REPORT # 822

TAX SECTION

New York State Bar Association

REPORT ON “EXCESS PRINCIPAL AMOUNT”

OF SECURITIES UNDER SECTION 356

January 31, 1995

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MEMORANDUM

Technical Corrections Bill Section 356 "Principal Amount"

Enclosed is a Report by the New York State Bar Association Tax Section concerning flaws in the tax rules contained in Section 356 of the Code relating to an exchange of debt securities in a corporate reorganization. A technical modification to the provision was contained in proposed 1991 tax legislation that was not enacted, although (possibly for reasons we discuss) not in the more recent technical corrections legislation passed by the House in 1994.

The flaws in Section 356 relate to the fact that the recognized gain under Section 356 is based on the excess of the "principal amount" of securities received over the principal amount of the securities surrendered. This concept of principal amount is inconsistent with recent legislative and regulatory developments concerning the treatment of debt securities under the Code.

The Report suggests that the 1991 proposed modification to Section 356 (which compared the "issue price" of the new securities to the "adjusted issue price" of the old securities) was an appropriate place to begin. However, that proposal would have caused gain to be recognized when it is not recognized under present law and in cases where we believe recognition is inappropriate.

The Report suggests two possible alternative modifications to the 1991 proposal that would alleviate this problem. In one case, gain would be recognized as under the 1991 proposal but would in any event be limited to the excess of the fair market value of the securities received over the value of the securities surrendered. In the other alternative, the gain recognized under the 1991 proposal would be limited to the gain recognized under the existing “principal amount” rule.

Our suggestions would necessarily be somewhat more complicated than the existing rule in Section 356 or the 1991 proposal. Nevertheless, we believe either of our suggestions would achieve a fair balance between accuracy and simplicity and eliminate most of the inconsistencies and tax planning opportunities that arise under existing Section 356.

The Tax Section, as always, strongly supports enactment of technical corrections and simplification legislation. Please let us know if we can be of further help in the development of technical corrections for Section 356 or in other efforts at technical corrections or simplification.

Sincerely yours,

Michael L. Schler

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Tax Report #822

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON REORGANIZATIONS

REPORT ON “EXCESS PRINCIPAL AMOUNT” OF SECURITIES UNDER SECTION 356

January 31, 1995

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON REORGANIZATIONS

REPORT ON "EXCESS PRINCIPAL AMOUNT" OF SECURITIES UNDER SECTION 356

January 31, 1995

I. INTRODUCTION

This report[1] discusses flaws in the tax rules contained in section 356[2] and related provisions concerning the treatment of debt securities received in a reorganization. The report also discusses several possible amendments to section 356 to address these flaws.

It has long been recognized that the section 356 rules in question are illogical and inconsistent with the treatment of debt securities under other provisions of the Code and regulations, and there has been much commentary on this subject.[3]

It is timely to revisit the issue, however, given the legislative and regulatory developments concerning the treatment of debt securities over the past several years that have some

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1 This report was prepared by Patrick C. Gallagher and Michael L. Schler with assistance from Peter C. Canellos, Bertram E. Kessler, Stephen B. Land, Carolyn Joy Lee, Richard L. Reinhold, Kevin W. Treesh and Mary Kate Wold.

2 All "section" references, unless otherwise specified, are to the Internal Revenue Code of 1986, as amended (the "Code").

3 See, e.g., B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, 6th ed. (1994) ¶12.27[4][b]; D. Garlock, Federal Income Taxation of Debt Instruments, 3rd ed. (1994) ¶7[3]; M. Ginsburg & J. Levin, Mergers. Acquisitions and Leveraged Buyouts (1994) ¶¶604.01, 605; G. Kohl, "The Fundamentals of Debt Swaps," 48 Tax Notes 1037 (1990); M. Schler, "The Sale of Property for a Fixed Payment Note: Remaining Uncertainties," 41 Tax Law Review 209, 234-237 (1986).

bearing on the question (including in particular the adoption of Reg. S 1.1001-1(g)). Moreover, as a result of these developments, the need to update section 356 has become more pressing and, at least in some respects, the nature of the required changes is clearer.

The flaws exist in two aspects of section 356:

First, under sections 356(d)(2), 354(a)(2)(A) and 355(a)(3)(A), a security holder recognizes gain in an exchange that otherwise qualifies under section 354 or 355 whenever the "principal amount" of any securities received exceeds the "principal amount" of any securities surrendered by the holder (the "excess principal amount rule").

Second, under sections 356(a)(1)(B) and 356(d)(2), if the excess principal amount rule applies, the holder's recognized gain (boot) is limited to the fair market value ("FMV") of the excess principal amount (the "FMV rule").

Recent developments bearing on the issues discussed herein include the following:

1. The January 1994 adoption of Reg. §§ 1.1001-1(g) and 1.1012-1(g), which compute amount realized (and basis) attributable to debt received (and issued) in an exchange by reference to the debt's "issue price" (generally as determined under section 1273 or 1274) for both cash and accrual taxpayers. In contrast, for exchanges made before the April 4, 1994 effective date of the regulation, the

rules were much less clear.[4]

2. The January 1994 adoption of Reg. § 1.163-7(c), providing that if an issuer repurchases its outstanding debt in exchange for its new debt, the issuer has repurchase premium equal to the issue price of the new debt less the adjusted issue price ("AIP") of the old debt. Any repurchase premium is deductible currently as interest expense unless the issue price of the new debt is determined under section 1273(b)(4) or 1274, in which case the repurchase premium is amortized over the term of the new debt.[5] Thus, subject to the above exception, the regulation provides that a debt swap is taxed to the issuer in the same manner as a cash repurchase of the old debt.

3. The January 1994 adoption of the final OID regulations.

4. The November 1990 repeal of old section 1275(a)(4), which, in the case of a section 368 exchange of securities,

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4 A cash basis taxpayer would have had an amount realized equal to the FMV of the note under section 1001(b), and basis in purchased property apparently equal to the principal amount of the note (net of imputed interest) under the section 1012 "cost" rule. An accrual method holder's amount realized and basis would have been the principal amount of the note net of section 1274 imputed interest. See, e.g., Rev. Rul. 79-292, 1979-2 C.B. 287, clarified by Rev. Rul. 89-122, 1989-2 C.B. 200. We assume the validity of Reg. § 1.1001-1(g) and 1.1012-1(g) for purposes of this report. See V below.

5 The Preamble to the regulations (T.D. 8517) defends denying a current deduction of repurchase premium in connection with a debt swap in which the new debt's issue price is determined under section 1274 by stating that "taxpayers could inappropriately accelerate deductions ... because of the flexibility inherent in section 1274 for determining the issue price of a debt instrument." The amortization required by Reg. § 1. 163-7(c) is similar to the treatment of debt swaps by prior cases. See, e.g., Great Western Power Co., 297 U.S. 543 (1936); South Carolina Continental Telephone Co., 10 T.C. 164 (1948); Missouri Pacific Railroad, 427 F.2d 727 (Cl. Ct. 1970).

had set a floor for the new security's issue price equal to the old security's AIP.

5. The November 1990 enactment of section 108(e)(11), which provides that the issuance of a debt instrument to satisfy a liability is treated for section 108 purposes as though the debtor had paid cash equal to the "issue price" of the new debt.

6. In general, a marked increase in the sophistication of the market place concerning debt securities and refinement in the tax law concept of "principal" since section 356(d) was enacted.

These developments reflect two trends. One is that, in connection with a disposition of property in exchange for a debt security, a consistent policy emerges (reflected particularly in the adoption of Reg. § 1.1001-1(g)) of computing amount realized for all purposes by reference to the issue price of the security received. For example, if a holder surrenders only stock and receives only securities, sections 354 and 356 do not apply,[6] and the holder's gain is based entirely on Reg. § l.l00l-1(g). It makes no sense that a holder also surrendering securities or receiving stock (even $1) should be subject to an entirely different regime based on principal amount.

The second trend is toward requiring full recognition of any gain or loss realized in an exchange of debt securities. Thus the repeal of section 1275(a)(4) and the enactment of section

[6] See section 354(a)(2)(A)(ii) (excluding from section 354(a) exchanges in which securities are received but none are surrendered); section 356(a)(1)(B) (applicable only if the property received consists "not only" of nonrecognition property but "also" of other property). Also compare Reg. § 1.354-1(d), Examples (2) and (3).

108(e)(11) requires gain recognition (cancellation of debt income) by the issuer when new debt is issued to retire old debt at a discount. Conversely, Reg. § 1.163-7(c) permits the issuer loss recognition when new debt is issued to retire old debt at a premium (with the exception that premium must be amortized if the new debt's issue price is determined under section 1273(b)(4) or 1274).

II. SUMMARY OF CONCLUSIONS

1. Both the FMV rule and the excess principal amount rule, literally applied, in some cases impose too much tax and in other cases impose too little tax on holders (see III and IV.A).

2. Replacing the FMV rule and excess principal amount rule with a rule that simply measures recognized gain by the excess of the issue price of the new security over the AIP of the old security (the “excess issue price rule”) would avoid the existing overtaxation and undertaxation in many circumstances (see IV.B). It would also be consistent with the current taxation of debt exchanges in other contexts. However, such a rule would create taxable gain (which often does not exist under current law) whenever an appreciated security is surrendered in a section 1001 exchange for a new security with an issue price above the old security's AIP. This would be particularly harsh if, for example, the new security and the old security had substantially the same terms.

3. In order to address the latter concern, consideration should be given to a rule that defers gain recognition in appropriate cases. Such a rule should be crafted in a manner that: (1) is reasonably equitable for exchanging holders of appreciated securities, (2) postpones the issuer's

deduction for bond repurchase premium (under Reg. § 1.163-7) to the extent the holder's gain is deferred and (3) is otherwise sufficiently harmonious with the existing regime for taxation of debt instruments (see I above) that minor adjustments to the terms of an exchange will not produce significant, irrational differences in tax treatment.

This report suggests two possible approaches that are intended to satisfy the above criteria. Both approaches would replace the existing FMV rule and excess principal amount rule. Under both approaches, gain recognized in a section 356 exchange would never exceed the lesser of (i) gain determined under the excess issue price rule as described above or (ii) a capped amount.

Under one approach (discussed in IV.C), the cap on recognized gain would equal the excess of the new security's FMV over the old security's FMV. For this purpose, the new security's FMV would be its issue price, and the old security's FMV would be (i) for a traded security, its trading price, and (ii) for a nontraded security, the present value of all future payments under the instrument, determined using an appropriate discount rate. The discounting mechanism for valuing nontraded securities, while imperfect, is intended to reasonably approximate FMV in a manner that minimizes taxpayer discretion but is not too complex. In certain cases simpler rules could apply.

Under the second approach (discussed in IV.D), the cap on recognized gain would equal the principal amount of the new security less the principal amount of the old security, but would be available only if certain conditions were satisfied.

Under both of the capped approaches, the issue price of the new security would be reduced by the amount by which the cap would have reduced an initial holder's recognized gain. This is designed to avoid mismatching the holder's gain and the issuer's deduction for bond repurchase premium, and otherwise to rationalize the section 356 result with the OID and related rules. See IV.C.3

Both capped gain approaches are more complex than the unadorned excess issue price rule and may still result in overtaxation or undertaxation in certain circumstances. However, each may be a fair compromise between the desire to avoid undue complexity and the desire to reach reasonable results in as many cases as possible.

4. If either the excess issue price rule (described in 2 above) or the excess issue price rule with a cap (described in 3 above) is adopted, it should be implemented by statutory amendment rather than by regulation (see V below). Beyond the issue price adjustments described above in connection with the “capped” approaches, it does not appear that any of the proposed modifications to the FMV rule and the excess principal amount rule would require other significant changes to the existing regime for taxing debt instruments. However, if any of the proposals is adopted, consideration also should be given to incorporating Reg. § 1.1001-1(g) into the statute, since it underlies each of the proposals.

5. For collateral installment sale issues, see VI below.

III. THE FMV RULE

The following example illustrates the difficulties raised by the existing FMV rule:

Example (1): A holder surrenders nontraded stock with a zero basis for:

(i) new nontraded stock with a FMV of $100 and

(ii) nontraded debt with a stated principal amount of $900, an issue price of $900 (because the debt bears adequate stated interest under section 1274) and a FMV of $800 (or $1,000).

Assume the installment sale rules do not apply. Under Reg. § 1.1001-1(g), the holder's realized gain is $1,000, i.e., the $100 FMV of the new stock plus the $900 issue price of the new debt. This is now the case whether the holder uses the cash method or the accrual method.[7] In the absence of section 356, the holder's recognized gain would also be $1,000, of which $900 would be attributable to the debt received. In contrast, because the transaction is governed by section 356(d), the holder's recognized gain attributable to the debt received is the debt's $800 (or $1,000) FMV, rather than the debt's $900 issue price.[8]

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[7] As noted in 1.1 above, for exchanges made before the April 4, 1994 effective date of Reg. § 1.1001-1(g), a cash basis holder's gain attributable to the debt would have been the debt's $800 (or $1,000) FMV under section 1001(b).

The analysis in text assumes that the new debt is not issued in a “potentially abusive situation” as defined in Reg. § 1.1274 3. For example, if the debt had “clearly excessive interest,” its issue price, and thus the amount realized with respect to the debt, would be the debt's FMV. See Reg. § 1.1274-2(b)(3).

[8] See Reg. § 1.356-3(b), Example (1).

As the example illustrates, the FMV rule is flawed for at least two reasons:

First, to the extent a holder receives recognition property (i.e., excess principal amount) in a reorganization, the taxpayer's recognized gain generally should equal the gain the taxpayer would have recognized under section 1001 with respect to the property in a fully taxable transaction (i.e., $900 in the example). Sections 356 and 1001 both refer to “fair market value” for determining the taxpayer's gain. If as a policy matter a security's “issue price” is an appropriate surrogate for its FMV for purposes of generally determining realized gain under the Code--a policy confirmed by Reg. § 1.1001-1(g)--it should also be appropriate for measuring the amount of recognized gain attributable to a security received as boot under section 356. The disparity between the section 356 and the section 1001 result has long existed in the case of accrual method holders. After the adoption of Reg. § 1.1001-1(g), it now exists as well for cash method holders. Given the consistency now in the treatment of cash and accrual method taxpayers under section 1001, it seems particularly timely and correct to conform the FMV rule to the section 1001 issue price rule.[9]

[9] The 1991 proposed amendments to section 356 discussed in IV.B below, which were intended to fix the excess principal amount rule and would have applied to both cash and accrual method security holders, would have left intact the FMV rule. Although the legislative history is silent on this omission, it may have stemmed in part from the disparity, prior to adoption of Reg. S 1.1001-1(g) (which was not issued in proposed form until December 1992), between the section 1001 treatment of debt received by cash method security holders (measuring gain by the debt's FMV) and accrual method taxpayers (measuring gain by the debt's face amount less imputed interest). See 1.1 above. That is, whether the FMV rule was changed to an “issue price” rule or left intact, there would have remained an inconsistency between the treatment under sections 356 and 1001 of either cash method security holders (if the FMV rule were changed to an issue price rule) or accrual method security holders (if the FMV rule were left intact). Given the adoption of a uniform issue price rule under Reg. § l.l00l-1(g), the need to conform section 356 is much more compelling.

Second, needless complexity arises from the difference between the holder's tax basis in the debt received and the debt's issue price for OID purposes. In Example (1), the holder apparently will have a tax basis of $800 (or $1,000) in the new debt under the FMV rule of sections 356 and 358(a)(2).[10] In contrast, the debt's section 1274 issue price is $900. If the holder's tax basis is $1,000, the holder apparently has $100 of amortizable bond premium under section 171 (i.e., $1,000 tax basis less $900 payable at maturity). If the holder's tax basis is $800, the holder should have $100 capital gain on payment of the principal amount.[11] The above treatment contrasts with the logical and much simpler result where the holder's recognized gain under section 356 (and the holder's basis under section 358) is the same as the debt's $900 issue price.

IV. THE EXCESS PRINCIPAL AMOUNT RULE

A. In General

Under the excess principal amount rule of section 356(d)(2), a holder recognizes gain in an exchange that otherwise qualifies under section 354 or 355 whenever the “principal amount” of any securities received exceeds the “principal amount” of any securities surrendered by the holder

This Part IV first identifies flaws in the excess principal amount rule and then analyzes alternative approaches to curing them. The analysis relies on hypothetical examples in

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10 See, e.g., Reg. § 1.358-2(c), Example (1).

11 It appears the market discount rules would not apply in the absence of regulations, because the holder acquires the bond at original issue and apparently not with a cost basis under section 1012. See section 1278(a)(1)(D).

which an old security is exchanged for a new security. Unless otherwise indicated, it is assumed in the examples that:

- the exchange is subject to section 356 (e.g., both the old debt and the new debt are “securities”),
- the installment method does not apply,
- the terms of the old and new securities are sufficiently different to result in an exchange under section 1001,
- the old security was purchased for cash equal to its FMV and is owned by its original holder (so that the holder's basis and the old debt's AIP are the same),
- “traded” means either traded or publicly offered for purposes of section 1273(b),
- the exchange occurs on the same date as the purchase of the old security, before any accrual of discount or premium but after any change in market conditions specified in the example, and
- the new security, if nontraded, is not issued in a “potentially abusive situation” (see Reg. SS 1.1274- 2(b)(3), -3(a)(2)).

The excess principal amount rule is seriously flawed. As acknowledged by Congress in explaining its 1991 proposed amendments to section 356 (H.R. 2777, discussed in IV.B below):

> "It is unclear under present law whether the OID rules apply for purposes of determining the principal amount of a security for purposes of the [section 354 and 355] nonrecognition rules."

This lack of clarity manifests itself in two ways:

First, the excess principal amount rule does not expressly reduce "principal" by amounts that are designated as such but are economically equivalent to interest (and so treated under the OID rules or section 483). This has the effect of drawing arbitrary distinctions between economically equivalent debt instruments. For example, the excess principal amount rule, by failing to identify interest implicit in the stated principal amount of the new security received by the holder, can require gain recognition where nonrecognition treatment should apply:

> Example (2) — Current pay debt surrendered for new zero coupon debt with higher principal amount but similar terms:
> A security (traded or nontraded) was issued for $1,000 cash, pays 7% interest currently (a market rate), and has an $1,000 principal amount. It is exchanged for a new (traded or nontraded) zero coupon security that has a $1,200 principal amount, a $1,000 issue price (under section 1273 or 1274), a $1,000 FMV, and a yield to maturity of 7% (in the form of the $200 discount). Thus the two securities are substantially the same except that the yield on the new security is in the form of discount rather than current pay interest.

	Principal Amount	(Adjusted) Issue Price	Fair Value
Old security	$1,000	$1,000	$1,000
New security	$1,200	1,000	1,000

> As part of the exchange, the holder surrenders old stock that has a $200 FMV and a zero basis and receives new stock that has a $200 FMV.

Viewing the debt exchange in isolation, there is no realized gain on the exchange under section 1001 and new Reg. § 1.1001-1(g), because the issue price of the new security equals the AIP of the old security. Thus, if the exchange were fully taxable, (i) there would be no tax consequences to the holder or issuer with respect to disposition of the old security, and (ii) there would be $200 of OID on the new security. This reflects the proper treatment of $200 of the $1,200 principal amount of the new security as OID, and also matches the result had the new security been issued for $1,000 cash in the first instance in lieu of the old security.

Section 356, however, literally compares the $1,200 “principal amount” of the new security to the $1,000 principal of the old security, arguably causing gain recognition where none should occur. That is, under a literal application of section 356, the $200 realized gain with respect to the zero basis stock surrendered in the exchange is recognized to the extent of the FMV of the $200 excess principal amount of debt received in the exchange.[12] As discussed in connection with Example (1) above, it is inappropriate for section 356 to create boot in excess of the amount of gain the taxpayer would have recognized had the debt-for-debt exchange been fully taxable.

Conversely, by failing to identify interest implicit in the stated principal amount of the old security surrendered by

[12] This report describes from time to time the effect of applying the excess principal amount rule “literally” (i.e., without regard to imputed interest principles). In so doing, we do not mean to suggest that the holder would necessarily adopt (or the Service respect or attempt to impose) the result described in text, or that a court would necessarily enforce that result. On the contrary, because it is widely understood that the “principal amount” concept is obsolete, we assume that in Example (2) the holder would likely take the position that the new security's “principal amount” for section 356 purposes is equal to its “issue price” under section 1273 or 1274. Nevertheless, as acknowledged by Congress in its explanation of the 1991 proposed amendment to section 356 (quoted in text above), the statutory language leaves room for doubt, thus inviting, for example, aggressive taxpayer reporting positions in some cases (such as Example (3) below).

the holder, the excess principal amount rule can permit gain that should be taxed under section 356 to escape taxation.

Example (3)--Zero coupon debt surrendered for new current pay debt with same principal amount. A zero coupon note (traded or nontraded) was issued for $600 cash and has a $1,000 principal amount (resulting in $400 of OID). Assume the discount represents an 8% yield to maturity (a market rate at issuance). The security, together with $400 of zero basis stock, is exchanged for a new traded or nontraded security. The new security pays 8% interest currently (still a market rate) and has a principal amount, issue price (under 1273 or 1274) and FMV of $1,000. Thus, although nominally the principal amounts of the two securities are the same, economically the new debt has a principal amount (as well as an issue price and FMV) $400 higher than the old.

	Principal Amount	Current (Adjusted) Issue Price	Current FMV
Old security	$1,000	$ 600	$600
New security	$1,000	1,000	1,000

The realized gain on the exchange under Reg. § 1.1001-1(g) is $400, i.e., the $1,000 issue price of the new security less the sum of the $600 AIP of the old security and the $0 basis in the stock surrendered. Therefore, if the exchange were fully taxable, (i) the holder would have $400 of capital gain, (ii) the issuer would have no gain or loss (there would be no repurchase premium under Reg. § 1.163-7(c), because the portion of the new debt's issue price attributable to retirement of the old debt is the same as the old debt's $600 AIP), and (iii) there would be no OID on the new debt (since its stated redemption price and issue price are both $1,000). Again, this result is the same as if the new security had been acquired in exchange for the zero basis stock and $600 cash in the first instance.

Because the $400 difference between the AIP and the stated principal amount of the old security is economically equivalent to interest to be accrued in the future, the "principal amount" of the old debt for section 356 purposes should be read to mean $600. This would properly treat the $400 of realized gain as boot, which is consistent with the surrender of $400 of zero basis stock for $400 of securities. Section 356, however, literally compares the "principal amount" of the old and new securities, which are identical. This may lead the holder to claim nonrecognition treatment where gain should be recognized.

A <u>second</u> flaw in the excess principal amount rule, which is related to the first, is that, applied literally, it does not increase principal amount by amounts attributable to unaccrued bond premium, which is economically equivalent to principal. As a result, the excess principal amount rule can create either too much boot (if the old security was issued at a premium) or too little (if the new security is issued at a premium).

Example (4)--<u>Debt issued at a premium surrendered for new debt with higher principal but similar terms; no realized</u> gain: A traded or nontraded security is issued for $1,200 cash, pays 10% interest currently (above a market rate), and has a $1,000 principal amount, creating $200 of bond premium. It is exchanged for a new traded or nontraded security that pays 8% interest currently (a market rate) and has a principal amount, issue price (under section 1273 or 1274) and FMV of $1,200.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$1,200	$1,200
New security	$1,200	1,200	1,200

As part of the exchange, the holder surrenders old stock that has a $200 FMV and a zero basis and receives new stock that has a $200 FMV.

Viewing the debt exchange in isolation, there is no realized gain under section 1001, because the new security's issue price and the old security's AIP are the same. Therefore, if the debt exchange were fully taxable, (i) there would be no tax consequences to the holder or issuer on retirement of the old security, and (ii) there would be no premium on the new security (because the holder is entitled to receive its $1/200 cost at maturity).

In contrast, the excess principal amount rule literally produces boot equal to the FMV of the $200 difference between the principal amounts of the new and old securities, which would result in inappropriate' gain recognition to the holder with respect to the appreciated stock surrendered in exchange for the new stock.

Example (5)--Debt and appreciated1 stock surrendered for new traded debt with same principal! amount and above market yield; A holder (1) surrenders stock with a basis of $0 and FMV of $200, and debt with a principal amount, AIP and FMV of $800 (bearing interest at a market rate), and (2) receives a new traded security with' a principal amount of $800, an issue price and FMV of $1000, and an above-market rate of interest.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$800	$800	$800
New security	800	1,000	1,000

The realized gain is $200, and the stock is economically being sold for future above-market interest payments. However, there is no excess principal amount and thus no gain recognized under section 356, literally applied.

The above examples illustrate that the excess principal amount rule needs to be clarified to make appropriate adjustments for OID (or amounts treated as interest under section 483) and bond premium.

B. Alternative #1: Excess Issue Price Rule.

1. In general. One alternative to the excess principal amount rule (and FMV rule) that would cure the above defects would be to limit gain recognition to the excess of the new security's issue price (as determined under section 1273 or 1274) over the old security's AIP (the "excess issue price rule"). An initial holder exchanging only securities would then be required to recognize all gain that is realized on the exchange under section 1001. This approach has been suggested previously by a number of commentators (including this organization[13]) and has progressed as far as legislation proposed in 1991.

Specifically, Section 444 of the Tax Simplification Bill of 1991 (H.R. 2777, introduced in the House and Senate in June 1991) would have amended section 356(d)(2) to require the security holder to treat as boot the excess of the "issue price" (as determined under sections 1273 and 1274) of any securities received over the "adjusted issue price" of the securities surrendered, with conforming amendments to sections 354 and 355 ("Proposed Section 444"). For this purpose, Proposed Section 444 defined "adjusted issue price" as issue price, increased by OID previously includible by an original holder or decreased by any bond premium that would have been allowable as a deduction (or

[13] See NYSBA Tax Section, "Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges," reprinted in 51 Tax Notes 79, 107 (1991).

offset) to an original holder.[14] H.R. 2777 was not enacted, and its proposed amendments to the excess principal amount rule were not included in subsequent versions of the legislation.

The excess issue price rule offers two clear improvements over the excess principal amount rule. First, it takes into account OID principles, so that appropriate adjustments are made for amounts representing interest and premium. Thus it produces the correct result in each of Examples (2) through (5) above (i.e., $0 boot in Examples (2) and (4), $400 boot in Example (3) and $200 boot in Example (5)). Second, it ensures that the section 356 gain recognition amount does not exceed the gain that would be realized by an initial holder of the old debt on a fully taxable exchange of securities (which as illustrated in Example (2) and (4) prevents inappropriate gain recognition if additional gain is realized on stock given up in the exchange).

2. Appreciated securities. However, none of Examples (2) through (5) involves securities given up on the exchange that have a value in excess of their tax basis to an initial holder. When the excess issue price rule is applied to an exchange of such securities, the rule differs from the excess principal amount rule in another important and more controversial respect.

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[14] Proposed Section 444 provided that section 1273(b)(4) would have applied by reducing the security's stated redemption price by the amount thereof treated as interest under the Code (e.g., under section 483). The latter modification to issue price determinations is appropriate for section 1273(b)(4) instruments and consistent with the issue price modifications made in computing amount realized in section 108(e)(11), Reg. S 1.1001-1(g) and Reg. § 1.1012-1(g).

The definition of “adjusted issue price” in proposed Section 444 was technically flawed in that, just as it increased AIP by any previously accrued OID, it should have reduced AIP by any

The excess issue price rule always treats as boot an initial holder's entire gain realized in the exchange of securities for securities. This has the merit of consistency with the regime of full gain recognition in debt exchanges, which is reflected in the legislative and regulatory developments described in Part I above. However, it departs significantly from the excess principal amount rule by taxing public bondholders (and often private holders) on any realized gain (up to that which would be realized by an initial holder) upon any exchange of appreciated securities for new securities. This is particularly harsh when the new securities are economically equivalent to the old securities but sufficiently different to trigger a realization event under section 1001. That is, under section 1273(b)(2), a new traded security's issue price is its FMV, whereas the old security's AIP does not reflect any increase in value (other than through OID inclusions) after its issuance.[15]

In contrast, the reorganization provisions are intended to provide for nonrecognition of gain arising from the exchange of certain qualifying property. Thus appreciated stock may be exchanged for stock of the same value without recognition of gain. There may be circumstances in which a similar rule should apply for exchanges of securities under section 356, instead of the excess issue price rule which requires recognition of all realized gain (up to that which would be realized by an initial holder) with respect to securities exchanges.

[15] Although the reasons for the withdrawal of Proposed Section 444 were not stated, we understand that concern over its treatment of appreciated securities may have been a factor. See, e.g., letter from Stuart Lipton to Chairmen Lloyd Bentsen and Dan Rostenkowski (July 31, 1991), reprinted in Tax Notes Today (August 28, 1991) (discussing H.R. 2777 proposed amendments to excess principal amount rule).

Example (6)--Appreciated traded debt surrendered for new traded debt with similar terms: A traded security is issued for $1,000 cash, pays 10% interest currently (a market rate at issuance), and has a $1,000 principal amount. Due to a decline in interest rates, the security's FMV increases to $1,200. The security is exchanged for a new traded security that pays 10% interest currently and has a $1,000 principal amount, a $1,200 FMV and a $1,200 issue price (under section 1273). Thus the two securities have similar terms.[16]

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$1,000	$1,200
New security	$1,000	1,200	1,200

The holder's realized gain is $200 under Reg. § 1.1001-1(g). Therefore, if the exchange were fully taxable (as it would be under the excess issue price rule), the holder would have (i) $200 gain on retirement of the old security and (ii) $200 of amortizable bond premium on the new security (i.e., the holder's $1,200 basis under section 358 less the $1,000 principal payable at maturity). As to the issuer, (i) there would be $200 repurchase premium, deductible currently, on retirement of the old security under Reg. § 1.163-7(c) (i.e., the new security's $1,200 issue price less the old security's $1,000 AIP), and (ii) the new security would be issued at a $200 premium under Reg. § 1.61-12(c)(2) (i.e., the new security's $1,200 issue price less its $1,000 amount payable at maturity), which would be amortizable into the issuer's income over the life of the new security.

In contrast, if nonrecognition treatment applied (as it would under the excess principal amount rule, literally applied), as to the holder (i) the $200 realized gain on

[16] This example is based on Example 2 of the explanation of Proposed Section 444 contained in H.R. 2777.

disposition of the old security would be deferred and (unless the new security were sold before maturity for more than $1,000) ultimately eliminated, because the holder would receive only its $1,000 basis at maturity, and (ii) there would be no bond premium on the new security, because the amount payable at maturity matches the holder's $1,000 basis under section 358. As to the issuer, it would still appear that (i) Reg. § 1.163-7(c) produces $200 of repurchase premium, deductible currently, on retirement of the old security, and (ii) the new security is issued at a premium under Reg. § 1.61-12(c)(2) which would be amortizable over the life of the new security.

There is a third possible interpretation of the transaction. If the old and new securities are similar enough, their substitution might be disregarded as an insignificant modification under Reg. § 1.1001-3. In that case, the exchange would be disregarded for tax purposes, so that (i) there would be no tax consequences to the holder or issuer from the exchange and (ii) the old security's $1,000 AIP would carry over to the new security.

Example (6) is a compelling case for nonrecognition treatment (which necessarily would require creating an exception to the excess issue price rule), for the following reasons:

(i) <u>Equitable treatment of holder</u>. To the extent the reorganization provisions are designed to permit the tax free exchange of qualifying property, nonrecognition treatment is appropriate, because the holder's debt position has not been enhanced in any way as a result of the exchange. It seems harsh to tax the holder on the unrealized appreciation in its old security upon receipt of a similar security in a reorganization exchange. The reorganization provisions were designed precisely to avoid taxing such appreciation attributable to qualifying property. As further discussed below, taxing the exchange would result in a deduction for the issuer equal to the income recognized by the holder. Theoretically the issuer could share its tax savings with the holder to alleviate the holder's tax burden. Such arrangements, however, would be complex and unlikely, and in their absence the holder might have no recourse but to sell a portion of its investment assuming it is liquid) to satisfy its tax liability from the exchange.

(ii) Avoiding cliff effect. Taxing the exchange would put considerable pressure on the debt modification rules of Reg. § 1.1001-3. That is, if the old and new securities are similar enough, their substitution might be structured to escape taxation as an insignificant modification under Reg. § 1.1001-3. As a result, if the excess issue price rule were applied, there would be a very fine line between nonrecognition (if the exchange were not a realization event) and full recognition of gain (if the exchange were a realization event). While this is an issue that taxpayers must grapple with in connection with debt swaps and modifications generally, we see no good reason to further inject it into the reorganization rules.

(iii) Overall policy. Subject to the discussion below of the issuer's deduction for bond repurchase premium and certain other issues, it does not offend any policy to permit nonrecognition treatment here. Although it may be tempting to require full recognition of gain on all debt exchanges for the sake of a consistent policy (see Part I above), as noted in the preceding paragraphs there are competing considerations. It is also instructive to consider the limitations on loss recognition that would apply on a comparable exchange where the original security has depreciated in value. For instance, assume that in Example (6) the FMV of the old and new securities at the time of the exchange was $800 (instead of $1,200), so that the issue price of the new security was $800. After repeal of section 1275(a)(4) and enactment of section 108(e)(11), the exchange would be taxable. Therefore, the issuer would have $200 of debt cancellation income under section 108 (although this income might be absorbed by a net operating loss or otherwise reduced by an exception to section 108). However, section 356(c) would prohibit the holder from recognizing loss, which would be asymmetrical with a regime requiring full recognition of gain in cases such as Example (6).[17]

(iv) Current law. When applied to Example (6), the excess principal amount rule literally provides for nonrecognition treatment and does not produce an obviously flawed result, as it does in Examples (2) through (5). A change in section 356 that itself causes a questionable result in Example (6) would be difficult to justify.

At the same time, Example (6) raises two significant policy concerns with respect to nonrecognition treatment, both of which we believe can be adequately addressed:

[17] It is true that this asymmetry exists in section 351. That is, after the Revenue Reconciliation Act of 1989, section 351, which similarly prohibits loss recognition (section 351(b)(2)), taxes in full any debt securities received in the exchange, which previously could be received tax free. However, the rules applicable to section 351 transfers of property should be distinguished from the reorganization provisions, which for decades have contained an elaborate mechanism expressly designed to permit the tax-free exchange of securities in appropriate circumstances.

(i) Bond repurchase premium. Normally a taxable exchange of an appreciated security produces equal gain to the holder (taxable currently) and repurchase premium to the issuer (deductible currently under Reg. § 1.163-7(c) unless the new security's issue price is determined under section 1273(b)(4) or 1274). The existence of repurchase premium distinguishes security exchanges from stock exchanges, for which there is no corollary to repurchase premium. Hence the potential tax benefit to the issuer from repurchase premium must be considered in determining how to tax holders on exchanges of appreciated securities. If nonrecognition treatment is permitted for the holder in Example (6), the issuer should not be entitled to deduct repurchase premium currently. This is further discussed in IV.C.3 and IV.D below.

(ii) Avoiding cliff effect and minimizing complexity. As noted above, taxing the holder in Example (6) creates an undesirable cliff effect turning on Reg. § 1.1001-3. Similarly, any nonrecognition rule under section 356 should coordinate with the existing regime for taxing debt instruments so that minor adjustments to the terms of an exchange will not produce significant, irrational differences in tax treatment. For example, if a holder surrenders only stock and receives only securities, sections 354 and 356 do not apply, and the holder's gain is based entirely on Reg. § 1.1001-1(g).[18] The taxation of the debt received should not be significantly different under section 356 if the holder also surrenders $1 of securities or receives $1 of stock in the exchange. Therefore, to minimize complexity and potential taxpayer manipulation of three

[18] See footnote 6.

separate regimes (i.e., no realization event under section 1001, realization but no recognition under section 356, and realization and full recognition for transactions failing to qualify for section 356), any nonrecognition (or recognition) rule under section 356 should drafted in a way that produces results similar to an exchange that would be disregarded (or taken into account) under Reg. § 1.1001-3.

Example (7)--Appreciated traded OID debt surrendered for new traded debt with similar terms: A traded security is issued for $800 cash, pays 7% interest currently (less than a market rate at issuance), and has a $1,000 principal amount (and hence $200 of OID). Due to a decline in interest rates, the security's FMV increases to $1,000. The security is exchanged for a new traded security that pays 7% interest currently (then a market rate) and has a principal amount, issue price and FMV of $1,000. Thus the two securities have similar terms.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$800	$1,000
New security	$1,000	1,200	1,000

The holder's realized gain under Reg. § 1.1001-1(g) is $200. Therefore, if the exchange were fully taxable (as it would be under the excess issue price rule), (i) the holder would have $200 gain on retirement of the old security, (ii) the issuer would have $200 repurchase premium on retirement of the old security, deductible currently under Reg. § 1.163-7(c), and (iii) the OID on the old security would be eliminated.

In contrast, if nonrecognition treatment applied (as it would under the excess principal amount rule, literally applied), (i) the holder's $200 of realized gain would be deferred until sale or retirement of the new security (at which time the gain should be capital, since the market discount rules apparently would not apply[19]), (ii) the issuer still would have $200 repurchase premium on retirement of the old security, deductible currently under Reg. S 1.163-7(c), and (iii) the OID on the old security would be eliminated.

A third possible interpretation of the transaction is that, if the old and new securities are similar enough, their substitution might be disregarded as an insignificant modification under Reg. § 1.1001-3. In that case, the exchange would be disregarded for tax purposes, so that (i) there would be no tax consequences to the holder or issuer from the exchange, and (ii) old security's $800 AIP and $200 OID would carry over to the new security.

This example is like Example (6) in that the old and new securities are similar, so that the exchange has not increased the holder's debt position. For that reason, Example (7) is also a strong candidate for nonrecognition treatment.

The key difference between Examples (6) and (7) is the elimination of OID in Example (7). That is, unless the exchange is treated as a nonrecognition event in which the issue price of the new security is deemed to be $800 (rather than $1000) for OID purposes, the exchange will eliminate the $200 of unaccrued OID on the old security. It might be argued that nonrecognition is appropriate in Example (7) just as it is in Example (6). If in Example (7) the holder had sold the old security for $1000 in cash, $200 of immediate capital gain would be realized. If the result in Example (7) is <u>both</u> the avoidance of immediate capital gain <u>and</u> the conversion of future OID accruals into capital gain

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[19] <u>See</u> section 1278(a)(1)(D).

on the eventual repayment of the new security, the result is more favorable than the mere deferral of gain that generally arises from the continued holding of an asset. This result may therefore be unduly favorable to the holder.

Another concern in permitting nonrecognition treatment in Example (7) is the issuer's deduction for repurchase premium. As in Example (6), the issuer's deduction should be deferred to the extent the holder's gain on the exchange is deferred (see IV. C.3 and IV.D below). With that modification, however, we believe nonrecognition treatment should be permitted in Example (7) to the same extent it is permitted in Example (6), although a carryover of OID would not be inappropriate in this situation.

3. Discrepancy between section 1274 issue price and FMV. If the new security is not traded and is not issued for traded property, its issue price will be determined under section 1274, in which case there may be a disparity between its issue price and its FMV. This can result in undertaxation or overtaxation under Reg. § 1.1001-1(g) and/or the excess issue price rule.

For example, if the new debt's FMV exceeds its issue price, the excess issue price rule will not tax all gain that theoretically should be taxed. In Example (5), for instance, if none of the exchanged stock or securities were traded and the new debt had adequate stated interest, the new debt's issue price would be only $800 and no gain would be recognized, even though the holder is still in effect selling the stock for future above-market interest payments. However, the absence of taxable gain in this situation flows directly from the absence of realized gain under Reg. § 1.1001-1(g) (because the amount realized, namely the issue price of the new debt, is generally $800 under section 1274 regardless of its value).[20] Thus, no rule under section 356 could be expected to cause taxable gain in this situation, so the result should not be viewed as a flaw in adopting an excess issue price rule for section 356 purposes.

Conversely, if the new debt's section 1274 issue price exceeds its FMV, Reg. Sl.l00l-1(g) theoretically can overstate the holder's realized gain. This will occur, for example, if a subsequent holder purchases the old debt for less than its AIP (because the old debt has declined in value) and the old debt then is exchanged for new nontraded debt (e.g., in a workout or bankruptcy reorganization). The excess issue price rule, like the excess principal amount rule, has the virtue of avoiding this inappropriate result.

Example (8)--Depreciated nontraded debt is sold at a discount and then surrendered for new nontraded debt with similar terms; A nontraded security is issued for $1,000 cash, pays a market rate of interest, and has a $1,000 principal amount. The debt declines in value, and the initial holder sells it to a third party for $800, its FMV at the time. The old debt is then exchanged for a new nontraded security with similar terms. The new debt has a principal amount and issue price (under section 1274) of $1,000 and a FMV of $800.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$1,000	$800
New security	$1,000	1,000	800

The holder's realized gain is $200 under Reg. § 1.1001-1(g) (i.e., the new debt's $1,000 issue price less the holder's

[20] The issue price of the new debt, and thus the amount realized, would be $1000 if the new debt were issued in a “potentially abusive situation”, which includes a debt instrument with “clearly excessive interest”. See Reg. §§ 1.1274-2(b)(3),-3(a)(2). In that case, Reg. § 1.1001-1(g) and the excess issue price rule would correctly create taxable gain of $200.

$800 basis in the old debt). However, under the excess issue price rule, the holder would have no section 356 gain, because the new debt's issue price does not exceed the old debt's AIP. The same would be true under the existing excess principal amount rule. Any accrued market discount on the old debt should transfer to the new debt under section 1276(c)(2), and section 1276(d)(1)(B) should prevent any further gain recognition to the holder from the exchange.

The issue raised in Example (8) is similar to the taxation of appreciated securities discussed in IV.B.2 above. In both cases, the holder has realized gain because the issue price of the new debt exceeds the holder's basis in the old debt. Example (8) differs from the appreciated securities problem in two respects. First, Example (8) is a concern only if the old and new debt are nontraded, because if either were traded the new debt would have an issue price equal to its FMV. Second, the excess issue price rule avoids overtaxation in Example (8) by taking into account the old debt at its AIP rather than the holder's lower basis. We believe this result is appropriate for the reasons discussed in connection with Examples (6) and (7) and also is consistent with the nonrecognition treatment contemplated by sections 1276(c) and (d).

See also the discussion in V below.

C. Alternative #2: Excess Issue Price Rule with FMV Cap.

If as a policy matter it is desirable to permit nonrecognition treatment in Examples (6) and (7), theoretically this could be achieved by taxing the holder on the gain it would recognize under the excess issue price rule (i.e., the issue price of the new security less the AIP of the old security) only to the extent the new security's FMV exceeds the old security's FMV. The excess issue price rule taxes unrealized appreciation in Examples (6) and (7) because the old security's AIP does not reflect increases in the old security's FMV since issuance. Limiting gain recognition to the difference between the values of the securities at the time of the exchange would eliminate such appreciation from gain recognition, in a manner similar to the treatment of stock exchanged in a reorganization.

The excess issue price rule with FMV cap could be implemented by replacing the FMV rule and excess principal amount rule with a rule providing that recognized gain under section 356 is the excess of (i) the issue price of the new security under section 1273 or 1274 over (ii) the greater of the old security's AIP or its FMV.

This rule would achieve nonrecognition treatment in Examples (6) and (7). Moreover, it ensures that there is no recognized gain in Examples (2) and (4) (where an increased principal amount gives rise to inappropriate gain under a literal application of section 356). The rule also retains the result in existing section 356 that there is no recognized gain in Example (8) (which otherwise results in inappropriate gain under Reg. § 1.1001-1(g)). Finally, the rule ensures that there is not undertaxation in Examples (3) and (5) (where an unchanged principal amount avoids taxation under existing section 356, but where the new issue price exceeds the old AIP, and FMV is increased).

For purely debt-for-debt exchanges, the above rule could be simplified by a presumption that the FMV of the securities surrendered is equal to the FMV of the securities received, so that there would be no recognized gain under section 356.

1. Traded securities. For exchanges of traded securities, taking into account the old security at its "FMV" under the above rule seems workable because of the availability of quotations. Moreover, since the new security's issue price is its FMV under section 1273(b)(3), the rule would take into account both the old and new securities at their actual FMV.

2. Nontraded securities. Consider, however, how such a rule would apply to nontraded securities. The taxation of unrealized appreciation under the excess issue price rule can arise in an exchange of nontraded as well as traded securities, although the circumstances in which this will occur are more limited in the case of nontraded securities.

For example, the issue raised by Example (6) often will not arise in an exchange of nontraded securities:

Example (9)--Appreciated nontraded debt surrendered for new nontraded debt with similar terms: Same as Example (6), except that the old and new securities are not traded. In contrast to Example (6), the new security's issue price will be its $1,000 stated principal amount under section 1274 (assuming adequate stated interest) rather than its $1,200 FMV under section 1273.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$1,000	$1,200
New security	$1,000	1,000	1,200

In contrast to Example (6), here the new security's issue price and the old security's AIP are the same. Therefore, the excess issue price rule, the excess principal amount rule and a FMV-based rule all lead to the same result: no realized or recognized gain.

Example (9) illustrates that, because of the operation of section 1274, and in contrast to an exchange of appreciated traded debt for new equivalent debt, a similar exchange of appreciated nontraded debt will not be taxed to the holder provided that (i) the old debt was issued for its stated principal amount, (ii) the old and new debt have the same stated principal amount and (iii) the new debt has adequate stated interest. That is, the section 1274 issue price of the new debt ignores its actual FMV and thus ignores any unrealized appreciation in the old debt.

On the other hand, the issue raised by Example (7) can arise in exchanges of nontraded as well as traded securities:

Example (10)--Appreciated nontraded OID debt surrendered for new nontraded debt with similar terms: Same as Example (7), except that the old and new securities are not traded.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$800	$1,000
New security	$1,000	1,000	1,000

The analysis is identical to Example (7) except that, because the issue price of the new security is determined under section 1274, any repurchase premium on retirement of the old security is amortized by the issuer over the life of the new security (rather than deducted currently) under Reg. § 1.163-7(c).

Example (10) raises a difficult problem. To the extent nonrecognition treatment is permitted for Example (7), presumably the same rule should apply for Example (10), which differs only in that it concerns nontraded securities. If so, it would be necessary to create a nonrecognition rule that works for both traded and nontraded securities.

If the old and/or the new debt is nontraded, however, creating a FMV-based cap on recognized gain is complicated by the absence of a readily ascertainable FMV. In particular, it is difficult to create a value-based rule applicable to nontraded securities that minimizes abuse potential without undue complexity. A rule that simply limits recognized gain to the excess of the new security's FMV over the old security's FMV (such as the rule for traded securities described above) would grant taxpayers considerable latitude in valuing the transaction, which could create significant abuse potential. This concern could be alleviated by devising an objective formula for FMV, thus minimizing taxpayer discretion.

If the new security is not traded and is not issued for traded property, one possible surrogate for the new security's FMV is its section 1274 issue price. Although this may bear little relationship to the security's actual FMV, at least it is treated as such for Code purposes (e.g., it is now used to determine amount realized under Reg. § 1.1001-1(g)). Regarding the possibility of theoretical undertaxation because of the disparity between the new debt's section 1274 issue price and its actual FMV, see IV.B.3 above.

An objective surrogate for the old nontraded security's FMV is less obvious. The reason unrealized appreciation is taxed under the excess issue price rule is that the old security's AIP does not reflect the decline in market interest rates (and other changes in market conditions) that have boosted the old security's FMV since issuance. In Example (10), for instance, if the lower interest rates and other market conditions in effect when the new security was issued had been in effect when the old security was issued, presumably the old security would have been issued for $1,000 rather than $800. Conversely, if interest rates had not declined (and other market conditions had not changed) since the old security was issued, then (to the extent the AFR reflects market interest rates), the new security would have had an issue price of $800, not $l,000. In either case, there would have been no section 1001 gain.

With this in mind, the following refinement to the basic FMV rule described above could be considered. It consists of the excess issue price rule with a formula-based FMV cap: Recognized gain under section 356 would equal the excess of (i) the issue price of the new security over (ii) the greater of the old security's AIP or (A) if the old security is traded, its FMV on the exchange date (measured by its current or recent trading price), and (B) if the old security is not traded, its "recomputed AIP."

The old nontraded security's "recomputed AIP" would be its present value on the exchange date, determined by discounting all payments that would have been made after the exchange date under the old debt instrument pursuant to its terms, using a discount rate equal to the old debt's yield to maturity (as defined in Reg. § 1.1272-1) ("<u>YTM</u>") <u>minus</u> any decrease in the applicable federal rate ("<u>AFR</u>") from the old debt's original issue date to the exchange date.

Note that if the AFR has <u>declined</u> since the old debt's issue date, the reduced discount rate will cause the old debt's recomputed AIP to exceed its actual AIP. As a result, recognized gain will be less than that determined under the excess issue price rule. We believe this result is appropriate because the purpose of the FMV cap is to avoid gain when the new debt is not in fact worth more than the old debt.

On the other hand, under the proposed calculation of recomputed AIP, if the AFR has increased since the old debt's issue date, no adjustment to the discount rate is made. The result is that the basic excess issue price rule applies. If the discount rate for calculating recomputed AIP were instead increased to reflect the increased AFR, then (i) the recomputed AIP would be less than the actual AIP,[21] and (ii) the holder's recognized gain would exceed its gain as computed under the excess issue price rule. We do not believe the latter result would be appropriate.[22]

To illustrate the recomputed AIP concept, consider Examples (7) and (10), where the excess principal amount rule produces gain of $200. Theoretically, if recognized gain is to be limited to the excess of the new debt's FMV over the old debt's FMV, no gain should be recognized in either example. The above FMV cap achieves this result in Example (7) if the old debt trades at its FMV. Applying the above rule for nontraded securities to Example (10), the holder's recognized gain would be (i) the new debt's issue price ($1,000, assuming the 7% coupon constitutes adequate stated interest) minus (ii) the greater of

[21] That is, if future payments on the old debt were discounted to the exchange date at a discount rate equal to the old debt's YTM plus the increase in the AFR since issuance, the discounted present value of the old debt would be less than its actual AIP on the exchange date.

[22] We recognize that we are asymmetric in our willingness to increase but not decrease the AIP of the old debt, thereby sometimes reducing but never increasing the recognized gain that would arise under the basic excess issue price rule. The result necessarily follows, however, from our goals of avoiding inappropriate gain on a debt-for-debt exchange and at the same time limiting recognized gain to the amount determined for an initial holder under Reg. § 1.1001-1(g). Note also that section 356 is inherently asymmetric in the opposite direction, since it allows some gain but no losses to be recognized.

the old debt's AIP ($800) or its “recomputed AIP.” The old debt's recomputed AIP is the present value of the remaining payments under the old debt (consisting of the 7% coupon and $1,000 principal at maturity), determined using as a discount rate the old debt's YTM (which is somewhat greater than 7%) less any decrease in the AFR since the old debt was issued. If the AFR in fact decreased (which is likely, because 7% was below market when the old debt was issued but a market rate on the exchange date), then the old debt's recomputed AIP would be greater than $800. If the old debt's YTM less the AFR reduction does not exceed 7%, the old debt's recomputed AIP will be at least $1,000, and the holder will recognize no gain, consistent with Example (7). Otherwise, the old debt's recomputed AIP will be between $800 and $1,000, and the holder will recognize some gain.

The premise behind the recomputed AIP definition is that the old debt's YTM less any reduction in the AFR approximates a market yield for the old debt on the exchange date. If so, the present value (as of the exchange date) of future payments due under the old debt, using that yield as a discount rate, fairly approximates the old debt's FMV. The premise of course is somewhat crude. For example, the AFR only roughly tracks (and tends to be substantially lower than) actual market interest rates on corporate debt. Moreover, it does not take into account at all the credit condition of the issuer and other market conditions.[23] To the extent the old debt's YTM less the decline in the AFR is less than a market yield on the old debt as of the exchange date, the old debt's recomputed AIP will exceed its FMV, which in turn could undertax the holder. Conversely, if the old debt's YTM less the decline in the AFR exceeds a market yield on the exchange date, the old debt's recomputed AIP will be less than its FMV, which could overtax the holder.

However, the AFR is generally less than a market yield on corporate debt. Therefore, on balance, the decline in the old debt's actual market yield since issuance ought to exceed the decline in the AFR unless the issuer's credit position deteriorates.[24] If this is correct, the recomputed AIP determination should tend to understate (rather than overstate) the old debt's FMV and hence overtax (rather than undertax) the holder. Therefore, while imprecise, it may reasonably balance the goals of approximating FMV in a manner that is reasonably conservative and objective but not too complex.

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[23] By comparison, if the old debt's present value were determined using a discount rate equal to the new debt's YTM (rather than the old debt's YTM less any reduction in the AFR), the issuer's credit position as of the exchange date would be reflected to some extent. However, that approach would suffer from the serious drawback of not taking into account key differences between the old and new securities which could significantly affect value (degree of seniority/subordination, extent of security, etc.). For example, assume that $600 principal amount of deeply subordinated 12% debt worth $600 and zero basis stock worth $400 were surrendered for $1,000 face amount of senior 8% debt worth $1,000. The holder should have $400 of recognized gain (compare Example (4)). However, this would not occur if, for purposes of applying the FMV cap, the old debt's present value were computed by discounting its future payments at a rate equal to the senior debt's 8% YTM. So doing would overstate (substantially, if the old debt's remaining term were significant) the old debt's present value in relation to its $600 FMV, which would understate the holder's economic gain.

[24] If the issuer's credit deteriorates, the decline in the AFR could exceed the decline in the old debt's actual market yield; indeed, that yield might go up even if prevailing rates decline. If the issuer's credit improves, then the decline in the AFR would likely be smaller than the decline in the old debt's market yield.

For exchanges involving traded property, the FMV cap could be simplified along the lines of section 1273(b). For example, if old nontraded debt is exchanged for new debt and traded stock, the old debt could be deemed to have a recomputed AIP equal to the new debt's issue price plus the new stock's FMV (resulting in no recognized gain). Similarly, if old nontraded debt and traded stock are exchanged for new debt and traded stock, the old debt could be deemed to have a recomputed AIP equal to (i) the sum of the new debt's issue price and the new stock's FMV less (ii) the old stock's FMV.

The principal drawbacks of the above FMV cap on recognized gain are that (i) it relies on an imperfect substitute for FMV when applied to nontraded securities and (ii) it is more complex than the excess issue price rule (including for the reasons discussed in 3 immediately below). Nevertheless, to the extent nonrecognition treatment is appropriate in Examples (7) and (10), this approach would provides an objective framework fordetermining nonrecognition in connection with nontraded securities. Moreover, it is in the spirit of current section 356, which by its terms requires recognition only of the “fair market value” of any increased principal amount.

3. Bond repurchase premium; issue price. If a FMV cap of the above type were adopted, we would recommend an additional rule that reduces the issue price of the new debt (as determined under general principles) for all purposes of the Code by the amount by which the FMV cap would have reduced an initial holder's recognized gain.

Such a rule would address the concerns raised in connection with the discussion of Examples (6) and (7) in IV.B above:

First, to the extent the holder's section 1001 gain is deferred under a FMV cap of the type described above, the issuer should not be entitled to a current deduction for bond repurchase premium under Reg. § 1.163-7(c). For instance, in Examples (6), (7) and (10), in the absence of the suggested rule the issuer would obtain $200 of deductible bond repurchase premium under Reg. § 1.163-7(c) despite the holder's nonrecognition treatment. This would permit an issuer to trigger a bond repurchase premium deduction by changing the terms of the new debt just enough to create a deemed exchange under section 1001 while preserving nonrecognition treatment under the proposed cap.

Second, the FMV cap, in the absence of any other adjustment, would create complexity by causing the holder's section 358 basis in the new debt to be less than the new debt's issue price. Thus in Example (6), where both the old debt and the new debt have a FMV of $1,200, the FMV cap reduces the recognized gain from $200 (based on the excess issue price of the new debt) to $0 (based on the excess FMV of the new debt). A holder would have a substituted basis ($1,000 to an initial holder of old debt) in the new debt. Nevertheless, the issue price of the new debt would be $1,200 under general principles. This would give rise to needless complexity from the holder's point of view, including issuer tax reporting that would reflect the “phantom” premium. As a result, the issue price of the new debt should be reduced from $1,200 to $1,000, thus conforming the issue price to the holder's basis.

Third, in Example (7), reducing the new debt's issue price by the amount of the holder's deferred gain avoids the elimination of the holder's OID on the old debt.

D. Alternative #3: Excess Issue Price Rule with

Principal Amount Cap.

An alternative approach would again adopt the excess issue price rule as the basic rule, so that gain generally would be recognized to the extent that the issue price of the new security exceeded the AIP of the old security. However, in addition, to avoid gain recognition in the case of appreciated securities, there would be a cap on recognized gain equal to the excess of the stated principal amount of the new security over the stated principal amount of the old security. However, the cap would be available only if (i) the stated interest rate (as a percent of stated principal) of the new debt does not exceed the stated interest rate of the old debt, and (ii) the new debt does not materially defer or accelerate payments due under the old debt.

This proposal appears to give the desired answers in the examples. Because of the basic issue price rule, Examples (2) and (4) would not give rise to inappropriate gain, as they do under a literal application of existing section 356. Examples (6), (7) and (10) would not give rise to gain, despite the increase in issue price, because of the excess principal amount cap. Example (8) would not give rise to gain (as it would under Reg. § 1.1001-1(g)) because of both the excess issue price rule and the excess principal amount cap.[25]

[25] If this rule were adopted, we would not suggest a safe harbor providing nonrecognition for all purely debt-for-debt exchanges, as we did suggest in IV.C in the case of the rule providing for an FMV cap. Such a safe harbor is appropriate under the FMV cap, because by definition FMVs are the same when only debt is exchanged, regardless of the results under the formulas intended to approximate FMV. However, where the rule is in terms of issue prices and principal amounts, there is no conceptual basis to adopt an additional safe harbor applying a different test.

The limitations on the availability of the excess principal amount cap are necessary to prevent unduly taxpayer-favorable results. Example (3) illustrates the need for the prohibition on increases in stated interest rate to be eligible for the cap. In that example, zero coupon debt with an adjusted issue price (and FMV) of $600 and stated principal amount of $1000, along with stock with a basis of $0 and FMV of $400, were exchanged for debt with a principal amount, issue price and FMV of $1000. The excess issue price rule results in the correct taxable gain of $400, while the excess principal amount cap would result in no taxable gain. The correct result is reached if the cap is unavailable as a result of the increased stated interest rate (from 0% to 8%) on the new debt. Conceptually, the reason for prohibiting application of the excess principal amount cap when the stated interest rate increases is that an increase in stated interest is economically equivalent to an increase in principal amount of the new debt. If an increase in issue price combined with an increase in principal amount is to be taxable, an increase in issue price combined with an increase in stated interest payments (even without an increase in principal amount) should also be taxable.

The following examples illustrate how the excess principal amount cap could lead to unduly protaxpayer results (and hence should not be available) if the new debt materially defers payments (Example (11)) or materially accelerates payments (Example (12)).

> Example (11)--<u>Debt and appreciated stock surrendered for new traded OID security with longer maturity</u>: This is a variation of Example (5). A holder surrenders (1) stock with a basis of $0 and FMV of $200 and (2) current-interest- pay traded or nontraded debt with an above market interest rate but worth its face of $800 because it is about to mature or is callable, in exchange for (3) $800 face amount of 10-year noncallable traded debt having the same interest rate, which debt trades for $1,000 because of the above-market rate.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$800	$800	$800
New traded security	$800	1,000	1,000

Since the principal amounts are the same, the cap would prevent any gain recognition. This is the wrong result, because the stock in effect is being sold for above-market interest to be paid in the future. By disregarding the cap because of the extension of maturity, the excess issue price rule applies and gain of $200 is properly recognized.

Example (12)--OID debt and appreciated stock surrendered for new traded OID debt with shorter maturity: A holder surrenders (1) $100 of zero basis stock and traded or nontraded OID debt with a principal amount of $1,000 and an AIP and FMV of $800 for (2) new traded OID debt with the same principal amount and interest rate, but with an issue price and FMV of $900 because it has a shorter maturity.

	Principal Amount	Current (Adjusted) Issue Price	Current Fair Value
Old security	$1,000	$800	$800
New traded security	$1,000	900	900

The excess issue price rule would cause the $100 of stock gain to be taxed, which is appropriate since the holder is receiving only debt securities in the exchange. The principal amount cap would improperly shield this gain.

The limitation on the use of the principal amount cap is also harsh in that slight increases in the interest rate of the new debt as compared to the old debt, or material changes to the timing of payments, make the cap completely unavailable and can lead to the undesirable results in the examples when only the issue price rule is applied. However, the availability of the principal amount cap, even with its limitations, makes it possible for taxpayers to avoid unfair results from the unadorned issue price rule. As a result, given the need for some significant limitations on the principal amount cap to avoid unduly protaxpayer results, the proposed limitations on the availability of the cap appear to be a fair compromise.

The “excess issue price with principal amount cap” rule does not tax more than the gain that would be recognized under the excess issue price rule. Regarding the possibility of theoretical undertaxation under this rule when the new debt's issue price is determined under section 1274, see IV.B.3 above.

If a principal amount cap of the above type were adopted, the issue price of the new debt should be reduced for all purposes of the Code by the amount by which the cap would have reduced an initial holder's recognized gain. See the discussion of this issue in connection with the FMV cap at IV.C.3 above (where the analysis of Examples (6), (7) and (10) is the same for the principal amount cap).

The principal amount cap is clearly more complicated than the excess issue price rule without a cap. However, the complexity appears to be manageable, and the rule does provide the theoretically correct result more often than the uncapped excess issue price rule. Thus, this rule may provide a reasonable trade-off between accuracy and complexity.

V. FORM OF AMENDMENT

We recommend that any changes to the FMV rule and the excess principal amount rule along the lines discussed above be made by statutory amendment rather than by regulation. Conceivably section 356 could be changed to some extent by regulation. However, for the reasons discussed above, rationalizing this area requires changing both the excess principal amount rule and the FMV rule. In addition, if a cap on recognized gain is adopted, changes to the issue price of the new "capped" security and limitations on the issuer's deductions for bond premium are needed. We believe the modifications proposed in this report depart too widely from the existing statute to be undertaken by regulation. Even the most straightforward of those alternatives (the excess issue price rule discussed in IV.B above) was considered significant enough to warrant a statutory amendment both in the 1991 proposed legislation (discussed in IV.B.1 above) and in the context of a similar modification to section 312(a)(2) enacted in 1984.[26] The more complex alternatives involving the excess issue price rule with a cap (discussed in IV.C and IV.D) would be even less susceptible to regulatory implementation.

At the same time, we have some concern about basing statutory amendments to sections 354, 355 and 356 on regulations under section 1001 and 1012 (referring to "issue price") which themselves do not flow obviously from the statute (which refers to "fair market value"). In particular, as noted in a previous report, while we believe Reg. SI.1001-1(g) reaches the right result and is consistent with Congressional intent, some concern exists as to whether there is statutory authority to impose the "amount realized equals issue price" requirement on debt with an

[26] See sections 312(a)(2) and 312(o), amended by Section 61(c)(1) of the Tax Reform Act of 1984.

issue price determined under section 1274.[27] Similarly, some commentators have questioned whether Reg. § 1.1001-1(g) is effective, in light of the express fair market value rule in section 1001(b), to impose on cash method holders an “issue price” regime which formerly applied only to accrual method holders. Therefore, if sections 354 through 356 are to be amended, consideration should be given to amending sections 1001 and 1012 as well to incorporate expressly the “issue price” rule of Reg. § 1.1001-1(g) and § 1.1012-1(g).[28] Although we do not believe that amending sections 1001 and 1012 is necessary to effect any of the proposed modifications to sections 354-356, such amendments would remove any risk of inconsistency if these regulations later were changed or held invalid.

VI. COLLATERAL ISSUES

Other provisions of the Code and regulations should be updated to reflect the recent amendments to the section 1001 regulations and other recent developments relating to issue price. In particular, Reg. § 15A.453-1(d)(2) treats a holder that elects out of the installment method as receiving property “in an amount equal to the fair market value of the installment obligation”. Likewise, Reg. § 15A.453-1(e)(2) provides that if a debt instrument is treated as payment because it is payable on

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[27] See NYSBA Tax Section, “Report on Proposed Original Issue Discount Regulations” (July 1, 1993) at VI.A. See also the discussion in IV.B.3 above.

[28] However, some aspects of Reg. § 1.1001-1(g) should be revisited before the provision is codified. For example, as illustrated by Example (8), if a creditor buys nontraded debt at a discount and subsequently negotiates a workout (which may even include a writedown), Reg. S 1.1001-1(g) can create realized gain, even though as a practical matter there has been no real change in the creditor's position. Nonrecognition under section 356 would not be available if, for example, the issuer was not a corporation. For this and related issues, see NYSBA Tax Section, “Report on Proposed Regulation § 1.1001-3 Relating to Modification of Debt Instruments” (January 20, 1994).

demand or readily tradable, the amount realized is (i) the debt's FMV for a cash method holder and (ii) its stated redemption price less amounts representing interest for an accrual method holder. Both of these provisions are obviously inconsistent with the determination of “amount realized” to the holder under new Reg. § 1.1001-1(g).

Finally, for purposes of computing installment sale gain, proposed regulations provide that the holder's “selling price” is based on the face amount of the note (reduced by any portion of the face amount characterized as interest under section 483 or the OID rules).[29] It would seem that the selling price should be the amount realized as defined under the section 1001 regulations.

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[29] See Prop. Reg. § 1.453-1(f)(2),(f)(1)(iii).