

Camp's Market Discount Proposal Is a Mixed Bag for Distressed Debt

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Are distressed debt investors required to treat their speculative investment gains as ordinary interest income under the market discount rules, while continuing to treat their investment losses as capital losses? Or can they rely on the common law “doubtful collectibility doctrine” to stop accruing market discount as interest income, notwithstanding an IRS memorandum that seems to reject this approach? The recent economic downturn underscores the need for clear, consistent rules that do not artificially deflate investor demand. This article examines the current state of the law, and considers whether House Ways and Means Committee Chairman Dave Camp’s proposal to reform the market discount rules (which parallels one of President Obama’s revenue proposals) would be a step in the right direction.

Introduction

When interest rates rise, secondary market bond prices decline to compensate investors for accepting a below-market stated interest rate. In response to this phenomenon, Congress enacted the market discount rules of the Internal Revenue Code.¹ These rules recharacterize principal payments as deferred interest to the extent of a bond’s market discount, so that economic gain on the maturity or sale of a discounted bond is taxed as interest income.

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¹ IRC §§ 1276, 1278. All “Section” references are to the Internal Revenue Code of 1986, as amended (the IRC), or to Treasury regulations promulgated thereunder. To differentiate Camp’s proposals from the current Code, we refer to his proposed new sections as “Proposed Sections.”

Secondary market bond prices also decline when an issuer's credit deteriorates, to compensate investors for increased risk of non-repayment. The market discount rules do not differentiate between discount that is attributable to a rise in general interest rates and discount that is attributable to credit risk.

Because principal payments on distressed debt lack the predictability and security that typify interest payments on performing debt, it is inappropriate to require taxpayers to treat market discount as interest income if the discount is attributable to an issuer's financial deterioration, and not a rise in interest rates. Moreover, it is implausible that Congress intended to tax bond investors (but not other investors) at ordinary income rates on their speculative gains, while still requiring them to treat their losses as capital losses that can offset only up to \$3,000 of ordinary income each year.²

Investors in distressed debt therefore have to make a tough decision. They can comply with the letter of the law, and suffer adverse (and probably unintended) tax consequences. Alternatively, they can take the position that the market discount rules do not apply to distressed debt.

The most obvious basis for treating accrued market discount as capital gain rather than as interest income is that the common law "doubtful collectibility doctrine" generally permits a taxpayer to stop accruing interest if it is unlikely that the interest will ever be collected. Some taxpayers have taken the position that an analogous rule applies to permit them to stop accruing a bond's market discount as interest income if there is no reasonable expectation that the issuer will fully repay the bond's principal amount.³

Unfortunately, in 1995, the IRS issued a Technical Advice Memorandum (the "1995 TAM") in which it concluded, based on highly flawed reasoning, that the doubtful collectibility doctrine does not apply to original issue discount (OID).⁴ OID is economically identical to market discount; accordingly, the 1995 TAM's existence is a problematic detail for distressed debt investors.

The recent financial crisis underscored the need for sensible market discount rules that differentiate between discount that is attributable to a rise in interest rates and discount that is attributable to credit risk. Without such rules, prospective debt investors who are uncomfortable disregarding the 1995 TAM could shy away from buying discounted bonds. A lack of investor

² Under IRC § 1211, corporations may use capital losses to offset only capital gains, and individuals may use capital losses to offset only capital gains and up to \$3,000 of ordinary income.

³ See generally New York State Bar Ass'n, *Report of the Tax Section of the New York State Bar Association on the Taxation of Distressed Debt* (Nov. 22, 2011), available at <http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1248report.pdf>.

⁴ TAM 9538007 (Sept. 22, 1995).

appetite could add undesirable momentum to a downward spiral of ratings downgrades, capital calls, and defaults, and unnecessarily prolong an economic downturn.

On February 26, 2014, Representative Dave Camp, Chairman of the House Committee on Ways and Means, released a discussion draft of a bill that would dramatically change the market discount rules.⁵ The bill would:

- Require investors to accrue market discount currently under a constant yield method, in the same manner as OID; and
- Limit market discount accruals in a manner intended to approximate the market discount that is attributable to increases in interest rates (and not to the issuer's financial deterioration).⁶

Under this proposal, every taxpayer who purchases discounted debt on the secondary market would have phantom taxable income each year, and broker-dealers would have to develop complex systems for reporting this income to their customers. Accordingly, the proposal could be highly disruptive for the secondary debt markets.

⁵ Camp's market discount proposal is consistent with a proposal contained in President Obama's Fiscal Year 2015 Revenue Proposals. See *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, at 175 (Mar. 2014), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf>. Camp's draft bill is available at http://waysandmeans.house.gov/uploadedfiles/statutory_text_tax_reform_act_of_2014_discussion_draft_022614.pdf. The Committee on Ways and Means released a section-by-section summary of the draft, and the Joint Committee on Taxation released a technical explanation of the draft. See Committee on Ways & Means, *Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary* (Feb. 26, 2014), available at http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf; Staff of Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III—Business Tax Reform* (Feb. 26, 2014), available at http://waysandmeans.house.gov/uploadedfiles/jct_technical_explanation_title_iii_business_jcx_14_14_022614.pdf.

⁶ Camp's discussion draft contains four other major proposals to reform the taxation of financial products. First, the bill would require all investors to treat their derivatives and other investments that are hedged with derivatives as sold for fair market value at the end of each year and to pay tax on any resulting paper gains at ordinary income rates. We discussed this proposal in an earlier article. See Jason Schwartz, Mark Howe & Daniel Mulcahy, "Missing the Mark: The Tax Reform Act of 2014 Would Hurt Ordinary Investors and Businesses and Complicate Taxation of Financial Products," 31(4) *J. Tax'n Invs.* 15 (Summer 2014). Second, the bill would limit the amount of phantom income incurred by investors and obligors in debt restructurings. Third, the bill would expand the ways that taxpayers can designate transactions as hedges for tax purposes by including certain financial accounting and other hedge designations. Finally, the bill would expand the "wash sale" rules by denying tax losses to an investor who disposes of a position if a "related party" reestablishes the position within the 61-day period beginning 30 days before the disposition.

Moreover, although the proposed cap on market discount inclusions is a step in the right direction, it fails to provide definitive guidance as to whether the doubtful collectibility doctrine can apply to OID and market discount, and therefore may raise more questions than it answers.

This article first discusses the doubtful collectibility doctrine, and then discusses Camp's market discount proposal.

The Doubtful Collectibility Doctrine

Overview. A taxpayer on the cash method of accounting generally includes interest in income upon receipt.⁷ A taxpayer on the accrual method of accounting includes interest in income when all events have occurred that fix the taxpayer's right to receive the interest and the amount of the interest can be determined with reasonable accuracy.⁸ Accordingly, an accrual method taxpayer generally will accrue "qualified stated interest"—interest that is unconditionally payable at least annually—ratably over the accrual periods to which the interest relates.⁹

However, under longstanding common law precedent, an accrual method taxpayer is not required to accrue qualified stated interest in advance of receipt if the interest "is of doubtful collectability or it is reasonably certain that it will not be collected."¹⁰

For example, assume that an investor using the accrual method of accounting purchases a 10-year bond at initial issuance, and that the bond has a \$100 issue price, a \$100 face amount, and provides for annual interest payments of \$3.64. Five years later, the issuer suffers a financial setback and, as a result, is unable to continue servicing its debt. Under the doubtful collectibility doctrine, the investor is not required to continue to accrue interest on the bond.

The contours of the doubtful collectibility doctrine are fuzzy.¹¹ Some courts have required taxpayers to demonstrate the absence of any reasonable expectation that interest would be received in order to stop accruing the

⁷ Treas. Reg. § 1.446-1(c)(1)(i).

⁸ Treas. Reg. § 1.446-1(c)(1)(ii).

⁹ Treas. Reg. § 1.446-2(b).

¹⁰ *Corn Exchange Bank v. U.S.*, 37 F2d 34 (2d Cir. 1930); see also *Clifton Mfg. Co. v. Comm'r*, 137 F2d 290 (4th Cir. 1943); Rev. Rul. 80-361, 1980-2 CB 164; *Comm'r v. Liftin*, 317 F2d 234 (4th Cir. 1963).

¹¹ See generally New York State Bar Ass'n, *supra* note 3; New York City Bar Ass'n, *Report Regarding Proposals for Accounting Treatment of Interest on Non-Performing Loans* (July 23, 2008), available at http://www.nycbar.org/pdf/report/ABCNY%20CityBar_%20Distressed_debt.pdf.

interest.¹² Other courts have required taxpayers to demonstrate only reasonable doubt as to future receipt.¹³ However, courts and the IRS agree that at some point in an issuer's financial decline an investor can stop accruing interest income.

Applicability of Doubtful Collectibility Doctrine to OID. OID is economically identical to interest, and is taxed similarly to interest, so there is no obvious reason for the doubtful collectibility doctrine to apply differently to OID than to interest.

For example, assume that an investor purchases a 10-year zero-coupon bond at initial issuance, and that the bond has a \$70 issue price and a \$100 face amount. Under Section 1272, the investor is required to include the bond's \$30 of OID in income over the term of the bond, under a constant yield method.¹⁴ This requirement arises from Congress's recognition that OID is economically indistinguishable from interest:¹⁵ the \$30 of discount from the bond's issue price reflects an unstated interest rate of 3.64 percent, compounded annually. In fact, the zero-coupon bond has the same yield to maturity, and thus has the same net present value, as the 10-year current-pay bond described in the prior example.

Misguided IRS Guidance. Even though OID is economically identical to interest, the IRS concluded in the 1995 TAM that the doubtful collectibility doctrine does not apply to OID.¹⁶ Thus, the investor in the zero-coupon bond described above must continue to accrue OID in income after principal on the bond becomes uncollectible, even though the investor in the current-pay

¹² See, e.g., *Harrington v. Comm'r*, 31 TCM (CCH) 888, 893 (1972) (taxpayers must show that there is no "reasonable expectancy" of receiving the interest); *Buhl Land Co. v. Kavanagh*, 131 F. Supp. 136, 142 (E.D. Mich. 1954) (taxpayers must show that there is no "reasonable expectation that payment will be made"), *aff'd per curiam*, 223 F.2d 265 (6th Cir. 1955); *O'Sullivan Rubber Co. v. Comm'r*, 42 BTA 721, 723 (1940) (taxpayers must show that there is "no reasonable anticipation" of payment); Rev. Rul. 2007-32, 2007-1 CB 1278 (taxpayers must show that there is "no reasonable expectancy of payment").

¹³ See, e.g., *Jones Lumber Co. v. Comm'r*, 404 F.2d 764 (6th Cir. 1968) (taxpayers must establish "reasonable doubt as to . . . collectibility"); *Hoffman v. Comm'r*, 57 TCM (CCH) 51, 54 (1989) (same); *Am. Fork & Hoe Co. v. Comm'r*, 33 BTA 1139, 1149 (1936) ("A taxpayer on the accrual basis cannot be charged with income if there exists good reason for believing that the income cannot be collected.").

¹⁴ See IRC § 1272(a)(3).

¹⁵ H.R. Rep. No. 98-432, at 1170 (1984) ("[F]rom the standpoint of the holder of a bond, market discount is indistinguishable from original issue discount (OID). In each case the discount is a substitute for stated interest."); S. Rep. No. 98-369 (1984) (same). See also *U.S. v. Midland-Ross Corp.*, 381 U.S. 54, 58 (1965) (OID is "precisely like" stated interest).

¹⁶ TAM 9538007 (Sept. 22, 1995).

bond described above may stop accruing interest once the interest becomes uncollectible.

The conclusion in the 1995 TAM is premised on a deeply flawed analysis and has been heavily criticized.¹⁷

Analysis of IRS Rationales. As discussed below, the IRS's four rationales for requiring current income accruals on a distressed OID bond are unpersuasive.

IRS Rationale #1: OID Is Different From the Accrual Method. According to the IRS, whereas the accrual method of accounting requires income inclusions "in advance of receipt," and therefore does not require income inclusions when there is no reasonable expectation of receipt, Section 1272 requires income inclusions "*in lieu of receipt*," and therefore requires income inclusions even when there is no reasonable expectation of receipt.

This effort to divorce the OID rules from the accrual method of accounting ignores the legislative history of the OID rules, which provides unequivocally that "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."¹⁸

IRS Rationale #2: Imputed Receipt Through Circular Cash Flow. According to the IRS, the OID provisions impute receipt by treating OID inclusions as a two-step process:

1. Interest is deemed paid to the investor; and
2. The investor is deemed to re-lend the interest to the issuer.

In support of this theory, the IRS cited prefatory language in legislative history published 15 years after the OID rules were enacted. This same legislative history, however, goes on to provide that investors purchasing OID bonds must account for the OID "on an economic accrual basis."¹⁹ Thus, it is more likely that the circular-cash-flow theory was intended merely as an unsophisticated explanation of compound interest.

¹⁷ See generally Andrew W. Needham, "Do the Market Discount Rules Apply to Distressed Debt? Probably Not," 8 J. Tax'n Fin. Instruments 19 (Apr. 1, 2009); David C. Garlock, "How to Account for Distressed Debt," 127 Tax Notes 999 (June 2, 2010).

¹⁸ S. Rep. No. 99-83, at 5 (1985) (emphasis added).

¹⁹ See H.R. Rep. No. 98-432, at 1034 (1984). A footnote in the legislative history provides (inaccurately) that the circular-cash-flow mechanism "is often referred to as the 'economic accrual' of interest or interest 'compounding.'"

IRS Rationale #3: Preventing Whipsaw. Under Section 163, an issuer that uses the accrual method of accounting generally may deduct interest whether or not the issuer is able to service its debt. The IRS expressed concern that allowing investors to stop accruing OID under the doubtful collectibility doctrine, without simultaneously requiring issuers to stop accruing OID deductions under Section 163, would be inconsistent with one of the principal purposes of the OID regime expressed in the legislative history—namely, matching investors' interest inclusions with the issuer's interest deductions.

The IRS's reliance on legislative history in support of this justification was disingenuous. The "mismatch" that concerned Congress occurred when accrual-method issuers were permitted to deduct OID on a current basis, while cash-method investors did not include the discount in income until they received it.²⁰ Section 163 existed when the OID rules were enacted, and there is no suggestion in the legislative history that Congress was concerned about the different legal standards that apply to determine when an accrual method issuer must stop accruing deductions and when an accrual method investor may stop accruing income. Moreover, if Congress were, indeed, concerned about these different standards, it is improbable that Congress would have addressed this concern only for instruments issued with OID and not for current-pay instruments.

IRS Rationale #4: Preemption. According to the IRS, the Tax Court had already ruled that "general accrual method principles," such as the doubtful collectibility doctrine, should not trump "more specific rules," such as the OID regime.²¹

However, in both cases cited by the IRS, the Tax Court had been asked to decide which of two statutes applied to the facts before it, and not—as the IRS suggested—whether a statute could overrule a common law doctrine by remaining silent on the doctrine's applicability. The Supreme Court has

²⁰ See H.R. Rep. No. 91-413, at 109 (1969) ("The present treatment of original issue discount results in a nonparallel treatment of the corporation issuing the bond and the person acquiring the bond. The corporation is allowed a deduction each year with respect to the discount. On the other hand, the holder is not required to report any income with respect to the original issue discount until he disposes of the bond."); S. Rep. No. 91-552, at 146-47 (1969) (same); see also Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, 98th Cong., 2d Sess. 93, 110 (1985) [hereinafter "Joint Committee on Taxation TRA 1984 Explanation"] ("Enacted in 1969, the OID rules were designed to eliminate the distortions caused by the mismatching of income and deductions by lenders and borrowers in discount lending transactions. Prior to that time, an accrual method borrower could deduct deferred interest payable to a cash method lender prior to the period in which the lender included the interest income.").

²¹ TAM 9538007 (Sept. 22, 1995), citing *Weis v. Comm'r*, 94 TC 473, 478 (1990) and *Williams v. Comm'r*, 94 TC 464, 470 (1990).

addressed the latter question and concluded that “statutes which invade the common law . . . are to be read with a presumption favoring the retention of long established and familiar principles, except when a statutory purpose to the contrary is evident.”²² Under this analysis, Congress’s silence with respect to the doubtful collectibility doctrine should be construed not as pre-emption, but as acquiescence.

An Unwarranted Obstacle. Though its reasoning is unsound, and it lacks precedential value,²³ the 1995 TAM reflects the IRS’s published view on the applicability of the doubtful collectibility doctrine to OID.²⁴ Adopting a contrary position could be perilous for a taxpayer.

Market Discount

In General. When market interest rates rise, the prices of outstanding bonds fall. As noted previously, this price reduction compensates purchasers of outstanding bonds for accepting below-market stated interest rates. For example, assume that an investor purchases a five-year zero-coupon bond at initial issuance, and that the bond has a \$70 issue price and a \$100 face amount. The bond’s yield-to-maturity is 7.39 percent, and the investor must include the bond’s \$30 of OID in income under a constant yield method. Assume that, immediately after issuance, market interest rates rise by 2 percent. In an efficient market, the bond’s price would drop to \$63.83, so that its yield-to-maturity is now increased to 9.39 percent (i.e., the bond’s original yield to maturity, plus 2 percentage points).

Congress enacted the market discount rules because it recognized that market discount arising as a result of interest rate fluctuations—such as the bond devaluation described immediately above—is indistinguishable from OID, and is a substitute for stated interest income.²⁵ Under Section 1276, an investor must treat any gain on the sale or retirement of a bond as ordinary income to the extent of accrued market discount.²⁶

²² *Isbrandtsen v. Johnson*, 343 U.S. 779, 783 (1952); see also *U.S. v. Texas*, 507 U.S. 529, 541 (1993) (“In order to abrogate a common-law principle, the statute must ‘speak directly’ to the question addressed by the common law.”).

²³ See IRC § 6110(k)(3) (private letter rulings “may not be used or cited as precedent”).

²⁴ See *Hanover Bank v. Comm’r*, 369 U.S. 672, 686 (1962) (“[A]lthough the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws.”).

²⁵ See Joint Committee on Taxation TRA 1984 Explanation, *supra* note 20, at 97-98 (“[F]rom the standpoint of the holder of a bond, market discount is indistinguishable from OID,” and is a “substitute for stated interest.”).

²⁶ IRC § 1276(a). Holders may elect to accrue market discount currently, either under a straight-line or constant yield method. IRC § 1276(b).

The Section 1276 regime differs from the OID regime in two respects:

1. The investor is not required to recognize any accrued market discount until he or she sells the bond or receives principal payments under the bond.
2. Market discount accrues ratably over the remaining term of the bond (in contrast to accrual under a constant yield method that reflects the principle of compound interest).

These distinctions exist only to avoid administrative complexity.²⁷ Because OID is calculated by reference to issue price, an issuer can report OID accruals for an entire debt issuance.²⁸ By contrast, the amount of a bond's market discount depends on the bond's purchase price, and therefore differs from holder to holder. Because the amount of market discount accruals must be made at the investor level, and not the issuer level, Congress apparently preferred to adopt a less complicated accrual calculation method, and to permit holders to avoid having to calculate accruals entirely if they hold their bonds to maturity (because, in that case, the amount of gain that is converted to ordinary income under the market discount rules is simply the discount from the issue price at which the bond was purchased).

Applicability of Market Discount Rules to Distressed Debt. One of the hallmarks of debt is an unconditional right to repayment, and an instrument the repayment of which is speculative when it is issued may not be characterized as debt for tax purposes, even if the parties refer to the instrument as "debt."²⁹ However, an instrument's debt or equity characterization for tax purposes generally is not retested after issuance.³⁰

²⁷ See Joint Committee on Taxation TRA 1984 Explanation, *supra* note 20, at 93 ("[T]he theoretically correct treatment of market discount . . . would involve administrative complexity.").

²⁸ See Treas. Reg. § 1.1275-3 (OID information reporting requirements). Issuers report OID on publicly offered debt instruments on IRS Form 8281.

²⁹ *Gilbert v. Comm'r*, 248 F.2d 399, 402 (1957) ("The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."); *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694, 696 (3d Cir. 1968) (label given to an instrument is just one of many factors relevant to the debt-for-tax analysis); *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972) (same).

³⁰ See, e.g., IRC § 385(c) (characterization by the issuer at "time of issuance" binds the issuer and investors); *Jack Daniel Distillery v. U.S.*, 379 F.2d 569, 580 (Fed. Cir. 1967) ("[D]id the parties intend, at the time of the issuance of the instrument, to create a real debtor-creditor relationship?") (emphasis added); Treas. Reg. § 1.1001-3(f)(7)(ii) (in determining whether a modification of a debt instrument results in an instrument that is not debt for tax purposes, "any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account").

As a result, by their terms, the market discount rules apply to distressed instruments that would not be treated as debt for tax purposes if they were issued on their acquisition date. The rules thus subject equity-like, risk-based returns to taxation as if those returns were interest. In so doing, the rules give rise to several inappropriate and unintended consequences.

Disproportionate Effect on Short-Term Bonds. Because discount on distressed debt reflects increased risk, not the time value of money, two bonds with the same level of priority in a financially distressed issuer's capital structure generally will have the same price, regardless of their maturity dates.³¹ Stated differently, when an issuer is in distress, the reduction in the price of its debt on the secondary market reflects the debt's rank in the issuer's capital structure—in effect, the investor's place in line in a hypothetical bankruptcy proceeding—and is not closely correlated to fluctuations in prevailing interest rates. However, because the market discount rules treat market discount as a return that is pegged to the time value of money, they require investors to accrue the discount based on the remaining number of years to the debt's maturity. The market discount rules thus disproportionately affect secondary market purchasers of shorter-term debt by requiring them to accrue market discount faster than purchasers of longer-term debt.

For example, suppose that an issuer issues two \$100 unsecured bonds at par on the same day, and that one bond matures in five years and the other in 10 years. At the beginning of Year 3, when the issuer is in financial distress (and interest rates remain unchanged), two secondary market purchasers buy the bonds for \$40 each. The issuer makes a full recovery so that, at the end of Year 5, the purchaser of the five-year bond receives \$100 of principal, and the purchaser of the 10-year bond sells the bond for \$100. Each purchaser has \$60 of economic gain. However, the purchaser of the five-year bond must treat the entire \$60 as ordinary income under Section 1276, whereas the purchaser of the 10-year bond must treat \$34.29 as ordinary income, and will treat the remaining \$25.71 as long-term capital gain.³² The \$60 of discount reflects a risk-based price adjustment for both investors, so there is no obvious reason to tax the discount on the two bonds differently.

Mismatch Between Investment Gains and Losses. The market discount rules treat investment gains differently from investment losses: investment gains are characterized as ordinary income, but investment losses are characterized as capital losses.

³¹ See Needham, *supra* note 17, at 21.

³² As mentioned above, market discount accrues ratably over the remaining term of the debt instrument. Because the remaining term of the 10-year bond is seven years at the time the bond is purchased, the purchaser must accrue one-seventh of the \$60 market discount each year.

For example, assume that an individual investor purchases two \$100 bonds with \$50 market discount and holds both bonds to maturity. One bond repays in full, but the investor is unable to recover any principal on the other. Thus, the investor breaks even economically. However, the investor is subject to a 39.6 percent tax on her economic gain (which is treated as ordinary income under the market discount rules),³³ and is entitled to deduct only 20 percent of her economic loss (which is treated as long-term capital loss).³⁴ Therefore, she owes \$9.80 of net tax on the transactions.³⁵

Disparate Treatment for Similar Investments. The market discount rules calculate the amount of a bond's market discount by reference to the bond's face amount, even when face amount is irrelevant to investors. The rules thereby tax holders of economically similar investments differently.

For example, assume that an investor purchases two distressed five-year bonds for \$40, that the bonds were issued at par one year before the purchase, that interest rates have not changed since the bonds were issued, and that one bond has a face amount of \$100 and the other a face amount of \$200. Assuming an efficient market, the \$40 price ascribed to each bond on the secondary market reflects the present value of all payments expected to be received on the bond. It is therefore peculiar that, if the investor sells each bond for \$80 one year later (for an economic gain of \$40), only \$15 of her gain would be treated as ordinary income in the case of the \$100 bond, whereas all \$40 of her gain on the \$200 bond would be treated as ordinary income.³⁶

Applying the Doubtful Collectibility Doctrine to Market Discount

The common law doubtful collectibility doctrine does not translate seamlessly onto the market discount regime. As mentioned above, courts have applied the doubtful collectibility doctrine to permit accrual-method taxpayers to avoid accruing specific interest payments only to the extent that those payments are of doubtful collectibility. Thus, applied mechanically to distressed debt, the

³³ The highest marginal U.S. federal income tax rate for individuals is currently 39.6 percent. See IRC § 1(a).

³⁴ The current long-term capital gains rate for individuals is 20 percent. See IRC § 1(h)(1)(D).

³⁵ Moreover, as mentioned above, an individual may use capital losses to offset only up to \$3,000 of ordinary income each year. See IRC § 1211(b)(1).

³⁶ In the case of the \$100 bond, the investor would accrue \$15 of market discount each year (i.e., \$60 of discount, divided by the bond's remaining four-year term). In the case of the \$200 bond, the investor would accrue \$40 of market discount each year (i.e., \$160 of market discount, divided by the bond's remaining four-year term).

doubtful collectibility doctrine might still require an investor to treat the difference between the investor's capital investment and the aggregate payments that she reasonably expects to receive on the debt as interest income.

This application of the doubtful collectibility doctrine would overstate the amount of market discount on distressed debt. An investor who buys distressed debt expects a return that exceeds the purchase price. However, the expectation of a return on an investment should not convert investment gain into interest income. The amount of the return is subject to volatility and risk that are uncharacteristic of interest income and therefore are inconsistent with the premise of Section 1276 that market discount is a "substitute for stated interest."

For example, assume that an investor purchases a \$100 five-year bond for \$40 two years before the bond matures and that, on the purchase date, the investor reasonably expects the issuer to repay \$64 of principal at maturity. Under Section 1276, if the investor is right, then all \$24 of her economic gain will be ordinary income, but if she is wrong, then any loss she suffers will be long-term capital loss. The doubtful collectibility doctrine, if applied mechanically to the debt, likely would not halt market discount accruals, because \$64 of principal is not "uncollectible." However, the bond clearly is in distress, and any return on the bond is not economically akin to interest income.

A more sensible application of the doubtful collectibility doctrine to distressed debt—and one proposed by the New York State Bar Association—would turn off market discount accruals if there is no reasonable expectation that the issuer will repay the debt's full principal amount (or, in the case of debt issued with OID, its issue price plus any OID previously included in income by the investor), plus any unpaid interest that accrued before the debt became distressed.³⁷ Anecdotally, some taxpayers have adopted this approach, and practitioners often supplement the approach with value- and yield-based rules of thumb.³⁸

However, as discussed above, Congress enacted the OID and market discount rules to address discounts that are economically identical to stated interest. Accordingly, if the IRS still believes that the 1995 TAM is right, and the doubtful collectibility doctrine does not apply to OID, then it is difficult to see how the IRS could agree to extend the doubtful collectibility doctrine to market discount.³⁹ Thus, practitioners often are hard-pressed to conclude

³⁷ See New York State Bar Ass'n, *supra* note 3, at 5.

³⁸ See *id.* at 16, 26; see also Garlock, *supra* note 17, at 14-15.

³⁹ One distinction between market discount and OID is that an issuer deducts OID that accrues on its debt, but does not deduct market discount. Because an issuer's deductions are uncorrelated to the amount of market discount on its debt, applying the doubtful collectibility doctrine to market discount and permitting holders to halt their interest accruals does not "whipsaw" the IRS. Thus, one of the concerns expressed in the 1995 TAM is not present in the market discount context.

at a high level of comfort that investors in distressed debt can avoid market discount accruals.

Camp's Proposal

Overview. Camp's proposal would make two major changes to the market discount regime. The proposal would:

1. Require investors to accrue market discount currently under a constant yield method, in the same manner as OID;⁴⁰ and
2. Limit market discount accruals to prevent an investor's aggregate ordinary income inclusions—taking into account stated interest, OID, and market discount—from exceeding the greater of (1) the applicable federal rate (determined at the time of acquisition using a term equal to the bond's remaining term) plus 10 percent, and (2) the bond's yield to maturity as of its issue date plus 5 percent.⁴¹

For example, assume that a \$1,000 15-year bond was issued on January 1, 2009, at par and provides for stated annual interest of \$50. Under current law, assuming that the doubtful collectibility doctrine does not apply to market discount, a secondary market investor who purchased the bond on January 1, 2014, for \$400, when the applicable federal rate was 4 percent, must accrue \$60 of the \$600 market discount each year, and treat any gain on the sale, maturity, or other disposition of the bond as ordinary income to the extent of accrued market discount. In addition, unless the interest is uncollectible, the investor must include the \$50 of annual interest payments in income each year, even if the issuer is unlikely to repay the bond's full principal amount. Thus, the investor accrues interest income at a 27.5 percent annual rate—that is, \$50 of stated interest, plus \$60 of market discount, on a \$400 investment. If the investor recovers the bond's full principal amount at maturity, then the investor will recognize \$600 of ordinary income (and no capital gain) at maturity.

Under Camp's proposal, however, market discount accruals on the bond would be capped so that the bond's annual interest rate does not exceed 14 percent of the bond's principal amount plus previously accrued (and taxed) discount,⁴² as illustrated in Table 1.

⁴⁰ Proposed Section 1278(a). Under Proposed Section 1278(d)(3), any losses recognized on an investor's sale or on the maturity of a bond would be treated as ordinary losses to the extent of previously accrued market discount.

⁴¹ Proposed Section 1278(c).

⁴² Fourteen percent is the greater of (1) the bond's 5 percent yield to maturity as of its issue date, plus 5 percent, and (2) the 4 percent applicable federal rate plus 10 percent.

Year	Adjusted Basis^a	Stated Interest	Market Discount (Capped)^b	Total Ordinary Income^c	Interest Rate^d
2014	\$400	\$50.00	\$6.00	\$56.00	14.00%
2015	\$406	\$50.00	\$6.84	\$56.84	14.00%
2016	\$412.84	\$50.00	\$7.80	\$57.80	14.00%
2017	\$420.64	\$50.00	\$8.89	\$58.89	14.00%
2018	\$429.53	\$50.00	\$10.13	\$60.13	14.00%
2019	\$439.66	\$50.00	\$11.55	\$61.55	14.00%
2020	\$451.21	\$50.00	\$13.17	\$63.17	14.00%
2021	\$464.38	\$50.00	\$15.01	\$65.01	14.00%
2022	\$479.39	\$50.00	\$17.11	\$67.11	14.00%
2023	\$496.51	\$50.00	\$19.51	\$69.51	14.00%

^a The bond's adjusted basis is its initial basis plus previously accrued market discount.

^b The constant yield market discount accrual would be the bond's 18.67 percent yield to maturity multiplied by its adjusted basis at the beginning of the year. The cap is 14 percent multiplied by the bond's adjusted basis at the beginning of the year, minus stated interest.

^c The total ordinary income includible in income each year is the stated interest plus the market discount.

^d The interest rate is calculated by dividing the total ordinary income includible for the year by the bond's adjusted basis at the beginning of the year.

At maturity, the investor will have accrued \$116.02 of market discount, and her adjusted basis in the bond will have increased by the same amount, to \$516.02. As a result, if the investor recovers the full principal amount of the bond at maturity, under Camp's proposal the investor will recognize \$483.98 of long-term capital gain at maturity.

Current Inclusion of Market Discount. The proposal's "current inclusion" requirement would affect both investors and brokers.

Effect on Investors. Camp's proposal would impose a substantive tax liability on secondary market debt investors before they receive any related income. Investors would be required to fund this tax liability from other sources.

Some investors may not have sufficient liquid assets or sources of financing to continue investing in secondary market debt. Camp's proposal could cause these investors to divert their funds into other investments, such as stock, that do not require current income accruals.

Thus, Camp's proposal could prevent investors from being able to match their investment portfolios to their risk profiles, while reducing overall

liquidity in the secondary debt market. The prospect of reduced liquidity could increase the rate of return demanded by initial debt purchasers, which would make it more difficult for many issuers to obtain financing.

In addition, requiring current inclusion of market discount would exacerbate the perverse consequences of treating discount that arises as a result of an issuer's financial deterioration as interest income. Under a current inclusion regime that lacks a well-tailored limitation on market discount accruals, investors that hold portfolios of distressed debt will be required to accrue and include income currently in respect of gains that may never materialize, while deferring losses. It is therefore important for policymakers to consider whether the Camp proposal's limitation on market discount accruals adequately protects investors from having to include market discount that is not analogous to interest.

Effect on Brokers. Under Camp's proposal, broker-dealers would bear the brunt of the administrative complexity that Congress recognized would necessarily accompany constant yield annual accruals of market discount.⁴³ Because the amount of a bond's market discount depends on the bond's purchase price, the amount differs from investor to investor. Thus, if Camp's proposal is adopted as proposed, broker-dealers will be required to develop systems to calculate annual market discount accruals with respect to each bond held by each of their customers, including bonds held by their customers but purchased through different brokers.

The reporting burden that Camp's proposal would impose on broker-dealers is far more onerous than the reporting burden imposed by the OID regime, since issuers calculate OID accruals each year with respect to an entire debt issuance and relay this information to the broker-dealers.

To make matters worse, Camp's proposal would eliminate a "de minimis" rule under current law that permits an investor to avoid accruing market discount that, at the time of acquisition, is less than 0.25 percent of a bond's principal amount (plus any interest that is not unconditionally payable at least annually) multiplied by the number of complete years remaining in the bond's term.⁴⁴ Thus, under Camp's proposal, even slight discounts would need to be reported and accrued.⁴⁵

⁴³ See Proposed Section 6045(i) (imposing market discount reporting obligations on broker-dealers).

⁴⁴ The current de minimis rule is in IRC § 1278(a)(2)(C).

⁴⁵ Many issuers offer debt at slightly varying prices, so that a portion of an initial issuance may have market discount, even if purchased on the issue date.

Limitation on Market Discount Accruals. As mentioned above, Camp's proposal would limit market discount accruals on a bond by capping the bond's yield at the greater of (1) the applicable federal rate plus 10 percent (the "AFR test"), and (2) the bond's yield to maturity as of its issue date plus 5 percent (the "issue date yield test").

This two-pronged "greater of" cap on market discount accruals is intended to be a "rough justice" substitute for the doubtful collectibility doctrine. The report issued by the Ways and Means Committee in connection with the proposal explains that the proposed limitation on accruals "approximates increases in interest rates since the loan was originally made." In other words, the proposed cap is intended to prevent investors from having to treat market discount as interest income if the market discount is attributable to a deterioration in the issuer's credit (and not to an increase in interest rates).

AFR Test. Because the AFR test is based on the applicable federal rate as of a bond's acquisition date, and applicable federal rates are based on current interest rates, the AFR test generally will require investors to accrue any market discount attributable to changes in interest rates since the bond's issuance. If interest rates rise by 2 percent, a bond's yield also generally will rise by 2 percent, and that additional 2 percent yield will be treated as market discount under the AFR test because the applicable federal rate will have risen in tandem with prevailing interest rates.

However, the AFR test is over-inclusive. For example, assume that a bond is issued with a 7 percent yield when the applicable federal rate is 5 percent, and that an investor purchases the bond at a discount that reflects a 15 percent yield when the applicable federal rate is still 5 percent. The accrual limitation under the AFR test is 15 percent (i.e., the 5 percent applicable federal rate at acquisition, plus 10 percent), so under Camp's proposal the investor must accrue all of the market discount, even though none of the discount is attributable to a rise in interest rates.⁴⁶

⁴⁶ President Clinton's Fiscal Year 2000 Revenue Proposals contained a market discount proposal that was substantially similar to Camp's proposal, except that the AFR test would have been the applicable federal rate plus 5 percent (instead of 10 percent). See *General Explanations of the Administration's Revenue Proposals*, at 121 (Feb. 1999), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2000.pdf>; see also New York State Bar Ass'n, *Report on Proposed Legislation to Amend the Market Discount Rules of Sections 1276-78*, at 5 (June 22, 1999), available at https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_1999/Tax_Section_Report_955.html. The AFR test contained in the Clinton administration's proposal had less potential to be over-inclusive than does the AFR test contained in Camp's proposal.

In addition, although interest paid on municipal bonds is not subject to tax, market discount on municipal bonds remains taxable.⁴⁷ However, interest rates for taxable bonds are greater than interest rates for municipal bonds, and applicable federal rates are based on taxable bonds, not municipal bonds. Thus, the AFR test is likely to be highly over-inclusive for municipal bonds.

Issue Date Yield Test. The issue date yield test is not adjusted for changes in interest rates, and therefore has a strong potential to characterize speculative returns as interest income under the market discount rules. For example, assume that a bond is issued with a 15 percent yield when the applicable federal rate is 8 percent, and that an investor purchases the bond at a discount that reflects a 20 percent yield when the applicable federal rate is 3 percent. In this case, prevailing interest rates have decreased by 5 percent, while the bond's yield has increased inversely, which strongly suggests that the bond's market discount reflects financial distress and not an interest-like return. However, the accrual limitation under the issue date yield test is 20 percent (i.e., the bond's 15 percent issue date yield, plus 5 percent), so the investor must accrue all of the market discount under Camp's proposal.

Conclusion

Camp's market discount proposal represents an express acknowledgement of the uncertain applicability of the doubtful collectibility doctrine to market discount. The report issued by the House Committee on Ways and Means in connection with the proposal provides that, under current law, market discount "appears to include discount associated with deterioration in the creditworthiness of the borrower, even though it may have been intended that current law should only apply to discount associated with increases in interest rates."⁴⁸

But the proposal seeks to provide only targeted relief to taxpayers with inappropriately high market-discount inclusions. High market-discount inclusions are a symptom of a larger problem—namely, the uncertain applicability of the doubtful collectibility doctrine to discount. The proposal fails to resolve this uncertainty.

This shortcoming of Camp's proposal should be particularly troubling for OID bond investors. As discussed above, even though OID and market discount are economically identical, Camp's proposal does not protect OID bond investors from having to accrue speculative OID. There is no logical reason to codify a version of the doubtful collectibility doctrine for market

⁴⁷ See IRC § 1278(a)(1)(A). Market discount is not treated as tax-exempt interest because it does not give rise to an interest expense for the issuer.

⁴⁸ Committee on Ways and Means, *supra* note 5, at 98.

discount, but at the same time to require an OID bond investor to continue accruing OID even after a bond's principal amount becomes uncollectible.⁴⁹

Not only would Camp's proposal fail to provide guidance on the scope of the doubtful collectibility doctrine, it also could meaningfully disrupt the secondary debt market by requiring investors to recognize phantom income and imposing new information reporting requirements on broker-dealers.⁵⁰ Moreover, under the proposal, investors will still be required, improperly, to treat certain equity-like returns as interest income.

Accordingly, although its limitation on market discount is a step in the right direction, Camp's proposal is no panacea. The softness of the secondary debt market during the recent economic downturn should galvanize policymakers to carefully develop a set of consistent and administrable rules that govern the tax consequences of investing in distressed debt. In no event should perverse tax consequences sideline prospective investors.

⁴⁹ As discussed above, one of the rationales expressed in the 1995 TAM for declining to extend the doubtful collectibility doctrine to OID was that the IRS believed that allowing investors to stop accruing OID while permitting issuers to continue accruing deductions would be inconsistent with one of the purposes of the OID rules. On this basis, some commentators might endorse Camp's proposal while still defending the 1995 TAM by noting that Camp's proposal does not raise the same asymmetry between accruals of income and deductions (since an issuer's deductions are uncorrelated to the amount of market discount on its debt). However, as discussed above, this concern about asymmetry is premised on a misinterpretation of the legislative history of the OID rules, and therefore does not justify applying the doubtful collectibility doctrine differently to OID and market discount.

⁵⁰ Policymakers should weigh the potential cost of this disruption against the relatively low \$900 million in revenue that the Joint Committee on Taxation expects the proposal to raise from 2014 to 2023. See Committee on Ways & Means, *supra* note 5, at 99.



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