



NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2017-2018 Executive Committee

MICHAEL S. FARBER

Chair
Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, NY 10017
212/450-4704

KAREN GILBREATH SOWELL

First Vice-Chair
202/327-8747

DEBORAH L. PAUL

Second Vice-Chair
212/403-1300

ANDREW H. BRAITERMAN

Secretary
212/837-6315

COMMITTEE CHAIRS:

Bankruptcy and Operating Losses

Stuart J. Goldring
David W. Mayo

Compliance, Practice & Procedure

Elliot Pisem
Bryan C. Skarlatos

Consolidated Returns

William Alexander
Richard M. Nugent

Corporations

Michael T. Mollerus
Gordon E. Warnke

Cross-Border Capital Markets

David M. Schizer
Andrew R. Walker

Cross-Border M&A

Yaron Z. Reich
Ansgar A. Simon

Employee Benefits

Robert C. Fleder
Jeffrey W. Ross

Estates and Trusts

Alan S. Halperin
Joseph Septimus

Financial Instruments

Lucy W. Farr
Jeffrey Maddrey

"Inbound" U.S. Activities of Foreign

Taxpayers

Peter J. Connors
Peter F. G. Schuur

Individuals

Megan L. Brackney
Steven A. Dean

Investment Funds

John C. Hart
Amanda H. Nussbaum

Multistate Taxation

Arthur R. Rosen
Jack Trachtenberg

New York City Taxes

Maria T. Jones
Irwin M. Slomka

New York State Taxes

Paul R. Comeau
Joshua E. Gewolb

"Outbound" Foreign Activities of

U.S. Taxpayers

Andrew P. Solomon
Philip R. Wagman

Partnerships

Phillip Gall
Eric B. Sloan

Pass-Through Entities

James R. Brown
Edward E. Gonzalez

Real Property

Robert Cassanos
Marcy Geller

Reorganizations

Neil J. Barr
Peter A. Furci

Securitized and Structured

Finance

Daniel M. Dunn
John T. Lutz

Spin Offs

Lawrence M. Garrett
Joshua M. Holmes

Tax Exempt Entities

Stuart Rosow
Richard R. Upton

Treaties and Intergovernmental

Agreements

Lee E. Allison
David R. Hardy

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Daniel Z. Altman
Austin W. Bramwell
Pamela L. Endreny
Jason R. Factor

Kathleen L. Ferrell
Elizabeth T. Kessenides
Shane J. Kiggen
Sherry S. Kraus

William L. McRae
Joel Scharfstein
Stephen E. Shay
Eric Solomon

Linda Z. Swartz
Andrea K. Wahlquist
S. Eric Wang
Sara B. Zablotney

Report No. 1366
March 10, 2017

The Honorable Thomas C. West
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1366 on Possible Regulations Interpreting Rules
Governing Applicable High Yield Discount Obligations*

Dear Messrs. West, Koskinen, and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report contains comments regarding possible regulations for the treatment of applicable high yield discount obligations ("AHYDO").

The AHYDO rules under section 163 generally defer and in some cases deny the ability to take deductions of accrued original issue discount ("OID") for issuers of certain high-yield debt instruments ("DIs"). The statute provides specific authority for the Treasury Department ("Treasury") to issue regulations modifying the AHYDO rules to carry out the purposes of those rules, including in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of DIs, conversion rights, or other circumstances where such modifications are appropriate to carry out the

FORMER CHAIRS OF SECTION:

Peter L. Faber
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel

Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee

Richard L. Reinhold
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Robert A. Jacobs
Samuel J. Dimon
Andrew N. Berg

Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher
David S. Miller
Erika W. Nijenhuis
Peter H. Blessing

Jodi J. Schwartz
Andrew W. Needham
Diana L. Wollman
David H. Schnabel
David R. Sicular
Stephen B. Land

purposes of sections 163(e)(5) and 163(i). The attached report contains our recommendations and requests for guidance with respect to the AHYDO rules.

Our primary recommendations are as follows:

1. We recommend that Treasury promulgate a rule under section 163(e)(5)(F)(iii) or 163(i)(1) that would automatically suspend the effects of the AHYDO rules upon the occurrence of certain economic triggers.
2. For purposes of determining (1) the maturity date of a DI under section 163(i)(1)(A) and (2) which accrual periods must be tested under the “significant OID” definition in section 163(i)(2), the last-day presumption in section 163(i)(3)(A) should be operative, and the deemed exercise of puts and calls in Treasury regulations section 1.1272-1(c)(5) should not apply.
3. For purposes of determining if the yield on a DI exceeds the threshold of the applicable Federal rate (“**AFR**”) plus 5% in section 163(i)(1)(B) and for purposes of calculating disqualified yield within the meaning of section 163(e)(5)(C)(ii), the regulations should specify whether (1) a DI’s yield to maturity is its yield at issuance under the OID rules (taking into account Treasury regulations section 1.1272-1(c)(5)) or (2) the last-day presumption in section 163(i)(3)(A) should be operative. Furthermore, the AFR used to test for AHYDO status (and compute disqualified yield) for purposes of section 163(i) should be determined in a manner consistent with the determination of the yield.
4. For purposes of determining if a DI has significant OID, a DI’s yield to maturity should be its yield at issuance under the OID rules.
5. We recommend that the disqualified portion of a DI’s OID should be based on a ratio of “disqualified yield” to “yield to maturity” (the “**Disqualified Fraction**”) that remains fixed for the entire term of the DI, even if the issuer makes payments in a manner inconsistent with the presumption used to determine the yield. We also recommend that regulations clarify the definition of “significant OID” under section 163(i)(2) to provide that the issue price and yield of a DI used for determining the product of the DI’s issue price and its yield to maturity should be the original issue price, and should remain constant for the term of the DI. Also, the regulations should clarify that upon a deemed reissuance of a DI for purposes of sections 1272 and 1273 if certain contingencies occur, the Disqualified Fraction, as of the issue date, should continue to apply to the new OID interest schedule resulting from the deemed reissuance.
6. With respect to modifications of DIs, if the borrower is related to the lender, we recommend that regulations provide a presumption that any modification results in a retroactive retesting of the DI for AHYDO purposes as of the original issue date of the DI taking into account the modified terms, and that if the redetermination causes the DI to be an AHYDO, the

determination should have retroactive effect to the issue date. For open tax years, the consequences should be the same as upon an audit adjustment. To the extent any deductions for OID were claimed in one or more closed tax years in excess of what would have been allowed under the AHYDO rules in those years (if any), we believe that the amount of improperly claimed OID deductions in such closed tax years should be recaptured as additional taxable income in the year of the retroactive retesting.

7. With respect to deferrals or modifications of so-called AHYDO “catch-up payments”¹ the regulations should provide that with respect to related lenders, any deferrals or modifications of the terms relating to catch-up payments should result in the DI being presumptively retested for AHYDO retroactively to its issue date based on the modified terms.

8. In the event of a “significant modification”² when a DI has accrued and unpaid OID, we believe regulations should clarify that after accrued OID on the new DI is deemed to be paid under the ordering rules of Treasury regulations section 1.1275-2(a)(1), payments that would otherwise be treated as paying down principal on the new DI should be treated as first paying down accrued OID on the old DI – *i.e.*, the accrued and unpaid OID on the old DI would “roll over” to the new DI and continue to be tracked going forward until deemed repaid.

9. Regulations should confirm that the yield for purposes of determining if a contingent payment debt instrument (“**CPDI**”) is an AHYDO is the comparable yield of the CPDI under Treasury regulations section 1.1275-4(b)(4)(i). The Disqualified Fraction of a CPDI should be used for purposes of determining the amount of disqualified and deductible OID for accruals of OID under the projected payment schedule, including being applied to positive and negative adjustments, and repurchase premium and cancellation of debt income (if any), upon an early retirement of the CPDI, subject to a specific exception.

10. For purposes of determining the appropriate AFR to use with respect to variable rate debt instruments (“**VRDIs**”) under the AHYDO rules, we believe that: (1) the three-month rule in section 1274(d)(2) and Treasury regulations section 1.1274-4(a)(1)(ii) should not apply, (2) regulations should explicitly state whether the rule of Treasury regulations section 1.1274-4(c)(2) (determining the term of a VRDI for purposes of determining AFR generally) also applies to determining AFR under the AHYDO rules, and (3) consistent with recommendation 3 above, regulations should clarify for purposes of determining such AFR, whether the presumptions in the OID rules (such as with respect to deemed exercise of puts and calls), or the last-day presumption in section 163(i)(3)(A) should be applied.

¹ Payments due and payable at the end of the first accrual period following the 5th anniversary of the DI (and each accrual period thereafter), which are designed to ensure a DI does not have any significant OID.

² Within the meaning of Treasury regulations section 1.1001-3(e).

March 10, 2017

11. Guidance should affirmatively provide that for convertible DIs, the fact that the DI may be satisfied in stock upon the exercise of a conversion right does not cause the convertible DI to have an indefinite term for AHYDO purposes, and the conversion right is not taken into account for purposes of determining a convertible DI's yield for AHYDO purposes, same as under the OID rules.

12. For a qualifying DI that has been integrated with a hedge under Treasury regulations section 1.1275-6 (which can be treated as a single "synthetic" DI having the same cash flows as the combined cash flows of the DI and the hedge), the regulations should clarify that the synthetic DI is tested for AHYDO status by reference to the terms of the synthetic DI, and not by reference to any particular term of the component parts of the synthetic DI.

13. Regulations should include guidance providing that: (1) if a subordinated junior DI has a term less than five years plus one accrual period, or calls for an appropriately structured AHYDO catch-up payment, the ability of any senior DIs to prevent the junior DI from being paid according to its terms will not cause AHYDO classification, provided that certain standards are met – *i.e.*, a failure to pay the junior note would trigger an event of default or other material adverse consequences (such as an actionable breach) that would make the required payment "unconditionally payable" within the meaning of Treasury regulations section 1.1273-1(c), and (2) that reasonable "standstill" provisions pursuant to which a junior creditor has agreed with other lenders to wait a certain amount of time before pursuing remedies should not change this result.

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,



Michael Farber
Chair

cc:

Krishna Vallabhaneni
Deputy Tax Legislative Counsel
Department of the Treasury

William E. Blanchard
Office of Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service

The Honorable Thomas C. West
The Honorable John Koskinen
The Honorable William M. Paul

March 10, 2017

Karl Walli
Senior Counsel (Financial Products)
Department of the Treasury

Michael Y. Chin
Office of Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service

Helen M. Hubbard
Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service

Steven Harrison
Office of Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service