No. 98-432, at 1248 (1984) (OID will be "treated as interest for all purposes of the Code"); S. Rep No. 99-83, at 5 (1985) ("the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently").

317 *See* Atlantic Coast Line Railroad Co. v. Commissioner, 31 B.T.A. 730, 751 (1934) ("where the obligation is worthless at the time the 'right to receive' arises, as in the instant case, the right to receive is without substance and there is in fact nothing to accrue"); Rev. Rul. 80-361, 1980-2 C.B. 164 (under Treasury regulation section 1.451-1(a), interest did not properly accrue where the right to interest became fixed after the debtor's insolvency, since the interest was uncollectible at the time such right arose).

continue to deduct interest even after there was no intention or expectation that it would ever be paid,[318] later courts have questioned this rule, and have declined to permit deductions by hopelessly insolvent obligors.[319]

In addition, the IRS appears to believe that issuers of undersecured nonrecourse debt may not properly deduct OID with respect to such debt. A 1987 General Counsel Memorandum interprets the OID legislative history as disallowing an issuer's deductions for accrued OID on nonrecourse debt when and to the extent the value of the property securing the nonrecourse debt does not exceed the principal balance of the obligation, plus the amount of OID previously deducted at the time of such deduction.[320] It is not clear whether deductions that are disallowed under this rule would be permanently lost or merely postponed until the value of the property once again exceeds the outstanding amount of the debt.

3. Allocation of Payments between Interest/OID and Principal

Historically, parties could control the allocation of payments between principal and interest through an arm's-length

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318 *See Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955); *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir. 1942); *see also* Rev. Rul. 70-367, 1970-2 C.B. 37.

319 *See Kellogg v. United States*, 82 F.3d 413 (5th Cir. 1996) (no deductions allowed on accrued interest where taxpayer is so hopelessly insolvent that the interest will never be paid); *Tampa and Gulf Coast Railroad Co. v. Commissioner*, 469 F.2d 263 (5th Cir. 1972) (holding that where a parent was excluding accrued interest from income as unlikely to be collected from a debtor-subsidiary, the subsidiary could not accrue the deduction); *Mooney Aircraft, Inc. v. Commissioner*, 420 F.2d 400 (5th Cir. 1969) (denying deduction for amounts that may never be paid since due at a non-fixed time in the future, and questioning the ruling in *Zimmerman* as "dubious"); *Continental Vending Machine Corp.*, 77-1 U.S.T.C. ¶ 9121 (E.D.N.Y., Nov. 19, 1976) (Chapter 11 company permitted to deduct accrued interest only on secured debt).

320 S. REP. NO. 98-169, at 255 (Apr. 2, 1984); G.C.M. 39,668 (Oct. 1, 1987).

expression of intent.[321] Absent such an agreement, payments made on debt before retirement were generally applied first to accrued unpaid interest and then to principal, and payments made at maturity were applied proportionately to accrued unpaid interest and principal.[322] However, courts have held that a final payment where principal is not recovered can be allocated solely to principal.[323]

The section 446 regulations and the OID regulations may have curtailed, and the IRS would argue, eliminated, the ability of taxpayers to control the allocation of these payments. Under these regulations, payments must be allocated first to accrued unpaid interest or OID, and then to principal.[324] It is not clear whether either or both of Treasury regulation section 1.446-2(e), which applies to "each payment under a loan," and Treasury regulation section 1.1275-2(a), which applies to "each payment under a debt instrument," are intended to cover payments made in partial or complete discharge of debt. Commentators have persuasively argued that, as a policy matter, the regulations should not apply in distressed situations where the holder does not recover the outstanding principal balance on its loan.[325] If the regulations do

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[321] *See Newhouse v. Commissioner*, 59 T.C. 783 (1973); Rev. Rul. 63-57, 1963-1 C.B. 103.

[322] *See European American Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (Ct. Cls. 1990), *aff'd*, 940 F.2d 677 (Fed. Cir. 1991); *Warner Co. v. Commissioner*, 11 T.C. 419 (1948), *aff'd per curiam*, 181 F.2d 599 (3d Cir. 1950); Priv. Ltr. Rul. 88-19-068 (Feb. 17, 1988).

[323] *See Newhouse v. Commissioner*, 59 T.C. 783 (1973); *Petit et al. v. Commissioner*, 8 T.C. 228 (1947); *Lackey v. Commissioner*, T.C. Memo 1977-213 (1977); *Drier v. Helvering*, 72 F.2d 76 (D.C. Cir. 1934); *see also* Priv. Ltr. Rul. 88-21-018 (Feb. 23, 1988) (ruling that where holders of tax-exempt bonds receive only half of the bond issue price, payments must be applied to principal since holders have incentive to apply payments to tax-exempt interest and thereby increase capital loss).

[324] Treas. Reg. §§ 1.446-2(e); 1.1275-2(a).

[325] *See* New York State Bar Association, Tax Section, *Comments on the Final OID Regulations*, 64 TAX NOTES 1747 (Sept. 26, 1994); KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS ¶ 3.02 (2000).

not apply, the case law permitting taxpayers to control the allocation of payments by agreement, as well as the case law allocating payments to principal in distressed situations, should apply.[326]

For cash basis holders, allocating more of a final payment to principal would decrease the holder's ordinary interest income instead of producing a larger capital loss. Where the holder is an accrual basis taxpayer, or a final payment is made on a debt instrument with OID rather than interest, interest or OID will already have accrued (unless collection of the interest or OID was doubtful). Thus, there is an issue as to whether the loss on the debt can be treated as ordinary to the extent of prior interest or OID income accruals. While there is no direct authority for this proposition, analogous authority in the legislative history to section 354(a)(2)(B),[327] the contingent payment debt instrument regulations,[328] the bond premium amortization regulations,[329] and

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[326] Priv. Ltr. Rul. 2000-35-008 (May 23, 2000) held that in the absence of an agreement between the parties, an issuer's payments on tax-exempt bonds prior to insolvency would be applied to accrued interest first, while later payments in liquidation of the bonds made when the issuer is insolvent would be applied first to principal. Interestingly, the letter ruling did not discuss Treasury regulation section 1.446-2(e). Although it is not clear from the facts of the ruling, the omission may be due to the fact that the bonds were issued prior to April 4, 1994, the effective date of that regulation. *See also* 1995 FSA Lexis 537 (Oct. 20, 1995) (proceeds from foreclosure sale of property acquired through issuance of tax-exempt bonds allocated to principal where issuer was insolvent on the date of foreclosure).

[327] S. REP. NO. 96-1035, at 38 (1980) (stating that under section 354(a)(2)(B) an exchanging security holder that previously accrued interest or OID to which property received is allocable recognizes a loss to the extent the interest is not paid in the exchange); TAM 95-38-007 (June 13, 1995); *see* GORDON D. HENDERSON AND STUART J. GOLDRING, FAILING AND FAILED BUSINESSES ¶ 304 n. 3 (2008).

[328] Under the contingent payment debt regulations, negative adjustments are treated as ordinary losses of the holder to the extent of prior ordinary income inclusions. Treas. Reg. § 1.1275-4(b)(6)(iii)(B). *See* DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 6.03[D][1] (5th ed. 2005); Section IV.H. below.

the bad debt regulations[330] each provide support for the position that losses on debt may be treated as ordinary to the extent of prior income accrual. Nonetheless, the IRS may be expected to challenge ordinary loss treatment in the absence of direct authority.

D. Debt Instruments Acquired at a Premium

A note purchased at its original issuance for an amount in excess of its issue price but less than its stated redemption price at maturity will bear "acquisition premium" equal to the difference between the purchase price and the issue price.[331] A holder of such a note that does not elect to treat all interest as OID (as described below) is permitted to reduce the daily portions of OID by a fraction, the numerator of which is the acquisition price over the issue price, and the denominator of which is the excess of the sum of all amounts subsequently payable on the note other than payments of qualified stated interest over the note's issue price.[332] Alternatively, a holder may elect to compute OID accruals under the general OID rules, treating the holder's purchase price as the issue price.[333]

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329 The bond premium amortization regulations provide that the excess of allocable bond premium over qualified stated interest for a taxable year can be taken as a deduction to the extent of prior net income inclusions with respect to the bond. Treas. Reg. § 1.171-2(a)(4)(i)(A).

330 In the case of certain debt obligations, if a portion of the debt remains unsatisfied after applying proceeds from a foreclosure sale of the collateral, the creditor may generally claim the unsatisfied amount, including accrued interest previously taken into income, as an ordinary bad debt loss if the creditor is a corporation or if the debt was a "business" debt in the hands of the (noncorporate) creditor. *See* I.R.C. § 166(a), (d)(1); Treas. Reg. § 1.166-6(a). Of course, ordinary loss treatment would not apply to unsatisfied amounts on debt issued by corporations that constitute "securities" under section 165(g)(2)(C). *See* I.R.C. §§ 166(e); 165(g).

331 Treas. Reg. § 1.1272-2(b)(3).

332 Treas. Reg. § 1.1272-2(b)(4).

333 Treas. Reg. § 1.1272-2(b)(5).

Under the Code, a holder that purchases a note for an amount in excess of its principal amount[334] will not be subject to the OID rules.[335] Such a holder may elect to treat such excess as "amortizable bond premium,"[336] in which case the amount of qualified stated interest that must be included in the holder's income each year with respect to interest on the note will be reduced by the amount of amortizable bond premium allocable to such year (based on the note's yield to maturity).[337] If the amount of deductible bond premium in an accrual period exceeds the qualified stated interest allocable in that period, then the holder may take a bond premium deduction.[338] The bond premium deduction is limited, however, to an amount equal to the excess of prior interest inclusions on the debt instrument over any bond premium deductions in prior accrual periods. Any remaining bond premium deduction is carried forward to the debt instrument's next accrual period.[339]

Because amortized bond premium reduces a holder's basis in a debt instrument,[340] the Treasury Department has noted that in the case of some zero-coupon bonds, a holder will only recover accrued bond premium as a capital loss upon sale or disposition of the debt instrument.[341] Regulations now permit a holder to deduct any remaining bond premium carryforward at the end of the holder's final accrual period (thereby providing allowing the holder to take an ordinary deduction) rather than treat the remaining carryforward as a capital loss.[342]

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334 Technically, principal amount equals the sum of all amounts payable on the note after the purchase date, other than payments of qualified stated interest.

335 I.R.C. § 1272(c)(1); Treas. Reg. § 1.1272-2(a), (b)(2).

336 I.R.C. § 171(c).

337 I.R.C. § 171(e), (b)(3)(A).

338 I.R.C. § 171(a)(1).

339 Treas. Reg. § 1.171-2(a)(4).

340 Treas. Reg. § 1.1016-5(b).

341 78 Fed. Reg. 666, 667 (Dec. 20, 2012).

342 *See* Treas. Reg. § 1.171-2(a)(4)(c); T.D. 9653, 2014-6 I.R.B. 460 (Jan. 15, 2014) (adopting proposed and temporary regulations permitting such treatment with no substantive changes); *see also*

The regulations prescribe rules for making the election and amortizing premium on the constant yield method, but the regulations do not apply to certain debt instruments, including regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments (or pools of debt instruments) with payments subject to acceleration as described in section 1272(a)(6)(C).[343] Any election by a holder to amortize bond premium is applicable to all bonds (other than bonds on which interest is excludible from gross income) held by the holder at the beginning of the first taxable year to which the election applies or is thereafter acquired by the holder, and the election may not be revoked without the consent of the IRS.[344]

E. Notes Purchased at a Market Discount

A debt instrument, other than a short-term note,[345] will be treated as issued at a market discount (a "market discount note") if the issue price of the note exceeds the amount for which a holder purchased the note by more than a *de minimis* amount.[346] This *de minimis* carve-out is similar to the carve-out for *de minimis* OID described above.[347] Absent a holder election, accrued market discount is not required to be currently included in a holder's

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William R. Davis, *Bond Premium Carryforward Final Regs Provide Ordinary Deduction*, 142 TAX NOTES 264 (Jan. 20, 2014).

[343] Treas. Reg. § 1.171-1(a)(1), (b)(2). The constant yield method of amortizing bond premium has been required even for debt instruments described in section 1272(a)(6)(C) under the clear reflection of income standard of section 446. *See* Priv. Ltr. Rul. 2001-52-028 (Sept. 28, 2001) (holder of mortgage-backed securities that amortized bond premium on a straight-line basis prior to acquisition of other mortgage-backed securities in a section 381 transaction must, following the acquisition, use the constant yield method because the straight-line method does not clearly reflect income).

[344] I.R.C. § 171(c).

[345] I.R.C. § 1278(a)(1)(B)(i).

[346] I.R.C. § 1278(a)(1)(D)(ii).

[347] I.R.C. § 1278(a)(2)(C).

income.[348] Instead, any partial payment of principal on, or gain recognized on the maturity or disposition of, a market discount note generally will be treated as ordinary income to the extent that such gain does not exceed the accrued market discount on such note.[349] Market discount accrues on a straight-line basis unless the holder elects to accrue such discount on a constant yield to maturity basis.[350] A constant yield election is applicable only to the note with respect to which it is made and may not be revoked without the consent of the IRS.[351] A holder of a market discount note that does not elect to include market discount in income currently will generally be required to defer deductions for interest on borrowings allocable to such note in an amount not exceeding the accrued market discount on such note until the maturity or disposition of such note.[352]

F. Optional Redemptions (the Put and Call Rules)

Certain issuer options to redeem a note and holder options to cause a note to be repurchased prior to the note's stated maturity will be presumed to be exercised. This result obtains if, by treating any date on which such note may be redeemed or repurchased as the maturity date for the note and the amount payable on such date in accordance with the terms of such note (the "redemption price") as the stated redemption price at maturity, the yield on the note would (i) in the case of an issuer option, be lower than its yield to stated maturity, or (ii) in the case of a holder option, be higher than its yield to stated maturity.[353] If such an option is not in fact exercised on a presumed exercise date, the note would be treated

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[348] A holder of a market discount note may elect to currently include market discount in income over the life of the market discount note. I.R.C. § 1278(b)(1). Such an election applies to all debt instruments with market discount acquired by the electing holder on or after the first day of the first taxable year to which the election applies and may not be revoked without the consent of the IRS. I.R.C. § 1278(b)(3).

[349] I.R.C. § 1276(a)(1).

[350] I.R.C. § 1276(b)(1), (2).

[351] I.R.C. § 1276(b)(2)(C).

[352] I.R.C. § 1277(b)(2).

[353] I.R.C. § 1272(a)(6)(C)(ii); Treas. Reg. § 1.1272-1(c)(5).

solely for OID purposes as if it were redeemed or repurchased on that date and a new note were then issued for an amount equal to the note's then adjusted issue price.[354] If the deemed reissued note has subsequent repurchase options, the above-described yield calculations would be performed once again to determine whether such options should again be presumed exercised.

G. Election to Treat All Interest as Original Issue Discount

Any holder may elect to include in gross income all interest that accrues on a note using the constant yield method described above under the general OID rules, with certain modifications.[355] For purposes of this election, interest includes stated interest, OID, *de minimis* OID, market discount, acquisition discount, *de minimis* market discount and unstated interest (as adjusted by any amortizable bond premium or acquisition premium).[356] If such election is made, the constant yield method is applied to a note as follows: the issue price of the note will equal the electing holder's adjusted basis in the note immediately after its acquisition, the issue date of the note will be treated as the date of its acquisition by the electing holder, and no payments on the note will be treated as payments of qualified stated interest.[357] This election is generally applicable only to the note with respect to which it is made and may not be revoked without the consent of the IRS.[358]

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[354] Treas. Reg. § 1.1272-1(c)(6).

[355] If such an election is made with respect to a note with amortizable bond premium, the electing holder will be deemed to have elected to apply amortizable bond premium to reduce interest with respect to all debt instruments with amortizable bond premium (other than tax-exempt debt instruments) held by such electing holder as of the beginning of the taxable year in which the note with respect to which the election is made is acquired, and to all debt instruments thereafter acquired. The deemed election with respect to amortizable bond premium may not be revoked without the consent of the IRS. Treas. Reg. § 1.1272-3(b)(2)(ii)(B).

[356] Treas. Reg. § 1.1272-3(a).

[357] Treas. Reg. § 1.1272-3(c).

[358] Treas. Reg. § 1.1272-3(d), (e).

If the foregoing election to apply the constant yield method to all interest on a note is made with respect to a market discount note, the electing holder will be treated as also having made the election to include market discount in income currently over the life of all other debt instruments then held or thereafter acquired by such holder.[359]

H. Contingent Payment Debt Instruments

Four sets of proposed regulations governing contingent payment debt instruments have been issued since 1986. Final regulations were issued in 1996 that are effective for instruments issued on or after August 13, 1996. According to the preamble to the final regulations, taxpayers may use any reasonable method to account for contingent payment debt instruments issued before August 13, 1996, including a method that would have been required under the proposed regulations when the debt instrument was issued.[360] Thus, a brief description of the previous rules is in order.

Generally, for pre-August 13, 1996 instruments, contingent interest would not be includible in income until the amount of interest becomes fixed or the payment is made. Under the 1986 proposed regulations, debt instruments issued for cash or publicly traded property calling for contingent payments equal to or greater than the issue price were separated into a non-contingent component analyzed under normal OID rules and a contingent component, payments under which were treated as interest payments when the contingent payments were fixed.[361] The treatment of instruments subject to section 1274 was governed by rules similar to the rules governing such instruments under the

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[359] Treas. Reg. § 1.1272-3(b)(2)(ii)(B).

[360] T.D. 8674, 1996-28 I.R.B. 7 (June 11, 1996); *see also* FSA 1999-22-024, (June 4, 1999) (company permitted to deduct OID on its contingent payments for patents or patent rights purchased before August 13, 1996, either when the payments became fixed, as permitted under the proposed regulations, or when the payments were made, as required by the final regulations).

[361] Prop. Treas. Reg. § 1.1275-4(e) (1986), 51 Fed. Reg. 12,022 (Apr. 8, 1986).

final regulations.[362] The 1991 proposed regulations provided a bifurcation method for certain instruments calling for contingent payments determined by reference to the value of publicly traded property, applying OID rules to the non-contingent component and treating the contingent component as non-debt.[363] The 1993 proposed regulations would have allowed a choice between five different methods of determining the amount of accrued interest on a market-based contingent payment debt instrument.[364] All three sets of proposed regulations were superseded by proposed regulations issued in 1994,[365] which set forth the "non-contingent bond method" for all contingent payment debt instruments issued for publicly traded property, and a separate rule for instruments issued for non-publicly traded property. The final regulations adopt the methods provided in the 1994 proposed regulations with a few changes.

The final contingent debt regulations apply to any instrument that is characterized as debt for tax purposes and provides for at least one contingent payment.[366] For this purpose, payments that are subject only to "remote" or "incidental" contingencies do not qualify as contingent payments.[367] Remote contingencies are those that are unlikely to come to pass,[368] and incidental contingencies are those that involve payments that are

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[362] *See* Prop. Treas. Reg. § 1.1275-4(c) (1986); Treas. Reg. § 1.1275-4(c).

[363] Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8,308 (Feb. 28, 1991).

[364] The Treasury regulations proposed in 1993 were never published in the Federal Register. Thus, the IRS could assert that the 1993 proposed regulations do not clearly constitute a reasonable method as defined in the preamble to the final regulations.

[365] 59 Fed. Reg. 64,884 (Dec. 16, 1994).

[366] Treas. Reg. § 1.1275-4(a)(1). Note that the regulations would apply to debt modified by a liquidating bankruptcy plan to provide for distributions to creditors, the amounts of which are contingent on the outcome of litigation pursued by the debtor's estate.

[367] Treas. Reg. § 1.1275-4(a)(5).

[368] Treas. Reg. § 1.1275-2(h)(2).

insignificant relative to the total projected payments under an instrument.[369]

The final regulations adopt the so-called non-contingent bond method for debt instruments with an issue price governed by section 1273, *i.e.*, instruments that are publicly traded or issued in exchange for publicly traded property.[370] A different method is provided for debt instruments whose issue price is governed by section 1274. The non-contingent bond method follows the OID regulations, which take the position that the entire accrued amount (calculated as described below) in any given year is taxable to the holder as interest income, and may be deducted by the issuer, in such year.[371] In effect, the non-contingent bond method treats estimated contingent payments in the same manner as fixed payments, and requires the current accrual of such amounts consistent with the OID Regulations.[372]

Implementation of the non-contingent bond method requires (i) the determination of the comparable yield at which the issuer could (and would) issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument,[373] (ii) the creation of a projected payment schedule, which must produce the comparable yield,[374] (iii) the calculation of the daily interest portion, which equals the product of the comparable yield and the adjusted issue price (determined under section 1273 and Treasury regulation section 1.1275-4(b)(7)) divided by the number of days in the period,[375] and (iv) a positive or negative adjustment to income or deductions to take into account differences between the projected and actual contingent payment amounts for a given year.[376]

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[369] Treas. Reg. § 1.1275-2(h)(3)(i).

[370] Treas. Reg. § 1.1275-4(b)(1).

[371] Treas. Reg. § 1.1275-4(b)(2).

[372] *See* T.D. 8674, 1996-2 C.B. 84 (June 11, 1996); Notice of Proposed Rulemaking, Fed. Reg. 64,884 (Dec. 16, 1994).

[373] Treas. Reg. § 1.1275-4(b)(3)(i), (4)(i).

[374] Treas. Reg. § 1.1275-4(b)(3)(ii), (4)(ii).

[375] Treas. Reg. § 1.1275-4(b)(3)(iii), (6).

[376] Treas. Reg. § 1.1275-4(b)(3)(iv).

The issuer of a debt instrument must first determine the comparable yield on the instrument, which must be a reasonable yield for the issuer and must not be less than the AFR.[377] The issuer must then prepare a projected payment schedule comprised of all non-contingent payments due under a debt instrument and the projected amount of each contingent payment due under such debt instrument.[378] If a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment.[379] A market-based payment, which is a payment derived from information on which an objective rate can be based under Treasury regulation section 1.1275-5(c)(1) or (2),[380] will in most cases be substantially similar to an option, future or similar instrument for which forward pricing is available (or in the absence of forward pricing, spot pricing). If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment determined on the issue date.[381] Non-market-based payments are payments based on indices that are not quoted in public markets, including, for example, payments based on the value of an issuer's assets. [382] If the projected payment schedule does not produce the comparable yield, the issuer must adjust the payment schedule such that the comparable yield is produced.[383] Where debt is modified in the context of workouts to include contingent payments, such payments will typically constitute non-market-based payments.

An issuer's projected payment schedule binds the holder, unless the schedule can be shown to be unreasonable.[384] It should

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[377] Treas. Reg. § 1.1275-4(b)(4)(i).

[378] Treas. Reg. § 1.1275-4(b)(4)(ii).

[379] Treas. Reg. § 1.1275-4(b)(4)(ii)(A).

[380] Treas. Reg. § 1.1275-4(b)(4)(iii).

[381] Treas. Reg. § 1.1275-4(b)(4)(ii)(B).

[382] Treas. Reg. § 1.1275-4(b)(4)(ii)(B).

[383] Treas. Reg. § 1.1275-4(b)(4)(ii)(C). If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for market-based payments.

[384] Treas. Reg. § 1.1275-4(b)(4)(v).

be noted that an issuer would generally prefer to create a projected payment schedule with a high rate of return, since the issuer may contemporaneously deduct amounts equal to the holders' required accruals of interest income. To the extent projected contingent prepayments are not ultimately made, holders would realize a loss when lesser contingent payments were ultimately made.

By contrast, holders would prefer that the projected payment schedule be based on a lower rate of return, so that their interest accruals would be minimized. In the case of restructurings and bankruptcies, it is most likely that the holders will prevail in their efforts to calculate projected yield on the basis of a lower rate of return. First, the holders typically have more power in the context of debt restructurings to dictate the terms of modified debt than in the case of a new issuance of debt. Second, holders of debt of troubled issues are often less inclined to view a deduction for a troubled issuer as having significant value than in the case of a new debt issuance, in light of the fact that troubled issuers often project future operating losses. The adoption of these rules as final regulations will have an important impact on the form that workouts and bankruptcies take, including whether lenders will continue to agree to decrease the principal amount of outstanding debt in favor of adding a contingent payment feature to the modified debt.

The final step of the non-contingent bond method requires taxpayers to make positive or negative adjustments to income during taxable years in which the taxpayer either holds or is primarily liable on the debt instrument.[385] If a contingent amount actually paid is more than the projected amount, a positive adjustment arises on the date of payment.[386] If the amount paid is less than the projected amount, a negative adjustment arises on the date of payment (or on the scheduled payment date if the payment amount is zero).[387] A net positive adjustment, *i.e.*, the amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceeds the total negative adjustments on the debt

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[385] Treas. Reg. § 1.1275-4(b)(6).

[386] Treas. Reg. § 1.1275-4(b)(6)(i).

[387] Treas. Reg. § 1.1275-4(b)(6)(i).

instrument, is treated as additional interest for the taxable year.[388] A net negative adjustment first reduces interest accruals on the debt instrument for the taxable year, and any excess is treated by a holder as ordinary loss and by the issuer as ordinary income to the extent that the amount of the holder's or issuer's total interest accruals on the debt instrument exceed the aggregate amount of the holder's or issuer's net negative adjustments treated as ordinary income or loss in prior taxable years.[389]

If the net negative adjustment would exceed the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss on the debt instrument for the taxable year, the excess is carried forward as a negative adjustment on the debt instrument on the first day of the succeeding taxable year.[390] However, if a holder has a negative adjustment carryforward in a taxable year in which the debt instrument is sold, exchanged, or retired, the carryforward reduces the holder's amount realized on the sale, exchange, or retirement.[391] If an issuer has a negative adjustment carryforward in a taxable year in which the debt instrument is retired, the issuer takes the carryforward into account as ordinary income.[392]

It should be noted that the 1994 proposed regulations treated an issuer's negative adjustment carryforward in the year in which a debt instrument is retired as COD income under section 61(a)(12).[393] Thus, for debt instruments issued prior to August 13, 1996, an issuer may be able to exclude from income any negative adjustment carryforward in the year that the debt instrument is retired under one of the COD income exclusion provisions of section 108.

The accounting of contingent payment features in non-publicly traded debt instruments issued in a sale or exchange of non-publicly traded property is governed by Treasury regulation

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[388] Treas. Reg. § 1.1275-4(b)(6)(ii).

[389] *See* Treas. Reg. § 1.1275-4(b)(6)(iii)(A), (B).

[390] Treas. Reg. § 1.1275-4(b)(6)(iii)(C).

[391] Treas. Reg. § 1.1275-4(b)(6)(iii)(C).

[392] Treas. Reg. § 1.1275-4(b)(6)(iii)(C).

[393] Prop. Treas. Reg. § 1.1275-4(b)(6)(iii)(C)(2) (1994).

section 1.1275-4(c), which splits debt instruments into contingent and non-contingent payment components.[394] The non-contingent payment portion is treated as a separate debt instrument with an issue price equal to the issue price of the overall debt instrument (determined under Treasury regulation section 1.1274-2(g)), and generally taxed under the rules for non-contingent debt instruments.[395] Contingent payments are treated first as payments of principal in an amount equal to the present value of the payment (discounting from the date payment was made to the issue date using the AFR), and any amount of the payment in excess of the amount treated as principal is includible in the holder's income and deductible from the issuer's income as interest when the payment is made.[396] Contingent payments that are fixed more than six months before payment is due are governed by a separate rule that treats the fixed but deferred payment as a separate debt instrument issued on the date the payment is fixed and maturing on the date payment is due.[397]

In the context of debt workouts, Treasury regulation section 1.1275-4(c) is likely to apply frequently, since many debt instruments that are the subject of workouts are not publicly traded, and non-publicly traded debt instruments that are deemed exchanged under section 1001 and thereafter provide for contingent payments would be subject to the rules under Treasury regulation section 1.1275-4(c). The inclusion of contingent payments in the modified debt generally would have the effect of overstating the borrower's COD, because the value of any contingent payments would not be included in the issue price of the modified debt.[398]

I. High Yield Debt Instruments

Debt instruments of a corporate issuer with more than a five-year term will constitute applicable high yield discount

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394 Treas. Reg. § 1.1275-4(c)(2).

395 Treas. Reg. § 1.1275-4(c)(3); T.D. 8674, 1996-2 C.B. 84 (June 11, 1996).

396 Treas. Reg. §§ 1.1275-4(c)(4)(i), (ii).

397 Treas. Reg. § 1.1275-4(c)(4)(iii).

398 *See* Treas. Reg. § 1.1274-2(g).

obligations ("HYDOs") if their yield to maturity is equal to or greater than the sum of the AFR for debt instruments at the time an instrument is issued plus five percentage points, and the notes are issued with "significant OID."[399] Significant OID exists if more than one year's interest will be accrued but unpaid at the end of five years.[400] If a debt instrument is a HYDO, an issuer will not be entitled to deduct OID that accrues with respect to such a debt instrument until amounts attributable to such OID are paid in cash or property other than stock or debt of the issuer.[401] In addition, if the yield to maturity of the debt instrument exceeds the sum of the relevant AFR plus six percentage points (the "Excess Yield"), an issuer's deduction for the "disqualified portion" of the OID accruing on the debt instrument will be disallowed.[402] In general, the "disqualified portion" of the OID for any accrual period will be equal to the product of (i) the Excess Yield divided by the yield to maturity on the debt instrument, and (ii) the OID for the accrual period.[403]

Subject to otherwise applicable limitations, holders of HYDOs that are U.S. corporations will be entitled to a dividends received deduction (currently at a 70% rate for holders of less than 20% of the issuer's stock) with respect to any disqualified portion of the accrued OID to the extent that an issuer has sufficient current or accumulated earnings and profits.[404] If part or all of the disqualified portion exceeds the issuer's current and accumulated earnings and profits, the excess will continue to be taxed as ordinary OID income in accordance with the general OID rules described above.

In enacting the HYDO rules, the Senate Finance Committee "expect[ed] that the regulations to be issued by the Secretary of the Treasury may take into account the expected amount of any such contingent payments in determining whether

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[399] I.R.C. § 163(i)(1).

[400] I.R.C. § 163(i)(2).

[401] I.R.C. § 163(e)(5)(A)(ii).

[402] I.R.C. § 163(e)(5)(A)(i).

[403] I.R.C. § 163(e)(5)(C)(i).

[404] I.R.C. § 163(e)(5)(B).

an obligation is an applicable high yield obligation."[405] Treasury has yet to issue such regulations under the HYDO rules. Interestingly, the above-quoted language is followed by the reference, "*Cf*. Code sec. 1272(a)(6)."[406] Section 1272(a)(6) determines the yield-to-maturity on REMIC regular interests and certain other debt instruments based on the prepayment assumption the parties used to price the transaction.[407]

By analogy to the payment assumption model of section 1272(a)(6), it may be reasonable to determine whether debt instruments with reasonably estimable contingent payments are HYDOs by using a yield-to-maturity based on the payment assumptions used to price the debt instrument. However, this analytic may not provide helpful guidance where troubled debtors agree to restructure debt to include contingent payments, since the absence of actual pricing under those circumstances may mean that such contingent payments are not based on reliable payment assumptions. Query whether, in the absence of regulations under the HYDO rules, using the comparable yield determined under the noncontingent bond method would also be a reasonable method of testing the HYDO status of a contingent payment debt instrument.[408] Contingent payment debt instruments governed by Treasury regulation section 1.1275-4(c) generally should not be subject to the HYDO rules by reason of such payments, since the contingent payments would generally be taken into account only when paid.

For purposes of determining whether an instrument has a term of more than five years, section 163(i) provides that any payment on a debt instrument is assumed to be made on the "last day *permitted* under the instrument."[409] When an instrument is

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[405] S. REP. NO. 101-56, at 54 (1989).

[406] S. REP. NO. 101-56, at 54 (1989).

[407] *See* H.R. REP. NO. 99-841, at II-238 (1986) (CONF. REP.).

[408] *See* American Bar Association Section of Taxation, *Comments on Proposed Contingent Payment Regulations*, 95 TNT 99-53 (May 22, 1995) (proposing use of the noncontingent bond method as the simplest way to apply the HYDO rules to contingent payment obligations).

[409] I.R.C. § 163(i)(3)(A) (emphasis added).

issued, it is often difficult to calculate such date. An example of this would be a loan agreement that is structured with senior and junior classes of debt and provides for payment on the junior class only after the more senior class has been repaid. In this case, the "last day permitted" under the junior debt is unknown at the time of issuance.[410] Consequently, it is unclear whether the junior class has a maturity of more than five years, thus subjecting it to the HYDO rules.[411]

Another area of considerable uncertainty is the application of the HYDO provisions to issuers that are taxed as partnerships. Section 163(e)(5)(A) disallows interest deductions only for HYDOs issued by corporations, and section 163(e)(5)(D) specifically exempts S corporations from the application of the HYDO rules. However, section 163(i)(5)(B) provides that regulations may be issued to prevent the avoidance of the HYDO rules "through the use of issuers other than C corporations." Consequently, certain HYDOs issued by partnerships may be subject to the HYDO interest deferral and disallowance rules, at least in the case of a partnership issuer formed by corporations and availed of to avoid the HYDO rules.

Moreover, an example in the partnership anti-abuse regulations provides that the existence of a partnership issuer formed by two corporations will be ignored, and each corporate partner will be treated as directly issuing its allocable portion of the partnership's debt obligations for purposes of applying the HYDO rules, without regard to whether the partnership was either formed or chosen as the issuer for the purpose of avoiding the HYDO rules.[412] It should be noted that the regulation example

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[410] Although the junior class may have a maturity date of less than five years, the imposition of the senior restriction may cause the term to exceed five years. A similar difficulty presents itself where a debt instrument with multiple classes is held by one person and is treated as a single issue under the section 1275 regulations, potentially subjecting the entire instrument to the HYDO rules.

[411] For a discussion of potential methods of avoiding this uncertainty and their effectiveness *see* Robert A. Rizzi, *Acquisition Indebtedness: Traps and Tricks*, 33 J. CORP. TAX'N 3 (May/June 2006).

[412] Treas. Reg. § 1.701-2(f), Ex. 1.

goes beyond the scope of the statute in its application of the HYDO rules to operating partnership issuers without regard to whether the partnership (or its partners) intended to avoid the HYDO rules through the use of such partnership. Neither the statute nor the regulation example makes clear whether the same treatment would follow for a partnership issuer with non-corporate partners, or whether the lack of a tax avoidance motive would exempt such a partnership issuer from the HYDO rules under any (or all) circumstances.

As a general matter, the HYDO rules should only be applied, if at all, at the partner level rather than at the partnership level.[413] If a debt instrument constitutes a HYDO, corporate partners of a partnership issuer may not be entitled to deduct OID that accrues with respect to such debt instrument until amounts attributable to such OID are paid.[414] In addition, those partners' deductions for their allocable shares of the disqualified portion of the OID accruing on the notes may be disallowed.

In addition, although the issue is extremely unclear, solely for purposes of the dividends-received deduction provisions of the Code, it is possible that a corporate holder of a debt instrument issued by a partnership could treat as a dividend that portion of the Excess Yield on the instrument that is allocated to U.S. corporate partners of the partnership issuer, to the extent such amount would have been treated as a dividend if it had been distributed by each corporate partner with respect to its stock.[415]

In the context of debt workouts, corporate issuers must take into account the HYDO rules. If a debt modification is a "significant modification" under section 1001, the new debt must be retested under the HYDO rules. Debt that was not a HYDO prior to the modification could become subject to the HYDO rules,

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413 Such treatment would be consistent, for example, with the determination of "excludible COD income" and other income items at the partner level.

414 I.R.C. § 163(e)(5)(A)(ii).

415 I.R.C. § 163(e)(5)(B).

or conversely (and more rarely), debt that was a HYDO prior to the modification could lose its status as such.[416]

In August 2008, amid a severe financial crisis that restricted lenders' ability to complete financings on previously contemplated terms, the IRS issued Revenue Procedure 2008-51.[417] The Revenue Procedure creates an exception from the HYDO rules for certain debt instruments issued by a corporation after August 8, 2008, pursuant to a binding financing commitment obtained prior to January 1, 2009, from an unrelated party (a "Financing Commitment") or in exchange for a debt instrument issued pursuant to a Financing Commitment.

The Revenue Procedure excepts from the HYDO rules debt instruments issued by a corporation pursuant to a Financing Commitment that would not have been subject to the HYDO rules if the issue price equaled the net cash proceeds actually received by the issuer (a "Pre-Committed Debt Instrument"). It also excludes from the HYDO rules certain debt instruments issued in exchange[418] for a Pre-Committed Debt Instrument, including indirectly through a prior exchange.[419]

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[416] *See* David C. Garlock & Mathew Urbina, *Modifications of Debt Instruments and the High-Yield Discount Obligation Rules*, 4 J. TAX'N FIN. PROD. 9 (2003) for a discussion of the more difficult issue of whether to retest a corporate debt instrument under the HYDO rules following a non-significant modification.

[417] Rev. Proc. 2008-51, 2008-2 C.B. 562.

[418] For purposes of this exception, an exchange includes a deemed exchange pursuant to section 1001. Rev. Proc. 2008-51, 2008-35 I.R.B. 562.

[419] A debt instrument that is issued in exchange for a Pre-Committed Debt Instrument is excluded if (1) the debt instrument is issued within 15 months after the Pre-Committed Debt Instrument is issued, (2) the maturity date of the debt instrument is not more than one year later than the maturity date of the Pre-Committed Debt Instrument, and (3) the stated redemption price at maturity of the debt instrument is not greater than the stated redemption price at maturity of the Pre-Committed Debt Instrument. A debt instrument that is exchanged for such a debt instrument is also excluded if it satisfies the three requirements. Rev. Proc. 2008-51, 2008-2 C.B. 562.

To provide additional relief, in 2009, Congress temporarily suspended the HYDO rules for most debt instruments issued in a deemed or actual exchange for a debt instrument that was not subject to the HYDO rules (or that qualified for the HYDO rules suspension) if the exchange occurs between September 1, 2008 and December 31, 2009.[420] In December 2009, the IRS extended the suspension of the HYDO rules for debt instruments issued in a deemed or actual exchange for a debt instrument that was not subject to the HYDO rules to exchanges occurring between January 1, 2010 and December 31, 2010.[421] The suspension does not apply to debt instruments issued (i) with contingent interest described in 871(h)(4)[422] or (ii) to a related person within the meaning of section 108(e)(4).[423]

J. Foreign Currency Notes

If an interest payment on a note is denominated in or determined by reference to a single foreign currency including the euro (each, a "Foreign Currency"), the amount of income recognized by a cash basis holder will be the U.S. dollar value of the interest payment, based on the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars.[424] Accrual basis holders may

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[420] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009); I.R.C. § 163(e)(5)(F). After 2009, the Secretary of the Treasury has authority to continue to apply the provision or raise the rate used to determine whether an instrument is subject to the HYDO rules if he or she determines the change is "appropriate in light of distressed conditions in the debt capital markets." I.R.C. §§ 163(e)(5)(F)(iii) and 163(i)(1).

[421] Notice 2010-11, 2010-1 C.B. 326.

[422] Debt instruments that pay contingent interest described in section 871(h)(4) without regard to section 871(h)(4)(D) are excluded. Section 871(h)(4) generally addresses interest that depends on the profits, income, value, cash flow, or distributions of the issuer.

[423] I.R.C. § 163(e)(5)(F)(i).

[424] Treas. Reg. §§ 1.988-1(a)(1)(ii), (2)(i); -2(b)(2)(ii)(B).

determine the amount of income recognized with respect to such interest payments in accordance with either of two methods.[425]

Under the first method, the amount of income recognized will be based on the average exchange rate in effect during the interest accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year).[426] Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or retirement of a note) determined by reference to a Foreign Currency, an accrual basis holder will recognize ordinary income or loss measured by the difference between such average exchange rate and the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars.[427]

Under the second method, an accrual basis holder may elect to translate interest income into U.S. dollars at the spot exchange rate in effect on the last day of the accrual period or, in the case of an accrual period that spans two taxable years, at the exchange rate in effect on the last day of the partial period within the taxable year.[428] Additionally, if a payment of interest is actually received within 5 business days of the last day of the accrual period or taxable year, an accrual basis holder applying the second method may instead translate such accrued interest into U.S. dollars at the spot exchange rate in effect on the day of actual receipt (in which case no exchange gain or loss will result).[429] Any election to apply the second method will apply to all of a holder's debt instruments held at the beginning of the first taxable year to which the election applies or thereafter acquired by the holder. Such election may not be revoked without the consent of the IRS.[430]

Foreign Currency received as interest on a note or on the sale or retirement of a note will have a tax basis equal to its U.S.

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425 Treas. Reg. § 1.988-2(b)(2)(ii)(C).

426 Treas. Reg. § 1.988-2(b)(2)(ii)(C).

427 Treas. Reg. § 1.988-2(b)(3).

428 Treas. Reg. § 1.988-2(b)(2)(iii)(B).

429 Treas. Reg. § 1.988-2(b)(2)(iii)(B).

430 Treas. Reg. § 1.988-2(b)(2)(iii)(B).

dollar value at the time such interest is received or at the time the note is sold or retired, as the case may be.[431] Any gain or loss recognized by a holder on the sale or retirement of a note that is attributable to changes in currency exchange rates will be treated as ordinary income or loss, but only to the extent of total gain or loss realized on the transaction.[432]

OID for any accrual period on a note that bears OID and is denominated in a Foreign Currency will be determined in the Foreign Currency and then translated into U.S. dollars in the same manner as stated interest accrued by an accrual basis holder.[433] Upon receipt of an amount attributable to OID (whether in connection with a payment of interest or the sale or retirement of a note), a holder may recognize ordinary income or loss.[434] Bond premium on a note that is denominated in a Foreign Currency will be computed in units of the Foreign Currency, and amortizable bond premium will also reduce interest income in units of the Foreign Currency.[435] At the time amortized bond premium offsets interest income on a note, a holder may realize ordinary income or loss, measured by the difference between exchange rates at that time, and at the time the notes are acquired.[436]

Market discount is similarly determined in units of the Foreign Currency.[437] Accrued market discount that is required to be taken into account on the maturity or disposition of a note is translated into U.S. dollars at the exchange rate on the maturity or disposition date, as the case may be (and no part is treated as exchange gain or loss). Accrued market discount currently includible in income by an electing holder is translated into U.S. dollars at the average exchange rate for the accrual period (or the partial accrual period during which the holder held the note). Exchange gain or loss is determined on maturity or disposition of

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[431] Treas. Reg. § 1.988-2(b)(2)(ii)(B), (3)(i), (5)(i).

[432] I.R.C. § 988(b)(1), (2); Treas. Reg. § 1.988-2(b)(8).

[433] Treas. Reg. § 1.988-2(b)(2)(ii)(A).

[434] *See* Treas. Reg. § 1.988-2(b)(3), (4).

[435] Treas. Reg. § 1.988-2(b)(10)(i).

[436] Treas. Reg. § 1.988-2(b)(10)(i), (ii), Ex. B.

[437] Treas. Reg. § 1.988-2(b)(11)(i).

the note (as the case may be) in the same manner as the computation of exchange gain or loss on the receipt of accrued interest by an accrual method holder.[438]

The IRS issued regulations applying the non-contingent bond method principles[439] to nonfunctional currency contingent payment debt instruments ("CPDIs").[440] The regulations apply to nonfunctional currency CPDIs issued for cash or publicly traded property as described in Treasury regulation section 1.1275-4(b)(1) or non-publicly traded property as described in Treasury regulation section 1.1275-4(c)(1), including debt instruments where all principal and interest are denominated in or determined by reference to (i) a single nonfunctional currency and which have one or more non-currency related contingencies, (ii) more than one currency and which have no non-currency related contingencies, or (iii) more than one currency and which have one or more non-currency related contingencies.[441] The translation of interest and adjustments from the denominated currency to the functional currency are determined under the principles of Treasury regulation section 1.988-2(b).[442]

K. Election to Consolidate Debt Issues

Revenue Procedure 2001-21 provides an election that can be used in the case of certain debt exchanges occurring on or after March 13, 2001, to facilitate the consolidation of some or all of the debt instruments from two or more outstanding debt issues.[443]

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438 Treas. Reg. § 1.988-2(b)(11)(i).

439 *See* Treas. Reg. § 1.1275-4.

440 T.D. 9157, 2004-2 C.B. 545 (Aug. 27, 2004). See Section IV.H for a discussion of the contingent payment debt provisions.

441 Treas. Reg. § 1.988-6(a)(1). The nonfunctional currency CPDI rules do not apply to (i) an instrument if any payment made under such instrument is determined by reference to a hyperinflationary currency, or (ii) an obligation that is tax-exempt under section 103. Treas. Reg. § 1.988-6(a)(2)(i), (f)(1).

442 Treas. Reg. § 1.988-6(b)(3).

443 The election applies to the substitution of new debt for old debt if (1) either (a) debt instruments from a single new issue are substituted for debt instruments from two or more old issues, or (b) debt

This election allows taxpayers to treat a debt substitution as a realization event, even though the exchange does not result in a significant modification, in order to permit the fungibility of debt issues. The election is designed to solve the problem created under Treasury regulation section 1.1275-2(j) by the creation of a different amount of OID in the new issue pursuant to the requisite OID redeterminations in certain debt exchanges, which may preclude the fungibility of old and new debt issues after an exchange.[444]

Revenue Procedure 99-18, as extended by Revenue Procedure 2000-29, generally provided the same election for debt substitutions occurring after March 1, 1999 but before March 13, 2001.[445] However, Revenue Procedure 2001-21 expands the scope of the debt instruments qualifying for the election in three significant ways. Under Revenue Procedure 99-18, the election applied only to debt instruments from a single new issue that were

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instruments issued in a qualified reopening (as defined in Treasury regulation section 1.1275-2) are substituted for debt instruments from one or more outstanding issues of debt; (2) the substitution does not result in a significant modification of the old debt and, therefore, is not a realization event; (3) the new debt and the old debt are publicly traded; (4) the old debt was issued at par, with premium, or with only a *de minimis* amount of OID; (5) the new debt is issued at par or with only a *de minimis* amount of OID or premium; (6) neither the new nor the old debt is a contingent payment debt instrument, a tax-exempt obligation, or a convertible debt instrument; (7) all payments on the old and new debt are denominated in or determined by reference to U.S. dollars, and the U.S. dollar is the functional currency of the issuer of the new debt; and (8) the issuer and one or more holders of the old debt each make the election. Rev. Proc. 2001-21, 2001-1 C.B. 742.

444 *See* New York State Bar Association, Tax Section, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273,* 2004 TNT 159-7 (Aug. 17, 2004) (questioning whether Revenue Procedure 2001-21 provides relief where tax fungibility would be most beneficial, *i.e.*, where additional bonds are issued under the same indenture, but at a discount exceeding a *de minimis* amount).

445 Rev. Proc. 99-18, 1999-1 C.B. 736; Rev. Proc. 2000-29, 2000-2 C.B. 113.

substituted for debt instruments from two or more old issues.[446] The election now applies also to debt instruments issued in a qualified reopening (as defined in Treasury regulation section 1.1275-2) that are substituted for debt instruments from one or more outstanding issues of debt.[447] Also, the election now applies even if the old debt was issued with more than a *de minimis* amount of premium.[448] Finally, the requirement that the substitution not result in a significant modification of the old debt may now be satisfied either as of (1) the substitution date, or (2) the date that is two days before the date on which the substitution offer commences, provided such date is no more than 30 business days before the date on which the substitution offer ends.[449]

If the election is made, the issuer and the holders can treat a substitution of debt instruments as a realization event for federal income tax purposes.[450] However, instead of recognizing a gain or loss, an electing holder will take into account any gain or loss on the date of the substitution as income or deduction over the term of the new debt instruments.[451] Immediately after the substitution, the holder's basis and holding period with respect to the new debt is the same as the holder's adjusted basis and holding period with respect to the old debt.[452] If the stated redemption price at maturity of the new debt exceeds the holder's basis in the new debt, the holder treats the difference as market discount on the new debt and treats the new debt as a market discount bond.[453] If the holder's basis in the new debt is greater than the stated redemption price at maturity of the new debt, the holder treats the difference as bond premium on the new debt.[454] The issuer must generally take any

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[446] Rev. Proc. 99-18, 1999-1 C.B. 736.

[447] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[448] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[449] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[450] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[451] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[452] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[453] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[454] Rev. Proc. 2001-21, 2001-1 C.B. 742.

difference between the adjusted issue prices of the old debt and the new debt into account over the term (or, in the case of a qualified reopening, the remaining term) of the new debt as increased OID, reduced OID, or bond premium.[455]

L. Consent Fees

Few authorities discuss the treatment of consent fees paid to holders of securities in connection with debt refinancings. The IRS has ruled privately that a corporation's expenses for consent solicitation fees paid to holders in order to effect a restructuring (which is a capital transaction for tax purposes) must be capitalized.[456] Similarly, issuers paying consent fees in connection with debt exchanges would typically be required to capitalize such fees as an expense incident to a capital transaction.

The character of consent fees paid to holders of debt has also been uncertain. Treasury regulation section 1.1273-2(g)(2) suggests that such payments made to tendering holders in connection with a disposition may increase the capital gain (or decrease the capital loss) of a holder.[457] One private letter ruling appears to step away from the recent market practice of treating consent fees paid to tendering holders as additional consideration paid for the sale or exchange of a capital asset (*i.e.*, the debt

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[455] Rev. Proc. 2001-21, 2001-1 C.B. 742.

[456] TAM 96-41-001 (May 31, 1996); *see also Denver & Salt Lake Railway Co. v. Commissioner*, 24 T.C. 709 (1955), *appeal dismissed*, 234 F.2d 663 (10th Cir. 1956) (expenses accrued by target while polling its bondholders for their consents to a merger constituted reorganization expenses that must be capitalized); *cf.* Rev. Rul. 73-146, 1973-1 C.B. 61 (where target employees holding stock options consented to relinquish the options in order to effect a reorganization, consideration paid to option holders was deductible as compensation paid to employees); Priv. Ltr. Rul. 95-40-003 (June 30, 1995) (same).

[457] The regulation states that cash payments from an issuer to a noteholder in a private transaction (other than payments for property or services provided by the lender such as commitment fees or loan processing costs) will reduce the issue price of the debt instrument, thus increasing the holder's capital gain (or decreasing the holder's capital loss) upon the simultaneous disposition of the debt instrument.

instrument that is tendered) and treated the consent fees paid as payments on a note and a factor in calculating the yield of the modified note.[458] The ruling indicated that the consent fee should be allocated first to pay interest accrued as of the date the fee was paid, then to repay the principal.[459]

M. Reopenings

On January 11, 2001, the Treasury Department issued regulations (the "2001 Regulations") that provided rules for determining which debt securities are part of the same "issue" as other debt securities or a "qualified reopening" of a prior issue of debt securities (which is treated as part of the original reopening).[460] The 2001 Regulations generally adopted the previously issued temporary regulations (which provided guidance with respect to Treasury securities) (the "1999 Temporary Regulations") and proposed regulations (which provided guidance with respect to debt instruments other than Treasury securities).[461] The Treasury Department subsequently issued new final regulations on September 12, 2012 which further revised the "qualified reopening" rules (the "2012 Regulations").[462]

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[458] Priv. Ltr. Rul. 2011-05-016 (Feb. 4, 2011). Note that, if the yield on the modified notes changes by more than the greater of 0.25% or 5% of the unmodified note's annual yield, the change in yield will constitute a significant modification.

[459] Furthermore, to the extent any part of the consent fee is treated as a repayment of principal, the debt instrument's adjusted issue price will be decreased accordingly. Priv. Ltr. Rul. 2011-05-016 (Feb. 4, 2011).

[460] T.D. 8934, 2000-1 C.B. 904 (Mar. 19, 2001).

[461] T.D. 8840, 1999-2 C.B. 575 (Nov. 22, 1999). The 1999 Temporary Regulations applied to reopenings of Treasury securities that occurred on or after November 5, 1999, but before March 13, 2001, and the proposed regulations would have been effective for reopenings occurring 60 days or more after issuance as final regulations.

[462] T.D. 9599, 2012-40 C.B. 417 (Sept. 13, 2012).

1. Reopenings of Treasury Securities

Prior to the issuance of the 1999 Temporary Regulations, in order for Treasury securities to be considered as part of the same issue as previously issued Treasury securities, and have the same issue price and issue date as previously issued Treasury securities, the later issued Treasury securities needed to (i) have the same terms as the original Treasury securities, (ii) be issued within 12 months after the original Treasury securities were first issued to the public, and (iii) be issued in a reopening intended to alleviate an acute, protracted shortage of the original Treasury securities.[463] Both the 1999 Temporary Regulations and the 2001 Regulations eliminated the requirement that the reopening be intended to alleviate an acute, protracted shortage of the original Treasury securities.[464] Under the 2001 Regulations, a reopening of Treasury securities on or after March 13, 2001, is a qualified reopening if either (i) the reopening occurs not more than one year after the issue date of the original securities, or (ii) the additional Treasury securities are issued with no more than a *de minimis* amount of OID.[465] If a reopening meets these qualified reopening requirements, any discount attributed to the additional issuance of Treasury securities would constitute market discount and not OID.

2. Reopenings of Debt Instruments Other Than Treasury Securities

Under the 2001 Regulations, two or more debt instruments, each of which was issued on or after April 4, 1994, but before March 13, 2001, were part of the same issue if they had the same credit and payment terms and were sold "reasonably close in time" either (i) pursuant to a common plan, or (ii) as part of a single transaction or a series of related transactions.[466] For debt instruments issued on or after March 13, 2001, the 2001 Regulations also imposed a bright-line window of thirteen days,

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[463] *See* Treas. Reg. § 1.1275-2(d)(2)(ii)(D) (defining "qualified reopening" for a reopening of Treasury securities occurring prior to November 5, 1999).

[464] T.D. 8840, 1999-2 C.B. 575 (Nov. 22, 1999); Treas. Reg. § 1.1275-2(d).

[465] Treas. Reg. § 1.1275-2(d)(2)(C).

[466] Treas. Reg. § 1.1275-1(f)(2), (3).

beginning with the date on which the first debt instrument that would be part of the combined issue is issued to the public, in place of the prior "reasonably close in time" standard.[467]

For additional related debt issuances issued more than 13 days after an original debt issuance, the 2012 Regulations provide that if a reissuance of debt instruments satisfies any of the new "qualified reopening" requirements, the later-issued debt instruments would be considered part of the same issue as the original debt instruments, and would carry the same issue date and issue price as the original debt instruments.[468] The qualified reopening rules apply to additional debt instruments that are themselves part of a single issue and that have terms that are identical in all respects to the terms of the original debt instrument as of the reopening date.[469] Since the additional instruments would have the same issue price, issue date, and redemption price at maturity, any discount attributable to the additional debt instruments (other than the amount of any discount on the original debt instruments) would be market discount rather than OID.[470]

A subsequent issuance will constitute a qualified reopening provided that (i) the additional debt instruments are taxable, (ii) the additional debt instruments are not contingent payment debt instruments, and (iii) either:

- (a) (i) the original debt instruments are publicly traded, (ii) the issue date of the additional instruments is not more than six months after the issue date of the original debt instruments, and (iii) on the earlier of the date on which the price of additional instruments is established or the announcement date,[471] the yield of the

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467 Treas. Reg. § 1.1275-1(f)(1)(iii).

468 Treas. Reg. § 1.1275-2(k)(1).

469 Treas. Reg. § 1.1275-2(k)(2)(ii).

470 *See* I.R.C. § 1278(a)(1)(D)(i) (distinguishing between a "market discount bond" and a bond acquired at original issuance).

471 The announcement date is the later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly

original instruments based on their fair market value is not more than 110% of the yield of the original debt instruments on their issue date (or the coupon rate, if the original debt was issued with no more than *de minimis* OID);[472]

- (b) (i) the original debt instruments are publicly traded, and (ii) the additional debt instruments do not have more than a *de minimis* amount of OID;[473]

- (c) the additional debt instruments are issued for cash to unrelated persons at an arm's-length price,[474] so long as either (i) the additional debt instruments are issued no later than six months after the original debt issuance and, as of the date the price of the additional debt instruments is established or announced (whichever is earlier), the yield on the additional debt instruments does not exceed 110% of the original debt instruments, or (ii) the additional debt instruments do not have more than a *de minimis* amount of OID;[475] or

- (d) the additional debt instruments are issued more than six months after the original debt

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announced through one or more media, including the standard electronic news services used by security broker-dealers (*e.g.*, Reuters, Telerate, or Bloomberg). Treas. Reg. § 1.1275-2(k)(2)(iv).

472 Treas. Reg. § 1.1275-2(k)(3)(ii).

473 Treas. Reg. § 1.1275-2(k)(3)(iii).

474 Under the 2012 Regulations, it is unclear whether the cash sale of debt instruments to unrelated persons would be respected if the issuer also sells a portion of the additional debt to related parties. The NYSBA has recommended that the regulations should deem such a sale to satisfy the unrelated persons requirement as long as a "substantial amount" of the additional debt instruments are sold for cash to unrelated parties. *See* New York State Bar Association, Tax Section, *Comments on Final "Publicly Traded" Regulations under Section 1273 of the Code*, 2012 TNT 220-30 (Nov. 12, 2012).

475 Treas. Reg. § 1.1275-2(k)(3)(iv).

> instruments and, as of the date the price of the additional debt instruments is established or announced (whichever is earlier), either (i) the original debt instruments are publicly traded and the yield on the additional debt instruments does not exceed the yield of the original debt instrument, or (ii) the additional debt instruments are issued for cash to unrelated persons at an arm's-length price and the yield of the additional debt instruments does not exceed the yield of the original debt instrument.[476]

The 2012 Regulations eliminate the requirement that the original debt instruments be publicly traded, provided that the additional instruments are issued for cash at an arm's-length price to unrelated persons and the other qualified reopening requirements are satisfied.[477] Further, in conjunction with the expanded "publicly traded" rules, new debt instruments issued for property, or to related persons, may satisfy the publicly traded requirement of the qualified reopening rules more easily.

In addition, by permitting a reopening of original debt instruments that are publicly traded to be a qualified reopening if the additional debt instruments are issued with no more than a *de minimis* amount of OID, theoretically, the 2012 Regulations could permit issuances of publicly traded debt with *de minimis* OID to be reopened at any time.[478] The 2012 Regulations do not retain any time limit with respect to this test for qualified reopenings.

The issuer's deductions for OID on reopened debt instruments will be adjusted if the holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument. The issuer must treat the difference as an adjustment to the issuer's interest expense for all of the original and additional debt instruments in the issue, and must take the adjustment into account over the term of the instruments using

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[476] Treas. Reg. § 1.1275-2(k)(3)(v).

[477] Treas. Reg. § 1.1275-2(k)(3)(iv).

[478] Treas. Reg. § 1.1275-2(k)(3)(iii).

constant yield principles.[479] If the holder pays more than the adjusted issue price of the original debt instrument, the issuer (but not the holder) must increase the aggregate adjusted issue prices of all of the original and additional debt instruments in the issue.[480] If the holder pays less than the adjusted issue price of the original debt instrument, the issuer (but not the holder), must reduce the aggregate adjusted issue prices of all of the original and additional debt instruments in the issue.[481]

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[479] Treas. Reg. § 1.163-7(e)(1).

[480] Treas. Reg. § 1.163-7(e)(2).

[481] Treas. Reg. § 1.163-7(e)(3).