

TAX SECTION

New York State Bar Association

Report on Proposed Original Issue Discount
Regulations Concerning the Treatment of
Contingent Debt Instruments

May 11, 1995

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May 15, 1995

FEDERAL EXPRESS

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Proposed Regulations Regarding
Contingent Payment Debt Instruments

Dear Secretary Samuels:

I am pleased to enclose a report of the Tax Section's Committee on Financial Instruments on Proposed Treasury Regulations sections 1.1275-4 and 1.1275- 6. David P. Hariton was the principal draftsman of the report.

As set forth in the report, we have a number of serious concerns about the approach taken by the Proposed Regulations. We are concerned about the implications such regulations may have for the general classification of an instrument as debt or non-debt; we are concerned about the tax arbitrage potential inherent in permitting the current accrual of contingent interest; and we are concerned that the proposed methods for projecting contingent interest present opportunities for tax abuse. Our concerns are heightened by our awareness that a large portion

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of debt instruments is held by tax-exempt holders (including foreign holders), with the result that overstated or accelerated interest deductions will not be effectively countered by income inclusions to taxable holders.

Because of these concerns, we believe that the rate of interest accrual on contingent payment debt instruments should not be based on price quotes or on issuers' projections of contingent interest. Instead, we recommend that the "Base Accrual Rate" be determined objectively, by reference to the issuer's all-in cost of capital (where the issuer is fully hedged), the current yield on comparable debt of the issuer (where available), or the applicable federal rate. We believe these same rules should apply both to debt with so called "quotable" payments, and to debt with "nonquotable" payments.

While we strongly recommend the foregoing modifications to the rules governing the rate of accrual of interest on contingent payment debt instruments, we do support the fundamental decision in the Proposed Regulations to accrue interest on the entire issue price of a debt instrument, rather than bifurcating the instrument and treating only a portion as debt. Furthermore, we believe that adopting our recommended approach will still require the retention of much of the substance of the Proposed Regulations, particularly those portions that govern the adjustments that must be made to coordinate the accrual of projected interest under the regulations with the actual resolution of the contingencies.

The report recommends a number of technical revisions to the Proposed Regulations, which are summarized at pages 27-37. These recommendations include comments on the interaction between these Proposed Regulations and Code §988; on the proper characterization of income from net negative adjustments; on the treatment of contingent debt issued for non-publicly traded property; on the treatment of tax exempt instruments; and on transitional issues. We trust you will find these comments helpful.

Please do not hesitate to contact me if we can be of any further assistance in this area. As we note at the beginning of our report, the treatment of contingent interest raises very difficult questions.

We commend Treasury and the Internal Revenue Service for undertaking to address this difficult area, and for the fine effort and careful thought the Proposed Regulations reflect.

Very truly yours,

Carolyn Joy Lee
Chair

cc: Hon. Margaret Richardson
Commissioner
Internal Revenue Service
Room 3000
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Washington, DC 20224

New York State Bar Association Tax Section
Report on Proposed Original Issue Discount
Regulations Concerning the Treatment of
Contingent Debt Instruments*

* This report was prepared by Charles Adelman, Micah Bloomfield, Douglas Borisky, Dan Breen, Peter Cobb, Sam Dimon, David Garlock, Ken Goldberg, David Hariton, Bruce Kayle, Kenneth Koen, Carolyn Lee, Lisa Levy, David Miller, Michael Mollerus, Charles Morgan, Michael Mundaca, John Narducci, Linda D'Onofrio, Deborah Paul, Mindy Piatoff, David Rievman, Robert Scarborough, Daniel Shefter, Po Sit, Nicole Tanguy and W. Kirk Wallace. David Hariton was the principal draftsman.

Helpful comments were received from Dickson Brown, John Corry, Stuart Goldring, Gordon Henderson, Charles Kingson, Stephen Land, Richard Loengard, Richard Reinhold, Michael Schler, Steven Todrys and Lary Wolf. May 11, 1995

May 11, 1995

I. Introduction -- Commentary on the General Approach^{1/}

Proposed Treasury Regulation sections 1.1275-4^{2/} and 1.1275-61^{3/} (the "Proposed Regulations") set out rules for the accrual of interest on certain debt instruments with payments which may vary in amount ("contingent debt instruments"). The regulations are issued under the authority of section 1275(d) of the Internal Revenue Code (the "Code"), which directs the Department of the Treasury, including the Internal Revenue Service (hereafter, the "Treasury"), to issue regulations to modify the treatment of such instruments to the extent appropriate to "carry out the purposes" of sections 1271 through 1275 of the Code.

The contingent payment debt regulations represent a valiant effort to impose some order on an exceedingly difficult area. There are no straightforward solutions to the myriad problems raised by contingent payment debt, nor are there any wholly satisfying solutions. We recognize the difficulty of balancing financial accuracy against systemic complexity, particularly in an area in which the underlying economic

^{1/} This report was prepared by the Committee on Financial Instruments, with substantial contributions from Charles Adelman, Micah Bloomfield, Douglas Borisky, Dan Breen, Peter Cobb, Sam Dimon, David Garlock, Ken Goldberg, David Hariton, Bruce Kayle, Kenneth Koen, Carolyn Lee, David Miller, Michael Mollerus, Charles Morgan, Michael Mundaca, John Narducci, Linda D'Onofrio, Deborah Paul, Mindy Piatoff, David Rievman, Robert Scarborough, Daniel Shefter, Po Sit, Nicole Tanguy and W. Kirk Wallace. David Hariton was the principal draftsman.

Helpful comments were received from Dickson Brown, John Corry, Stuart Goldring, Gordon Henderson, Charles Kingson, Stephen Land, Richard Loengard, Richard Reinhold, Michael Schler, Steven Todrys and Lary Wolf.

^{2/} 59 Fed. Reg. 64893 (Dec. 16, 1994).

^{3/} 59 Fed. Reg. 64905 (Dec. 16, 1994).

arrangements are continually in flux. We commend the Treasury for the efforts reflected in the Proposed Regulations.

We do, however, have a number of serious concerns about the approach taken by the Proposed Regulations. First, we believe that the introduction of this kind of elaborate and comprehensive regime for the imputation of interest on instruments that include contingent payments of interest and/or principal necessarily puts considerable new pressure on the distinctions between debt and non-debt. Whatever caveats the final regulations may include, and however carefully they are drafted to avoid implications as to the classification of highly contingent instruments as debt, we think it inevitable that the presence of this kind of regulation lends credence to taxpayers' assertions that even highly contingent instruments are debt instruments, and that contingent payments thereon are deductible payments of interest. The promulgation of regulations in this area carries the implication that the Treasury considers such instruments to be debt, and it seems likely this blessing will be interpreted more broadly than the Treasury might have intended. This is not to say that regulations should never be promulgated in this area. However, in doing so the Treasury should be aware that such regulations inevitably will provide support for the classification of contingent instruments as debt that goes beyond existing authorities, and the Treasury should consider the collateral effects of the regulations on fundamental "debt/non-debt" issues.

Second, we are concerned that finalization of the Proposed Regulations will make it easier for taxpayers to arbitrage the tax system by debt financing appreciating assets. For example, consider a taxpayer who owns an asset that is appreciating in value but that generates no current taxable income. Under the Proposed Regulations, the taxpayer can borrow

against the asset by issuing debt bearing interest that is contingent upon the future value of the asset, and can currently deduct the interest based on estimations of the amount of interest that will ultimately be paid, even though the taxpayer does not currently recognize income based on estimations of the amount of income or gain that will ultimately be generated by the asset. We recognize that current law permits taxpayers to take deductions for interest expense on fixed-rate zero coupon debt that finances appreciating assets that produce little or no current income. Likewise, we recognize that current law grants taxpayers a deduction for interest that is paid currently notwithstanding that the amount of the interest varies with the value or performance of the issuer's assets.^{4/} In both of these cases, however, the borrower has either committed to pay or actually paid the interest allowed as a deduction; the financial pressures inherent in making such a commitment or payment limit the attractiveness of such financing as a means of achieving tax arbitrage. By contrast, when the proposed Regulations are finalized, issuers will for the first time be permitted to accrue current interest deductions for amounts that they are not yet obligated to pay, while deferring realization of the economically offsetting gains.

Integration of substantially hedged positions may limit the potential for this tax arbitrage to some extent, and in some other cases the Treasury might invoke the "straddle rules" and section 263(g) of the Code to defer current interest deductions. It is probably not practical to require integration in most cases, however, and the straddle rules and section 263(g) have

^{4/} Such an instrument does not qualify as a variable rate debt instrument under current regulations, but this generally does not result in deferral of interest deductions so long as the instrument promises a return of principal substantially equal to its issue price.

limited application.^{5/} Accordingly, at some point the Treasury will have to accept the timing mismatch that is a consequence of its decision to permit current deductions for the projected amount of deferred contingent payments. We recognize, of course, that this problem is not peculiar to the non-contingent bond approach adopted by the Proposed Regulations, but would accompany adoption of any current accrual approach, including the one recommended in our 1993 report.^{6/}

Third, we are very concerned that the Proposed Regulations' reliance on dealer price quotations and on taxpayer-generated projections where quotes are not available presents a substantial opportunity for tax abuse. The treatment of debt instruments providing solely for "quotable" contingent payments appears at first to constrain the projection of contingent interest by tying such projections to market estimations of the contingencies. As discussed more fully in Part III below, however, we believe that the quotes which taxpayers will be able to obtain will in practice be influenced by many factors, and will not serve as reliable bases for projecting future interest payments. Furthermore, we are very concerned about the basic approach of the Proposed Regulations in the "non-quotable" area. A system that permits the accrual of deductions for amounts that

^{5/} For example, debt and business property purchased with the proceeds of issuance of the debt do not form a straddle because the business property is not of a type which is actively traded. Even where debt is issued to finance actively traded property and the debt and the property constitute a straddle, moreover, it is arguable that section 263(g) does not apply unless the proceeds of the debt are used to acquire the property or the property serves as collateral for the loan. Cf. Rev. Proc. 72-18, 1972-1 C.B. 740, although authority under section 265 of the Code does not necessarily reflect the policy objectives or proper interpretation of section 263(g).

^{6/} See New York State Bar Association, Tax Section, Report on the Proposed Original Issue Discount Regulations (July 1, 1993). See also New York State Bar Association, Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations (Jan. 29, 1987), 34 Tax Notes 363 (Jan. 26, 1987).

are neither owed nor paid based solely on taxpayers' subjective determinations of what constitutes a "reasonable rate of accrual" under the facts and circumstances (including the variability of the payments), and that directs taxpayers to construct payment schedules based on "reasonable projections" of contingent amounts, is fraught with opportunities for abuse.

The foregoing concerns are heightened by our concern that holders will not in fact serve as an effective check on issuers' overstatement or acceleration of interest projections on contingent debt instruments. Where a contingent payment debt instrument is held by, or could be transferred to, non-taxable persons (including tax-exempt entities, foreigners eligible for the portfolio interest exemption and foreign parties relying on treaties), the usual tension between a payor's desire to accelerate deductions and a payee's desire to defer income will not exist. In these cases, the government will suffer a clear revenue loss from the inappropriate acceleration of interest. While we have no statistics on the matter, we believe that instruments that require the accrual of income sooner than when the right to income is fixed will likely be held in relatively large proportions by tax-exempt entities, non-U.S. persons and other persons not generally subject to U.S. tax. We therefore believe that the potential for overstatement or acceleration of interest should be a real concern in evaluating the approach of the Proposed Regulations.

Because of these concerns, we strongly urge that the Treasury not adopt regulations that permit the timing of interest accruals to be based primarily on price quotes and subjective taxpayer projections. That said, we recognize the difficulty of devising any completely satisfactory method of accounting for contingent interest. The "all-events test" (often referred to as

the "wait and see" approach) has the merit of postponing the recognition of interest income and expense until the fact and amount of the payment are established. This avoids the need for complex adjustment methodologies, and has common sense appeal in that contingencies are not taken into account until they are resolved. The "all-events test" does, however, permit lenders to defer income, and instruments have been structured to take advantage of that deferral potential by providing for contingencies that, while real, arguably are not of the sort that justify the deferral of interest income on the debt. Moreover, the taxation of hybrid debt instruments under the all-events test is inconsistent with the taxation of economically equivalent investment units consisting of debt plus a forward or option contract, and with developing rules for the taxation of financial instruments that are designed to separate out and accrue interest on embedded loans (e.g., Treasury Regulation section 1.446-3(g)(4) governing the treatment of certain notional principal contracts). Accordingly, while use of the "all-events test" in this context has merit, we think that some kind of current interest imputation scheme is warranted, particularly in the case of interest, which is so inexorably tied to the passage of time.

II. Rate of Interest Accrual -- Background

The Proposed Regulations effectively adopt a "deconstruction approach" for purposes of determining the timing, but not the character, of income from unhedged contingent debt instruments, i.e., they "deconstruct" the instrument into a non-contingent debt instrument and an agreement to exchange fixed amounts for variable amounts. Deconstruction, as manifested in the Proposed Regulations, is to be distinguished from "bifurcation." The principal difference is that under

deconstruction, interest accrues on the entire issue price of the bond.

Consider a five-year stock-indexed zero-coupon note which is issued for \$1,000 and promises \$1,000 plus a contingent additional amount at maturity. Under bifurcation, this instrument is bifurcated, for example, into (a) a fixed zero-coupon note under which the holder pays \$700 at issuance and receives \$1,000 at maturity, and (b) a cash-settlement option under which the holder pays \$300 at issuance and receives an indeterminate amount at maturity. Under bifurcation, therefore, \$300 of interest (\$1,000 - \$700) accrues over the life of the bond. Under deconstruction, however, this instrument is deconstructed, for example, into (a) a fixed zero-coupon note under which the holder pays \$1,000 at issuance and receives \$1,500 at maturity, and (b) a bilateral contract under which the holder agrees to pay the issuer \$500 at maturity and receives in exchange an indeterminate amount. Under deconstruction, therefore, \$500 of interest (\$1,500 - \$1,000) accrues over the life of the bond.

Deconstruction is a somewhat greater transgression than bifurcation against the all-events test of accrual basis accounting.^{2/} We believe, however, that the authority conferred

^{2/} Treasury's authority to require the accrual of original issue discount ("OID") (i.e., to require the accrual of interest income prior to the receipt of cash) is partly by analogy to United States v. Midland-Ross, 381 U.S. 54 (1965), wherein the Supreme Court mandated the treatment as interest of a "fixed excess" of stated redemption price over issue price. Sections 1271 through 1275 of the Code of course require current accrual of such a fixed excess as interest income. Under deconstruction, the holder of the note described above is treated as though the holder were certain to receive \$1,500, and interest accrues accordingly, even though the holder may never receive more than \$1,000. While the same may be said to a lesser extent of bifurcation, accrual under bifurcation is arguably based on the certainty that the issuer will receive \$1,000, rather than on a hypothetical receipt of \$1,500. Given that accrual under bifurcation requires the artificial removal from the instrument of part of the instrument's issue price, however, the distinction between the two is somewhat elusive in this regard.

upon the Treasury by section 1275(d) of the Code is sufficiently broad to permit the Treasury to adopt either bifurcation or deconstruction as an approach to the treatment of contingent debt instruments. Moreover, both bifurcation and deconstruction are consistent with the tax treatment of some, and inconsistent with the tax treatment of other, economically equivalent investments.^{8/}

The tax treatment of an instrument under bifurcation resembles the tax treatment of an economically equivalent investment unit consisting of non-contingent debt plus a long-term option, with the implicit result that interest does not accrue on the portion of the instrument treated as the premium for a long-term option. This result is arguably out of step with evolving principles of federal income taxation. A taxpayer paying for a long-term option is permitting the recipient to use its capital for a period of time and is exposed to the risk that the recipient will default on its obligations. Such a taxpayer is presumably receiving compensation for the use of its capital. The Treasury has already issued guidance treating certain payments under notional principal contracts as embedded loans,^{9/} and we understand that it has a project underway to treat certain prepayments of forward contracts and premiums paid for in-the-money options as embedded loans. Accrual of interest on less than the full issue price of a contingent debt instrument solely to maintain parity with the treatment of long-term options,

^{8/} The treatment of the stock-indexed note described above under bifurcation is equivalent to the treatment of a zero-coupon debt instrument purchased for \$700 and a cash-settlement option purchased for \$300, while the treatment under deconstruction is equivalent to a zero-coupon debt instrument purchased for \$1,000 and a forward contract to exchange \$500 of the \$1,500 for a variable payment.

^{9/} Treas. Reg. § 1.446-3(g)(4).

therefore, would seem a step backwards from the evolving principles of taxation of financial instruments.

Deconstruction also has advantages over bifurcation in that it is more easily applied where a contingency may cause the payment at maturity to go down as well as up.^{10/} In light of the foregoing, we support the adoption of deconstruction over bifurcation as a general approach to current interest accrual.^{11/}

One principal objection to deconstruction is that holders may accrue interest income which they ultimately do not receive, and upon subsequent sale or redemption, recognize an offsetting capital loss which generally cannot be used to offset the interest income.^{12/} Primarily in response to this objection, the Proposed Regulations do not apply the deconstruction approach in determining the character of income from the instrument. Rather, while interest generally accrues under the Proposed Regulations at a rate equal to the rate on comparable non-contingent debt, gains and losses on bilateral derivative contracts embedded within the instrument are generally treated as increases or decreases in interest accrual when they are realized. It does not follow, however, that the Treasury should

^{10/} Bifurcation cannot be applied in such a case, because there are no fixed payments to apportion to the non-contingent portion of the instrument. Thus, bifurcation cannot be applied to instruments with embedded forward contracts or embedded issuer options.

^{11/} Taxpayers have independently suggested that a deconstruction approach might be applied to financial instruments that will be mandatorily exchanged, after a period of time, into stock of a company unrelated to the issuer. See, e.g., American Express Co.'s issuance of Debt Exchangeable for Common Stock described in a prospectus dated October 7, 1993 ("DECS"); and Salomon Inc.'s issuance of 6.750% Digital Equipment Corp. Common Equity-Linked Securities described in a prospectus supplement dated July 26, 1993 ("ELKS").

^{12/} Under both bifurcation and deconstruction, interest accrues at a rate equal to the rate on comparable non-contingent debt of the same issuer, and any gain or loss apart from this accrual is generally capital gain or loss. See, e.g., sections 1271(a) (1) and 1234A of the Code.

adopt an approach to the treatment of contingent debt under which interest accrues not at a rate equal to the rate on comparable non-contingent debt, but rather at a rate which reflects the greater anticipated yield associated with higher beta risk and variability of return. We believe, for reasons discussed in III below, that such an approach would be exceedingly difficult to administer and enforce.

III. Rate of Accrual -- The Non-Contingent Bond Method

A. Overview of the "Non-Contingent Bond Method"

The Proposed Regulations adopt the so-called "non-contingent bond method" of accruing interest on contingent debt. Under the Proposed Regulations, the issuer of a contingent payment debt instrument must construct a "projected payment schedule" for the instrument. Interest initially accrues on the debt instrument in an amount equal to the interest that would accrue on a non-contingent debt instrument providing for the projected payments (the "hypothetical non-contingent bond") under the general OID rules of sections 1272 and 1273 of the Code, and the regulations thereunder. Subsequent adjustments to interest accrual are made to account for differences between projected and actual payments. An issuer must disclose the projected payment schedule to the holders of its contingent debt instrument, and all holders are bound by the issuer's projected payment schedule unless the schedule is unreasonable.

The method for projecting the amount of each contingent payment depends upon whether the payment is "quotable" or "non-quotable." A payment is a quotable contingent payment if it "is substantially similar to a property right for which forward price

quotes are readily available.”^{13/} The projected amount of a quotable contingent payment is equal to the quoted forward price of the property right. If a quotable contingent payment is substantially similar to an option, and no forward price for such option is available but a “spot price” is readily available, the projected amount of such quotable contingent payment is the spot price of such option, increased by compounding at the applicable federal rate from the issue date to the exercise date of the option.^{14/}

If a contingent debt instrument provides for one or more “non-quotable” contingent payments, the issuer must first determine a “reasonable rate” at which interest should accrue on the instrument, based on a variety of factors including (i) the credit quality of the issuer, (ii) general market conditions, and (iii) the terms and conditions of the debt instrument, including the terms of the embedded (quotable and/or non-quotable) contingent property rights.^{15/} The reasonable rate may never be less than the lower of (i) the applicable federal rate or (ii) the yield on the debt instrument absent the non-quotable contingent payments.^{16/} A projected amount for each non-quotable contingent payment is then selected such that the yield to maturity of the resulting hypothetical non-contingent bond equals the reasonable rate of accrual. The amounts selected for the non-quotable contingent payments must reasonably reflect the relative expected values of the non-quotable contingent payments.

^{13/} Prop. Treas. Reg. § 1.1275-4(b)(4)(i)(A).

^{14/} Prop. Treas. Reg. § 1.1275-4(b)(4)(i)(D).

^{15/} Prop. Treas. Reg. § 1.1275-4(b)(4)(ii).

^{16/} Id.

B. Principal Recommendation Regarding the Base Rate of Accrual
1. Debt Providing for "Quotable" Contingent Payments

We understand that, at least in the case of a debt instrument providing solely for "quotable" contingent payments, the required rate of accrual of interest (the "Base Accrual Rate") is, under the Proposed Regulation, intended to result in the current accrual of interest (until the relevant contingencies are resolved) at a rate equal to the rate at which interest would accrue on comparable non-contingent debt. In general, we understand the assumption to be that forward prices quoted by dealers for embedded property rights will reflect what it would cost the dealer to borrow money and purchase the relevant property, taking account of the fact that the dealer will pay interest on the borrowing and earn income from the property until the property is effectively delivered on the forward date. Meanwhile, the actual issue price of the contingent debt instrument will reflect the risk that the issuer may default on its promise to make the contingent payments. Thus, once "objective" (rather than issuer-specific) forward price quotes set the stated redemption price of the comparable non-contingent bond, the actual (i.e., issuer specific) issue price will cause interest to accrue on the comparable non-contingent bond at the issuer's true cost of capital on non-contingent debt.^{17/}

The assumption described above may be accurate as a matter of theory, but our experience indicates that as a practical matter this approach is in most cases unlikely to result in accurate Base Accrual Rates. Rather, for the reasons discussed below, we believe that reliance on dealer price quotes

^{17/} See Appendix A for a further explanation of why the forward price quote will be less than the expected future value of the property and why the Base Accrual Rate should therefore not, in theory, reflect any "risk premium" for the anticipated variation in the value of the property.

to determine Base Accrual Rates is likely to result in substantial inaccuracy, uncertainty and abuse. We accept the non-contingent bond approach insofar as the approach requires construction of a projected payment schedule. Construction of a projected payment schedule will be necessary in any case where a debt instrument provides for more than one contingent payment, and dealer price quotes, to the extent they are available, may serve as a reasonable basis for assigning relative values to multiple projected contingent payments. We see no reason, however, to rely on such quotes to determine the overall rate at which interest accrues on the hypothetical non-contingent bond. We emphasize that the following comments on the reliability of dealer price quotes as a basis for a tax accrual stem largely from our observations of markets and transactions with which we have some familiarity and do not reflect particular market expertise. They do reflect discussions which we have had, however, with various professionals employed in the financial services community. Our impressions could be mistaken, but at this point our experience leads us to believe that reliance on dealer price quotes is misplaced.

First, we believe that a dealer cannot offer a forward price quote for an embedded property right without estimating the amount of income the property is likely to generate between the issue date and the forward date. This, as we understand it, is a subjective estimation (e.g., how much will IBM pay in dividends over the next 10 years?) which can lead to wide variations in forward price quotes. Moreover, a dealer cannot offer a forward (or spot) price quote for an option, embedded or otherwise, without estimating the likely volatility of the underlying property, as well as the income from the property, between the issue date and the option exercise date. Estimation of such

volatility is an even more subjective exercise that is likely to result in even wider variations in quoted prices.

In the case of many relatively short-term option and forward contracts, active trading determines their market prices. There is, of course, a relationship between these prices and such factors as the anticipated income from, and anticipated volatility of, the underlying property. It is our belief, however, that trading prices imply what the market anticipates regarding future income and volatility. Thus, assumptions about income or volatility which may be relatively easy to make in pricing short-term option and forward contracts become sheer conjecture in pricing long-term contracts. We do not believe that such speculation and conjectures, randomly obtained from whichever dealers are consulted, can serve as an accurate, equitable or effective means of assessing federal income tax.

Second, we observe that the model for accrual based on "objective" price quotes results, as a matter of theory, in accrual at the rate of comparable non-contingent debt only if the options dealer from whom a price quote is sought is a risk-free credit. In practice, however, the spot price which an options dealer will quote for an embedded long-term option will reflect the fact that the purchaser will require some discount for the risk that the options dealer will default on its obligation to make a future payment. The resulting projected payments under the instrument will therefore be lower than they would be if obtained from a risk-free credit, and these projected payments will result in under-accrual of interest on the instrument. For example, assume that a willing buyer would pay a AAA-rated options dealer \$1,000 today in exchange for the right to receive a specified contingent payment in five years, but that a willing buyer would pay an A-rated dealer only \$900 for the same right. If the issuer obtains a price quote from the A-rated dealer, rather than from

the AAA-rated dealer, less interest will accrue on the instrument, because the projected payment at maturity of the instrument will be smaller. See Appendix A for a further explanation.

In light of the above, we believe it would be simpler, and far more accurate, to define the Base Accrual Rate as follows:

1. In most cases where an instrument provides for payments based on the value of publicly traded property, the actual rate of interest incurred by the issuer will be readily apparent, for the issuer of the instrument will be fully hedged and will have an all-in cost of capital for the borrowing. In such cases the Base Accrual Rate should be the issuer's all-in cost of capital, as evidenced by the net cash flows under the transactions as a whole, including the hedge.

2. Where the issuer is not fully hedged, issuers of such instruments will sometimes have issued comparable non-contingent debt which is publicly traded in the marketplace. The current yield on such comparable debt should provide a relatively accurate measure of the rate at which the issuer can borrow on comparable non-contingent debt (or in any event, a far more accurate measure than one obtained through reliance on dealer price quotes). In these circumstances, the Base Accrual Rate should be the rate at which the issuer can borrow on comparable non-contingent debt, as evidenced by the yield on the other comparable debt.

3. In cases involving unhedged issuances of contingent debt by issuers who do not have outstanding comparable publicly-traded non-contingent debt, we believe that the Base Accrual Rate

should be the applicable federal rate, or a rate based on the applicable federal rate (either rate being hereinafter referred to as the "AFR"). We think the AFR strikes an appropriate balance between the need for a current accrual mechanism and the concern that such a mechanism not overly accelerate the accrual of interest deductions. We see no reason why issuers of unhedged instruments should be entitled to accrue and deduct interest at a rate higher than the AFR, on the basis of price quotations or otherwise. Furthermore, we do not believe that permitting holders to accrue at the AFR would deprive the fisc of revenue, compared to the current-law alternative of permitting holders to defer interest completely under the all-events test. Moreover, unhedged instruments often provide for multiple contingent payments based on factors that are not measurable at the time of issuance. It seems unlikely in such a case that a more accurate Base Accrual Rate could be obtained by directing issuers to seek "objective" price quotations for each of the projected payments under the instrument.

We have no specific recommendation regarding where to draw the line between choosing a Base Accrual Rate based on the issuer's true cost of capital, as evidenced by other publicly-traded debt, and choosing instead the AFR. We think the line could reasonably be drawn, however.^{18/} Moreover, we are comfortable with accrual at the AFR in a broad range of cases. An AFR-based accrual rate has been increasingly relied on as a reasonable measure of interest in cases where the terms of the instrument are not adequate to measure interest more accurately (e.g., Code sections 1274, 7872, 483, etc.). We believe it would be appropriate and efficient to use the AFR as a basis for

^{18/} We note in this regard the rule of Treas. Reg. § 1.1273-2(f) (5) (ii)(D), which draws a line between publicly- and privately-traded debt based on whether comparable publicly-traded debt matures within 3 years of the issue in question.

imputing interest accruals on contingent payment debt instruments, and clearly more appropriate and efficient than looking to independent price quotes or deriving reasonable yields based on all the facts and circumstances.^{19/}

If the yield taking into account only the non-contingent payments (the "non-contingent yield") exceeds the Base Accrual Rate as computed under the foregoing principles, the issuer and holder should accrue at the non-contingent yield. In other words, the rate of interest should be the greater of the non-contingent yield or the Base Accrual Rate. In the case of convertible debt, a special rule seems warranted, inasmuch as the fixed yield on convertible debt may well be less than the AFR. We are concerned that permitting issuers of such debt to accrue interest at the AFR, or at a rate based on the AFR, simply by providing for a small additional contingent payment might permit issuers to deduct more interest than they could deduct on an otherwise non-contingent debt instrument. We therefore recommend consideration of a rule limiting interest accruals on convertible debt to the non-contingent yield on the debt under some set of appropriate circumstances.

Finally, we reiterate that our recommendation is not a rejection of the non-contingent bond approach. We generally support the Treasury in its decision to deal with instruments providing for more than one contingent payment by constructing a

^{19/} There is one case where accrual at the AFR may produce counterintuitive results: the case where an instrument provides for fixed payments of interest at a market rate but has contingent principal (which principal, given the market rate of interest, is presumably expected to approximate the issue price of the instrument). Assuming that the instrument is debt, recharacterization of fixed market-rate interest because it does not equal the AFR seems an awkward way to address the contingency of the principal. We believe that an adequate exception could be developed to deal with this case, however. See, e.g., the 1993 NYSBA Report, Part VII-E, 61 Tax Notes 1241, 1257 (Dec. 6, 1993).

payment schedule, rather than by introducing more complex payment characterization rules. If our recommendation is adopted, much of the substance of the Proposed Regulations will remain intact. The difference is that any projected payment schedule will be required to result in an aggregate yield to maturity which equals a Base Accrual Rate that does not rely on price quotes or subjective judgments. While price quotes may determine the relative amounts of the payments under an instrument providing for more than one contingent payment, the resulting projections will all be increased or decreased to result in an aggregate yield which equals the Base Accrual Rate.

2. Debt Providing for Non-Quotable Contingent Payments

The Proposed Regulations imply that in the case of a debt instrument providing for contingent payments which do not vary with the value of publicly traded property ("non-quotable instruments"), the Base Accrual Rate should not be the rate of accrual on comparable non-contingent debt of the issuer, but rather a higher rate that reflects "the uncertainty inherent in the contingent payments." The Proposed Regulations also provide different treatments for quotable versus non-quotable contingent debt instruments, on the theory that treatment of the former, but not the latter, can be determined by objective data as to projected payments.

We strongly disagree with both assumptions. We believe that a Base Accrual Rate for non-quotable instruments which reflects the uncertainty of the contingency (i.e., the "beta risk") is the wrong rate, for both theoretical and practical reasons.

For the reasons set forth below, we recommend that the distinction between "quotable" and "non-quotable" be eliminated from the Proposed Regulations. Moreover, we believe that the accrual of interest on debt with "non-quotable" contingencies should be based on the same Basic Accrual Rate as applies to debt providing for quotable contingent payments. In most cases, therefore, we believe that the Base Accrual Rate for debt with non-quotable contingencies should be the AFR (or a rate based on the AFR).

First, as discussed in Part II above, the theory behind the Proposed Regulations is accrual by reference to the treatment of an economically equivalent investment unit consisting of a non-contingent debt instrument and one or more forward agreements to exchange the fixed payments under the instrument for variable payments. Interest should therefore accrue on the instrument at the rate on comparable non-contingent debt. Accrual at a higher rate reflecting beta risk diverges from this theoretical model.

Second, there is no reasonable means of determining a rate of accrual reflecting beta risk. No objective information or default rate can accurately reflect the risk inherent in the uncertainty of payment of non-quotable contingent amounts.

Third, permitting issuers to deduct interest on non-quotable instruments at a rate reflecting beta risk is an invitation to abuse and loss of revenue. Issuers may reasonably conclude that the appropriate yield on a contingent debt instrument is a very high rate, "given the uncertainty inherent in the contingent payments." The Proposed Regulations permit the issuer to project a yield that includes compensation for the risk inherent in a contingent payment formula and then deduct interest at that rate as if the interest were fixed.

Finally, the considerable difference in treatment under the Proposed Regulation of "quotable" versus "non-quotable" instruments -- in particular, the ability in the latter case to determine interest accruals on the issuers' subjective projections, and taking into account the beta risk in estimating yield -- will put great pressure on the characterization of payments as "quotable" or "non-quotable." It does not make sense to us that the presence of quotes should so dramatically change the methodology for imputing interest.

More broadly, we disagree with the proposal to treat quotable instruments differently from non-quotable instruments in any significant respect. In our view, seeking "objective" price quotes for embedded rights to publicly traded property does not provide a better, or even an adequate, means of determining a Base Accrual Rate. Moreover, we think it will be exceedingly difficult for taxpayers to determine in many cases when quotes for projected payments are "readily available," or when quotable payments are "substantially similar" to the rights embedded in the instrument.

Based on the foregoing, we believe the treatment of debt with non-quotable contingencies should be the same as our recommended treatment of debt with quotable contingencies.

If notwithstanding our recommendations, the distinction between quotable and non-quotable payments is retained, the Proposed Regulation should provide more guidance on the meaning of the words "readily available." For example, must the request for a quote be answered within a reasonably short time frame (e.g., two days)? Is a quote that can be obtained only if a fee is paid to a dealer considered "readily available"? Is a quote

tainted if the quote provider knows the identity of the issuer or the proposed terms of the debt instrument?

IV. Summary of Technical Recommendations

The technical recommendations which follow generally are applicable regardless of whether our recommendations in I through III above are adopted. In summary of what is set out more fully in the balance of this report, our principal recommendations are as follows:

1. Mechanics of Projecting Multiple Contingent Payments

If a debt instrument provides for more than one contingent payment that is substantially equivalent to an embedded cash-settlement option, and independent spot price quotes for the options will be considered in determining the relative values of the payments, the aggregate amount of the contingent payments should be projected by (a) discounting the non-contingent payments to present value at the Base Accrual Rate, (b)' allocating the remainder of the issue price of the instrument to the contingent payments, (c) apportioning such remainder among the contingent payments by reference to the spot price quotes, and (d) accruing forward at the Base Accrual Rate to arrive at projections for each contingent payment.

We propose other simplifying assumptions. If a debt instrument promises annual interest equal to, say, 5%, 10%, 15%, 20% and 25% of a fixed-rate formula and the formula itself is not designed to produce a front- or backloading of interest, for example, we suggest the issuer should assume that the relative values of the payments are 1:2:3:4:5, respectively. We also suggest that taxpayers issuing debt instruments which would qualify as small issuances under section 1274A(b) of the Code if issued for property (hereafter "small issuers"), might be permitted or required to make this assumption regardless of whether the underlying formula arguably produces a backloading of interest.

2. Small Issuers Exception

If our recommendations in III above are not adopted, AFR-based accrual should at least be available to small issuers.

3. Further Guidance Concerning Issuer's Obligations in Projecting a Payment Schedule

Language in the preamble to the Proposed Regulations (the "Preamble") promising issuers substantial flexibility in projecting payments and limited dispute on audit should be contained in the text of the final regulations. A projected payment schedule should be treated as reasonable in any case where an issuer maintains adequate records to support the schedule. The regulations should state when, and under what circumstances, an issuer may rely on a schedule provided by a financial institution --particularly by an institution hedging the issuer --and what records, if any, must be maintained by the financial institution. The final regulations should make it clear that issuers are not required to publicly disclose the basis for their projections to holders (although they may be required to disclose them to the Service).

4. Projection Date Should be the Pricing Date

Projected payment schedules should be based on information available as of the pricing date or signing of the relevant commitment letter, rather than as of the issue date.

5. Treatment of Remote or Incidental Contingencies

The Proposed Regulations should offer specific guidance regarding how remote or incidental contingencies are treated, both in terms of (a) how an instrument should be treated until such contingencies materialize, and (b) how to make adjustments if and when such contingencies do materialize. The Proposed Regulations should also provide further guidance as to the definition of remote and incidental. The possibility that additional interest will be paid if an issuer defaults or ceases to be an investment-grade credit should generally be treated as a remote contingency.

6. Constant-Yield Instruments with Payments Contingent Solely as to Time

An instrument should not be treated as contingent (with the result that gain or loss from disposition of the instrument is ordinary rather than capital) merely because payments under the instrument may be accelerated or deferred, provided that the yield on the instrument is constant in all cases (e.g., a pay-in-kind bond, a demand loan, a cash flow mortgage, etc.).

7. Interaction Between the Proposed Regulations and § 988 of the Code

The ambit of the Proposed Regulations should be expanded to govern contingent debt instruments that are also governed by section 988 of the Code, other than instruments with contingencies relating solely to the values of foreign currencies. The Proposed Regulations should generally be applied to contingent debt instruments in the currency in which they are denominated (or in which their interest payments are denominated, if that differs from the currency in which their principal is denominated), and the resulting accruals of foreign-currency denominated ordinary income or loss should be translated into U.S. dollars under the general rules of section 988 of the Code.

Because the Proposed Regulations are fundamentally inconsistent with the taxation of foreign-currency denominated debt instruments prescribed by Congress under section 988 of the Code (i.e., the former mandates market-rate accrual in light of anticipated forward rates of exchange, while the latter mandates above- or below-market accrual based on spot rates of exchange, without consideration of anticipated changes in the values of foreign currencies), instruments with contingencies relating solely to changes in the values of foreign currencies should be expressly excluded from the ambit of section 1275(d) of the Code.

8. Interaction Between the Proposed Regulations and the Rules for Alternative Payment Schedules under Treas. Rea. S 1.1272-1 (c)

The rule for alternative payment schedules should be deleted. Certain contingencies should be dealt with either as remote contingencies or on a case-by-case basis.

9. Interaction Between the Proposed Regulations and the Rules for Variable Rate Debt Instruments

We applaud the further expansion of the definition of a variable rate debt instrument. An example dealing with front and backloading should be clarified.

10. Portfolio Exchangeables

We support the significant change in law treating portfolio exchangeables as contingent debt instruments. We recommend a presumption that American-style options are equivalent to European-style options for purposes of projecting payments under these instruments.

11. Clarification of Treatment When All Remaining Payments Become Fixed

If all the remaining contingent payments under an instrument become fixed, the resulting positive or negative adjustment is "spread" over the remaining life of the instrument. The Proposed Regulations offer no guidance, however, as to how this spread rule should operate. We recommend that projected payments be replaced with the fixed stated redemption price without making any positive or negative adjustments. The adjustment will then automatically be reflected as a "yield adjustment" over the remaining life of the instrument.

If such an instrument is disposed of prior to maturity, the Proposed Regulations treat the resulting gain or loss as capital gain or loss. We question whether the drafters of the Proposed Regulations intended to permit holders to convert ordinary income which would otherwise be spread over the remaining life of the instrument into capital gain by disposing of the instrument immediately after the payments become fixed. A similar concern exists where a taxpayer legs into integrated treatment and then disposes of the resulting fixed-rate synthetic debt.

12. Multiple Contingent Payments Subject to a Maximum Amount

The Proposed Regulations contain no special rule to deal with multiple contingent payments that are subject to a minimum or maximum amount, or fixed

payments contingent solely as to the time of payment. We recommend treating as a negative adjustment the present value of the excess, if any, of the projected amount of the remaining payments over the maximum amount of such payments. We likewise recommend treating as a positive adjustment the present value of the excess, if any, of the minimum amount of the remaining payments over the projected amount of such payments.

13. Proposed Adjustment to Interest Accrual for Secondary Holders

Secondary holders will systematically over- or under-accrue because interest accrues at a rate based on the original projected payment schedule. Consideration could be given to an alternative under which a secondary holder's accrual in respect of the original projected payment schedule would be multiplied by a fraction the numerator of which is the basis of the instrument (decreased or increased by any portion of the premium or discount that is allocable to interest, rather than to projected contingent payments) and the denominator of which is the adjusted issue price of the instrument as of the purchase date. Rules would have to be devised, however, to account for the difference between projected and actual accruals of interest, including rules adjusting the secondary holder's basis accordingly, and rules properly adjusting subsequent receipts. We recognize that implementing this kind of methodology would add considerable complexity to the regulations, which may not be warranted by this problem.

14. Clarification of Allocations Made by Secondary Holders

Secondary holders must allocate purchase premium or discount between anticipated contingent payments and anticipated interest accruals. We recommend clarification that premium or discount attributable to a shortening of the remaining term of the instrument in light of the slope of the yield curve, or changes in the issuer's credit rating, be allocated solely to interest accruals; and that secondary holders be permitted to determine the portion of premium or discount attributable to changes in interest rates by reference to standard interest rate indices. In the case of a taxpayer required to accrue market discount currently, we recommend a clarification that the discount be accrued in proportion to the remaining OID accruals on

the bond, rather than pro-rata over the remaining life of the bond.

15. Negative Adjustment Carryforwards to Property Received in a Reorganization

A negative adjustment carryforward should be allocated among the items of property received in a tax-free reorganization in proportion to their respective fair market values. If the property received is a security, the carryforward generally should offset subsequent interest on the security. If the property is stock, the carryforward should increase the basis of the stock. If the property received is boot, the carryforward should be recognized as decreased gain or increased loss.

16. Characterization of Net Negative Adjustments

The Proposed Regulations offer no guidance as to the character of net negative adjustments for various purposes of the Code. For purposes of foreign tax credit limitations, earnings stripping rules and other purposes, an issuer should characterize income in respect of a net negative adjustment by reference to the nature of the prior deductions in respect of the debt.

Likewise, a holder's net negative adjustments should be allocated to and reduce income from the same source as the interest income previously accrued on the bond, including for purposes of passive loss limitations and investment interest deduction limitations. In particular, a holder's deductions for net negative adjustments should not be subject to the 2% floor for miscellaneous itemized deductions. We refer the Treasury to section 171(e) of the Code, treating amortization of bond issuance premium as a reduction of interest income, rather than as a deduction subject to the 2% floor.

17. Character of Issuer Gain on Redemption

We do not think an issuer's income on redemption of a contingent debt instrument should be treated as cancellation of indebtedness income, given that the issuer is paying the instrument in full according to its terms.

18. Recommendations for Information Reporting

We recommend a new reporting methodology similar to the one available for REMIC regular interests and other collateralized debt obligations. We also recommend that the above described information reporting scheme be adopted for non-publicly traded contingent debt instruments, in lieu of the current legending requirement.

19. Non-Publicly Traded Debt Issued in Exchange for Non-publicly Traded Property

We approve of the exclusion under the Proposed Regulations of the value of non-quotable contingent payments from the buyer's initial basis in the property acquired and the buyer's initial issue price of the instrument issued in exchange. We believe this exclusion should be extended to all contingent payments, however, rather than solely to "non-quotable" contingent payments.

We approve of what we believe to be a proposal to require sellers of property to include the entire fair market value of any contingent debt instrument received in exchange for property in the amount realized from the sale of the property if the seller elects out of installment sale treatment. The amount realized by such a seller should be specifically defined as the issue price of the contingent payment debt instrument (now defined to include only the present value of the non-contingent payments) plus the fair market value of any rights to contingent payments. The resulting excess of the basis of the contingent debt instrument in the hands of the seller over its issue price should be allocated among the contingent payments to be received under the rules set out under section 453 of the Code, dealing with the treatment of installment obligations.

If the seller does not elect out of installment sale treatment, the seller's amount realized should be limited to the non-contingent payments and increased as additional payments become fixed. The interest component of contingent payments should be computed as such payments are received; and an "interest charge" should be assessed under section 453A of the Code from the year of sale to the year of the payment on any additional gain that arises as payments of deferred

additional purchase price become fixed.

Where a seller has not elected out of installment treatment, the gain or loss attributable to the principal portion of contingent payments should be treated as capital or ordinary based on the character of the underlying asset sold. Where a seller elects out of installment treatment, we similarly believe any gain or loss should be characterized under Arrowsmith^{20/} principles, and not under the adjustments methodology of the Proposed Regulations.

In the case of a debt for debt exchange, the issue price of the new debt should include the fair market value of any anticipated contingent payments, to prevent the issuer from recognizing "phantom" cancellation of indebtedness income attributable to the removal of contingent payments from the issue price of the instrument.

If a payment becomes fixed within six months of the payment date, discounting to characterize payments as principal or interest should be from the payment date, rather than the fixing date, to the issue date.

20. Tax-Exempt Contingent Debt Instruments

Consistent with the "deconstruction approach" to the treatment of contingent debt instruments adopted by the Proposed Regulations, if the Treasury treats positive adjustments as increasing taxable gain, it should treat negative adjustments as giving rise to deductible loss (either ordinary or capital, but consistently in either case).

21. Requirements for Integration

Under the Proposed Regulations, a contingent debt instrument and hedge are not eligible for integration if the latter hedges currency risk. Likewise, a contingent debt instrument is not eligible for integration if it is subject to the rules of section 988. We believe these exclusions are too broad. We recommend that the Proposed Regulations merely exclude from integration any transaction that is already integrated under section 988(d) of the Code. In

^{20/} 344 U.S. 6 (1952)

connection with the foregoing, we recommend that when Treasury Regulation section 1.988-5 is next amended, it should limit integrated treatment under section 988(d) to cases where the synthetic debt instrument is denominated in a currency that is different from the currency in which a material amount of the payments on the qualifying debt instrument are denominated.

22. Imperfect Hedging

We recommend a rule permitting taxpayers to ignore incidental contingencies and other minimal variations in the yield of the resulting synthetic debt instrument arising from "imperfect hedging" if the taxpayer elects and otherwise qualifies for integration under Treasury Regulation section 1.1275-6.

23. Other Limitations on Integration

Rules permitting the integration of hedges with related mark-to-market entities are, we believe, unintentionally defined to include only related mark-to-market entities that are corporations (since they cross-reference similar rules in the consolidated return regulations). We recommend clarification that they apply to other mark-to-market entities as well.

Under the Proposed Regulations, a transaction may not be integrated unless the hedge is acquired after the debt. We recommend an exception where the hedge is acquired in anticipation of acquisition of the debt within a relatively short period of time.

We also recommend elimination of a rule that a debt instrument may not be integrated if it has previously been integrated with another hedge.

24. Integration by the Commissioner

The Commissioner may integrate a transaction under the Proposed Regulations without a taxpayer election if the combined cash flows are substantially the same as fixed-rate debt, without regard to other facts and circumstances, such as whether the debt and hedge were entered into in contemplation of each other. This diverges from the standard under Treasury Regulation section 1.988-5, which is based on all the

facts and circumstances. We recommend that the section 1275 standard be conformed to the section 988 standard.

25. Term of the Synthetic Debt Instrument

The Proposed Regulations provide that the term of a synthetic debt instrument is the term of the qualifying debt instrument. This produces the wrong result in any case where the hedge (a) requires the taxpayer to dispose of the debt prior to maturity, or (b) effectively changes the term of the resulting synthetic instrument because the taxpayer exchanges actual principal for synthetic principal received at a different time. We recommend technical corrections.

26. Holding Periods for "Legging In" and "Legging Out"

We request guidance concerning the holding period of debt and hedges upon "legging in" and "legging out" of integrated treatment.

27. Hedge Payments on the Issue Date

Amounts paid or received under a hedge on the issue date are initially treated as increasing or reducing the stated redemption price of the synthetic debt and affecting the issue price of the debt. The issue price and stated redemption price of the resulting synthetic debt is then immediately reduced or increased in respect of the resulting payment on the synthetic debt. While this works as a technical matter, we think it would be less confusing simply to define the issue price of the synthetic debt as equal to the net payments made and received on the issue date.

28. Transitional Rules -- Accounting Methods

Absent further guidance, taxpayers who have already filed a return reporting income or expense from a contingent debt instrument under the regulations withdrawn on December 16, 1994 (the "Old Regulations") will technically be required to seek a change in accounting method to apply current law, or the Proposed Regulations, to any instrument. We generally recommend (a) finalization of the Old Regulations (other than the rule of Old Regulation section 1.1275-4(f) recharacterizing certain qualified stated interest as principal) for instruments issued before December 16, 1994, and (b) adoption of a "cutoff" accounting

procedure under which taxpayers would be permitted to account for instruments issued on or after December 16, 1994 in a manner consistent with current law. The Proposed Regulations would apply to instruments issued on or after the date such regulations are finalized, with a similar cutoff accounting procedure for taxpayers who have adopted a method of accounting based on current law.

Some of our members believe that taxpayers who acquire during the "Window Period" (i.e., the period between withdrawal of the Old Regulations and finalization of the Proposed Regulations) instruments that were issued before the Old Regulations were withdrawn -- or who acquire, after the Proposed Regulations are finalized, instruments that were issued before the Proposed Regulations were finalized -- should be permitted to account for income from the instruments under any reasonable method. This is not our general recommendation, as we are concerned that such an approach might offer taxpayers too great an advantage. We acknowledge, however, that there are circumstances under which such an approach might be reasonable.

V. Construction of the Projected Payment Schedule

As discussed above, we believe that the Base Accrual Rate should be determined independently of any dealer price quotes. Independent price quotes from options dealers should then serve to determine the relative values of the payments under the instrument. Comment A below assumes that our recommendation in III above will be adopted. Most of the remaining comments below apply regardless of whether our recommendation is adopted.

A. Instruments Providing for More Than One Payment

Given that only spot, rather than forward, price quotations are generally available for options, relative valuation of contingent payments based on option quotes must take account of the fact that some variable payments will be made

sooner than others. For example, suppose a 10-year instrument issued for \$1,000 promises \$1,000 at maturity plus one contingent payment at the end of five years based on the increase in the value of a stock index during the first five years, and another contingent payment at the end of ten years based on the increase in the value of the stock index during the second five years. If the spot price of the first payment were \$100 and the spot price of the second payment were \$200, it would not suffice to project the second payment to be twice as great as the first payment. The future value of each payment would have to be determined by accruing forward at the Base Accrual Rate. To this end we recommend the following approach:

First, the amount of the anticipated non-contingent payments should be discounted to present value at the Base Accrual Rate. Assume in the above example that the present value of the non-contingent payment, i.e., the \$1,000 payable at maturity, is \$490. The remainder of the issue price of the instrument should next be allocated to the contingent payments and divided among the contingent payments in proportion to their relative values based on spot price quotes. In the example above, \$170 of the remaining \$510 would be allocated to the first contingent payment, and \$340 would be allocated to the second contingent payment. These present values would then be accrued forward at the Base Accrual Rate to arrive at appropriate projections of the amount of the payments on the hypothetical non-contingent bond. Thus, the projected payments on the bond might turn out to be, say, \$250 and \$1,000 respectively.^{21/}

^{21/} Note that it is no longer correct to accrue the payments forward at a risk-free rate (see Appendix A), since the aggregate amount of the spot prices is based on what the issuer, rather than what a AAA credit, could issue the options for.

B. Fixed Formula Contingencies

Certain debt instruments providing for variable interest payments will not qualify as variable rate debt instruments because they are designed to produce a front- or backloading of interest. Nevertheless, it will be relatively easy to construct a hypothetical non-contingent bond in respect of these instruments, because the payments are based on a single interest-rate formula which does not itself produce front- or backloading. Consider, for example, a five year debt instrument issued for \$1,000, promising \$1,000 at maturity and annual interest equal to 5%, 10%, 15%, 20% and 25%, respectively, of the percentage increase in the value of a specified stock index. We recommend explicit provision in such a case that the relative values of the projected contingent payments be 1:2:3:4:5. These relative values would be used for purposes of constructing a hypothetical non-contingent bond, once the overall yield on the bond has been determined.

C. Small Issuers Assumptions

If our recommendation in III above is not adopted, we urge that some AFR-based accrual methodology be provided for small issuances, at least on an elective basis. ("Small" could be defined, for example, as any instrument which would qualify under section 1274A (b) of the Code if it were issued in exchange for property.)

Simplifying assumptions might also be made available for such issuers in constructing the projected payment schedule. For example, it might be assumed that any single interest rate formula is not front-or back-loaded and is therefore eligible for

the simplifying assumption for fixed formula contingencies described above.

D. Standard of Diligence for Issuers Constructing Projected Payment Schedules

Under Proposed Treasury Regulation section 1.1275- 4(b) (4), the projected payment schedule used by the issuer to compute interest accruals and adjustments determines the interest accruals and adjustments of the holder. The issuer's determination of the projected payment schedule will be respected unless the schedule is unreasonable. We believe that further guidance is needed as to the degree of flexibility issuers will be granted to avoid a determination by the IRS that projected payment schedules they issue are unreasonable.

The Preamble states that due to the difficulties of pricing, the rules that apply to an issuer who must set a projected payment schedule allow substantial flexibility. These comments note further that the purpose of respecting the issuer's projected payment schedule is to avoid potential audit disputes. It would be helpful to include these statements as general standards in the final regulations.

The Proposed Regulations as currently drafted provide instances where projected payment schedules would be considered unreasonable. A better approach would be to describe circumstances under which projected payment schedules would be respected as reasonable. For instance, the Proposed Regulations should specify that a projected payment schedule will generally be considered reasonable when an issuer makes a reasonable effort to follow the Proposed Regulations and maintains adequate contemporaneous records to support the overall projected payment

schedule. Contemporaneous records which would support a projected payment schedule might include a record of any quotations received from brokers or dealers, or a brief description of the information which was analyzed to arrive at a projected payment and how the analysis was performed. Recordkeeping requirements might resemble those contained in the recently finalized regulations for hedging transactions.^{22/}

The Proposed Regulations should state when, and under what circumstances, an issuer may rely on a projected payment schedule provided by a financial institution, particularly by an institution hedging the issuer, and what records, if any, must be maintained by the financial institution. The Proposed Regulations should in any case make clear that provision of the schedule from an arm's length hedge counterparty satisfies the above-described record-keeping requirements.

The Proposed Regulations provide that if the payment schedule set by the issuer is unreasonable, the issuer must set the projected payment schedule. This implies that issuers may be required to disclose details regarding the pricing and projection of anticipated contingent payments. Compliance with such disclosure requirements would be difficult, particularly if quote providers are unwilling to reveal their pricing assumptions. Such requirements would also add significant complexity to the non-contingent bond method. The Proposed Regulations should therefore expressly provide that no such disclosure is necessary.

²² See Treas. Reg. § 1.446-4 (d) Books and records must be maintained which contain a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show that the "clear reflection of income" standard has been satisfied.

E. Determination Date Should be the Pricing Date

Proposed Treasury Regulation section 1.1275- 4 (b) (3) (i) provides that the first step in applying the non-contingent bond method is the determination of the projected payment schedule as of the issue date of the debt instrument. Likewise, Proposed Treasury Regulation section 1.1275- 4(b)(4) provides that the schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument.

As part of their marketing and selling efforts, underwriters and placement agents typically set the terms of debt instruments one week prior to the issue date (such date being referred to as the "pricing date"). They then print the relevant disclosure document, based on the terms set on the pricing date, prior to the closing date. In other areas, financing terms may be set by commitment letters issued sometime before the loan proceeds are drawn down, or by loan agreements under which funds are drawn down in stages over time. For technical and practical reasons therefore, we strongly recommend that, absent clear abuse by the issuer, the Base Accrual Rate and the projected payment schedule be determined as of the date on which the terms of the debt are fixed, rather than as of the issue date.^{23/}

^{23/} Cf. Treas. Reg. § 1.860F-2 (b) (3) (iii), dealing with the use of information as of the "pricing date."

VI. Definition of Contingent Debt and Scope of Treas. Reg. S
1.1275-4

A. Definition of Contingent Debt

1. Background

Proposed Treasury Regulation section 1.1275-4 applies, with certain specified exceptions, to debt instruments having one or more "contingent payments", but does not affirmatively define a contingent payment. A payment is not treated as contingent, however, if the contingency is either remote or incidental. It is remote if there is either a remote likelihood that the contingency will occur or a remote likelihood that the contingency will not occur. It is incidental if the potential amount of the payment under any reasonably expected market conditions is insignificant relative to the total expected payments on the debt instrument. Furthermore, a payment is not contingent merely because it might be impaired by insolvency, default or similar circumstances, nor because the debt may be converted into stock of the issuer or a related party or paid with property.

2. Treatment of Instruments With Remote or Incidental
Contingencies

The treatment of debt instruments with remote or incidental contingencies should be clarified. The Proposed Regulations should state that remote contingencies cannot cause an otherwise fixed instrument to be treated as a contingent instrument and that remote contingencies will be ignored for all purposes of Code sections 1271 through 1275 (e.g., for purposes of determining whether interest is qualified stated interest,

whether gain or loss from such an instrument will be capital gain or loss, etc.). If an instrument is otherwise a contingent debt instrument, remote contingencies should be ignored in creating any projected payment schedules. The regulations should expressly state that (i) if it is extremely unlikely that a payment will be made, the payment is treated as not being made, and (ii) if it is extremely likely that a payment will be made, the payment is treated as being made.

The Proposed Regulations should provide examples of contingencies that are remote or incidental, including (a) a contingency which is incidental because there is only limited variation in the amount of the payment, and (b) a contingency which is remote because, while there is infinite potential variation in the amount of the payment, the variation is unlikely to occur. It may also be appropriate to define incidental contingency to include any contingency which, taking into account both the likelihood of the contingency occurring and the magnitude of the contingency under reasonably expected market conditions, is not expected to be substantial.

The definition of a contingency should expressly exclude contingencies that are dealt with under the option rules of Treasury Regulation section 1.1272-1(c)(5).

Some guidance is needed concerning the treatment of an instrument when remote contingencies do materialize. It would not seem appropriate, for example, to treat an increase in future interest payments arising from the materialization of a remote contingency as a "minibond", and therefore grant the issuer an immediate deduction for the entire present value of the increase in such payments, given that the contingency itself was never considered in arriving at a projected payment schedule for the

instrument. A simple approach might be one analogous to the treatment of unexpected exercises or non-exercises of puts and calls under Treasury Regulation section 1.1272-1(c) (5), i.e., adjusting the stated redemption price of the instrument (or its projected payment schedule, if the instrument is otherwise a contingent debt instrument) without changing the instrument's issue price or making positive or negative adjustments, in which case materialization of the contingency would effectively result in an adjustment to the yield of the instrument over the period between the date the additional payment becomes fixed and the date the payment is made. This approach appears consistent with Proposed Regulation section 1.1275-4(b)(9)(ii)(E), which recognizes that contingencies relating to the appropriateness of an interest rate (because of a reduction in credit quality, for example) should result in income inclusion over the period of the increase in rate, rather than at the time the rate is changed.

3. Definition of Contingent Payment

We believe the regulations should provide an affirmative definition of a contingent payment. One possibility would be to provide that a payment is contingent unless it is unconditionally payable in cash or property at a fixed time.^{24/} Implicitly, this seems to be the approach the Proposed Regulations adopt.^{25/}

4. Constant-Yield Instruments With Payments Contingent Solely as to Time

^{24/} This definition generally follows the definition of qualified stated interest. See Treas. Reg. § 1.1273- 1(a).

^{25/} The Proposed Regulations properly exclude debt instruments governed by § 1272(a)(6) of the Code from the definition of a contingent debt instrument for purposes of Treas. Reg. § 1.1275-4.

The 1986 proposed regulations provided that a debt instrument would not be treated as contingent simply because the timing of principal was contingent if interest on the outstanding revised issue price was paid at a fixed rate or a qualified variable rate. It would seem appropriate to continue to provide this exception to the contingent debt rules, particularly given the increase in stakes, i.e., that treatment of an instrument as contingent causes gain or loss from the sale of the instrument to be treated as ordinary rather than capital. Treasury Regulation section 1.1272-1(d) suggests that, at least when the debt instrument is issued at par, the instrument should not be treated as a contingent debt instrument merely because the timing of principal payments is uncertain. It should be clarified whether Treasury Regulation section 1.1272-1(d) provides an exclusion from the contingent payment rules of Proposed Treasury Regulation section 1.1275-4.

More broadly, we believe that an instrument should not be governed by Proposed Treasury Regulation section 1.1275-4 if it provides for a constant yield in any case where payments under the instrument may be accelerated or deferred. For example, pay-in-kind bonds, cash flow mortgages and other instruments under which an issuer may defer a payment of interest provided that additional interest accrues on the deferred payment at the same rate as interest accrues on the entire instrument should be expressly excluded from the definition of a contingent debt instrument.

5. Remote and Incidental Contingencies

Many debt instruments provide for adjustments to the interest rate, or the making of other payments, based on contingencies that are relatively unlikely to occur, and, in all

events, are not intended to represent a major economic element of the overall transaction. Examples include a requirement of a higher interest rate in the event of a. substantial deterioration of the issuer's credit rating, and an obligation to pay certain amounts -- often labelled liquidated damages -- upon failure to register a debt instrument for sale under the securities laws by a certain date (with the obligation to make such payments terminating when the registration occurs).

We think such contingencies are properly regarded as remote and incidental, and we think it would be inappropriate to bring the contingent payment debt regime into play -- with the requirement that a projected payment schedule be constructed, and recharacterization of all gain on disposition of the instrument as ordinary -- merely by reason of the presence of such contingencies. Given the highly speculative nature of these contingencies, we also think that the issuer and holder are properly taxed by taking the changes into account only if and when they occur. Therefore, we suggest that the final regulations include examples of remote and incidental payment obligations such as the foregoing. Recognizing that other, similar contingencies exist, or will come into use in the future, we recommend that Treasury be receptive to ruling requests or otherwise provide guidance concerning such contingencies that are brought to its attention.

B. General Interaction Between Code § 988 and the Contingent Payment Rules^{26/}

The general approach to the taxation of foreign currency indexed debt instruments under Code section 988 is inconsistent

^{26/} The interaction between Prop. Treas. Reg. § 1.1275-6 and § 988(d) of the Code is discussed under Part XI-B below.

with the approach of the Proposed Regulations. The former accrues interest and OID in the currency or currencies of the obligation and translates the resulting nonfunctional currency accruals into the taxpayer's functional currency based on spot rates of exchange at the time of accrual. As suggested in the legislative history of section 988 of the Code, these accruals do not take account of anticipated changes in the values of foreign currency, based on forward rates of exchange or otherwise. By contrast, the Proposed Regulations accrue interest at a market rate for U.S. dollars, by estimating future values based on forward rates of exchange (if quotable) and reasonable estimates of yield (if not).

In light of this difference, the drafters of rules governing foreign currency indexed contingent debt instruments will have to draw a line between the application of the principles of the Proposed Regulations and the application of the principles of section 988. The Proposed Regulations currently state that an obligation governed by section 988 of the Code (a "Section 988 Obligation") will be subject to the rules of Proposed Treasury Regulation section 1.1275-4 only to the extent provided in section 988 of the Code and the regulations thereunder.^{27/} Since the regulations under section 988 do not so provide, this means that Treasury Regulation section 1.1275-4 will not apply to any instrument with a foreign currency component. It also means that taxpayers can "steer out" of market rate accrual under Treasury Regulation section 1.1275-4 by providing for such a component. We think this is a mistaken approach:

^{27/} Prop. Treas. Reg. § 1.1275-4(a)(2)(iv)

In a prior report on the Final and Proposed 988 Regulations submitted October 21, 1992 (the "1992 Report"), we suggested that the principles of section 988, and not the principles of Proposed Treasury Regulation section 1.1275-4, should govern any contingent debt instrument whose contingencies relate solely to the values of one or more nonfunctional currencies. This approach is consistent with Internal Revenue Service Announcement 86-92, which states that an obligation will not be subject to the rules of Proposed Treasury Regulation section 1.1275-4 merely because the obligation provides for payments which vary with the values of one or more foreign currencies.^{28/} This approach is also consistent with the treatment of an instrument that is actually denominated in a foreign currency. For example, an instrument actually denominated in Japanese Yen would not be treated as having OID, even though the Yen was expected to appreciate in value and the obligation therefore had a below-market rate of interest.

In light of these facts, it seemed to us appropriate to treat an instrument promising a U.S. dollar payment at maturity equal to the value of a specified amount of foreign currency as having no OID so long as the U.S. dollar payment promised at maturity equaled the issue price of the instrument based on spot rates of exchange at the time of issuance. Thus, if an instrument was issued for 100,000 Yen and 100,000 Yen was worth \$1,000 on the date of issuance, we believe that the instrument should not have OID regardless of whether it promised at maturity 100,000 Yen, the U.S. dollar value of 100,000 Yen, \$2,000 minus the U.S. dollar value of 100,000 Yen, or a similar payment based on a complex multi-currency formula where the formula produces, at spot rates of exchange, a redemption price equal to the issue price.

^{28/} 1986-32 I.R.B. 46 (July 30, 1986).

The 1992 Report was submitted at a time when subjecting Section 988 Obligations to the rules of Treasury Regulation section 1.1275-4 would have meant application of the "all events test" approach of the 1986 Proposed Regulations, with the resulting deferral of interest accrual. Under the Proposed Regulations, the question effectively shifts to whether interest should accrue at the market rate for U.S. dollars or at the market rate for the currency in which the instrument is effectively denominated. This is a more difficult question than the one we confronted in the 1992 Report. We have little doubt that the rules in the Proposed Regulations could be applied with equal facility to foreign currency contingencies. Moreover, the results under the Proposed Regulations would reflect economic reality and would minimize the difference between hedged and unhedged issuers and holders.

Nevertheless, Congress plainly rejected a broad-based use of forward rates of exchange to determine accruals on foreign currency instruments.^{29/} Thus, it would seem that a major change in the treatment of foreign currency denominated debt instruments is neither desirable nor within the scope of Treasury's regulations authority. We believe, moreover, that it is more important to preserve consistency within the realm of nonfunctional currency instruments than to extend the market rate accrual approach of the Proposed Regulations to a wider range of contingent instruments. We believe that a consistent set of rules

^{29/} See Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., 2d Sess. (the "1986 Bluebook") 1088 (1987) ("The Congress was not persuaded that exchange gain or loss should be currently accrued in most cases. Because a right to receive (or an obligation to pay) foreign currency is not a right (or obligation) to receive (or pay) a fixed number of dollars, it would be problematical to require income inclusions (or permit deductions) due to exchange gain or loss that could be lost through subsequent exchange rate fluctuations.").

for all payments which vary solely with the values of one or more nonfunctional currencies will be simpler for taxpayers to understand and apply and less susceptible to manipulation. Thus, we continue to recommend exclusion from the definition of a contingent debt instrument for purposes of Proposed Treasury Regulation section 1.1275-4 of any instrument with contingencies relating solely to the values of one or more foreign currencies. We further recommend clarification that this exclusion extends to payments which are determined by complex multi-currency formulae.

With regard to Section 988 Obligations that also involve non-currency related contingencies, however, we believe that such contingencies can and should be governed by the rules of the Proposed Regulations. In the case of a contingent obligation all of whose payments are denominated in a single currency, the rules of the Proposed Regulations could simply be applied in that currency, with translation back into the taxpayer's functional currency, just as with non-contingent obligations. The Base Accrual Rate would equal the risk-free rate of interest (or, in some cases, the yield on comparable non-contingent debt) for the currency in which the instrument was denominated. The projected payment schedule would then be computed under the usual rules.

For contingent obligations involving more than one currency, a determination would first be made as to the currency in which the projected payment schedule would be computed. As in the 1992 Report, we would suggest that this currency be the currency in which the interest payments are denominated (assuming all interest payments are denominated in a single currency)^{30/}

^{30/} For obligations whose interest payments are not all denominated in a single currency, one might use the relevant taxpayer's functional currency, with authority for the Commissioner to require accruals in another currency if substantially all of the value of the interest payment depends on that currency.

Under the approach outlined above, noncurrency contingencies will not dramatically change the taxation of foreign currency indexed debt instruments, and currency contingencies will not significantly alter the general treatment of a contingent debt instrument.

C. The Line Between Prop. Treas. Reg. § 1.1275-4 and Treas. Reg. § 1.1272-1(c) (Alternative Payment Schedules)

The final OID regulations issued in January 1994 contain special rules for certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). These rules, which are set forth in Treasury Regulation section 1.1272-1(c), expand upon the rules for debt instruments subject to put and call rights that had been in the proposed OID regulations since 1986. In general these rules provide that, for purposes of applying the OID rules, the debt instrument will be treated as calling for payments according to the payment schedule that is most likely to occur.

We understand that the rules for debt instruments with alternative payment schedules were expanded beyond the old puts and calls rule for essentially two reasons: (1) to cover contingencies that could result in the early retirement of a debt instrument and that are economically similar to a put or call right, and (2) to assure issuers and holders of debt instruments with alternative payment schedules that were unlikely to occur that such payments could be ignored in applying the OID rules. The rules in Treasury Regulation section 1.1272-1(c) are much broader than necessary to cover these two situations, however. If

taken literally, these rules would even cover a debt instrument such as a stock- or gold-indexed note that calls for a contingent interest payment at maturity, so long as the number of possible amounts of the contingent payment was limited (so that each of the possible values created a different "alternative payment schedule").

Apparently for this reason, the Proposed Regulations would amend Treasury Regulation section 1.1272-1(c) by limiting its application to debt instruments having a "reasonable number" of alternative payment schedules. While no guidance is given on what constitutes a "reasonable number", it would appear that this restriction is sufficient to preclude the most transparent attempts to cause debt instruments that would otherwise be subject to Proposed Treasury Regulation section 1.1275-4 to be treated under the rules of Treasury Regulation section 1.1272-1(c). The restriction to a reasonable number of payment schedules does not, however, preclude the issuance of debt instruments that offer the investor a contingent return but avoid the non-contingent bond method's requirement of a market accrual on the instrument's issue price.

Consider, for example, a two-year debt instrument issued for \$100 that provides for a full return of principal plus a single interest payment at maturity based on the occurrence of one of three contingencies. Contingency A, which has a 31% likelihood of occurring, would result in a \$21.68 payment; Contingency B, which has a 34% chance of occurring, would result in a \$42 payment; and Contingency C, which has a 35% likelihood of occurring, would result in no interest payment. The projected interest payment at maturity on this debt instrument is \$21 and therefore the expected yield on the instrument is 10%, compounded annually. Nevertheless, under Treasury Regulation section 1.1272-

1 (c), the holder would not be required to accrue any OID because the contingency most likely to occur (Contingency C) would result in no interest payment. This is the result even though, viewing the other two contingencies together, there is a 65% likelihood that the holder will receive a contingent payment of at least \$21.68 (i.e., slightly higher than a 10% return).

As this example illustrates, the approach of Treasury Regulation section 1.1272-1(c) is fundamentally inconsistent with that of Proposed Treasury Regulation section 1.1275-4(b). The former regulation takes into account only the contingency that is most like to occur, while the Proposed Regulations in effect take into account the weighted average of all possible values for a contingent payment. Moreover, the rules governing subsequent adjustments differ under the two regimes. The former regulation treats a bond as reissued on the adjustment date for purposes of accruing OID, while the Proposed Regulations apply various minibond and spread rules more fully described in Part VII below.

We see no need to disturb the longstanding and well-accepted rules governing puts and calls, or similar rights that are within the control of the issuer or the holder, that is now embodied in Treasury Regulation section 1.1272-1(c)(5). The rules for alternative payment schedules (and other contingencies that are not within the control of either party to the instrument), however, should probably be eliminated. Contingencies that could result in the early retirement of a debt instrument can be ignored, and the instrument treated as non-contingent, if such early retirement would not affect the instrument's yield.^{31/}

^{31/} See A-4 above.

Alternative payment schedules that are unlikely to occur can be dealt with as remote contingencies.^{32/}

We understand that there are a few contingencies that are not remote and that are better dealt with by an all-or-nothing rule. For example, some debt instruments provide for a lower rate of interest if and when the instrument is registered. Likewise, some instruments require automatic redemption, rather than provide for an issuer's right to redeem, if market interest rates fall substantially below the yield of the instrument. Such instruments should arguably not be treated as contingent debt instruments, with the resulting recharacterization of fixed payments and treatment of gain and loss from early disposition as ordinary income or loss. We think these instruments are best dealt with, however, on a case-by-case basis, rather than with a broad rule which will also apply to instruments more properly dealt with under Treasury Regulation section 1.1275-4.^{33/}

D. The Line Between Prop. Treas. Reg. § 1.1275-4 and Treas. Reg. 5 1.1275-5

Generally, under the Proposed Regulations, the treatment of a debt instrument as a contingent payment debt instrument rather than as a variable rate debt instrument under Treasury Regulation section 1.1275 (a "VRDI") has significant tax consequences. For example, under the Proposed Regulations, any gain recognized by the holder of a contingent payment debt instrument on the sale, exchange or retirement of such instrument is characterized as interest income and any loss from such a

^{32/} See A-2 above.

^{33/} For example, the latter instrument might be treated as if it were subject to an issuer call right within the meaning of Treas. Reg. § 1.1272-1(c)(5).

sale, exchange or retirement is characterized as ordinary loss to the extent of the holder's total ordinary income previously taken into account. Any gain or loss from the sale or exchange of a VRDI, however, generally would be capital gain or loss if such debt instrument were held as a capital asset.

For this reason, we think it important to define the line between VRDIs and contingent payment debt instruments as clearly as possible. We also think the Treasury should expand the application of Treasury Regulation section 1.1275-5, and limit the application of Treasury Regulation section 1.1275-4, to whatever extent possible, given that VRDI treatment is simpler and diverges less from general principles of federal income taxation than does the treatment of contingent debt instruments under the Proposed Regulations.

The Proposed Regulations broaden the definition of an "objective rate" for purposes of the VRDI rules-. An objective rate is proposed to be defined as a rate (other than a "qualified floating rate") that is determined using a single fixed formula and that is based on objective financial or economic information that is not (i) within the control of the issuer or a related party or (ii) unique to the circumstances of the issuer or a related party (such as dividends or profits of the issuer or such related party or the value of the stock of such issuer or related party). We approve of the further expansion of the definition of an objective rate. The treatment of VRDIs is simple and logical, and expanding its application will limit the number of instruments to which the Proposed Regulations apply. We would appreciate further guidance, however, on the meaning of the requirement that payments not be "within the control of the issuer".

Section 1.1275-5(d), Example 5, of the Proposed Regulations states that the new definition of an objective rate would encompass an interest rate based on the change in value of the S&P 500 Index, but not one based on a percent acre of the value of the S&P 500 Index. The implication is that the latter rate reasonably would be expected to result in a significant back-loading of interest. The example should state the term of the instrument. While an expectation of backloading would be reasonable if the term of the instrument were, say, 30 years, it might not be reasonable if the term of the instrument were three years.

E. Portfolio Exchangeables

Proposed Treasury Regulation section 1.1275- 4(a)(4) provides an exception to the contingent payment rules for instruments convertible into stock of the issuer or a related party, but not for debt exchangeable into stock of an unrelated party. Thus, so-called portfolio exchangeable debt instruments are treated as contingent debt instruments subject to the rules of Proposed Treasury Regulation section 1.1275-4. The Preamble makes it clear that this result was intended. This is a substantial change from prior law, however, in that (a) interest therefore accrues on such instruments at a market rate, based on projected payments, rather than at the below-market rate on the stated interest coupons, (b) holders treat gain on the sale or exchange as interest income, rather than as capital gain, and (c) issuers treat the excess of the value of the stock delivered over the issue price of the debt as deductible interest expense, rather than as capital loss.

We support the basic decision to bring portfolio exchangeables within the contingent payment rules. Given that

stock-indexed notes are the equivalent of cash- settlement exchangeables, treating the two types of instruments consistently follows the sensible trend in the tax law towards treating cash- settlement rights and equivalent property rights alike.^{34/}.

If a debt instrument is exchangeable for stock at any time, however, it is not clear to us when taxpayers should assume that the instrument will be exchanged for purposes of constructing a projected payment schedule. It is our understanding that an option that is exercisable at any time (a so-called "American style option") is economically equivalent to an option that is exercisable only at maturity. If this is true, and if the adjusted issue price of the relevant exchangeable debt instrument does not increase over the life of the instrument (i.e., if the strike price of the option embedded in the instrument does not increase over time), then we recommend that the noncontingent bond method be applied as if the instrument were exchangeable only at maturity.

It is not clear to us, however, how a projected payment schedule should be constructed for an exchangeable debt instrument in cases where it appears likely that the instrument will be exchanged prior to maturity. For example, many exchangeable debt instruments "cap" the upside participation of the holder in the stock for which the debt may be exchanged (e.g., the holder may not receive stock with a value greater than 130% of the face amount of the debt). Under these circumstances, a holder is likely to exchange once the value of the underlying stock reaches the cap amount, long before the maturity date of the debt (so as to avoid loss of participation in further increases in the value of the stock). Likewise, if an instrument

^{34/} See, e.g., Code § 1234 (c) (2); Treas. Reg. § 1.1272-1 (e).

is issued at a discount and therefore has an adjusted issue price that increases over time, the "strike price" of the corresponding embedded option will likewise increase over time, and it may therefore be reasonable to assume that the "option" will be exercised prior to maturity, when the strike price is lower. Moreover, in the case of long term exchangeable debt, it may be reasonable to assume that dividends on the underlying stock will increase and substantially exceed interest on the debt, with the result that holders will exchange long before the maturity date of the debt. We would appreciate guidance on these points.

VII. Adjustments Methodology

A. Background

Under the Proposed Regulations, to the extent that the actual amount of a contingent payment is greater or less than the amount projected by the issuer in its projected payment schedule, the holder and the issuer are required to adjust their income and deductions, respectively, for the difference. Adjustments for contingent payments that are greater than the projected amounts (positive adjustments) and adjustments for contingent payments that are less than the projected amounts (negative adjustments) generally are taken into account when payments are made (not when fixed), unless fixed more than six months before they are paid.

As a preliminary step, positive and negative adjustments are netted for each taxable year with respect to each contingent debt obligation. Net positive adjustments give rise to additional interest income (or expense). A net negative adjustment first reduces any interest income or expense on the instrument for the taxable year. Any excess is treated as a current-year ordinary loss to the holder (and ordinary income to the issuer) up to the

amount of previously accrued interest income (or expense) on the instrument (to the extent not previously offset by prior years' net negative adjustments). Any remaining net negative adjustment is not currently accrued, but instead is carried forward and treated as a negative adjustment in the succeeding year and thus is available to offset interest accruals in the future.

Consistent with the theory that adjustments generally are attributable to interest income, positive and negative adjustments generally affect neither the adjusted issue price of a contingent debt obligation nor a taxpayer's basis in the obligation. Adjusted issue price and basis adjustments generally are determined in accordance with the obligation's projected payment schedule. Any negative adjustment carryforward remaining when a holder disposes of a contingent debt obligation (including upon retirement of the debt obligation), however, reduces the amount realized by the holder on such disposition. Thus, any residual negative adjustment carryforward remaining at maturity of an obligation will give rise to a capital loss to a holder. Likewise, the issuer must take any negative adjustment carryforward remaining on the retirement of the obligation into account as income from the discharge of indebtedness.^{35/}

Secondary market purchasers of contingent debt obligations, like initial holders, generally are required to accrue interest income in accordance with the original payment schedule. If the purchaser's basis is greater than, or less than, the adjusted issue price of the obligation (i.e., the purchaser acquires the obligation at a premium or discount), the premium, or discount, is treated as a negative or positive adjustment that must be allocated to the accruals or projected payments over the

^{35/} But see our comment at Part VIII-B-4 below.

remaining term of the obligation. Adjustments so allocated generally are taken into account at the time the corresponding interest is accrued or projected payment is made.

B. Comments on General Approach

1. Requirement to Accrue Without Regard to Changed Expectations About Contingent Payments

The Proposed Regulations require parties to accrue OID based on expectations regarding the amount of contingent payments as of the time of issuance.^{36/} Changes in the expected values of contingent payments are not realized until the payments become fixed or are made. Arguably such deferral differs from the deferral of anticipated gains and losses from changes in the value of property under the realization system of federal income taxation. Interest is paid for the use of capital,^{37/} and accrues with the passage of time.^{38/} Thus, changed expectations as to the amount of interest to be paid on an instrument might reasonably alter the rate at which interest accrues for tax purposes over the remaining life of the instrument. Alternative methods that would allow revisions to the accrual schedule based on changed expectations were included in the contingent payment debt instrument regulations that were filed and then withdrawn in January 1993 (the "1993 Proposed Regulations")^{39/}

^{36/} Prop. Treas. Reg. § 1.1275-4(b)(2), (3).

^{37/} Deputy v. Du Pont, 308 U.S. 488 (1940).

^{38/} Cf. Treas. Reg. § 1.461-4(e).

^{39/} See, e.g., the yield adjustment method and the spot price method in the 1993 Proposed Regulations §§ 1.1275-4(b)(3) and -4(b)(7), respectively.

The non-contingent bond method is simpler than these alternative methods, however. It does not require holders to engage in the difficult exercise of reevaluating expectations of future contingent payments. Requiring such adjustments would also raise difficult questions relating to identification of the circumstances that would trigger a reevaluation. We therefore support the adjustments methodology adopted by the Proposed Regulations.

2. Limitation on Negative Adjustments

Although the Proposed Regulations generally require the full amount of positive adjustments to be recognized currently, a negative adjustment generally is taken into account currently only to the extent of prior and current year's interest accruals with respect to the obligation (the "Negative Adjustment Limitation")⁴⁰/ Any negative adjustment in excess of such amount must be deferred until future years to offset interest accruals in those years. This results in a "one-way street" with respect to the timing of accruals attributable to the differences between projected and actual payments: Positive adjustments are always included or deducted immediately, while negative adjustments may be deferred.

However, this approach accommodates the character rule that negative adjustments effectively reverse accruals of interest income on the instrument rather than reduce principal. Immediate recognition of negative adjustment carryforwards as a capital loss could cause holders to recognize capital loss and subsequent mismatched ordinary income. We, therefore, support the approach adopted by the Proposed Regulations.

⁴⁰/ Prop. Treas. Reg. § 1.1275-4(b)(6)(iii).

3. Treatment of Contingent Payments that Become Fixed Prior to Payment

The Proposed Regulations provide three different adjustment rules for contingent payments that become fixed prior to their payment date:

First, in the case of a payment that is fixed six months or less before payment is due, the entire amount of the adjustment is recognized on the payment date (the "General Rule"). Second, under Proposed Treasury Regulation section 1.1275-4(b)(9)(ii) (the "Minibond Rule"), if the amount of a contingent payment is fixed more than six months prior to the payment date, the difference between the present value of the fixed amount and the present value of the projected amount is treated as a positive or negative adjustment on the date the payment becomes fixed. The holder's basis in, and the adjusted issue price of, the debt instrument is increased or decreased by the amount of such adjustment, and the debt instrument's projected payment schedule is modified to replace the projected payment with the now fixed amount of the future payment. Finally, under Proposed Treasury Regulation section 1.1275-4 (b) (9) (v) (the "Spread Rule"), if all remaining contingent payments become fixed substantially contemporaneously, the resulting positive or negative adjustment is spread over the remaining term of the instrument in a "reasonable" manner.

There is an exception from the Minibond Rule for contingencies relating to the reasonableness of the debt instrument's stated rate of interest -- such as those relating to the credit quality of the issuer and the liquidity of the debt

instrument -- which we think is appropriate.^{41/} We believe that this exception should be extended, however, to all remote or incidental contingencies.^{42/} The Minibond Rule is not appropriately applied to remote or incidental contingencies which have not been considered in constructing projections under the hypothetical non-contingent bond. If interest is increased for a temporary period because the issuer's credit is unexpectedly downgraded, for example, the present value of the increase in subsequent interest payments should not be available for current deduction by the issuer.

The Proposed Regulations offer no guidance as to what constitutes a reasonable manner for spreading an adjustment over the remaining life of the debt under the Spread Rule. It is presumably intended that the adjustment accrue on a constant yield basis over the remaining life of the debt, consistent with the treatment which would prevail if the parties legged into an integrated transaction on the fixing date. In the absence of any guidance, however, taxpayers may seek to accrue additional interest pro-rata over the remaining life of the debt, or take other inconsistent positions.

Yield to maturity accrual can be accomplished by adjusting the projected payments under the hypothetical non-contingent bond without making any positive or negative adjustments on the fixing date for the change in the instrument's present value. The resulting change in the yield of the instrument, and consequently, in the rate of interest accrual, will effectively amortize the change in value over the term between the fixing date and the payment date. For example,

^{41/} Prop. Treas. Reg. § 1.1275-4(b)(9)(ii)(E).

^{42/} See Part VI-A-2 above.

suppose that immediately after issuance of a \$1,000 stock indexed note that is projected to pay \$1,500 at maturity, the payment at maturity becomes fixed at \$2,000. Simply changing the projected payment to \$2,000 without making any positive or negative adjustment on the fixing date, or changing the \$1,000 issue price, will effectively "spread" the adjustment by causing the additional \$500 of interest to accrue on a yield to maturity basis over the remaining life of the bond.

If this suggestion is not adopted, further guidance will be needed regarding not only the proper means of spreading an adjustment, but also the treatment of basis and adjusted issue price under the Spread Rule. Because positive and negative adjustments are accrued at a time different from the payments to which they relate, for example, the basis and adjusted issue price of the instrument should be adjusted to reflect the accrual of positive and negative adjustments, as they are under the Minibond Rule.

The Minibond Rule and the Spread Rule are not consistent with each other. Which approach is more theoretically correct in any given case depends on whether the adjustment is attributable to the use of capital for a period that has already passed (e.g., when an amount becomes fixed shortly before maturity) or that has yet to pass (e.g., when an amount becomes fixed shortly after issuance)^{43/} The Spread Rule is consistent with the treatment of an economically equivalent non-contingent debt obligation and with the results of legging into integrated treatment under Proposed Treasury Regulation section 1.1275- 6. (No income or loss is recognized when a taxpayer legs into integrated

^{43/} Cf. discussion in Part VIII-B-1 below.

treatment.⁴⁴/ See Part XI below.) The Minibond Rule is consistent, however, with the treatment of a variable rate debt instrument under Treasury Regulation section 1.1275-5. On balance, we support the "split approach" of the Proposed Regulations. In light of the inconsistency of the two treatments, however, additional guidance is needed to determine which rule applies in any given case.

For example, we assume that the Spread Rule applies to a debt instrument with only one remaining contingent payment that becomes fixed, but this should be clarified. We likewise assume that the General Rule prevails over the Spread Rule, i.e., that there is no adjustment, if all remaining payments under an instrument become fixed within six months of when the instrument matures, but this is unclear.

4. Technical Comment on Negative Adjustments

It appears from the Proposed Regulations that negative adjustments are not netted against accruals of qualified stated interest for the same year, but rather effectively reverse them by virtue of the ordinary loss they generate. We think this may be a technical oversight requiring clarification.

We assume that adjustments governed by the Spread Rule are subject to the Negative Adjustment Limitation, although the Proposed Regulations do not explicitly so provide. This should be confirmed, however.

⁴⁴/ Prop. Treas. Reg. § 1.1275-6 (d)(ii), (g).

C. Timing Contingencies, Multiple Contingent Payments
Subject to a Minimum or Maximum Amount and Other
Interrelated Payments

The Proposed Regulations do not deal with instruments providing for multiple contingent payments that are subject to a minimum or maximum amount, or with fixed payments that are contingent solely as to time. Providing for full positive or negative adjustments in these cases will result in considerable distortion, since increased payments in earlier years will generally decrease payments in later years, and decreased payments in earlier years will increase payments in later years.

If there are only two contingent payments, the resolution of the amount payable in the earlier year will necessarily fix the amount payable in the later year: if the earlier amount becomes fixed at an amount greater than projected (producing a positive adjustment), the later amount will necessarily be less than projected (producing a negative adjustment under the Minibond Rule), and vice versa.^{45/} This will not be true of instruments promising more than two contingent payments, however, since an increase in the first payment will not necessarily result in a decrease in any particular subsequent payment, even though it may decrease the maximum or likely amount of the subsequent payments as a whole.^{46/}

^{45/} The later adjustment generally will not fully offset the earlier adjustment because, under Prop. Treas. Reg. § 1.1275-4(b)(9)(ii), the later adjustment must be discounted to present value (as of the time the amount of the two payments becomes fixed). In other words, the net adjustment (positive or negative) is simply the difference between the present value of the payments as originally projected and the present value of the payments as actually determined (discounting to the date the contingency becomes resolved).

^{46/} An example would be a 3-year debt instrument issued for \$100,000 promising total interest payments of \$30,000, with the payments occurring at the end of Years 1, 2 and 3. Assume that the projected

The most accurate rule would require a new projected payment schedule each time a contingent payment became fixed, but this appears unworkable and inconsistent with the general approach of the Proposed Regulations. In the interest of simplicity, we would suggest a mechanical rule that computes an adjustment based on the maximum or minimum possible adjustment. Specifically, we suggest that if at any time it is determined that the sum of the remaining payments on a contingent debt instrument will necessarily be greater or less than the sum of the remaining payments under the projected payment schedule, there will be a positive or negative adjustment at such time determined by assuming that the excess or shortfall will occur with respect to the last possible contingent payment or payments that could result in such excess or shortfall.^{47/} The projected payment schedule, issue price and basis of the instrument will be correspondingly adjusted in the same manner as is required under the Minibond Rule for payments that become fixed prior to maturity.^{48/}

amount of each payment is \$10,000, and the projected yield on the instrument is 10%. If the actual payment received at the end of Year 1 is \$15,000, a straightforward application of the non-contingent bond method would give rise to a \$5,000 positive adjustment at that time. There would be no offsetting negative adjustment because the payments at the end of Years 2 and 3 would both remain contingent (although the combined amount of these two payments would necessarily be \$5,000 less than under the originally projected payment schedule).

^{47/} An example of such a rule is Temp. Treas. Reg. § 15a.453-1(c)(2), which deals with contingent installment sales with a maximum selling price.

^{48/} In the example above, the \$15,000 payment at the end of Year 1 would give rise to a positive adjustment of \$5,000 under the usual rules. Since the payment would make it certain that the two remaining interest payments will sum to only \$15,000, which is \$5,000 less than the originally projected sum of \$20,000, however, there would be a negative adjustment computed as if the last payment had been fixed at \$5,000. That adjustment would be \$4,132, the present value of the \$5,000 decrease, discounted for two years at 10%. There would therefore be a net positive adjustment at the end of Year 1 of \$868. The adjusted issue price and basis of the instrument would be decreased under Prop. Treas. Reg. § 1.1275-4(b)(9)(ii)(D) by \$4,132 to \$95,868, as is generally required under the Minibond Rule.

An alternative but more complex rule would be to treat all subsequent contingent payments as proportionately increased or decreased. Another alternative rule would be to assume that such excess will occur with respect to the first possible contingent payment, although that would often result in no net adjustment at all.

D. Treatment of Secondary Holders

1. Proposed Adjustment to Interest Accrual

The Proposed Regulations require secondary holders to determine their periodic OID inclusions based on the original payment schedule. We generally support this approach: the retention of the original payment schedule by secondary holders obviates the need for secondary holders to construct a new payment schedule based on changed expectations. Such an exercise would be difficult for unsophisticated taxpayers and would likely be a source of controversy between taxpayers and the IRS.

If contingent payments on a debt instrument are expected to be less than originally projected, however, taxable persons are unlikely to purchase them in the secondary market, because the Proposed Regulations will require secondary holders to accrue such OID based on the original payment schedule. The resulting over-accrual of interest will not be offset by negative adjustments to contingent payments, since accrual is based on the original payment schedule while negative adjustments are only made when the contingent payment is made (e.g., at maturity). Likewise, taxable persons are likely to pay more than the present value (determined without taking into account tax consequences) of expected future payments on obligations whose contingent

payments are expected to be greater than originally projected. This "tax premium" will reflect the deferral benefits available to the secondary holder as a result of interest accrual based on the original payment schedule. For example, a U.S. person who purchases for \$5,000 an instrument that was originally issued for \$1,000 might accrue \$80 of interest income per annum (8% of \$1,000), which is only 1.6% per annum of the purchase price of the instrument.^{49/}

This problem might be remedied by requiring secondary holders to multiply accruals of interest income based on the original payment schedule by a fraction the numerator of which is the basis of the bond and the denominator of which was the adjusted issue price of the bond. In effect, interest would accrue at the Base Accrual Rate on the purchase price, rather than the issue price, of the instrument. This would require no new computations, since the fraction would be applied directly to accruals on the unadjusted hypothetical non-contingent bond. In the example above, the amount of OID accruing on the bond after the purchase date would be \$400, rather than \$80, to reflect the purchase for \$5,000 of an instrument with an adjusted issue price of \$1,000.

We recognize, however, that this proposal involves substantial additional complexity which might not be justified by the resulting increase in accuracy. For example, the numerator of the fraction would have to be reduced (or increased) to account for any premium (or discount) that effectively represents

^{49/} Thus, a U.S. taxpayer subject to these rules would likely pay the initial holder less than the present value (determined without taking into account tax consequences) of expected future payments on an obligation whose contingent payments are anticipated to be less than originally projected. Such instruments are likely to be sold instead to foreign persons or to domestic tax-exempt entities.

acquisition premium or market discount and is therefore allocated to interest, rather than to contingent payments. Rules would also have to be devised to adjust the taxpayers' basis to account for the difference between the amount of interest that actually accrues after application of the fraction and the amount of interest accruing on the unadjusted hypothetical non-contingent bond, so as to assure that secondary holders did not recognize mismatched capital gain or loss when payments on the bond were actually received.

2. Allocation of Discount and Premium Between Daily Portions of Interest and Contingent Payments

If a secondary holder purchases a debt instrument for more or less than its adjusted issue price, the holder must first reasonably allocate a portion of the resulting premium or discount to daily portions of interest and allocate the remainder to projected contingent payments.^{50/} The theory behind this allocation is that if expectations regarding contingent payments have not changed and the premium or discount is attributable solely to changes in market interest rates, then the difference between the price paid for the debt instrument and its adjusted issue price is similar to market discount, acquisition premium or premium on non-contingent OID instruments and therefore should affect the holder's periodic inclusions.

We recommend that the Proposed Regulations clarify that premium and discount attributable to any of the following factors should be allocated to daily portions of interest: (i) the yield curve, which in a normal environment will tend to cause premium

^{50/} Prop. Treas. Reg. § 1.1275-4(b)(9)(i)(B) (premium), (C) (discount). But see Prop. Treas. Reg. § 1.1275-4(b)(9)(i)(E) (safe-harbor for exchange-listed property).

(and in an inverse environment will tend to cause discount), (ii) changed conditions in the issuer's creditworthiness, and (iii) changed market interest rate conditions. We also recommend that the regulations specifically permit taxpayers to determine the amount of an adjustment that is attributable to changed market interest rates based on changes in standard interest rate indices. (The Preamble contemplates a taxpayer's ability to allocate premium or discount based on such indices,^{51/} but permission does not appear in the text of the Proposed Regulations.)

Thus, Example 2 of Proposed Treasury Regulation section 1.1275-4(b)(9)(i)(F) deals with a five-year bond with semiannual payments of \$35 and a single contingent payment at maturity that is originally projected to be \$1,175. The bond was originally issued at par for \$1,000. After the second year, a secondary holder purchases the bond for \$910 (which is \$150 less than its adjusted issue price of \$1,060). The example indicates that two factors have changed since the original issuance of the bond. The market rate of interest on similar debt instruments has increased from approximately 10 percent to approximately 13 percent and the expected value of the contingent payment has declined by about 9 percent. In light of our suggestions above, the Proposed Regulations should clarify the example to provide that the 13 percent interest rate is the market rate of interest on debt instruments with a term comparable to the remaining term of the debt instrument and issued by debtors with creditworthiness comparable to that of the issuer as of the purchase date. This change would make clear that premium or discount attributable to the yield curve and changes in the issuer's credit rating are properly allocable to periodic accruals. They should also provide in the example that, because a secondary holder that expected a

^{51/} 59 Fed. Reg. 64884, 64888 (Dec. 16, 1994).

\$1,175 payment at maturity but demanded a yield of 13% would pay \$975 for the debt instrument, \$85 of the discount (\$1,060 - \$975) could reasonably be allocated to daily portions of interest and the remainder of \$65 could reasonably be allocated to the projected contingent payment.

We also recommend that the Proposed Regulations provide a safe harbor that permits a holder to assume, for purposes of allocating discount or premium between contingent payments and daily portions of interest, that changes in market rates of interest (taking into account the yield curve) are equal to the difference between (i) the yield on Treasuries in effect when the debt instrument was originally issued (for maturities equal to the debt instrument when originally issued and based on semi-annual compounding) and (ii) the yield on Treasuries in effect when the debt instrument was purchased (for maturities equal to the remaining term on the debt instrument and based on semiannual compounding). This approach is consistent with the statement in the Preamble permitting allocations based on standard interest rate indices.

3. Further Allocation of Daily Portions Among Accrual Periods

After a secondary holder determines the amount of discount or premium that is allocable to daily portions of interest, the secondary holder must additionally allocate that amount among those daily portions.^{52/} The Proposed Regulations in one example permit an allocation to daily portions of interest on "a pro-rata basis"^{53/} and in another permit an allocation under a

^{52/} Prop. Treas. Reg. § 1.1275-4(b)(9)(i)(A), (B) (premium), (C) (discount); see Prop. Treas. Reg. § 1.1275-4 (b)(9)(i)(F), Example 2(ii).

^{53/} Prop. Treas. Reg. § 1.1275-4(b)(9)(F), Example 2(ii) (A). It is unclear whether allocation on a "pro-rata basis" means that the payments are

methodology that does not appear to be either pro-rata or based on constant yield concepts.⁵⁴/ In the case of a taxpayer that is required to include market discount in income on a current basis, we recommend that the regulations permit allocation of the discount among daily portions of interest in proportion to the remaining OID accruals that arise under the hypothetical non-contingent bond and that the Treasury prohibit secondary holders from allocating such discount equally among the remaining periods. Otherwise allocations could result in distortion.

E. Exchange of Contingent Debt Obligations in Reorganizations

The Proposed Regulations do not discuss how a negative adjustment carryforward should be treated if an obligation is exchanged in a reorganization, and the Preamble asks for comments on this point. We believe that if a contingent debt instrument is exchanged for a package of consideration (in a reorganization or otherwise), any negative adjustment relating to the security exchanged should be allocated, based on fair market values, among the properties received. Then, consistent with the policies underlying the reorganization provisions, if a debt obligation received in the exchange is a "security" and such exchange is tax-free, any negative adjustment carryforward allocated to the security received should be carried forward to offset subsequent interest income. If stock is received tax-free, the basis of the stock should be increased to reflect the carryforward. Any negative adjustment carryforward that is allocated to taxable consideration (including the excess principal amount of any securities received) should be recognized in the same manner and

allocated evenly among all remaining accrual periods or whether they allocated among OID accruals in proportion to the accruals required to be made under the original payment schedule.

⁵⁴/ Prop. Treas. Reg. § 1.1275-4(b)(9)(i)(F), Example 2(ii) (B).

to the same extent as if the old obligation had been retired by the issuer for cash.

It might be appropriate for the Proposed Regulations to include an anti-abuse rule designed to prevent holders from avoiding ordinary interest income by exchanging the instrument for stock of the issuer in a tax-free reorganization shortly before the receipt of a large payment of contingent interest^{55/}

VIII. Character of Income from Contingent Debt

A. Background

The Proposed Regulations provide rules for determining the character of gain or loss on the sale, exchange or retirement of a contingent payment debt instrument. These rules represent a substantial departure from the treatment of non-contingent debt instruments under present law. Under the Proposed Regulations, such gain is ordinary interest income, and such loss is ordinary to the extent of the holder's prior interest inclusions (as reduced by any prior year net negative adjustments treated as ordinary losses). Any loss in excess of that treated as ordinary is treated as loss from the sale, exchange or retirement of a debt instrument. However, if no additional contingent payments are scheduled when the debt instrument is sold, exchanged or retired, these character rules do not apply, and any gain or loss is treated as gain or loss from the sale, exchange or retirement of a debt instrument.

^{55/} Cf. our recommendation in Part XI-D-2 below proposing to expand the integration anti-abuse rule of Prop. Treas. Reg. § 1.1275-6(d)(1)(iii) to character as well as timing.

The Preamble states that the treatment of net positive and net negative adjustments necessitated the adoption of rules for characterizing gain or loss on the sale, exchange or retirement of contingent payment debt instruments that differ from those applicable to other debt instruments. Without a rule characterizing all gain, and loss to the extent of prior interest income inclusions, as ordinary, holders of contingent payment debt instruments could convert interest income from anticipated positive adjustments into capital gain, or suffer conversion into capital loss of amounts by which anticipated negative adjustments would reduce ordinary income, if the debt instrument were sold immediately before the adjustments were to occur.

The Proposed Regulations indicate that net positive adjustments are treated as additional interest. Net negative adjustments are treated as a reduction in original issue discount that otherwise would accrue on the contingent debt instrument for the taxable year and any additional net negative adjustment is treated as an ordinary loss by the holder and as ordinary income for the issuer. No guidance is given regarding the treatment of the additional ordinary income or loss for purposes of various provisions of the Code.

B. Comments

We generally support the character related rules contained in the Proposed Regulations, but have the following comments and recommendations:

1. Integration of Character and Spread Rule

In general, when a contingent payment becomes fixed more than six months prior to maturity, there is an immediate positive

or negative adjustment equal to the present value of the excess of the fixed payment over the project payment. The positive or negative adjustment is spread over the remaining life of the instrument, however, if all of the remaining contingent payments have become fixed.^{56/} If all of the remaining payments under the instrument are fixed, however, gain or loss from the disposition of a contingent debt instrument is capital gain or loss.^{57/}

The interaction of these two rules apparently permits a holder to sell a debt instrument immediately after the remaining contingent payment or payments become fixed and convert what would otherwise be a positive adjustment that is "spread" over the remaining life of the instrument into a capital gain. We presume that the result described above is an oversight requiring technical correction. We note in this regard that Proposed Treasury Regulation section 1.1275-4(b)(8)(iv) is designed to prevent such a result where the positive adjustment is not included in income immediately because the contingent payment has become fixed within six months of the payment date.

2. Character of Net Negative Adjustments for Issuers

For the issuer of a contingent debt instrument, the characterization of net negative adjustments in excess of current interest expense on that instrument can have significance in applying numerous different Code provisions that require income to be categorized. For example, for purposes of the earnings stripping rules, investment interest limitations and foreign tax credit limitations, it is important to determine whether the ordinary income produced by the additional net negative

^{56/} See Part VII-B-3 above.

^{57/} Prop. Treas. Reg. § 1.1275-4(b)(8)(iii).

adjustment offsets other interest deductions, and if so, which ones. It is in any case important to determine the source and character of such income for purposes of foreign tax credit limitations (including the "basket" of the income) and the passive loss rules, i.e., whether the income is "passive" or "portfolio" income.

In general, we recommend a rule that, for the foregoing and any other purposes, treats the additional net negative adjustment in a manner that is coordinated with the income tax treatment of the prior (excess) interest deduction offset. For example, where the previous interest deduction was deferred (under, e.g., Code section 163(d), section 163 (j) or section 469), the negative adjustment corresponding amount of interest expense still subject to deferral. Where the prior deduction was disallowed (under, e.g., section 265), the negative adjustment should not be included in income. If the prior interest expense was capitalized (e.g., under section 263A), then the negative adjustment should not be included in income but rather should reduce the basis of the relevant property. Where the prior (excess) interest was deducted, the character of the negative adjustment should be the same as the character of the income that the deduction offset. For example, for purposes of foreign tax credit limitations, income attributable to the additional net negative adjustment should be allocated between U.S. and foreign sources, and among the various categories of foreign source income, in proportion to the allocation of deductions previously taken on the contingent debt instrument. Under the passive loss rules, income attributable to the additional net negative adjustment should have the same characterization as the income previously offset.

In applying all of these rules, tracing of the income previously offset will be required. For simplicity, we would recommend a "LIFO" rule that would look to the deductions in the most recent year until exhausted, and then to the next most recent preceding year.

3. Character of Net Negative Adjustments for Holders

Holders of contingent debt instruments similarly need to characterize these additional net negative adjustments for various purposes. Accordingly, we recommend that similar rules apply to additional net negative adjustments for holders. For example, the adjustment should be treated as a reduction in net investment income, and should have the same source as income derived from the contingent debt instrument.

In particular, we recommend that it be clarified that for individuals, any deduction attributable to a net negative adjustment not be subject to the "2 percent floor" of section 67(c) of the Code. We see no reason why a rule designed to "correct" prior overaccruals of interest income should be subject to a limitation on deductions. A reasonable analogy might be to section 171(e) of the Code, which treats amortization of bond issuance premium as a reduction in interest income, rather than as a miscellaneous itemized deduction.

4. Character of Issuer's Gain on Retirement of the Debt

Under the Proposed Regulations, in each year prior to the year in which a contingent debt instrument is retired, the issuer treats the excess of the negative adjustments over the interest that accrues in that year as ordinary income to the extent of prior interest expense. Any residual negative

adjustment carryforward in the taxable year in which the debt instrument is retired, however, is treated by the issuer as cancellation of indebtedness ("COD") income under section 61(a)(12) of the Code.

The treatment of the issuer's gain as COD income is theoretically consistent with the notion that the interest imputed and accrued on a contingent payment debt instrument should be treated for all purposes of the Code as if the interest had actually accrued. We note, however, that an issuer that retires a contingent debt instrument for the full amount required under its terms has not been discharged from an indebtedness instead, the contingency has been resolved and the amount of the indebtedness has been established in accordance with the terms of the parties original agreement. Under established law, this kind of resolution of the issuer's indebtedness does not give rise to COD income.^{58/} The effect of the Proposed Regulations is to permit an issuer to accrue deductions in respect of contingent interest and then, if the issuer pays less upon maturity than the imputation scheme treated as accruing, to treat the amount of the residual negative adjustment carryforward as eligible for exclusion from income under section 108 of the Code. We question

^{58/} United States v. Centennial Savings Bank FSB, 499 U.S. 578 (1981). In Centennial, a savings bank claimed that withdrawal penalties earned when depositors withdrew the principal amount of CDs prior to maturity was COD income eligible for exclusion under section 108. The Supreme Court held that the bank had not been "discharged" of an obligation: "[T]he depositor and the bank have determined in advance precisely how much the depositor will be entitled to receive should the depositor close the account on any day up to the maturity date. Thus, the depositor does not discharge the bank from an obligation when it accepts an amount equal to the principal and accrued interest minus the penalty, for this is exactly what the bank is obligated to pay under the terms of the CD agreement." Id. at 581. On this basis the Supreme Court held the penalties were not COD income.

whether this result is consistent with the purpose underlying section 108 of the Code ^{59/}

IX. Non-Publicly Traded Debt Issued for Property

A. Background

The non-contingent bond method of Proposed Treasury Regulation section 1.1275-4(b) does not apply to a contingent payment debt instrument that is not publicly traded and that is issued in exchange for non-publicly traded property. Rather, Proposed Treasury Regulation section 1.1275-4(c) requires that such a contingent debt instrument (referred to in the Proposed Regulations as the "overall debt instrument") be separated into components: the non-contingent payments and any quotable contingent payments are analyzed together under one set of proposed rules, while each non-quotable contingent payment is analyzed separately under another set of proposed rules.

Under Proposed Treasury Regulation section 1.1275-4(c)(3), the non-contingent payments and any quotable contingent payments are treated as a separate debt instrument (referred to herein as the "Separate Debt Instrument"); the issue price of the Separate Debt Instrument is determined under the rules of Treasury Regulation section 1.1274-2.^{60/} OID is accrued on the Separate Debt Instrument applying the general rules of the OID

^{59/} See Centennial, 499 U.S. at 582-83 ("Congress established the tax deferred mechanism in section 108 so that the prospect of immediate tax liability would not discourage businesses from taking advantage of opportunities to repurchase or liquidate their debts at less than face value.").

^{60/} Where it is necessary to determine an issue price for the overall debt instrument, the issue price for the Separate Debt Instrument is to be used, without taking into account any non-quotable contingent payments on the overall debt instrument. See Prop. Treas. Reg. § 1.1274-2(g), discussed below.

regulations, including the non-contingent bond method of Proposed Treasury Regulation section 1.1275-4(b) if there are quotable contingent payments.^{61/}

Under Proposed Treasury Regulation section 1.1275-4(c)(4), the treatment of a non-quotable contingent payment is determined when the amount of the payment becomes fixed. In general, a non-quotable contingent payment is treated as principal in an amount equal to the present value of the payment, determined by discounting the payment at the AFR^{62/} from the date the amount of the payment was fixed to the issue date of the overall debt instrument.^{63/} The remainder of the payment is treated as interest which is includible in and deductible from gross income in the respective taxable year of the holder or issuer in which the amount of payment becomes fixed.^{64/}

^{61/} None of the interest payments on the Separate Debt Instrument are treated as qualified stated interest (within the meaning of Treas. Reg. § 1.1272-1 (c)), however, and the de minimis rule of Code § 1273 and Treas. Reg. § 1.1273-1(d) does not apply to the Separate Debt Instrument.

^{62/} Under Prop. Treas. Reg. § 1.1274-5(c) (4) (ii) (C), the appropriate test rate is the rate that would be the test rate for the overall debt instrument under Treas. Reg. § 1.1274-4 based on a term beginning on the issue date of the overall debt instrument and ending on the date the contingent payment becomes fixed.

^{63/} Prop. Treas. Reg. § 1.1275-4 (c)(4)(ii)(A). A non-quotable contingent payment is treated entirely as principal if it is accompanied by a payment of adequate stated interest.

^{64/} Prop. Treas. Reg. § 1.1275-4 (c)(4)(i); (ii)(B). If a non-quotable contingent payment becomes fixed more than six months before it is due, a separate debt instrument to which section 1274 applies is deemed to be issued on the date the amount of the payment becomes fixed (the "fixing date"), maturing on the date the payment is due. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed, while the issue price is the present value of the payments under the separate debt instrument, determined by discounting the payments at the appropriate test rate from the maturity date of the separate debt instrument to the fixing date. The issue price is treated as a payment of principal and interest and accounted for under the rules discussed above. Prop. Treas. Reg. § 1.1275-4(c)(4)(iii)(A).

Thus, the Proposed Regulations generally follow the approach of Old Regulation section 1.1275-4(c), except that (a) quotable contingent payments are included in the issue price of the instrument, and (b) there is no limit to the amount of the payments that may be treated as principal. Under the Old Regulations, once deemed principal exceeded a fixed or maximum stated principal amount, payments under the instrument were treated entirely as interest.

Any gain on the sale, exchange or retirement of a debt instrument subject to Proposed Treasury Regulation, section 1.1275-4 (c) is treated entirely as interest income, unless there are no remaining contingent payments on the debt instrument at the time of the sale, exchange or retirement. For this purpose, if a contingent payment becomes fixed more than six months before it is due, it is no longer treated as a contingent payment after the date it is fixed.^{65/}

Under Treasury Regulation section 1.1001-1(g) in its current form, if a debt instrument is issued in exchange for property, the seller's amount realized that is attributable to the debt instrument is the issue price of the debt instrument as determined under Treasury Regulation section 1.1273-2 or section 1.1274-2 (b), as applicable. The Proposed Regulations would amend Treasury Regulation section 1.1001-1(g) to provide that this rule does not apply to a contingent payment debt instrument. We interpret the proposed amendment to Treasury Regulation section 1.1001-(g) to require that, if a contingent payment debt instrument is issued in exchange for non-publicly traded property, Treasury Regulation section 1.1001-1(a) and not Treasury Regulation section 1.1001-1(g) will apply; therefore,

^{65/} Prop. Treas. Reg. § 1.1275-4(c)(5).

the amount realized by the seller of the property will be the fair market value of the debt instrument. Whether the seller would be required to include the income from the sale currently would depend upon whether the seller elected out of the installment method.^{66/}

By contrast, the Proposed Regulations would retain the current rule in Treasury Regulation section 1.1012-1(g) that, if a debt instrument, including a contingent payment debt instrument, is issued in exchange for property, the buyer's cost basis for the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under Treasury Regulation section 1.1274-2(b). Under Treasury Regulation section 1.1274-2(b), the issue price of a debt instrument that provides for adequate stated interest is its stated principal amount; otherwise, the issue price is its imputed principal amount. Proposed Treasury Regulation section 1.1274-2(g) provides that, for purposes of Treasury Regulation section 1.1274-2(b), the stated principal amount of a contingent payment debt instrument is the sum of the non-contingent principal payments and the projected amount of any quotable contingent payments, while the imputed principal amount is the sum of the present value of each non-contingent payment and the present value of the projected amount of each quotable contingent payment, as determined by discounting at the AFR. Thus, the buyer's cost basis is limited under the Proposed Regulations to the value of the fixed and quotable contingent payment (i.e., unlike the seller's amount realized, the buyer's basis does not include the value of any non-quotable contingent payments).

^{66/} See generally Code § 453.

B. Comments

1. Treatment of the Buyer

We generally approve of the "wait and see" approach adopted by the Proposed Regulations to deal with a taxpayer who issues non-publicly traded contingent debt in exchange for non-publicly traded property, whereby non-quotable contingent payments are excluded from the buyer's initial basis for the acquired property and the issue price of the debt instrument issued in exchange, and then are treated partly as additional purchase price when their amounts become fixed.^{67/} If our recommendations in Part III above are adopted and the distinction between quotable and non-quotable payments is eliminated, moreover, we think that quotable contingent payments should be dealt with like other contingent payments issued in exchange for property, i.e., they should be initially excluded from the buyer's basis and issue price.^{68/}

It would, of course, be possible to apply the non-contingent bond method to an instrument issued in exchange for non-publicly traded property by estimating the fair market value of the instrument to arrive at an issue price for the instrument; that is in fact what the seller of the property who elects out of installment sale treatment must do to determine the amount of gain or loss recognized from the sale of the property. We are concerned, however, about the potential for abuse if buyers are given additional cost basis in respect of the estimated value of

^{67/} Prop. Treas. Reg. § 1.1275-4(c)(6), Example 1, part (iv) indicates that the portion of a non-quotable contingent payment that is treated as principal gives the buyer additional basis in the property acquired. We recommend that, for clarity, Treas. Reg. § 1.1012-1(g) be amended to include a provision to that effect with a cross-reference to Prop. Treas. Reg. § 1.1275-4(c).

^{68/} This would require revision of Prop. Treas. Reg. § 1.1274-2.

anticipated contingent payments on debt issued in exchange for property and are also permitted to increase the issue price of the debt by the value of such payments and deduct market rate interest on the resulting increase in the debt's issue price. We observe in this regard that the non-contingent bond method permits and requires the accrual of income in advance of the resolution of contingencies. We believe that adding the value of anticipated contingent payments to the basis of acquired property and the issue price of debt issued in exchange would invite the structuring of tax avoidance transactions favoring issuers of instruments not subject to the discipline of a public market or of cash, sales.

We observe, moreover, that these kinds of sales generally involve contingent payments precisely because the buyer and seller cannot agree on the value of the property being sold. In such a context, we think it appropriate to treat at least a portion of any deferred contingent payment as a capitalizable payment of additional purchase price. By contrast, the non-contingent bond approach generally treats any deviations from the projected schedule of payments as an adjustment to deductible interest. Finally, we observe that the debt instruments issued in exchange for non-publicly traded property often involve relatively small issuances providing for multiple contingent payments. As discussed in various places above, the non-contingent bond method is poorly adapted to such instruments, particularly when issued by relatively unsophisticated taxpayers.

2. Seller's Amount Realized

We approve of the "closed transaction" approach to taxing the seller of non-publicly traded property who elects out of installment sale treatment, pursuant to which the seller's

amount realized is definitely determined at the time of the sales transaction. We do not oppose requiring that the value of future contingent payments be currently realized by such a seller while denying the buyer basis in the acquired property in respect of such payments.^{69/}

If the seller does not elect out of installment sale treatment, however, the seller's amount realized should be limited to the initial issue price of the contingent debt received and then increased as subsequent contingent payments become fixed and are treated as principal. We see no point in drafting complex rules under section 1274 of the Code to force realization based on current valuation of variable future payments, and then complex rules under section 453 of the Code to defer recognition of the resulting gain. Rather, it seems simpler to wait and recompute interest in respect of deferred payments of principal when they are received, by discounting from the date when the additional purchase price is received to the issue date of the instrument, as generally provided for under Temporary Treasury Regulation section 15a.453-1(c). Furthermore, when the contingent payment becomes fixed, the interest charge provisions of Code section 453A should then be applied with respect to the additional gain, from the year of the sale of the property to the year in which the payment becomes fixed. Rules in the regulations under sections 1274, 453, and 453A should make this clear, and provide examples.

As discussed above, we interpret the proposed amendment to Treasury Regulation section 1.1001-1(g) as generally requiring that the seller's amount realized equal the fair market value of the debt instrument. As noted above, however, Treasury Regulation

^{69/} This approach is consistent with current law. See Albany Car Wheel Co. v. Commissioner, 333 F.2d 653 (2d Cir. 1964).

section 1.1001-1(g) should apply if the seller has elected installment sale treatment. The proposed amendment is in any event too broad, inasmuch as it would cause Treasury Regulation section 1.1001-1(g) to be inapplicable to all contingent payment debt instruments. Proposed Treasury Regulation section 1.1274-2 provides rules for determining the issue price of a contingent payment debt instrument governed by Proposed Treasury Regulation section 1.1275-4(c) that has non-contingent payments and quotable contingent payments, while Treasury Regulation section 1.1273-2 provides rules for determining the issue price of contingent payment debt instruments governed by Proposed Treasury Regulation section 1.1275-4(b); there is no reason why these issue prices should not be used under Treasury Regulation section 1.1001-1(g) as a surrogate for fair market value in determining the seller's amount realized. We therefore recommend that the amendment to Proposed Treasury Regulation section 1.1001-1(g) be clarified to provide that Treasury Regulation section 1.1001-1(g) is inapplicable only to debt instruments subject to Proposed Treasury Regulation section 1.1275-4(c) that provide for one or more non-quotable contingent payments (as defined in Proposed Treasury Regulation section 1.1275-4(b) (4) (ii)) where the seller has elected out of installment sale treatment.

Rules should be provided, moreover, for determining the fair market value of a contingent debt instrument received by a seller who elects out of installment sale treatment, under Treasury Regulation section 1.1001-1(a). Our preferred alternative would be to use the issue price of the Separate Debt Instrument (as determined under Proposed Treasury Regulation section 1.1274-2) plus the aggregate fair market values of the non-quotable contingent payments. We recommend this alternative because it would not create a discontinuity between the treatment of debt with no non-quotable contingent payments and debt with even a

small non-quotable contingent payment. Also, this alternative is consistent with Treasury Regulation section 15A.453-1(d), which provides that the amount realized by a seller that elects out of the installment method includes the fixed amount payable under the obligation (excluding any imputed interest) and the fair market value of the contingent payments.

If our recommendation above is adopted to eliminate the distinction between quotable and non-quotable payments, and remove quotable payments from the buyer's cost basis and issue price, then (a) the definition of issue price in Proposed Treasury Regulation section 1.1274-2 should be revised to exclude the value of all contingent payments, (b) a contingent debt instrument should be excluded from the application of Treasury Regulation section 1.1001-1(g) if the seller elects out of installment sale treatment, but otherwise should be included, and (c) the amount realized by a seller electing out of installment sale treatment should be the issue price of the contingent instrument under Proposed Treasury Regulation section 1.1274-2 plus the fair market value of all contingent payments under the instrument.

3. Treatment of the Holder of the Contingent Debt

We note that the Proposed Regulations do not deal with the treatment by the seller of the property of the payments received on the contingent debt instrument received in exchange. As noted above, a seller electing out of installment sale treatment will have realized an amount from the sale of the property that includes the fair market value of the non-quotable contingent payments and will therefore have a basis in the contingent debt instrument received in exchange that exceeds the issue price of the instrument by an amount equal to the fair

market value of the non-quotable contingent payments (such excess hereafter defined as the "Contingent Instrument"). The Proposed Regulations should provide rules allocating the holder's aggregate basis in non-quotable contingent payments among the non-quotable contingent payments, and otherwise determining the timing of income and loss from the instrument.

One alternative would be to apply to the holder the same basis recovery rules of Temporary Treasury Regulation section 15A.453-1(c) as apply for contingent payment sales reported on the installment method. Thus, for example, following the principles of Temporary Treasury Regulation section 15A.453-1(c), where there is a maximum amount payable on the Contingent Instrument, the allocation of basis therein to a particular non-quotable contingent payment would generally be made by reference to the ratio of the actual amount of that payment to the maximum amount payable, as adjusted to reflect subsequent events; where there is no maximum amount payable and the non-quotable contingent payments are to be received over a fixed period, the holder's basis in the Contingent Instrument generally would be allocated among the non-quotable contingent payments in equal increments.^{70/}

^{70/} A second alternative would be an "aggregation approach": the portion of each non-quotable contingent payment that is treated as principal under Prop. Treas. Reg. § 1.1275-4(c)(4)(ii)(A) would be applied first to recover the holder's basis in the Contingent Instrument. Once the holder's basis in the Contingent Instrument was fully recovered, any additional payments on the Contingent Instrument characterized as principal would be treated entirely as gain. The holder would not recognize any loss on the Contingent Instrument until the maturity date of the Contingent Instrument. Cf. Code §§ 165(g)(2), 166(a)(2); Treas. Reg. § 15A.453-1(c)(3). Admittedly, this method would result in a backloading of gain on the Contingent Instrument. Nevertheless, this approach offers relative simplicity of treatment, and the deferral of loss recognition until the Contingent Instrument is retired or disposed of has a backloading effect that favors the fisc.

A third alternative would be to allocate the aggregate basis of the Contingent Instrument (which presumably would equal its fair market value) among the contingent payment rights based on their relative fair

Regardless of the timing of returns of principal on a contingent debt instrument received in exchange for property, any gain or loss from such returns of principal should be treated as capital gain or loss, or as ordinary income or loss, under principles analogous to those of Arrowsmith v. Commissioner.^{71/}

4. Sale of Contingent Debt Prior to Maturity

For the reasons set out above, the rule of the Proposed Regulations treating all gain from the sale of a contingent debt instrument prior to maturity as ordinary income should not apply to an instrument received in exchange for non-publicly traded property. Rather, the proceeds of sale should itself be treated partly as interest and partly as principal under the rules which generally govern payments received on the instrument. If the seller has elected out of installment sale treatment, the holder should allocate the sales proceeds between the fixed portion of the instrument (hereafter, the "Separate Debt Instrument") and the Contingent Instrument based on their relative fair market values at the time of disposition. Gain or loss from the Separate Debt Instrument would be treated solely as capital gain or loss. The portion of the sales proceeds allocated to the Contingent Instrument would be treated as principal and interest under the

market values at the time of issuance. Under this approach, the holder would compute its gain or loss on each contingent payment right equal to the difference between the principal portion of the non-quotable contingent payment and the holder's basis in the contingent payment right. This approach is similar to the treatment under Code § 1286(a) of a holder of coupons that were stripped from a debt instrument. This approach has the virtue of measuring the timing of the holder's gain and loss more precisely than an aggregation approach; however, it is more complex, would require more record keeping than an aggregation approach and would require separate and inherently difficult valuations of each contingent payment right.

^{71/} 344 U.S. 6 (1952).

rules of Proposed Treasury Regulation section 1.1275-4(c) (ii), and the interest would be includible in the holder's income in the year of the disposition. The difference between the portion of the sales proceeds treated as principal and the holder's basis in the Contingent Instrument would be capital gain or loss.

5. Treatment of Subsequent Holders

We assume that a taxpayer who purchases for cash a contingent debt instrument originally issued for non- publicly traded property will be subject to the general rules for instruments purchased for cash. Such a purchaser would have to construct a projected payment schedule, presumably based on facts as of the date the purchaser acquires the instrument, as if the bond were issued at that time. Thus, the purchaser would not have to apply the premium or discount rules which generally apply to secondary holders.

Alternatively, and assuming that the "separate treatment" approach suggested in 4 above will be adopted, a subsequent holder could determine its basis in the Separate Debt Instrument and the Contingent Instrument by allocating its purchase price between the two instruments based on their relative fair market values at the time of acquisition and then follow the rules of Proposed Treasury Regulation section 1.1275-4(c)(ii). This would be relatively distortive and complex, however.

6. Coordination with S 108(e)(11) of the Code

Under section 108(e)(11) of the Code, the amount of an issuer's cancellation of indebtedness ("cod") income is equal to the excess of the adjusted issue price of the retired debt over

the issue price of the new debt. Under Proposed Treasury Regulation section 1.1274-2(g), the issue price of a contingent payment debt instrument is the issue price of the Separate Debt Instrument and therefore does not take into account the value of any non-quotable contingent payments. Thus, if an issuer retires a non-publicly traded debt instrument in exchange for a non-publicly traded contingent payment debt instrument that provides for non-quotable contingent payments, the Proposed Regulations require the issuer to recognize "phantom" cod income equal to the value of the non-quotable contingent payments.

Because the holder will not be under the installment sale method, the holder will include the entire fair market value of the debt received in its amount realized from the debt exchanged therefor (although gain or loss may not be recognized if the exchange qualifies as a tax-free recapitalization). We recommend that the issuer and holder be subject to symmetrical treatment. The issue price of a contingent payment debt instrument should therefore include the fair market value of all contingent payments, quotable or otherwise.

The issuer's treatment after the exchange should also be clarified. We assume that each non-quotable contingent payment would be treated as principal and interest under Proposed Treasury Regulation section 1.1275-4(c)(4)(ii). The principal portion would be applied first to recover the issuer's issue price in the contingent debt instrument. Once the issue price was fully recovered, the principal portion of any non-quotable contingent payments would be treated as deductible repurchase premium. At maturity, any remaining issue price of the contingent debt instrument would be treated as ordinary income.

7. Technical Point on Discounting of Payments

Where the fixing date is less than six months before the payment date, the portion that is treated as principal should be determined by discounting the non-quotable contingent payment from the payment date, rather than from the fixing date, to the issue date, and the interest portion should be includible and deductible by the holder and issuer in their respective taxable years in which the payment is made. Otherwise, no interest accrues between the fixing date and the payment date, since the Minibond Rule does not apply in such a case.

X. Tax-Exempt Obligations

The Proposed Regulations provide special rules in section 1.1275-4(d) for tax-exempt obligations. Following the premise presented in the Preamble that "it is generally inappropriate to treat payments on a property right embedded in a tax-exempt obligation as ... tax-exempt interest," these rules are highly restrictive. First, the rate at which tax-exempt interest accrues on the hypothetical non-contingent bond is capped at the greater of (i) the yield on the tax-exempt bond determined without accounting for the contingent payments, and (ii) the tax-exempt AFR, i.e., the composite measure of current tax-exempt market rates published monthly by the IRS. Second, any positive adjustments made to the projected payments are treated as taxable gain from the sale or exchange of the tax-exempt bond in the year of the adjustment, rather than as additional tax-exempt interest. Third, any negative adjustments reduce a bondholder's total tax-exempt interest from all sources for the year, with any excess losses carried forward to offset future tax-exempt interest. As a result, such losses are in effect not recognized.

We have not reached a consensus as to the proper treatment of tax-exempt contingent debt. Some of our members are satisfied with the approach of the Proposed Regulations and believe that the basic principle of the regulation, which appears to be grounded in a prohibition against converting equity returns into tax exempt interest, is sound. There are, however, several reasons to question the treatment of tax-exempt contingent debt under the Proposed Regulations, and some of our members believe that the Proposed Regulations do not reflect an appropriate treatment of tax-exempt instruments.

First, the treatment of tax-exempt contingent debt under the Proposed Regulations plainly differs from the treatment of taxable contingent debt. Questions have been raised as to whether the Treasury has the authority under section 1275(d) of the Code to provide a different treatment of tax-exempt contingent debt. If the consequence of treating amounts received on contingent debt as interest income is that such amounts are not included in income where the bond qualifies under section 103 of the Code, and if this result is thought undesirable, then the Treasury might reasonably seek legislation to limit the application of section 103(a) of the Code. We do not believe, however, that section 103(a) is so limited under current law, and some members have questioned the Treasury's authority under § 1275(d) to provide different rules for "interest" based upon the qualification of the indebtedness under § 103. We observe, moreover, that as a practical matter, treating contingent interest on tax-exempt debt as taxable capital gain will likely eliminate the market for tax-exempt contingent debt instruments.

Second, given the Proposed Regulations' treatment of interest in excess of projected payments on a tax-exempt

contingent debt instrument (i.e., of positive adjustments) as taxable capital gains, the theoretically consistent treatment of negative adjustments should be as deductible capital losses. As discussed in Part II above, for purposes of timing, the Proposed Regulations effectively deconstruct a contingent debt instrument into a comparable non-contingent debt instrument and a forward agreement to exchange fixed payments for variable payments. For purposes of determining character, however, the Proposed Regulations generally adopt a unitary approach by treating gain or loss on the forward agreement as increasing or decreasing interest on the debt, rather than as giving rise to capital gain or loss, so as to prevent holder mismatches of ordinary income and capital loss. The Proposed Regulations effectively extend the deconstruction approach to character as well as timing in the case of tax-exempt contingent debt, presumably because holders are not required to include interest from tax-exempt debt in income and therefore cannot suffer a mismatch of income and loss. It follows, however, that holders should treat negative adjustments as deductible capital losses. We do not, therefore, support the "one-way street" approach of the Proposed Regulations, under which holders treat positive adjustments as taxable capital gain and negative adjustments reductions of tax-exempt interest.

Third, we question why the Base Accrual Rate on a tax-exempt contingent debt instrument is limited to the tax-exempt federal rate of interest in cases where the issuer's true cost of capital on comparable non-contingent debt can be clearly established (e.g., because the issuer is fully hedged). There is no obvious abuse inherent in permitting holders to accrue tax-exempt interest income at a rate equal to the issuer's rate on comparable non-contingent debt. The Proposed Regulations, however, presume to characterize any excess of the issuer's cost

of capital over the tax-exempt AFR as taxable gains to the holders. If the concern in this regard is that tax-exempt issuers might seek to manipulate the rules by overstating projected payments and thereby generate artificial losses for holders, we believe that our recommendations in Part III above should ameliorate this problem.

If the Proposed Regulations continue to treat a portion of the income earned on tax-exempt contingent debt instruments as taxable capital gain, some members believe that the scope of tax-exempt debt instruments which can qualify as variable rate debt instruments under Treasury Regulation section 1.1275-5 should be expanded. As a practical matter, unless a tax-exempt contingent debt instrument qualifies as a variable rate debt instrument, it will no longer be possible to market the instrument to the public. Under current Treasury Regulation section 1.1275-5, a tax-exempt debt instrument provides for a qualifying "objective rate" of interest only if the relevant variable rate is a "qualified inverse floating rate"^{72/} Municipalities may reasonably wish to issue debt instruments, however, that are tied to inflation-based indices, or that are tied to multiples in excess of 1.35 of objective interest-based indices (if the issuers are relatively weak credits). To the extent that the underlying index relates to a measure of the cost of funds in a borrowing-type transaction, such issuances may not present any particular opportunity for tax abuse; and many non-equity linked indices are well within the range of conventional measures of interest.^{73/} Consideration should therefore be given to expanding the scope of the VRDI rules to include these instruments.

^{72/} Treas. Reg. § 1.1275-5(c)(5).

^{73/} Abuse potential may exist, however, where periodic payments are based on an equity return.

In addition, in the case of bonds issued to finance multi-family housing projects for low-income tenants, interest rates are often tied to formulas based on a percentage of the cash flow or profits from the project, since developers cannot otherwise attract investors to the project. Loss of tax-exempt status of payments of interest under these circumstances might as a practical matter eliminate these projects. Special relief might be in order for these cases.

XI. Integrated Transactions

A. General Approach

Proposed Treasury Regulation section 1.1275-6 generally provides for the integration of a "qualifying debt instrument" with a financial instrument (or instruments) if the combined cash flows of the qualifying debt instrument and the financial instrument(s) are equivalent to the cashflows on a fixed or variable rate debt instrument. The proposed regulation is modeled on the foreign currency hedging integration rules under Treasury Regulation section 1.988-5, which are widely recognized as providing an appropriate measure of income where they apply. The application of integration rules to other debt instruments and hedges represents a welcome advance, which we strongly support. We commend the Treasury for its flexible approach to the treatment of hedged contingent debt.

B. Respective Scopes of Prop. Treas. Reg. § 1.1275-6 and Treas. Reg. § 1.988-5

Proposed Treasury Regulation section 1.1275-6 excludes from the definition of an eligible hedge any transaction which hedges currency risk. Section 988(d) of the Code, however,

provides for integration only where a taxpayer enters into a hedging transaction "primarily" to reduce the risk of currency fluctuations. A financial instrument that hedges not only currency risk but also other risks (such as stock index risk) might not be entered into primarily to hedge currency risk, and thus arguably might not be eligible for integration under section 988 of the Code.^{74/} Such a hedge would appear to be excluded from the definition of a hedge under Treasury Regulation section 1.1275-6 (a "section 1.1275-5 hedge") as well, however, because the latter regulation currently excludes "[a] financial instrument that hedges currency risk."^{75/} We recommend that Proposed Treasury Regulation section 1.1275-6 exclude "any transaction that is treated as an integrated financial transaction under section 988(d) of the Code and the regulations thereunder," rather than any instrument which hedges currency risk.

^{74/} By its terms, Treas. Reg. § 1.988-5 can apply to the hedge of virtually any form of debt security, without regard to whether the hedging pertains to currency risk, although absent a primary purpose of reducing the taxpayer's currency risk, a transaction would not meet the statutory requirements for integrated treatment under section 988(d) of the Code. Treas. Reg. § 1.988-5 provides for the integration of a "qualifying debt instrument" (any bond, debenture, note, certificate, or other evidence of indebtedness -- regardless of whether denominated in, or determined by reference to, nonfunctional currency -- including dual currency debt instruments, multi-currency debt instruments and contingent payment debt instruments) and a "§ 1.988-5(a) hedge" (generally any financial instrument or combination of financial instruments that, when integrated with the qualifying debt instrument, permits the calculation of a yield to maturity in the currency in which the synthetic debt instrument is denominated).

When the regulations under § 988 of the Code are next revised, we recommend that the definition of a "qualified hedging transaction" in Treas. Reg. § 1.988-5(a)(1) be amended to require that the resulting synthetic debt instrument be denominated in a currency that is either different from the currency in which the qualifying debt instrument is denominated (assuming that the qualifying debt instrument is a single currency debt instrument) or different from a currency in which a material amount of the payments due under the qualifying debt instrument are denominated.

^{75/} Prop. Treas. Reg. § 1.1275-6(b)(2)(i).

As discussed in Part VI-B above, the definition of an instrument subject to Proposed Treasury Regulation section 1.1275-4 should exclude a foreign currency indexed debt instrument only if its contingencies relate solely to changes in the value of foreign currency. If this recommendation is not adopted, however, then the definition of a qualifying debt instrument under Proposed Treasury Regulation section 1.1275-6 should at least be broadened to include a contingent debt instrument subject to section 988 of the Code, even though such an instrument might not be subject to Proposed Treasury Regulation section 1.1275- 4.^{76/} otherwise, a transaction which clearly would not qualify for integrated treatment under section 988(d) of the Code would technically not be eligible for integration under Proposed Treasury Regulation section 1.1275-6, e.g., a foreign currency linked debt instrument which also includes a non-currency linked contingency and which is hedged solely for stock risk but not for currency risk.^{77/}

C. Scope of Permissible Section 1.1275-6 Hedges

1. Imperfect Hedging

The definition of a section 1.1275-6 hedge requires a perfect hedge in order for the taxpayer to integrate the financial instrument and the qualifying debt instrument. By

^{76/} Under the regulations as currently proposed, an instrument is not eligible for integration under Prop. Treas. Reg. § 1.1275-6 unless it constitutes a qualifying debt instrument under Prop. Treas. Reg. § 1.1275-6(b)(1), which as currently formulated would require that the instrument be subject to Prop. Treas. Reg. § 1.1275-4, which in turn, as currently drafted, excludes an instrument denominated in foreign currency "except to the extent that section 988 of the Code and the regulations thereunder require otherwise." Prop. Treas. Reg. § 1.1275-4(a)(2)(iv).

^{77/} see Treas. Reg. § 1.988-5 (a) (9), Example 7.

contrast, the Commissioner may require integration if the hedge is not perfect but the qualifying debt instrument and hedge have in substance the same combined cash flows as a fixed or variable rate debt instrument.^{78/} The preamble states that taxpayers may not avoid integration by altering the hedge so that there is a small amount of basis risk or the payments on the hedge do not fully match the payments on the qualifying debt instrument, but that the Commissioner will not integrate a debt instrument with an imperfect hedge if the taxpayer retains substantial risk.

We believe that a taxpayer, like the Commissioner, should be entitled to integrate a qualifying debt instrument and an imperfect hedge where the qualifying debt instrument and the hedge have in substance the same combined cash flows as a fixed or variable rate debt instrument. In most cases, a taxpayer will be able to (and will) enter into a perfect hedge. In some cases, however, a taxpayer may enter into a slightly imperfect hedge (because, for example, a perfect hedge is unavailable or uneconomic). Provided that the taxpayer properly elects integrated treatment, we believe that integration is still appropriate in such circumstances.

The general approach in the proposed regulations to such insignificant contingencies is illustrated by Proposed Treasury Regulation section 1.1275-4(a)(5), which provides that a payment is not a contingent payment if the contingency is incidental, i.e., if the potential amount of the payment under any reasonably expected market conditions is insignificant relative to the total expected payments on the debt instrument.^{79/} A similar rule

^{78/} Prop. Treas. Reg. § 1.1275-6(c)(2).

^{79/} See also Prop. Treas. Reg. § 1.1275-4 (a)(9)(ii) (a contingent payment is treated as a fixed payment if all remaining contingencies with

permitting a taxpayer to ignore any incidental contingencies with respect to the combined cash flows of the qualifying debt instrument and the financial instrument should be included in the definition of a section 1.1275-6 hedge in Proposed Treasury Regulation section 1.1275-6(b)(2).^{80/}

2. Related Party Hedges

Under Proposed Treasury Regulation section 1.1275-6(c)(1)(ii), in order to integrate a qualifying debt instrument with a section 1.1275-6 hedge, “[n]one of the parties to the § 1.1275-6 hedge [can be] related within the meaning of section 267(b) or 707(b) (1) (other than parties that have made a separate-entity election under § 1.1221-2(d)).” By permitting hedges between related parties electing under Treasury Regulation section 1.1221-2(d), the Proposed Regulations properly recognize that advantageous timing mismatches are not likely to occur where the related party providing the hedge (i.e., the party not holding the integrated position) is a United States person using a mark-to-market method of accounting, and that it is economically beneficial for a mark-to-market entity to hedge the positions of its affiliates.^{81/} As currently proposed, however, such hedging would not be available except for members of consolidated groups, i.e., not where the related mark-to-market entity is a partnership or trust. We recommend that related party

respect to the payment are remote or incidental); Prop. Treas. Reg. § 1.12754 (a)(9)(v) (same).

^{80/} We recommend that Treas. Reg. § 1.988-5 be amended to provide a similar rule.

^{81/} See. e.g., Prop. Treas. Reg. § 1.1221-2(d). The preamble to Prop. Treas. Reg. § 1.1221-2(d) states “the IRS and Treasury believe that there is less opportunity for manipulation or distortion if a member of a group enters into a hedging transaction with another member that is using mark-to-market accounting for tax purposes.”

hedges, regardless of whether between members of a consolidated group of corporations, be permitted so long as the party providing the hedge is on a mark-to-market method of accounting.^{82/} ^{83/}

To achieve this, Proposed Treasury Regulation section 1.1275-6 (c) (1) (ii) could be amended by adding at the end of the parenthetical "... or, in the case of parties not part of a consolidated group, where the party providing the hedge uses a mark-to-market method of accounting with respect to the hedge."

3. Anticipatory Hedges

Proposed Treasury Regulation section 1.1275- 6(c)(1)(vi) requires that a section 1.1275-6 hedge must be entered into on or after the date the qualifying debt instrument is issued or acquired. In other words, a taxpayer cannot "leg into" an integrated transaction if the debt is acquired after, rather than before, the hedge.

We recognize that there are technical concerns, as discussed in the Preamble, with permitting taxpayers to leg into an integrated transaction under these circumstances. As implied by the Preamble, the Treasury is concerned that a rule marking a hedge to market prior to legging in might permit inappropriate accelerations of income or loss, and a rule permitting gain or loss on the hedge to be deferred until maturity of the debt might permit inappropriate deferrals.

^{82/} Related parties outside of consolidated groups are treated as separate entities that can hedge with each other for purposes of the inventory hedging rules of Treas. Reg. § 1.1221-2; this result occurs without the requirement of a separate entity election.

^{83/} We recommend that a similar rule be adopted under the integration rules of section 988 of the Code.

We recommend an exception, however, for a truly "anticipatory hedge," i.e., a hedge entered into with the intention of issuing or acquiring debt within a relatively short period of time. While an anticipatory hedge may require a cash flow prior to the issuance or acquisition of the debt instrument, this cash flow could presumably be treated as part of the integrated transaction. Such cash flow would of course be recognized if the debt was not acquired within the specified period.

Alternatively, the Proposed Regulations could at least permit integration of an anticipatory hedge entered into shortly before issuance or acquisition of a qualifying debt instrument if the cash flow of such hedge does not begin until the issue date or the acquisition date of the qualifying debt instrument. For example, an issuer who enters into a firm agreement to issue a qualifying debt instrument and simultaneously enters into a section 1.1275-6 hedge could be allowed to integrate the debt instrument and the hedge if no payment has been made or received by the issuer under the hedge prior to the issuance of the debt instrument.

4. Recycled Debt Instruments

In order for a taxpayer to apply the integration rule, neither the qualifying debt instrument, any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the section 1.1275-6 hedge can have been part of an integrated transaction entered into by the taxpayer that has been terminated under the legging out rules. We do not believe that such a limitation should be imposed.

If a qualifying debt instrument is part of an integrated transaction that is terminated by a sale or disposition of the section 1.1275-6 hedge, appropriate adjustments are required to be made on the qualifying debt instrument under Proposed Regulation section 1.1275- 6(d)(2)(ii)(B) on the leg-out date to reflect any difference between the fair market value and the adjusted issue price of the qualifying debt instrument that is part of the integrated transaction. Because adjustments have been made to the qualifying debt instrument, we do not see why another section 1.1275-6 hedge cannot be entered into with respect to such debt instrument after the leg-out date.

5. Standard for IRS Integration

Treasury Regulation section 1.988-5(a)(8)(iii) permits the Commissioner to integrate a qualifying debt instrument (as defined in Treasury Regulation section 1.988- 5(a)(3)) and a hedge if, on the basis of all of the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualified hedging transaction (as defined in Treasury Regulation section 1.988-5(a)(1)), whereas the Commissioner may integrate a transaction under Proposed Treasury Regulation section 1.1275-6 if the combined cash flows are substantially the same as the combined cash flow on fixed-rate debt, without regard to other facts and circumstances, such as whether the debt and hedge were entered into in contemplation of each other. We see no reason why different standards should be adopted under Treasury Regulation sections 1.988-5 and 1.1275-6. We recommend that the section 988 standard be adopted for purposes of Treasury Regulation section 1.1275-6, since that takes account of relevant facts and circumstances.

D. Mechanics of Integration

1. Forward Contract to Sell a Qualifying Debt Instrument

An amendment should be made to Proposed Treasury Regulation section 1.1275-6(g)(3), which defines the term of a synthetic debt security as the period beginning on the issue date of the synthetic debt security and ending on the maturity date of the qualifying debt instrument. The end of the term of the synthetic debt security should be the earlier of the maturity date of the qualifying debt instrument or the maturity date of the section 1.1275-6 hedge if such hedge is a forward contract or other financial instrument requiring disposition of the qualifying debt instrument prior to maturity. Similar rules should apply where the taxpayer effectively shortens or lengthens the term of the instrument by exchanging actual principal for synthetic principal received at a different time.

2. Legging In: Holding Period

Proposed Treasury Regulation section 1.1275-6(g) is silent as to a taxpayer's holding period with respect to a synthetic debt instrument. There is no issue in the case where the qualifying debt instrument and the section 1.1275-6 hedge are acquired on the same date. Where a taxpayer legs into integrated treatment, however, clarification is needed regarding the holding period for the synthetic debt instrument.

In general, we recommend that the Proposed Regulations be amended to clarify that a taxpayer's holding period for the synthetic debt instrument includes the taxpayer's pre-integration holding period, if any, for the qualifying debt instrument. A taxpayer who legs into integrated treatment has held the

qualifying debt instrument prior to the leg-in date, and absent application of the anti-abuse rule of Proposed Treasury Regulation section 1.1275-6(d) (1) (iii),⁸⁴/ the taxpayer does not realize any gain or loss with respect to the qualifying debt instrument on the leg-in date. In such circumstances, the taxpayer's holding period for the synthetic debt instrument should include its pre-integration holding period, if any, for the qualifying debt instrument. The resolution of this issue may depend, however, on the resolution of the issue discussed in 3 below. Otherwise, taxpayers may be able to "age" what would otherwise be short-term gain on a risk-free basis by legging into integrated treatment.

3. Legging In: Disposition Prior to Maturity

A taxpayer does not recognize gain or loss when it legs into integrated treatment. This permits a taxpayer to lock in gain which, under Proposed Treasury Regulation section 1.1275-4 (b)(8)(i), would have been interest income if the contingent debt security had been retained unhedged or sold and subsequently realize capital gain by disposing of the synthetic debt instrument. In this regard, we recommend amending the anti-abuse rule governing leg-ins (Proposed Treasury Regulation section 1.1275-6(d)(1)(iii)), which currently targets legging into an integrated transaction "with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument," by adding the words "or converting unrealized gain on a contingent debt instrument into long-term capital gain in a manner inconsistent with the purposes of § 1.1275-4." See the discussion in Part VIII-B-1 above concerning the possibility that

⁸⁴/ If the anti-abuse rule is applied to treat the qualifying debt instrument as sold for its fair market value on the leg-in date, it follows that a new holding period for the synthetic debt instrument should begin on the day following the leg-in.

conversion of unaccrued interest income into capital gain might not be "inconsistent with the purposes of Treasury Regulation § 1.1275-4."

4. Holding Period -- Legging Out

Where a taxpayer legs out of an integrated transaction by selling or otherwise terminating one of the positions, the other position is treated as sold and entered into again at its fair market value immediately after the taxpayer legs out.^{85/} It seems logical that the holding period for the retained property should begin on the day following the leg-out. We recommend that this rule be explicitly included under Proposed Treasury Regulation section 1.1275-6(g), and that similar rules be incorporated in Treasury Regulation section 1.988-5.

5. Other Integration Mechanics

Although the mechanics for computing issue price and stated redemption price at maturity for a synthetic debt instrument work, in the sense of producing correct answers, they are also somewhat counterintuitive. It would seem less confusing to treat amounts paid by the issuer on the leg-in date as simple adjustments to the issue price of the synthetic debt instrument, rather than as adjustments to the stated redemption price at maturity and immediate payouts on the synthetic debt security. We recognize that this approach is less pure conceptually, and would mean treating amounts paid by the issuer at the inception of the hedge differently from amounts subsequently due by the issuer under the hedge. On balance, however, we prefer the conceptually impure approach because we think it somewhat less confusing on

^{85/} Prop. Treas. Reg. § 1.1275-6(d)(2)(ii)(C).

first encounter. Such an approach is consistent, moreover, with the approach of Treasury Regulation section 1.1273-2(g)(2).

6. Identification

Clauses (ii) and (iii) of Proposed Treasury Regulation section 1.1275-6 (f) require a taxpayer to enter and retain as part of its books and records (1) description of the qualifying debt instrument and the section 1.1275-6 hedge and (2) a summary of the cash flows and accruals resulting from an integrated transaction. We believe that these requirements are generally appropriate in order for the IRS to verify the calculation of the yield to maturity or the qualified floating rate or rates of the synthetic debt instrument. However, we would recommend the Proposed Regulations be clarified to indicate that such requirements are satisfied if (1) the description and the summary contains sufficient details enabling the calculation of the issue price and the yield to maturity or the qualified floating rate or rates of the synthetic debt instrument and (2) the summary explicitly states the issue price and the yield to maturity or the qualified floating rate or rates of the synthetic debt instrument.

XII. Information Reporting Obligations For Issuers And Nominees

Due to the special characteristics of contingent payment debt obligations, the existing information reporting rules are inadequate. Furthermore, the issuer is not in a position to determine how much income accrues in respect of a contingent payment debt obligation for any given holder.^{86/} It is therefore

^{86/} Because, for example, the characterization of negative and positive adjustments depends on taxpayer-specific facts and circumstances, such as how much income a taxpayer has previously included in respect of the instrument and the taxpayer's taxable year.

necessary to design a reporting system that will convey to a beneficial holder of a contingent debt instrument all the information necessary to compute the correct interest accruals.

A. Issuer's Reporting Obligations on Issuance

Because the taxation of contingent payment debt obligations would be similar to the taxation of non-contingent obligations, contingent payment debt obligations should be regarded as OID obligations for which issuers are required under Treasury Regulation section 1.1275-3(c) to file a Form 8281. To accommodate the special characteristics of contingent payment debt obligations, Form 8281 would need to be amended to require the issuer, in addition to meeting the other requirements of Form 8281, to provide the projected yield and the projected payment schedule of the instrument (in terms of \$1,000 of original principal amount). The issuer should be directed to use such projected yield and payment schedule in calculating the remaining items required to be set forth on Form 8281.

B. Annual and Periodic Reporting Requirements

To calculate interest accruals under the Proposed Regulations, holders will need both the projected payment schedule for the debt obligation and a record of the actual payments made by the issuer. To ensure that holders have timely and ready access to this information, we recommend the institution of an information reporting scheme similar to the existing information reporting system for REMIC regular interests under Treasury Regulation section 1.6049-7, as described below.

1. Annual Form 1099 Reporting

Consistent with the current rules, issuers and brokers or other middlemen who hold contingent payment debt obligations as nominees should be required to furnish and file information returns on Form 1099-OID if the holder of the obligation is not an exempt recipient under section 6049(b)(4) of the Code and Treasury Regulation section 1.6049-4 (c)(1).^{87/} The amount of interest income to be reported on the Form 1099-OID for each holder would presumably be calculated in accordance with the rules provided in Treasury Regulation section 1.6049-5(c) and by using the projected payment schedule and the projected yield on the contingent payment debt obligation ("reported unadjusted accrual"). Accrual taking account of positive or negative adjustments ("adjusted accrual") should also be reported assuming an unhedged calendar year taxpayer who purchased the instrument on original issuance. Other taxpayers will be responsible for adjusting reported unadjusted accrual by any applicable positive or negative adjustment and for any difference between their tax basis and the adjusted issue price of the contingent payment debt obligation, as required by the Proposed Regulations. The Form 1099-OID would be accompanied by a written statement of additional information needed to make the required adjustments to reported unadjusted accrual.^{88/} Issuers, brokers and other

^{87/} See below regarding the proposed procedure for making information available to exempt recipients.

^{88/} We believe this information might reasonably include: (1) the name of the issuer, the CUSIP number or other identifying number and a description of the contingent payment debt obligation for which the information is being provided; (2) the issue date of the contingent payment debt obligation; (3) the projected yield to maturity of the contingent payment debt obligation; (4) the amount and date of any projected payments (in terms of \$1,000 of original principal amount) within the calendar year for which the return is made; (5) the amount and date of any actual payments (in terms of \$1,000 of original principal amount) made during that calendar year; (6) the amount and date of any positive or negative adjustments (in terms of \$1,000 of original principal amount) resulting from the difference between actual and projected payments for that calendar year; and (7) the aggregate

middlemen would be required to furnish the written statement to the holder by the due date for mailing Form 1099-OID, but would not be required to file the written statement of additional information with the IRS.

2. Requirement That Issuers Timely Furnish Information to Nominees. Corporations and Other Specified Persons

Issuers should be required to file an information return similar to Form 8811 (Information Return for Real Estate Mortgage Investment Conduits (REMICs) and Issuers of Collateralized Debt Obligations). The form would require that the issuer provide its name and address, the CUSIP number or other identifying number, the issue date and a description of the contingent payment debt obligation, and the name, address and telephone number of an individual to be contacted by the public for tax information on the specified debt obligation. Issuers should also be required to file a new information return within 30 days after the change of the contact information provided on a previously filed information return. The IRS, in turn, would publish a directory of issuers of contingent payments debt obligations in a publication similar to Publication 938 (Real Estate Mortgage Investment Conduits (REMICs) Reporting Information (And Other Collateralized Debt Obligations (CDOs))) that identifies the contact person specified by the issuer.

Any of the following nominees or taxpayers should be authorized by the final regulations to request and obtain from the issuer or its appointed representative the same information

amount of projected interest income (in terms of \$1,000 of original principal amount) accrued on the contingent payment debt obligation for each accrual period (or part thereof) within that calendar year.

set forth on the issuer's Forms 1099-OID and the accompanying statement:

- ◆ any broker who holds on its own behalf or as a nominee any contingent payment debt instrument;
- ◆ any middleman who is required to make an information return and who holds as a nominee any contingent payment debt instrument;
- ◆ any corporation or non-calendar year taxpayer who holds a contingent payment debt instrument directly, rather than through a nominee; and
- ◆ any other holder that is an exempt recipient who holds a contingent payment debt instrument directly, rather than through a nominee.

The information can be provided in the same manner as permitted under Treasury Regulation section 1.6049-7(e)(3)(i) for REMIC regular interests. The final regulations should make clear that a nominee or a middleman is entitled to obtain the required information directly from the issuer or its representative, rather than through another nominee or middleman in the chain of ownership, even if the requesting nominee or middleman does not appear as the record owner of the contingent payment debt obligation on the books of the issuer.^{89/}

^{89/} Otherwise, the issuer could by refusing to honor the information request effectively prevent the nominee or middleman, in turn, from providing timely and correct Forms 1099-OID to non-exempt recipients.

Given the potential volatility of income and loss accruals on contingent debt instruments, we recommend that the final regulations allow any holder to request information for specified calendar quarters and/or calendar years. Information provided for periods other than the calendar year will facilitate the timely payment of estimated taxes by some taxpayers and the accurate reporting of interest income by non-calendar year taxpayers.

To be useful, the required information must be furnished to the requestor in a timely manner. We recommend that it be provided on or before the later of:

- ◆ the day that is 2 weeks after the receipt of the request; or
- ◆ the 30th day after the close of the calendar quarter for which the information was requested.^{90/}

3. Requirement That Nominees Furnish Information to Corporations and Other Specified Persons

The final regulations should provide that taxpayers described in Treasury Regulation section 1.6049- 7(f)(7)(i) that hold a contingent payment debt obligation through a nominee or middleman be given a regulatory right to request periodically the

^{90/} In the case of requests made by nominees or middlemen who are required to prepare Forms 1099 for information respecting the fourth calendar quarter, it may be necessary to shorten the time frame from 30 days to 2 weeks in order to allow the nominee or middleman sufficient time to prepare the Forms 1099-OID and written statement. Alternatively, the usual due date for furnishing Forms 1099-OID to non-exempt recipients could be extended to February 15.

information required to compute correctly their taxable interest income, ordinary loss or negative adjustment carryforward from their nominee or middleman, rather than from the issuer. The information request could be made in writing or by telephone. The information required to be provided should be the same as that obtained by the nominee or middleman from the issuer or its representative, and should be required to be provided within a reasonable time after it is obtainable from the issuer.

C. Legending Obligations for Issuers of Privately Placed Debt

The Secretary is prohibited by section 1275(c)(1)(B) of the Code from issuing regulations that require a debt instrument that is not publicly offered to be legended before its first disposition. In the case of a "plain vanilla" OID obligation, the first purchaser of the OID obligation presumably knows the issue date and issue price of the debt obligation and, therefore, has the ability to compute its yield to maturity and the current inclusion of OID in the same manner as the issuer computes its interest expense, even if this information is not shown on the physical instrument. In the case of a contingent payment debt obligation, however, the first purchaser cannot calculate the amount of his taxable interest income, or the positive or negative adjustments, in the same manner as the issuer, unless he receives the projected payment schedule established by the issuer. It is therefore necessary to impose some requirement -- albeit not legending -- for disseminating the required information in written form to the first purchaser of a contingent debt instrument.

XIII. Transition Issues Presented by Release of the Proposed Regulations

The IRS's decision to supersede the Old Regulations as of December 16, 1994 has left taxpayers who reported income and expense based on, or have otherwise acted in reliance on, the Old Regulations in need of guidance.

Taxpayers that have filed returns for at least two years reporting income and/or expense from contingent debt instruments consistently with the Old Regulations have adopted a method of accounting for contingent interest. Taxpayers that have filed only one such return have arguably done the same.^{91/} These taxpayers technically would require the consent of the IRS to change their method of accounting, and this applies not merely to instruments already issued or acquired, but also to any new instrument issued or acquired.^{92/} In the absence of any specific guidance from the IRS as to how to change their methods of accounting, these taxpayers would be subject to the general procedures governing accounting method changes set forth in regulations under section 446 of the Code and in Revenue Procedure 92-20. Under these general procedures, the change in method of accounting would be made on a taxable year basis, rather than on an instrument-by-instrument basis.

Thus, an issuer would restate the adjusted issue price of all outstanding contingent debt instruments and a holder would restate its basis in such instruments, as of the end of the year

^{91/} See Rev. Proc. 92-20, § 2.01, 1992-1 C.B. at 688.

^{92/} See Treas. Reg. § 1.446-1(a) (1) ("method of accounting" includes accounting treatment of any item); Code § 446(b) (requiring consent to change method of account); Rev. Proc. 92-20, 1992-1 C.B. 685, 688 (stating that "treatment of a material item in the same way ... in two or more consecutively filed tax returns (without regard to any change in status of the methods as permissible or impermissible)" constitutes adoption of accounting method); Rev. Rul. 90-38, 1990-1 C.B. 57.

of change. After such restatement, adjusted issue price or basis would be the same as it would have been if the taxpayers had never used the old method of accounting (i.e., had never followed the Old Regulations) and instead had always used the new method of accounting (i.e., had always taken contingent interest into account under "current law"). To the extent that the amount of interest expense or income taken into account under the old method of accounting differed from the amount that would have been taken into account under the new method of accounting, such difference would be taken into account as an adjustment to income ratably over a "spread period" determined under rules set forth in Revenue Procedure 92-20.

We do not think it is in anyone's interest to require that taxpayers, including holders of publicly traded debt, seek permission to change their methods of accounting in order to follow current law with respect to instruments acquired after the Old Regulations were withdrawn, or to follow the Proposed Regulations after they are finalized (hereafter, the "New Regulations") with respect to instruments acquired after the New Regulations are finalized. On the other hand, we think an effort to apply the New Regulations to instruments issued before the New Regulations were finalized would prove confusing and difficult to administer. For example, holders and issuers of such instruments will not have the benefit of an "original projected payment schedule" for such instruments from which to determine interest accruals under the New Regulations.

We therefore recommend that guidance be promulgated to permit and require taxpayers to account for contingent debt instruments on an instrument-by-instrument "cut-off basis" based on the law in effect when the instrument was issued. Thus, instruments issued before December 16, 1994 would continue to be

accounted for under the Old Regulations; instruments issued during the Window Period would be accounted for under the "all events test" of current law; and instruments issued on or after the date final regulations are promulgated would be accounted for under the New Regulations. In each case, the date of issuance, not the holder's date of acquisition, would be determinative.

Consistent with this approach, the Old Regulations should in general be finalized for all instruments issued before December 16, 1994. We believe that taxpayers should continue to report income and expense from such instruments consistently with the Old Regulations, until the maturity of the instruments. In the absence of finalization of the Old Regulations, there will be questions as to taxpayers' ability to rely on, and be bound by, the Old Regulations, and there will be practical problems in locating copies of the superseded regulations.

We do not, however, recommend finalization of the rule of Old Regulation section 1.1275-4 (f) which provides for the recharacterization of qualified stated interest as principal until the minimum amount of the fixed payments under the instrument equals the issue price of the instrument. We do not view this aspect of the Old Regulations as a reasonable method of accounting, and we understand that many taxpayers did not in fact follow the rules proposed in Old Regulation section 1.1275-4 (f).

In making this recommendation, we recognize the difficulty inherent in any effort to deal equitably with holders of instruments issued before the finalization of regulations in this area, particularly where such instruments were acquired on or after December 16, 1994. Some of our members have pointed out that such holders may reasonably have relied on the assumption that the Old Regulations would not apply.

Furthermore, some of our members would favor permitting holders to adopt any reasonable method of accounting for income from instruments issued prior to the withdrawal of the Old Regulations that were acquired after withdrawal of the Old Regulations, or from instruments issued prior to finalization of New Regulations that are acquired after finalization of New Regulations. We do not recommend this approach, primarily out of concern that it may offer too great an advantage to holders. We do not specifically disapprove of this approach, however, and we believe that this approach might be reasonable under some circumstances.

On balance, we favor finalization of the Old Regulations (other than Old Regulation section 1.1275-4(f)) for all holders of instruments issued before December 16, 1994, because that is the simplest approach, and there are no more attractive alternatives. For the same reasons, we recommend a "cutoff" approach similar to the one described above when the Proposed Regulations are finalized, given that the treatment of contingent debt instruments will then shift from the all-events approach of current law to the current accrual approach of the Proposed Regulations.

Appendix A

Accrual of interest on instruments providing for "quotable" payments should in theory result, under the Proposed Regulations, in accrual at the issuer's cost of capital on comparable non-contingent debt. As an example, consider a basket of stocks (the "Stock Index") which is worth \$1,000 today and is expected to yield dividends of \$50 per annum over the next six years. Assume that the market rate of interest for a AAA credit is 8% per annum. Under the laws of arbitrage, the forward price of the basket of stocks at the end of six years is approximately \$1,200.^{1/} This is because a AAA credit could borrow \$1,000, purchase the basket of stocks, enter into a forward contract to sell the basket for \$1,200 at the end of six years, and earn a guaranteed profit: The AAA credit would incur net capital expenses of \$30 per annum (\$80 of interest expense less \$50 of dividend income), which would accrue to less than \$200 over six years. If the forward price of the Stock Index were any higher than \$1,200, therefore, AAA credits would sell the Index forward, earning arbitrage profits, until the forward price fell to equilibrium.

The \$1,200 forward price of the Stock Index has nothing to do with the expected value of the Index at the end of six years. Indeed, a rational investor would not purchase the Stock Index if he or she expected the Index to be worth only \$1,200 at the end of six years, for this would reflect an 8% per annum aggregate return, a return which the investor could earn by making risk-free fixed investments. The investor might expect the Index to be worth say \$1,400 at the end of six years, for an aggregate return of 12% per annum. The excess of the 12% per

^{1/} It is actually \$1,196.

annum expected return over the 8% per annum return reflected by forward prices is the premium for so-called "beta risk", i.e., risk which cannot be hedged through diversification. Put differently, it is perfectly rational for an investor to agree to sell the Stock Index for \$1,200 at the end of six years, even though he or she believes the Index will be worth \$1,400, because entering into the forward sale eliminates the investor's beta risk. Note that the premium for beta risk has nothing to do with the premium, described below, for the risk that a given issuer will default on its obligations.

Suppose that a AAA rated issuer actually issues a six-year debt instrument promising interest at a rate of 5% per annum plus a payment based on the value of the Stock Index at the end of six years. The instrument will be issued for \$1,000, the current value of the Stock Index, but only because the issuer is a AAA credit capable of borrowing at 8% per annum. Under the proposed approach, the issuer will obtain a forward price quote for the Stock Index of \$1,200, and \$200 of OID will accrue over the life of the instrument. In other words, interest will accrue on the instrument at a rate of 8% per annum, the issuer's cost of capital on comparable non-contingent debt.

Suppose the same instrument is issued by a BBB credit, however. A rational marketplace might pay only \$800 for this instrument, in light of the increased risk that the issuer may default on its obligations, and \$400, rather than \$200, of OID will therefore accrue over the life of the instrument. In other words, interest will accrue on the instrument at a rate of 12% per annum, this particular issuer's cost of capital on comparable non-contingent debt.

In this regard, the rate at which interest accrues on the instrument for tax purposes will be entirely consistent with the rate at which interest accrues on the following economically equivalent transaction: (a) the issuer issues a debt instrument promising \$50 per annum and \$1,200 at maturity, and (b) the issuer and holder then enter into a forward contract under which the holder will pay the issuer \$1,200 for the Stock Index at the end of six years. The issue price of the debt instrument will vary with the credit of the issuer, and thus so will the yield on the instrument. In no case, however, will the rate of accrual include any premium for beta risk associated with the fact that the amount of the payment at maturity is variable.