REPORT #767

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED ORIGINAL ISSUE
DISCOUNT REGULATIONS

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Tax Report # 767

TAX SECTION
New York State Bar Association

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July 1, 1993

Margaret Richardson
Commissioner
Internal Revenue Service
1111 Constitution Ave. NW
Room 3000
Washington, D.C. 20224

Dear Commissioner Richardson:

Enclosed is a report of an ad hoc committee of the Tax Section dealing with proposed regulations relating to original issue discount. The report, which is in outline form, generally approves these proposed regulations as a major step forward in terms of simplification and clarification as compared with the 1986 set of proposed regulations. The report also suggests certain changes and clarifications.

The report is the product of an interactive process involving members of the Tax Section and representatives of the Internal Revenue Service and the Treasury Department. We believe this process has been particularly useful in developing the recommendations reflected in the report.

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We expect to submit additional comments on proposed regulations which are to be released in the near future dealing with contingent payment obligations. Please feel free to call with any comments or questions.

Yours truly,

Peter C. Canellos

cc: Leslie B. Samuels
Harry L. Gutman

enclosure

Tax Report # 767

REPORT ON PROPOSED ORIGINAL ISSUE DISCOUNT REGULATIONS

An *Ad Hoc* Committee of the Tax Section of the New York State Bar Association has reviewed the recently-issued proposed regulations relating to original issue discount ("OID") (FI-189-4, 1993-3 I.R.B. 21) (the "proposed regulations"). In general, the committee believes that the proposed regulations represent a substantial improvement upon the 1986 proposed regulations. The committee, however, has a number of specific comments and suggestions with respect to the proposed regulations as set forth below.[1]

I. Proposed Regulations Under Internal Revenue Code ("Code")§ 1271

A. Intention to Call Before Maturity Under Prop. Reg. §§ 1.1271-1(a)(1) and (2).

We find the exclusion from the "intention to call before maturity" rules for a debt instrument which is publicly offered a helpful rule. We assume the logic of the exclusion is based on the fact that there can be no hidden understandings with the public, particularly in light of disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. We believe the rule might be profitably extended to include private placements solicited with private placement memoranda distributed to more than 10 offerees. These memoranda are subject to the sanctions of securities laws under Section 12(2) of the Securities Act of 1933 Act or Rule 10b-5 under the Securities Exchange Act of 1934.

B. Short-term Obligations Under Prop. Reg. § 1.1271-1(b).

The short-term obligation rules should contain a cross-reference to Prop, Reg. § 1.1272-1(f) (the counting rules for determining if an obligation is "short term").

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[1] This report was prepared by Esta E. Stecher, Jodi J. Schwartz, David P. Hariton, Mary Kate Wold and Bernadino Pistillo, Jr. Helpful comments were received from Elliott Pisem, Michael Schler, John Corry, Richard L. Reinhold, Bruce Kayle, David S. Miller, James M. Peaslee, Loretta J. Finger, David W. Mayo, John Narducci and Peter C. Canellos.

II. Proposed Regulations Under Code § 1272

A. Elective Accrual Periods of Prop. Reg. § 1.1272-1(b).

1. The elective determination of accrual periods creates helpful flexibility and is consistent with the proposed regulations' "rough justice" approach. However, such flexibility raises a number of technical questions, described below.

a. Because more frequent compounding during a year will cause interest to accrue more nearly at an economic rate (lower accruals in the early part of the year and higher accruals in the later part of the year) and less frequent compounding will cause interest to accrue more nearly at a pro rata rate (the same accrual each day of the year), it is likely the issuer and each holder separately will elect the accrual period that yields the most favorable result in its respective case,[2] The resulting timing differences may lower government revenues.

For example, on a two year bond with an issue price of $90,000 and stated redemption price of $100,000, the first day's interest would be $12.9906 under daily compounding and $13.3379 under annual compounding, for a net difference of $0.3473. If initial holders elect daily accrual and the issuer elects annual accrual, the issuer will deduct more interest than the holders will report. At some point during the year, however, the daily portion of OID under daily compounding will exceed that under annual compounding, and if an initial holder sells to a new purchaser who elects annual compounding, timing and/or character distortions can occur.

b. i. It is not clear which accrual periods the issuer must use to report OID on Forms 1099-dD. The issuer likely will not be able to determine the accrual periods elected by the holders. Thus, the amount of OID reported by the issuer to the IRS and each holder and the amount of OID reported by each holder on its tax return will differ, impairing the efficiency of using computers and information returns to ensure full income reporting.

ii. In addition, in the case of a non-publicly offered debt instrument, it is not clear what number of accrual periods should be used in calculating the yield to maturity for purposes of the OID legend to be placed on such instrument.

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[2] Another potential problem is the opportunities these rules would present for a taxpayer to purchase and issue debt simultaneously and elect non-consistent accrual periods.

c. Elective accrual periods create a question under Code § 163(i) which defines an applicable high yield discount obligation by reference to the close of accrual periods ending more than five years after the obligation's issuance. Will the holder's or issuer's elected accrual period control, or will the default six-month accrual period of Code § 1272(a)(5) control?

d. In addition, elective accrual periods create questions for secondary holders. Examples include:

i. Adjusted issue price. Prop. Reg. § 1.1275-1(b) defines adjusted issue price to include the OID previously included in income by <u>any</u> holder. A secondary holder will have no means of determining this amount, since the amount will depend on the accrual periods selected by prior holders. As a technical matter, obligations in the secondary market will be non-fungible, since they will have different amounts of OID.

ii. Market discount. Different accrual periods for different holders will make it impossible to determine the revised issue price under Code § 1278(a)(4).

iii. Acquisition Premium. Different accrual periods for successive holders will make it impossible to determine the amount of OID included by all previous holders for purposes of determining acquisition premium under Code § 1272(a)(7)(B)(i)(II).

i. Possible Solutions. i. We believe that these problems could be remedied in a manner consistent with the “rough justice” approach of the proposed regulations if the regulations were to provide that the issuer could choose a single accrual period and that the issuer's choice of accrual period would be binding on the holders.

ii. Alternatively, if there is a perceived need to allow this flexibility to holders, the problems described in A.1.a and A.1.d, above, could be solved by allowing holders to select a single accrual period and requiring them to compute adjusted issue price and whether or not the obligation has market discount or acquisition premium by reference to such accrual period. If this approach is taken, the regulations will need to prescribe a rule in order to address the problems described in A. 1.b and A.1.c, above.

iii. We believe that the flexibility inherent in allowing the holder or issuer to select multiple accrual periods (other than an initial or final long or short accrual period) is

outweighed by the resulting complexity in applying virtually all of the mechanical rules of the proposed regulations.

B. Allocating Qualified Stated Interest ("QSI").

1. Accrued but unpaid QSI increases the adjusted issue price under Prop. Reg. § 1.1272-1(c)(1) solely for purposes of calculating OID for a particular accrual period. (In contrast under Prop. Reg. § 1.1275-1(b), the adjusted issue price is increased by previously accrued OID, which backs out QSI.) Prop. Reg. § 1.1272-1(c)(1) also should clarify that the adjusted issue price is only increased for purposes of calculating OID for that accrual period, i.e., once the accrued QSI is paid it is not included in adjusted issue price.

2. It would be helpful if the proposed regulations stated explicitly that cash basis holders are not required to include in income accrued but unpaid QSI.

C. Options, Acceleration, Deferral and Paydowns Under Prop. Reg. §§ 1.1272-1(d) and (j), examples (6) and (7).

1 The rule of Prop. Reg. § 1.1272-1(d)(3) that an increase or decrease in the yield of a debt instrument (regardless of market conditions) will cause the deemed exercise of an option to accelerate or defer payments may lead to anomalous results in certain circumstances. For example, assume that a ten year bond provides a yield of 9.5% when the market rate for comparable bonds is 10%, and that the holder has the option to put the bond to the issuer at the end of year one at an exercise price that would produce a 6% return. Assume further that the market rate on the issue date for comparable one year obligations is 5.5%. Based on all of the facts and circumstances as of the issue date, it is more likely than not that the option will be exercised, but under Prop. Reg. § 1.1272-1(d)(3), the option would not be treated as being exercised for purposes of determining the issuer's OID deductions, and the holder's OID inclusions, because the exercise of the option would not increase the holder's yield to maturity. One possible solution to this problem would be to incorporate the "more likely than not" standard of Prop. Reg. § 1.1272-1(d)(2)(i) into -1(d)(3). We recognize, however, that such a standard could lead to additional complexity in terms of the required analysis, additional uncertainty for taxpayers, and potential audit issues, and that a "bright-line" test might therefore be desirable.

2. The proposed regulations should clarify whether the special rule for determining if an obligation is a short-term obligation (Prop. Reg. § 1.1272-1(f)) overrides the general

option rule of Prop. Reg. § 1.1272-1(d)(3) for determining maturity. We believe it would not be appropriate to apply the general option rule in this context. If the option rule were to apply, an anti-avoidance rule would be necessary. Otherwise, for example, a 20-year debt instrument with a 10% yield and call option that allows the issuer to reduce its borrowing cost to 9.999% prior to the close of one year might be treated as a short-term obligation for which no OID accruals are required.

3. In cases where puts and calls are exercised (or not) where their non-exercise (or exercise) is presumed and subsequent adjustments are required under Prop. Reg. § 1.1272-1(d)(4)(i), the regulation provides that a reissuance is treated as occurring "solely for purposes of sections 1272 and 1273." In such a case, given that bond premium also can result, a cross-reference to Code § 171 would be helpful.

4. We are concerned that the rule of Prop. Reg. § 1.1272-1(d)(4)(ii) that a "change in circumstances" that accelerates a payment is treated as a prepayment yields anomalous results. For example, the partial redemption of a debt instrument at a premium generally gives rise to capital gain at the time of partial redemption under Code § 1271(a)(1). Prop. Reg. § 1.1272-1(j), example (6), inappropriately converts this to ordinary income or loss recognized over the life of the unredeemed portion of the debt instrument. Thus, in that example, the issuer pays the holder $55,000 to retire $50,000 of the outstanding $100,000 principal amount of an instrument with an adjusted issue price of $97,725. The payment is treated as a prepayment of principal under Prop. Reg. § 1.1272-1(d)(4)(ii). Shouldn't the payment be viewed, however, as redeeming $50,000 of debt with an adjusted issue price of $48,863 ($97,725/2), resulting in the holder recognizing $6,138 of capital gain ($55,000 - $48,863) at that time? Instead, the payment reduces the issue price of the unredeemed portion of the debt by $6,138 (from $48,863 to $42,725); this is reached in the example by subtracting $55,000 from $97,725 (the issue price of the entire debt instrument immediately prior to the partial redemption). The yield on the obligation does not change; therefore, a holder recognizes some gain as OID in the final accrual period in accordance with Prop. Reg. § 1.1272-1(c)(2). This treatment diverges from the equivalent case in which the issuer actually issues two separate $50,000 debt instruments, each for $48,863, and exercises an option, to redeem one of them for $55,000; both the timing of the holder's income inclusion and the characterization of that income have changed.

Consider the reverse situation: For example, if, in Prop. Reg. § 1.1272-1(j), example (6), instead of the issuer

having the right to call 50% of the principal amount of the debt instrument for $55,000, the holder had the right to put 50% of the principal amount of the debt instrument to the issuer for $35,000 on January 1, 1997, the option would be presumed not to be exercised under Prop. Reg. § 1.1272-1(d)(3) because it would lower the holder's yield. If interest rates changed and the holder in fact exercised the option, the payment would be treated as a prepayment, reducing the debt instrument's adjusted issue price to $62,725 ($97,725, the issue price of the entire debt instrument immediately prior to the partial redemption, minus $35,000). Shouldn't the payment be viewed, however, as redeeming $50,000 of debt with an adjusted issue price of $48,863 ($97,725/2), resulting in the holder recognizing $13,863 of capital loss ($48,863-$35,000) at that time? If the regulations retain the rule that treats the $35,000 as a prepayment the regulations should clarify the subsequent tax treatment of the debt instrument, i.e., should the holder continue to accrue OID on the debt instrument and how much OID should a holder accrue? Does the holder now have a premium bond? Once again, however, the timing and character of the holder's income will change.

In the more complex situation where a prepayment does not reduce each stated principal payment proportionately, the adjusted issue price of the bond would have to be allocated to the prepayment by discounting the principal payment satisfied under the terms of the bond at the yield to maturity of the bond. We would anticipate that market discount on such a prepayment would be allocated in a similar manner. Untaxed market discount allocable to a prepayment would be determined by allocating the untaxed market discount in proportion to the adjusted issue price of the portion prepaid.

5. Prop. Reg. § 1.1272-1(j), example (7), provides a helpful example of the tax treatment of pay-in-kind ("PIK") debt that is issued at a discount with the result that the option to make interest payments with "baby bonds" decreases the issuer's yield and the issuer is presumed to exercise its option to PIK. It would be helpful, though, to provide an example dealing with the most common case, PIK debt issued at par where the option to make interest payments in baby bonds does not affect the yield of the instrument, that specifies this debt is still issued with OID (because none of the payments would be QSI under Prop. Reg. § 1.1273-1(c)(1)) and explains the tax consequences if the PIK option is exercised. In addition, it would be helpful to provide an example where it is presumed the issuer of PIK debt will pay interest in cash (because that results in the lowest possible yield), and an issuer subsequently decides to issue a baby bond with a higher yield, rather than pay interest in cash. In that case, under Prop. Reg. § 1.1272-1(d)(4)(1), the issue price and

yield would be recomputed for the entire instrument causing the baby bond not to have a higher yield than the instrument itself. We agree with this result and believe it should be expressly set out in an example, since it is a basis for concluding that the bond and baby bonds are fungible in the marketplace.

D. Convertible and Exchangeable Obligations Under Prop. Reg. §§ 1.1272-1(e) and 1.1273-2(g).

1. In general we believe the proposed regulations reach the correct conclusion. Regarding exchangeable debt, however, is there any reason why debt that is exchangeable for debt of a related party is excluded from Prop. Reg. § 1.1272-1 (e) while it is included in Prop. Reg. § 1.1273-2(g)?

2. The regulations (or, an administrative pronouncement) should clarify what constitutes substantial authority and what is the substantive law for the period that the proposed regulations and the old contingent payment regulations (i.e., Prop. Reg. § 1.1275-4(g)) are both outstanding.

E. Special Basis Rule of Prop. Reg. § 1.1272-2(b)(6).

1. This special rule limits a partner's basis in a debt instrument acquired in exchange for other property. The example in Prop. Reg. § 1.1272-2(b)(6)(1) given is unclear, however, because it covers a distribution from a partnership subject to Code § 731. Very few distributions of debt instruments will be treated as exchanges of property under Code § 731. Does "subject to section 731" mean any distribution from a partnership, or only one in which the partner recognizes gain or loss? Why does the example refer to Code § 731, which does not determine a partner's basis, instead of Code § 732 which does? More explanation and a numerical example would be helpful.

F Election to Treat all Interest as OID Under Prop. Reg. § 1.1272-3.

1. We see no reason why this election should not be available to cash basis taxpayers.

III. Proposed Regulations Under Code § 1273

A. QSI Under Prop. Reg. § 1.1273-1(c).

1. The proposed regulations define QSI as interest payable at least annually at a fixed rate, but do not state on what amount. One possibility would be interest payable on the aggregate of the stated principal amount plus any accrued but

unpaid stated interest from prior accrual periods. The proposed regulations should also contain examples dealing with QSI after a prepayment and QSI on an installment obligation.

2. The proposed regulations should clarify that no special compounding rate is required in the case of a long initial or final interest accrual period. Thus, if an instrument provides for an initial long accrual period of seven months and thereafter accrual periods of six months, and interest for the first accrual period is 7/6 of interest for the remaining accrual periods, all interest should be QSI, notwithstanding that compounding based on a seven-month accrual period would require a slightly higher rate. This rule should be a general one and should apply regardless of whether the debt instrument otherwise has OID. The rule of Prop. Reg. § 1.1273-1(d)(5), under which a teaser rate might result in de minimis OID, should not apply.

3. The regulations should clarify that the rule of Prop. Reg. § 1.1273-1(d)(5) relating to interest holidays, teaser rates and other interest shortfalls, applies for purposes of both determining whether OID is de minimis and whether interest on the debt instrument is QSI. The rule should also clarify whether, in the case of a debt instrument that has OID as a result of an interest holiday or teaser rate, no portion of the stated interest may be QSI (as in the case of Prop. Reg. § 1.1273-1(f), example (3), paragraph (iii)). If in that example the first accrual period had been six months, would some portion of the stated interest be QSI under Prop. Reg. § 1.1273-1(c)?

4. The regulations should clarify that in the case of de minimis OID arising solely as a result of an interest holidays, teaser rates and other interest shortfalls (i.e., when debt is issued for its principal amount) no amount of de minimis OID has to be included in income as principal payments are made.

5. Prop. Reg. § 1.1273-1(c)(4) provides that no payments on a short-term debt instrument are QSI.

a. It is not entirely clear whether a cash-basis holder that receives a semi-annual interest payment must include it in income.[3] The regulations should clarify that such payments

[3] Prop. Reg. § 1.446-2(a)(1) provides a general rule that interest is generally taken into account under the taxpayer's usual method of accounting. Under this rule, fixed interest payments would be taxable to a cash basis holder when received. However, Prop. Reg. § 1.446-2(a)(2)(D) provides that the general rule "does not apply to interest that is taken into account under Sections 1281 through 1283 (discount on certain short-term obligations)". Under Prop. Reg. § 1.1275-2(a), however, each payment under a debt

should be included in income and whether the amount received or the amount of accrued OID on a constant yield basis should be included.

b. Under this rule, a cash-basis holder of a short-term obligation might be permitted to include a lesser amount in income as ordinary income upon the sale of the obligation. This is because QSI accrues on a straight-line basis while a holder may elect to accrue OID on a short-term obligation on a constant yield basis. Constant yield accrual provides for lower accruals in the early days of a short-term debt instrument than does straight-line inclusion. Because more frequent compounding widens the disparity between straight-line and constant yield accrual, the greatest disparity will occur in the case of daily compounding.

c. Finally, treating interest that would otherwise be QSI as OID may change the character of a cash-basis holder's loss on the sale of a debt instrument. Consider a one year note issued at $100 with face amount $100 and $10 interest payable at maturity. Assume an initial purchaser sells the note for $104 six months after issuance, when $5 of interest has accrued on a straight-line basis. If the note's interest is QSI and Treas. Reg. § 1.61-7(d) requires holders to recognize sales proceeds as ordinary income to the extent of accrued interest, the holder would recognize $5 of interest income and $1 capital loss (the difference between the amount realized as principal, $99, and the holder's basis, $100). However, under the proposed regulations the fixed interest would be OID and the holder would recognize interest income only to the extent of gain, or $4, under Code § 1271(a)(4).

d. It would be helpful if Prop. Reg. § 1.1273-1(c)(4) were to incorporate the language of the preamble which states that "the rule applies for purposes of sections 871 and 881."

B. Issue Price Under Prop. Reg. § 1.1273-2.

1. Definition of "Publicly Offered" Under Prop. Reg. § 1.1273-2(a)

a. It would be helpful to provide a specific definition of "substantial amount" (e.g., the lesser of 10% or $5 million). See, e.g., Prop. Reg. § 1.148-1(b). What happens if there is no single price at which a substantial amount is sold

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instrument, other than a payment of QSI, would first be treated as a payment of accrued OID.

(e.g., because debt is sold to the public over a period of time at a fluctuating price)?

b. The reference in Prop. Reg. § 1.1273-2(a)(2)(ii)(B) to sections 2 and 4 of the Securities Act of 1933 is obscure because those sections do not in general consider "the identity of the issuer or the nature of the security".

2. Issue Price of Private Placement Under Prop. Reg. § 1.1273-2(b)

a. In a private placement, the price paid by the first buyer determines the issue price for the entire issue. This may permit taxpayers to manipulate the amount of an instrument's OID by finding a single buyer to purchase a small amount of debt at an artificially high or low price.

b. We believe the rule applicable to public offerings (i.e., the first price at which a substantial amount of the issue is sold) should apply as well in the case of private placements. If this is not possible in light of the explicit statutory language of Code § 1273(b)(2), it would be appropriate for the regulations to include an anti-abuse rule to prevent manipulation of the issue price.

3. Issue Price of Debt Issued Under a Common Plan

a. The regulations should clarify that the issue price of debt instruments that are part of the same "issue", i.e., issued under a common plan, is the same. Thus, for example, if a portion of an issue of debt is "publicly offered" within the meaning of Prop. Reg. § 1.1273-2(a) because it is sold for cash in an offering intended for distribution to non-U.S. persons and a portion of the same issue is privately placed, the regulations should specify that, as long as a substantial portion (e.g., the lesser of 10% or $5 million) of the issue is "publicly offered", the issue price of the entire issue is determined under Prop. Reg. § 1.1273-2(a). Similarly, if a substantial portion (e.g., the lesser of 10% or $5 million) of an issue of debt is "publicly offered" and a portion is issued in exchange for property, the issue price of the entire issue should be determined under Prop. Reg. § 1.1273-2(a).

b. The definition of "issue" in Prop. Reg. § 1.1275-1(g) should be modified to clarify that, regardless of whether two obligations are, or are not, "publicly offered", they may be considered to be part of the same issue if they have the same credit and payment terms and are issued or sold contemporaneously pursuant to a common plan. Thus, it would be

helpful to clarify that an issue includes the substantially simultaneous issuance of debt with identical terms in different markets (i.e., internationally and domestically, publicly offered and privately placed, etc.). Moreover, where identical debt instruments are issued in two separate transactions to different holders (or groups of holders) for different consideration they should be part of a single issue. The notion of a "common plan of marketing" appears to be too narrow to insure that all such debt will have the same issue price.

4. Definition of "Publicly Traded" Under Prop. Reg. § 1.1273-2(c)

a. As a general proposition, we believe that property should not be treated as traded on an established securities market unless reliable information relating to recent sales transactions is readily available to issuers and holders. Thus, in our view, property is traded on an established securities market if it is described in Prop. Reg. § 1.1273-2(d)(1), (2)[4] or (3). With respect to Prop. Reg. § 1.1273-2(d)(4), while we agree that property appearing on a quotation medium on which recent sales transactions are reported should be treated as traded on an established securities market, we believe that property should not be so treated merely because a quotation medium contains recent price quotations of identified brokers or dealers for such property. This is because these prices are at best indicative; there can be no assurance that these prices actually reflect fair market value or that the quoted broker or dealer would actually be willing to purchase or sell the quoted property at such prices. Consistent with this view, we believe that Prop. Reg. § 1.1273-2(d)(5) should be deleted. In some respects, this rule is even more troubling than the rule of Prop. Reg. § 1.1273-2(d)(4) relating to price quotations because under -2(d)(5) the term "readily available" is not defined and it is not clear how a taxpayer would ever establish on audit that price quotations were (or were not) "readily available."

If, for some reason, the Internal Revenue Service (the "Service") believes that the rules of Code § 1274 for establishing issue price are not appropriate in the case of a debt instrument that itself is, or is issued for property that is, "quoted," we would suggest that the regulations prescribe a specific rule that the issue price of the debt instrument is determined on the basis of a yield equal to 150% of the applicable AFR for the debt instrument.

[4] We note, however, that the property listed on the Luxembourg Stock Exchange does not necessarily trade thereon. Prop. Reg. § 1.1273-2(d)(2) should require both actual trading (as well as listing) and the availability of a report of actual trading prices.

5 Treatment of Cash Payment Under Prop. Reg. § 1.1273-2(j). We believe that payments from the borrower to the lender for property (not just services) should not reduce issue price.

IV. Proposed Regulations Under Code § 1274

A. Issue Price of Debt Instruments Issued in Potentially Abusive Situations U.S. Under Prop. Reg. § 1.1274-2(b)(3).

Although the proposed regulations may be straightforward in the case of property that has recently been sold between unrelated parties for cash, in many of the other "potentially abusive" situations it may be very difficult to value the property involved and the stated (or, in proper cases, imputed) principal amount of the debt instrument may in fact serve as the best indicator of the value of the property. Accordingly, it may be appropriate for the regulations to provide that where the property received in a "potentially abusive" situation is not susceptible to ready valuation, one of the approaches utilized in either Reg. § 1.1274-2(b)(1) or (2), as appropriate, may be employed.

B. Treatment of Options as Exercised Under Prop. Reg. § 1.1274-2(c)(3).

In the case of options that are subject to contingencies affecting the right to exercise the option, the option should not be treated as exercised unless the contingency is more likely than not to occur.

Furthermore, under the option rule as written, a debt instrument subject to a call option will be presumed to be called if the "imputed principal amount" thereof assuming it is called is less than the "imputed principal amount" thereof assuming no call. (In each case, the imputed principal amount is computed using the appropriate AFR.) Thus, a debt instrument bearing interest at a rate in excess of the AFR will often be presumed to be called prior to maturity. For example, a debt instrument with a 7 year term callable after 5 years that bears interest at 8% when the AFR is 5% will be deemed to be called after 5 years because the imputed principal amount assuming such call ($1131.28 per $1000, with semiannual compounding) is less than the imputed principal amount assuming no call ($1195.82). The rule thus in effect treats the borrower as if it were able to borrow at the same rate as the federal government. This is an inappropriate result, particularly in the case of debt workouts where a

modification of the existing debt instrument results (under Prop. Reg. § 1.1001-3) in a deemed exchange of such instrument for a new instrument without substantially changed economic terms but which, due to the financial condition of the borrower, bears interest at a rate in excess of the AFR. By accelerating the retirement to the earlier optional call date, the proposed rule may result in faster accruals of OID than those anticipated by the parties and in the accrual of additional OID if the debt instrument were deemed called at a premium. The Code § 1274 option rule should perhaps be conformed with the Code § 1272 option rule, which employs a comparison of the yields that result if the instrument is called and if it is not called. In such case, a more specific rule could be crafted to address the abuse at which the current rule was aimed -- a long- or mid-term instrument bearing interest at a short-term rate designed so as to be deemed called under the Code § 1272 option rule within three years of issuance, thereby allowing the short-term AFR to be used to test for adequate stated interest under Code § 1274.

C. Variable Rate Debt Instruments Under Prop. Reg. § 1.1274-2(d)(1).

It would be helpful for taxpayers to be given some guidance regarding the meaning of "significantly less" and "reasonably symmetric" as used in Prop. Reg. § 1.1274-2(d)(1)(ii).

D. Contingent Payments Under Prop. Reg. § 1.1274-2(e).

Prop. Reg. § 1.1274-2(e) generally would treat the fair market value of a contingent payment obligation as the issue price of the obligation.[5] We think this significant departure from present law raises numerous problems of tax administration and compliance and we therefore suggest that the rule be rejected in favor of the approach contained in the 1986 proposed regulations, which generally provided that contingent payment obligations are disregarded until the obligation becomes fixed.[6]

Under the 1992 proposed regulations, (i) purchasers of property in contingent payment transactions will obtain immediate

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[5] The applicability of section 1274 assumes, of course, that neither the obligation nor the acquired property is considered publicly traded. Technical issues presented by the rule as drafted are discussed below

[6] See 1986 proposed regulations at §1.1274-4(f). Obviously, it will be necessary to synchronize the rules in the section 1274 setting with the overall approach that ultimately is taken in dealing with contingent payment obligations.

tax basis for the acquired property equal to the fair market value of the contingent payments, thus overruling Albany Car Wheel Co. v. Commissioner. 40 T.C. 831 (1963), aff'd per curiam, 333 F. 2d 653 (2d Cir. 1964), and (ii) sellers of property in such transactions will treat the fair market value of the obligation as an amount realized upon the sale.[7] It seems clear that, at least in many cases, it will not be possible to value contingent payment obligations subject to the proposed rule with any degree of certainty. In non-tax-motivated transactions, contingent payment obligations often depend on the future value of real property, corporate stock, unexploited technology or other assets. In such cases, the parties' inability to agree upon the value of the asset frequently prompts the use of a contingent payment obligation. In many circumstances, it would not be surprising if the amount ultimately payable under a contingent payment obligation were either 10 times or 1/10th of any estimate that the parties might make at the time of issuance.

Given the extreme difficulty of valuing many contingent payment obligations it is not surprising that the tax law generally avoids such questions where possible (a conspicuous exception is the estate tax setting where there is no second opportunity to address the transaction). We think that the proposed rule requiring such valuations may well (i) lead to aggressive valuations by non-compliant taxpayers (including tax shelter transactions relying on overvalued assets), (ii) produce reasonable concerns about the assertion of 20% or 40% accuracy-related penalties under section 6662 on the part of taxpayers who try in good faith to comply with the law, but whose estimates of value differ from those proffered by the IRS and (iii) result in significant audit activity and litigation for the IRS, with the IRS being disadvantaged by a lack of funds to hire expert witnesses as skilled and knowledgeable as those hired by taxpayers. A rule requiring consistent valuation of the contingent payments by purchaser and seller would obviously represent an improvement, but would still leave open opportunities for aggressive valuations where the parties' tax interest are not in conflict (e.g., where the acquired property is non-depreciable and non-amortizable). There is also the question of the Service's resources to audit and litigate successfully where parties take divergent views.

In light of the foregoing, we believe on balance that the "wait and see" method contained in § 1.1274-4(f) of the 1986 proposed regulations should be followed. Under that approach, the

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[7] Prop. Reg. §§ 1.1274-2(e)(1), 1.10112-l(g), 1.1001-1(g). In certain cases, sellers will qualify for deferred recognition of resulting gain under section 453.

inputed principle amount under Section 1274 is determined solely by reference to the noncontingent payments. This regulation has a cross-reference to § 1.1275-4 of the 1986 proposed regulations, which provides that "remote and incidental" contingencies may be disregarded by the IRS (but not the parties). If a "wait and see" approach is adopted, it may make sense to incorporate a beefed-up version of this anti-avoidance rule in the Section 1274 Regulations rather than awaiting the promulgation of new contingent payment regulations.

In the event that it is determined to retain the rule of Prop. Reg. §1.1274(e), we have the following technical comments:

The proposed regulations provide divergent results in the case of a contingent payment, the fair market value of which is significantly less than the present value of the maximum amount thereof, depending upon whether the contingent payment is denominated as principal or interest. This is because the proposed rule, in effect, defines the issue price as the lesser of (i) the maximum principal amount and (ii) the sum of (x) the present value (computed using the AFR) of all fixed payments and (y) the fair market value of all contingent payments. This formula can enormously increase the issue price as the result of a large contingent principal payment that is unlikely ever to be paid, as, for example, in the case where the AFR is lower than the interest rate provided for in the instrument.

The foregoing discussion can be illustrated with an example. Assume that a debt instrument is issued for property with a fair market value of $100, bears interest at 10% payable annually (at a time when the AFR is 7%), and has a contingent amount payable at maturity with a maximum amount payable of $50 but an initial fair market value of $2. Assume further that the fixed payments on the note have a value of $100 and the note therefore has a value of $102.

If there were no contingent payment provision, the issue price of the note would be $100 and the stated principal amount of the debt instrument would be $100. The imputed principal amount would exceed $100 (since the AFR is less than the stated interest rate), and the issue price would equal $100, the lesser of the stated principal amount and the imputed principal amount.

If the contingent payment is denominated as interest, the stated principal amount would be $100, and the imputed principal amount would be the present value of the noncontingent payments, discounted at the AFR (i.e., $121), plus the fair market value of the contingent payments as of the issue date ($2), for a total of $123. The issue price would be the lesser of

the stated principal amount and the imputed principal amount, or $100

However, if the contingent payment is denominated as principal, the stated principal amount of the debt instrument is the maximum amount of the contingent and noncontingent payments under the instrument (excluding stated interest), or $150. The imputed principal amount is the sum of the present values (using the AFR) of the noncontingent payments ($121) and the fair market value of the contingent payments ($2) as of the issue date, or $123. The issue price is the lesser of the stated principal amount ($150) and the imputed principal amount ($123). The designation of the contingent payment as principal has therefore increased the issue price of the instrument by $23 under the proposed regulations.

This is a counterintuitive result and represents a trap for the unwary taxpayer. One possible solution would be to define the issue price of any contingent payment instrument (whether contingent as to principal or interest) as the issue price of the fixed payment component of the instrument increased by the fair market value (as of the issue date) of any contingent payments to be made under the instrument. This would equalize the treatment for instruments that are contingent as to either principal or interest, would eliminate any ability to inflate artificially the issue price of an instrument, and finally would include the value of the contingent payments in the determination of the amount realized by a seller and the purchaser's cost basis in the asset acquired. In this context, it would also seem appropriate to require consistency between the purchaser and the seller in connection with the valuation of the contingent payments.

The proposed regulations also provide if it is not possible to determine the fair market value of the contingent payments separate from the noncontingent payments, the imputed principal amount of the debt instrument is its fair market value. In the context of a financially troubled taxpayer, this rule when applied in conjunction with Code § 108(e)(11) will prevent a taxpayer from being forced to recognize cancellation of indebtedness income at the time of a workout which would be offset by deductions in subsequent taxable years. Under the proposed regulations, the taxpayer may issue a contingent payment obligation whose fair market value equals the face amount of currently outstanding indebtedness and if subsequent events result in the actual payments on the instrument being less than its fair market value at the time of issuance, cancellation of indebtedness income will result at such later time. This seems to be a sensible rule. It would be important to clarify, in the context of the general effective date discussion of the

regulations, the extent to which this rule is to be treated as in effect immediately.

E. Interaction of Prop. Reg. §§ 1.1274-2 (e) and 1.1275-4.

Guidance should be provided (perhaps in the context of the general effective date discussion) as to the interrelation of the contingent payment rules contained in Prop. Reg. § 1.1274-2(e) and the existing proposed regulations governing contingent payments generally, given the fact the regulations governing contingent payments generally will presumably not be reissued and finalized until some time after the regulations under Code § 1274 have been finalized. At a minimum, it would appear that the current proposed regulations under Prop. Reg. § 1.1275-4 should be expressly repealed to the extent that they are inconsistent with final regulations under Prop. Reg. § 1.1274-2(e).

F. "Potentially Abusive" Situations Under Prop. Reg. § 1.1274-2(b)(3).

1. Given the impact of "potentially abusive" characterization, it would be helpful to have additional guidance regarding the breadth of the categories listed in the proposals. For example, what constitutes a "recent sales transaction"? (In the context of debt-for-debt exchanges, it would not seem necessary to rely upon the "potentially abusive" rules, given the scope of the rules regarding publicly traded debt. To provide otherwise would effectively result in the elimination of the ability to use the AFR as a safe harbor.) It should be clarified that "recent sales" applies to only the property transferred in exchange for a debt instrument, and not to an exchange of debt instruments. It would seem appropriate for the regulations to provide explicitly that an exchange of new debt of an issuer for outstanding debt of the same issuer is not a "potentially abusive situation," even if the outstanding debt had recently been sold. Is it relevant whether the issuer and/or holder know of the recent sales transaction? How is the "useful life of the property" to be determined in the case of improved real estate where significant value is attributable to the underlying land or in the case of a blanket financing of an operating facility? What is the proper treatment of property that is partly recourse and partly nonrecourse financed, and does this affect the necessity for, or amount of, a substantial down payment?

2. The regulations, perhaps, should make explicit that there are no collateral consequences to characterization of an instrument under Reg. § 1.1274-3(b)(3) as having "clearly excessive" interest, for example, under the contingent interest rules.

G. Test Rate Definition Under Prop. Reg. § 1.1274-4.

1 It would be helpful to have rules addressing the possibility of debt instruments denominated in more than one currency.

2 Under the proposed regulation, it will not be possible to determine the exact weighted average maturity of a floating rate debt instrument that does not provide for QSI. It might be appropriate for the regulations to establish a presumption under these, presumably limited, circumstances that the stated term of an instrument would govern for purposes of determining the AFR.

H. Assumptions of Debt Instruments Under Prop. Reg. § 1.1274-5.

1. In the event of the assumption of a debt instrument in connection with a property sale, the proposed regulations will provide taxpayers with flexibility in structuring debt assumption transactions.

V. Comments on Proposed Regulations Under Code § 1275

A. Prop. Reg. § 1.1275-1.

1. It would be helpful to clarify the issue date of PIK debt. The issue date of PIK debt, presumably relates back to the date of original issue even if the "interest bonds" are more substantial than the initial bond.

B. Prop. Reg. § 1.1275-2.

1. We think it is important to clarify the relationship between the "payment ordering mile" of Prop. Reg. § 1.1275-2(a), the Code § 1001 proposed regulations, and Revenue Ruling 89-122. For example, paydowns and prepayments requiring holder consent generally result in deemed exchanges under the Code § 1001 proposed regulations if the resulting yield changes by more than 25 basis points.

C. Prop. Reg. § 1.1275-3.

1. For purposes of the legending rule, we think that a debt instrument should be treated as "publicly offered" if it is part of an issue described in Prop. Reg. § 1.1273-2(a)(2)(i) and (ii)(A) and (c), or if it would be required to be registered but

for the fact that it is not a security for purposes of the Securities Act of 1933.

We think that the definition of “publicly offered” in Reg. § 1.1275-3 should be conformed to refer to debt instruments which are part of an issue which is publicly offered, with the exception that no Form 8281 should be required in the case of an issue described in Prop. Reg. § 1.1273-2(a)(ii)(C) unless some portion of the issue is sold in the United States. Moreover, under the current rules, Form 8281 is required to be filed where OID debt securities are publicly offered. A problem arises where such securities are privately placed at the outset and later distributed in a public offering. Issuers are not required to file Form 8281 as a result of the initial sale or the later distribution and consequently the needed information never finds its way into IRS Publication 1212. It would seem sensible to require filing of Form 8281 if the issuer participates in a later public offering, such as by filing a registration statement.

2. If publicly offered debt is not required to be legended, consideration should be given to modification of legending rules for publicly offered REMIC regular interests, currently subject to legending requirements in Treas. Reg. § 1.6049-7(g).

3. Under Prop. Reg. § 1.1275-3(b)(ii) the issuer can, in lieu of legending the security to reflect issue price, OID and yield, provide the name and address or telephone number of a representative of the issuer who will make that information available. There is no explicit requirement to respond to inquiries, keep the line available, etc.

D. Prop. Reg. § 1.1275-5.

1. Prop. Reg. § 1.1275-5(a)(2) provides that for a debt instrument to qualify as a variable rate debt instrument, the debt instrument must provide for total noncontingent principal payments that are at least equal to the debt instrument's issue price. As a result, for example, a debt instrument issued at a premium would not qualify as a variable rate debt instrument because the total noncontingent principal payments would be less than the debt instrument's issue price. There appears to be no reason for such a debt instrument to be treated as a contingent debt instrument, subject to the rules in Prop. Reg. § 1.1275-4. Accordingly, the regulations should provide that for a debt instrument to qualify as a variable rate debt instrument, the debt instrument must provide for total noncontingent principal payments that are at least equal to the

debt instrument's initial principal amount rather than the debt instrument's issue price.

2. As a general proposition, we think that the term "variable rate debt instruments" should include all debt obligations that bear interest based upon one or more formulae tied to the cost of funds or actively traded property, including stock, providing that there is not front- or back-end loading of interest. Therefore, the definition of a "qualified floating rate" should be clarified to include any rate expected to measure variations in the cost of funds in any currency, by any issuer and for any period of time, regardless of the facts and circumstances of the actual borrowing. Thus, 5-year Deutschemark LIBOR should be a "qualified floating rate" notwithstanding that the borrowing is a three year borrowing in U.S. dollars and that the issuer's credit would not warrant a risk-free rate of interest. (There should be exclusion for rates in hyperinflationary currencies.) Where a rate does not measure the cost of the funds borrowed by the issuer, it would be reasonable to require that the rate be based on publicly available indices or quotations. It should be clear, however, that a rate which measures the cost of funds is a qualified floating rate regardless of whether it is generally used in connection with borrowings, i.e., a publicly quoted swap rate (e.g., a rate quoted on the Reuters screens that is used to determine the proper pricing of, or the amount of payments to be made under, an interest rate swap, a cross-currency interest rate swap, or a yield curve swap) should be a qualified floating rate. The definition of an objective rate should clearly include formulae which are based on algebraic combinations of qualified floating or objective rates (e.g. (RATE A x RATE B) - RATE C), as well as the combination of a fixed rate plus one or more objective rates (e.g., 200 basis points plus RATE A). The reference to Code § 1092(d)(1) in the definition of an "objective rate" should be clarified to explicitly carve out the exception contained in Code § 1092(d)(3).

3. Prop. Reg. § 1.1275-5(a)(3)(ii) only allows a "single qualified floating rate followed by a second qualified floating rate." Typical revolving bank debt allows the borrower to elect to switch from time to time between LIBOR-based rates, CD-based rates and prime-based rates. Such an instrument should constitute a variable rate debt instrument. Moreover, instruments that go from qualified floating to objective rates and fixed to objective rates should constitute variable rate debt instruments.

4. The regulations should provide a safe harbor or presumption as to what may constitute "significantly more" and "significantly less" under Prop. Reg. §§ 1.1275-5(b)(2) and

(c)(2) so that issuers and holders can have certainty calculating the amount of OID for debt instruments subject to restrictions on the stated rate of interest (i.e., maximum or minimum numerical interest rate limitations).

5. Prior to the issuance of the proposed regulations, Internal Revenue Service officials stated that they were considering the expansion of the scope of the rules regarding variable rate debt instruments in the 1986 proposed regulations to encompass reset notes (i.e., notes which provide that interest on such notes may be reset on a prescribed date or dates to a market rate of interest so that such note will trade at par). It is unclear whether the proposed regulations would treat a rate determined under a reset mechanism as a qualified floating rate or an objective rate. It would be helpful if the proposed regulations stated that reset notes or auction rate notes qualify as variable rate debt instruments (i.e., that such a mechanism is intended to measure variations in cost of funds), perhaps by way of an example under Prop. Reg. § 1.1275-5(d).

6. Because of the possible difficulty in applying the proposed "accelerated" and "deferred" interest rules to instruments where multiple formulas are used, i.e., where interest is paid based on more than two qualified floating rates) or where the formula is based upon an objective rate which can be expected to back-end interest (i.e., a fixed percentage of the S&P Index), the rules should be expanded to contain a more generalized front- ending or back-ending of interest restriction.

7. There should be a safe harbor or presumption as to what may constitute a "reasonable substitute" under Prop. Reg. § 1.1275-5(f)(1)(i) so that issuers and holders can have certainty calculating the amount of OID for debt instruments described in that section.

8. The intended impact of the rule in Prop. Reg. § 1.1275-5(c)(2)(ii) for holders of tax-exempt instruments should be clarified.

VI. Proposed Regulations Under Code § 1001

A. Amount Realized Under Prop. Reg. § 1.1001-1(g)

1. The regulations should clarify that the issue price equals amount realized rule governs in the case of an installment

instrument for which the taxpayer elects out of Code § 453. See Reg. § 1.453-1(d)(2).[8]

2. The regulations should also clarify that in the case of debt the issue price of which is not determined under Code § 1274, issue price in excess of face amount is included in amount realized and basis.

VII. Effective Dates

A. Debt Instruments Issued Prior to December 22, 1992.

For the reasons more fully set out in our December 31, 1992 letter to you, we believe that the Service should clarify the taxpayers were entitled to rely on the 1986 proposed OID regulations in determining the substantive tax consequences of transactions entered into between the issuance of the 1986 proposed regulations and December 21, 1992 (the day before the new proposed regulations were published in the Federal Register). The 1986 proposed regulations were proposed to be effective retroactively, were in effect for more than 6 years and taxpayers reasonably relied on them in determining the consequences of their business transactions and in reporting their taxable income.

B. Debt Instruments Issued On or After December 22, 1992.

We believe that the Service should clarify the taxpayers are entitled to rely on the proposed regulations for transactions entered into on or after December 22, 1992, the date on which the current proposed regulations were published in the Federal Register and before the regulations are finalized. Alternatively, when the regulations are finalized, the Service should clarify that taxpayers may rely on the final regulations retroactively.[9] We do not believe it is in the interest of either taxpayers or the Internal Revenue Service to have a "gap period" for which no set of regulations applies.

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[8] We note that in the context of debt with an issue price determined under Code § 1274 that some concern exists as to whether there is statutory authority for the amount realized equals issue price requirement. The committee believes, however, that such a rule reaches the right result and is consistent with Congressional intent in the enactment of Code § 1274.

[9] There is considerable authority for such a step, e.g., the section 884 final regulations (September 11, 1992), the regulations interpreting the dual resident corporation provisions of section 1503(d) (September 9, 1992), the section 367(e) final regulations (January 25, 1993), and final foreign tax credit regulations interpreting section 901 (October 12, 1983).