REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON THE TAXATION OF DISTRESSED DEBT
REPORT NO. 1248

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REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON THE TAXATION OF DISTRESSED DEBT

I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association discusses certain anomalies that occur when the current federal income tax rules generally applicable to debt instruments are applied to distressed debt instruments, and recommends that the Treasury promulgate regulations to address these anomalies.[2]

Under general U.S. federal income tax principles,[3] the determination of whether an instrument is debt for tax purposes is generally made at the time of issuance[4] and this determination is not revisited unless the instrument changes[5] or the parties behave inconsistently

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1 This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section consisting of Howard Adams, Dale Collinson, Lucy Farr, Stuart Goldring, Robert Kantowitz, Jiyeon Lee-Lim, Vadim Mahmoudov, Andrew Needham, Deborah Paul, David Schnabel, Jodi Schwartz, and Kirk Wallace. The principal author of this Report is David R. Sicular, with the substantial assistance of Lindsay B. Kurasz and Samuel M. Duncan. Helpful comments were received from Andrew Berg, Andrew Braiterman, Sam Dimon, Michael Farber, Edward Gonzalez, Stephen Land, Erika Nijenhuis, Richard Reinhold, Joel Scharfstein, Michael Schler and Eric Sloan. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

2 A number of excellent articles on the taxation of distressed debt have been published in recent years, offering valuable insight into the issues discussed in this Report. *See, e.g.*, David H. Schnabel, *Great Expectations: The Basic Problem of Distressed Debt*, Taxes Magazine, March 2011, at 173; David C. Garlock, *How to Account for Distressed Debt*, 2010 TAX NOTES 999 (May 31, 2010); Deborah L. Paul, *The Taxation of Distressed Debt Instruments: Taking Stock*, 64 TAX. LAW. 37 (2010); Andrew W. Needham, *Do the Market Discount Rules Apply to Distressed Debt? Probably Not*, 8 J. TAX'N FIN. PRODUCTS 19 (2009); John Kaufmann, *The Treatment of Payments on Distressed Debt Instruments* 26 J. TAX'N INV. 13 (2008).

3 Unless otherwise indicated, all references herein to the "Code" or "Section" or "§" refer to the United States Internal Revenue Code of 1986, as amended. References to "Regulations" or "Treas. Reg. Section" refer to Treasury Regulations in effect as of the date of this document. All references to the "IRS" or "Service" refer to the Internal Revenue Service.

4 David C. Garlock, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS (6th ed. 2010) at ¶ 102(.01)[A]; Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS (Thomson Reuters/WG&L, 7th ed. 2006 & Supp. 2011-2), at ¶ 4.02[5].

5 *See, e.g.*, Treas. Reg. Section 1.1001-3. Indeed, even if the instrument's terms change significantly so that there is a "reissuance" this will not necessarily result in its status as debt being retested. *See* Treas. Reg. Section 1.1001-3(f)(7).

with the terms of the instrument.[6] Thus, merely by becoming distressed, a debt instrument generally will not cease to be treated as a debt instrument for U.S. federal income tax purposes. Yet many of the tax rules generally applicable to debt instruments are based on the assumption that debt instruments will be repaid in accordance with their terms. Where this assumption is not true, as is the case with distressed debt, the generally applicable rules may lead to inappropriate results if applied without modification.

For example, under current law, it is unclear in respect of distressed debt whether, and under what circumstances: (i) stated interest accruals are required (i.e., while the existence of a "doubtful collectibility" exception (the "DCE") is clear in this context, the scope of the exception is not clear), (ii) original issue discount ("OID") accruals are required (because the Service has not accepted the applicability of the DCE in this context),[7] (iii) market discount accruals are required (for several purposes of the market discount rules), and (iv) the interest-first payment ordering rule[8] applies (whether to final or interim payments). For interest and OID, these uncertainties raise issues of acceleration of income that the taxpayer may never receive, as well as potential character mismatches if the taxpayer does not in fact ultimately receive the income (because in some cases all the taxpayer will get is a capital loss). The payment ordering rule raises essentially the same issues. For example, where a debt instrument is distressed and settled

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6 *See, e.g.*, *Cuyuna Realty Co.* v. *United States*, 382 F.2d 298 (Ct. Cl. 1967); *see also Laidlaw Transportation, Inc.* v. *Comm'r*, 75 T.C.M. (CCH) 2598 (1998).

7 *See* IRS Tech. Adv. Mem. 9538007 (Sept. 22, 1995) (taking the position that OID accruals were required regardless of the issuer's distress); IRS Field Serv. Adv. 200018017 (May 5, 2000) (stating "However, whether Taxpayer is required to accrue interest on a nonperforming loan may differ depending on whether the debt to which the interest relates is subject to the original issue discount ('OID') rules of the Code.… Consequently, for OID instruments, there is no comparable exception from current accrual for OID as exists for interest on non-OID instruments held by an accrual basis taxpayer."). However, we understand that many if not most taxpayers have taken the position that OID accruals are not required in certain distressed situations. *See* Kaufmann, *supra* note 2 at 14-15.

8 Treas. Reg. Section 1.446-2(e).

for less than its principal amount, the literal application of the payment ordering rule could require a cash basis holder to include accrued interest in income with a corresponding capital loss on the principal.[9] While some read the payment ordering rule not to apply in this context (where the payment is a payment in final settlement of the obligation),[10] the result seems equally inappropriate when applied to an interim principal payment (and maybe even an interim interest payment) where the likelihood of full recovery of principal seems remote at best. The payment ordering rule may also cause confusion in applying the DCE because that doctrine requires that the taxpayer show that collection of the interest is doubtful. Taken together with an overly broad payment ordering rule, the DCE could be interpreted to require that the holder expects to collect nothing at all (because the first dollar collected would be deemed interest) before accruals can be foregone.[11] We do not believe any of these results make sense as a policy matter.

The anomalies of the market discount rules in the distressed area are more complex. Assuming (and many commentators and practitioners do not)[12] that market discount accruals on distressed debt may be required under a strict literal application of the rules, the implications are more multi-faceted. Indeed, the issue on which many practitioners and commentators seem to focus is whether any gain ultimately realized on the disposition of a distressed debt obligation purchased at a substantial discount should be ordinary or capital (a pure character issue rather than a character mismatch issue). In addition, the market discount rules present issues similar to those presented in the interest and OID area (timing and mismatch) for holders who have made a

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9 Section 446; Treas. Reg. Section 1.446-2(e).

10 We note that, at least in the bankruptcy context, taxpayers (and disclosure statements) often take the position that the usual payment ordering rules do not apply to final payments in settlement of the debt instrument, but the tax disclosure is invariably caveated heavily.

11 Garlock, *Distressed Debt*, *supra* note 2 at 1001.

12 *See, e.g.*, Needham, *supra* note 2; Kaufmann, *supra* note 2.

current accrual election, which is not bond-by-bond,[13] and where there are partial payments.[14] More arcane issues arise as well, such as the amount of potential interest deduction deferral under Section 1277 and the amount of potential character taint that carries over to stock received in exchange for a market discount debt instrument in a non-recognition transaction.

Other distressed debt anomalies also exist where the law is clear. For example, where a debt instrument is significantly modified, the old debt instrument is treated as exchanged for a new debt instrument.[15] Under current regulations, the amount realized on the deemed exchange is the issue price of the new debt instrument, which in the case of a debt instrument that is not publicly traded, is the face value of the new debt instrument.[16] Issue price is determined in this manner even if the new debt instrument is distressed, which can result in the recognition of a substantial amount of uneconomic gain that may be particularly inappropriate in this context. In other distressed debt exchanges involving related parties, there may be loss disallowance that some regard as inappropriate.

This report proposes changes and clarifications to the tax rules applicable to distressed debt that are intended to address these issues.[17] Part II summarizes the principal recommendations of this report. Part III suggests a definition of distressed debt for purposes of the rules we propose. Part IV discusses the relevant measurement dates for applying the proposed definition. Part V discusses the application of the proposed definition of distressed

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[13] Section 1278(b)(1).

[14] Section 1276(a)(3).

[15] Treas. Reg. Section 1.1001-3(b).

[16] Treas. Reg. Section 1.1001-1(g), 1.1274-2(b); Section 1274.

[17] This report does not seek to address all anomalies in this area. For example, it does not discuss special issues that may arise for REMICs and other securitizations that are distressed.

debt to specific provisions of the Code. Part VI addresses reporting considerations. Parts II – VI focus primarily on the taxation of holders. Part VII briefly discusses issuer-side issues.

II. SUMMARY OF RECOMMENDATIONS

Assuming that the Treasury and the Service wish to address the issues discussed above, we see at least two possible ways to do so. One approach is to provide a definition of distressed debt and provide specific rules that would apply when an instrument falls within the definition. Debt not meeting this definition would be taxed under existing rules and debt classified as distressed debt would be treated under modified rules. Under this approach, the Treasury could issue regulations which would turn off or modify the application of certain provisions of the Code when the definition is met, including (but not limited to): (i) the accrual of interest, OID, and market discount, (ii) the payment ordering rule, and (iii) the issue price equals amount realized rule for nonpublicly traded debt. A variation on this approach might define three categories of debt (with two new sets of rules).[18]

An alternative approach would be to solve specific problems on an ad hoc basis. If this approach were adopted, such limited scope solutions could include (i) revoking TAM 9538007

[18] Our proposal involves a single category of distressed debt rather than multiple categories. David Garlock has suggested a three-tier system of distressed debt, where debt would be classified as "healthy or mildly distressed," "significantly distressed" or "severely distressed." In Garlock's proposed approach, "healthy or mildly distressed" debt would be subject to the federal income tax laws in their current form, "significantly distressed debt" instruments would compute accruals based on expected collections, and "severely distressed" debt would be governed by the open transaction doctrine. Garlock suggested this approach, at least in part, because a three-tier system with reasonable rules for "significantly distressed" debt would put less pressure on classifying debt as "severely distressed debt". In this system, a narrow definition of "severely distressed debt" (those debt instruments to which the most holder-friendly income tax treatment would apply) could be adopted. Garlock, *Distressed Debt*, *supra* note 2. Although we agree that a three-tier system could offer advantages, we are not convinced that these advantages are significant enough to justify the complexity of three regimes (rather than just two).

and issuing guidance that the DCE applies to OID and (ii) modifying the market discount rules to limit or eliminate accruals under specified circumstances for some or all purposes.[19]

We have considered both approaches, and we recommend that the Treasury Department take the first version of the first approach (one category of distressed debt, not two) and, through regulations, define an umbrella concept of distressed debt. The proposed definition and its application are discussed in the balance of this report.

III. DEFINITION OF DISTRESSED DEBT

We recommend that the Treasury promulgate regulations that provide that a debt instrument is distressed if, based on all the facts and circumstances, there is no reasonable expectation that the holder will recover the debt instrument's principal amount (or, in the case of a debt instrument issued with OID, its adjusted issue price), in each case plus any unpaid interest that accrued before the instrument became distressed (hereinafter, the "Tax Principal Amount"). We recommend that this test be supplemented with two numeric safe harbors and at least one presumption.[20]

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[19] One possible discrete approach to market discount might be based on (although quite different from) a proposal made by the Clinton administration. Under the administration's proposal, subject to certain exceptions, accrual method taxpayers would have been required to include market discount in income currently using the constant-yield method, but accruals would be capped at the greater of (i) the debt instrument's original yield-to-maturity plus five percent and (ii) the AFR at the time the holder acquired the debt instrument plus five percent. U.S. Department of the Treasury, General Explanation of the Administration's Fiscal Year 2000 Revenue Proposals, February 1999 p. 121. *See also* New York State Bar Association Tax Section Report on Proposed Legislation to Amend the Market Discount Rules of Section 1276-78 (June 22, 1999) (generally supporting the administration's proposal to limit market discount accruals, but recommending a cap of AFR at time of acquisition plus six percent, which would align with the AHYDO rules).

[20] We believe, as tax lawyers, that the framework proposed in this report (a basic definition, two safe harbors and one or more presumptions) is the most sensible path for the regulations to take. We note, however, that the specific safe harbors and presumptions we propose are based, in part, on our "common sense" (as opposed to expert) economic analysis, and sense of current and recent market conditions. We are not, of course, financial experts, and fully expect that the Treasury may use its own expertise to test the numerical proposals and perhaps reach different conclusions on the safe harbors even if it accepts our framework. In addition, even if our numerical recommendations are adopted, we explicitly recommend that the Treasury draw on that expertise to determine whether one or more of the thresholds or parameters should be adjusted to address significant market changes. *See infra* Parts III(C)(1)(a), (III)C(2) & notes 59, 63.

Some commentators have suggested framing the definition of distress based on the expectation that the holder will receive total undiscounted payments equal to such holder's basis in the debt instrument.[21] We believe that basing the test for distress on the collectibility of a debt instrument's Tax Principal Amount is a more logical test. If a holder's basis were used, the same debt instrument held by two different taxpayers could be taxed under two different systems, which does not seem appropriate if the threshold issue is whether the debt instrument itself is "distressed." Further, a test based on a holder's basis, by its terms, could not apply to any debt instrument that is distressed at the time that instrument is acquired, and thus would address the problems and anomalies in this area only for holders in whose hands the debt instrument has deteriorated. Thus, any such approach would either need to be supplemented by other rules or, alternatively, would leave the problems of the distressed debt investor unaddressed. For these reasons and others[22] we favor a definition based on Tax Principal Amount.

Under our proposal, a holder of an instrument meeting this definition would be taxed under special rules intended to avoid tax consequences under the general rules that diverge from the economic reality of the relevant transaction. Some situations where we think the definition of distressed debt should apply are discussed in Part V.

We propose that the same definition of distress be used across the board, but note that its implications will vary depending on the context. For example, in the context of interest and OID, our proposed rule is, in common sense terms, "do not accrue income you do not expect to receive." For market discount, the focus is different. At acquisition, an investor in a distressed debt instrument generally *does* expect to receive some of the amounts that would be accrued as

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[21] *See, e.g.*, Garlock, *Distressed Debt*, *supra* note 2 at 1011.

[22] For a more extensive discussion of these issues, *see* Schnabel, *supra* note 2 at 182-83.

market discount under a literal application of those rules. For example, when an investor buys a $1,000 8-year bond for $400 (a bond that would clearly be considered distressed under at least one of our proposed safe harbors discussed below), the investor may well have no prospect of ever collecting more than $1,000, but she fully expects to collect more than $400 (otherwise she would not have invested $400). Thus, the investor does expect to collect at least some of the amount that might literally be viewed as market discount. However, it is unlikely that she reasonably expects to collect amounts on the bond with the regularity and predictability of an interest-like return, the paradigm on which the market discount rules are premised. We believe that the core policy of the market discount rules is to tax market discount like interest when it is an interest equivalent. If the debt is distressed, this premise does not apply. Accordingly, we believe that using the same definition of distress to suspend accrual of market discount that is used in the interest and OID context makes sense.[23]

A. Doubtful Collectibility Exception

Our proposed general rule is based on the common law DCE applicable to qualified stated interest accruals. Generally, interest is taken into account by a taxpayer in accordance with the taxpayer's regular method of accounting.[24] Accordingly, a cash method taxpayer generally includes interest in income when it is actually or constructively received,[25] and an accrual method taxpayer includes interest in income when all events have occurred that fix the holder's right to receive the income and the amount of income can be determined with

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[23] We note, however, that there may be certain second-order differences, such as the choice of measurement or "testing" dates. *See infra* Part IV.

[24] Treas. Reg. Section 1.446-2(a).

[25] Treas. Reg. Section 1.446-(1)(c)(1)(i).

reasonable accuracy.[26] As such, an accrual method taxpayer generally will accrue qualified stated interest ratably over the accrual period (or periods) to which the interest is attributable.[27]

The Courts long ago established an exception to the general rule described above where income is "of doubtful collectibility or it is reasonably certain that it will not be collected."[28] This exception was first articulated in *Corn Exchange Bank*, where the court held that an accrual basis lender did not have to accrue unpaid interest in income where the borrower went into receivership, the lender did not receive interest payments in the then-current taxable year and the lender was not likely to receive such interest within a reasonable time thereafter.[29] The Court reasoned that as a general matter income should only be accrued when there is reason to believe that such amounts will actually be collected:

> "When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received. A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectible, and, where it is of doubtful collectibility or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation." [30]

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[26] Treas. Reg. Section 1.446-1(c)(1)(ii).

[27] Treas. Reg. Section 1.446-2(b).

[28] *Corn Exchange Bank* v. *United States*, 37 F.2d 34 (2d Cir. 1930).

[29] *Id*. at 35.

[30] *Id.* at 34 (citations omitted).

Since *Corn Exchange,* the DCE has been applied by various courts[31] and the Service, [32] and thus the doctrine's existence is clear. The precise contours of the DCE, are, however, far from clear. For example, the *Corn Exchange* language, that income does not accrue if it is "of doubtful collectibility or it is reasonably certain that it will not be collected,"[33] can be read to articulate two somewhat different standards ("doubtful" collectibility and "reasonably certain" not to be collected), although it does suggest a high standard. Many courts have noted that the exception should be construed narrowly, which also suggests a high standard.[34] Different courts have looked to different factors to determine if the standard is met. For example, some courts have: (i) concluded that the debtor must be insolvent for the "doubtful collectibility" exception

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[31] *See, e.g.*, *Jones Lumber* v. *Comm'r*, 404 F.2d 764, 766 (6th Cir. 1968) ("The right to receive as distinguished from the actual receipt determines the accrual of income unless, at the time the right arises, there exists a reasonable doubt as to its collectibility."); *H. Liebes & Co.* v. *Comm'r*, 90 F.2d 932, 937-38 (9th Cir. 1937) ("We believe that no income accrues unless there is a reasonable expectancy that the right will be converted into money or its equivalent.… The complete definition [of "accrues"] would therefore seem to be that income accrues to a taxpayer, when there arises to him a fixed or unconditional right to receive it, if there is a reasonable expectancy that the right will be converted into money or its equivalent." (internal citations omitted)).

[32] *See* Rev. Rul. 2007-32 2007-1 C.B. 1278 (stating that the DCE did not apply in determining that accrual method lender was required to include accrued interest in income where borrower was expected to make some but not all payments on a loan); Rev. Rul. 81-18 1981-1 C.B. 295 (accrual method taxpayer was not required to continue to accrue interest in income where no payments were made on the loan and previously included amounts were written off as bad debts); Rev. Rul. 80-361 1980-2 C.B. 164 (holding that an accrual method lender was not required to accrue interest after a debt became uncollectible due to borrower's insolvency); *see also* I.R.S. Tech. Adv. Mem. 9538007 (Sept. 22, 1995) (declining to extend reasoning of Rev. Rul. 80-361 to OID).

[33] *See* Schnabel, *supra* note 2 at 175; *see, e.g.*, *Trinity Indus., Inc.* v. *Comm'r*, 132 T.C. 6, 18 (2009); *Harmont Plaza, Inc.* v. *Comm'r*, 64 T.C. 632, 649-50 (1975). A similar articulation used by some courts is income does not have to be accrued where there is no "reasonable expectancy" of receiving income. *See, e.g.*, *M.J. Byorick, Inc.* v. *Comm'r*, 55 T.C.M. (CCH) 1037, 1048-1049 (1988); *Georgia School-Book Depository, Inc.* v. *Comm'r*, 1 T.C. 463, 468-69 (1943); *Cappuccilli* v. *Comm'r*, 40 T.C.M. (CCH) 1084, 1092-1093 (1980).

[34] *See M.J. Byorick, Inc.*, 55 T.C.M. at 1049 ("Like most exceptions to general rules, this non-inclusion exception [DCE] is to be narrowly construed, for to do otherwise would undermine the integrity of the accrual accounting system." (internal citations omitted)); *Georgia School-Book Depository, Inc.*, 1 T.C. at 469 (stating that the "reasonable expectancy" exception "is, after all, an exception, and the exception must not be allowed to swallow up the fundamental rule…"); *Geer-Robbins Co.* v. *Comm'r*, 119 F.2d 92, 93 (9th Cir. 1941) (noting that taxpayer had the burden to show the bad debt character of accrued interest).

to apply,[35] (ii) looked to whether the debtor is in receivership,[36] (iii) considered the fair market value of the debt instrument,[37] (iv) analyzed the overall financial condition of the debtor[38] and (v) observed whether payments were ever made.[39]

We note, however, that some courts have articulated the DCE in different ways, that, at least on the surface, suggest a lower standard. For example, one court stated that income "is not accruable as long as reasonable doubt exists as to the amount that is collectible by reason of the financial condition or insolvency of the debtor,"[40] and another stated that income does not have to be accrued if there is "a reasonable doubt as to the ability of the [issuer] to pay the interest, or if it was reasonably certain for any reason that the interest would never be received."[41] Under our reading of the *Corn Exchange* formulation, if an investor had a 60 percent chance of receiving the interest payment the income would accrue, but under a "reasonable doubt"

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35 *See Georgia School-Book Depository, Inc.*, 1 T.C. at 469 ("To allow the exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable. Postponement of payment without such accompanying doubts is not enough."); *see also Jones Lumber Co.*, 404 F.2d at 766 (noting that "substantial evidence" as to the financial instability or insolvency of the borrower has been necessary to utilize the DCE, but declining to decide whether insolvency is required).

36 *Corn Exchange*, 37 F.2d at 34-35.

37 *Jones Lumber Co.*, 404 F.2d at 767 (stating that market value and collectibility are related, but not identical concepts. The Court also noted the lack of evidence as to the debtor's financial condition of insolvency, the course of dealings between the seller and purchaser, and the irregularity of payments).

38 *Cappuccilli*, 40 T.C.M. at 1093-1095 (considering the debtor's assets, liabilities, cash flows, proceeds and uses of other borrowings and profitability); *Atlantic Coast Line Railroad Co.* v. *Comm'r*, 31 BTA 730, 748-51 (1934) (considering the debtor's losses, the nature and amount of its assets, past financial performance and current financial condition).

39 *Atlantic Coast Line Railroad Co.*, 31 BTA at 748-49 (noting that payments were never made).

40 *Clifton Mfg. Co.* v. *Comm'r*, 137 F.2d 290, 292 (4th Cir. 1943).

41 *Atlantic Coast Line Railroad Co.*, 31 BTA at 749.

formulation, it likely would not (40% chance of not collecting the interest would presumably satisfy text of "reasonable doubt" as to collectibility).[42]

With a variety of standards being applied and numerous factors being considered, it is not surprising that the DCE is difficult for taxpayers and the Service to apply. We believe that it is important that the standard be clear, and on balance we believe that a high standard is appropriate. Our proposed general rule would clarify the DCE by stating that the holder is required to continue to treat a debt instrument under the typical debt rules unless there was no reasonable expectation that the issuer will make total payments on the debt instrument equal to the debt instrument's Tax Principal Amount. (Another way of stating this proposed rule is that to the extent that the payments on a debt instrument are applied to the Tax Principal Amount first, there is no reasonable expectation that the interest or OID in question would be paid.) We believe that the "no reasonable expectation" standard is the appropriate rule because the holder should have to establish a high level of uncertainty as to the collectibility of payments before accruals are foregone. A holder should not be able to treat a debt instrument as distressed merely because some level of doubt exists as to the collectibility of receipt. In that case, the all events test should prevail, and non-collection should be dealt with in later taxable periods.[43]

We note that our formulation, although based on the common law DCE is, at least on the surface, quite different. The common law DCE tended to consider the collectibility of a specific

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[42] It is not entirely clear to us that at least some of the courts articulating the seemingly looser (and pro-taxpayer) standard really meant it. Indeed, *Atlantic Coast Line Railroad Co.*, *supra* note 38 at 749, seemed to state both standards. *Clifton Manufacturing*, *supra* note 40 at 292, however, may well have applied the looser test.

[43] In this case, there could still, of course be a character mismatch if the holder's later deduction is a capital loss. Treasury may wish to consider whether to address the mismatch issue directly outside of the distress area, perhaps through an Arrowsmith-type approach. A discussion of this issue is beyond the scope of this report.

payment,[44] whereas our proposed formulation is focused on expected total payments. If the holder has no realistic prospect of recovering his Tax Principal Amount, we think it is unfair to require accrual of the next interest payment even if there is a reasonable prospect that that particular payment may be made. Accruing such a payment results in ordinary income inclusions for the holder with respect to the interest and a capital loss on the instrument itself. We believe that result should generally be avoided. Accordingly, the proposed general rule would focus on the total of all payments that are expected on a debt instrument and whether the holder expects to have such timing and character mismatches with respect to the debt instrument.

B. Safe Harbors and Presumptions

There are circumstances where it may be straightforward to demonstrate that the general rule is satisfied, such as in some cases where an issuer has missed a required payment and is in default. Establishing that a debt instrument not yet in default meets the proposed general rule may be much more difficult in cases where the debtor is currently performing, but holders anticipate that the debtor will not make full payments on the debt instrument in the future. In that case, in the absence of any objective standards, the holder would be left to show whether recovery is expected based on all the facts and circumstances. Many of the relevant facts and circumstances that the holder would need to establish look to detailed information about the issuer and its projected cash flows, which is information that a holder frequently will not have. As such, the general rule, by itself, may be very difficult for holders to apply. Therefore, we recommend that the general rule for holders be supplemented with two safe harbors and one

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[44] *See, e.g.*, *Atlantic Coast Line Railroad Co.*, 31 BTA at 747-751 (discussing the collectibility of the interest payments); *Cappuccilli*, 40 T.C.M. at 1093-1095 (discussing whether interest payments could have been made).

additional presumption (the "Distressed Debt Safe Harbors and Presumption").[45] The Distressed Debt Safe Harbors and Presumption, which discussed in greater detail below, would be based on the valuation and yield of the debt instrument.[46] We recommend implementing objective tests based on these characteristics because such information is more readily available to debt holders who have to make the accrual determinations than some of the information considered under the DCE. We would recommend providing two safe harbors because the Valuation Safe Harbor (defined below), which is our primary proposal, will not work well for certain debt instruments, specifically those with short remaining maturities or those initially issued with low credit quality (although, at issuance, short of being distressed). If only one safe harbor is adopted, for the reasons discussed below, we recommend that the Treasury choose the Valuation Safe Harbor.

C. Valuation Safe Harbor and Presumption

We recommend the Valuation Safe Harbor, under which a debt instrument would be treated as distressed based on a specified discount to its Tax Principal Amount. A test based on the valuation of a debt instrument would give the holder a relatively straightforward means to demonstrate objectively that a debt instrument is distressed. In the case of truly publicly traded debt instruments (a narrower category than debt instruments treated as publicly traded under the

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[45] We also considered whether the issuer might make the determination as to whether its debt instruments qualify for the general rule. We ultimately rejected this approach because it would be difficult for the issuer to have the incentive to make an accurate determination. If consistency is required between issuer and holder treatment (i.e., if the holder's income accruals are tied to the issuer's deduction), the issuer might have incentive to say that the general rule is not satisfied, even when it is reasonably certain that the issuer would not make payments on the debt instrument equal to the Tax Principal Amount. If the law did not require consistent treatment between issuer and holder, the issuer would have incentive to say that the DCE applied to debt instruments that were not actually distressed because it would benefit the holders of its debt without any consequence to the issuer. Based on the conflicts of interest that could arise with an issuer level determination, we recommend that the determination be made at the holder level.

[46] We also considered a third alternative test based on credit ratings that would be easier to apply, but concluded that it was not permissible under the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203 ("Dodd-Frank") (*see* T.D. 9533, July 6, 2011).

recently proposed OID regulations),[47] a valuation may be relatively easy, as fair market value information is readily available to the holder. In the case of a nonpublicly traded debt instrument, the holder would be required to perform a valuation of the instrument, but we expect that at least some of the information required for such valuation will generally be available to a holder in most cases.

1. Valuation Safe Harbor

Under the proposed valuation safe harbor (the "Valuation Safe Harbor"), a debt instrument would be distressed if on the relevant measurement date it meets the following criteria: (i) the debt instrument is valued at less than 50 percent of its Tax Principal Amount (the "50 Percent Test") and (ii) it has less than 15 years remaining to its legal maturity (the "Maturity Requirement").

(a) 50 Percent Test

The 50 Percent Test takes into account that bond prices are affected by a host of factors, including maturity, prevailing interest rates, coupon, issuer credit worthiness, sinking funds, call features and market liquidity.[48] A decrease in the fair market value of a debt instrument may be attributable to any or all of these factors or additional factors not listed above.[49] Although it is not possible to address all of these factors individually, the 50 Percent Test, supplemented by the

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[47] The appropriate definition of "publicly traded" is itself a complex issue, but at least some cases are reasonably clear. *See* New York State Bar Association Report on Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273 and Related Issues (March 30, 2010).

[48] *See* Martin L. Leibowitz, Ph.D., *Topics That Didn't Make It into the 1972 Edition*, *Introduction* to Sidney Homer and Martin L. Leibowitz, Ph.D, INSIDE THE YIELD: THE CLASSIC THAT CREATED THE SCIENCE OF BOND ANALYSIS (Martin Leibowitz, Ph.D. ed., Bloomberg Press 2004) (1972) at xxxvi.

[49] All things else being equal, with the same percentage change in yield, the volatility of the price of the bond increases: (1) as maturity lengthens (the longer the maturity, the greater the price volatility), (2) as coupon rate declines (the lower the coupon, the greater the price volatility), and (3) as yields rise (the higher the yield level from which a yield fluctuation starts, the greater the price volatility). Sidney Homer and Martin L. Leibowitz, Ph.D, INSIDE THE YIELD: THE CLASSIC THAT CREATED THE SCIENCE OF BOND ANALYSIS (Martin Leibowitz, Ph.D. ed., Bloomberg Press 2004) (1972) at 43.

Maturity Requirement, is designed to isolate debt instruments that, whatever else may be affecting their respective valuations, have almost certainly experienced significant credit deterioration.

While the 50 Percent Test is admittedly somewhat arbitrary, it is currently used as a rule of thumb by practitioners in the market place, and for good reason.[50] First, it is consistent with, indeed more conservative than, some case law in the pre-1984 discount income area, which found obligations to be "speculative" so that owner would not be required to include discount income currently when debt instruments were valued at discounts which were, in some cases, less than 50 percent.[51] Second, a 50 percent value loss is a very strong indicator of distress. Indeed, a 50 percent loss in value entirely attributable to deterioration in credit quality of the issuer is, we think, far more than is needed to indicate that collection of any interest is quite unlikely. Instead we would have thought that in most cases deterioration of just 35 percent or even 25 percent entirely attributable to credit deterioration would be sufficient to indicate that collection of interest is unlikely in most markets.[52] A 50 Percent Test leaves room for significant

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[50] The 50 Percent Test would provide guidance approving of a current market practice. We understand that it is not uncommon for taxpayers to take, and for accounting firms to sign-off on, a return position that market discount or original issue discount does not accrue on debt instruments with valuations of 50 percent or less of face value. Kaufmann, *supra* note 2 at 15. Additionally, commentators have suggested that a discount of greater than 50 percent may be an appropriate place to distinguish between distressed debt instruments and non-distressed debt instruments. Garlock, *Distressed Debt*, *supra* note 2 at 1002 (noting that there is appears to be a consensus that 50 percent is "reasonable and conservative" place to draw the line in low-interest rate environments).

[51] *Liftin* v. *Comm'r*, 36 T.C. 909, 911-12 (1961) (instruments with discounts of approximately 45 percent); *Underhill* v. *Comm'r*, 45 T.C. 489, 490-91 (1966) (instruments with an average discount of approximately 35 percent).

[52] *See supra* note 51.

other factors, such as changes in prevailing interest rates.[53] In Appendix A and Appendix B, we illustrate this point with a series of numerical examples that seek to show the generic impact on bond pricing of a fairly dramatic increase in prevailing interest rates and calculate how much incremental loss of value would need to occur for bonds in those examples to meet the 50 Percent Test. Our implicit assumption is that the cause of incremental loss of value would be primarily credit deterioration.[54] (We are not financial experts, of course, but the only other generic factor that occurred to us was that the remaining duration of the bond would be less than it had been at issuance. That factor, however, would, assuming a static interest rate environment and constant credit quality, tend to make the value of the debt instrument go up, not down, unless the yield curve is inverted.) Because prices of longer-term bonds are more sensitive to changes in prevailing interest rates we considered a range of remaining maturities and also a range of initial interest rates. The impact of interest rate changes is greatest for debt instruments with longer maturities, and thus to add further "safety" (from the government's perspective), to the Valuation Safe Harbor, we have included the Maturity Requirement.

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[53] Although many factors may affect the valuation of a debt instrument, generally, for high-grade debt instruments changes in prevailing interest rates are the primary source of changes in price. Leibowitz, *supra* note 48 at xxxvi.

[54] Of course, not all cases are that simple. Consider, for example, the following scenario. Corporation X has $100 of debt outstanding and is involved in a major litigation. If it wins the litigation, there will be more than enough money to pay the debt in full with interest with a comfortable cushion (i.e., substantial value for the equity). If it loses the litigation, the debt will be largely wiped out. There is a 50/50 chance that the company will lose and the market accordingly values the debt instrument at less than $50. This instrument would meet our proposed Valuation Safe Harbor (as its value is less than 50); yet, it could be argued that it does not meet our ultimate test for the DCE because there is a fairly reasonable likelihood that the interest will be repaid (more than the 40 percent chance we said above would not meet the articulated test). One could argue that by reason of this analysis the safe harbor is over-inclusive even without movements in prevailing interest rates.

We believe that the Treasury should be willing to live with this glitch. While the debt instrument in this case may not meet the ultimate test for which the Valuation Safe harbor is a proxy, it is also not like classic debt. It is more like a lottery ticket, and it does not trouble us for a holder of a lottery ticket not to have to accrue stated interest on that ticket (at least until the drawing occurs).

As shown in the appendices, given a 50 percent increase in prevailing interest rates, debt instruments issued at par with 6, 8, and 10 percent coupons would still have to experience between approximately 29 percent and 43 percent price deterioration attributable to factors other than prevailing interest rates to meet the 50 Percent Test (with the lower percentages corresponding to higher initial yields, which in turn correspond to lower initial credit quality). These amounts indicate that these debt instruments must experience clear credit deterioration to meet the 50 Percent Test even given a 50 percent increase in prevailing interest rates. If interest rates increase 75 percent, most hypothetical debt instruments in our sample would still have to experience deterioration of 25 percent or more to meet the 50 Percent Test. However, debt instruments with long remaining terms, higher yields or both characteristics may satisfy the 50 Percent Test without experiencing credit deterioration of 25 percent or more. For example, a bond with a 15 year remaining term initially issued at a 10 percent yield could meet the 75 Percent Test with as little as 18 percent deterioration in price attributable to factors other than changes in interest rates.

These numerical examples confirm our views that the 50 Percent Test generally draws a reasonable, long-term line. The line is, however, one that may need to be revisited if interest rates were to rise dramatically.[55] For example, the 75 percent/15-year example raises some questions for us and other market conditions (e.g., higher base-line initial interest rates) could also raise questions. We understand that it is difficult to craft numeric tests that are appropriate

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[55] An in-depth study of interest rate changes is beyond the scope of this paper. We did, however, consider monthly annualized yields of corporate debt instruments issued by seasoned issuers which were rated Aaa and Baa by Moody's between 1919 and August 2001. We then took each monthly annualized yield for the class of debt instruments and compared that yield to the monthly annualized yields for such debt instruments for the subsequent ten-year period to determine if prevailing yields had increased (or decreased) 50 percent. We found that over the 80 year period covered, although not the norm, it was not all that unusual for a ten-year bond to be outstanding for a period during which prevailing interest rates increased 50 or 75 percent (though 75 percent increases were noticeably more rare than 50 percent increases). We note that most of these instances corresponded to periods of very high interest rates (like the 1980s) or very low interest rates (like the 1950s).

in all market environments. Rules with numeric thresholds that look appropriate at the time adopted can result in unintended consequences when circumstances change if those thresholds are inflexible.[56] Therefore, we recommend that the regulations provide that the Treasury has the authority to determine how the initial valuation, maturity, yield and spread amounts, each discussed in more detail below, are determined or reset in the case of changing market conditions. We anticipate that the procedures would provide parameters within which the Service could publish updated initial valuation, maturity, yield or spread amounts without a notice-and-comment procedure, similar to the procedures used with respect to resetting the AFR.[57]

An alternative possible approach might be to adopt a more complex safe harbor, which would adjust and attempt to isolate changes in interest rates from the price deterioration test.[58] Although such an approach has theoretical appeal, it would be difficult for the Service and taxpayers to apply. The Service would have to develop an index or indices far more complicated than the AFR to isolate for such effects and taxpayers would need to make complex calculations to determine if a debt instrument met the safe harbor. As such, our recommended approach is to adopt the more straightforward 50 Percent Test, which we believe generally would accurately

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[56] Consider for example the AHYDO rules prior to modification by the American Recovery and Reinvestment Act of 2009 (2009 ARRA), P.L. 111-5, Sections 1232(b)(2), (c)(2) (section references are to the ARRA).

[57] Section 1274(d)(1)(B); Treas. Reg. Section 1.1274-4(b). *But see* Section 163(i)(1) which permits the Treasury, through regulation, to use a higher rate on a temporary basis for AHYDO, if the Secretary believes such rate is appropriate in light of distressed conditions in the financial markets.

[58] Another alternative, which also would add greater complexity in application for some incremental accuracy, would be to specify ranges of remaining maturity, similar to the rule for the AFR, and set an appropriate trigger value for the Valuation Safe Harbor for each basket.

identify distressed debt instruments under current market conditions, and give the Treasury the authority to change the threshold where necessary due to changes in market conditions.[59]

(b) Maturity Requirement

The Maturity Requirement addresses the fact that the pricing of debt instruments with longer remaining maturities is generally more sensitive to changes in prevailing interest rates than that of debt instruments with shorter remaining maturities.[60] If prevailing interest rates increased by 50 percent or 75 percent, 30 year bonds issued at par with 6, 8 or 10 percent coupons would be expected to price between $67 – $70 and $56 – $60, respectively. Further, if prevailing interest rates double, 30 year debt instruments would come close to meeting the 50 Percent Test solely because of changes in prevailing interest rates, and without any credit deterioration, because the present value of the principal payment is a negligible component of the instrument's discounted cash flows. To insulate the proposed Valuation Safe Harbor from this

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[59] If the Treasury decides nonetheless to adopt the more complicated approach, we would recommend that the threshold be set to require less than 50 percent price deterioration because the 50 Percent Test was chosen to allow for changes in price attributable both to changes in prevailing interest rates and credit deterioration. Requiring 50 percent price deterioration attributable solely to changes in credit would surely be underinclusive.

We note that much of the analysis above is focused on the case of fixed rate debt. Other types of debt instruments, such as variable rate debt instruments ("VRDI"), convertible debt instruments and contingent payment debt instruments ("CPDI") present special issues. VRDI may be the easiest case – a classic VRDI by its nature will reduce or eliminate the effect of an increasing interest rate environment and thus will present no special issues for the Valuation Safe Harbor other than the fact that it is even more likely to be underinclusive. The 65 Percent Valuation Presumption, discussed in Part III(C)(2), *infra,* will help to alleviate this issue. In the case of convertible debt, the value of the stock into which the debt instrument is convertible will be an additional factor that will affect valuation, but on balance it seems to us that at least in the case of debt convertible into stock of the issuer, a significant drop in the value of the stock will tend to indicate at least some measure of distress and as a result the 50 Percent Test may still be appropriate. CPDI are the hardest case because the contingency may bear a more attentuated (or conceivably no) relationship to the financial condition of the issuer. Treasury may wish to consider this issue further and possibly reserve on it pending further study and analysis.

[60] Homer & Leibowitz, *supra* note 49 at 43.

factor we propose to draw a somewhat arbitrary line of 15 years remaining until maturity.[61] Holders of such instruments would be able to invoke the Valuation Presumption discussed in the next section; however, the Service would be able in appropriate circumstances to rebut the presumption.

2. Valuation Presumption

To supplement the Valuation Safe Harbor, we recommend that a debt instrument with a fair market value of less than 65 percent of the instrument's Tax Principal Amount be presumed to be distressed (the "65 Percent Valuation Presumption"). Many in our group would add an additional requirement that the holder reasonably believes that the instrument meets the DCE. This presumption would be rebuttable by the Service if the Service demonstrates that the instrument is not distressed.

We think a presumption based on valuation makes sense for the following reasons. First, although the value of debt instruments with longer maturities is more sensitive to changes in interest rates, in the absence of significant interest rate changes, we believe holders should have a straightforward method of showing that a debt instrument is distressed. Second, the 50 Percent Test is designed to identify debt instruments that are clearly distressed even in rising interest rate

[61] There may be circumstances where it is more appropriate to test the Maturity Requirement using a date other than the debt instrument's final legal maturity date. For example, if there are several dates for the payments of principal, it may be more appropriate to test the date determined by its weighted average maturity. Similarly, if the holder of a debt instrument has an option to put the instrument at its par value on one or more dates, it may be more accurate to test an early redemption date rather than the legal maturity date of the instrument. It may also make sense to modify the rule for variable rate debt instruments whose interest payments automatically adjust with market interest rates, arguably making a maturity date limitation unnecessary.

environments.[62] It will be, in our view, very under-inclusive in steady state, or decreasing, interest rate environments. In a steady state interest rate environment, we believe that a 35 percent (or even smaller) drop in price, with no portion attributable to changes in interest rates, would by itself be a likely indicator of distress. Finally, as shown in the appendices, valuations of debt instruments with shorter remaining maturities are less sensitive to changes in prevailing interest rates than instruments with longer remaining maturities. Even when interest rates rise by 50 percent and 75 percent, the incremental amount by which the price of bonds with relatively short remaining terms (e.g., 5 years) would need to decrease by reason of other factors to satisfy the 50 Percent Test is in excess of 35 percent. Because changes in interest rates contribute less to the value of such debt instruments, less overall price deterioration is needed to demonstrate that these instruments have experienced significant credit deterioration.

For these reasons, among others, the 50 Percent Test is a tight safe harbor and may exclude instruments that are actually distressed because it requires a large price change. Accordingly, we would recommend a presumption for instruments with less price deterioration.

The 65 Percent Valuation Presumption we propose has less "cushion" for other factors and thus may be over inclusive in periods of rising interest rates. This concern could be addressed in the following ways. As noted above, the regulations could require that a taxpayer must, before claiming that a debt instrument is distressed under the 65 Percent Valuation Presumption, make a good faith determination that the ultimate test is satisfied—that there is no reasonable expectation that the debt instrument's Tax Principal Amount will be repaid. In

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[62] We also note that although the 50 Percent Test is consistent with the market practice in this area, it is also a discount well in excess of what is considered distressed in other contexts. The Loan Syndications and Trading Association (the "LSTA"), an association that participates in facilitating transactions in loans and related claims, requires different types of documentation and settlement procedures for transactions in debt treated as "par/near par" and "distressed." Debt trading on distressed paper (i.e., debt perceived to be at risk for full and timely repayment or debt that trades at varying discounts depending on the market's assessment of the risk of less than full repayment) historically was used for debt trading at 90.

addition, we suggest that the regulations provide the Service and Treasury with the authority to adjust the threshold by simple ruling or notice without going through the APA notice and comment procedures.[63] Finally, we recommend that the Regulations expressly provide that the Service can rebut the presumption simply by showing that prevailing interest rates have risen substantially, and that the substantial rise in interest rates accounts for enough of the drop in price of the debt instrument that an insufficient amount of the price decline is attributable to other factors, such as issuer distress. This principle could be illustrated in an example, such as the following:

> A debt instrument is issued on January 1, year 1 for $100, maturing in 20 years, and bearing interest at the market rate of 8 percent. On December 31, Year 5, the prevailing market interest rate for similar debt instruments has increased to 12 percent. The debt instrument has a fair market value of $64. Under the Valuation Presumption, the debt instrument would be treated as distressed because its fair market value is less than 65 percent of its Tax Principal Amount. However, if the issuer's credit quality had remained unchanged since year 1, a similar debt instrument would be expected to have a fair market value of $72.76 based solely on the increase in interest rates. Hence, the Valuation Presumption is rebutted because an insufficient amount of the decrease in the fair market value of the debt instrument (approximately 12.04 percent) is caused by factors other than the prevailing interest rate.[64]

Of course, the Service could also rebut the presumption by showing that there is a reasonable expectation that the issuer of such instrument will make total payments on the debt instrument equal to the debt's Tax Principal Amount based on all the facts and circumstances.

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[63] As is also contemplated for the Valuation Safe Harbor. *See supra* Part III(c)(1)(a).

[64] *See* Appendix A, Chart 3.

D. Yield Safe Harbor

We also recommend a second safe harbor, based on yield. We do so because, as some commentators have noted, a test based on valuation has certain limitations.[65] For example, because changes in interest rates have greater impact on the pricing of debt instruments with longer maturities, even if interest rates rise dramatically, debt instruments with short remaining maturities may have to experience substantially more credit deterioration than debt instruments with longer remaining maturities before trading at 50 percent discounts.[66] For example, a $100 debt instrument issued at par with a 6 percent coupon trading at $75 with one year remaining to maturity would clearly be distressed unless interest rates had become astronomical. Additionally, debt instruments that are issued at par with relatively low credit quality, and thus high coupon rates, may well cross the line over to distressed yet fail to satisfy either the Valuation Safe Harbor or Valuation Presumption (because they were so much closer to the edge to begin with). Although some commentators think a test based on yield is preferable to a test based on valuation,[67] we recommend including a Yield Safe Harbor only to supplement the Valuation Safe Harbor and 65 Percent Valuation Presumption, primarily to address the common cases that a valuation test is likely to miss, specifically debt instruments with short remaining maturities or low credit quality at issuance.

Our proposed Yield Safe Harbor (defined below) would have three requirements. The first requirement would be that the debt instrument have a yield (calculated assuming that the

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[65] Garlock, *Distressed Debt*, *supra* note 2 at 1002-03.

[66] *Id.*

[67] Kaufmann, *supra* note 2 at 48-49.

debt instrument will make payments in accordance with its terms)[68] in excess of AFR (or some other objective index)[69] plus 1,000 basis points (the "Yield Threshold Test"). In addition, the Yield Safe Harbor would require evidence of credit deterioration from issuance in the form of a requirement that the spread between the yield-to-maturity of the debt instrument and the AFR (or other index) on the date of measurement is more than 300 basis points greater than the spread between the yield-to-maturity of the debt instrument and the AFR (or other index) at issuance (the "Increased Spread Test" together with the Yield Threshold Test (the "Yield Safe Harbor")).[70] Finally, the Yield Safe Harbor would require a debt instrument that has less than 12 months remaining to maturity to have a fair market value of not more than 90 percent of its Tax Principal Amount.[71]

Some commentators have suggested tests similar to the Yield Threshold Test, but at different yield thresholds, some as low as the AHYDO rate for interest deduction disallowance.[72]

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[68] It may be appropriate for this purpose to take into account puts, calls, and alternative payment schedules in a manner similar to the approach of the OID regulations. *See* Treas. Reg. Section 1.1272-1(c)(5).

[69] The safe harbor described below is based on the AFR though other indexes used in financial markets, like LIBOR, could also be used.

[70] A more complex version of this test would require a showing that the spread has widened more than credit spreads generally.

[71] This last requirement is intended to address cases like the following example: a $100 debt instrument with an 8 percent coupon has one year left until maturity. Assume that the market expects that the principal will be paid at maturity, but some or all of the interest may not, and as a result the instrument now trades at, say, $92 (reflecting the discounted value of the $100 cash payment at maturity plus a highly discounted view of the interest). This instrument would have a yield in excess of 16%, which we assume is more than 1000 basis points above the short-term AFR, and the spread between the yield-to-maturity and the AFR would have increased by more than 300 basis points, and hence the Yield Safe Harbor would otherwise apply. However, the debt instrument would not be distressed under our ultimate definition, as the holder can reasonably expect full repayment of the Tax Principal Amount of the debt instrument.

[72] *See, e.g.*, Kaufmann, *supra* note 2 at 49 (looking to the AHYDO rules in suggesting that sensible rule to treat as distressed any debt instrument with a yield-to-maturity of more than 6 percentage points more than the AFR on the date of purchase); Garlock, *Distressed Debt*, *supra* note 2 at 1003 (suggesting a rule whereby debt instruments would be treated as "severely distressed" if the yield-to-maturity was in excess of the AFR plus 10 percent).

We recommend a 1,000 basis point margin over the selected index as the safe harbor because, especially in light of the recent experience of the financial crisis, this seems too low for a safe harbor.[73]

The Yield Threshold Test is also designed to formalize a developing market practice. We understand some taxpayers take the position that they can stop accruing interest, OID and market discount, on a debt instrument when the yield-to-maturity of the debt instrument exceeds the AFR plus a certain percentage.[74] The Increased Spread Test is not part of that practice, but is intended to provide additional support that there has been credit deterioration since the debt was issued.

In addition to the Yield Safe Harbor we would also suggest that Treasury consider a second presumption based, in part, on the Yield Safe Harbor and in part on following observation: The typical relationships between price, yield and maturity, discussed above, change where debt is in severe distress and debt prices become a function of where the instrument sits in the capital structure (and the expected recovery upon default), rather than yield or maturity.[75] For example, if default is imminent, one may see a 2-year bond and a 10-year bond with equal seniority both trading at about 70. In this circumstance, the 2-year bond will likely meet the Yield Safe Harbor, and the 10-year bond likely will not. However, it is likely

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[73] Even without that experience, using the AHYDO threshold seems contrary to the intent of Congress, which clearly contemplated that a holder could have income even though the issuer is denied a deduction.

[74] *See* Garlock, *Distressed Debt*, *supra* note 2 at 1002-03 (noting that a yield-based test for distinguishing between mildly and severely distressed debt, while less prevalent than a price test, is "gaining increased acceptance").

[75] For further discussion of this issue, *see* Needham, *supra* note 2, at 21.

that both bonds are distressed. Under our suggested additional presumption, the 10-year bond in this fact pattern would be presumed to be distressed.[76]

IV. MEASUREMENT DATE

Once the tests are set, the next questions are on what date (or dates) to apply them and whether these dates should be the same for all purposes. In determining measurement dates for the Distressed Debt Safe Harbors and Presumption, it is necessary to strike a balance between determining accurately whether a debt instrument is distressed and adopting a test that is not overly burdensome. Each of the Distressed Debt Safe Harbors and Presumption is potentially cumbersome to apply other than on the date the debt instrument is acquired (except for debt instruments that trade regularly and for which pricing information is readily available) because valuations are time consuming and expensive.[77] On the other hand, less frequent measurement will decrease the accuracy of the Distressed Debt Safe Harbors and Presumption, and will increase the possibility that the tax characterization of a debt instrument as distressed or nondistressed will not accurately reflect its economics between measurement dates.

In balancing concerns regarding accuracy and administrability, our proposed general rule is that debt instruments would be tested under the Distressed Debt Safe Harbors and Presumption once a year, specifically on the last day of the calendar year. This determination would

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[76] Such a presumption would, of course, be limited to situations where the issuer of a debt instrument had other outstanding debt of equal seniority, and so could not serve as a universal rule. Under the fact pattern discussed in the presumption, however, it seems to us hard to justify not treating the 10-year debt as distressed if the 2-year instrument is treated as distressed.

[77] As noted above, we considered an alternative based on credit ratings that would be easier to apply but concluded that it was not permissible under Dodd-Frank. *See supra* note 46.

determine if the debt instrument was distressed for the following calendar year.[78] We choose the calendar year because this is a holder-focused proposal and for many holders, the calendar year will be their taxable year. We also believe it is desirable to have the same testing date for all holders of the same debt instrument. In theory other dates could be used (e.g., the last day of the issuer's fiscal or taxable year), but we believe that this added complexity will add little benefit. In addition, many holders will already be doing year-end valuations, so using this date may simplify the application of the Distressed Debt Safe Harbors and Presumptions. A debt instrument would also be tested upon the occurrence of certain identifiable events, including a bankruptcy of the issuer, sale of substantially all of the assets of the issuer, or cessation of the issuer's business.[79] Determinations made on the occurrence of these events would override the determination made on the last day of the preceding calendar year (or on the acquisition date, where applicable). We discuss below whether a debt instrument should also be tested on the date on which the holder acquires it.

The Treasury may, however, wish to consider more frequent testing, perhaps quarterly, or on the date that interest is paid or compounded. Such an approach is clearly more accurate and might not be terribly burdensome in the case of debt instruments where valuation is easy to perform, or if valuations are frequently performed for nontax reasons. The paradigmatic case where such a test might make sense is a debt instrument that is actively traded and for which

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[78] Although testing at the end of a taxable year rather than the beginning (for which the end of the prior year is a proxy) has a number of merits, as discussed in note 82, we propose testing on the last day of the preceding calendar year in order to allow taxpayers to plan their affairs. For example, it is important for taxpayers to know how a given debt instrument will be treated for the upcoming year, so that (for example) they can determine their estimated tax payments. We recommend that the last day of the preceding calendar year is used because markets are generally closed on the first day of the calendar year.

[79] Case law regarding "identifiable events" that demonstrate that a debt may be worthless for purposes of Section 165(g) is informative on the types of events that should result in retesting.

quotes are readily available on media available to the public (e.g., TRACE).[80] On the other hand, such a rule would increase administrative complexity both in terms of the line-drawing exercise to determine which instruments would be tested more frequently and in terms of how to treat the additional dates and data for those that are. Further, more frequent testing for some but not all holders could lead to situations in which a given debt instrument is treated as distressed for some but not all holders. Such inconsistency is at least troubling from the perspective of our general rule. On balance, we think annual testing is the better, but not the only reasonable, resolution to the tradeoff between accuracy of determination and the burden of repeated testing.

Although our proposed general measurement date rule, which provides for testing once a year and then upon the occurrence of certain identifiable events, seems a sensible rule for the base case of interest and OID, there may be reasons to use different testing dates in different contexts depending on (i) the nature of the debt instrument and (ii) which substantive rule is being applied. For example, many practitioners would argue that for purposes of applying the market discount rules, the only date that matters is the date of acquisition. However, for interest and OID an approach where the acquisition date is the only testing date clearly makes no sense (as in that case original lenders could never stop accruing interest and OID on loans clearly gone bad). These and other issues are discussed below.

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[80] We do not believe in any event that it would make sense to extend more frequent testing to all instruments treated as publicly traded under section 1273 because the standard of "publicly traded" in that area, especially under the proposed regulations under section 1273, is relatively low for reasons that, whether or not they make sense in that context, would not make sense here, where frequent testing should only be imposed if market valuations will be consistently available on testing dates. Under the proposed regulations, a debt instrument would be considered to be "publicly traded" if is listed on an exchange, a sales price for the property is reasonably available, one or more firm quotes are available for the debt instrument or one or more indicative quotes are available for the debt instrument. REG-131947-10, 76 Fed. Reg. 1,101 (Jan. 7, 2011).

A. Interest, OID and Payment Ordering

Interest, OID and the payment ordering rule would be tested under the same measurement date rules because OID is the equivalent of interest and the payment ordering rule relates to the allocation of payments between interest and principal.[81] We propose that the measurement date for interest, OID and the payment ordering rule be the last day of the preceding calendar year. If a debt instrument is distressed on the measurement date, either under the general rule or any of the Distressed Debt Safe Harbors or Presumption, the debt instrument would be treated as distressed, or in the case of the Valuation Presumption would be presumed to be distressed, for the entire year.

We also considered whether the date of acquisition should be a testing date for interest and OID to a secondary-market purchaser in an arms-length transaction. This is, of course, a testing date where the Distressed Debt Safe Harbors and Presumption are easy to administer with respect to that holder because the price paid by such holder could be used for purposes of the calculations for the Distressed Debt Safe Harbors and Presumption. Adding this date also has the benefit of conforming to testing dates that we propose would be used for market discount (if retesting is adopted in that area). On the other hand, the benefits of such an additional testing date may not be that compelling. In addition, such a rule would not result in consistent treatment because the same instrument could be taxed differently in the hands of different taxpayers.[82]

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81 The equivalence of discount and stated interest has been recognized by the courts. *U.S.* v. *Midland-Ross Corp.*, 381 U.S. 54, 57 (1965); *Comm'r* v. *Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 145 (1974).

82 The importance of having such a measurement date would be greater if the annual testing date is the first day of the year rather than the last day of the year, because it would not seem to make sense for a holder who held an instrument and never had a realistic prospect of collecting the interest (or OID) while she held it to be forced to include it.

B. Market Discount

The market discount rules present a very different set of issues. In the context of market discount rules, we suspect that most practitioners instinctively believe that the date the holder acquires the debt instrument would be an appropriate testing date. Rationales vary, but this view is often informed by a belief that an instrument that is distressed at acquisition is a risky, equity-like investment, and that gains on such investments should be taxed as capital gains.[83] Whatever one's view on the capital gains point, using the acquisition date as the measurement date seems clearly appropriate to us in the market discount context. Many practitioners (perhaps thinking primarily of the capital gains point) would also argue that market discount should not be retested at all, but we think that retesting is a difficult question.

The issue of whether debt instruments acquired with market discount should be retested for distress after the acquisition date of the instrument is admittedly complex. As noted above, many practitioners and commentators appear to believe that there should not be retesting of an instrument that was distressed at acquisition, largely on the basis that a distressed obligation carries an equity-like risk and thus should get capital gains treatment on any subsequent increase

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[83] *See, e.g.*, Garlock, DEBT INSTRUMENTS, *supra* note 4 at ¶ 1107(.01) ("Most obviously, a taxpayer that buys a debt at a deep discount and that is lucky or foresighted enough to realize a gain on that bond would be deprived of capital gain treatment on that gain for no good tax policy reason."); Kevin M. Keyes, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS & TRANSACTIONS ¶ 8.01 (1997 & Supp. 2011-12) ("However, prior to the enactment of the market discount rules, market discount typically was taxed, as capital gain, only when the bond was disposed of or retired."); Needham, *supra* note 2 at 20 ("In the case of market discount, the failure of the statute to discriminate between healthy and distressed debt will convert an uncertain, purely speculative return into something altogether different."). *But see Liftin*, 36 T.C. 909; *Underhill*, 45 T.C. 489. These pre-1984 cases, which involve non-accrual of discount income with respect to debt instruments considered to be "speculative," are frequently cited by commentators in connection with an argument that a speculative debt exception should apply even after the enactment of the market discount rules, perhaps on the basis that these cases were not preempted. However, it is noteworthy that in those cases, while the taxpayer was not required to include "discount income" in income until the taxpayer recovered his cost with respect to debt instruments considered to be "speculative," any resulting income was ordinary. As some commentators have noted, the courts perhaps did not decide whether discount accruals in excess of basis should be capital gain or ordinary income, nor discuss this issue, as it was agreed by the parties that it was not in dispute (such amounts were ordinary income). *But see* Garlock, *Distressed Debt*, *supra* note 2 at 1001 & n.17.

in value. Retesting could get in the way of the desired capital gains result if the debt instrument determined to have been distressed at acquisition is retested periodically and recovers substantially before it is sold.

On the other hand, retesting in the reverse case, where a market discount obligation is not distressed at acquisition but becomes so, seems compelling. If the market discount rules are not suspended when interest and OID rules are suspended, it would be possible for the holder of a debt instrument to accrue market discount on debt instruments when interest and OID do not accrue. This result seems anomalous at a number of levels and outside of the capital gains context would lead to results that are almost impossible to justify from a policy perspective.[84]

In theory, one could retest for deterioration but not for recovery. While this may make some policy sense, such a regime seems too one-sided. If the regulations implement retesting in the market discount context, we recommend applying the rule consistently, in both the improvement and deterioration scenarios.

C. Debt Exchanges

We believe that the best date for testing distress in relation to a debt exchange is the exchange date. Our general proposed rule is at least somewhat inapplicable to the new instrument, which will not be outstanding on the last day of the year before the debt exchange.

D. Anti-Abuse Rule

We also recommend that the Service establish an anti-abuse rule to avoid manipulation of the testing dates and valuation rules. For example, if a holder owns 70 percent of a given class of debt instruments, it might be able to manipulate these rules by selling a small amount of those instruments at a steep discount at the time of a testing date. Absent an anti-abuse rule, this

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[84] For example, continuing to pick up market discount pursuant to a Section 1278(b) election or applying Section 1276(a)(3) to market discount notionally accrued while the instrument was distressed.

transaction could then be used to establish that the debt instruments in question are distressed regardless of their actual economics. Related party transactions may also be an area of concern.

V. APPLICATION OF THE DEFINITION OF DISTRESSED DEBT

A. Interest, OID and Payment Ordering

The adoption of the regulations described above would clarify the application of the common law DCE for accrual method taxpayers. Accrual method holders would not be required to include interest or OID in income under either the general facts and circumstances test, or upon satisfaction of any Distressed Debt Safe Harbors and Presumption. The next question is what to do if a distressed debt instrument recovers and ultimately pays the interest (or OID) that the holder previously did not accrue. We believe that while there are complicated issues as to when this should be deemed to occur (under the payment ordering rule), when it happens, the holder should have ordinary income.[85]

There are a variety of ways to revise the payment ordering rule for distressed debt. For example, the payment ordering rule could simply be turned off (so that the prior common law rule of respecting the designation given to the payment by the parties would be respected). If the payment ordering rule was reversed for distressed debt instruments, payments on a debt instrument would be treated as a repayment of principal, even if labeled "interest" by the parties.

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85 At least one commentator has suggested that if accruals are foregone and then a holder receives payments, there should be an interest charge on such payments, similar to the interest charge under the passive foreign investment company rules. *See* Schnabel, *supra* note 2 at 187 & n.115. *But see Corn Exchange*, 37 F.2d at 35 (suggesting that interest that is not accrued pursuant to the DCE should nonetheless be included in income if and when received: "[t]he government should not tax under the claim of income, that which is not received during the taxable year and in all probability will not be paid within a reasonable time thereafter. When and if such income is received, it must be returned as such for the year received."); *Clifton Mfg Co.*, 137 F.2d at 292 ("The controversy is therefore reduced to the single question whether a taxpayer on an accrual basis, who does not accrue a debt in the tax year when it is due and owing because of reasonable doubt as to its collectibility, must accrue and report it in a later year as soon as its collectibility is established, or defer its inclusion until the year when it is actually received. There are no decisions directly in point, but in our view the debt should be accrued and reported as income when its collectibility is assured.").

We all believe that that the payment ordering rule should be reversed for final payments on distressed debt instruments, which reflect the entire remaining recovery on the instrument; the tax treatment of such payments should be conformed to the economic reality.[86] Indeed, many of us believe that this is the most sensible interpretation of current law, and should not be limited to the distress area. In the distress area, we further recommend that, at a minimum, the payment ordering rule be turned off for partial payments on distressed debt instruments. Only a few of us would take the next step of reversing the rule (so as to treat a payment denominated as interest as principal); while such a rule has theoretical merits, it simply goes too far for most of us except in extreme cases. While it is undesirable for the holder of a distressed debt instrument to recognize ordinary income on interest payments, and a capital loss on the debt instrument if the Tax Principal Amount is not repaid, most (but not all) of us step back from recharacterizing stated interest as, in effect, principal unless principal repayment is truly impossible.[87] If such a reversal rule is adopted for any cases, it should be supplemented by a rule that recharacterizes stated principal as interest to the extent that the taxpayer ultimately recovers its Tax Principal Amount.[88]

B. Market Discount

Under the recommended approach, none of the market discount rules would apply to distressed debt instruments, with several implications. There would be no accrual of market discount on an obligation that was distressed at the time of acquisition, regardless of whether a holder made an election to accrue market discount on a current basis. As a result, for distressed

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[86] *See supra* note 10.

[87] Such cases do exist, but we expect that they are unusual outside of the structured security area.

[88] *See also* Schnabel, *supra* note 2 at 187 & n.115 (discussing possible interest charge).

debt, gains, subject to possible reclassification, would be taxed at capital gains rates[89] and partial payments on distressed debt instruments would not be treated as ordinary income. Additionally, holders of distressed debt instruments will accrue less market discount to taint property received in certain nonrecognition exchanges involving market discount debt and interest deduction deferrals on debt that is related to a market discount bond would not apply.

If debt instruments are to be retested under the Distressed Debt Safe Harbors and Presumption for purposes of the market discount rules, there are a number of possible ways to implement retesting.

First, consider the case of an instrument that is distressed at acquisition but later recovers. One possible approach to implement retesting is as follows: the holder of a distressed debt instrument would notionally accrue market discount under Section 1276(a) for the period during which the debt instrument is treated as distressed, but none of the substantive market discount rules would apply to amounts so notionally accrued. At a later point in time, if the debt instrument no longer qualifies as distressed (the "Reclassification Date"), the general debt rules would apply to the market discount that accrues after the Reclassification Date. To illustrate:

> A $100 debt instrument with a six year remaining maturity is purchased for $46 on January 2nd of year 1. Its value is $49 on December 31 of year 1. The debt instrument is distressed in years 1 and 2 because it met the Valuation Safe Harbor on the acquisition date and on December 31 of year 1. In each of years 1 and 2, $9 of market discount would notionally accrue; under the proposed rule, the market discount rules never apply to that $18.

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[89] *But see Liftin*, 36 T.C. 909; *Underhill*, 45 T.C. 489. These cases are discussed in greater depth at note 83.

> The debt instrument's value then recovers in year 2, and is $80 on December 31 of year 2. Thus, this debt instrument ceases to be treated as distressed. The debt instrument is sold for $95 on December 31 of year 4. The market discount rules would apply to discount accrued in years 3 and 4, and thus $18 would be ordinary income under the market discount rules, and the remaining gain of $31 would be capital gain.

An alternative approach would be for the instrument to be revalued on the Reclassification Date and have the normal market discount rules apply as if the instrument had been acquired on the Reclassification Date for a price equal to its value on that date.[90] To illustrate this approach:

> Assume the same facts as the previous example. (A $100 debt instrument with a six year remaining maturity is purchased for $46 on January 2nd of year 1, is valued at $49 at the end of year 1, recovers to $80 at the end of year 2 and is sold for $95 at the end of year 4.)
>
> Under this alternative, the market discount rules would never apply to discount notionally accrued in years 1 and 2. The market discount rules would apply to discount accrued in years 3 and 4. The amount of market discount accrued would be determined as if the debt instrument was newly acquired on December 31 of year 2 for its value on that date, $80. Hence, upon sale $10 would be ordinary income under the market discount rules and the remaining gain of $39 would be capital gain.

This approach is simpler in some ways than the first approach because it does not require calculation of the notional accrual of market discount while the instrument is distressed.

Note that either of these approaches is more favorable to the taxpayer than our proposed treatment of interest and OID in analogous fact patterns. In that context, we propose that, if interest or OID that did not accrue because of the DCE is ultimately paid (taking into account an

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[90] This rule may need to be refined to address complex situations, for example where a holder owns a nondistressed debt instrument acquired with market discount which becomes distressed and later recovers, so that the amount of market discount that would be taken into account under this rule does not exceed the amount of market discount that would have been taken into account had the market discount rules applied without modification.

appropriate revised payment ordering rule), that amount would be ordinary income. Such an approach could also be adopted in the market discount area by providing that if amounts of market discount that notionally accrue while an instrument is distressed are ultimately paid, such amounts would be treated as ordinary income. We note, however, that such an approach would largely, if not entirely, eliminate any capital gains opportunity with respect to distressed "market discount" investments.

For instruments that are not distressed when acquired (and to which the market discount rules initially apply), we think that the answer is more straightforward. The normal market discount rules would apply to amounts before it becomes distressed. On the testing date on which it becomes distressed, actual market discount accruals would cease. If it rebounds and once again ceases to be distressed, we would propose that the holder would be treated as having acquired the instrument at fair market value on the relevant testing date for the purposes of, and to the extent necessary to, apply the rules described above.

C. Treasury Regulation Section 1.1001-3

1. Recommended Approach

Debt modifications that are considered to be "significant modifications" are exchanges of such instruments (so that the post-modification instrument is treated as a new instrument for tax purposes), and under some circumstances may be taxable exchanges. This raises at least two issues in the distressed debt context: (i) recognition of gain or loss on the exchange (if the exchange is taxable) and (ii) whether the new debt will be classified as distressed for purposes of the other rules described above.

Upon a significant modification of a distressed debt instrument, a holder realizes gain (if any), in an amount equal to the excess of the issue price of the new debt instrument over the

holder's basis in the old debt instrument.[91] In the case of non-publicly traded debt instruments, the issue price of the new debt instrument is the face value of such instrument regardless of the instrument's fair market value, which can result in uneconomic gain to the holder.[92] This result seems particularly harsh in the distressed debt area where the fair market value of a distressed debt instrument may well be substantially lower than the face value of the new instrument. Conversely, if the deemed exchange results in a loss (more likely if the debt instrument is publicly traded and its issue price is determined by reference to fair market value or other consideration, such as stock received), the loss may be permanently denied if the issuer and holder are related parties.[93]

We would propose to address these issues with two new rules. We propose two rules because each addresses only part of the problem. The first rule would treat the amount realized in such an exchange under Treas. Reg. Section 1.1001-3 as fair market value even if the debt instrument received is not publicly traded,[94] which will reduce the risk of large artificial gains on exchanges of debt of both corporate and noncorporate issuers. The second rule would expand the scope of the recapitalization rules in this context, which will address a broader range of issues, but only with respect to debt issued by corporations.[95]

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[91] Treas. Reg. Section 1.1001-1(g), 1.1001-3.

[92] Treas. Reg. Section 1.1001-1(g), 1.1273-2.

[93] Section 267.

[94] *Cf.* Treas. Reg. Section 1.1001-1(g).

[95] Although a holder will not recognize gain under our proposed rules, some members of the Executive Committee are troubled by the possibility that if such a debt instrument recovers, the gain will be treated as ordinary under the market discount or OID rules, if at all.

2. Amount Realized for Non-Publicly Traded Distressed Debt

This rule is easy to state, but it may be a bit burdensome to apply. If in a debt exchange, both the old debt and the new debt are distressed, the amount realized would always be fair market value even if the new debt is not publicly traded. The issue price of the new non-publicly traded debt would remain its face value, assuming adequate stated interest, and thus the treatment of the issuer would not be affected. Of course, determining the value of non-publicly traded debt may be extremely difficult in this context (that is why Congress gave us Section 1274) but we feel it is the right balance in this context where otherwise wildly artificial gains could result. We note that this approach does not address the loss issues arising in such transactions. For example, if a holder exchanges debt for debt and equity of a debtor and the debt instrument exchanged does not qualify as a security for tax purposes, the exchange may result in lost or suspended loss deductions for a holder who acquires new distressed debt securities and also acquires (or previously owned) more than 50 percent of the equity of the debtor. This result may be undesirable if it impedes transactions in the distressed context where creditors may exchange debt instruments at a loss for equity of the debtor in an effort to restructure a debtor's capital.

We note that this proposal elicited a wide range of views from the Executive Committee, ranging from: (1) discomfort at having to value non-traded securities, to (2) discomfort at having

asymmetry between the issue price and amount realized,[96] to (3) support on the ground that the 1.1001-1 regulation is of questionable validity in the Section 1274 context in the first place.[97]

3. Recapitalization

The second approach to issues on the exchange would be to (i) treat all distressed debt as "securities" per se for purposes of Sections 354 and 356 (whether or not they initially met this test, as a result of their deterioration, they will have become sufficiently equity-like for this classification to apply in the context of the restructuring), and (ii) clarify that the principles of

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[96] The use of a different rule for amount realized and issue price creates not only an asymmetry between the treatment of issuers and holders, but also an apparent asymmetry between the holders of publicly traded and non-publicly traded distressed debt instruments. The former disparity is obvious—the issuer does not have COD income but the holder (who bought at a deep discount) also does not recognize gain based on the issue price of the instrument. As the holder's gain is artificial, this result may make sense as a policy matter—the threat of such gain may prevent business transactions from occurring that should occur. For example, an issuer, whose debt is way under water, may believe that with 3 more years and a 200 basis point increase in interest rate, it can turn things around. The lender, while skeptical, may be willing to let the issuer try, and should not be prevented from doing this by the prospect of artificial tax gain.

The inter-holder disparity is that if the debt instrument is publicly traded, its issue price is fair market value and thus the new instrument will be issued with OID. If the debt instrument is not publicly traded, however, its issue price will be face, but with a lower amount realized the same amount will be market discount. We acknowledge the distinction, but note that this seeming benefit to the latter holder is more apparent than real in most cases unless the instrument recovers. As discussed below in Part V(C)(4), we would revise the definition of distressed debt in the debt exchange area so that, at least initially, OID and stated interest would not accrue on the debt instrument issued in the exchange because it is "born distressed." Accordingly, the market discount/OID distinction would become relevant only if the debt instrument recovered and ceased to be distressed.

[97] Some members of the Executive Committee would contend that Section 1001(b) casts doubt on the validity of Treas. Reg. 1.1001-1(g) because the Code section unambiguously provides that the amount realized on a disposition of property is determined by reference to its fair market value. ("[M]oney received plus the fair market value of property (other than money) received.") Under this interpretation, some would argue that the regulation fails the first prong of *Chevron* analysis because it determines the amount realized on a non-traded debt instrument without regard to any valuation criteria whatsoever in a situation where the unambiguous intent of Congress is to determine amount realized by reference to fair market value, and that *Mayo* does not change the result. *See Chevron U.S.A.* v. *NRDC*, 467 U.S. 837, 842–843 (1984); *Mayo Foundation for Medical Ed. and Research* v. *United States*, 562 U.S. ___ (2011).

Rev. Rul. 2004-78[98] apply in the context of recapitalizations and apply regardless of how many characteristics of the debt instrument have changed.[99]

If this rule applied, in the case of corporate issuers, the deemed exchange that results from the modification of a distressed debt instrument would be a tax-deferred recapitalization under Section 368 unless the new debt instrument is both not distressed and cannot meet the definition of a security under the clarified analysis of Rev. Rul. 2004-78.[100] In such transactions, this approach could address both uneconomic gain and disallowed losses in the context of a corporate restructuring that, as discussed above, is particularly relevant in the distress context. Unfortunately, absent an amendment to the Code, this approach would be limited to transactions involving debt of corporate issuers as there are no tax-deferred recapitalization rules for partnerships or other types of issuers. Hence, this rule will complement, rather than serve as a substitute for, the rule discussed above addressing the amount realized on the exchange.

4. Definition of Distressed Debt in Debt Exchanges

An additional technical question arises as to how to apply the definition of distressed debt described above to an instrument resulting from a deemed (or actual) exchange. In the case of a "new" debt instrument that is publicly traded, the issue price would equal the fair market value of the new instrument. Accordingly, if the definition of Tax Principal Amount discussed above is applied literally in this context, the new instrument would never be considered distressed at

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[98] 2004-2 C.B. 108.

[99] In Rev. Rul. 2004-78, the debt instruments exchanged were identical except for changes to interest rate. Therefore, the ruling would support the proposition that if a new instrument represents a substantially similar instrument to the old debt instrument, then the old debt instrument should be tested under the Distressed Debt Safe Harbors and Presumption to determine if modified tax treatment applies. However, it is not clear how much the terms of two instruments could differ and still qualify under Rev. Rul. 2004-78, and so our proposed approach would go beyond the holding of that ruling. This ruling is discussed in further detail in note 101.

[100] In addition, there could be boot under Section 356 in the (probably unusual) case where the principal amount increases.

issuance (even if the "old" instrument was distressed and the principal amount was not changed). To address this last issue, we would suggest that the proposed rules should be applied by reference to the Tax Principal Amount of the old debt instrument (appropriately adjusted for changes in the restructuring of the principal amount payable)[101] and its original yield. In addition, the new instrument would be treated as distressed for all of the rules described in this report (e.g., accrual of interest and OID).

VI. REPORTING AND WITHHOLDING

We believe that the proposals described above make sense for holders even if they are somewhat complex and burdensome to implement. We do not, however, believe that it makes sense to subject the back offices of financial intermediaries to this complexity. Accordingly, we recommend that the special rules that apply to distressed debt not affect the reporting obligations of payors or intermediaries, for example the amount of interest reported on Form 1099. Similarly, we recommend that the proposed rules for distressed debt not affect the obligations of withholding agents to withhold on payments under Sections 1441 and 3406 (or any other applicable withholding provision).

Some may view the result that holders will be forced to file tax returns that are inconsistent with the 1099s they receive as a cloud overhanging our 1099 proposal. We actually see this result more as a silver lining, as these 1099s will help to police our next proposal.

We also recommend that the regulations include a reporting provision that would require a holder of a debt instrument who treats that instrument as distressed under the proposed general rule or the Distressed Debt Safe Harbors and Presumption to disclose this treatment on her tax

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[101] *Cf.* Rev. Rul. 2004-78 (treating the new debt instrument as a continuation of the old for purposes of determining whether the new debt instrument is a "security").

return. This reporting requirement could include disclosure of the amounts that would have accrued under the normal federal income tax rules applicable to debt instruments.

Additionally, to the extent such instruments are easily identifiable to the Service, it could consider issuing a non-exclusive list of debt instruments that it considers to have met the definition of distressed debt. Such a list could facilitate compliance, and decrease unnecessary controversy (and provide uniformity) on audit.

VII. TREATMENT OF THE ISSUER

If debt is treated as distressed under either the general rule or any the Distressed Debt Safe Harbors and Presumption, should this affect the issuer? A majority of our group believes, on balance, that the answer should be no.[102]

In some areas the answer to the issuer question is easy. The rules we propose for market discount and debt exchanges would have no issuer-level consequences.[103] For interest and OID, the question is more complex as a policy matter; current law generally allows a deduction, but to do so where there is no reasonable prospect that the interest would be repaid is troubling under the principles of accrual accounting. A majority of our group recommends that the current law be preserved in most contexts.[104] In the event, however, that the Treasury concludes that the

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102 A substantial minority of the Executive Committee would favor a symmetrical rule under which both the issuer and holder of a distressed debt instrument would be subject to alternative treatment.

103 Note that in the debt exchange area our amount realized proposal is limited by its terms to Treas. Reg. Section 1.1001-1(g) (amount realized rule).

104 It may, however, be appropriate to apply a symmetrical rule in situations where interest is effectively certain not to be paid, for example post-petition interest of a bankrupt issuer. However, the Service recently took a different approach to that issue in a chief counsel advice, in which it determined that a bankrupt issuer could continue to deduct stated interest on unsecured debt following its filing for bankruptcy, except for interest accruing in the year of emergence, after the determination that no interest would be required to be paid. ILM 200801039 (Sept. 24, 2007). The Service went on, however, to state that the taxpayer would have to include an offsetting amount in income under the tax benefit rule to take account of the prior deduction of stated interest that became nonpayable on emergence. A discussion of these complex issues is beyond the scope of this Report.

general rule should have issuer-level consequences, we do not think that Distressed Debt Safe Harbors and Presumption should be binding on issuers.

A. Interest and OID

Issuers are generally permitted a deduction for all interest paid or accrued within the taxable year on the issuer's indebtedness and, for debt instruments issued with OID, a deduction equal to the sum of all the daily portions of original issue discount for days during such taxable year.[105] Under current law, although a holder is permitted to stop accruing interest under the DCE, the borrower generally continues to get the benefit of interest deductions, even where the borrower does not reasonably expect to make such interest payments.[106] Commentators have offered varying explanations of this inconsistent treatment, including that: (i) an accrual method taxpayer should not be permitted to select the year of deduction,[107] (ii) if deductions exceed income (as could be the case for an issuer that is in distressed), the value of such deductions should be limited through net operating loss carry forward rules instead of disallowing a deduction to the issuer altogether,[108] and (iii) the Code and regulations include many provisions that demonstrate concern for distressed taxpayers and inconsistent treatment of accrued interest may be a part of that larger policy.[109]

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[105] Section 163.

[106] *See* Rev. Rul. 70-367, 1970-2 C.B. 37 (issuer permitted a deduction for all interest accrued in a given year even though there was no reasonable expectation that issuer would pay accrued interest in full); *Cohen* v. *CIR*, 21 T.C. 855, 857 (1954) (acq.) (interest deductible even though payment extremely doubtful, unless it can be "categorically said at the time these deductions were claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely doubtful.").

[107] Keyes, *supra* note 83 at ¶ 3.02[4][c][iii].

[108] *Id.*

[109] Schnabel, *supra* note 2 at 180-81.

The counterargument is that borrowers should not be able to deduct interest that will not be included in the income of the lender, if there is no reasonable expectation that the issuer will pay such amounts.[110] Although it may seem unfair to deny a debtor the benefit of a deduction for an amount the debtor is legally required to pay, the insolvency exception to the *Kirby Lumber* rule requiring cancellation of indebtedness to be included in income,[111] may support the position that the debtor's deduction should be disallowed. The insolvency exception permits debtors to exclude cancellation of indebtedness income if the debtor is insolvent after the debt cancellation.[112] Under prior case law in this area, an insolvent debtor was not treated as having an accession to wealth upon the cancellation of the debtor's indebtedness because the debtor was not relieved of the payment of an amount which the debtor was able to pay.[113] The flip side of such a position might be that although a debtor may be contractually liable for an amount, if such debtor has no prospect of ever paying the incremental accrued amount on its debt obligation, the debtor has not truly decreased its wealth despite the existence of a legal obligation for such amounts. This would argue that the debtor should not get the benefit of a deduction for interest on the debt in advance of payment. In effect, this argument would mean that an accrual basis taxpayer would use the cash method to determine when to deduct interest.

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[110] An issuer may recognize cancellation of indebtedness on a deemed exchange under Treas. Reg. Section 1.1001-3, however, this result is independent of the holder's issue regarding amount realized on the exchange.

[111] *See* Section 108(a)(1)(B).

[112] *Id.*

[113] *See, e.g.*, *Porte F. Quinn.* v. *Comm'r*, 31 BTA 142 (1934) (cancellation of a mortgage did not result in income to the taxpayer because taxpayer was insolvent and the discharge did not make any assets available to the taxpayer); *Dallas T & T. Warehouse Co.* v. *Comm'r*, 70 F.2d 95, 96 (5th Cir. 1934) (discharge of indebtedness not included in income where taxpayer was insolvent because the taxpayer did not receive anything of exchangeable value); *Simmons Gin Co.* v. *Comm'r*, 43 F.2d 327, 329 (10th Cir. 1930) (noting that the taxpayer had no assets both before and after the cancellation of indebtedness).

B. Payment Ordering

If distressed debtors are to continue to be entitled to deduct interest and OID that they are not reasonably expected to pay, then the payment ordering rule should not be turned off for debtors. If the modified payment ordering rule applied under such circumstances payments by the issuer would be treated first as a payment of principal and second as a payment of interest. The issuer would lose the benefit of the interest deduction, the same as if the distressed debt rules applied directly to interest. This rule may, as a practical matter, be of little importance. It would only come into play for cash method debtors, which we understand to be a small number of the taxpayers to whom these rules would apply, because accrual method debtors would continue to accrue interest deductions over time regardless of the timing of actual payments.

C. Application of the Distressed Debt Safe Harbors and Presumption

Even if the general rule described were to apply to issuers, the numerical tests in the Distressed Debt Safe Harbors and Presumption should apply to issuers only as rebuttable presumptions. The principal reason that we recommend the Distressed Debt Safe Harbors and Presumption for holders is that it is difficult for a holder (and IRS auditors of the holder) to get the issuer specific information required by the general rule. Issuers will not have this problem, and the Service can require issuers to provide that information in the audit process, or issuers can rebut the presumption of distress by voluntarily producing such information. It would be reasonable for the Service to require issuers to file a statement disclosing if the issuer has knowledge that the numerical tests in the Distressed Debt Safe Harbors and Presumption are met. Although we recommend that this information not be determinative of the issuer's treatment, it is certainly relevant to the audit process.

Prevailing Interest Rates Increase 50%

Chart 1: Debt Instruments With Five Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	9%	88.34	43.40%
8%	12%	85.59	41.58%
10%	15%	83.25	39.94%

Chart 2: Debt Instruments With Ten Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	9%	80.76	38.08%
8%	12%	77.41	35.41%
10%	15%	74.91	33.25%

Chart 3: Debt Instruments With Fifteen Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	9%	75.82	34.06%
8%	12%	72.76	31.28%
10%	15%	70.76	29.34%

Prevailing Interest Rates Increase 75%

Chart 4: Debt Instruments With Five Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	10.5%	83.17	39.88%
8%	14%	79.41	37.04%
10%	17.5%	76.29	34.46%

Chart 5: Debt Instruments With Ten Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	10.5%	72.94	31.45%
8%	14%	68.71	27.23%
10%	17.5%	65.69	23.89%

Chart 6: Debt Instruments With Fifteen Year Remaining Term Issued at Par at 100

Coupon	Prevailing Interest Rate	Value if Interest Rates Only Factor Impacting Price	Percentage Decrease Attributable to Changes Other than Changes in Prevailing Interest Rates
6%	10.5%	66.74	25.08%
8%	14%	63.15	20.82%
10%	17.5%	60.96	17.97%