REPORT #686

TAX SECTION

New York State Bar Association

REPORT OP AD HOC COMMITTEE

ON PROVISIONS OF THE REVENUE RECONCILIATION

ACT OF 1990 AFFECTING DEBT-FOR-DEBT EXCHANGES

March 25, 1991

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TAX SECTION
New York State Bar Association

March 25, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I enclose our report on the provisions of the Revenue Reconciliation Act of 1990 affecting debt-for-debt exchanges. The principal authors of the report are Yaron Z. Reich, Jodi J. Schwartz and David M. Rievman.

The report concludes that the repeal of section 1275(a)(4) of the Internal Revenue Code was a mistake for a number of practical, policy and conceptual reasons, and recommends that it be reenacted with modifications to resolve problems that had arisen in applying the provision. Moreover, we suggest that consideration be given to expanding the scope of a new section 1275(a)(4) to cover <u>all</u> debt-for-debt exchanges involving a single issuer.

One advantage of the reinstatement of section 1275(a)(4) is that it would obviate the need for the IRS and Treasury to address several significant and difficult issues that have been brought to the forefront by the section's repeal. More specifically, if the section is not restored, prompt guidance will be necessary on the issues of (a) what modifications in the terms of a debt instrument constitute an “exchange” and (b) when is a debt instrument “traded on an established securities market” for purposes of section 1273. These issues, which are discussed in detail in the report, need to be considered under current law in determining the tax consequences of even the most routine debt exchanges and modifications.

Finally, the repeal of section 1275(a)(4) was proposed and implemented over a period of a few weeks as a deficit reduction measure (repeal was projected to raise $300 million during the period 1991 through 1995). While a critique of the tax legislative process is beyond the scope of our report, we do not think it is wise to make changes affecting the basic structure of taxation in an economically important area without meaningful deliberation.

We would be pleased to discuss the report and its recommendations with your staff at their convenience.

Very truly yours,

James M. Peaslee
Chair

Enclosure

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Tax Report #686

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT OP AD HOC COMMITTEE

ON PROVISIONS OF THE REVENUE RECONCILIATION

ACT OF 1990 AFFECTING DEBT-FOR-DEBT EXCHANGES

* * *

March 25, 1991

I. INTRODUCTION[1]

Section 11325(a) of the Revenue Reconciliation Act of 1990 (the "1990 Act")[2] amended the Internal Revenue Code of 1986 (the "Code") by adding section 108(e)(ll)[3] and repealing section 1275(a)(4). These amendments effect significant changes in the treatment of exchanges of outstanding debt instruments for new debt

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[1] This report was prepared by an ad hoc committee chaired by Yaron Z. Reich and Jodi J. Schwartz who, with David M. Rievman, were the principal authors of this report. Portions of the report were written by Shlomo Cohen, Andrew Feiner, Michael S. Kutzin, David Miller, Elliot Pisem and Lawrence Silverstein, and important assistance in its preparation was provided by Peter Termote. Helpful comments were provided by Harold Adrion, Herbert L. Camp, Peter C. Canellos, John A. Corry, Sam Dimon, Arthur A. Feder, Simon Friedman, Gordon D. Henderson, James M. Peaslee, Richard Reinhold, Matthew Rosen, Michael Schler, Avishai Shachar, Mark Shifke, Willard B. Taylor and Mary Kate Wold.

It is with considerable diffidence that the Committee is submitting such a lengthy report, in view of the strongly held views of the New York State Bar Association Tax Section that Treasury regulations and other forms of government guidance should be shortened and simplified. However, the legislation raises a number of significant and complicated issues. It is hoped that this report will persuade Congress and the Treasury to reinstate section 1275(a)(4) with certain modifications and thereby obviate the need to address these questions.

[2] The Revenue Reconciliation Act of 1990 was enacted on November 5, 1990 as Title XI of the Omnibus Reconciliation Act of 1990, P.L. 101-508, 104 Stat. 1388. Subject to certain "grandfather" exceptions, the amendments effected by Section 11325(a) of the 1990 Act generally apply to debt instruments issued after October 9, 1990 in satisfaction of indebtedness.

[3] Except as otherwise indicated, all section references are to the Code or the Treasury regulations promulgated thereunder. References to regulations under sections 1271-1275 are to the proposed regulations that were published in the Federal Register, 51 F.R. 12022 (April 8, 1986), as corrected at 51 F.R. 23431 (June 27, 1986).

instruments of the issuer {“debt-for-debt exchanges”).[4]

Section 108(e)(11) provides that for purposes of determining cancellation of indebtedness income (“COD”) of a debtor from a debt-for-debt exchange, the debtor is treated as having satisfied its outstanding indebtedness with an amount of money equal to the “issue price” of the new debt instrument issued in exchange therefor. For this purpose “issue price” is to be determined (with one technical modification) under sections 1273 and 1274, which provide rules for determining the amount of original issue discount (“OID”) in respect of a debt instrument.[5]

In general, under section 1273(b)(3) and the pro-posed regulations promulgated thereunder, in the case of a debt instrument issued for property (including an outstanding debt instrument), the issue price of the new debt instrument will equal its fair market value (i.e., its trading price) or the fair market value (trading price) of the property for which it was exchanged if the new debt instrument or the property, respectively, is publicly traded (i.e., is “traded on an established securities market”).

[4] The outstanding debt instruments that are exchanged for new debt instruments in a debt-for-debt exchange are referred to in this report as the “old debt instruments”. The term “debt instrument” is defined broadly for purposes of sections 1271 through 1275 to mean “a bond, debenture, note, or certificate or other evidence of indebtedness”, other than certain annuity contracts. Section 1275(a)(1). See also prop. reg. section 1.1275-1(b) (further elaborating upon the meaning of the term). The Committee recommends that the term “debt instrument” be defined for purposes of section 108(e)(11) to have the same meaning as in section 1275(a)(1).

[5] OID is defined in section 1273(a)(1), subject to a de minimis rule, as the excess (if any) of the “stated redemption price at maturity” (“SRPM”) of a debt instrument over its “issue price”. “Stated redemption price at maturity” is defined in section 1273(a)(2). “Issue price” is defined in sections 1273(b) and 1274, as described below.

In general, under section 1274, if neither the new debt instrument nor the property for which it is exchanged is publicly traded, the issue price of the new debt instrument will be determined -- regardless of its actual fair market value -- by reference to its stated principal amount if the new debt instrument has adequate stated interest or, if not, by using the applicable Federal rate ("AFR")[6] to discount all payments due under the debt instrument.

Section 1275(a)(4), which was repealed by the 1990 Act, contained a special rule for determining issue price in the case of a debt-for-debt exchange by a corporate issuer that was pursuant to a plan of reorganization. Under this special rule, the issue price of the new debt instrument was equal to the "adjusted issue price"[7] of the old debt instrument if the issue price, as determined under sections 1273 and 1274, would otherwise have been less than such adjusted issue price. Thus, section 1275(a)(4) prevented the creation of OID upon a debt-for-debt exchange that qualified as a reorganization, regardless of the fair market value of the debt instruments or the adequacy of the interest rate of the new debt instrument, so long as the principal amount of the new debt instrument was not greater than the principal amount of the old debt instrument (or, more precisely, the SRPM of the new debt instrument was not greater than the adjusted issue price of the old debt instrument).

As a result of the enactment of section 108(e)(11) and the repeal of section 1275(a)(4), a debt-for-debt exchange by a corporate issuer will now give rise to COD if the issue price of

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6 AFR is defined in section 1274(d) and prop. reg. section 1.1274-6.

7 "Adjusted issue price" equals the issue price increased by accrued OID. Section 1275(a)(4)(B)(ii).

the new debt instrument (determined under sections 1273 and 1274) is less than the adjusted issue price of the old debt instrument, even if the exchange constitutes a reorganization and the principal amount of the new debt instrument is equal to the principal amount of the old debt instrument. In addition, such an exchange will give rise to OID if the issue price of the new debt instrument (determined under sections 1273 and 1274) is less than its SRPM. These results can be illustrated by the following example.

> Example 1. Assume that a corporation issued, for \$1,000 cash, a \$1,000 bond that provided for annual interest payments at 15 percent (a market rate of interest at that time for the corporation), that had an eight year maturity and that was part of an issue that is publicly traded. Two years later, when the corporation encounters financial difficulty, the corporation agrees with the bondholders to issue a new bond in exchange for each old bond. The new bond has a principal amount of \$1,000, an interest rate of 10 percent and trades publicly for \$400. The new bond matures in six years and therefore has a yield to maturity of 35.31 percent.[8]

Under the law that existed prior to the 1990 Act, the exchange of the old debt instrument for the new debt instrument would not have given rise to any tax consequences to the issuer or the bondholders (other than a reduction in interest expense and income, respectively, in subsequent periods). After the 1990 Act, however, because the debt instruments are publicly traded, the new debt instrument will have an issue price of \$400 under section 1273 and accordingly the issuer will recognize COD of \$600 (the excess of the \$1,000 adjusted issue price of the old debt instrument over the \$400 issue price of the new debt instrument). The new debt instrument will have OID of \$600 which, as a result of section

[8] For the definition of “yield to maturity”, see prop, reg. section 1.1272-l(f).

163(e)(5),[9] will not be deductible by the issuer until paid, and will be permanently nondeductible to the extent the yield exceeds the AFR plus 600 basis points. The OID will be includible in income by the bondholder under the "constant yield to maturity" method prescribed by the OID rules. Assuming both debt instruments qualify as "securities",[10] under section 354 a bondholder that has a tax basis in the old debt instrument of more than $400 will not be entitled to recognize any loss on the exchange but will instead be required to defer such loss.[11] It is important to note that if neither the old nor the new bond in Example 1 is publicly traded and the 10 percent interest rate on the new bond is at least equal to the AFR, the new bond would have an issue price of $1,000 under section 1274 and no COD or OID would be created.

This report considers the treatment of debt-for- debt exchanges after the enactment of section 108(e)(11) and the repeal of section 1275(a)(4). The report concludes that the repeal of section 1275(a)(4) was a mistake and recommends restoration of section 1275(a)(4) with modifications to address

[9] In general, under section 163(e)(5), which was enacted by the Revenue Reconciliation Act of 1989, if a debt instrument has "significant" OID within the meaning of section 163(i)(2), a term that is greater than five years and a yield to maturity that is more than the AFR plus 500 basis points, the deduction for OID is deferred until paid (and disallowed permanently to the extent the debt instrument has a yield to maturity that is more than the AFR plus 600 basis points). In the case of a corporate debtholder, the disallowed portion is treated as a dividend solely for purposes of the dividends-received deduction.

[10] Although the Code does not define the term "security", the term is generally understood to mean medium or long-term debt instruments of a type offered in the capital markets. Bonds and debentures ordinarily are treated as "securities"; commercial paper ordinarily is not. See generally Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, 750-51 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956).

[11] Subject to certain technical ambiguities (see Part VII.A., infra), section 1272(a)(7) should in effect allow the holder to amortize such loss as an offset against the amount of OID required to be included in income.

problems that had arisen in applying the provision prior to the 1990 Act. The report also deals with a number of important practical interpretive issues that require prompt guidance if section 1275(a)(4) is not reenacted, so that issuers and debtholders can determine the federal income tax treatment of specific debt-for-debt exchanges. Prompt guidance is also desirable to eliminate the many ambiguities created by the 1990 Act which may enable issuers to take dissimilar reporting positions on similar transactions and, in so doing, to contravene one of the primary policy goals of the legislation.[12]

II. SUMMARY OF CONCLUSIONS AND PRINCIPAL RECOMMENDATIONS[13]

A. Reinstatement, Revision and Expansion of Section 1275(a)(4)

The Committee believes that the repeal of section 1275(a)(4) was a mistake for the practical, policy and conceptual reasons stated in Part IV below. Accordingly, the Committee recommends that section 1275(a)(4) be reinstated but that it be clarified to provide (subject to certain additional refinements) that the issue price of a new debt instrument, if determined under section 1275(a)(4), will be the lesser of the adjusted issue price of the old debt instrument and the stated principal amount of the new debt instrument.

The Committee also recommends that Congress consider expanding the scope of a reenacted and modified section 1275(a)(4) to cover all debt-for-debt exchanges involving a

[12] See text accompanying notes 27-28, infra.

[13] The Committee recognizes that the implementation of these recommendations (and particularly the suggestion that a reinstated section 1275(a)(4) be expanded to all debt-for-debt exchanges) requires careful consideration of appropriate effective date and grandfather rules to avoid unduly upsetting the reasonable expectations of debtholders and issuers.

single issuer, whether or not they constitute a reorganization and whether or not the debtor is a corporation.[14] Any such expansion of the scope of a reenacted and modified section 1275(a)(4) should be accompanied by conforming changes in the rules governing the recognition of gain or loss by debtholders. Thus, under the approach suggested herein, no gain or loss would be recognized by debtholders on any debt-for-debt exchange involving equal principal amounts of debt instruments, and no COD, OID or premium would be created as a result of such an exchange.

B. Implementation of the 1990 Act

If section 1275(a)(4) is not reinstated, several important issues need to be addressed as a result of the 1990 Act. Our principal recommendations are set forth below.

1. What modifications constitute an "exchange".

Prompt guidance containing "bright line" rules is necessary on the question of what modifications in the terms of a debt instrument constitute an "exchange", so that issuers and debtholders do not inadvertently trigger significant adverse tax consequences. The "hair trigger" rule that may be inferred from certain existing authorities, under which relatively minor modifications are treated as an "exchange", should be relaxed in appropriate circumstances. Part V.B. contains specific recommendations regarding the treatment of various common forms of modifications.

[14] The New York State Bar Association Tax Section Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations, reprinted in 34 Tax Notes 363, 375 (January 26, 1987), (the "1987 OID Report") recommended that the regulations under section 1275(a)(4) clarify that that provision applies to exchanges of corporate debt instruments pursuant to a plan of reorganization even if the debt instruments do not constitute "securities". 34 Tax Notes at 376.

2. Definition of "traded on an established securities market" and application of sections 1273 and 1274. As illustrated by Example 1 above, dramatically different consequences can result from a debt-for-debt exchange under the 1990 Act depending upon whether the issue price of the new debt instrument is determined under section 1273 or section 1274, which in turn depends upon whether either the new or the old debt instrument is "traded on an established securities market". The Committee believes that, in the case of many debt-for-debt exchanges, the applicable rules are not adequate to determine whether particular debt securities are "traded on an established securities market" and to arrive at an appropriate issue price, for COD and OID purposes. These shortcomings in the existing statutory and regulatory scheme are largely attributable to the fact that virtually all trades of most debt securities are privately negotiated transactions, involving large blocks of the security, at prices that are not reported anywhere. Accordingly, for example, the Committee believes that notwithstanding a contrary indication in the proposed regulations,[15]* most securities that are listed on the "yellow sheets" are not "traded on an established securities market" for purposes of section 1273.

In order to effectuate the policies of section 1273 in an administrable manner, the Committee recommends that the regulations under section 1273 be revised to provide that a debt security is "traded on an established securities market" so as to have its issue price (or the issue price of a new debt security issued in exchange therefor) equal its trading price only if (i) actual trading prices or "bid" and "asked" prices are reported

[15] Prop. reg. section 1.1273-2(c)(1), by cross-reference to reg. section 1.453-3(d)(5).

and published and (ii) either (A) in the case of actual trading prices, the trading frequency for that security on the securities market for the relevant time period satisfies minimum threshold standards or (B) in the case of bid and asked quotations, the frequency with which these quotations are updated and reported, as well as the number of market makers whose quotations are reported for the particular security during the relevant time period, satisfy minimum threshold standards.

If Congress and the Treasury conclude as a policy matter that certain categories of debt securities that fail to qualify as “traded on an established securities market” under the foregoing standard should nonetheless have an issue price that is closer to fair market value than would result under section 1274, a number of alternative, albeit imperfect, approaches can be considered. One approach, which raises a number of problems, would require the fair market value (and issue price) of debt securities not “traded on an established securities market” to be determined pursuant to valuations rendered by disinterested broker-dealers or, alternatively, by agreement between the issuer and the exchanging security holders under guidelines similar to those that apply to non-publicly traded investment units.[16] A second approach would subject such categories of debt securities to section 1274 but would require that the adequacy of the interest rate on the debt security be tested by utilizing, instead of the AFR, a designated multiple of the AFR (which might vary depending on credit agency ratings of the security or the issuer) or, alternatively, the original yield to maturity of the old debt security. These approaches are considered in Part VI.F.

[16] See prop. reg. section 1.1273-2(d)(iv). The establishment of such issue price would, however, have to take into account any trading (or bid and asked) price information that is available.

3. Acquisition premium. As illustrated by Example 1, an exchanging security holder in a debt-for-debt exchange may be precluded from recognizing a loss on the exchange but required to include in income OID arising from the exchange. In order to eliminate any uncertainty as to whether the exchanging securityholder is entitled to reduce the amount of includible OID by the excess of its (substitute) basis in the new debt security over the issue price of that security pursuant to the "acquisition premium" rule of section 1272(a)(7), the Committee recommends that the Treasury promptly promulgate, in a slightly revised form, proposed regulation section 1.1272-l(g) as a temporary or final regulation. This provision should be revised to clarify (i) that the term "cost" as used therein means the exchanging holder's initial adjusted basis in the new debt instrument and (ii) that it also applies to a holder whose basis is exactly equal to the SRPM.[17]

4. Gain and loss to exchanging securityholders in a recapitalization. Under sections 354(a) and 354(d), exchanging securityholders in a debt-for-debt exchange of securities pursuant to a plan of reorganization do not recognize any gain or loss except that, if the "principal amount" of the new debt securities exceeds the "principal amount" of the old debt securities, gain is recognized in an amount equal to the fair market value of such excess principal amount. In view of the fact that "issue price" now controls the determination of OID and premium on the new security as well as, we believe, the amount realized on the exchange,[18] the Committee believes that sections 354 and 356 should be amended to provide explicitly that any

[17] See Part VII.A., infra.

[18] See note 182, infra, for a proposed clarification in this regard.

realized gain is to be recognized if the “issue price” of the new debt security exceeds the “adjusted issue price” of the old debt security, in an amount equal to such excess (and not the fair market value of such excess). The Committee recommends that exchanging security-holders should continue to be denied a loss on a reorganization exchange provided that they are permitted to offset OID arising from the exchange with acquisition premium under section 1272(a)(7).[19]

5. Exchanges involving multiple properties and debt instruments of affiliates. The Committee recommends, in Part VIII below, a number of technical clarifications regarding the application of the COD and OID rules to debt-for-debt exchanges involving multiple properties (including multiple debt instruments, stock, cash and other property). In the case of exchanges involving the use of a new debt instrument of an affiliate as part of an exchange for an old debt instrument, the Committee recommends that COD, OID and related consequences be determined as if the affiliate's new debt instrument was issued directly by the affiliate to the debtholder in exchange for the old debt instrument, even if the affiliate's debt instrument was in fact exchanged by the issuer for the old debt instrument. Notwithstanding proposed regulation section 1.108-2(a), issued March 21, 1991, the Committee recommends that COD be measured in the case of any such exchange by reference to the issue price of the new debt instrument rather than the fair market value of the old or the new debt instrument.

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[19] See Part VII.C., infra.

III. BACKGROUND OF RELEVANT OID AND COD RULES AND OF 1990 ACT PROVISIONS

A. Treatment of OID and COD in Debt-for-Debt Exchanges Pursuant to a Plan of Reorganization Prior to the 1990 Act[20]

As explained above, prior to its repeal by the 1990 Act, section 1275(a)(4) provided an exception to the general rules, contained in sections 1273 and 1274, for determining the issue price of a debt instrument. Essentially, section 1275(a)(4) prevented the creation of OID upon a debt-for-debt exchange pursuant to a plan of reorganization, regardless of the fair market value of the debt instruments (if section 1273 was otherwise applicable) or the adequacy of the interest rate of the new debt instrument (if section 1274 was otherwise applicable), so long as the SRPM of the new debt instrument was not greater than the adjusted issue price of the old debt instrument. While the conceptual basis of section 1275(a)(4) has not been clearly articulated, it appears that the provision was based on the notion (which we have termed the "substitution of obligation theory") that it is inappropriate to create OID upon such a debt-for-debt ex-change if the amount of the issuer's obligation has not increased, because the issuer has merely substituted one form of obligation for another but has not experienced an increase or diminution in its capital or assets and has not incurred an

[20] A detailed review of the judicial, statutory and administrative development of the provisions discussed herein is contained in Wilcox, "Issuing Mixed Consideration in Troubled Debt Restructurings", 10 Va. Tax Rev. 357 (1990). See also Hariton, "Recapitalizations: The Issuer's Treatment", 40 Tax Lawyer 873 (1987); Lipton, "Section 1274 and COD Income Due to Modification of the Interest Rate in a Debt Instrument", 68 Taxes 504 (1990); Cohen, "The Repeal of Section 1275(a)(4)", Tax Forum No. 464 (unpublished) (December 3, 1990).

additional cost of borrowing capital.[21] Moreover, the antecedents of section 1275(a)(4) may have reflected a reluctance to permit an issuer to convert nondeductible market discount into deductible OID.

A similar "substitution of obligation" concept underlay the rule contained in Revenue Ruling 77-437[22] and other authorities that COD is recognized on a debt-for-debt exchange only if and to the extent that the principal amount of the new debt instrument is less than the principal amount of the old debt instrument.

Notwithstanding Revenue Ruling 77-437, as a result of section 1275(a)(4) there was some uncertainty as to the proper measurement of COD in certain debt-for-debt exchanges prior to the 1990 Act. The issue can be framed by the following example:[23]

[21] See Wilcox, supra note 20, 10 Va. Tax Rev. at 382-92. See also G.C.M. 36627 (March 15, 1976) (indicating that the first statutory antecedent of section 1275(a)(4) -- an amendment to section 1232(b)(2) of the Internal Revenue Code of 1954 (the "1954 Code") that was enacted as part of the Tax Reform Act of 1969 -- was requested by the Treasury Department to support the litigation position of the Tax Division of the Department of Justice in several pending cases, in which the courts adopted the "substitution of obligation theory"). For an example of a judicial articulation of the "substitution of obligation theory" in the context of a debt-for-preferred stock exchange, see Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 151-55 (1974) ("National Alfalfa").

[22] 1977-2 C.B. 28. See also Commissioner v. Stanley Co. of America, 185 F.2d 979 (2nd Cir. 1951); Commissioner v. Coast-wise Transportation Corp., 71 F.2d 104 (1st Cir. 1934), cert. denied, 293 U.S. 595 (1934). See also G.C.M. 36602 (March 1, 1976). See generally Wilcox, supra note 20, 10 Va. Tax Rev. at 375-82. For applications of the "substitution of obligation theory" for purposes of determining COD upon the repayment of debt instruments that have been issued in debt-for- preferred stock exchanges, see U.S. Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988); Fashion Park, Inc. v. Commissioner, 21 T.C. 600 (1954).

[23] This example is contained in the legislative history of the 1990 Act, see H.R. Rep. No. 881, 101st Cong. 2d Sess. 355, and served to frame the debate among various positions during the months prior to the enactment of the 1990 Act, see Sheppard, "Debt for Debt Exchanges", 48 Tax Notes 954 (Aug. 20, 1990).

Example 2. Assume that a corporation issued for $1,000 a bond that provided for annual interest payments at a market rate of interest and that was and is publicly traded. Some time later, when the old bond is worth $600, the corporation exchanges (in a reorganization) the old bond for a new publicly traded bond that has a SRPM of $750.

The issue is whether COD has been created as a result of the exchange, and if so in what amount. Prior to the 1990 Act, commentators advanced three different approaches to this fact pattern.[24]

One view was that Revenue Ruling 77-437 and related authorities continued to determine the COD consequences of a debt-for-debt exchange. Accordingly, the corporation in the example would recognize $250 of COD as a result of the exchange because the principal amount of its debt has been reduced by this amount. Under this view, section 1275(a)(4) should be interpreted to contain a limitation whereby the issue price of the new debt instrument could not exceed the maximum amount the issuer is required to pay (i.e., $750, the principal amount of the new bond).

A second view was that section 1275(a)(4) should be applied literally, resulting in an issue price of $1,000 for the new bond and bond premium of $250 (the difference between the

[24] See G. Henderson & S. Goldring, Failing and Failed Businesses, CCH Tax Transactions Library Vol. 1A fl 403.012 (1990); Schler, “The Sale of Property For A Fixed Payment Note: Remaining Uncertainties”, 41 Tax L. Rev. 209, 237-38 (1986); Asofsky, “Reorganizing Insolvent Corporations Today”, 47 N.Y.U. Int. on Fed. Taxation K 40.03(6], at 40.27-28 (1989); Hariton, supra note 20; D. Garlock, “A Practical Guide to the Original Issue Discount Regulations”, 170.5-6 (Supp. 1989); Kohl, “The Fundamentals of Debt Swaps”, 48 Tax Notes 1037 (August 20, 1990); Haims & Schaumberger, “Restructuring the Overleveraged Company”, 47 Tax Notes 91 (July 2, 1990); Willens, “Debt Swaps Offer Important Tax Planning Opportunities”, 1 Corp. Tax’n 13 (1988); Cohen & Reinhold, Memorandum for the Treasury Department, reprinted in 47 Tax Notes 1247 (June 4, 1990); Sheppard, “Is There Cancellation of Indebtedness Income in Debt-for-Debt Exchanges?” 47 Tax Notes 900 (May 21, 1990); Sheppard, “Debt for Debt Exchanges”, supra note 23.

$1,000 issue price and the $750 principal amount of the new bond) that would be includible in income by the issuer over the life of the bond. Under this view, section 1275(a)(4) resulted in a conversion of COD into bond issuance premium.

A final view was that section 1275(a)(4) should be interpreted to contain a limitation whereby the issue price of the new debt instrument could not exceed the maximum amount that a bankruptcy court would allow the holder of the new debt to recover. While this view was difficult to reconcile with either the OID provisions of the Code or the preexisting law governing COD on debt-for-debt exchanges, some support could be found in two controversial bankruptcy cases, which had misconstrued the OID rules in the course of limiting a holder's allowable claim in bankruptcy to the fair market value of the debt.[25]

Accordingly, under this view, the issue price of the new bond would be $600 (its fair market value), resulting in $400 of COD and $150 of OID.

B. Section 11325(a) of the 1990 Act and Its Rationale

As described in Part I above, section 11325(a) of the 1990 Act repealed section 1275(a)(4) and enacted section

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25 In re Chateaugay Corp., 109 B.R. 51 (Bankr. S.D.N.Y. 1990); In re Allegheny International Inc., 100 B.R. 247 (Bankr. W.D. Pa. 1989). After concluding that unaccreted OID represents a disallowable claim for “unmatured interest” under section 502(b) of the Bankruptcy Code, the cases relied heavily on the tax law to determine the existence and amount of OID. However, both cases misapplied the Code. The Allegheny International case, which involved debentures that were issued in 1984 in exchange for preferred stock, properly concluded that OID was created on the exchange, but did so by distinguishing National Alfalfa on the same grounds as the courts in certain subsequent cases, instead of recognizing that National Alfalfa was effectively overruled in the case of debt-for-stock exchanges by the changes in sections 1232(b)(2) and 1232(b)(4) of the 1954 Code that were implemented by the Technical Corrections Act of 1982. See Wilcox, supra note 20, 10 Va. Tax Rev. at 390-91. The Chateaugay Corp. case, which involved a 1986 issuance of new debt securities and stock in exchange for old debt securities, referred to section 1273 but failed to address section 1275(a)(4) in concluding that OID was created as a result of the exchange.

108(e)(11). Section 108(e)(11) provides that for purposes of determining COD arising from a debt-for-debt exchange, the debtor is treated as having satisfied its outstanding indebtedness with an amount of money equal to the issue price (determined generally under section 1273 and 1274) of the new debt instrument issued in exchange therefor. Thus, as explained in the legislative history of the 1990 Act, the result in Example 2 would be in accordance with the third view described above: the issuer would have COD of $400 in respect of the old bond, and the new bond would have an issue price of $600, a SRPM of $750 and OID of $150.[26]

In view of the different positions that were being taken by taxpayers as to the proper approach for determining COD in a debt-for-debt exchange, clarification of the applicable rules was appropriate in order to provide guidance to taxpayers and to ensure similar treatment for taxpayers undertaking similar transactions. Section 108(e)(11) is an important step in that connection because it statutorily synchronizes the treatment of COD with the OID rules.

It is not entirely clear, however, from the legislative history why Congress concluded that the appropriate substantive solution to the issue presented by Example 2 was to repeal section 1275(a)(4) (and thereby achieve the result advanced by the third view -- $400 of COD and $150 of OID) rather than to amend section 1275(a)(4) to clarify that the issue price determined thereunder cannot exceed the principal amount of the new debt (and thereby achieve the result advanced by the first view -- $250 of COD). The legislative history suggests two reasons for this result: <u>first</u>, Congress wanted “to prevent taxpayers from selectively choosing the tax treatment for a

[26] H.R. Rep. No. 881, 101st Cong. 2d Sess. 353-54, Examples 1 and 2 (1990).

transaction”, and second, Congress believed that “the OID rules, as modified by the bill, provide the appropriate framework for determining the issue price of a new obligation” for purposes of determining the amount of COD created on a debt-for-debt exchange.[27]

The concern that taxpayers could selectively choose the tax treatment for a transaction appears to be based on the fact that, under section 1275(a)(4), an issuer was able to control whether it would have COD, OID or other tax consequences upon a debt-for-debt exchange that constituted a reorganization by varying the principal amount of the new debt instrument and making appropriate changes in other terms (such as its maturity and interest rate) while maintaining the same fair market value for the new debt instrument.[28] To illustrate, in Example 2, COD of $250 (or, under the second view, bond premium of $250) was created because the new bond had a principal amount of $750. If, instead, the new bond had a principal amount of $1,000, no COD, bond premium or OID would have been created even if its interest rate, maturity and other terms were sufficiently different from those of the old bond for the transaction to constitute an exchange and even if the fair market value of the new bond was also $600.[29] Alternatively, if the new bond had a principal amount (and SRPM) of $1,250 (but, as a result of its other terms,

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27 Id

28 It is also possible that Congress was concerned about the ambiguity of section 1275(a)(4) itself, which enabled taxpayers to take differing reporting positions with respect to identical transactions, see text accompanying notes 23-25, supra, and not merely with an issuer's ability to design the terms of its new debt instrument so that economically equivalent instruments produced different economic results.

29 Some issuers took the position that they could trigger COD by issuing the new bond as part of an investment unit together with a warrant or share of stock, see prop. reg. sections 1.1273-2(d) and 1.1275-2(a)(1), or by causing an affiliate to issue a debt instrument in exchange for the old debt instrument. See section 108(e)(4); text accompanying note 201, infra.

a fair market value of $600), the issuer would have created $250 of OID.

Such discretion in selecting tax consequences is not necessarily troubling, particularly under a tax system that, in the first instance, measures debt obligations by reference to their principal amounts and that deals with variations in the other monetary terms of an obligation through adjustments in the amount of periodic interest (or OID) income and deduction that must be taken into account over its life. Nor is such discretion necessarily worse than the forms of discretion introduced by the 1990 Act, described in Part IV below. Nonetheless, such discretion in selecting tax consequences is open to criticism in a tax system in which the general rule is that the consequences of every ex-change that constitutes a "tax event" should be determined based on the fair market value of the property involved in the exchange and in which transactions having equivalent economic results should have equivalent tax treatment.[30]

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[30] As indicated by the recommendations set forth in note 47 and the accompanying text, infra, repeal of section 1275(a)(4) was not the only possible solution to the perceived problem of taxpayers selectively choosing the tax treatment of a transaction.

It is also possible that Congress was concerned about issuers that reported book income (but no COD) as a result of debt-for-debt exchanges involving new debt instruments having the same principal amount as the old debt instruments. Compare Accounting Principles Board Opinion No. 26, "Early Extinguishment of Debt", with Statement of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" and American Institute of Certified Public Accountants Statement of Position 90-7 "Financial Reporting by Entities in Reorganization under the Bankruptcy Code". However, there are many disparities between financial statement income and taxable income, which is perfectly understandable given the different policies and objectives reflected by them. See, e.g., Rev. Rul. 85-42, 1985-1 C.B. 36 ("in-substance" defeasance does not give rise to COD, in contrast to accepted financial accounting treatment at that time). See generally Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) (general discussion of differences between tax and financial accounting). In recent years, Congress has attempted to limit disparities between taxable income and "economic income" through the alternative minimum tax. See, e.g., S. Rep. No. 99-313, 99th Cong. 2d Sess. 518-21 (1986).

Essentially, the enactment of section 108(e)(11) and the repeal of section 1275(a)(4) appears to derive from a conceptual view that debt-for-debt exchanges should not be treated differently, for purposes of determining COD and OID, from retirements and issuances, respectively, of debt instruments in exchange for cash. Thus, in effect, the 1990 Act rejected entirely the “substitution of obligation theory” for debt-for-debt exchanges that had been manifested, in some form, in both section 1275(a)(4) and the COD rules, and replaced that conceptual approach with a “hypothetical cash exchange theory”. Stated differently, a debt-for-debt exchange under the 1990 Act will be treated for purposes of determining COD and OID as if the debtor issued the new debt instrument for an amount of cash equal to the issue price of the new debt instrument (such issue price to be determined under sections 1273 and 1274 as if the new debt instrument were issued in exchange for the old debt instrument) and used the cash proceeds to retire the old debt instrument.

Section 108(e)(11) strongly resembles section 108(e)(10), which deals with the COD consequences of stock-for-debt exchanges. Section 108(e)(10) was enacted by the Deficit Reduction Act of 1984 (“DEFRA”) to repeal the so-called “stock-for-debt” exception from COD treatment for solvent debtors not in bankruptcy proceeding under which a debtor did not recognize COD upon the issuance of its own stock to cancel its indebtedness. This exception essentially was based on the “substitution of obligation theory”, to wit, “that the stock was simply a substitute liability for the debt and that no event had occurred which should cause the recognition of income”.[31] The principal purpose for the enactment of section 108(e)(10) was to eliminate the disparity between the issuance of stock to discharge debt and the issuance of stock for cash followed by the use of such cash to discharge the debt.[32] Although the legislative history to the 1990 Act does not refer to section 108(e)(10), the changes effected by the 1990 Act might be further rationalized on the basis that they removed some of the disparity in treatment for COD purposes that existed between stock-for- debt exchanges under section 108(e)(10) and debt-for-debt exchanges.[33]

This line of reasoning, however, appears to over-look a significant distinction between stock-for-debt exchanges and debt-for-debt exchanges. In a stock-for-debt exchange, where the substitute liability for the indebtedness -- a stock interest -- represents a totally different type of claim against the issuer from the original indebtedness, the exchange may be an appropriate occasion, as a policy matter, to determine whether the issuer has COD.[34] On the other hand, as discussed in Part IV below, policy considerations may suggest that a debt-for-debt exchange, where the substitute liability is also a debt claim, is not an appropriate occasion for determining whether the issuer has COD, notwithstanding the conceptual appeal of the “hypothetical cash exchange theory”.[35]

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[31] H.R. Rep. No. 98-432, Part 2, 98th Cong. 2d Sess. 1201 (1984).

[32] Id

[33] The disparity still remains where the debtor is insolvent or bankrupt and the stock-for-debt exception is applicable.

[34] As discussed in note 48 below, however, it may be appropriate to draw a distinction in this regard between common stock and preferred stock.

[35] Indeed, the “hypothetical cash exchange theory” and the objective of “preventing taxpayers from selectively choosing the tax treatment for a transaction” cannot by themselves justify the repeal of section 1275(a)(4), for they equally mandate the repeal of most of the reorganization rules of section 368 as well as other nonrecognition provisions. Instead, a decision as to the appropriateness of nonrecognition treatment in any given situation needs to be informed by an analysis of the relevant and practical, policy and conceptual issues.

IV. SUMMARY OF PRACTICAL, POLICY AND CONCEPTUAL ISSUES RAISED BY 1990 ACT AND RECOMMENDATION OF AN ALTERNATIVE APPROACH

The Committee believes that the repeal of section 1275(a)(4) -- which repeal was not subjected to meaningful public deliberation during the brief legislative process[36] -- was unwise as a tax policy matter, for the reasons set forth below.

The repeal of section 1275(a)(4) has made debt-for- debt exchanges involving corporate debt instruments that have the same principal amount into a "tax event", thereby introducing a "break" into what previously was a continuum of the debtor-

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[36] The proposal to repeal section 1275(a)(4) was first released to the public on October 10, 1990, see Staff of the Joint Committee on Taxation, "Description of Proposed Amendments to the Revenue Provisions of the Budget Summit Agreement", 101st Cong., 2d Sess. 42 (Comm. Print 1990). The 1990 Act was passed by Congress on October 27, 1990. Thus, only two-and-one-half weeks passed between the first public announcement of the proposal to repeal section 1275(a)(4) and its enactment.

The Committee notes that the repeal of section 1275(a)(4) was proposed as a deficit reduction measure (repeal was projected to raise $300 million during the period 1991-5). While a critique of the tax legislative process clearly is beyond the scope of this report, it should be of concern whenever changes affecting the basic structure of taxation in a significant area are made without meaningful deliberation in order to meet revenue targets.

Despite the very limited opportunity for public comment, a number of comments were submitted during the legislative process, including comments of the New York State Bar Association Tax Section, which raised substantial policy objections to the proposal. See letter from Arthur A. Feder, Chair, New York State Bar Ass'n Tax Section to Senator Lloyd Bentsen and Congressman Dan Rostenkowski (Oct. 17, 1990), reprinted in 19 Highlights & Documents 855 (1990) (the "NYSBA Letter"); Letter from Jere D. McGaffey, Chair, Section of Taxation, American Bar Ass'n, to Robert Scarborough, Attorney Adviser, Department of the Treasury (Oct. 18, 1990), reprinted in 19 Highlights & Documents 1030 (1990); Letter from Jere D. McGaffey, Chair, Section of Taxation, American Bar Ass'n to Terrill Hyde, Deputy Tax Legislative Counsel, Department of the Treasury (Oct. 23, 1990), reprinted in 19 Highlights & Documents 1227 (1990). See also Sheppard, "Section 1275(a)(4) Should Not Be Repealed", 49 Tax Notes 262 (October 15, 1990).

For a description of the proposals put forth by the tax bar and the financial community during the brief comment period prior to the repeal of section 1275(a)(4), see Wilcox and Rievman, "Restructuring Troubled Debt Under the New Debt Exchange Rules", 10 Va. Tax Rev. 665, 671-72 (1991).

creditor relationship between the issuer and the exchanging debtholder. This “break” raises a number of practical, policy and conceptual issues which, in the aggregate, lead the Committee to conclude that debt-for-debt exchanges involving debt instruments that have the same principal amount should generally not be treated as “tax events”.

On a practical level, the repeal of section 1275(a)(4) raises considerable uncertainties as to the proper treatment of even routine debt-for-debt exchanges and debt modifications under the new rules, and will require taxpayers and the Internal Revenue Service (the “Service”) to address a number of difficult fact-sensitive issues (with complicated policy ramifications) that are not readily resolvable.

The first issue relates to identifying the “trigger” -- i.e., what should be considered to be an exchange. As discussed in Part V below, determining what modifications of a debt instrument should constitute an exchange requires fine line drawing to balance between competing considerations, and does not lend itself to a logical framework. Moreover, existing authorities, which are unclear in many important respects, often treat relatively minor modifications of a debt instrument as giving rise to a deemed exchange. Such a “hair trigger”, which may well be necessary in order to have a coherent framework for dealing with different types of debt modifications, appears to cause unusually severe and disproportionate consequences to arise from modifications that are viewed by businessmen as incidental events.

The second -- and more fundamental -- practical issue is that, as illustrated by Example 1 above, the repeal of section 1275(a)(4), in conjunction with the enactment of section

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The second -- and more fundamental -- practical issue is that, as illustrated by Example 1 above, the repeal of section 1275(a)(4), in conjunction with the enactment of section 108(e)(11), places enormous significance on whether the issue price of the new debt instrument is determined under section 1273(b)(3) or, alternatively, under section 1274. Whether the issue price is to be determined under section 1273(b)(3) rather than under section 1274 in turn depends on whether either debt instrument is considered to be “traded on an established securities market". However, as explained in Part VI below, in the case of most debt-for-debt exchanges, there simply is no readily available source for obtaining a reliable market value quotation for the debt instruments at the time of the exchange. Thus, it may not be appropriate or feasible to determine the issue price of the new debt instrument under section 1273(b)(3). Moreover, while section 1274 provides a workable fallback rule for preventing taxpayer abuse in those situations in which non --publicly traded debt instruments are issued in exchange for non-publicly traded property other than outstanding debt instruments, it is not a particularly effective substitute for determining "issue price" in debt-for-debt exchanges, and may produce dramatically different consequences from section 1273. A number of alternative approaches for determining the issue price of the new debt instrument may be considered, each with its own problems.[37] However, the more fundamental issue raised by the valuation problem is why a debt-for-debt exchange should be treated as a "tax event", particularly in view of the other issues discussed herein.

Treating a debt-for-debt exchange as a "tax event" raises other conceptual and policy issues as well. In many circumstances, this "tax event" creates significant distortions and, therefore, adverse tax consequences to the issuer, the exchanging debtholders, or both (or, in certain circumstances, inappropriate tax benefits).

In general, an issuer will be required to recognize COD at the time of the exchange and an equal amount of OID deductions in subsequent years, thereby creating for most issuers an adverse timing difference even where the debt-for-debt exchange did not

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[37] See Part VI.F., infra.

produce a material change in the issuer's economic position. In many situations, the issuer will be even more prejudiced because it will be required to recognize COD but precluded from deducting a portion of the OID on the new debt instrument as a result of section 163(e)(5), which limits OID deductions on certain "high yield debt obligations". This seems to be a particularly inappropriate (and, apparently, unintended) application of section 163(e)(5), which was enacted to curb highly leveraged buyouts and recapitalizations where the issuer did not have adequate current cash flow to support the creation of such leverage,[38] not to trap financially troubled issuers that are restructuring outstanding indebtedness and not raising new capital or converting their equity into debt.

In other situations, an issuer may find it advantageous to structure the terms of the new debt instrument to avoid section 163(e)(5) and thereby to generate perfectly offsetting tax consequences (and inappropriate tax benefits), such as when it wishes to "freshen" net operating losses ("NOLs") that are scheduled to expire or that are about to become subject to the section 382 limitation as a result of an ownership change.[39]

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[38] See H.R. Rep. No. 247, 101st Cong. 1st Sess. 1220 (1989).

[39] As illustrated in Part V below, such an exchange could be effected through relatively insignificant modifications in the terms of an outstanding debt instrument. While it might be contended that it is in keeping with the policies of section 382 to permit an issuer to offset COD against the NOLs that were created by the deterioration in the issuer's credit (i.e., that such gain is "built in"), it is somewhat anomalous to permit an issuer to freshen NOLs in connection with a section 382 ownership change by modifying the terms of outstanding debt securities and thereby causing them to be "marked to market", given that (a) assets and liabilities generally are not marked to market as part of a section 382 ownership change and (b) it is presently unclear whether COD that is recognized upon the satisfaction of indebtedness, for cash, after a section 382 ownership change is a "recognized built-in gain" for purposes of section 382.

Moreover, the distortion created by this “tax event” will often result in adverse tax consequences to exchanging debtholders. For example, where a publicly traded old debt instrument has declined in value since its issuance, a debtholder that purchased the old debt instrument subsequent to its issuance but prior to the exchange would generally be required to include in income what previously was market discount, even though the yield to maturity on the new debt instrument may be well in excess of what can be attributed to economic interest as opposed to a speculative, quasi-equity return.[40] This consequence can be expected to have a negative impact on the market value of the new debt instrument (and the old debt instrument prior to consummation of the proposed exchange), and may limit its attractiveness to investors.[41]

Furthermore, the repeal of section 1275(a)(4) is likely to make it far more expensive for many financially troubled companies to restructure their publicly traded debt because it will require them to recognize COD even where an old debt instrument is exchanged for a new debt instrument of equal principal amount.[42] Creditors are likely to be less willing to agree to a debt restructuring because the tax cost of the COD arising from the restructuring will often seriously reduce the

[40] See Part VII.B, infra. Such inclusion in income would be required even where the issuer's OID deduction is deferred or disallowed under section 163(e)(5), although a corporate holder would be entitled to treat the amount of OID inclusion corresponding to the portion of the OID deduction disallowed to the issuer as eligible for the dividends-received deduction.

[41] Where the old debt instrument is publicly traded, the result of this conversion of market discount into OID may well be to reduce trading value and therefore to increase both the COD and OID generated as a result of the exchange.

[42] It is not uncommon for such companies to have insufficient NOLs to offset such COD. See Scherck, “Restructuring Today's Financially Troubled Corporation”, 68 Taxes 881, 882-84 (1990).

assets, particularly the liquid assets, of the debtor corporation. As a result, many companies that might otherwise have been restructured outside bankruptcy may be forced into bankruptcy proceedings, where COD can be avoided under the bankruptcy exception of section 108(a).[43] This could have profound nontax consequences, including increased legal and economic costs, and appears to be in conflict with the policy of the Bankruptcy Code.[44] For this reason, the Tax Section of the New York State Bar Association previously urged Congress to reject this aspect of the 1990 Act and, instead, to direct a study of this area of the law, taking into account bankruptcy law considerations.[45] Other interested parties sought to address this concern by proposing that Congress include in the legislation a

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[43] While in many instances financially troubled companies might be able to avail themselves of the insolvency exception from COD contained in section 108(a), that exception applies only to the extent of the insolvency and, more significantly, raises substantial uncertainties because of the difficulty in establishing the debtor's insolvency (and the precise amount thereof). See generally Asofsky, supra note 24, 11 40.03[3] at 40.6-7; Scherck, supra note 42, 68 Taxes at 884-85.

[44] Similar arguments were made in 1986 in connection with the enactment of section 108(g), dealing with the discharge of qualified farm indebtedness of solvent farmers, see 132 Cong. Rec. S7827 (daily ed., June 18, 1986). However, that same legislation repealed the rule permitting solvent taxpayers to reduce the basis of depreciable property in the case of qualified business indebtedness instead of recognizing COD. See section 822(b)(2) of the Tax Reform Act of 1986, P.L. 99-514.

[45] See NYSBA Letter, supra note 36.

provision exempting financially troubled companies from these rules.[46]

A final conceptual problem with the repeal of section 1275(a)(4) is that, as indicated in Part III.B. above, such repeal appears to have been guided by the hypothetical cash exchange theory. In many circumstances, however, the assumption that underlies this theory, i.e., that the issuer issued a new debt instrument for cash and used such cash to retire the old debt, is unrealistic. It is highly questionable whether an issuer whose outstanding debt instruments are trading at a deep discount from their adjusted issue price could in fact issue, for cash, the new debt instruments that it is deemed to have issued (particularly since the yields to maturity on these instruments exceed -- often by a multiple -- even the upper range of yields at which high yield debt obligations have historically been issued to investors).

The Committee believes that the foregoing issues indicate that the repeal of section 1275(a)(4) was unwise as a tax policy matter and should be reversed. Essentially, the Committee believes that the foregoing issues demonstrate that debt-for-debt exchanges are a particularly inappropriate occasion to trigger various tax consequences. For these reasons, the

[46] The Committee does not favor such an approach because it lacks conceptual justification, leaves unaddressed many of the issues raised above and in any event would require the modifications that are proposed below to be made to a re-enacted section 1275(a)(4). Moreover, it is likely that any definition of "financially troubled company" would produce arbitrary and unsatisfactory results. (Cf. section 108(e)(10)(C), as it existed prior to its repeal by the Tax Reform Act of 1986, which contained a special rule for "qualified workouts" that never became operative but which was subject to the criticism that it arbitrarily excluded many financially troubled companies that could not satisfy the requirements of that provision.) An alternative approach that avoids that definitional issue but not other problems would be to provide an exemption for debt instruments that are trading at a substantial discount from their adjusted issue price.

Committee believes that the "substitution of obligation theory" for treating debt-for-debt exchanges produces more satisfactory overall results than the "hypothetical cash exchange theory" that is reflected in the 1990 Act. Accordingly, the Committee recommends that section 1275(a)(4) be reinstated but that it be clarified to provide (subject to the refinements described in the footnote below) that the issue price of a new debt instrument, if determined under section 1275(a)(4), will be the lesser of the adjusted issue price of the old debt instrument and the stated principal amount of the new debt instrument (the "Principal Amount Limitation").[47] This modification would ensure that COD is

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[47] The Committee also recommends that consideration be given to promulgating additional rules to restrict the potential for abuses under section 1275(a)(4). Thus, the Committee recommends that, for purposes of applying the Principal Amount Limitation, the stated principal amount of the new debt instrument should be adjusted, where appropriate, in order to prevent issuers from creating "artificial" COD (and offsetting interest deductions in subsequent years) by reducing the stated principal amount of a debt instrument but increasing its interest rate. This objective of preventing the re-labeling of principal as interest might be achieved by providing that where the new debt instrument has a stated interest rate that is greater than the stated interest rate on the old debt instrument but a lower stated principal amount than the stated principal amount of the old debt instrument, its principal amount will be treated as equal to the sum of the present values of all payments due under the new debt instrument, determined by using a discount rate equal to the yield to maturity at issuance of the old debt instrument.

Although the policy considerations are not as clear as in the previous case, it might also be appropriate to adjust the stated principal amount of the new debt instrument for purposes of applying the Principal Amount Limitation in order to prevent issuers from avoiding COD by having the new debt instrument bear an artificially low interest rate and, consequently, a greater principal amount than it otherwise might have had (albeit, in the context of section 1275(a)(4), not greater than the stated principal amount of the original debt instrument). This objective might be achieved by providing that where the new debt instrument has a stated interest rate that is below the AFR on the date of the exchange (or, if lower, the original yield to maturity of the old debt instrument), its principal amount will be treated as equal to the sum of the present values of all payments due under the new debt instrument, determined by using a discount rate equal to the AFR (or, if lower, the original yield to maturity of the old debt instrument). Alternatively, in view of the fact that a reduction in interest rate to below the AFR without an increase in principal amount above the original stated principal amount will generally arise only in the case of a financially troubled issuer, where the reduction in interest reflects a decrease in the real economic return of the debt holders, it may not be necessary or (Footnote Continue…)

be the creation of $250 of COD, as suggested by the first view discussed above.[48]

The Committee further recommends that Congress consider according the same treatment to all debt-for-debt exchanges, regardless of whether or not an exchange constitutes a reorganization and whether or not the debtor is a corporation.[49] The same considerations that suggest that the "substitution of obligation theory" provides the most satisfactory overall results

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(Footnote Continue…)
appropriate to put a "floor" on the interest rate for tax purposes. Because the issuer remains liable to pay the stated principal amount, allowing an elimination of stated interest without recognition of COD could find support in the "substitution of obligation" theory (see the first sentence in the paragraph of text accompanying note 30, supra).

Finally, in order to prevent circumvention of the stock-for-debt rules of section 108(e)(10), taking into account the considerations adverted to in note 48 below and generally applicable debt/equity principles, it might be appropriate to promulgate a rule that would treat a new debt instrument that is issued in a debt-for-debt exchange as ineligible for section 1275(a)(4) treatment under certain discrete circumstances, such as where a substantial amount of current- pay interest on the old debt instrument is converted into non-current pay interest in the new debt instrument and the new debt instrument has a maturity that is both very long-term and substantially in excess of the maturity of the original debt instrument.

[48] If the foregoing recommendations are implemented, the Committee recommends that consideration also be given to whether the "substitution of obligation theory" should be extended to preferred stock-for-debt exchanges and debt-for- preferred stock exchanges (cf., e.g., the cases cited in notes 21 and 22, supra), particularly in view of the changes to sections 108(e)(10) and 305(c) that were effected by the 1990 Act. These changes remove most preferred stock-for-debt exchanges from the stock-for-debt exception to COD and subject most preferred stock that is issued at a discount to dividend accrual under rules similar to the OID rules for debt. It should be noted that sections 108(e)(10) and 305(c) can produce a greater amount of COD and a harsher income accrual rule for preferred stock-for-debt exchanges than the rules applicable to debt-for-debt exchanges after the 1990 Act because (at least in the absence of regulations) there is no AFR-type safe harbor for non-publicly traded preferred stock.

Clarification should also be provided respecting the application of a modified and reenacted section 1275(a)(4) to debt-for-debt exchanges involving multiple property exchanges and debt instruments of related parties. See note 191, infra.

[49] In that event, the nonrecognition rules applicable to debt-for-debt exchanges of corporate securities in a reorganization should also be extended to all debt-for-debt exchanges. See Part II.A, supra.

for debt-for-debt exchanges of corporations pursuant to a plan of reorganization appear to apply to other debt-for-debt exchanges as well.

V. WHAT MODIFICATIONS CONSTITUTE AN "EXCHANGE"

A. Introduction

Regulations section 1.1001-1(a) provides that gain or loss is recognized "from the exchange of property for other property differing materially either in kind or in extent". Furthermore, in the case of debt instruments, an actual exchange need not take place for there to be an "exchange" for purposes of section 1001: "[w]hen the changes [in the terms of a security] are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if the new security were actually issued".[50] Under the 1990 Act, if a debt modification transaction constitutes an exchange, especially if publicly traded debt instruments are involved, the issuer and the holders will be subject to potentially significant tax consequences, including possible COD and partially nondeductible OID, as illustrated by Example 1 above. Because of these implications, it becomes particularly important under the 1990 Act to determine when a modification of an outstanding debt instrument

[50] Rev. Rul. 73-160, 1973-1 C.B. 365. See also Rev. Rul. 81-169, 1981-1 C.B. 429. This treatment of modifications of debt instruments, including an explicit incorporation of the standards for what constitutes an "exchange" for purposes of section 1001, is now contained in the proposed OID regulations under section 1274. Prop. reg. section 1.1274-l(c)(1). Although presumably the same principle applies for purposes of section 1273, no similar rule appears in the proposed regulations under section 1273.

is deemed to be an exchange.[51]

The question of whether a modification is deemed to be an exchange is one as to which there are significant uncertainties. While there is a substantial body of case law and published and private rulings that address this subject, a number of common fact patterns in this area remain, surprisingly, unresolved. The courts and the Service have reached different conclusions on similar issues, thereby making it difficult to structure transactions with a reasonable level of certainty. In addition, many debt restructurings involve the modification of a number of different terms of the outstanding debt instruments; even if each of the modifications has been addressed individually through case law or administrative pronouncement, it is not necessarily clear how the totality of the transaction would be analyzed. The question whether a change in the terms of a debt instrument is sufficiently material to constitute a deemed exchange is essentially a question of line-drawing. While the Committee believes that it is generally undesirable to trigger a debt-for-debt exchange readily, the Committee does not believe that the determination of the type of modifications that should constitute an exchange affords much opportunity for implementing

[51] For a discussion of this issue, see generally Winterer, "Reissuance" and Deemed Exchanges Generally, 37 Tax Lawyer 509 (1984); Kalteyer, Real Estate Workouts -- Original Issue Discount Implications of Troubled Debt Restructurings, 43 Tax Lawyer 579, 628-35 (1990); Henderson & Goldnng, supra note 24, at V 402. The Supreme Court's expected decisions in the mortgage swap cases, Cottage Savings Ass'n v. Commissioner, cert. granted, 890 F.2d 848 (6th Cir. 1989), rev'g 90 T.C. 372 (1988), cert, granted 111 S. Ct. 40 (1990), and Centennial Savings Bank v. United States, 887 F.2d 595 (5th Cir. 1989), cert, granted 111 S. Ct. 40 (1990), may have some implications for the issues discussed herein. See generally Bacon, "S&L Loan Swaps at the Supreme Court: Ripple Effects", 49 Tax Notes 1121 (Dec. 3, 1990); Sheppard, "Supreme Court Considers Realization in Mortgage Swaps", 20 Highlights & Documents 491 (January 16, 1991).

significant policies.[52] Nevertheless, the Committee believes that in light of the 1990 Act, the test of what constitutes an exchange should be relaxed somewhat and should at a minimum provide specifically that modifications commonly viewed from a business perspective as incidental events are not so material as to constitute an exchange.[53] This would, prevent minor modifications from giving rise to disproportionately severe adverse tax consequences.[54]

Moreover, given the potentially significant implications arising from a debt-for-debt exchange, it is very important that the Service provide authoritative and comprehensive guidance as soon as possible on what modifications will be deemed to trigger such an exchange. The guidance should contain a uniform set of rules governing what constitutes an “exchange” for purposes of sections 1001, 354 and 356, as well as what constitutes an “issuance” of a debt instrument for purposes of sections 108(e)(11) and 1271-1275.[55] Consideration, of course, would need to be given as to the regulatory authority for issuing such

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[52] For example, it does not appear to be particularly fruitful to attempt to reduce the ability of issuers to trigger the acceleration of income in order to “freshen” expiring NOLs (see text accompanying note 39, supra) by having a higher threshold for what constitutes an “exchange”.

[53] See, e.g., Part V.B.6., infra.

[54] See Example 1 and Part IV, supra. Also, uncertainty about whether an exchange has occurred could result in penalties to the issuer under section 6706, which imposes penalties upon the failure of an issuer to comply with 010 information requirements, “unless it is shown that such failure is due to reasonable cause and not to willful neglect”.

[55] The legislative history of the 1990 Act states that, “[i]n any case in which an old debt instrument is exchanged by the holder for a new debt instrument, or in which the terms of an old debt instrument are modified so as to constitute an exchange by the holder, the debtor is treated as having issued a new debt instrument in satisfaction of an old debt instrument”. H.R. Rep. No. 881, 101st Cong. 2d Sess. 354, n.38. While it appears that a uniform set of rules should apply for purposes of determining OID and COD and for purposes of sections 1001, 354 and 356, different rules may be appropriate in other contexts. See, e.g., Notice 88-130, 1988-2 C.B. 543 (providing guidance on when state and local government bonds will be treated as retired and reissued for purposes of sections 103 and 141-150); reg. section 1.163-5(c)(2)(i).

guidance, in view of the long-standing, albeit amorphous, judicial and regulatory interpretations of what constitutes an "exchange" under section 1001 and the absence of statutory authorization for the issuance of legislative regulations in any of the relevant provisions other than section 1275(d). In the absence of adequate authority for the issuance of guidance, the Service could be whipsawed if taxpayers were able to elect whether to apply the new guidance or existing case law.

The traditional approach that has been utilized by the courts and the Service to determine whether a modification constitutes a deemed exchange has focused on whether particular terms of a debt instrument (and changes thereto) are material (a "term-based analysis"). While alternative approaches are theoretically possible,[56] the Committee recommends that the guidance provided by the Service should generally adhere to the term-based analysis of existing law. However, in order to have an administrable set of rules, the Committee recommends that only specified changes in the specifically identified terms set forth below should give rise to a deemed exchange.[57]

B. Specific Recommendations Regarding Treatment of Debt Modifications

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[56] One proposal that has been made for dealing with the issue of what modifications constitute deemed exchanges is to replace the existing "term-based analysis" approach with an approach that compares the net present value of the cash flows under the original debt instrument with the net present value of the cash flows under the modified debt instrument, using the same discount rate. This suggestion, which has a number of shortcomings, is described extensively in an article by Adrion and Blasi, "Renegotiated Debt: The Search for Standards", expected to be published in 44 Tax Lawyer (1991), and is summarized in Sheppard, "Debt Exchanges: Issue Price in Reorganizations and in Taxable Exchanges", 48 Tax Notes 954, 957-58 (Aug. 20, 1990).

[57] See Part V.B., paragraphs 8 and 9, infra.

1. Change in Interest Rate. The courts have not explicitly considered a case where the only modification to a debt instrument is a change in its interest rate.[58] In contrast to the case law, the Service's current position is that a change of interest rate results in a deemed "exchange".[59] It appears, however, that the Service recognizes that a de minimis change in interest rate does not trigger a deemed exchange.[60]

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[58] Indeed, although many cases have held that a deemed exchange arose from a change in interest rate and other terms, at least two precedents indicate that a change in interest rate might not constitute a deemed exchange even when coupled with other changes in terms. Compare Girard Trust Co. v. United States, 166 F.2d 773 (3rd Cir. 1948); Emery v. Commissioner, 166 F.2d 27 (2nd Cir. 1948); Watson v. Commissioner, 8 T.C. 569 (1947), acq., 1947-2 C.B. 5 (deemed exchange) with Mutual Loan & Savings Co. v. Commissioner, 184 F.2d 161 (5th Cir. 1950); Newberry v. Commissioner, 4 T.C.M. 576 (1945) (no exchange).

[59] See Rev. Rul. 87-19, 1987-1 C.B. 249 (waiver of scheduled changes in interest rates); Rev. Rul. 89-122, 1989-2 C. B. 200 (situation 1); prop. reg. sections 1.1274-l(c)(2), example and 1.1274-7(a)(3), example 2. The Service has indicated that a change in interest rate is "the factor we view as most critical to a taxable conclusion". G.C.M. 37002 (Feb. 10, 1977).

Revenue Ruling 87-19 implies that an automatic adjustment of interest rates pursuant to a formula explicit in the terms of a debt obligation (as would have occurred in that case but for the waiver) does not trigger a deemed exchange. Presumably this principle applies as well to other changes in terms (such as conversion rates) that are pursuant to the terms of the debt instrument. See also Rev. Rul. 57-535, 1955-2 C.B. 513. However, if the terms of a debt instrument permit or require the exercise of discretion or judgment at the time of the automatic adjustment in terms, an exchange might be deemed to have occurred. Cf. Rev. Rul. 90-109, 1990-52 I.R.B. 17 (deemed section 1001 exchange where company designates different executive under a key person insurance policy even though terms of policy permitted a substitution of insured because "there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option"). Notice 88-90, 1988-2 C.B. 414, and Notice 88-27, 1988-1 C.B. 496, deal with the application of the contingent interest rules to certain auction rate, remarketed or reset debt instruments, but do not address whether, or under what circumstances, the resetting of an interest rate through such a mechanism could constitute a deemed exchange. The Committee recommends that the Service issue guidance addressing Dutch auction and other interest reset provisions and that, except where the issuer or holder has discretion in resetting the rate, such instruments should not be deemed to be exchanged as a result of such a mechanism.

[60] See, e.g., private letter rulin;1; 8835050 (June 8, 1988) (less than 3 basis points); private Letter ruling 8932067 (May 17, 1990) (less than 12.5 basis points). Compare private letter ruling 8834090 (June 3, L988) (assuming, without specifically ruling, that a change o E 20 basis points constitutes a deemed exchange).

Given the current importance of this question, the Committee believes that it would be appropriate for the Service to issue formal guidance as to what changes in interest rate would be considered de minimis. The Committee believes that the de minimis rule for changes in interest rate should be at least as generous as the OID de minimis rule contained in section 1273(a)(3), in part in or *3er to avoid a “hair trigger” for other changes that should be treated consistently with changes in interest rate s (see paragraphs 2, 3 and 6 below). Thus, at a minimum, a change in interest rate should not be treated as a deemed exchange if it results in an increase or decrease in the original yield to maturity of the debt instrument of less than one-quarter of one percent.[61]

2. Extension of Maturity Date and Other Deferrals in Timing of Payments.

In general, the courts and the Service have agreed that an extension of the maturity date of an obligation would not, by

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[61] The Committee recommends that an increase in the principal amount of a debt instrument should be treated as an increase in interest rate to the extent the original yield to maturity of the debt instrument is thereby increased. All modifications described in paragraph s 1, 2, 3 and 6 which increase the yield of the debt instrument or, alternatively, which decrease the yield, and which, in either case, occur at the same time (or pursuant to an integrated plan) should be aggregated in determining whether the de minimis rule has been satisfied, but increases should not be offset against decreases.

For purposes of the de minimis rules described in this Part V.B., the yield of a debt instrument issued as part of an investment unit should be considered to be equal to the yield agreed upon by the parties, even if such yield is subsequently redetermined by the Service.

itself, trigger a deemed exchange.[62] It is open to question, however, whether an extension of the maturity date might be of a sufficient magnitude (for example, an extension of a debt instrument with an original maturity of two years to eight years) so as to be viewed as constituting a deemed exchange[63] or whether an extension which affects the original yield to maturity (e.g., in the case of a deep discount security) would constitute a deemed exchange.

Subject to the considerations raised in paragraph 3 below, the Committee recommends that the Service clarify that an extension of a debt instrument's maturity and changes in its amortization schedule or sinking fund provisions that have the effect of extending the weighted average life of the debt instrument should not be considered a deemed exchange unless such changes cause a change in the original yield to maturity of the debt instrument.

A de minimis rule similar to the one set forth in

[62] See, e.g., West Missouri Power Co. v. Commissioner, 18 T.C. 105 (1952),acq., 1952-2 C.B. 3; Motor Products Corp. v. Commissioner, 47 B.T.A. 983 (1942), aff'd, 142 F.2d 449 (6th Cir. 1944), acq. 1946-1 C.B. 3; Rev. Rul. 73-160, 1973-1 C.B. 365. Similarly, changes in amortization schedules and sinking fund obligations have generally not been viewed as triggering a deemed exchange. See, e.g., Motor Products Corp. v. Commissioner; private letter ruling 8907049 (Nov. 23, 1988); private letter ruling 8848033 (Sept. 1, 1988).

[63] Indications that under such circumstances an extension of maturity might trigger a deemed exchange can be found in Watson v. Commissioner, supra note 58, private letter ruling 8346104 (Aug. 18, 1983) and G.C.M. 37884 (March 19, 1979).

paragraph 1 above should be applicable to such changes.[64]

3. Forbearances on Collection of Interest and Principal. In the workout of troubled loans, debtholders sometimes forbear -- through formal standstill agreements or informal arrangements -- from the exercise of remedies upon the failure of the issuer to pay interest or principal. Debtholders may also waive their right to collect cash interest and, instead, allow interest payments to accumulate or, alternatively, accept payment in the form of additional debt obligations such as “baby bonds”. Several older cases and private letter rulings have held that an agreement to defer the payment of interest or to make such payment in additional bonds does not constitute a deemed exchange.[65] Nonetheless, it would be highly desirable for taxpayers to be able to rely on more contemporary authority in view of the importance of this question in many workout situations.

Subject to the considerations raised below, the Committee recommends that the Service set forth a rule that as long as unpaid interest accrues (or is paid in “baby bonds”) at the original yield to maturity of the debt instrument, a forbearance from the collection of interest will not result in a deemed exchange. Similarly, the Committee recommends that the

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[64] An alternative approach would be to provide that an extension of a debt instrument's maturity or weighted average life constitutes a deemed exchange if it exceeds, say, a stated percentage of the debt instrument's original weighted average life. The Committee does not favor such an approach because it would be difficult to reconcile with the considerations discussed in paragraph 3 below, and because it would add complexity that appears to be unnecessary in view of the rule regarding changes in interest rate proposed in paragraph 1 above.

[65] See West Missouri Power Co. v. Commissioner, supra note 62; Motor Products Corp. v. Commissioner, supra note 62; City Bank Farmers Trust Co. v. Hoey, 52 F. Supp. 665 (S.D.N.Y. 1942), aff’d, 138 F.2d 1023 (2d Cir. 1943 private letter ruling 8920047 (Feb. 17, 1989). See also note 62 and accompanying text, supra, respecting extensions of maturity date.

failure of a debtholder to exercise remedies upon a default in the payment of principal (and, a fortiori, upon any other default) should not constitute a deemed exchange so long as (i) the debtholder retains the right to claim such unpaid principal and (ii) interest accrues on the unpaid principal at a rate that is equal to the original yield to maturity of the debt instrument.[66]

A de minimis rule similar to the one set forth in paragraph 1 should be applicable to these changes. In addition, the Committee recommends that clarification be provided that the yield to maturity that must be preserved is either (i) the original yield to maturity of the debt instrument, (ii) the yield as adjusted to take into account any penalty interest rate that might be provided for in the debt instrument in the event of a failure to make timely payments or (iii) any yield that is between such yields.[67]

The Committee is concerned, however, that the rule set forth above may produce severe and arguably inappropriate results in many circumstances[68] and, accordingly, believes that

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66 Where the debtholder and issuer are related, a failure to exercise remedies may indicate that the debt instrument is really an equity interest. See generally Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal", 26 Tax L. Rev. 369, 493-96 (1971) and cases cited therein.

67 This rule would comport with what typically takes place in the case of a forbearance. Thus, the Committee recommends that Revenue Ruling 87-19, supra note 59, not apply to waivers of penalty interest rates.

68 Moreover, if an exchange is deemed to occur merely because a debtholder did not exercise its remedies upon a default on the payment of principal and as a result causes a non-de minimis decrease in yield, there would be no readily identifiable maturity date for purposes of determining the yield to maturity of the new debt instrument and, thus, its issue price under section 1274 (or the periodic accrual of OID under section 1272).

consideration should be given to crafting a somewhat more relaxed rule for these circumstances.[69]

The circumstances in which a strict "preserve the yield to maturity" test may produce inappropriate harsh results fall into two broad categories. The first category encompasses debt instruments ("moderate discount obligations") that have a yield to maturity that is somewhat greater than their stated interest rate and therefore a moderate amount of OID.[70] Because these debt instruments were considered at the time of their issuance to be "straight, current pay debt", they usually do not provide a mechanism (which often is contained in a deep discount obligation) for preserving the yield (as opposed to the stated interest rate) if principal is not paid at maturity.[71]

The second category encompasses those debt instruments -- whether "current pay" or (moderate or deep) discount obligations -- that are silent as to the applicable interest rate

[69] Because it does not appear to be feasible to define and distinguish among (i) "involuntary" forbearances, in which the debtholders have not agreed to any deferral of payments but simply have not yet exercised their remedies, (ii) formal forbearances, in which the debtholders agree to extend the time for payments because the issuer has financial problems and (iii) agreements to extend maturity dates and/or interest payment schedules for other, perhaps less compelling reasons, the Committee believes that if any relaxation is to be provided, such relaxed rule should also apply as an exception to the rules proposed in paragraphs 1 and 2 above.

[70] Moderate discount obligations arise, for example, as a result of (i) a "mispricing" of the security, (ii) related payments made by the issuer to the lender at the time of the transaction, see prop. reg. section 1.1273-2(f)(2), or (iii) the debt instrument being issued to a debtholder as part of a transaction in which the debtholder acquires other interests (such as stock and/or warrants) in the issuer and a portion of the purchase price of the debt instrument is (or should be) allocated to the other interests, see prop. reg. section 1.1273- 2(d) (investment unit rules).

[71] While such instruments may provide for a penalty rate in the case of payment defaults, which rate may, in effect, preserve the yield, that is not necessarily the case and, in any event, the holder usually agrees not to assert the penalty rate as part of its forbearance. See note 67 and accompanying text, supra.

(if any) after maturity or that provide for simple interest.[72] This category would include, for example, "short-form" notes drafted by businessmen without the advice of sophisticated counsel.

In view of the foregoing, it may be appropriate to permit forbearances from the collection of principal and interest as long as (a) stated interest continues to accrue on unpaid principal (and, if provided in the debt instrument, compounds on unpaid interest) at the rate set forth in the debt instrument (or is paid in "baby bonds"),[73] and (b) the forbearance does not result in a reduction of the yield to maturity of the debt instrument to a rate that is below an objective rate.[74] While this rule may permit issuers and debtholders to defer (and perhaps avoid) the tax consequences of a deemed exchange[75] and

[72] While most states now authorize interest on interest prior to judgment, there is authority holding that in the absence of an express statutory or contractual provision providing for compounded interest, the creditor is entitled only to simple interest. See, e.g., Estate Landscape & Snow Removal Specialists, Inc. v. Mountain States Telephone and Telegraph Co., 793 P.2d 415 (Ct. App. Utah, 1990); Southern Onion Exploration Co. v. Wynn Exploration Co., Inc., 624 P.2d 536, 543 (N.M. App. 1981); Shadow Lawn Savings & Loan Ass'n v. Palmarozze, 190 N.J. Super. 314, 463 A.2d 384 (App. Div. 1983). Moreover, it is not clear that a secondary market purchaser of such a discount obligation could enforce a claim to preserve the original yield (as opposed to its own yield) on the debt instrument.

[73] For the reason indicated in note 67 and the accompanying text, above, the applicable interest rate should be any rate that is not lower than the original interest rate and not greater than any penalty rate. Also, the de minimis rule set forth in paragraph 1 above should be applicable.

[74] This objective rate might be the AFR or (as suggested in Part VI.F. below, in a different context) a rate that is a multiple of the AFR in the case of a debt instrument that has an original yield substantially in excess of the AFR. Alternatively, this rate might be stated in terms of a percentage change in the yield. The determination should probably be made and given effect at the time of the initial forbearance if the parties agree on an extended maturity date and, if not, at the time the yield drops below the "floor". While this rule would not eliminate the problem identified in note 68 above, it would reduce the circumstances in which the problem would arise.

[75] In this regard, a subsequent forgiveness of interest or principal should generally be treated in the manner proposed in paragraph 7 below unless such forgiveness is pursuant to an earlier agreement.

would not be entirely consistent with the rules that are promulgated to deal with other situations discussed herein, it may be justified on the basis that it is not appropriate to have a “hair trigger” for a deemed exchange where the debtholder has not legally agreed to modify its rights to claim principal and interest.

4. Accelerations of Payments. The Committee believes that the treatment of prepayments of principal and accelerations of amortization schedules should also be clarified.[76] Notwithstanding proposed regulation section 1.1274-1(c), the Committee believes that an actual prepayment of principal, even if not provided for in the original debt instrument and even if accompanied by a premium, should not be treated as a modification of the entire debt instrument so long as the prepayment premium represents a commercially reasonable premium and is not a disguised payment for other modifications in the portion of the debt instrument that remains outstanding. Instead, the portion of the debt instrument that was prepaid should be treated as a separate debt instrument and the prepayment should be treated as a modification only of the redeemed portion (which, of course, would not result in a debt-for-debt exchange because the modified portion is retired as part of the modification).[77] Similarly, the Committee believes that the addition of a prepayment (i.e., call)

[76] See note 62, supra for relevant authorities. Similarly, the addition of a prepayment (call) right has been held not to constitute a deemed exchange. See, e.g., Motor Products Corp., supra note 62; City Bank Farmers Trust Co. v. Hoey, supra note 65. On the other hand, proposed regulations section 1.1274-l(c) states that “a payment to, or from the lender (or a successor) not provided for in the debt instrument shall be treated as a modification of the debt instrument”. Read literally, this provision could mean that any prepayment of principal that was not provided for in the original debt instrument will give rise to a deemed exchange. See 1987 OID Report, supra note 14, 34 Tax Notes at 408 (criticizing this provision of the proposed regulations).

[77] See paragraph 7, infra, discussing an analogous problem involving a partial forgiveness of principal.

right, even if a commercially reasonable prepayment premium schedule is added, should not be treated as a deemed exchange, because, if the issuer actually exercises this right, the debt instrument (or the portion that is prepaid) would be extinguished altogether. The Committee also believes that it would be useful for the Service to confirm that a modification that has the effect of reducing the maturity or weighted average life of a debt instrument (including a change in amortization schedule or sinking fund provisions) would not be treated as a deemed exchange, so long as it does not result in a commercially unreasonable prepayment premium.[78]

5. Changes in Other Terms. Any guidance that is issued on what constitutes an exchange should include confirmation that none of the following changes constitute deemed exchanges (at least in the absence of a cash payment to induce such a modification, as discussed in paragraph 6 below): (i) changes in covenants contained in a debt instrument or related indenture or loan agreement (other than those covenants relating to the payment of principal and interest); (ii) changes in the level of seniority or subordination of a debt instrument; and (iii) changes in collateral for a debt instrument.[79] Any exceptions to the foregoing should be noted by the Service.

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[78] In the case of OID obligations, whether a prepayment premium is commercially unreasonable should generally be determined by reference to the adjusted issue price of the debt instrument at the time of the modification, and, for the reasons discussed in the text accompanying notes 68-71, supra, perhaps under a somewhat more relaxed standard.

[79] See Rev. Rul. 77-416, 1977-2 C.B. 34; Rev. Rul. 73-160, supra, private letter ruling 9037009 (June 12, 1990); private letter ruling 8753014 (Oct. 1, 1987); private letter ruling 8346104 (Aug. 18, 1983).

Guidance should also be provided on the treatment of substitutions of obligors[80] and on the treatment of changes in the terms of a conversion privilege[81]

6. Cash and Other Property Payments to Induce a Modification. Issuers will frequently offer creditors a small cash payment in exchange for their agreement to changes in terms of the debt instrument (such as the relaxation of certain negative covenants or financial tests) that would otherwise not themselves be treated as a deemed exchange.[82]

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[80] A substitution of obligors has been held to result in a deemed exchange, see Rev. Rul. 69-142, 1969-1 C.B. 107 (substitution of acquiring corporation's debentures for target corporation's debentures constitutes a taxable exchange); private letter ruling 8848051 (Sept. 7, 1988), although it is not clear whether there is a deemed exchange upon the addition of an obligor having joint and several liability with the original obligor. The Service has indicated in private letter rulings that no deemed exchange would take place if the co-obligor is merely a new holding company or an original guarantor of the debt instrument. See, e.g., private letter ruling 8813035 (December 31, 1987); private letter ruling 8223044 (March 9, 1982). See also private letter ruling 8734042 (May 27, 1987) (no deemed exchange upon liquidation of wholly owned issuer into its parent, when debt was and continued to be guaranteed by grandparent).

[81] The Committee believes that a change in the terms of a conversion privilege (and presumably, the addition of a conversion privilege to a debt instrument that was not previously convertible) generally should constitute a deemed exchange. However, a change in a conversion formula that merely implements antidilution adjustments should not constitute a deemed exchange, regardless of whether an antidilution provision was contained in the debt instrument or was granted as a quid pro quo for the debtholders' consenting to modification of nonmonetary covenants. Similarly, no exchange should occur if, as part of establishing a holding company structure, a conversion right is modified only to substitute stock of the holding company for stock of the issuer where the principal asset of the holding company is stock of the former issuer. See private letter ruling 8509066 (Dec. 3, 1984).

[82] Such a modification and the related cash payment are commonly viewed from a business perspective as incidental events. The cash payment is not considered by the parties as an adjustment in the amount being charged to the issuer for the use of the lenders funds, but usually is viewed either as necessary and appropriate compensation to the debtholders for their management's services in evaluating and agreeing to the requested modification, or as the price that is exacted by the lenders in exchange for the issuer's “repurchase” of its covenant.

Proposed regulation section 1.1274-1(c) includes a blanket rule that "a payment to or from the lender (or a successor) not provided for in the debt instrument shall be treated as a modification of the debt instrument". The underlying premise of this provision of the proposed regulation is not readily apparent. Assuming that the agreement to modify a covenant would not by itself constitute a deemed exchange, the Committee believes that the receipt of a nominal payment for that consent should not result in a deemed exchange of the entire debt instrument but, instead, should simply be treated either as compensation for the consent or as a repurchase of a portion of the debtholder's contractual rights. Although based on its understanding of business practices the Committee believes that a payment to the debt-holder (excluding transaction expenses) of less than 2 percent of adjusted issue price should be considered nominal, at the very least, such payments should be subject to a de minimis rule in the same manner as changes in interest rates (see paragraph 1 above).

In contrast to nominal cash payments that are made to induce debtholders to agree to covenant modifications, the Committee believes that making of substantial cash payments or the issuance of stock, warrants or other property (not provided for in the original debt instrument) to a debtholder to compensate for such a modification should constitute a deemed exchange of the old debt instrument for a new debt instrument plus cash or for an investment unit consisting of the new debt instrument and the stock, warrants or other property (as the case may be).[83]

[83] See Part VIII below for a discussion of issues arising as a result of such multiple property exchanges. It may also be advisable to expand the rule recommended for nominal cash payments to issuances of stock, warrants or other property.

7. Partial Forgiveness of Principal and Accrued Interest. Historically, if a debtholder forgave a portion of the outstanding principal amount of a debt instrument or forgave all or a portion of the interest accrued thereon, whether unilaterally or pursuant to a compromise agreement with the issuer, the issuer was viewed as having COD in an amount equal to the portion of its liability that was forgiven,[84] the debtholder was entitled to a deduction if it could establish the worthlessness of the forgiven portion and otherwise satisfied the requirements of section 166 (or, in the case of a security, section 165(g)), and the balance of the debt instrument remained unaffected.[85] In Revenue Ruling 89-122 (Situation 2), however, the Service held that if a debtholder and a noncorporate issuer agree to reduce the principal amount of a debt instrument, that agreement constitutes an "exchange" of the old debt instrument for a new debt instrument, and the debtholder recognizes a loss under section 1001 rather than a bad debt deduction under section 166.[86] While it may be desirable as a policy matter to permit the debt-holder to claim a loss in such a situation without having to establish that it meets the requirements for a bad debt deduction under section 166, it is not clear why the Service concluded that there was a taxable exchange affecting the entire debt instrument, instead of simply a taxable exchange of the forgiven

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84 In the case of an issuer that utilizes the cash method of accounting, a debtholder's forgiveness of accrued but unpaid interest would not give rise to COD by reason of the exception contained in section 108(e)(2) since the issuer would have been entitled to an interest deduction upon payment of the interest.

85 See generally Henderson and Goldring, supra note 24, at H 402.

86 The Service explained that it reached that conclusion because the transaction involved a bilateral agreement rather than a unilateral determination by the debtholder that a portion of the debt is uncollectible. In the ruling, a loss under section 1001 was desired because a bad debt deduction under section 166 would have resulted in a less favorable net operating loss carryover rule for the bank lender under section 172(b)(1)(K).

portion for no consideration.[87] Moreover, in the case of a corporate security, this rule would result in an unrecognized loss under section 354. The Committee recommends that the Service reconsider this portion of the ruling.

8. Relevance of Other Factors. A number of cases have suggested that if, as a result of changes in terms, the fair market value of a debt instrument has also changed, such variation in fair market value may be a good indication that the changes were sufficiently material to constitute a deemed exchange.[88] The Service, however, has expressed the view that differences in fair market value are not a material factor in determining whether there is an exchange.[89] Also, some authority suggests that an involuntary change in terms (such as changes arising in a bankruptcy proceeding) is less likely to be considered a deemed exchange.[90] The Committee believes that these factors would impair the administrability of the term-based analysis recommended in the preceding paragraphs and should

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[87] Although prop. reg. section 1.1275-2(d) provides for the aggregation of debt instruments issued in connection with the same transaction or a series of related transactions or as part of the same issue and the treatment thereof as a single debt instrument for purposes of sections 1271 through 1275, that provision (and the aspects of sections 1271-1275 to which it relates) addresses the issuance of a debt instrument, not its exchange, retirement or forgiveness.

[88] See, e.g., Mutual Loan & Savings Co. v. Commissioner, supra note 58; Emery v. Commissioner, supra note 58; Girard Trust Co. v. United States, supra note 58.

[89] See Rev. Rul. 81-169, supra; GCM 37884 (Mar. 19, 1979) (indicating, however, that a difference in fair market values may be evidence that the changes in the terms are material).

[90] See, e.g., Mutual Loan & Savings Co. v. Commissioner, supra note 58; West Missouri Power Co. v. Commissioner, supra note 62; New berry v. Commissioner, supra note 58. See also G.C.M. 37002 (February 10, 1977) (indicating that, although the Service's view is that it is irrelevant whether a change in terms is involuntary, “as a matter of policy, the Service would not litigate when there was an involuntary change of defaulted bonds except when, as in the Mutual Loan & Savings Co. case, the bonds were acquired after the default in contemplation of realizing a gain from the refunding plan”).

therefore not be taken into account independently of the specific rules discussed in the preceding paragraphs. In any event, clear guidance on these issues would be appropriate.

9. Multiple Changes in Terms. Finally, many debt restructuring situations involve changes in a number of the terms of the outstanding indebtedness. By emphasizing that a deemed exchange had occurred in particular situations based on the totality of changes made to a debt instrument, existing authorities suggest that changes which individually might not trigger a deemed exchange would trigger such an exchange in the aggregate.[91] If the Service believes this to be the case, it would be useful to articulate standards under which multiple changes in terms would be treated, in the aggregate, as giving rise to a deemed exchange. The Committee believes, however, that such a rule is likely to be unadministrable. Moreover, particularly if any change in interest rate (other than a de minimis change) constitutes a deemed exchange, it would appear that the specific rules described above should be adequate to identify all situations in which the changes are sufficiently material so as to constitute a deemed exchange. Accordingly, the Committee recommends that, except as indicated in note 61 above, changes that individually do not cause a deemed exchange should not be treated as material in the aggregate.

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[91] See, e.g., Girard Trust Co. v. United States, supra note 58 (citing changes in interest rates, maturity, call dates and fair market value); Emery v. Commissioner, supra note 58 (citing similar factors); Rev. Rul. 81-169, supra note 50; Rev. Rul. 79-155, 1979-1 C.B. 153.

VI. APPLICATION OF SECTIONS 1273 AND 1274

A. Overview

As discussed above, newly enacted section 108(e)(11)(B) provides that "issue price" for purposes of determining the amount of COD in a debt-for-debt exchange is to be determined under section 1273 or section 1274, as applicable. As a result, the stakes associated with the question of whether, in fact, section 1273 or section 1274 applies to the issuance of a particular debt instrument have increased sharply, as illustrated by Example 1 above. As discussed below, however, it is not at all clear in many cases, especially where high yield debt securities are involved, whether section 1273 or section 1274 applies to determine the issue price of the new debt instrument. This is because it often is not clear whether such securities are "traded on an established securities market". Consequently, exchanging issuers may be faced with substantial uncertainty as to the amount of COD income realized in a debt-for-debt exchange, and may have as much opportunity to select their tax treatment (or at least reporting positions) under the new law as under the old law.

This Part describes the principal systems through which corporate debt securities are traded and pricing information with respect to such securities is disseminated, and considers whether and under what circumstances such debt securities should be treated as "traded on an established securities market" within the meaning of section 1273(b)(3).

B. Summary of Significant Debt Securities Market Systems

Corporate debt securities[92] are quoted or traded through a variety of systems and means. The description of the principal information and trading systems for debt securities contained herein is based on published materials and interviews with market participants. However, because corporate debt securities are traded primarily in privately negotiated transactions that are not reported anywhere,[93] it is difficult to gather a substantial amount of quantitative empirical information. Nevertheless, the Committee's study of the bond markets has yielded several important conclusions with respect to the nature and characteristics of the bond markets that are relevant to a determination of what constitutes trading on an established securities market for purposes of section 1273.

1. The National Securities Exchanges. Approximately 3,000 issues of corporate debt securities are listed on the national securities exchanges. The principal national securities exchanges on which bonds are listed are the New York Stock Exchange (“NYSE”) and the American Stock Exchange (“AMEX”).[94] The majority of exchange-listed issues are investment grade

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[92] The aggregate outstanding principal amount of debt securities issued by U.S. corporations is currently estimated to be approximately $1,480 billion. See Federal Reserve Statistical Release (March 6, 1991).

[93] See Fabozzi and Pollack, eds., The Handbook of Fixed Income Securities (2nd ed. 1988) at 281; Anders, “Is Insider Trading Widespread in Junk Market?”, Wall St. J., Jan. 31, 1991, at C16, Col. 3. The market in corporate debt securities and the systems by which pricing information with respect to such securities is disseminated stand in marked contrast to the market in U.S. Treasury Securities, where screen-based systems such as the Government Pricing Information System disseminate executed trade prices, the volume of executed trades, best bid and offer quotations, and other information with respect to most U.S. Treasury Securities on a real-time basis. As discussed below, the market in, and the mechanisms for trading, corporate debt securities do not approach the levels of liquidity and efficiency present in the market for U.S. Treasuries.

[94] The NYSE currently lists 2150 corporate debt issues with a total principal amount of $312 billion. AMEX currently lists approximately 250 corporate debt issues with an aggregate principal amount of $27 billion.

securities of blue-chip issuers,[95] while very few high yield "junk" bond issues are exchange-listed. This is due in large part to the "minimum standards" and listing criteria enforced by the exchanges as well as the expense and regulatory burdens associated with listing securities.[96]

Even where bond issues are exchange-listed, it appears that only a very small portion of the trading volume and number

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[95] Although most exchange-listed corporate debt is rated investment grade by the ratings services at the time of issue, such debt generally continues to be exchange-listed in the event the corporation encounters financial difficulties and the bonds trade at substantial discounts to par. For example, several series of LTV Corp., Circle K Corp. and Pan Am Corporation bonds are listed on the NYSE, and the obligations of Continental Airlines Holdings, Eastern Airlines, Resorts International, and Trump Taj Mahal continue to be traded on the AMEX.

[96] According to Section 102.03 of the New York Stock Exchange Listing Manual (the "Manual"), debt securities are eligible for listing on the NYSE provided the aggregate market value or principal amount of the issue equals or exceeds $5 million and "the company is in a position to cover interest charges on all debt issued by it ... including the issue it is seeking to list". The Manual further states that the NYSE has no set minimum criteria for the distribution of debt securities but evaluates each application to determine whether the anticipated distribution will be sufficient for trading on the NYSE. Although these requirements appear quite lax (compare, e.g., the more explicit criteria for equity securities in Section 102.01 of the Manual), the NYSE retains significant discretion in evaluating applications for listing and it is reasonable to assume, for example, that the NYSE in practice requires very comfortable debt coverage and cash flow ratios and wide public ownership of listed securities; in short, requirements that assure (at least at the time of listing) a blue-chip roster of listed companies. It is likely that self selection also plays a role, i.e., an issuer whose securities are not widely held may not derive sufficient benefit from listing to justify subjecting itself to NYSE fees and regulation.

Section 104 of the American Stock Exchange Company Guide (the "Guide") states that the listing of bond issues is considered on a "case by case basis, in light of the suitability of the issue for an exchange market". Additionally, the Guide provides that debt securities will be considered for listing only where the issuer appears to be able to "satisfactorily service the debt issue" and meets certain size and earnings criteria. In the case of issuers whose stock is not listed on the AMEX or the NYSE, the Guide requires that the debt issue have an aggregate market value or principal amount of $20 million and at least 100 holders.

of trades in such bonds take place over the exchange.[97] Trades on the exchanges generally are in the widely held debt issues of large, well-known issuers, and are transacted primarily for the accounts of small, non institutional investors. Large trades are generally handled in off- market, privately negotiated institution-to-dealer or dealer-to-dealer transactions.[98] Although it appears that listed distressed bonds trade somewhat more actively than the average overall NYSE bond trading volume of 3.5 percent,[99] particularly if extraordinary events (such as bankruptcy filings, restructuring proposals or debt-for-debt

[97] Although there is no readily available source of information with respect to total trading volume in listed bonds (since most trades are in unreported privately negotiated transactions), an examination of trading volume on the NYSE and discussions with market participants reveal that exchange volume is extremely small, both in absolute terms and in relation to the total estimated volume of trading. In fact, although $312 billion principal amount of corporate debt securities are listed on the NYSE, total trading volume over the NYSE in 1990 was only $11 billion, or 3.5 percent. Similarly, only $700 million, or 2.8%, of the $27 billion aggregate principal amount of corporate debt listed on the AMEX was traded in 1990. Active participants in the bond trading markets estimate that total trading volume in exchange listed bonds exceeds exchange volume by several factors of 10.

[98] Indeed, in general, the NYSE only requires that member firms attempt to execute customer orders for nine or fewer bonds on the floor of the Exchange (and then only when a better price cannot be obtained off the floor); orders for 10 bonds or more may be executed in over-the-counter trading without restriction. This rule, designed to protect small bond investors, has rendered the NYSE the principal trading forum for odd-lot trades by the general public; large institutional bond investors rarely trade through the Exchange.

[99] For example, in 1990, 4% of Carter Hawley Hale's 12-1/2's of 2002 traded on the NYSE; 7% of Carter Hawley Hale's 12-1/4's of 1996 traded on the NYSE; and 6% of LTV's 15's of 2000 traded on the NYSE. Although many factors may bear on the result of the Committee's unscientific empirical sampling, it appears that on-exchange trading in debt securities of most issues, blue chip or distressed, high-yield or investment grade, is very light (although the average volume in distressed issuers appears to exceed the overall average NYSE volume of 3.5%).

exchanges) are anticipated or recently have been announced,[100] the on-Exchange trading volume in distressed issues is still small in absolute terms and is estimated to account for (perhaps significantly) less than five percent of the overall trading in such distressed issues.[101] In addition to the low level of on-Exchange volume in listed issues, the majority of exchange listed issues also appear to trade very infrequently.[102]

In theory, a securities exchange is the most efficient possible market for securities and therefore produces prices that are highly accurate indications of value. Like listed stocks, exchange-listed bonds are bought and sold in an "auction" in which all bids to purchase and offers to sell a particular security through the exchange facilities are channeled to a

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[100] For example, approximately 33% of the principal amount of Ames' 10's of 1995 and 7-1/2's of 2014 traded on the NYSE during 1990, during which Ames filed for bankruptcy. Total AMEX volume in the Trump Taj Mahal 14's of 1998, an issue that was the subject of a highly publicized restructuring transaction, was approximately 10 percent of the issue. Since overall trading activity in such "deal" bonds is believed to be much higher than average, these figures are believed to represent a very small percentage of the total trading activity in the distressed issuers' obligations.

[101] Notable exceptions to the generally small volume of on- exchange trading are the bonds of RJR Nabisco and its subsidiaries; 200% of the outstanding 17-3/8's of 2009, 20% of the pay-in-kind 15's of 2001 and 20% of the 0's of 2001 were traded on the NYSE during 1990. These issues are perhaps the most widely held of all high-yield debt issues and are considered unique due to their wide distribution and the large principal amounts involved. Indeed, total on-Exchange trading volume in RJR bonds in 1990 exceeded $2 billion, or approximately 20% of <u>total</u> NYSE bond volume for 1990. As one trader noted, RJR bonds are the only issues sufficiently large and widely held to acquire the "critical mass" necessary to trade actively over the Exchange. They are the only issues professional traders will generally seek to trade over the exchanges.

[102] Although complete data are difficult to compile, it appears that on average, approximately one-quarter to one-third of all NYSE and AMEX bonds trade on a given day. Representative issues also appeared, on average, to trade on approximately one-third of all trading days, although again distressed bonds seemed to trade somewhat more frequently than the average. At the other extreme, in 1990 approximately 400 NYSE-listed and 50 AMEX-listed issues traded fewer than 100 bonds on the exchanges for the entire year, suggesting that these issues traded on very few days during the year (during which there were approximately 240 trading days).

central location on the exchange.[103] When the highest bid and lowest offer coincide, a trade is executed.[104] The efficiency of the debt market is hampered, however, by the large volume of off-exchange trading in debt securities and the absence of the specialist system for bond issues.[105] Efficiency is further constrained by the somewhat infrequent and sporadic nature of exchange trading in listed debt issues and the very small volume of bonds traded over the exchange.

Although many exchange-listed debt securities trade on the exchange sporadically, infrequently, or in small volumes relative to overall trading, at any given time the price at which a trade of debt securities is actually consummated on a securities exchange should nonetheless correlate relatively closely with off-market trades occurring at the same time. This should be true because exchange prices are widely publicized, and, if, for example, the published exchange price was

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[103] See generally, Loll & Buckley, The Over-the-Counter Securities Market, (3d ed. (1973) 233; Pessin, The Fundamentals of the Securities Industry, (1983), 220-222, 280-283. Given the limited volume and frequency of bond trading on the exchanges, however, the exchanges do not provide a separate "post" where each bond issue trades as they do for stock. All listed bond orders are instead channelled to an area of the Bond Room known as the "trading ring", and it is in the trading ring that buy and sell orders are entered and posted. For the more active bond issues, bids and offers are entered verbally; for less active issues, bids and offers are recorded in writing and are designated as "day orders", "good-through-the-week", "good-through-the-month" or "good-til-cancelled". See Pessin at 281-282.

[104] The auction process is conducted through an exchange employee known as a quotations clerk, who maintains a record of best bids and offers and posts them on a quotation board on the trading floor. The prices at which exchange trades in listed bonds occur are displayed through public ticker systems, and volume and price information with respect to such bonds is published daily in newspapers of general circulation. Pessin at 280-282.

[105] The auction process in listed stocks, by contrast, is conducted through a market maker known as a specialist who, among other functions and responsibilities, matches buyers and sellers of a particular stock, maintains a written record of all transactions in that stock, and, to the extent reasonably practicable, takes steps necessary to maintain a fair and orderly market in the stock. This latter duty generally requires that the specialist purchase and sell the security in which it makes a market for its own account as necessary to balance supply and demand forces.

significantly lower than the price being paid in off-market transactions, an arbitrage opportunity would emerge, and dealers would be expected to purchase bonds on the exchange for immediate resale in a privately negotiated transaction. A small differential between the exchange and over-the-counter market prices might exist, of course, because the arbitrage spread and the volume of bonds offered would have to be adequate to cover the arbitrageur's transaction and “nuisance” costs. Nevertheless, the arbitrage opportunity presumably would prevent the spread between off- exchange prices and exchange prices for listed securities at any given time from becoming very large.

2. NASDAQ System for Over-the-Counter Securities. The National Association of Securities Dealers, Inc. Automated Quotation System (“NASDAQ”) is a computer-based quotation system for equities and convertible debt securities actively traded in the over-the-counter market.[106] NASDAQ links approximately 1,000 market makers and 3,500 other broker-dealers by a sophisticated communications system which permits market makers to submit their quotations in specific securities instantaneously and permits subscribing broker-dealers to receive current quotations on a substantial number although there is no requirement that they be of securities.[107] Only two-sided quotations may be submitted, i.e., prices on both the buy and sell sides of the market. Each market maker registered for a particular security must be willing to buy and sell such security on a continuous basis and must maintain and update quotations that are reasonably related to the

[106] Approximately 100 issues of convertible debt instruments are currently listed on NASDAQ. It appears that approximately 20% of all NASDAQ-listed issues are traded through NASDAQ on an average trading day and that the volume of NASDAQ trades in such bonds is very small relative to the total outstanding amounts of such bonds. According to NASDAQ, however, unlike exchange-listed securities, most trades in NASDAQ securities are in fact transacted through NASDAQ, although there is no requirement that they be.

[107] Bloomenthal Securities Law Handbook (1990-91 ed.), pp. 33-34.

prevailing market. The market maker submitting a quotation to NASDAQ is generally obligated to buy or sell at least a normal unit of trading[108] at that price unless a counter bid or offer is made or the quotation is designated as not firm or “subject”. At least two market makers must be registered for each security. Throughout the trading day, NASDAQ releases to the press representative “bid” and “asked” prices for securities and such information is published the next day in newspapers across the country.

3. “Yellow Sheets”. The majority of corporate bonds that are not exchange-listed or quoted on NASDAQ generally appear in the privately published National Daily Quotation Service (“NDQS”) “yellow sheets”.[109] The yellow sheets, available only to subscribing broker-dealers, identify the bond and its principal terms, the names and telephone numbers of persons expressing an interest in making a market in the security and, on rare occasions, the bid or asked price at which the market maker[110] is willing to buy or sell the security. Where both a bid and asked quote appear it is almost always the prior day's closing quote with respect to a NASDAQ listed convertible bond. In virtually

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[108] Generally one convertible bond or 100 shares of stock.

[109] Approximately 3,000 bond issues are carried in the yellow sheets, including many exchange-listed and NASDAQ securities. For convenience, the discussion of yellow-sheet bonds in this section assumes that the bonds are not listed elsewhere. To the extent a bond is listed on an exchange or quoted by NASDAQ, of course, the foregoing discussion will be applicable.

[110] Although a broker-dealer expressing its interest in a security through the yellow sheets is not a market maker in the NASDAQ sense, see text accompanying notes 107-108, supra, above, the term will be used in its broad sense, for ease of reference, to describe firms expressing an interest in buying or selling a particular security by including themselves in the yellow sheets. It is noteworthy that the market makers that are listed on the yellow sheets typically are small, regional or local broker-dealers. The larger national firms typically do not list themselves in the yellow sheets even if they consider themselves market markers in an issue.

all other cases, the market maker will at most indicate “OW” (offer wanted) or “BW” (bid wanted), or more commonly, provide its firm name and telephone number, indicating a general interest in both purchasing and selling the security, and will furnish quotations in the security only when contacted by an interested broker-dealer. Even where bid or asked prices appear in the yellow sheets, they are often considered to be unreliable because they may not reflect recent trading activity and may not even reflect the particular market maker's current appraisal of the security's value.[111] Moreover, there is no requirement that the market maker stand ready to purchase any number of bonds at the stated price. As a result, market participants interested in buying or selling a security listed in the yellow sheets must generally contact the market maker (either directly or through a so-called “broker's broker” intermediary)[112] to obtain the current

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[111] Unlike the securities exchanges or NASDAQ, NDQS does not require an interested broker-dealer to maintain quotations on a current basis; priced entries may be updated as often or as infrequently as a particular broker-dealer sees fit.

[112] A “broker's broker” is a broker-dealer who, acting as agent on behalf of an undisclosed principal, seeks to buy or sell a particular security on terms acceptable to such principal. A broker's broker may provide buy or sell quotations to other brokers on behalf of its principals via printed sheets or computer screens, but such quotations are generally subject to negotiation and there is no reporting of the prices at which broker's broker transactions are consummated.

bid or asked price and then, in the usual case, engage in a negotiation.[113] There is no public reporting of the prices or volume of actual transactions in yellow sheet bonds that are not also either exchange-listed or carried by NASDAQ.[114] There is no

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[113] Market participants refer to the yellow sheets as the "yellow pages" -- they provide little more than a list of names and telephone numbers of potential brokers for a particular security. See "Sellers Beware", Forbes, January 21, 1991 at p. 36-38. If an interested buyer calls one of the listed names to purchase or sell bonds, the caller is typically given a quote which is "subject" or that reflects an unreasonably wide spread. The calling party is typically asked, "What do you want to do?" (i.e., the market maker is trying to ascertain whether the caller wants to buy or sell in order to know how to skew its quotation). A negotiation ensues, with each party reluctant to display its full hand of cards. The market maker then generally indicates that it will get back to the interested buyer or seller. At that point, the market maker will call its sources, seeking to establish an offsetting position at a price that would permit it to give an acceptable quotation to the buyer or seller. By the time the*purchase or sale is consummated, the purchase price could be substantially different from the original "market" quotation.

[114] On January 3, 1991, The Wall Street Journal began printing a daily feature entitled "High Yield Bonds" which charts information supplied by Salomon Brothers regarding the daily performance of various Salomon junk bond indexes and 25 "popular" junk bond issues, 22 of which are non-exchange-listed yellow sheet securities. Although High Yield Bonds purports to supply "pricing" information with respect to such bonds, such information is based solely on Salomon Brothers' estimates and not actual transaction data, and does not represent quotations of Salomon Brothers (or any other broker-dealer) for the tracked securities or the actual prices at which trades have been consummated. Salomon may in fact have no knowledge of recent trades and, indeed, there may be no recent trades in the tracked securities. Instead, High Yield Bonds, like the various Bloomberg valuation services discussed in note 117 below, simply provide a "ballpark" estimate of value. See Wall St. J., January 3, 1991 at C14, Col. 3.

Although attempts have been made to create a more liquid and efficient "auction" market in yellow sheet bonds, to date these efforts have not been particularly successful. In 1990, for example, The New York Securities Auction Corporation ("NYSAC") began operations with the goal of providing a computerized auction forum for illiquid junk bonds and other securities. On Friday of each week, NYSAC makes available, through Bloomberg and advertisements in the financial press, a list of auction "lots" of bonds and other securities offered and permits registered participants to bid for such securities by telephone through the following Tuesday. Once received, bids are displayed through Bloomberg. Although NYSAC originally was heralded as an important new mechanism to increase liquidity and efficiency in the junk bond market, the system has failed, as yet, to have a meaningful impact on the junk bond market. According to traders, NYSAC has attracted mostly "off-the-run" issues and "real orphan paper". See generally, Hawkins, "Illiquid Bonds to Hit Auction Block", Investor's Daily, June 15, 1990, p. 30; Gillen, "First Public Bond Auction Set; Investors Cheer, High Yield Traders Jeer", The Bond Buyer, July 16, 1990, p. 3.

ready method, short of consulting with broker-dealers that have effected such transactions, of ascertaining at a given time whether, to what extent, or at what prices, transactions involving securities listed in the yellow sheets have taken place or, if no such transactions have taken place, of ascertaining listed market makers' bid and asked quotations.[115]

4. The Bloomberg. The Bloomberg is a private computerized database that lists the names and, in some cases, bid and asked prices of various broker-dealers with respect to non-exchange-listed bonds which generally are listed in the yellow sheets as well.[116] The Bloomberg, like the yellow sheets, basically serves an advertising function; it helps prospective buyers flush out offers and prospective sellers flush out bidders. Qualifying subscribers gain access (for a fee) to the bid and asked quotations only of those broker- dealers with which they do business, subject to the consent of such broker-dealers (and then only if such broker-dealers have listed a bid or asked price for the particular security in question).[117] The bid and

[115] In fact, there is no guarantee that consulting broker-dealers will yield accurate or useful information and there is no requirement that broker-dealers disclose trade data.

[116] Indeed, the system is basically an electronic version of the yellow sheets and is used as a convenient substitute for the yellow sheets or for calling broker-dealers directly. Despite its electronic format, however, the system is not necessarily any more current than the yellow sheets since the updating of quotations is entirely within the discretion of individual broker-dealers. Additionally, as with the yellow sheets, the Bloomberg is not interactive; in order to consummate a transaction an interested party must pick up the telephone and initiate the negotiation process; the system itself does not permit buyers and sellers to execute trades.

[117] In addition to providing subscribers with individual brokers' quotations, Bloomberg also provides various analytical services designed to assist subscribers in valuing their bond portfolios where no recent trading prices (or bid and asked prices) are available. These services include "Bloomberg Fair Value", "Bloomberg Market Price", and "Bloomberg Generic", all of which employ statistical and analytical valuation techniques to determine what the bond is "worth", relying variously on Bloomberg analysts' sense of the market and analyses of trading values of "comparable" bonds in addition to technical financial analysis.

asked prices displayed through the Bloomberg are often outdated, however, since there is no requirement to update prices continuously as there is in NASDAQ. Like the yellow sheets, the Bloomberg does not enable subscribers to execute transactions and does not record or report the prices or volume of actual transactions.

5. PORTAL.[118] PORTAL is a computerized automated trading system available only to investors eligible under SEC Rule 144A[119] that lists price quotations for certain privately placed debt securities that can be traded under that rule. The system facilitates worldwide trading, clearing and settlement of securities, both in primary market placements and secondary market trading. Application to list a security on PORTAL may be made by any dealer, broker or qualified investor that meets the applicable requirements of the PORTAL Market Rules[120] and such application may be made with or 191 without the concurrence of the issuer.[121] Although PORTAL has been in operation for

118 "PORTAL" is the acronym for "Private Offerings, Re-sales and Trading through Automated Linkages" and is a registered service mark of the National Association of Securities Dealers.

119 Rule 144A, promulgated under the Securities Act of 1933 (the "1933 Act"), provides a nonexclusive safe harbor exemption from the registration requirements of the 1933 Act for specified re-sales of restricted securities to institutional investors. SEC Rule 144A, effective April 30, 1990. In order to qualify as a "PORTAL Security" that therefore qualifies to trade in the PORTAL market, a security must be (i) eligible to be sold pursuant to Rule 144A, (ii) approved by the NASD for trading in the PORTAL market and (iii) in negotiable form and not subject to any transfer restrictions. PORTAL Market Rules, Part II, Section 2.

120 PORTAL Market Rules, Part II, Section 1; Part III (brokers and dealers); Part IV (qualified investors).

121 PORTAL Market Rules, Part II, Section 1. Thus, the issuer of a privately placed debt security exempt from registration under Section 4(2) of the Securities Act may not have any control over whether its securities are carried on the PORTAL system.

approximately nine months, only six bonds are listed as "PORTAL Securities" and trading volume has been virtually nonexistent.[122]

Price quotations in PORTAL are purely voluntary and sales are negotiated privately. The price and volume of each PORTAL sale, however, are reported in the system.[123] In a typical PORTAL trade, a qualifying "PORTAL Dealer", "PORTAL Broker" or "PORTAL Qualified Investor" will examine the computer screen for available quotations (firm or indicative) and contact the listed counterparty by telephone to negotiate the trade. Once terms are agreed to, the buying and selling broker-dealers will transmit through PORTAL trade reports containing confirmation details. These reports, known as PORTAL Transaction Reports,[124] must be prepared on the same day as the execution of the transaction and must include information identifying the seller and purchaser, the price of the security, the quantity of the security and the total value of the transaction.[125]

6. The Eurobond Market.[126] Bonds that are issued in the international capital markets ("Eurobonds") are often listed on one or more foreign exchanges, such as the Luxembourg Stock

[122] The Committee understands that NASD is currently considering modifications to PORTAL to enhance its usefulness and its appeal to institutional investors. Additionally, the AMEX, the NYSE and the Depository Trust Corporation are all developing systems to compete with PORTAL for trading in the Rule 144A market.

[123] See PORTAL Market Rules, Part VI, Section 5.

[124] PORTAL Market Rules, Part VI, Section 5; SEC release No. 34-27956, pp.21-22.

[125] Id

[126] See generally, Clarke, Guide to Eurobonds: A Comprehensive Analysis for Issuers and Practitioners (1990) Appendix I, and Fisher, Eurobonds (1988), Chapter 13, for useful descriptions of how Eurobonds are traded in the secondary markets.

Exchange and the International Stock Exchange of the United Kingdom and the Republic of Ireland, located in London. Listed Eurobonds, however, generally do not trade on the foreign exchanges but, instead, are traded in privately negotiated transactions between broker-dealers and market makers (i.e., market participants that buy and sell Eurobonds for their own account and undertake to make a market in particular Eurobond issues). Information regarding bid and asked prices is available through computer screen-based market information systems and publications.

The Reuters service is the most widely used screen-based information system. Subscribers to the Reuters service are able to have "on-line" access to the current prices at which the various market makers are offering to buy and sell Eurobonds by entering the Reuters code assigned to the Eurobond issue. If the price quoted by a market maker is attractive, the subscriber will contact the market maker (usually by telephone) to negotiate the purchase or sale. There is no requirement to update prices quoted on the Reuters screen, and market makers are not required to honor their quotations. Nonetheless, in the case of many Eurobond issues, the quotations are updated at least daily, and in the case of active issues, are often updated several times a day.

Eurobond bid and asked quotations are published on a daily and weekly basis by the Association of International Bond Dealers ("AIBD"), an organization of Eurobond dealers and market makers. The daily quotations represent a composite of the closing bid and asked quotations reported to the AIBD at the end of the business day by member organizations of the AIBD Council of Reporting Dealers (which includes most of the important Eurobond market makers). The composite closing bid and asked prices for the day are available electronically after 9:30 p.m. (U.K. time) and are published the following day in the AIBD "Daily Eurobond Listing" and the Financial Times. The prices quoted in the AIBD "Weekly Bond" guide represent an average of the daily composite closing quotations for the week.

Although bid and asked prices for most Eurobonds are readily available on a relatively current basis, virtually no information is available regarding actual trading prices or the frequency of actual trades, and market participants tend to be very secretive about such information.

C. The Statutory and Regulatory Scheme and Its Underlying Policies

1. Publicly Traded Debt Instruments. Two conditions must be satisfied in order for the issue price of a debt instrument to be determined under the fair market value regime of section 1273: (i) either the new debt instrument or the old debt instrument must be "traded" (or, in the case of the new debt instrument, be part of an issue a portion of which is "traded") and (ii) the traded debt instrument must be traded on an "established securities market".[127]

(a) "Traded". Other than providing that a debt instrument will be treated as "traded" if it is traded on an established securities market on or within 10 days after the date it is issued, section 1273 and the proposed regulations are

[127] Section 1273(b)(3); prop. reg. section 1.1273-2(c)(1).

silent as to the meaning of "traded".[128] There appears to be no authority as to the volume or frequency of trading activity required to satisfy the "traded" portion of the section 1273 test. Additionally, there is no authority as to what percentage of all trading in a security must occur on the established securities market in order to satisfy the "traded" requirement.[129]

(b) "Established Securities Market". As to the second element of the section 1273 threshold test, i.e., whether the securities are traded on an "established securities market", the proposed regulations provide that the term "established securities market" has the same meaning as set forth in regulation section 1.453—3(d)(4) (relating to limitations on use of the installment method for certain debt instruments payable on

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[128] See prop, reg. section 1.1273-2(c)(1). The "10-day rule" of the proposed regulations (which is also contained in the regulations under section 1232 of the 1954 Code) needs to be clarified in several respects. First, the Committee believes that the regulations should be amended to provide that a prearranged, temporary trading restriction would be ignored unless it extended substantially beyond the 10-day period (e.g., for at least 30 days). Second, the regulations should be clarified to provide that, in the case of a debt-for-debt exchange, the determination of whether the old debt instrument is traded for purposes of section 1273 is to be based upon a time period substantially contemporaneous with the exchange, and not relate back to the time of its original issuance (as might be inferred from a literal reading of the proposed regulation). In this regard, a 10-day look-back rule to determine whether the old debt instrument is publicly traded, based on an analogy to the 10-day rule that applies to determine whether the new debt instrument is publicly traded, would seem to be appropriate. See Sheppard, "How to Avoid Cancellation of Indebtedness Income", 49 Tax Notes 613, 615-616 (Nov. 5, 1990); Cohen, supra note 20, at 84.

[129] By way of contrast, section 1273(b) allows the Treasury to promulgate regulations providing that the issue price of a debt instrument issued for property -- other than stock or securities -- "of a kind regularly traded on an established securities market" (emphasis added) will be determined under the fair market value regime of section 1273(b). It is unclear whether any distinction was intended between the standard for stock or securities (i.e., that they be "traded on an established securities market'*) and the standard for other property (i.e., that such property be of a kind "regularly traded on an established market"), and no regulations have been promulgated under that grant of authority.

demand or readily tradable).[130] The cross-referenced regulation provides that the term "established securities market" includes (i) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934, (ii) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1934 because of its limited volume of transactions and (iii) any over-the-counter market.[131] For these purposes, "an over-the-counter market is reflected by the existence of an inter-dealer quotation system", which is "any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer".[132]

In an example following this definition, the regulation refers to "notes which are quoted in the Eastern Bond section of the National Daily Quotation Sheet" (commonly known as the "yellow sheets") and states that the National Daily Quotation Sheet "is an interdealer quotation system".[133] The regulation concludes that since the yellow sheets constitute an interdealer quotation system, they therefore "reflect an over-the-counter market" which constitutes an established securities market within

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[130] Prop. reg. section 1.1273-2(c)(1). Reg. section 1.453-3(d)(4) applied to installment sales prior to October 20, 1980. Temp. reg. section 15A.453-1(e)(4), applicable to sales after that date, contains substantially identical language to that found in reg. section 1.453-3(d)(4).

[131] Reg. section 1.453—3(d)(4); temp. reg. section 15A.453- 1(e)(4)(iv). The Committee recommends that the definition be revised to include foreign national securities exchanges. Cf. reg. section 1.897-1(m).

[132] Id.

[133] Reg. section 1.453-3(d)(5), Ex. 2; temp. reg. section 15A.453-1(e)(4)(v), Ex. 2.

the meaning of the regulations.[134] As will be discussed below, however, a closer analysis of yellow sheet listings and the way in which the securities listed on the yellow sheets trade casts serious doubt on whether bonds that are listed on the yellow sheets should be treated as "traded on an established securities market" for purposes of section 1273.[135]

2. Non-Publicly Traded Debt Instruments. In general, if an outstanding non-publicly traded debt instrument, i.e., a debt instrument that is not "traded on an established securities market", is exchanged for a new non-publicly traded debt instrument, section 1274 and not section 1273 will apply to determine the issue price of the new debt instrument for purposes of computing both OID on the new debt instrument and the issuer's COD on the exchange. Under section 1274, the issue price of a debt instrument will equal its stated principal amount provided that its yield to maturity is at least equal to the AFR or, if not, the issue price will equal the present value, using a discount rate equal to the AFR, of all payments due under the debt instrument. Thus, in contrast to the fair market value regime of section 1273, section 1274 seeks to ensure only that a yield equal at least to the AFR is inherent in every debt obligation.

The issue price of a debt instrument that is determined under section 1274 may be greater (and, depending on the interest

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[134] The 1970 Treasury Decision adopting the section 453 regulations, T.D. 7197, makes it clear that the Treasury was adopting the Securities and Exchange Commission ("SEC") definition of an interdealer quotation system for the definition of over-the-counter market, which is contained in Rule 15c2-7 under the Securities Exchange Act of 1934. The SEC considers the yellow sheets to constitute an "interdealer quotation system" for purposes of that rule, which is intended to regulate the conduct of brokers and dealers submitting quotations (including any indications of interest in receiving a bid or offer).

[135] See text accompanying notes 156-58, infra.

rate environment and creditworthiness of the issuer, possibly considerably greater) than its fair market value. Nonetheless, this issue price is generally treated as a proxy for the "fair market value" of the debt instrument for all tax purposes.[136] The Committee believes that this approach is consistent with the statutory scheme. It should be recognized, however, that this approach may create some distortions in the amount of COD, OID premium, gain or loss recognized in particular transactions, and consequently may warrant some corrective rules (as discussed elsewhere in this report), including possibly a curtailment of the situations in which issue price is determined under the AFR safe harbor rule of section 1274.[137]

As illustrated by Example 1 above, COD can generally be avoided in a debt-for-debt exchange if the issue price of the new debt instrument is determined under section 1274, provided the SRPM of the new debt instrument is at least equal to the adjusted issue price of the old debt instrument and the yield to maturity of the new debt instrument is at least equal to the AFR. However, several potential pitfalls must be considered. First, if the new debt instrument is deemed to have "contingent interest" under the highly technical rules of the proposed OID regulations, such contingent interest payments would appear to be excluded altogether under those proposed regulations in discounting the payments under the debt instrument to determine its issue

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[136] See prop. reg. section 1.1274-2(a). See also note 148 and accompanying text, infra, for a discussion of the policies underlying the AFR safe harbor approach of section 1274.

[137] See Part VI.F., infra.

price.[138] While this approach may produce acceptable consequences for OID purposes,[139] it could result in draconian consequences for COD purposes and result in immediate COD income on what is in reality "contingent COD". Thus, for example, if a debtholder agreed with a financially troubled issuer that stated interest on outstanding indebtedness bearing interest at the AFR would be owed and payable prior to maturity only to the extent of available cash flow, and that any unpaid interest would accrue simple interest and be unconditionally payable at maturity, the issue price of the new debt instrument issued in the deemed exchange would be computed under this special rule. As a result, under the proposed regulations it would appear that a large amount of COD would result initially, even though contingent payments might well eventually be made (and be recharacterized in part under the proposed regulations as principal) so that the total principal payments would equal the principal amount of the old debt instrument.[140] The Committee hopes that these

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[138] see prop. reg. section 1.1275-4(c). While a portion of the contingent payments may be treated as principal under proposed regulation section 1.1274-4(c)(3), it appears that such contingent principal is not to be taken into account for purposes of determining the issue price of either the fixed portion of the debt instrument or the debt instrument as a whole. See prop. reg. sections 1.1274-4(f) and 1.1275- 4(c)(2).

[139] See generally 1987 OID Report, 34 Tax Notes at 392-93.

[140] The amount of interest that would be treated as contingent in the above example, however, may be limited by prop, reg. section 1.1274-3(d)(1)(iv). On the other hand, if unpaid interest were forgiven at maturity in the absence of sufficient cash flow, a much greater amount of COD would apparently be recognized initially. To give another example, interest payable under a floating rate debt instrument that does not satisfy the requirements of proposed regulation section 1.1275-5 for variable rate debt instruments because it is not based on "current values of an objective interest index" will be treated as contingent interest. See prop, reg. section 1.1275-5(a). See also prop. reg. section 1.1274-3(d). Consequently, if a modification that constitutes an "exchange" is made in a debt instrument that had been issued at par for cash and which calls for interest at a fixed spread over LIBOR but subject to a cap, the new debt instrument that is deemed to have been issued would be treated as having contingent interest (and a substantially reduced issue price under section 1274) if the cap fails to satisfy the technical requirements of proposed regulation section 1.1274-3(d)(1)(iii) at the time of the exchange.

implications will be taken into account as part of the revision of the contingent interest rules of the proposed regulations.[141]

Second, an issuer may be dissuaded from utilizing convertible debt instruments as part of an exchange for outstanding debt instruments if the coupon on the new debt instruments will be less than the AFR, because the value of the conversion feature is ignored for purposes of section 1274. Instead, such an issuer might consider issuing warrants or stock as part of an investment unit with the new debt instrument.[142]

Third, section 1274(b)(3) of the Code gives the Treasury the authority to treat the imputed principal amount -- and therefore the issue price -- of a non-publicly traded debt instrument issued for non-publicly traded property as equal to the fair market value of the property in a “potentially abusive situation”.[143] The Code provides that a “potentially abusive situation” means, inter alia, any “situation which, by reason of ... recent sales transactions ... or other circumstances is of the type which ... [has] potential for tax avoidance”.[144] If it is concluded that debt securities that are listed on the yellow sheets and perhaps on other securities markets are nonetheless not “traded on an established securities market” and therefore are not subject to the fair market value regime of section 1273, it would still be possible for the Treasury to promulgate a rule

141 One possible approach might be to permit issuers to treat the transaction as an “open transaction” for purposes of determining the amount of COD arising in the exchange. However, this approach would permit issuers to defer the recognition of COD by tacking contingent interest onto their new debt instruments unless the rule were properly circumscribed. In addition, this rule would have to be coordinated with the rules for determining OID and the amount realized on the exchange.

142 See Part VIII, paragraph 2, infra.

143 Section 1274(b)(3)(A).

144 Section 1274(b)(3)(B).

under the authority of section 1274(b)(3) that requires the issue price of such debt instruments to be their fair market value rather than being determined under the AFR safe harbor regime of section 1274. However, the Committee believes that such an approach would be inappropriate and inadvisable. As discussed below, the section 1273/section 1274 distinction was the product of a deliberate policy decision to distinguish between situations in which fair market value is readily ascertainable and those situations in which it is not;[145] the use of section 1274(b)(3) to, in effect, write section 1274 out of the Code when dealing with ex-changes of corporate debt instruments goes far beyond the intent of Congress.[146]

3. Analysis of Policies Underlying Section 1273(b)(3) and Regulation Section 1.1273-2(c)(1). In general, section 1273 is intended to apply where the fair market value of a security can be determined accurately and objectively.[147] In providing that section 1273(b)(3) applies only where a debt instrument is traded

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145 See notes 147-150 and accompanying text, infra.

146 Moreover, there are significant practical and conceptual problems with the "recent sales transactions" test of section 1274(b)(3), including the difficulty of obtaining information on such transactions and determining the reliability of such information, especially where the "recent sales transactions" are privately negotiated, off-market transactions. Although proposed regulations have been promulgated under section 1274(b)(3), they shed no light on these issues. See prop, reg. section 1.1274-4(g)(2)(i)-(ii). The example of "recent sales transactions" contained in the Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "1984 Blue- book") involves a recent cash sale of property later sold for a non-publicly traded note with a face amount significantly greater than the cash price. In that case, "[u]nless the seller substantially improved the property or the higher purchase price can otherwise be justified, the principal amount of the loan would be limited to the fair market value of the property". 1984 Bluebook at 119.

147 See Rev. Rul. 75-117, 1975-1 C.B. 273 (the "traded on an established securities market" standard of section 1232 of the 1954 Code, the predecessor of section 1273, is intended to distinguish cases where uniform fair market valuations are available from those where such valuations are not possible; liquidity is not the relevant inquiry under section 1232); 1984 Bluebook at 114.

on an established securities market, it appears that Congress recognized that fair market value is determinable with sufficient precision, accuracy, objectivity and reliability to be used as the measure of issue price only where an efficient and public market in the debt instrument exists and where the information regarding such market is publicly available and ascertainable.[148] Where no objective indication of a debt instrument's value is available, because neither the old debt instrument nor the new debt instrument trades publicly, the law does not require (or permit) the parties to engage in speculation or attempts to estimate the fair market value of the new debt instrument.[149]

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[148] In fact, when the predecessor of section 1273(b)(3) was enacted as part of the Tax Reform Act of 1969, the Treasury Department specifically requested that in the case of a debt instrument issued in exchange for property, the issue price should equal the fair market value of the property only where there was public trading on an established securities market because the Treasury Department was concerned that, as a result of the "severe difficulty of valuing property not traded on some recognized exchange", it would be whipsawed as issuers claimed a low value in order to maximize OID deductions while holders claimed that the fair market value of the property equaled the face amount of the debt in order to avoid inclusion of OID. See Letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Sen. John J. Williams, dated November 28, 1969, 115 Cong. Rec. 36730-31 (1969).

[149] Indeed, proposed regulation section 1.1273-2(c)(1) provides an exception to the fair market value rule in the case of an exchange involving a publicly traded debt instrument where the trading price fails to reflect accurately the value of the new debt instrument because of "extraordinary circumstances such as the existence of control premium or blockage discount". Prop. reg. section 1.1273-2(c)(1). Where such circumstances are present, the issue price of the new debt instrument is to be determined under section 1274 and the regulations thereunder. Id. Significantly, the proposed regulation expressly requires application of section 1274 where the trading price does not accurately reflect fair market value; it does not require or permit issue price to be determined based on an estimate of true fair market value assuming away the extraordinary circumstances. By way of contrast, former reg. section 1.1232-3(c) provided that the "fair market value of property ... shall be determined as provided in § 20.2031-2 ... but without applying the blockage and other special rules contained in paragraph (e) there of". Since the proposed regulation may be read literally to provide that the "extraordinary circumstances" exception from the "trading price equals fair market value" rule of section 1273(b)(3) only applies where the trading price of the old debt instrument does not reflect its fair market value, the regulations should be clarified so that the exception will clearly also apply where the trading price of the publicly traded new debt instrument does not reflect its market value due to extraordinary circumstances or market conditions.

Instead, the admittedly imperfect AFR safe harbor rule of section 1274 is to be applied where objective, reliable data regarding a debt security's fair market value are unavailable.[150]

Although accurate valuation is the primary goal of section 1273 and the regulations thereunder, the proposed regulations under section 1273 adopt by cross-reference the definition of “established securities market” that is contained in the regulations under section 453. The essential policy concern of section 453 and its regulations is liquidity, not valuation. Section 453 seeks to determine whether a debt instrument is “readily tradable on an established securities market”; that is, whether it can readily be converted to cash and therefore should be treated as cash for installment method purposes.[151] The essential determination for section 1273, by contrast, is not liquidity (except to the extent liquidity impacts the reliability and ascertainability of pricing information) but whether a security's trading price is an accurate reflection of its fair market value.[152]

While the mere existence of a market for a particular debt instrument may be enough to enable one to conclude that the

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[150] The AFR safe harbor rule of section 1274 reflects a deliberate policy decision by Congress. When Congress enacted Section 1274 to expand the scope of the OID rules to cover issuances of non-publicly traded debt instruments in exchange for non-publicly traded property, it recognized that, “[t]he principal obstacle to applying the OID rules to a transaction in which neither side is traded is the difficulty of determining the issue price of the debt instrument directly”. 1984 Bluebook at 111. See also H.R. Rep. No. 98-432, Part 2, 98th Cong. 2d Sess. 1244 (1984). Accordingly, Congress concluded that the issue price of such a debt instrument should be determined under section 1274 by assuming that an approximation of the fair market value of the property exchanged for the debt instrument could be arrived at by using a minimum rate of interest which parties dealing at arm's length and without tax motivations could be expected to agree upon. Id.

[151] See section 453(f)(4) and (5); S. Rep. No. 552, 91st Cong., 1st Sess. 146 (1969).

[152] See Rev. Rul. 75-117, supra note 147.

debt instrument is sufficiently liquid to preclude section 453 installment sale treatment, this test does not by itself fulfill the policies underlying section 1273.[153] A quoted price of a debt instrument is likely to be an accurate indicator of its fair market value upon issuance where (i) the quoted price is reasonably contemporaneous with the issue date, (ii) the security is traded in sufficient volume and frequency to render it relatively liquid; (iii) a forum or system exists to concentrate trading in a central arena or to display simultaneously the quotations of multiple interested parties or market makers; (iv) multiple bid and ask quotations or actual transaction data including the dates of trading and the prices, volumes and quantities of trades are recorded; and (v) such information is published and generally available.[154] To the extent that one or more of the foregoing elements is missing, it is more likely that the quoted price is not an accurate indicator of the fair market value of the debt instrument as of the issue date.

D. Analysis of Whether the Various Trading Systems Satisfy the Policies of Section 1273(b)(3)

Although the national securities exchanges are not the exclusive (or even predominant) venue for trading listed debt instruments, it appears that exchange-listed debt instruments adequately satisfy the policies of section 1273, at least where

[153] Moreover, it is significant that the definition of "established securities market" in the section 453 regulations was adopted from SEC rules that serve very different policy objectives than section 1273. See note 134, supra. See notes 159-162 and accompanying text, infra, for a discussion of other Code and regulation provisions that contain concepts similar to the "traded on an established securities market" standard.

[154] The efficiency of the pricing mechanism and the reliability of pricing information are further enhanced where the system on which trading is transacted and information is reported is subject to oversight or regulation, whether private or governmental.

they trade on such exchanges in sufficient volume and with reasonable frequency. It is less clear, however, whether the policies of section 1273 are satisfied in the case of debt securities that are traded on such exchanges in insignificant volumes and frequencies. Moreover, in view of the potentially dramatic consequences that can result after the 1990 Act from a determination that section 1273 (instead of section 1274) applies to a new debt instrument issued in a debt-for-debt exchange, it appears extremely undesirable to have the tax treatment of the exchange materially affected by whether or not there happened to be an odd-lot trade of the old or the new debt securities on a national securities exchange within 10 days of the debt-for-debt exchange, where those securities are otherwise traded on the national securities exchanges during the relevant period in insignificant volumes and frequencies.[155]

Since NASDAQ quoted bonds are traded through an interactive, computerized system which lists in one place the bid and asked quotations of multiple brokers and dealers and records, centralizes and publicizes actual trade data, including pricing and volume information, NASDAQ quoted bonds also should be treated as traded on an established securities market, again, at least with respect to debt securities that trade with sufficient volume and frequency.

It also appears that the PORTAL system reflects an over-

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[155] The arbitrary nature of this result is illustrated by the case of Turner Broadcasting Systems, Inc.'s 12% Senior Subordinated Debentures of 2001 which were issued and listed on the AMEX on October 11, 1989. Of the 550,000 bonds in the issue, none traded on the AMEX until October 24, the ninth business day after the issue date (when ten bonds traded) and the issue did not trade again on the AMEX until 14 bonds traded on November 6, nine trading days later.

the-counter market within the meaning and policies of section 1273 since PORTAL is an interactive system listing the quotes of all PORTAL participants that tends to centralize trading activity and records actual trade prices and volumes and disseminates these data to eligible subscribing investors and broker-dealers. Although PORTAL would appear to satisfy the “established securities market” component of the publicly traded test, however, at present no securities could be regarded as “traded” on that market. If and when PORTAL and its competitors are refined and gain in popularity, however, it seems likely that many PORTAL securities would be publicly traded within the meaning of Section 1273(b)(3) provided they trade with sufficient volume and frequency.

The example contained in regulation section 1.453-3(d)(5) and in temporary regulation section 15A.453-1(e)(4) notwithstanding,[156] it appears that most non-NASDAQ, nonexchange-listed bonds that are listed only in the yellow sheets or the Bloomberg should not be considered traded on an established securities market for purposes of section 1273. First, the yellow sheets and the Bloomberg do not “regularly disseminate quotations of obligations by identified brokers or dealers.” No quotes appear with respect to the vast majority of yellow sheet/Bloomberg bonds for long periods of time, and any quotes that do appear generally appear sporadically and infrequently and represent nothing more than the initial volley in an expected round of negotiations to buy or sell the quoted security. The dealer who “advertises” in the yellow sheets or Bloomberg is under no practical or legal obligation to honor its quote or to make a market in the quoted security. Quotes may be out of date and in any event do not represent actual transaction prices or

[156] See text accompanying notes 133-134, supra.

even firm “bid” and “asked” quotes of a market maker that stands ready to purchase and sell the bonds at the quoted prices.[157] Although trading prices are not recorded or available for public disclosure, it is understood that actual transaction prices can and do differ widely from the quotes which appear in the yellow sheets or Bloomberg. In view of the policies underlying section 1273, it is difficult to see how bonds that are listed on these services -- even if a bid and asked quotation appears with the listing and certainly if no quotation appears -- can possibly be treated as publicly traded for purposes of section 1273.[158]

Finally, it appears that Eurobonds that are regularly quoted on Reuters and in the AIBD guides should generally be treated as publicly traded for purposes of section 1273 in view of the widespread availability and constant updating of current bid and asked quotations from the principal market makers, although it is of some concern to the Committee that information respecting actual trading prices, frequency and volume is not available.

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[157] Moreover, given the requirement that individual customers subscribe to a particular broker-dealer's information contained on Bloomberg, the Bloomberg may well not qualify as an “interdealer quotation system” since the Bloomberg could be viewed as a series of systems providing quotations of only one broker or dealer.

[158] The fact that a yellow sheet or Bloomberg bond is tracked in High Yield Bonds or is “valued” by Bloomberg through its “Fair Value”, “Generic” or “Market Price” services should not cause such bond to be treated as publicly traded under present law. These services merely provide valuation estimates and appraisals rather than actual trade data or quotations and do not meet the policy requirements of section 1273 and the proposed regulations. See notes 147-150, supra. These services might be relevant, however, if the law were amended to permit valuation estimates to suffice for section 1273 purposes. See note 167 and accompanying text, infra.

E. Analysis of Other Code and Regulatory Provisions Defining "Public Trading" and "Established Securities Market"

It is worth noting that several other provisions of the Code and regulations contain wording similar to the "traded on an established securities market" language of proposed regulation section 1.1273-2(c)(1),[159] Although the purposes and policies served by these provisions[160] generally differ from the purposes and policies of section 1273 as detailed above, certain concepts and tests embodied in these provisions are instructive for section 1273 purposes.

In particular, the "publicly traded securities" test of regulation section 1.170A-13(c)(7)(xi), which is used to

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[159] See, e.g., temp. reg. section 15A.453-1(e)(4) ("readily tradable" securities, i.e., securities that are "regularly quoted by brokers or dealers making a market in such obligations" or "are part of an issue which in fact trades on an established securities market"); reg. section 1.170A-13(c)(7)(xi) ("publicly traded securities", i.e., "securities for which market quotations are readily available on an established securities market"); reg. section 1.1232- 3(b)(2)(iii) (securities "traded on an established securities market"). See also reg. section 1.884-5T(d)(4) ("regularly traded" securities), reg. section 1.897-9T(d) (same); reg. section 54.4975-7(b)(i)(iv) ("publicly traded" security, i.e., a security that is "listed on a national securities exchange or that is quoted on a system sponsored by a [registered] national securities association"); reg. section 1.280G-1, Q & A 6 ("readily tradable" securities, i.e., securities that are regularly quoted by brokers or dealers making a market"); reg. section 1.897-l(m) ("established securities market"; same as section 453 regulations); Notice 88-75, 1988-2 C.B. 386 (treating limited partnerships as corporations under section 7704 where interest is "readily tradable on a secondary market or the substantial equivalent thereof"); H.R. Conf. Rep. No. 445, 100th Cong., 1st Sess. 947-50 (1987) (same). Cf. private letter ruling 9036039 (June 13, 1990) (concluding that the pink sheets (the equity version of the yellow sheets) do not satisfy the test of reg. section 54.4975-7(b)(1)(iv)).

[160] See, e.g., reg. section 1.453-3(d) (liquidity); reg. section 1.170A-13(c)(7)(xi) (accurate, verifiable valuation); reg. section 1.1232-3(b)(2)(iii) (same); reg. section 1.884- 5T(d)(iv) (locus of ownership, principal trading forum); reg. section 1.897-9T(d) (distinguishing between closely held and publicly traded corporations); reg. section 1.280G-1, Q & A 6 (same); reg. section 54.4975-7(b)(1)(iv) (to ensure liquidity and fairness to employees' stock ownership plans).

determine whether a non-NASDAQ, non-exchange-listed security has a readily ascertainable market price that is an accurate measure of its value for purposes of the charitable contribution deduction, states that a security will be considered publicly traded, and therefore not subject to the stringent substantiation and appraisal requirements that apply to donations of non-publicly traded securities, only if the security is "regularly traded" on an interdealer quotation system, the issuer keeps records of trading prices and volumes, and trading prices and volumes are published in a newspaper of general circulation. The term "regularly traded" is not defined in regulation section 1.170A-13(c)(7)(xi).[161] A useful definition of "regularly traded" does appear in regulation section 1.884-5T(d)(4), however, which provides that securities are "regularly traded" for purposes of that provision only if they trade on an established securities market in specified volume (i.e., at least 30 percent of the outstanding securities trade during the year) and with specified frequency (i.e., the securities trade on at least 60 days during

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[161] However, regulation section 1.170A-13(c)(7)(xi)(B) (2)(ii) defines "interdealer quotation system" in a manner similar to that contained in the regulations under section 453 (see text accompanying note 132, supra) except that it explicitly requires that the identified brokers and dealers "compute the average trading price of the security." Regulation section 1.170A-13(c)(7)(xi)(B)(2)(iii) provides that the average trading price is to be weighted by volume, and that "bid and asked quotations are not taken into account".

the year).[162]

F. Conclusions

The Committee's analysis of the bond market illustrates that the information available with respect to market prices -- even with respect to exchange-listed securities -- is of significantly lower quality than the information available with respect to equity securities. In order to be consistent with the purposes of section 1273 and to assure that section 1273 will only apply where reasonably accurate price information is readily available, the Committee believes that the regulations under section 1273 should be revised to provide that a debt security will be treated as “traded on an established securities market” so as to have its issue price (or the issue price of a new debt security issued in exchange therefor) equal its trading price[163] only if (i) actual trading prices or “bid” and “asked” prices are reported and published and (ii) either (A) in the case of trading prices, the trading frequency for that security on the securities

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[162] The regulation sets forth standards for when a publicly traded corporation is to be treated as a qualified resident of a foreign country for purposes of the branch profits tax. See also temp. reg. section 1.897-9T(d) (similar tests but on a quarterly basis). As indicated in note 129 above, it is not clear whether Congress intended to draw a distinction between “regularly traded” and “traded” in the context of section 1273(b)(3).

By suggesting that temporary regulation sections 1.884-5T(d)(4) and 1.897-9T(d) and regulation section 1.170A- 13(c)(7)(xi) be used as models for the standard of “traded on an established securities market” under section 1273, the Committee does not intend to suggest that the approach of such regulations be adopted without modification. Thus, the Committee is not specifically endorsing the 30 percent volume/60 trading day test for volume and frequency, respectively, contained in temporary regulation 1.884-5T(d)(4) and, indeed, as discussed in note 164 and the accompanying text below, believes that a shorter testing period for frequency would be more appropriate. Similarly, the issuer recordkeeping requirements under regulation section 1.170A-13(c)(7)(xi)(B)(ii) and (iv) would not appear to be an appropriate requirement for section 1273.

[163] In the case of bid and asked prices, the issue price generally will equal the weighted average of the mean between the bid and asked prices during the relevant period. See reg. section 20.2031-2(c).

market for the relevant time period[164] satisfies minimum threshold standards (see, e.g., the temporary regulations under sections 884 and 897) or (B) in the case of bid and asked quotations, the frequency with which these quotations are updated and reported during the relevant time period, as well as the number of market makers whose quotations are regularly reported for the particular security, satisfy minimum threshold standards.[165]

While the Committee believes that the actual trading volume (and, possibly, the number of holders) of a debt issue are important factors in determining whether trading prices or bid and asked prices are reliable indicators of fair market value, the Committee recognizes that such information is simply not ascertainable in the context of the over-the-counter markets and, moreover, is of the view that the unavailability of such information can largely be compensated for through appropriate standards in the test that is proposed in the preceding sentence.

The Committee believes, moreover, that notwithstanding the current cross-reference to the section 453 regulations contained in proposed regulation section 1.1272-2(c) and

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[164] For example, a 30 or 45 day period before and after the debt-for-debt exchange may be an appropriate time period. In selecting the appropriate time period, consideration should be given to applicable time periods for legending and information reporting. See sections 1275(c) and 6049 and the regulations thereunder.

[165] The actual quantitative tests should be based upon a thorough study of the trading patterns in the debt securities markets and with a view to assuring the reliability of the trading price (or bid and asked price) information as an indicator of fair market value. In this regard, for example, the absolute number, as well as the proportion, of securities issues quoted on a particular information system that satisfy the minimum threshold standards adverted to in the text may be relevant for ascertaining whether the price information respecting a particular security is a sufficiently reliable indicator of the security's fair market value. In the case of bid and asked prices, wide “spreads” between the bid and asked quotations and great disparities between quotations submitted by brokers may be an indication that the reported price information is unreliable (e.g., because the market is illiquid).

notwithstanding example 2 under regulation 1.453- 3(d), the great majority of non-exchange-listed debt instruments are not, in fact, “traded on an established securities market” within the meaning of section 1273, particularly where the securities are merely listed on the yellow sheets or on the Bloomberg.[166]

The Committee recognizes that if the proposed regulations under section 1273 are modified to reflect the Committee's view, most debt-for-debt exchanges would fall within the purview of section 1274. As a result, in general, the 1990 Act's changes would have little impact on most debt-for- debt exchanges despite the apparent “mark-to-market” intention behind the 1990 Act's changes. If this result is viewed as problematic, and Congress and the Treasury were to conclude that the range of bonds for which a fair market value approach rather than the section 1274 AFR safe harbor approach is appropriate is greater than what could be justified under a fair interpretation of the policies and language of section 1273(b)(3), several approaches may be considered.

One possible approach would be to retain an expansive definition of the term “traded on established securities market” for purposes of section 1273, but to provide a bifurcated test

[166] It quite possible that even under the proposed regulations the issue price of securities that are listed on the yellow sheets or the Bloomberg and, in many circumstances, securities that are listed on a national securities exchange must be determined under section 1274 rather than under section 1273, as a result of the exception from the section 1273 fair market value rule that is contained in proposed regulation section 1.1273-2(c)(1) for “extraordinary circumstances” in which the trading price fails to reflect accurately the value of the debt instrument, see note 149, supra. However, because the scope of the “extraordinary circumstances” exception is extremely unclear, the Committee recommends that specific guidelines be provided as to when debt instruments are to be treated as “traded as an established securities market.” In addition, the Committee recommends that the scope of the “extraordinary circumstances” exception be clarified.

for determining fair market value under section 1273(b)(3). In the case of debt securities as to which trading or bid and asked price information satisfies minimum threshold frequency tests to be set forth in the regulations, the regulations under section 1273 could provide that the trading price (or mean between the bid and asked quotations) determines the issue price of the debt securities. However, in the case of other debt securities that are issued in exchange for stock or securities and that are listed on “an established securities market” -- including securities that are listed only on the yellow sheets or on the Bloomberg as well as exchange-listed and NASDAQ securities but which fail to meet the proposed frequency tests -- the OID regulations could be amended to require that the valuations of, perhaps, three disinterested broker-dealers be obtained by the issuer and that the average of the three valuations constitutes the new debt instrument's issue price.[167] Alternatively, the approach of the proposed regulations' investment unit rules could be applied to such debt instrument.[168] These approaches, however, would represent a significant departure from the existing policies of sections 1273 and 1274 (that is, using “market value” to determine issue price only where it is clearly ascertainable), and would have to be carefully crafted to ensure that the Service (and exchanging security holders) would not be adversely affected by positions taken by issuers or “independent” valuation services.

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[167] As indicated in notes 16 and 158 above, valuation estimates provided in High Yield Bonds or Bloomberg might serve as one appraisal source, and the valuations should be required to take into account any reported market trading prices or bid and asked quotations.

[168] See prop, reg. section 1.1272-2(d)(iv), summarized in note 193 infra. It should be noted, however, that there are significant technical and practical difficulties in utilizing the standard set forth in these regulations. See also reg. section 20.2031-2.

A second approach would be to apply a rigorous, narrow definition of the term “traded on an established securities market” that reflects the policies underlying section 1273 but to amend section 1274 to provide that some multiple of the APR be used to test the adequacy of interest in the case of a debt-for-debt exchange involving non-publicly- traded noninvestment grade bonds. The multiple could vary, for example, depending on the credit agency ratings of the bond or the issuer).[169] Alternatively, section 1274 could be amended to use as the “test rate” the yield to maturity of the old non-publicly traded bond; however, this last approach may not reflect economic reality any more than the AFR approach, in light of changes in interest rate and market conditions between the dates the two obligations were issued.

VII. ADDITIONAL ISSUES FOR DEBTHOLDERS AND ISSUERS

A. Loss of Acquisition Premium

A technical problem caused by the repeal of section 1275(a)(4) is that a holder of a new debt instrument received in a reorganization may be required to include OID in income, even though that holder had a basis in the old debt instrument equal to its principal amount and “carried” that high basis over (as a substitute basis) to the new debt instrument under sections 354 and 358.[170] For example, consider a holder of the debt instrument described in Example 1 of this report. After the repeal of

[169] If this approach is adopted the Committee recommends that the law provide that the test rate can in no event exceed the AFR plus 500 basis points. This would be consistent with the general debt/equity principles inherent in section 163(e)(5) and would prevent unintentional triggering of those rules.

[170] See text accompanying note 187 infra, for a discussion (and rejection) of an alternative approach to dealing with this problem -- repealing the nonrecognition of loss rule under section 354.

section 1275(a)(4), OID can be created on a debt-for-debt exchange even though the original tax basis of the debt instrument is already equal to its SRPH. If section 1272(a)(7), which allows a holder of a debt instrument to reduce OID income inclusions by acquisition premium, were applicable to the holder in Example 1, such reduction would reduce the OID inclusion to zero. On the other hand, it is not entirely clear that section 1272(a)(7) applies to the initial holder of an instrument issued in a reorganization.

By its terms, section 1272(a)(7) applies "in the case of any purchase after its original issue of a debt instrument to which [section 1272(a)] applies". (Emphasis added.) While an original holder of the new debt instrument would meet the "purchase" requirement,[171] it would not qualify for relief under a literal reading of section 1272(a)(7).[172] Proposed regulation section 1.1272-1(g) is more expansive and appears to solve the initial holder's problem, by stating that the acquisition premium relief provision applies to an original holder of a debt instrument that acquires the instrument for less than the SRPM

[171] "Purchase" is defined in section 1272(d) and proposed regulation section 1.1272-1(m) as any acquisition of a debt instrument where basis is not determined "by reference to the adjusted basis of such debt instrument in the hands of the person from whom acquired". Presumably, this definition includes acquisitions of debt instruments in tax-free reorganizations in which the holder obtains a substitute (rather than a carryover) basis.

[172] This is not a new problem. It was possible for an original holder to pay an acquisition premium under certain circumstances even prior to repeal of section 1275(a)(4) (for example, in the case of a single "issue" of publicly traded instruments sold at varying cash prices). However, such circumstances were not likely to produce distortions as dramatic as those now possible in the reorganization context.

but more than the issue price. However, the favorable regulation (although in substance identical to the parallel regulation under section 1232 of the 1954 Code)[173] remains only in proposed form, almost five years after its publication. In addition, the proposed regulation does not literally apply to a holder whose basis equals the SRPM.[174] Finally, there is an ambiguity in section 1272(a)(7) and regulation section 1.1272-1(g)(ii), which determine the amount of amortizable premium based on the "cost" of the new debt instrument to the holder.

In order to resolve the foregoing ambiguities, the Committee recommends that the Treasury Department promptly promulgate section 1.1272-1(g) (with appropriate clarifications regarding holders whose bases equal SRPM and the meaning of "cost") as a final (or temporary) regulation, without regard to any decision that may be made regarding the disposition of the rest of the OID proposed regulations.

B. Conversion of Market Discount into OID

Another major change caused by the repeal of section 1275(a)(4) is that a purchaser of an old debt instrument at a market discount is required, as a result of the debt-for-debt exchange, to accrue OID over the term of the instrument, rather than merely recognizing ordinary income, instead of capital gain,

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173 See reg. sec. 1.1232-3A(a)(2)(ii) and (4). As in the case of section 1272(a)(7) and the proposed regulations thereunder, the regulation under section 1232 related to a statutory provision that explicitly applied only to purchasers after the original issue of the debt instrument. See sections 1232(a)(3) and 1232A(a)(6) of the 1954 Code.

174 Such a holder would also not be a purchaser at a "true" premium for purposes of relief under sections 1272(c)(1) and 171. See prop, reg. section 1.1275-1(f).

when the instrument is retired.[175] Suppose, for example, that the holder purchased the old debt instrument in Example 1 for $400 just prior to the reorganization. Instead of having market discount of $600, includible in income generally upon the disposition of the bond, there is OID of $600. The exchange has the effect of converting $600 of market discount into OID, which must be included in income over the term of the instrument. And, unlike an initial holder, who might have been able to offset the OID income with acquisition premium (see the discussion in Part VII.A., above), a purchaser at a market discount by definition will not have sufficient basis in the debt instrument to offset the newly created OID.

This result represents a significant departure from prior legislative decisions regarding market discount[176] and is particularly troublesome where the issuer of the debt instrument is near insolvency or bankruptcy. In such a case, a subsequent purchaser at a discount will be forced to accrue what was formerly market discount, even though there is substantial uncertainty about the issuer's ultimate ability to pay even the

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[175] Cf. section 1276(a)(3), which requires current inclusion of accrued market discount where partial principal payments are made.

[176] In 1987, when the House Ways and Means Committee proposed current inclusion of accrued market discount, that proposal did not become law. H.R. Rep. No. 391, 100th Cong., 1st Sess. 1056 (1987). The accrual would have been limited to an amount which would have resulted in the holder's currently accounting for a yield to maturity of three times the AFR when the debt instrument was purchased. Similarly, there is no indication that Congress intended to create a current inclusion regime for market discount when it enacted section 1276(a)(3), which is limited to cases in which a taxpayer receives partial payments of principal, and, even then, inclusion of accrued market discount is capped by the actual principal payments received. 1984 Bluebook at 14.

principal portion of the indebtedness.[177] Moreover, to the extent that the subsequent purchaser includes the OID in income, it might be able to recoup the inclusion only as a capital loss under section 165(g) or 166(c).

C. Gain and Loss to Exchanging Security-holders in a Recapitalization

Under section 354, loss is not recognized when securities are exchanged in a reorganization.[178] Gain is recognized, but only to the extent of the value of the excess of the principal amount of securities received in the reorganization over the principal amount of securities surrendered.[179]

The Committee believes that it is appropriate to reexamine the "excess principal amount" rule of sections 354 and

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[177] At some point, such a debtholder might determine that it is appropriate to stop including OID in income. For authorities relating to the accruability of stated interest, see, e.g., Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934) (receivable held accruable as gross income even though debtor later went bankrupt in same year); Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930) (interest not accruable where debtor went into receivership on last day of year); Rev. Rul. 80-361, 1980-2 CB 164 (Service position that when an item is properly accruable and subsequently becomes uncollectible, taxpayer's remedy is by deduction rather than through elimination of accrual; accrual may end once item is uncollectible). See generally Calvin and Farias, When Can Holders of Defaulted Debt Cease Accruing Interest Income?, 73 J. Tax. 378 (1990). While the Committee is not aware of any direct authority on the issue of includibility of OID where ultimate payment is questionable, and arguably section 1272(a) requires inclusion of OID regardless of collectibility by, in effect, imposing a mandatory tax accounting method for OID on all taxpayers (see Calvin and Farias, supra), the holder of an OID instrument should be able, at some point, to stop including OID in income. Nevertheless, this is an area of substantial uncertainty in which an unsuspecting buyer of a debt instrument with market discount can find itself. The Committee recommends that the Service clarify that OID is not includible in income under circumstances where an accrual basis taxpayer would not have to accrue cash interest as a result of its uncollectibility.

[178] Section 354(a)(1)(B).

[179] Sections 354(a)(2)(A) and 356(a) and (d). Section 354(a)(2)(B) also provides that any property received in the exchange which is attributable to accrued interest is excluded from the scope of sections 354 and 356.

356 in light of the OID provisions.[180] The issues outlined herein may be illustrated by an example.[181]

> Example 3. Assume that a corporation issued for $300 a publicly traded bond that provided for no cash interest payments for five years and then interest at 12 percent (a market rate of interest at that time for the corporation), and a principal amount of $1,000. Several years later, when the corporation is in improved financial condition and the adjusted issue price of the bond is $500 but its fair market value is $800, the corporation agrees with the bondholders to exchange the bond for a new publicly traded bond with a fair market value (and issue price) of $800 and a principal amount of $1,000.

An original debtholder in the above example realizes a $300 gain (the difference between the $800 issue price of the new debt instrument and its $500 basis in the old debt instrument).[182] The extent to which that gain is recognized depends on whether the securities received have a greater principal amount than those surrendered. Some commentators have argued that the excess principal amount rule of section 354 should be read as

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180 The legislative history to the 1990 Act states, "[t]he provision does not change the present-law rules of sections 354, 355 or 356 regarding the amount of gain or loss recognized or not recognized in a reorganization". H.R. Rep. No. 881, 101st Cong., 2d Sess. 354 (1990).

181 See Kohl, supra note 24, 48 Tax Notes at 1041 ex. 2. For purposes of illustration, the example assumes that the old and new debt instruments are publicly traded securities with identical payment terms that are nevertheless materially different within the meaning of section 1001.

182 In this regard, the Committee believes that it would be desirable to have an explicit statutory or regulatory statement to the effect that the issue price (under sections 1273 and 1274) of a debt instrument issued in exchange for property determines the amount realized in respect of the property exchanged therefor (and the basis of such property in the hands of the issuer). While proposed regulation section 1.1274-2(a) provides such a rule, this rule is not explicitly stated in the context of section 1273. Compare reg. sections 1.1001-l(g) and 1.1232-3(b)(2)(iii)(b) (prior regulatory scheme provided explicit rule to that effect). In the case of a debt instrument the issue price of which is determined, pursuant to section 1273(b)(4), to be equal to its SRPM, the issue price for purposes of determining amount realized and basis should be reduced by the portion of such SRPM which is treated as interest for federal income tax purposes (cf. section 108(e)(11)(B) (analogous adjustment for COD purposes)). See generally 1987 OID Report, supra note 14, 34 Tax Notes at 373; Schler, supra note 24, 41 Tax L. Rev. at 229-32.

incorporating the subsequently enacted OID rules, and that the references in section 354 to "principal amount" should be read as references to the "adjusted issue price" of the old debt instrument and "issue price" of the new debt instrument.[183] The basis for that argument is the fact that the OID rules by their terms apply for all tax purposes.[184] Because the difference between adjusted issue price and SPRM is OID, which is interest, these commentators have argued that it should not be included in the term "principal amount" for section 356 purposes. The regulations promulgated under section 356, however indicate that the appropriate comparison is literally "principal amount" to "principal amount", with a subsequent determination of the fair market value of the excess.[185] Thus, because the "principal amount" of both the old and the new debt instruments is $1,000, under the regulations under section 356, the excess of the $800

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[183] See Henderson & Goldring, supra note 24 at ¶ 403.011; Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 14.34 n.371 (5th ed. 1987); Schler, supra note 24 at 236-37. See also S. Rpt. 99-47, The Subchapter C Revision Act of 1985, 99th Cong. 1st Sess. (1985) at 52, 132, 216 (proposing in effect such a change of law).

[184] Section 1272(a) applies the OID inclusion rule for all purposes of the Code. That arguably encompasses the allocation of debt between principal and interest. But see section 61(c)(1)(A) of P.L. 98-369 (amending section 312(a)(2) to refer specifically to "issue price" (instead of principal amount) in the case of obligations). While the OID and issue price definitions in section 1273 and 1274 expressly apply only for purposes of the OID provisions contained in sections 1271 through 1275, those definitions were probably thought to be useful only to measure OID. Notably, the proposed regulations under section 1274 do not treat this as a substantive limitation, since they provide that the issue price that is determined under section 1274 determines both basis and amount realized when property is acquired with a debt instrument that is subject to section 1274. See prop. reg. section 1.1274-2(a).

[185] See reg. section 1.356-3(b), examples 2, 4, 5 and 6. For instance, in example 4, an individual exchanges securities in the principal amount of $1,000 for stock and a security in the principal amount of $1,200 with a fair market value of $1,100. The example concludes that $200/1,200 x $1,100 ($183.33) is the fair market value of the excess principal amount which is treated as "other property". Assuming that these debt instruments were publicly traded and that the difference between their respective issue prices was $100, there would be a different result if section 356 is interpreted to refer to "issue price".

issue price of the new debt instrument over the $500 adjusted issue price of the old debt instrument is not taxable at the time of the exchange. Rather, this gain is deferred until the new debt instrument is satisfied or sold. However, the exchange immediately reduces the unaccrued OID on the old debt instrument by $300 since the issue price of the new debt instrument is $800 and the SRPM is $1,000.[186]

In view of the foregoing, the Committee recommends that sections 354 and 356 be amended to provide explicitly that gain is recognized if the "issue price" of the new debt securities exceeds the "adjusted issue price" of the old debt securities, and that the amount of such gain equals such excess (rather than the fair market value of such excess).

An argument can be made on conceptual grounds for complete repeal of the nonrecognition rule of section 354(a) in the case of debt-for-debt exchanges, so that exchanging securityholders could recognize a loss on such exchanges. However, such an approach may not be acceptable because it permits exchanging securityholders to recognize an immediate loss at the expense of incurring deferred OID inclusions. Moreover, this approach is not as satisfactory as clarifying that exchanging securityholders suffering a nonrecognizable loss are entitled to an offset against OID for acquisition premium under section 1272(a)(7)[187] because this approach would result in creating, for many exchanging securityholders, a capital loss on the exchange and ordinary OID income.

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[186] In contrast, reg. section 1.1232-3(b)(1)(iv) provides for a carryover of OID to the new debt instrument in the case of an exchange in which gain or loss is not recognized in whole or in part pursuant to sections 354 and 356.

[187] See Part VII.A., supra.

D. Issuer's Deduction of Retirement Premiums

The repeal of section 1275(a)(4) raises a question about the treatment of retirement premium by the issuer. In Example 3, the issuer paid a $300 premium to retire the old debt instrument — the excess of the $800 issue price of the new debt instrument over the $500 adjusted issue price of the old debt instrument. Generally, an issuer can deduct retirement premium in the taxable year in which it repurchases its debt for an amount that is more than the adjusted issue price of the debt.[188] However, cases have disallowed the deduction in a debt-for-debt exchange on the theory that the exchange was not a repurchase, but a substitution of a new debt instrument for the old debt instrument. These cases held that the premium represents a cost of obtaining the proceeds of the new debt instrument and therefore must be amortized over its term.[189] The continuing viability of that theory has been called into question, however, by the repeal of section 1275(a)(4). An issuer could assert that, because a debt-for- debt exchange is now treated as a repurchase of old debt for an amount of money equal to the issue price of the new debt followed by an independent issuance of new debt, the retirement premium is immediately deductible.[190] If so, the exchange would accelerate the issuer's $300 of lost OID deductions by converting it into $300 of retirement premium.

The Service should clarify whether this retirement premium is immediately deductible by the issuer or, instead, must be amortized over the life of the new debt instrument. While an immediate deduction may be justified as a conceptual matter under

188 See reg. section 1.163-4(a).

189 See, e.g., Great Western Power Co. v. United States, 297 U.S. 543 (1936).

190 See Kohl, supra note 24, 48 Tax Notes at 1040 n.20.

the “hypothetical cash exchange theory” and would provide symmetrical treatment to the issuer and the exchanging debtholders (who, as suggested in Part VII.C., supra, should recognize the corresponding gain immediately), the Committee recognizes that the Service may conclude that such premium should be amortized over the life of the new debt instrument.

VIII. TREATMENT OF DEBT-FOR-DEBT EXCHANGES INVOLVING MULTIPLE PROPERTIES (INCLUDING MULTIPLE DEBT INSTRUMENTS, STOCK, OTHER PROPERTY AND DEBT INSTRUMENTS OF AFFILIATES)

Debt-for-debt exchanges often involve multiple exchanges, particularly in the case of restructurings of financially troubled companies. Thus, old debt instruments may be exchanged for a combination of (i) new debt instruments plus cash, (ii) an investment unit consisting of new debt instruments plus stock, warrants or other property, or (iii) two or more different classes of new debt instruments. Conversely, new debt instruments may be issued in exchange for a combination of (i) old debt instruments plus cash, (ii) old debt instruments plus stock, warrants or other property, or (iii) two or more different classes of old debt instruments. In addition, the exchange may involve old or new debt instruments of related parties. Regulations should clarify the treatment of each of these situations under the 1990 Act and, in particular, how the issue price of the new debt instrument and COD are to be determined.[191] Set forth below are specific issues that should be addressed in this connection and our recommendations.

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[191] If the Committee's recommendation to reinstate a modified version of section 1275(a)(4) is adopted, somewhat different rules would be appropriate in certain of the situations discussed in this Part VIII in order to reflect the policies underlying section 1275(a)(4) and to prevent manipulation of the applicable rules by taxpayers. See notes 29 and 48, supra. See generally Wilcox, supra note 20, 10 Va. Tax Rev. at 402-22.

1. Old debt instrument exchanged for new debt instrument and cash. The Committee recommends that regulations provide that where an old publicly traded debt instrument is exchanged for a new non-publicly traded debt instrument and cash, the issue price of the new debt instrument is to be determined under section 1273(b)(3) by treating the cash as having reduced, dollar-for-dollar, the aggregate fair market value of the old debt instrument.[192]

2. Old debt instrument exchanged for an investment unit. Proposed regulation section 1.1273-2(d) provides rules for determining the issue price of a new debt instrument that is issued as part of an investment unit. The Committee recommends that the regulations clarify that where an old non-publicly traded debt instrument is exchanged for a non- publicly traded investment unit in which the new debt instrument is not publicly traded, regardless of whether or not the property right component is publicly traded, section 1274 (and not paragraph (iv) of proposed regulation section 1.1273-2(d))[193] governs the

[192] An exchanging debtholder's initial basis in the new debt instrument either will equal its issue price or, in the case of an exchange described in sections 354 and 356, will be determined under section 358 (in which case the debtholder may have market discount or acquisition premium).

[193] Paragraph (iv) provides that if neither the new debt instrument nor the property right component of the investment unit is publicly traded, the issue price of the debt instrument is equal to the present value of all payments under the debt instrument, discounted at a rate agreed upon by both the issuer and the holder (but not less than the AFR) based upon similar debt instruments issued within the previous six months by the issuer. If no such instruments exist, comparable debt instruments issued by other issuers may be used, taking into account relevant factors (such as solvency of the issuers, nature of their business, the presence and nature of any security for the debt instruments and geographic location).

determination of the issue price of the new debt instrument.[194] Section 1274 (rather than paragraph (iv)) should also apply where neither the new debt instrument nor the property right component is publicly traded but where the investment unit's issue price is determinable (because either the old debt instrument or the investment unit is publicly traded), it would appear to be appropriate in that case to have the existing proposed regulation on investment units apply in order to avoid the possibility of the new debt instrument having an issue price (determined under section 1274) that is greater than the issue price of the investment unit.

In addition, the regulations should provide that where an investment unit is issued in exchange for an outstanding debt instrument, COD is measured by reference to the sum of the issue price of the new debt instrument and the fair market value of the property right component of the in-vestment unit.[195] The regulations should clarify that the fair market value of the property right is equal to (a) its trading price if it is publicly traded, unless the debt instrument is publicly traded

[194] See private letter ruling 8829067 (April 27, 1988). This clarification would preclude potentially dramatically different consequences from arising from the inclusion or noninclusion of a nominally valued property right in the debt-for-debt exchange. It should be noted, however, that this approach generally would result in the fair market value of the property right being taxable to the holder (assuming the issue price of the new debt instrument under section 1274 is at least equal to the holder's adjusted basis in the old debt instrument), even if the aggregate fair market value of the new debt instrument and the property right is less than the holder's adjusted basis in the old debt instrument. See text accompanying notes 136-37, supra.

[195] An alternative approach would be to treat the old debt instrument as having been exchanged, in part for the new debt instrument and in part for the property right (or, in the situation described in paragraph 1 above, the cash), based upon their relative fair market values. This would produce different results under section 1275(a)(4), see Wilcox, supra note 20, 10 Va. Tax Rev. at 410-15. However”, it would not affect the amount of COD under the 1990 Act, assuming the issue price that is determined under section 1274 is treated as the debt instrument's fair market value, see text accompanying note 136 supra.

and the issue price of the investment unit is determinable, (b) the difference between the issue price of the investment unit (if determinable) and the issue price of the debt instrument, or (c) if neither (a) nor (b) applies, its fair market value as determined on the basis of all relevant factors.[196]

3. Old non-publicly traded debt instrument ex-changed for combination of publicly and non-publicly traded new debt instruments. The regulations should provide that where an old debt instrument that is not publicly traded is exchanged for two classes of new debt instruments, one non- publicly traded and the other publicly traded, the issue price of the new publicly traded and new non-publicly traded debt instruments should be determined under sections 1273 and 1274, respectively.

4. Publicly and non-publicly traded classes of old debt instruments exchanged for new non-publicly traded debt instruments. A financially troubled issuer involved in a debt restructuring may issue a single class of new debt instruments that are not publicly traded in exchange for different classes (both publicly traded and non-publicly traded) of old debt instruments held by a number of debtholders in substantially different proportions. The regulations should clarify that, - rather than applying sections 1273 and 1274 separately to each exchange, the issue price that is determined under section 1273 will apply to the entire class of the new debt instruments. This result seems to be sensible and will permit all of the debt

[196] Where receipt of the property right by the exchanging debtholder triggers taxable gain or loss, the debtholder's initial basis in the property right should be equal to the fair market value of the property right (determined as provided in the text). Where receipt of the property right qualifies for nonrecognition of gain under sections 354 and 356, the debtholder's initial basis in the property right will be determined under section 358. As indicated in note 192 above, where a debtholder's initial basis in the new debt instrument is determined under section 358, the debtholder may have acquisition premium or market discount.

instruments of that class to have the same amount of OID and therefore be fungible to investors.[197] On the other hand, sections 1273 and 1274 should be applied separately to each exchange where the terms of the new debt instruments differ from one another.

5. Old non-publicly traded debt instrument and cash exchanged for new non-publicly traded debt instrument. The current regulations do not provide an explicit rule for determining the issue price of a new non-publicly traded debt instrument that is issued in exchange for an old non-publicly traded debt instrument and cash. In theory, the new non- publicly traded debt instrument is subject to section 1273(b)(2) to the extent the debt instrument is issued for cash, with the remainder of the new debt instrument being subject to section 1274. The regulations, however, do not provide a mechanism for determining what portion of the new debt instrument should be considered to have been issued for cash and what portion for the old debt instrument.

Three possible approaches present themselves. The first approach would require the old debt instrument to be valued, and the issue price of the new debt instrument would be equal to this amount plus the cash. This approach would avoid abuse, but is inconsistent with the statutory scheme of sections 1273 and 1274, which generally does not require valuations that are not directly

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[197] But compare section 1273(b)(3)(A) (provision applies if new debt instrument "is part of an issue a portion of which is traded on an established securities market") (emphasis added) with section 1273(b)(3)(B) (provision applies if new debt instrument "is issued for stock or securities which are traded on an established securities market"). Where the exchange is confined to a discrete number of exchanging debtholders, it may be appropriate to apply the rules suggested in paragraphs 5 and 6 below in potentially abusive situations.

based on the trading price on an established securities market.[198]

The second approach would determine the issue price of the new debt instrument under section 1274 without taking into account the cash payment. However, for purposes of determining COD on the old debt instrument, the new debt instrument would be treated as having been issued for cash to the extent of the cash, and only the excess of the issue price of the new debt instrument over the cash would be treated as having been issued in exchange for the old debt instrument. This approach apparently is contemplated by proposed regulation section 1.1273-2(f)(5), Example 6. However, this approach invites abuse by debtholders seeking to avoid the creation of OID on non-publicly traded debt instruments that are issued for cash because it would enable them to have the issue price of the debt instrument determined under section 1274, instead of under section 1273(b)(2), simply by adding to the cash consideration an old debt instrument of the issuer having a small fair market value relative to the cash.[199]

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[198] In addition, this first approach would penalize transactions where the new debt instrument is exchanged for an old debt instrument and a relatively small amount of cash. For example, the issue price of a new privately traded debt in strument having adequate stated interest would change dramatically depending on whether it was issued solely in exchange for a privately traded debt instrument or for a privately traded debt instrument and one dollar.

[199] While the cost of such avoidance of OID generally would be the recognition of gain on the exchange, this technique could be utilized by taxpayers seeking to accelerate income, such as taxpayers with net operating losses that are about to expire or become subject to limitation under section 382. It is unclear whether such an exchange could be challenged under the antiabuse rule of section 1274(b)(3) and proposed regulation section 1.1274-4(g).

To avoid the undesirable results of either of these approaches and to provide bright line rules for taxpayers, the Committee recommends a third approach, whereby the regulations would provide a safe harbor in which debt-for-debt exchanges involving non-publicly traded debt instruments would be subject to section 1274, notwithstanding the inclusion of a cash payment from the exchanging debtholder to the issuer, provided that the cash payment does not exceed a stated percentage (perhaps 25 percent) of the adjusted issue price of the old debt instrument.[200]

6. Old non-publicly traded debt instrument and other property exchanged for new non-publicly traded debt instrument. The regulations, similarly, do not provide guidance for determining the issue price of a new non-publicly traded debt instrument that is issued in exchange for an old non-publicly traded debt instrument and publicly-traded property. The

[200] Proposed regulation section 1.1273-2(f)(5), example 6 treats an exchange of a new non-publicly traded debt instrument for an old non-publicly traded debt instrument and cash representing 10% of the adjusted issue price of the old debt instrument as being subject to section 1274.

The Committee further recommends that the regulations provide that if the cash payment exceeds the safe harbor percentage, the issue price of the new debt instrument is to be determined under section 1273(b)(2) and that for this purpose the old debt instrument will be considered to have a value of zero. Consequently, in that event the issue price of the new debt instrument would equal the amount of the cash payment and the issuer would have COD in an amount equal to the adjusted issue price of the old debt instrument. However, to ease this harsh rule, the Committee further proposes that the regulations (as an exception to the aggregation rules provided in proposed regulation section 1.1275-2(d)) permit the issuer and the debtholder to agree to bifurcate the transaction and treat the new debt instrument as two new debt instruments, one issued in exchange for cash (and having an issue price determined under section 1273(b)(2)), and the other one issued in exchange for the old debt instrument (and having an issue price determined under section 1274), provided that (A) the cash payment is less than a stated percentage (perhaps 75 percent) of the adjusted issue price of the old debt instrument, (B) each of the new debt instruments has adequate stated interest, and all interest thereunder is qualified periodic interest and (C) the two new debt instruments have substantially the same yield to maturity.

Committee recommends that the fair market value of the publicly traded property be treated as cash, and that the issue price of the new debt instrument be determined in the same manner as suggested in paragraph 5 above. If the property is not publicly traded, the issue price of the new debt instrument would, of course, be determined under section 1274, but the regulations should clarify that it is necessary to determine the fair market value of the property (based on all relevant factors) in order to determine how to allocate the issue price of the new debt instrument between the property and the old debt instrument for purposes of determining COD in respect of the old debt instrument.

7. Exchanges involving debt instruments of related parties. Debt restructurings frequently involve the exchange of old or new debt instruments of related parties. Thus, in the case of a restructuring of the debt of a group of troubled companies, the outstanding debt instruments of several companies in the group might be exchanged for a new debt instrument of the parent corporation (often in combination with stock, warrants or other property). In other situations an issuer may retire its old debt instruments in exchange for a combination of its new debt instruments plus new debt instruments of a related corporation. Alternatively, the related corporation might issue a new debt instrument directly to the debtholder in exchange for an old debt instrument of the original issuer.

In developing a framework for addressing these situations, several considerations should be taken into account. First, section 108(e)(4) provides that, for purposes of determining COD, to the extent provided in regulations, the acquisition of outstanding indebtedness by a person related to the debtor from a person who is unrelated to the debtor is to be treated as the acquisition of such indebtedness by the debtor. Thus, under section 108(e)(4), in the third situation described above, where a corporation acquires an outstanding debt instrument of its affiliate in exchange for its own new debt instrument, the issuer of the old debt instrument would be treated as if it had acquired that debt instrument. Section 108(e)(4), however, does not provide guidance as to how any COD is to be measured in that case, although proposed regulations issued March 21, 1991 provide that COD is to be measured in that case by reference to the fair market value of the old debt instrument on the acquisition date.[201] Nor does section 108(e)(11) provide an answer to that question because it addresses only the situation of the issuance by a debtor of a new debt instrument in satisfaction of its own indebtedness.

A second relevant consideration is that, in general, a debt instrument is treated as property in the hands of a person other than the issuer, even if that person is related to the issuer. Thus, in the absence of a contrary rule, such a related person obtains a basis in a debt instrument acquired by it, which basis depends upon the manner in which such debt instrument was acquired by it, and measures gain or loss realized on a disposition of that debt instrument pursuant to section 1001, generally by reference to the fair market value of the property

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[201] See prop. reg. section 1.108-2(a) and Notice of Proposed Rulemaking relating thereto, 56 Fed. Reg. 12,135 (March 22, 1991). See generally Peaslee, "Discharge of Debt Through Its Acquisition by a Person Related to the Debtor -- An Analysis of Section 108(e)(4)", 37 Tax L. Rev. 193 (1982); New York State Bar Ass'n Tax Section, "Report of the Committee on Bankruptcy on Related Party Debt Acquisitions Under Section 108(e)(4) of the Code" (April 12, 1984) (the "Section 108(e)(4) Report").

received in exchange for the debt instrument.[202] If these principles were to be applied to the form of the transaction in situations in which a debt instrument of an affiliate is used by a debtor corporation to acquire its old debt instruments, the debtor corporation would be treated as using property to satisfy its outstanding indebtedness/ and COD would be determined based on the fair market value of its affiliate's debt instrument.

The Committee recommends that the regulations treat all of the situations described above -- i.e., situations in which the issuer utilizes a debt instrument of an affiliate to satisfy its outstanding indebtedness as well as situations in which an affiliate of the issuer acquires the issuer's outstanding debt instrument from a debtholder in exchange for a new debt instrument of that affiliate -- in the same manner for purposes of determining the issue price of the new debt instrument and COD. Consistent treatment appears to be warranted in order to avoid having taxpayers choose their desired tax treatment by varying the form of the transaction.

It appears that two possible approaches exist to treating these situations. The first approach, outlined above,

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[202] Section 1275(a)(4) (prior to the 1990 Act, section 1275(a)(5)) provides that if a corporation distributes its own debt instrument with respect to its stock, the debt instrument is to be treated as if it had been issued for property and, accordingly, its issue price (and therefore its tax basis) would be determined under sections 1273 and 1274. The regulations should clarify that a similar result arises where a corporation contributes its own debt instrument to a subsidiary on the theory that the debt instrument was in effect issued in exchange for stock of the subsidiary; otherwise the debtor corporation would have a zero basis in its parent's note if it did not issue stock to its parent and would recognize gain on the disposition of the note. See Lessinger v. Commissioner, 872 P.2d 519, 522 (2d Cir. 1989) (issuance of stock by corporation to its sole shareholder in exchange for contributed property “would be a meaningless gesture”).

would measure the issuer's COD based on the fair market value of the affiliate's new debt instrument (or, alternatively, based on the fair market value of the old debt instrument) at the time of the exchange. This approach -- which was adopted by newly issued proposed regulation section 1.108-2(a) for situations governed by section 108(e)(4) -- has several disadvantages, not least of which is that it requires either the affiliate's new debt instrument or the issuer's old debt instrument to be valued for purposes of determining COD even where neither debt instrument is publicly traded.[203] Moreover, this approach appears to be inconsistent with the Congressional intent, as evidenced in section 108(e)(11), of not requiring the valuation of non-publicly traded debt instruments for purposes of determining COD.[204]

An alternative approach, which the Committee favors, would in all cases treat the affiliate's debt instrument as having been issued by the affiliate directly to the exchanging

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[203] In addition, where the issuer uses a debt instrument of an affiliate to satisfy its outstanding indebtedness, this approach potentially would result in the issuer recognizing gain or loss on the disposition of its affiliate's debt instrument and in debtholders having acquisition premium or market discount, in each case based on the difference between the issue price of the affiliate's debt instrument and its fair market value at the time of the exchange for the old debt instrument. However, where the issue price is determined under section 1273, the new debt instrument's issue price should equal its fair market value at the time of the debt-for-debt exchange if both transfers occur substantially contemporaneously. A similar result may occur under section 1274 as a result of the “potentially abusive situation” rule of section 1274(b)(3). But cf. text accompanying notes. 144-146, supra.

[204] Indeed, although the Committee has not had an opportunity to consider fully the newly issued proposed regulations under section 108(e)(4) and, in particular, to analyze the implications thereof in fact patterns not discussed in the text, the position taken by proposed regulation section 1.108-2 (a) -- that COD is measured by the fair market value of the debt instrument being discharged rather than the fair market value (or, in the case of a newly issued debt instrument, the issue price, cf. note 136 and the accompanying text, supra, and note 182 supra) of the affiliate's new debt instrument exchanged therefor -- appears to be inconsistent with existing law. See, e.g., section 108(e)(10)(A); reg. section 1.1001-2(c) example 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

debtholder in exchange for the issuer's old debt instrument. Pursuant to the authority granted under section 108(e)(4), the regulations should provide that the issue price (and initial basis) of the affiliate's new debt instrument in the hands of the debtholder will be determined under sections 1273 and 1274 as if the affiliate's new debt instrument was issued in exchange for the issuer's old debt instrument, and such issue price should also govern the determination of COD by the issuer. This approach appears to be more consistent with the Congressional intent of not requiring the valuation of non-publicly traded debt instruments upon their issuance for purposes of determining OID and COD, and is more practical to apply. In addition, this approach recognizes that the transitory ownership of the affiliate's debt instrument by the issuer of the old debt instrument in a situation in which the issuer utilizes a debt instrument of an affiliate to satisfy its outstanding indebtedness should not be permitted to change radically the tax treatment of the new debt instrument.[205]

The Committee recognizes that if this approach is adopted, the regulations would also have to address the actual and constructive intercompany transactions between the issuer and its affiliate. These issues interrelate, in part, with some of the basic policy issues raised by section 108(e)(4), which are

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[205] Cf. Notice 89-102, 1982-2 C.B. 436, 443 (apparently applying a similar analysis to determine issue price of net worth notes issued by RTC, FDIC or FSLIC in federally- assisted acquisitions of financial institutions; for purposes of determining issue price, the acquiring institution is treated as the first holder of the notes, regardless of whether the note was originally issued to the target institution or to the acquiring institution and notwithstanding the fact that the note is treated as having been paid to the target immediately prior to the acquisition for purposes of determining its taxable income, see Id. at 439).

beyond the scope of this report.[206]

[206] See generally prop. reg. section 1.108-2(e) and Notice of Proposed Rulemaking relating thereto, 56 Fed. Reg. 12,135 (March 22, 1991); S. Rep. No. 1035, 96th Cong. 2d Sess. 19 (1980); Peaslee, supra note 201 at 218-23; Section 108(e)(4) Report, supra note 201.