REPORT #693

TAX SECTION

New York State Bar Association

ACQUISITIONS OF DISCOUNT DEBT BY RELATED PARTIES UNDER THE NEW SECTION 108(e)(4) REGULATION

by New York State Bar Association Tax Section
Committee on Bankruptcy

June 21, 1991

Table of Contents

Tax Report #693

TAX SECTION
New York State Bar Association

June 21, 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 Acquisitions of Discount Debt by Related Parties Under the New Section 108(e)(4) Regulation. The drafters of the report are Robert A. Jacobs, co-chair of the Committee on Bankruptcy, Linda Z. Swartz, Simon Friedman and James M. Peaslee.

Although we recommend a number of changes in the proposed regulation, the most significant recommendation is that cancellation of indebtedness income of the debtor be measured based on the related party's cost of acquiring the debt rather than its fair market value. If this change were made, a number of the problems we see with the proposed regulation would be eliminated.

We would be pleased to discuss the report further with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

Enclosure

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20020

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Victor L. Penico, Esq.
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 4410
Washington, D.C. 20224

Warren M. Joseph, Esq.
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 5512
Washington, D.C. 20224

Michael J. Graetz, Esq.
Deputy Assistant Secretary of
the Treasury for Tax Policy
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Robert R. Wootton, Esq.
Tax Legislative Counsel
Department of the Treasury
3046 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Deputy Tax Legislative Counsel
for Regulatory Affairs
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Andrew Dubroff, Esq.
Attorney Advisor
Department of the Treasury
4013 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Tax Report #693

June 21, 1991

ACQUISITIONS OF DISCOUNT DEBT BY RELATED PARTIES UNDER THE NEW SECTION 108(e)(4) REGULATION

by New York State Bar Association Tax Section
Committee on Bankruptcy[1]

1. An Overview of the Regulation

A debtor generally realizes cancellation of indebtedness income ("COD") when it reacquires its outstanding debt at a discount. In 1980, Congress enacted Section 108(e)(4)[2] to prevent a debtor from avoiding the basic COD rules through an economically equivalent acquisition of its debt by a related person.[3] Under Section 108(e)(4)(A), for purposes of determining COD income, a debtor is deemed to acquire debt acquired by a person related to the debtor "to the extent provided in regulations prescribed by the Secretary." The Code directs the regulations to "provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be

---

[1] The drafters of this report are Robert A. Jacobs, co-chair of the Committee on Bankruptcy, Linda Z. Swartz, Simon Friedman and James M. Peaslee. Significant contributions were made by Stuart J. Goldring, Elliot Pisem and Michael L. Schler. Helpful comments were received from Alan S. Alpert, Sheldon H. Alster, David B. Buss, John A. Corry, Gordon D. Henderson, Dan Lundenberg, Bruce M. Montgomerie, William J. Neild, Robert J. Preminger, Richard L. Reinhold, Norman M. Rosenberg, Morris Werner, and Reuven Avi Yonah.

[2] All section references are to sections of the Internal Revenue Code of 1986 ("Code") or to the regulations there-under.

[3] Section 108(e)(4) was enacted as part of the Bankruptcy Tax Act of 1980, P.L. 96-589, Section 2(a). Prior to the legislative change, where the related purchaser did not act as a conduit or agent for the debtor, no COD was triggered when debt was acquired by a person related to the debtor. See Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969) and Forrester v. Commissioner, 4 T.C. 907 (1945), acq. 1945 C.B. 3.

appropriate....” Pursuant to its statutory mandate, on March 21, 1991, the Treasury issued Proposed Treasury Regulation § 1.108-2 (the “Regulation”)[4] addressing acquisitions of debt by a party related to the debtor. In this report, an acquisition of debt that triggers Section 108(e)(4) will be referred to as an “Acquisition”, and the acquired debt and the debtor will be referred to as the “Debt” and “Debtor”.

The Regulation addresses two distinct types of Acquisitions referred to as “Direct” and “Indirect” Acquisitions. We believe it is helpful in understanding the Regulation to subdivide the Indirect Acquisition category into “Conduit” and “Reverse Sequence” Acquisitions. The three types of Acquisitions may be illustrated as follows:[5]

---

[4] The Regulation was published in the March 22, 1991 Federal Register (56 FR 12135) and corrected June 19, 1991 (56 FR 28124).

[5] This report refers throughout to the parties listed below:

D The Debtor (which is assumed to be a corporation).

P D's parent corporation, either historically or as a result of the contemplated transaction.

A An historic holder or purchaser of D Debt or D stock.

B Another historic holder or purchaser of D Debt or D stock.

While the examples generally involve corporate debtors and corporate related parties, Section 108(e)(4) and the Regulation apply with equal vigor to debt acquisitions involving partnerships and individuals.

1. Direct Acquisition: P owns (or acquires) a controlling stock interest in D. P subsequently (or contemporaneously) acquires D Debt at a discount.

2. Conduit Acquisition: D (or P) purchases, under specified circumstances, a controlling stock interest in a corporation that holds D Debt with a value less than its adjusted issue price. The transaction is a “Conduit” Acquisition because D or P acquires D Debt through an intermediate entity.

3. Reverse Sequence Acquisition: P acquires D Debt. Subsequently, at a time when the D Debt's value is less than its adjusted issue price, P acquires a controlling stock interest in D. There is a “Reverse Sequence” Acquisition because P first acquires D Debt and then acquires an ownership interest in D, rather than P being related to D when P acquires the Debt.

Generally, under the Regulation, in each of these Acquisitions, D has COD (subject to section 108) measured by reference to the fair market value of the Debt on the Acquisition date. If COD is realized, the Debtor is deemed to issue new debt (“New Debt”) to the related party holder with an issue price equal to the fair market value of the New Debt. The excess of the stated redemption price at maturity of the New Debt over its fair market value issue price is original issue discount (“OID”). In the case of an Indirect Acquisition, the Debt holder is deemed to have sold the Debt at its fair market value.

2. Summary of Recommendations

We recommend the following changes in the Regulation:

2.1 The Debtor’s COD should be measured by the related party’s cost of acquiring the Debt, rather than the Acquisition date fair market value of the Debt. There are at least four categories of transactions that illustrate the need for the change:

2.1.1 Acquisition price pre-determined by contract.

2.1.2 Issuance of debt of a related party acquirer.

2.1.3 Carryover basis acquisitions.

2.1.4 Fluctuations in value of debt in Reverse Sequence Acquisitions.

2.2 The 25%-of-assets test should not apply to Reverse Sequence Acquisitions.

2.3 The consequences of Acquisitions should not be affected by transfers of Debt between related persons.

2.4 The Regulation should not apply to an Acquisition of Debt from a party related to the Debtor, even if that related party ceases to be related to the Debtor at the time of the Acquisition.

2.5 New Debt should be treated as a continuation of old Debt for various Code purposes.

2.5.1 Debt should not be treated as New Debt after it is transferred to a holder unrelated to the Debtor (at least if the Debtor’s consent is obtained).

2.6 The holder deemed sale rule applicable to Indirect Acquisitions should be eliminated.

2.7 The Regulation should clarify the application of the stock-for-debt exception to Acquisitions, and should provide that the exception applies to an exchange of parent stock for subsidiary Debtor Debt.

2.8 The treatment of pre-March 21, 1991 transactions should be clarified.

3. A Detailed Explanation of the Regulation

3.1 Direct and Indirect Acquisitions.

The Regulation applies to both Direct and Indirect Acquisitions of Debt. A Direct Acquisition occurs when a person related to the Debtor (or a person who becomes a related party on the date the Debt is acquired) acquires Debt from a party not

related to the Debtor.[6] A Direct Acquisition is effected when a previously unrelated party simultaneously purchases both Debt and more than 50% of the Debtor's stock, at least where the sellers are not related to one another.[7]

An Indirect Acquisition occurs if (i) a Debt holder becomes a related party, and (ii) the holder acquired the Debt in anticipation of becoming a related party. A holder is treated as acquiring Debt in anticipation of becoming a related party in three cases:

1. The holder acquires Debt less than six months before becoming a related party.[8]

2. The holder becomes a related party, at a time when the holder's Debt represents (i) more than 25% of the fair market value of the holder's total gross assets, or (ii) more than

---

[6] Regulation §1.108-2(b). Section 108(e)(4) treats two persons as being related if they are related within the meaning of either Section 267(b) or Section 707(b)(1). Section 108(e)(4) provides special family attribution rules in lieu of the regular Section 267(c)(4) family attribution rules. Under Section 108, an individual's family consists of his or her spouse, children, grandchildren and parents, and the spouse of a child or grandchild. The relationships described in Section 707(b)(1) are (i) a partnership and a partner owning, directly or indirectly, more than a 30% capital or profits interest, and (ii) two partnerships in which the same persons own, directly or indirectly, more than a 50% capital or profits interests. Entities treated pursuant to Section 414(b) or (c) as under common control for purposes of Section 401 are also considered related. Section 108(e)(4)(C). Under Sections 267(b)(3) and (0, two corporations under common control (measured by ownership of more than 50% of the vote or value of their stock) are considered to be related.

The Indirect Acquisition rule means that Section 108(e)(4) could apply where two parties become related because of fluctuations in value or other fairly innocuous changes (e.g., in a partnership context, the change in a profit ratio) that are not tied to debt acquisitions. The Regulation should disregard fluctuations in value between classes of stock in determining related party status. Cf. Section 382(1)(3)(C).

[7] The preamble to the Regulation (the "Preamble") states that "the rule of section 108(e)(4) applies if, for example, an acquirer simultaneously purchases the debtor's indebtedness and an ownership interest in the debtor."

[8] Regulation §1.108-2(b)(2)(ii).

25% of the fair market value of the total holder group gross assets. Gross assets do not include (i) cash and cash equivalent assets, marketable securities or similar items, or (ii) any ownership interest in, or debt of, members of the holder group. The Regulation states that a holder group includes "all persons who are both (1) related to the holder before the holder becomes related to the debtor and (2) related to the debtor after the holder becomes related to the debtor."[9] The Preamble instructs us that if the Debt represents more than 25% of the assets of the holder group, all Debt held by any holder group member is subject to the Regulation, but if the Debt represents more than 25 % of the assets of a single holder group member, only that member's Debt is subject to the Regulation.

3. The holder acquires Debt more than six, but less than 24, months before becoming a related party and cannot rebut a presumption that an Indirect Acquisition has occurred.[10] A holder may rebut the presumption by facts and circumstances that establish that it did not acquire the Debt in anticipation of becoming a related party. Evidence that a holder acquired Debt in the ordinary course of its portfolio investment activities, and before discussing an acquisition of Debtor stock, would generally rebut the presumption.[11]

The running of the six and 24 month holding periods is suspended during any period in which the holder, or any person related to the holder, is directly or indirectly protected against risk of loss on the Debt by an option, a short sale, or any other device or transaction. Activities that trigger a suspension of the holding period are evidence that a holder acquired Debt in anticipation of becoming a related party.[12] The period for which a holder holds Debt includes the period for

---

[9] Regulation §1.108-2(b)(2)(ii)(B).

[10] Id.

[11] Id.

[12] Regulation §1.108-2(b)(2)(ii)(D).

which the Debt was held by a corporation to whose attributes the holder succeeded pursuant to section 381.[13]

If the holder acquires the Debt more than 24 months before becoming a related party, and the 25%-of-assets and holding period suspension rules do not apply, the Debt acquisition will not be in anticipation of becoming a related party.

An Acquisition causes the Debtor to realize COD "to the extent required by section 61(a)(12) and section 108" measured by reference to the fair market value of the Debt on the Acquisition date.[14]

If the Debtor realizes COD because of an Acquisition, the Debt held by the related party is treated as New Debt issued by the Debtor to the related party. The New Debt carries an issue price equal to its fair market value. The excess of the stated redemption price at maturity of the New Debt over its fair market value issue price is OID.[15]

---

[13] Regulation §1.108-2(b)(2)(ii)(E).

[14] Regulation §1.108-2(a).

[15] Regulation §1.108-2(e)(1). The Preamble explains that the Regulation does not follow an example in the Senate Report on the Bankruptcy Tax Act, which provides that when a subsidiary corporation pays $1,000 to its parent to retire a $1,000 face amount bond that was acquired by the parent for $900, $100 of the payment should be characterized as a dividend. The introduction to this example in the Senate Report reads as follows: "[i]t is intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment...of debt which had been acquired by a related patty subject to the rule of the bill treating the debtor as having acquired the debt." The Preamble mischaracterizes this direction as a "suggestion", and we believe that an issue is raised as to the authority to issue a regulation that takes a position directly contrary to the legislative history. As a policy matter, we agree with the substance of the position taken by the Regulation.

As indicated above, we believe it will be helpful to subdivide Indirect Acquisitions into Conduit Acquisitions and Reverse Sequence Acquisitions. A Conduit Acquisition occurs when the Debtor, or a party related to the Debtor, acquires an equity interest in the Debt holder, which acquisition causes the holder to become related to the Debtor. The paradigm Conduit Acquisition involves a Debtor, D, and its investment bank ("IB"). IB, following discussions with D's management, organizes a special purpose subsidiary, IBS, which purchases all of D's Debt. Later, but not pursuant to any definitive agreement, D buys the IBS stock from IB. IBS continues to hold the D Debt. Under the Regulation, D's acquisition of the IBS stock is an Indirect Acquisition.

3.2 Deemed sale of holder's Debt when Indirect Acquisition occurs.

The Regulation creates a deemed sale of the Debt upon an Indirect Acquisition. The Debt holder is deemed to sell the Debt at fair market value to an unrelated party one day before the Acquisition date.[16] The holder recognizes gain or loss on the deemed sale equal to the difference between the holder's adjusted basis in the Debt and its fair market value. Any loss realized is not subject to the Section 1091 wash sale rules.[17] The holder's basis in the Debt is restated to equal its fair market value.

3.3 Acquisitions not reached by the Regulation.

---

[16] Regulation §1.108-2(b)(3).

[17] Regulation §1.108-2(b)(3).

The Regulation does not apply to Acquisitions of Debt that matures within one year after the Acquisition date, provided the Debt is retired on or before its stated maturity date.[18]

In addition, a security dealer's acquisition of Debt of a related party is not subject to the Regulation if the dealer (i) directly or indirectly acquires the Debt in the ordinary course of its business, (ii) disposes of the Debt within a period consistent with holding the Debt for sale to customers and (iii) does not transfer the Debt to a person related to the Debtor unless that person's holding of the Debt is within the dealer exception. This exception also applies to a dealer's exchange of Debt for new debt as part of a transaction in which unrelated holders also exchange Debt, provided the three above conditions are satisfied.[19]

4. Recommendations

4.1 The Debtor's COD should be measured by the related party's cost of acquiring the Debt, rather than the Acquisition date fair market value of the Debt.

The Regulation's fair market value standard of measuring COD will often conflict with the avowed purpose of Section 108(e)(4) -- to treat Debt Acquisitions by a related party as acquisitions of the Debt by die Debtor -- by causing a Debtor to realize COD when a related party acquires its Debt, although the Debtor would realize no COD if it reacquired its own Debt on the same terms. The purpose of Section 108(e)(4) would be better carried out if COD were measured based on the related party's

[18] Regulation §1.108-2(d)(1).

[19] Regulation §1.108-2(d)(2).

cost of acquiring the Debt as measured for tax purposes ("Acquisition Cost"). Using Acquisition Cost to compute COD insures that COD will not exceed the Debtor group's accession to wealth.

A discrepancy between purchase price and Acquisition Cost will not arise in the simple case where Debt is purchased for cash in a transaction negotiated at a time close to the purchase date. However, as the examples below demonstrate, a discrepancy can arise (1) where the Acquisition occurs under a preexisting contract that fixes the price, (2) where the consideration given for the Debt is debt of the related party acquirer, (3) where Debt is acquired in a carryover basis transaction, or (4) in a Reverse Sequence Acquisition, where the value of the Debt changes between the date it was acquired and the date of the Acquisition. We consider each case in turn.

4.1.1 Acquisition price pre-determined by contract.

Example 1: P is the parent of D. P enters into a contract with A to purchase D Debt for $100 (its adjusted issue price), with a closing to occur when a government approval is obtained. In the meantime, D's financial condition deteriorates and, at the closing, the Debt is worth only $80.

Under the Regulation, D would apparently recognize COD of $20, even though the economic income of the P-D group is zero. P would be considered to hold New Debt with a principal amount of $100 and an issue price of $80 (and thus $20 of OID). Although the Regulation does not address the treatment of the effect of the exchange of

Debt for New Debt in the case of a Direct Acquisition,[20] we assume P would not recognize a loss of $20, offsetting D's COD, because the deemed exchange by P of old D Debt for New Debt would be a recapitalization under Section 368(a)(1)(E) (at least assuming that both the Debt and New Debt are "securities"). P's basis in the New Debt would be $100, and P should be allowed to offset the $20 purchase premium against the $20 of OID under Section 1272(a)(7).[21] (Similar results would follow in any Direct Acquisition where P's basis in the Debt exceeds its fair market value and are not separately discussed in subsequent examples.)

Example 2: P is the parent of D. D issues $100 principal amount Debt to unrelated investor A for $100 cash. In exchange for a premium of $2, P writes a put (that may be traded separately from the D Debt) on the debt instrument in favor of A with a strike price of $102, the sum of the adjusted issue price of the debt instrument and the put premium received by P. The debt instrument declines in value to $80 and the put is exercised.

---

[20] In an Indirect Acquisition, the related party is considered to sell the Debt to an unrelated party on the day before the Acquisition date for an amount of money equal to the Debt's fair market value. Presumably, that money is considered to be used to buy the New Debt. The deemed sale rule is criticized in part 4.6 below.

[21] The application of this section to original debt holders is discussed in our Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges, 51 Tax Notes 79 (April 8, 1991) ("Debt-for-Debt Exchange Report").

Under the Regulation, D would realize COD income of $20, the difference between the $100 adjusted issue price of the instrument and its $80 fair market value at the time of the put exercise, even though the P-D group has retired the instrument at is adjusted issue price.

4.1.2 Issuance of debt of a related party acquirer.

As the following examples illustrate, economically similar transactions may produce disparate results under the Regulation to both the Debtor and the holder when a related party uses its debt to acquire Debt.

Example 3: D exchanges non-traded new D debt, face amount $100, worth $80 (with adequate AFR interest) for outstanding non-traded D Debt with an adjusted issue price of $100 and a fair market value of $80. The old Debt in the hands of the exchanging Debtholders has an adjusted basis of $92.

1. D has no COD. Under Section 1274, the issue price of the new debt is $100, its face amount. Section 108(e)(11).

2. The new debt carries no OID because its issue price is $100, its face amount.

3. The exchanging Debtholders recognize no gain or loss on their exchange, provided the exchange qualifies as a Section 368(a)(1)(E) recapitalization reorganization. The new debt will have a substituted basis ($92) in their hands. Section 358.

Example 4: P is the parent of D. P exchanges non-traded new P debt, face amount $100, worth $80 with adequate AFR interest) for outstanding non-traded D Debt with an adjusted issue price of $100 and a fair market value of $80. The old Debt in the hands of the exchanging Debtholders has an adjusted basis of $92.

1. Under the Regulation, D has $20 of COD. The COD is measured by reference to the fair market value of the D Debt acquired by P on the Acquisition date. Regulation § 1.108-2(a).

2. Under Regulation §1.108-2(e)(l), the old D Debt acquired by P is deemed reissued as New Debt with a fair market value issue price. The $20 excess of the $100 stated redemption price at maturity of the D Debt over the $80 New Debt issue price is OID. Because P's basis in the New Debt is $100 (see 3 below), P should not be required to report any OID income (see discussion of Example 1 above).

3. The Regulation does not alter the rules establishing the issue price of the P debt issued in exchange for the D Debt. Under Section 1273, the issue price of the P debt, when that debt is non-publicly traded, is not established by its fair market value but is instead established by its stated redemption price at maturity or $100. Thus, P will be considered to buy, and the Debtholders (assuming they are accrual basis taxpayers) will be considered to sell, the Debt for $100. See Rev. Rul. 89-122, 1989-2 C.B. 200. Because the exchange will not qualify as a Section 368(a)(1)(E) recapitalization, the Debt holders will recognize an $8 gain on the exchange. The new P debt carries no OID because its issue price is $100, its face amount.

As Example 3 demonstrates, when D uses new non-traded D debt (with adequate AFR interest) to acquire its Debt, D realizes no COD because the tax cost to D of retiring the Debt, as measured by the issue price of the new debt, equals the adjusted issue price of the old Debt. The P-D group’s tax cost of retiring the Debt is the same in Example 4 as in Example 3, and we do not

see any justification for the difference in results. The same results would be achieved in both Examples if the Acquisition Cost for the D Debt were used to measure the COD recognized by D.[22]

The 1990 amendments to Section 108(e)(11) demonstrate Congress's belief that Sections 1273 and 1274 should determine the issue price of debt in Section 108 cases. The Preamble states that the Regulation does not apply the Section 108(e)(11) issue price rules because those rules apply only to debt issued by a debtor to retire its own debt. Given the Section 108(e)(4) directive that the acquisition by P be deemed an acquisition by D (and more generally, the policy of the section to treat P and D as a single entity), the Preamble's explanation is less than satisfying.

Example 4: posits a formal exchange of P debt for D Debt. Less formal transactions could produce equally formidable results.

> Example 5: P owns all the outstanding D stock. Bank holds D's Debt. The Debt has an adjusted issue price of $100 and a fair market value of $80. Bank's senior secured position causes key trade creditors to decline to issue credit to D. P assumes the Debt and Bank agrees to a novation. P's obligation to Bank has a face amount of $100, is worth $85 and bears adequate AFR interest. If the Debt assumption is viewed as an Acquisition of the Debt from Bank by P, followed by a contribution by P of the Debt to D's capital, then:

[22] For a more complete argument in favor of consistent treatment, see the Debt-for-Debt Exchange Report.

1. Under the Regulation, D has $20 of COD. The COD is measured by reference to the fair market value of the D Debt acquired by P on the Acquisition date. Regulation §1.108-2(a). D would have no COD if COD were based on P's Acquisition Cost because that amount (the adjusted issue price of the P debt under Section 1273) would be $100.

2. Under Regulation §1.108-2(e)(1), the old D Debt acquired by P is deemed reissued as New Debt with a fair market value $80 issue price. Upon P's simultaneous contribution of that New Debt to D's capital, D would recognize no COD under Section 108(e)(6), because P's $100 basis would exceed the $80 adjusted issue price of the New Debt.

4.1.3 Carryover Basis Acquisitions.

The definition of Acquisition is not limited to transactions in which basis is measured by cost, but apparently may also apply where Debt is acquired by a related person in a carryover basis transaction. In those cases, the measurement of COD income by reference to fair market value produces distorted results, as the examples below demonstrate. We would measure COD income based on Acquisition Cost, which equals the carryover basis amount.[23]

[23] The transactions discussed here are different from the carryover basis transactions referred to in the Preamble (as amplified by Notice 91-15). The Preamble appears to be concerned with transactions in which Debt is transferred to the Debtor and legally discharged, whereas we are dealing with cases where Debt is acquired by a related person and remains a legal liability.

Example 6: D is owned by two shareholders, A and B, who own 20% and 80% of its stock respectively. A and B have made loans of $20 and $80 to D, which have a current fair market value of $10 and $40. A and B agree to contribute the loans to the capital of D.

D does not recognize COD income under Section 108(e)(6) because the basis of the loans is not less than their adjusted issue price.

Example 7: Same facts as Example 6, except that A and B own their interest in D through holding company H which owns 100% of the stock of D. A and B contribute their loans to the capital of D by first contributing them to H, which then contributes them to D.

Under the Regulation, the contribution of the loan from A (a person unrelated to D) to H would result in COD income to D of $10 (the excess of the adjusted issue price of the A loan over its fair market value).

Example 8: T and D are unrelated corporations. T owns D Debt with an adjusted issue price of $100. T purchased the Debt for $100, and it has a current fair market value of $80. D acquires T through a merger of T into D (qualifying as an “A” reorganization), with D surviving.

No COD income is recognized because D did not discharge

the T debt at a discount.[24]

Example 9: Same facts as Example 8, except that T is merged into S, a wholly-owned subsidiary of D. Under the Regulation, the transaction appears to be a Direct Acquisition, resulting in COD income for D of $20.

Example 10: Same facts as Example 9, except that T was indebted to D, rather than the other way around.

The transaction appears to be an Indirect Acquisition under the Regulation ("a transaction in which a holder of outstanding indebtedness becomes related to the debtor") although it is not clear if the Regulation was thought to extend to transactions in which related party status is gained by a change in the identity of the debtor. If the Regulation applies, then S (or perhaps T) would recognize COD income of $20 upon the consummation of the merger.[25]

To reiterate, we do not believe Section 108(e)(4) was intended to produce results so different from direct discharges of Debt by the Debtor.

---

[24] Cf. Rev. Rul. 74-54, 1974-1 C.B. 76 (no gain recognized on a Section 332 liquidation of a subsidiary into a parent where the subsidiary owned debt of the parent purchased at par); Rev. Rul. 72-464, 1972-2 C.B. 214 (upon merger of debtor into creditor in an "A" reorganization, gain recognized only by creditor, in the amount of the market discount at which the debt was purchased).

[25] One argument against treating the transaction as an Indirect Acquisition is that the definition appears to contemplate a case where Debt has been held by the holder for some period while the holder is unrelated to the Debtor. See Example 21 below. However, this requirement could be considered to be satisfied by viewing T as a predecessor of S.

One case involving the equivalent of a carryover basis acquisition that deserves some comment is a Conduit Acquisition where the basis of the Debt is not altered by the acquisition.

> Example 11: T and D are unrelated corporations. T owns D Debt, which has an adjusted issue price of $100. T purchased the Debt for $100, and it has a current value of $80. D acquires all of the T stock for cash (without making a Section 338 election) and T is immediately merged upstream into D in a Section 332 liquidation. Under the Regulation, the acquisition of T stock will result in COD income to D of $20.

Assuming the proper treatment of the discharge of parent debt in a Section 332 liquidation is that the parent is treated as discharging the debt at a price equal to its basis to the subsidiary,[26] then, apart from the Regulation, the transaction would yield the same result as the direct tax-free merger of T into D described in Example 8. Given that the net effect of the two transactions at the corporate level is the same, this result is appropriate.

> Example 12: Same facts as Example 11, except that T is maintained as a subsidiary of P.

This example raises the question, which has been given much attention in the ongoing debate over the consolidated loss disallowance regulations, of how the tax system should deal with the purchase of stock in corporations having built-in gain or loss assets. In this case, there is a built-in loss of $20 in T

[26] Rev. Rul. 74-54, 1974-1 C.B. 76, holds that a parent debtor recognizes no income upon a Section 332 liquidation of the subsidiary creditor, but in the ruling the subsidiary had purchased the parent debt at its principal amount.

(the excess of T's $100 basis in the D Debt over its value of $80). The Regulation deals with the discrepancy between inside and outside basis by requiring T to recognize the built-in gain or loss one day prior to the Acquisition, so the problem is eliminated.

In all of the debates over the discrepancy between inside and outside basis, requiring mark-to-market treatment for target assets (essentially mandatory Section 338) was never seriously proposed (at least as a solution that might be adopted through regulations). To the extent proposals were made to equate inside and outside basis, equality was to be achieved by conforming outside to inside basis, not the other way around; We do not believe the Regulation is an appropriate place to introduce approaches that are so far out of step with the rules applicable to assets other than related party debt.

We note that a rule measuring COD based on Acquisition Cost would not prevent the realization of appropriate amounts of COD in the paradigm Conduit Acquisition case where an investment banker establishes a subsidiary to buy debt and then sells stock of the subsidiary to the debtor or its affiliate. The only consequence of our proposal is that COD would be based on the cost of the Debt to the subsidiary, rather than the fair market value of the Debt on the date the subsidiary is acquired.

4.1.4 Fluctuations in Value of Debt in Reverse Sequence Acquisitions.

Measuring COD by the fair market value of the holder's Debt on the date of a Reverse Sequence Acquisition can yield anomalous results. Consider the following examples:

Example 13: P is the parent of D. A owns all the D Debt, which Debt has a $100 adjusted issue price and $100 fair market value. D acquires the D Debt from A for $ 100 cash.

D has no COD.

Example 14: P is the parent of D. A owns all the Debt of D, which Debt has a $100 adjusted issue price and $100 fair market value. P acquires the D Debt from A for $100 cash. Subsequently the D Debt declines in value to $80.

D has no COD.

Example 15: X owns all the D stock. P purchases D Debt with a $100 adjusted issue price from A for $100. Five months later, when the fair market value of the D Debt is $80, D is merged into P in a reorganization and the D Debt is discharged.

Neither P nor D recognizes any income with respect to the Debt as a result of the merger.

Example 16: The facts are the same as in Example 15, except that instead of D merging into P, P acquires 51 % of the stock of D from X (or an option to purchase the D stock).

Under the Regulation, D would have COD income of $20 at the time of the stock acquisition. Under the Acquisition Cost proposal, D would realize no COD income.

The purpose of Section 108(e)(4) is to place the debtor in the same position for purposes of determining COD as if it and the related person were a single entity. To carry out that purpose, a Reverse Sequence Acquisition (where the holder of the debt acquires a controlling interest in the debtor) should be treated the same as a transaction in which the debtor merges into the holder (with no change in the basis of the Debtor's assets) and the debt is discharged (Example 15). In those transactions, no COD would be recognized if the holder's Acquisition Cost equalled the adjusted issue price of the Debt.

More generally, the cost to the P-D group of acquiring the Debt from the outside world in Example 15 is $100, the same as in Examples 13 and 14 above. As in those examples, D should realize no COD.

If the holder purchased the Debt for less than its adjusted issue price, a subsequent Reverse Sequence Acquisition will cause D to recognize COD, even under our Acquisition Cost approach.

Example 17: X owns all the D stock. P purchases D Debt with a $100 adjusted issue price from A for $80. Five months later, when the fair market value of its D debt is $77, P buys 51% of the D stock from X.

Under the Regulation, D has $23 of COD. Under our recommendation, D's COD would be $20.

It could be questioned whether Section 108(e)(4) should apply at all in this situation. The section refers to Acquisitions of Debt by related parties, and not to acquisitions of a controlling stock interest in the Debtor by Debt holders. Nonetheless, we believe that as a tax policy matter, it is difficult to distinguish a case in which the Debtor is first acquired and then Debt is acquired (where the Section clearly applies) from a case where the steps are reversed, at least in a setting where the acquisition of the Debtor is anticipated at the time of the Debt acquisition.

4.2 The 25%-of-assets test should not apply to Reverse Sequence Acquisitions.

Presumably, the purpose of the 25%-of-assets rule is to identify cases in which Debt is repackaged for resale to the Debtor or a person related to the Debtor. That rule does not seem to work properly when applied to Reverse Sequence Acquisitions, as demonstrated by the following example:

> Example 18: On January 1, 1992, V, an investment fund whose assets consist solely of cash and marketable securities, invests $40 (2% of its assets) in publicly traded D Debt with a $100 face amount. V does not hedge its investment in the Debt. On April 30, 1995, V purchases 51 % of the D stock and becomes related to D. Under Regulation §l.108-2(b)(ii)(B), an Indirect Acquisition would occur because the Debt represents more than 25 percent of the assets of V (disregarding marketable stocks and securities) on the date V becomes related to D.

This is not a case where the Debt is being repackaged for sale, and we do not see why the acquisition of the Debt should be considered to be made in anticipation of V becoming related to D.

4.3 The consequences of Acquisitions should not be affected by transfers of Debt between related persons.

The Regulation should clarify that the 6 and 24 month holding periods are not affected by transfers of Debt between related persons. As a policy matter, we do not see why a preliminary transfer of Debt between related parties should affect whether a Debtor recognizes COD.

In part, this issue could be resolved by applying the holding period tacking rules of Section 1223. The Regulation does not make clear whether these holding period rules apply in determining if there has been an Indirect Acquisition. The 6 and 24 month rules that are part of the definition of Indirect Acquisition apply based on the period between the date on which the holder "acquires" debt and the date on which the holder becomes related, rather than based on the "holding period" for the Debt, but the date when property is acquired is sometimes determined to be the beginning of a holding period.[27] Also, the 6 and 24 month periods are referred to in the Regulation as "holding periods," and the Regulation states that, unless the 25%-of-assets rule applies, a holder is not treated as acquiring debt in anticipation of becoming related if the holder "held" the debt for 24 months before becoming related. See Regulation §1.108-2(b)(ii)(2)(C) and (D). On the other hand, the conclusion

[27] See, for example, page 11-333 of the Conference Report on the Tax Reform Act of 1986, H.R.N., 99-841, 99th Cong. 2d Sess. (discussion of "acquired after August 7, 1986" in Section 265(b)(2)(A)).

that the holding period tacking rules of Section 1223 do not apply is implicit in Regulation §1.108-2(b)(ii)(3), which creates a tacking rule for periods for which indebtedness was held by a corporation to whose attributes the holder succeeded pursuant to Section 381. This rule would not be needed if Section 1223 applied.

If Section 1223 tacking (or some other similar rule) does not apply, some anomalous results may arise, as illustrated by the following example:

> Example 19: A, a corporation unrelated to D, holds (and has held for many years) D Debt. On January 1, 1992, A contributes the Debt to S corporation, wholly owned by A, in a transaction described in Section 351 that is not a reorganization. On April 15, 1992, A purchases 51% of the D stock. Assume the 25%-of-assets rule does not apply.
>
> If A had retained the Debt, no Indirect Acquisition would occur because A has held the Debt for more than two years. However, because S is not treated as holding the Debt for the period it was held by A, there is an Indirect Acquisition because S acquired the Debt within six months of becoming related to D.
>
> Even applying the tacking rule of Section 1223 may not be enough:
>
> Example 20: Same facts as Example 19, except that, instead of contributing the Debt to S, A distributes the Debt to B, an individual who owns all of the stock of A.

Although the transfer to B is not a transaction that results in a tacking of holding periods under Section 1223, is there any reason to treat this transaction differently from Example 19?

Perhaps the rule should be that a holder of Debt that becomes related to the Debtor can tack any period in which the Debt was held by any other person if that other person (or a successor to that other person if it is no longer in existence) is also treated as related to the Debtor.

In addition, COD should not be created by transfers of Debt to newly created subsidiaries. Consider the following example:

Example 21: P owns all the D stock and also all the D Debt. On a single day, P forms a new subsidiary S and transfers the Debt to S in a transaction that is not a reorganization.

Although S both holds D Debt and becomes related to D, we assume there is not an Indirect Acquisition because S was at no time both a holder of the Debt and unrelated to D (and thus cannot be a holder that becomes related). A Regulation example clarifying this point would be helpful.

4.4 The Regulation should not apply to an Acquisition of Debt from a party related to the Debtor, even if that related party ceases to be related to the Debtor at the time of the Acquisition.

The Regulation treats a simultaneous acquisition of Debt and a controlling interest in the Debtor from different unrelated parties as a Direct Acquisition.

> Example 22: A holds D Debt having an adjusted issue price of $100. P simultaneously purchases the Debt from A for $80, and 100% of the D stock from B (who is unrelated to A and D).
>
> A Direct Acquisition is effected because P, by reason of its simultaneous acquisition of 100% of D's stock and the Debt, is related to D on the Acquisition date and purchased the Debt from a person unrelated to D.

Because the Regulation does not specify when a seller's "related party" status is to be determined, it is unclear whether the simultaneous purchase of Debt and a controlling interest in D from the same party triggers COD.

> Example 23: A owns 100% of the D stock and D Debt, which Debt is worth $80 and has a $100 adjusted issue price. P simultaneously purchases from A all of the D Debt and D stock it holds.
>
> Is this a purchase by a related party from a related party?

The better view supported by the Tax Section's 1984 report on Section 108(e)(4) ("NYSBA 1984 Report"),[28] is that A should be treated as a party related to D in determining whether

[28] New York State Bar Association Tax Section, Report of the Committee on Bankruptcy on Related Party Debt Acquisitions Under Section 108(e)(4) of the Code (April 12, 1984), DOC 84-3025.

P purchased Debt from a related person. One argument in favor of this result is that it is the result that would be achieved if an entity were formed to hold the related person's interest in the Debt and the stock, and that entity were sold to P. Consider the following:

> Example 24: Same facts as Example 23, except that A holds its Debt and stock interests in D through a corporation H and sells the H stock to P.
>
> No Direct or Indirect Acquisition would occur because there is no new holder of the Debt and the holder does not <u>become</u> related to D (but remains related throughout).

More complex transactions involving acquisitions of related party entities are illustrated by Example 25:

> Example 25: Same facts as Example 24 , except that (1) A is a corporation that files a consolidated return with H and D, and A makes a Section 338(h)(10) election, or alternatively (2) H is a grantor trust.
>
> In these transactions, a new person may be considered to purchase the Debt (the "new H" created by virtue of the Section 338 election or P as the beneficiary of the trust), but it is difficult to see why, in terms of the policies of Section 108(e)(4), a different result should arise than in Example 24.

Under our approach, it would make no difference how the Debt and D stock were held at the time of the sale to P. If our approach is not adopted, A would have an incentive to rearrange

its holdings in D Debt and stock to come within the facts of Example 24.[29] Step transaction principles would be hard to apply if A acts before it has an agreement with P. What tax policy objective would be served by requiring A to go through these extra steps? We reiterate our 1984 recommendation that the Regulation not treat the transaction described in Example 23 as an Acquisition.

4.5 New Debt should be treated as a continuation of the old Debt for various Code purposes.

The Preamble states that the deemed issuance of New Debt applies for all purposes of the Code, but requests comments on whether the deemed issuance should not apply for purposes of specific provisions of the Code. As discussed below, we believe the New Debt should be considered a continuation of the old Debt for purposes of applying any case law or Code rules (1) relating to the status of the debt as debt or equity (including the high yield debt obligation, or HYDO, rules in Section 163(e)(5), enacted in 1989), or that are affected by (2) the circumstances in which debt is issued or (3) when debt is issued.

Treating D as issuing New Debt to P was suggested by the NYSBA 1984 report,[30] and we believe that the fiction of a deemed issuance of New Debt is a useful mechanical approach to computing the adjustments to the income and deductions of the related party and the Debtor needed to account for the recognition of COD by

---

[29] A transfer of Debt and an interest in D by A to a new entity would not itself trigger Section 108(e)(4) because both A and the entity would be related to D, both before and after the transfer. See also Example 21 above.

[30] NYSBA 1984 Report at 21.

the Debtor.[31] However, in our view, the fiction of a deemed issuance should not be applied to alter the basic tax rules governing the Debt. Newly issued debt might be subject to a different tax regime as a result of changes in law, a deterioration in the financial condition of the Debtor (and any resulting increase in the market yield of the Debt) or a change in the circumstances of issuance of the Debt (for example, the fact that the New Debt would be issued privately to a related party, whereas the old Debt might have been issued in a public offering to unrelated investors). These changes should be disregarded in taxing the New Debt.

Two reasons support our view. First, the first sentence of Section 108(e)(4) treats D as acquiring its own debt "[f]or purposes of determining income of the debtor from discharge of indebtedness" and not for all purposes of the Code. The second sentence of the Section states that regulations adopted by the Service "shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence." We believe the statutory language is best read to mean that the deemed retirement of the D Debt, and any correlative adjustments, should, to the extent possible, be limited to the purpose of achieving the proper treatment of discharge of indebtedness income. We believe this purpose can be served

[31] It might be argued that the consequences of a deemed issuance of debt should be limited to the Debtor (on the ground that nothing more is needed to account for the recognition of COD), and accordingly that the discount at which the related party acquired the Debt should not be transformed from market discount into OID through a deemed issuance of New Debt. However, given the tax policy favoring the matching of OID deductions and income, we support the consistent treatment of discount on the New Debt as OID from the perspective of both the holder and Debtor. However, it does not follow that the income reported by the holder should always equal the Debtor's deductions. See the discussion of the deemed sale rule in part 4.6 below.

without treating the New Debt as a newly issued obligation for all Code purposes.[32]

Second, the acquisition of Debt by a related person does not result in an actual retirement of debt. Thus, unless and until there is some modification of the instrument, the policies favoring consistent treatment of a debt instrument over its life apply (except as needed to ensure the proper measurement of COD). The need for consistent treatment is important, given that the definition of related person is broad enough to cover cases where the Debtor and related person are distinct economic interests, and that the Debt may be resold to an unrelated person.

While, under our approach, the deemed issuance of New Debt would be disregarded for many Code purposes, any actual modification of the terms of the Debt by the Debtor and the related holder would potentially result n a deemed exchange of an old debt for a new one under general Code principles to the same extent as if Section 108(e)(4) had not applied.

Under our proposal, New Debt would not be treated as new indebtedness for purposes of testing its status as debt or equity for tax purposes. While some clarification of this point would be helpful, it appears this result would be reached under the

[32] A recently enacted example of a rule that re-characterizes a portion of an instrument for limited purposes is Section 163(e)(5)(B)(i) (the dividend equivalent portion of OID on a HYDO is treated as a dividend solely for purposes of Sections 243, 245, 246 and 246A).

Regulation as now written.[33] Similarly, we do not believe the HYDO rules should apply to the New Debt if they did not apply to the old Debt, because those rules are based on debt/equity concerns.[34] Clarifying this result would be particularly important if the issue price of the New Debt continues to be based on fair market value, rather than Acquisition Cost, because application of the HYDO rules depends on the amount of OID and

---

[33] Regulation § 1.108-2(e)(1) states that the New Debt will be treated as new indebtedness, and notes that the OID on the debt will be deductible by the Debtor and includible in the income of the holder to the extent provided in Sections 163 and 1272. The Preamble states that these two Sections "apply only if the [New Debt] remains true indebtedness under general tax law principles in the hands of the related party. If the indebtedness is not true indebtedness (because, for example, the debtor and the related holder do not intend for the indebtedness to be repaid), no deduction is permitted for stated interest or for original issue discount." We do not read this language to mean that the status of New Debt will automatically be retested as if it were a newly issued instrument, but only that it will be subject to the same rules as any continuing indebtedness (including the possibility of re-characterization upon a modification by the parties).

[34] In some cases, this result would be achieved under a transition rule if the Debt was issued on or before July 10, 1989, although our recommendation also extends to New Debt that does not benefit from this rule. The HYDO rules are generally effective for instruments issued after July 10, 1989. See Section 7202(c)((1) of the Revenue Reconciliation Act of 1989 (the "1989 Act"). However Section 7202(c)(2)(C) of the 1989 Act provides that debt "issued to refinance an original issue discount debt instrument to which the amendments made by this section do not apply" will not be treated as a HYDO if: (i) the maturity date of the refinancing instrument is not later than the maturity date of the refinanced instrument, (ii) the issue price of the refinancing instrument does not exceed the adjusted issue price of the refinanced instrument, (iii) the stated redemption price at maturity of the refinancing instrument is not greater than the stated redemption price at maturity of the refinanced instrument, and (iv) the interest payments required under the refinancing instrument before maturity are not less than (and are paid not later than) the interest payments required under the refinanced instrument. We believe New Debt would generally satisfy these four requirements, and thus should not be generally subject to the HYDO rules if the Debt was issued on or before July 10, 1989. On the other hand, the transition rule would not literally apply unless the Debt was an "original issue discount debt instrument" and frequently the Debt would not have OID. It seems very odd to limit the transition rule to cases where the refinanced debt has OID, and we question whether such a limitation was intended.

the fair market value rule would, in our view, overstate OID.[35]

New Debt should also be viewed as a continuation of the old Debt for purposes of any rule relating to the circumstances in which debt is issued. Thus, the New Debt should not be treated as new debt in determining if the Eurobond exception in Section 163(f)(2)(B) applies. Finally, the New Debt should be treated as a continuation of the old Debt (with the same issue date) for purposes of new regulations or rules that apply to debt issued after the date on which the old Debt was issued. One example is the recently proposed Treas. Reg. §1.1275-5 contingent payment debt regulations.[36]

We have tried to be as precise as possible in describing the areas where the deemed issuance rule should not apply in light of the request in the Preamble to specify rules to which the deemed issuance principles ought not to apply. However, in light of the language of Section 108(e)(4), it might make more sense to limit the purposes for which a deemed issuance is deemed to occur to particular provisions specified in the Regulation.

4.5.1 Debt should not be treated as New Debt after it is transferred to a holder unrelated to the Debtor (at least if the Debtor's consent is obtained).

---

[35] Debt is a HYDO if it satisfies four requirements: (i) the debt is issued by a corporation, (ii) the debt term exceeds five years, (iii) the debt has a yield to maturity that exceeds the AFR by more than 5 percentage points, and (iv) the debt has "significant OID" because deferred and unpaid interest outstanding after five years exceeds one year's interest on the issue price at the instrument's yield to maturity.

[36] Application of the contingent payment rules might also be precluded under our first proposal on rules dealing with debt-equity classification issues (because the proposed regulations would deny debt treatment for contingent payments).

As discussed above, the Preamble warns that the deemed issuance of New Debt applies for all purposes of the Code. Ordinarily, the resulting adjustments would continue to apply even after transfers of the New Debt to an unrelated party. In particular, the Debtor will continue to deduct (subject to applicable limitations), and the new holder must include in income, the OID attributable to the New Debt as it accrues. The Preamble recognizes that unrelated holders may have difficulty in differentiating New Debt from old Debt of the same series.

The Service invites comments on whether a different rule should apply after a transfer of New Debt to an unrelated party, e.g., a rule that suspends the debtor's deduction of OID attributable to New Debt until maturity and does not require a corresponding current inclusion of OID in an unrelated holder's income. Subject to the discussion below, we endorse that suggestion.

Our first comment is that Debt previously held by a related person can be treated as interchangeable with debt that was never held by a related person only if the two are identical. Thus to achieve its end, the rule must treat the Debt that has been transferred to an unrelated person in all respects the same as debt to which Section 108(e)(4) never applied. Second, this rule should not apply to Debt that continues to be held by the related person merely because that person ceases to be related to the Debtor. Finally, and most importantly, the termination of OID accruals that results under the proposal from a transfer of Debt to an unrelated person in most cases will visit hardship on the Debtor. Ordinarily, the debtor and the related person will be under common control, so that a conscious decision can be made as to whether the benefits of fungibility outweigh the tax disadvantages to the Debtor, but this will not always be the

case. We recommend that the Service consider requiring the Debtor's consent to any deferral of OID deductions.

4.6 The holder deemed sale rule applicable to Indirect Acquisitions should be eliminated.

The Regulation requires the holder of Debt in an Indirect Acquisition to recognize gain or loss as if it sold the Debt at its fair market value on the day before the Acquisition. The deemed sale rule can cause harsh results and is not needed to carry out the purposes of Section 108(e)(4). We recommend it be eliminated.

Where the holder has held the Debt from the date of its original issue, the holder will recognize a loss on its deemed sale, which loss will generally be a capital loss. The holder will then recognize an equal amount of ordinary income in the form of OID on the New Debt. The capital loss cannot be used to offset the OID income. Had the holder not recognized loss from a deemed sale of the Debt, the difference between the Debt's value and original purchase price would presumably create "acquisition premium," the amortization of which would offset the OID created through the deemed issuance of New Debt. Compare Example 1 above. Other limitations on use of a capital loss from a deemed sale may apply if the Debt holder's stock is acquired in the Acquisition.[37]

[37] Any carryover of the capital lots may be subject to the limitations of Section 383, because the deemed sale occurs before the holder becomes a related party. Similarly, any such carryover would be subject to the SRLY rules of Treas. Reg. §1.1502-22 if the related party purchasing the holder's stock includes the holder corporation in its consolidated group.

In other cases, the deemed sale rule may cause holders to recognize gain.

> Example 26: On January 1, 1992, V, an investment fund, buys for $40 D publicly traded Debt with a $100 face amount representing a portion of the outstanding class of Debt. On April 30, 1992, V tenders for all of the D stock. V announces that if the tender is successful, it will take over D's management and invest substantial equity in X. The markets respond by increasing the value of the D Debt held by V to $80.
>
> The tender is successful and V buys the D stock on June 15, 1992. Under the Regulation, when V completes its tender offer, V will recognize $40 of gain attributable to the deemed sale of its $40 adjusted basis D Debt for $80 (its fair market value). D will recognize $20 of COD ($100 Debt adjusted issue price minus $80 Debt fair market value). Under our proposals, V would not recognize gain and D's COD would be $60, the difference between the $100 Debt and V's $40 Acquisition Cost.
>
> In effect, the fair market value and deemed sale rules shift income of $40 from D to V.

We can imagine two possible arguments for a deemed sale rule. One argument is that the transaction in which the Debt holder and Debtor become one is an appropriate realization event for the holder, because the debt is effectively discharged at that time. That view is suggested by the Preamble.[38] The second

[38] The Preamble justifies the deemed sale rule on the ground that "indirect acquisitions are treated as equivalent to direct acquisitions".

possible argument is that a deemed sale is needed to cause the tax basis of the Debt in the hands of the holder to equal the issue price of the New Debt. The conformity of the holder's basis and the issue price will help to ensure that the OID deductions of the issuer match the OID income of the holder.

Turning to the first of these arguments, it is highly questionable whether the Service has authority to treat an Indirect Acquisition as a realization event from the perspective of the Debt holder. As noted above, Section 108(e)(4) treats the Debt as being acquired by the Debtor only for purposes of determining discharge of indebtedness income-not for purposes of measuring the income of the holder. Moreover, if the holder were considered by Section 108(e)(4) to exchange old Debt for New Debt, at least where the Debtor is a corporation, the exchange would often be a nontaxable recapitalization. Requiring the recognition of gain or loss by a holder of property in the absence of a disposition of the property is an extraordinary step under our realization based tax system, and we do not believe a regulation imposing that result should be adopted without clear statutory authority.[39]

As to the need to conform the holders' basis with the issue price of the New Debt, we have recommended that the Debtor's COD be measured based on the Acquisition Cost, rather than fair market value. If this recommendation is accepted, there

---

[39] The recent Supreme Court decision in Cottage Savings Association v. Commissioner, _____ U.S. _____ (No. 89-1965, April 17, 1991), while holding that a particular exchange of mortgages was a taxable event, reviews and reaffirms the authorities that require a realization event before gain or loss can be recognized. In the context of a Conduit Acquisition involving a corporate Debt holder, the deemed sale rule may be viewed as a mandatory Section 338 election, limited to the Debt. See the discussion of Example 12 above.

would no longer be a need for the deemed sale rule to conform the two amounts. In any event, we question whether conformity is always needed. Holders of OID debt frequently have a basis in the debt that exceeds the adjusted issue price (resulting in a reduction in OID income). Indeed, as a result of the 1990 repeal of Section 1275(a)(4), it will be commonplace for holders of debt to have a basis immediately following a debt-for-debt exchange that exceeds the issue price of the new debt (so that the debt issuance has significance more for the debtor than the holder).[40] We do not see why it is necessary to match OID income and accruals with respect to New Debt to a greater extent than is required for debt issued in actual debt-for-debt exchanges.

Finally, as demonstrated in part 4.1 above, a holder of Debt following a Direct Acquisition may well have a tax basis that differs from fair market value, and yet the deemed sale rule is not applied in that setting.

For the foregoing reasons, we recommend the deemed sale rule be abandoned.

4.7 The Regulation should clarify the application of the stock-for-debt exception to Acquisitions, and should provide that the exception applies to an exchange of parent stock for subsidiary Debtor Debt.

The Regulation does not explain how the stock-for-debt exception applies to exchanges of parent stock for subsidiary debt. Consider the following:

Example 27: H is a holding company, owning all of the

[40] See the Debt-for-Debt Exchange Report.

stock of D. A, unrelated to D, acquires $100 face amount of D Debt (which was issued at par) on January 2, 1992 for $40. On May 15, 1992, while D is in a bankruptcy proceeding, H exchanges its stock for the Debt held by A.

This transaction is a Direct Acquisition. The Regulation does not explain whether the stock-for-debt exception applies. We reiterate the recommendation in the NYSBA 1984 Report that the exception should apply.[41] This result is particularly appropriate given Section 108(e)(4)'s basic approach of treating the Debtor and related party as one person for purposes of determining the COD consequences of Debt acquisitions.

Outside of the context of section 108(e)(4), there is a some uncertainty as to whether the Service will apply the stock-for-debt exception to exchanges of parent stock for subsidiary debt.[42] We believe the exception should apply. This conclusion is consistent with Congress's intent when it enacted the Bankruptcy

---

[41] NYSBA 1984 Report at 26-28.

[42] See Rev. Rul. 59-222, 1959-1 C.B. 80. The Service has indicated it is revisiting the continued viability of this ruling under the new Section 382 consolidated corporation regulations.

Tax Act of 1980.[43]

The Regulation should also coordinate the Indirect Acquisition Rules with the rules governing stock-for-debt exchanges.

> Example 28: P, unrelated to D, acquires $100 face amount of D Debt (which was issued at par) on January 2, 1992 for $40. On May 15, 1992, while D is in a bankruptcy proceeding, P exchanges $20 of D debt for 51% of D's common stock, worth $8.

Apart from the Regulation, under the stock-for-debt exception to COD recognition, D would be treated as exchanging $8 of stock for $20 of debt, realizing $12 of COD, which COD is not recognized.[44] The remaining $80 of Debt would not have been viewed as exchanged. Under the Regulation, P's acquisition of a controlling interest in D is an Indirect Acquisition. As a result, D would potentially realize a total $60 of COD (the

---

[43] Congress's belief that parent stock should satisfy the stock-for-debt exception is supported by its decision to permit triangular "G" reorganizations, the practical utility of which depends on the application of the stock-for-debt exception and its application of Section 108(e)(7), addressing the creditor side of a stock-for-debt exchange, to parent stock. It has been suggested that the "stock of the debtor" language of new Section 108(e)(10)(B)(i) may preclude the applicability of the stock-for-debt exception to exchanges of debt for parent stock or even, reversing close to 50 yean of case law, successor stock. See, e.g., Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872 (1943), acq. 1943 C.B. 1. There is no hint that this basic change was intended by Congress in 1990. The sole purpose for the 1990 revision to Section 108(e)(1) was to disqualify certain redeemable stock for purposes of the stock-for-debt exchange. Set Conference Report, H. Rep. No. 964, 101st Cong., 2d Sess. 1099 (1990). To avoid confusion, we recommend Section 108(e)(10)(B)(i) be corrected to read: "Subparagraph (A) shall not apply in the case of a dear in a title 11 case or to the extent the debtor is insolvent (other than in the case of disqualified stock)." This adjustment would reinstate the pre-1990 language of Section 108(e)(10)(B) with an additional parenthetical exclusion for disqualified stock.

[44] See Section 108(e)(10).

excess of $100 over the $40 fair market value of the $100 of Debt) although that COD would be realized only "to the extent required by section 61(a)(12) and section 108".[45] P would be considered to exchange $80 of Debt for New Debt. There are three possible methods of coordinating the stock-for-debt rule and the Regulation:

1. The entire stock-for-debt exchange should not be eligible for the stock-for-debt exception. If P and D are viewed as an economic unit, the economic unit has a $60 accession to wealth as against the outside world and the outside world has not received any D stock.

2. At least $20 of the D debt should be eligible for the stock-for-debt exception. Congress's considered decision to retain the stock-for-debt exception in bankruptcy cases should be respected at least with respect to the debt that is considered to be discharged without regard to Section 108(e)(4). It is counter-intuitive to provide that the stock-for-debt exception applies if P acquires 50% or less of D's stock, but not if P acquires more than 50% of the stock.

3. The entire stock-for-debt exchange should be eligible for the stock-for-debt exception. The general rule is that when debt is exchanged for (i) stock and (ii) cash or other property (including debt), the cash or other property offsets the exchanged debt on a dollar for dollar basis, and the remainder of the debt is exchanged for stock. The purpose of Section 108(e)(4) is to place D in the same position as if it had directly discharged its own debt, so why should it not receive the same treatment as if it had actually exchanged New Debt and stock for the $100 of Debt?

The choice among these alternatives is not an easy one. Bankruptcy and tax considerations may point in different directions. On balance, we believe that the stock-for-debt

[45] Most likely, the $60 figure would be considered to consist of $12 of potential COD income attributable to the actual discharge of $20 of Debt and $48 of income attributable to Section 108(e)(4). The basic question raised by the example is how an actual discharge is to be coordinated with a deemed discharge under the Regulation.

exception should be preserved, at least to the extent it would apply in the absence of Section 108(e)(4).

The Regulation's lack of clarity is compounded when a holder acquires stock of a Debtor's parent.

> Example 29: Same facts as Example 28 except that a holding company H owns all of the stock of D, and D acquires stock of H rather than stock of D.

4.8 The treatment of Pre-March 21, 1991 transactions should be clarified.

The Regulation applies to Acquisitions of discounted Debt by a related party after March 20, 1991. The Regulation states that while it is not proposed to apply to any transaction before that date, Section 108(e)(4) is effective for any transaction after December 31, 1980. In addition, the Preamble states that general tax principles such as the step-transaction and substance over form doctrines will be applied in determining whether a transaction is subject to Section 108(e)(4). The Service may attempt to apply the principles of the Regulation retroactively through reliance on these doctrines.[46]

We believe the Service should be more forthright in addressing the applicability of Section 108(e)(4) prior to March 20, 1991. The section states that it applies "to the extent provided in regulations," and we do not understand what it means to say that the section applies to periods before March 20 if no

---

[46] See Sheppard, L., IRS Implements Related Party Debt Acquisition Rule, Tax Notes Today, 91 TNT 70-3 (March 29, 1991).

regulation has been promulgated for that period.[47] Obviously, the Section applied by its terms, at the least in the sense that it authorized regulations, but what did it do in die absence of regulations?[48]

---

[47] 47 We do not believe the mere statement in the Regulation that Section 108(e)(4) applies to transactions after December 31, 1980 should be construed as a retroactive regulation that makes the section effective for earlier periods. The text suggests the Service is not relying on this approach, providing that "this regulation" is not effective before March 21, 1991.

[48] In Traylor v. Commissioner, TCM 1990-132, the Service asserted successfully that Section 108(e)(4) is self-executing. However, it is doubtful that the Court gave careful consideration to the issue. In Traylor, petitioner's children partially satisfied petitioner's debts in settlements with petitioner's creditors. The remaining debt was discharged. Petitioner's children were assigned a portion of the creditor's debt claims against petitioner. The Tax Court adopted the Service's assertion that petitioner realized COD income to the extent the debt was discharged, citing Sections 61 and 108(e)(4). The briefs filed by the Service and the petitioner demonstrate that the legal issue of whether Section 108(e)(4) ii self executing was never presented to the Tax Court. Because the Service raised the Section 108(e)(4) issue in its amended answer, not in the original pleadings, it bore the burden of proof on this issue. In its brief, the Service argued:

> for purposes of determining the income of a debtor from a discharge of indebtedness, when the outstanding debt is acquired from an unrelated party by a party related to the debtor, the debt is treated as having been acquired by the debtor, [citation omitted]. This rule is intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount. Accordingly, petitioners received a discharge of the indebtedness on the $611,113.50 which was assigned by their judgment creditors to their children.

Brief for Respondent at 122.

Petitioner did not discuss the merits of his case in his pro se (handwritten) brief. Instead, the petitioner asserted:

> This is not a trial to collect taxes purported by the Respondent. Rather, it is a cover up attempt by Respondent to bury illegal evidence by IRS in what is fast becoming a scandal in the Southern District of Indiana Federal Court System expanding into the Indiana Federal Bankruptcy and District Courts.

Petitioner's brief at 1.

The petitioner went on to claim various wrongdoings on the part of the Service attorney handling the litigation. These assertions were found to be "irrelevant, immaterial. . . spurious, scurrilous" and "scandalous" by the IRS in its reply brief. In his Answer to (Footnote Continued...)

We do not favor retroactive regulations, particularly where the regulations fairly might be characterized as legislative, rather than interpretative. If the Service determines to take the position that the substantive rules of Section 108(e)(4) did apply to periods prior to March 20, 1991, it would be more consistent with the statute for the Service to adopt a regulation that applies retroactively to December 31, 1980. Given the retroactivity of that regulation, it should be very liberal in allowing taxpayers to follow any approach that represented a reasonable interpretation of the statute. Compare Treas. Reg. § 1.1502-99(b), allowing taxpayers considerable latitude in applying Section 382 to consolidated groups before issuance of the consolidated Section 382 regulations. See also Treas. Reg. § 707-9(a)(2) (for transactions occurring before promulgation of the Section 707(a)(2) regulations, the determination of whether the transaction is a disguised sale is to be made on the basis of the statute and the legislative history).

(Footnote Continued...)
Respondent's Brief at 2, petitioner claimed that the Service lawyer "has been leading a charge against Petitioners since 1981 in an illegal and unethical manner for full reasons not yet fully know to

Petitioners." The petitioner contended that the "cover-up" and "scandal" purportedly furthered by the case involved civil, criminal, RICO, ERISA, and legal ethics violations involving, among other things, the Service attorney's purported aid to "mafia associates" and requested that the court find treble damages in his favor in the amount of $300 million.

One would hope the next time the question of the self-enforceability of Section 108(e)(4) comes before the Tax Court, it will have the benefit of a taxpayer's brief on the issue. One relevant case might be Alexander v. Commissioner, 95 T.C. No. 33 (1990), where the Service argued and the Tax Court agreed that Section 465(b)(3) was not effective in the absence of regulations, because Section 465(c)(3)(D) provided that Section 465(b)(3) "... shall apply only to the extent provided in regulations. ..." One point of difference may be that the word "only" does not appear in Section 108(e)(4).

Elements of the Regulation that could not have been anticipated should in no event be imposed retroactively. These elements would include the rule treating Debt as being acquired at fair market value, the rule treating New Debt as being issued for that amount, and generally the rules governing Indirect Acquisitions (including the deemed sale requirement).

5. Other Transactions

The Preamble states that the Treasury intends to issue additional Section 108(e)(4) regulations ("Additional Regulation") to prevent avoidance of COD in non-recognition transactions, including transactions described in Sections 332, 351, 368, 721 and 731. Those regulations will treat the acquisition of Debt by a debtor, or the assumption of Debt by a holder, in a non-recognition transaction as an acquisition of Debt followed by a separate deemed satisfaction of the Debt. To the extent Debt is acquired at a discount, the surviving entity would recognize COD. The Preamble states that these regulations, when published, will be effective for transactions after March 20, 1991.[49]

On May 16, the Treasury issued Notice 91-15,[50] which significantly limits the circumstance in which the Additional Regulation will be effective as of March 21, 1991. According to Notice 91-15, this effective date is intended to apply only if (i) the holder (or a predecessor of the holder) acquired the Debt, or became a related party of the Debtor, prior to the non-recognition transaction by reason of a transaction that would

---

[49] PLR 8933001 (Aug. 22, 1988) and PLR 9105042 (Feb. 1, 1991) illustrate the Service's current position that a debtor may realize COD in non-recognition transactions.

[50] 1991-22 I.R.B___.

constitute a Direct or Indirect Acquisition if the transaction had occurred on or after March 21, 1991, and (ii) the Debtor did not report COD as a result of the holder's acquisition of the Debt or becoming related to the Debtor.

Notice 91-15 provides that other than the above-described transactions, the Preamble and the Notice do not alter the current treatment of “transactions in which debtor and creditor interests are combined.” In addition, the Notice confirms that the transfer of partnership debt to a partnership in exchange for a partnership interest is not within the scope of the Preamble. We welcome this clarification.

The Preamble also states that the Treasury plans to issue regulations under Section 1502 applying the rule of Section 108(e)(4) to any transaction in which a debtor corporation and a Debt holder become members of the same consolidated group. It is not clear whether these regulations would apply where two corporations that are members of an affiliated group elect to file a consolidated return, or only where, as a result of a change in ownership, a new entity is brought within the group. Presumably, the reference to “transaction” is intended to limit the rule to the latter case.

These regulations could potentially apply to cases clearly outside of the scope of Section 108(e)(4). In particular, if a Debtor and a holder of its Debt are related parties within the meaning of Section 267 before becoming members of a consolidated group, their joining a consolidated group would not trigger the application of Section 108(e)(4). For example, if P has for years owned 79 percent of the stock of D, and owns debt of D with an adjusted issue price of $100 and value of $80, then apparently the rule would cause D to recognize $20 of COD if P

acquired an additional 1 percent of the stock of D. This result would not be achieved under Section 108(e)(4), because P and D were at all times related parties. We do not understand the justification for the proposed rule. At least to date, consolidation has not been viewed as an appropriate occasion for marking-to-market intra-group contracts.