REPORT #798

TAX SECTION

New York State Bar Association

REPORT ON THE FINAL ORIGINAL ISSUE DISCOUNT REGULATIONS

August 5, 1994

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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Report on Final OID Regulations

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section on the original issue discount regulations that were finalized this past January. The Report commends the Treasury Department and the Internal Revenue Service for developing an effective, streamlined set of rules setting forth a practical and logical treatment of debt instruments issued at a discount.

The Report goes on to make a number of suggestions for modification and clarification of the final regulations. Some of the suggestions relate to provisions of the final regulations that were not contained in the previously proposed regulations, and other suggestions are based on experience that we have had in working with the final regulations.

Please let me know if we can be of further help in connection with these regulations.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Glen Kohl

Tax Report #798

NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON THE FINAL ORIGINAL ISSUE DISCOUNT REGULATIONS

August 5, 1994

Introduction

This report on the original issue discount ("OID") regulations deals with the regulations that were issued in final form on January 27, 1994 (the "Final Regulations").[1/] The regulations were originally issued in proposed form in 1986, and in re-proposed form in 1992. We previously commented on the proposed and re-proposed regulations.

We again commend the Treasury Department and the Internal Revenue Service (the "Service") for developing an effective, streamlined set of rules setting forth a practical and logical treatment of most debt instruments issued at a discount or providing for variable payments. We also commend the Treasury Department and the Service for their responsiveness to prior taxpayer comments, and in particular for the expansion of the definition of a variable rate debt instrument (a "VRDI"). We are hopeful that the revised and expanded VRDI treatment provided by the Final Regulations will ease the burden of developing an effective set of rules under Prop. Reg. § 1.1275-4 to deal with the treatment of contingent debt instruments generally. Finally, we commend the Service for providing a table of contents. The table will have considerable practical value in terms of taxpayer accessibility and compliance.

[1/] This report was prepared by David Hariton, Bruce Kayle and Michael Schler. David Hariton was the principal draftsman. Helpful comments were received from Andrew Berg, John Corry, Elliot Pisem, Yaron Reich and Richard Reinhold.

Specific Comments

1. Reg. § 1.1272-1: Elective Accrual Periods and Issuer Reporting. The preamble to the Final Regulations states that until further guidance on reporting is issued, an issuer should use the same length accrual periods for Form 1099 reporting purposes as it uses for computing its own OID deductions. We urge that this rule be incorporated in the Final Regulations. An issuer will generally report interest deductions based on an accrual period which corresponds to the interval between interest payments (a six-month accrual period in many cases), because this will accelerate the issuer's interest deductions to the maximum extent.[2/] Thus, the proposed reporting rule will accelerate income inclusions for holders to the maximum extent. The rule should be expressly required, therefore, in view of the fact that some holders may object.

We do think the proposed reporting rule is the right approach. We observe that, as a technical matter, the issuer's deductions for OID are, under Section 163(e) of the Internal Revenue Code, supposed to follow the holder's inclusions. Obviously, however, an issuer cannot deduct OID on the basis of the accrual periods individually selected by each of thousands of holders. The practical solution is to require the issuer to deduct OID in a manner that is consistent with how it reports OID

[2/] The aggregate OID allocated to the interval between two interest payment dates is the same regardless of the length of the accrual periods contained within that interval. However, if that interval is a single accrual period, such aggregate OID is deducted pro-rata over the period, while if there is more than one accrual period in that interval, such aggregate OID is deducted in proportion to the upwardly accreting issue price arising from the prior periods within the interval.

income to holders. Put the other way around, the practical solution is to require the issuer to report on Form 1099 in a manner that is consistent with the accrual periods which it adopts on its own return. We do note, however, that not requiring issuers and holders to use the same accrual period may result in some minor loss of revenue and complicate the Service's information matching program, because some holders may choose to adopt daily accrual periods notwithstanding that the issuer reports and deducts on the basis of six-month accrual periods.

2. Reg. § 1.1272-1(c)(1) through (4): Instruments Subject to Contingencies. The Final Regulations set out a new rule to determine the yield on certain debt instruments with alternative specified payment schedules that will occur in the event of specified contingencies. Under the rule, OID accrues based on the stated payment schedule if that schedule is more likely than not to occur. Otherwise, OID accrues based on the payment schedule that is most likely to occur.

We recognize that this rule was provided in response to previous taxpayer comments and that it will produce a sensible outcome in many cases. Moreover, we believe that this rule will be useful in cases where contingencies that are not initially expected to occur give rise to alternative payment schedules.

At a minimum, however, it will be necessary to integrate this rule with final regulations on contingent payments issued under Section 1275 of the Code. Suppose, for example, that Reg. § 1.1275-4 ultimately provides for the accrual of interest, at some specified rate, on the issue price of a zero-coupon bond providing for either no payment or a large payment at maturity, depending on a contingency. Under Reg. § 1.1272-1(c), either no

interest at all would accrue prior to maturity (if no additional payment at maturity was the more likely result), or interest would accrue at an above-market rate (if payment at maturity was the more likely result). The final regulations under Section 1275 should contain specific rules for integrating Reg. § 1.1272-1(c) with Reg. § 1.1275-4 and one or more examples applying these integration rules.

Moreover, until final regulations under Reg. § 1.1275-4 are issued, we believe the Service should consider limiting application of the rule to cases where there is one payment schedule that is more likely than not to occur. One reason for this suggestion can be illustrated with the following example. Suppose a bond provides for 10 alternative payment schedules: a small payment is provided for under the stated payment schedule, which is 11% likely to occur; a much larger payment is provided for under the remaining nine payment schedules, each of which has a 9.9% likelihood of occurring, or an 89% likelihood of occurring in the aggregate. Under the rule as currently drafted, interest apparently accrues assuming a small payment, because the stated payment schedule is the most likely to occur.

A second reason for our proposed limitation of application of the rule is that payments under alternative payment schedules are likely to coincide to some extent. Under the rule as currently drafted, it is not clear what the most likely payment schedule is under these circumstances. Suppose, for example, that some minimum amount is certain to be paid under five or six of the alternative payment schedules. Would the minimum amounts themselves constitute an alternative payment schedule? Any reasonable answer to questions such as this is likely to prove complex when applied to specific cases.

3. Reg. § 1.1272-1(c)(5): Treatment of Certain Options. The Final Regulations continue to provide, as an exception to the general ("more likely than not") rule for certain contingencies contained in Reg. § 1.1272-1(c)(1), that a put (call) is to be treated as exercised only if the exercise would increase (decrease) the yield to maturity. As discussed in our report on the 1992 proposed regulations, this "bright line" test for options has the virtue of simplicity and certainty, but it can produce anomalous results because it ignores market conditions (such as the yield curve).[3/]

Prop. Reg. § 1.305—5(b)(3), which was issued on June 21, 1994 and addresses the treatment of callable preferred stock, generally adopts the principles of the OID rules contained in Reg. § 1.1272-1(c). However, the proposed regulation sets out a "more likely than not" test as the general rule for an issuer's call option, and further provides that a call of debt held by an unrelated holder will never be deemed exercised unless it either decreases the yield to maturity or there are arrangements effectively requiring it to be exercised.

We recognize that some of the policy considerations underlying the proposed section 305 regulations differ from those underlying the OID rules (such as the need to prevent deemed dividends that will not in fact be paid but nevertheless are eligible for the dividends received deduction and increase tax basis). Also, the Service may be less concerned about uneconomic

[3/] For example, suppose one-year interest rates are 6%, ten-year rates are 8%, and a ten year zero-coupon bond with a yield to maturity of 7% is puttable after one year with a resulting yield of 6% (or 6.9%). Since the put reduces the holder's yield to maturity it is assumed not to be exercised, even though exercise is in fact very likely.

results of the option rules for debt because it can prevent taxpayer manipulation of those rules by invoking the anti-abuse rule under Reg. § 1.1275-2T(g). Nonetheless, in light of the approach taken in the proposed section 305 regulations, further consideration might be given to whether more flexibility should be provided for puttable or callable debt instruments, e.g., changing the existing automatic put/call rule in Reg. § 1.1272-1(c)(5) into a presumption of exercise or non-exercise, with the taxpayer entitled to overcome the presumption with a showing that the presumed result was highly unlikely to occur. We would expect the issuer-holder consistency requirement of Reg. § 1.1272-1(c)(4) to apply to such a rule. Such a rule would, on the one hand, reduce the simplicity and certainty of the existing regulation but would, on the other hand, reduce the number of situations where a taxpayer would be required or permitted to accrue OID on a non-economic basis.

4. Reg. § 1.1272-1(f): Definition of a Short-term Debt Obligation. We believe this section, which further defines a short-term debt obligation, also belongs in Reg. § 1.1271-1, further clarifying Sections 1271(a)(3)(B) and (a)(4)(B) of the Internal Revenue Code. Its absence there has been a minor source of confusion (i.e., only the initiated know to look for the definition under Section 1272).

5. Reg. § 1.1273-1(c): Definition of Qualified Stated Interest. Qualified stated interest is defined under this regulation as stated interest that is unconditionally payable in cash or property, and interest is only “unconditionally payable” for this purpose if late payment is expected to be penalized or is subject to remedies to compel payment. In an asset-backed securities transaction, an entity holds debt obligations

(the “underlying collateral”) and issues debt and equity interests, and payments on the debt interests are limited to cash received by the issuer on the underlying collateral. It is common in these transactions for late payments or non-payments of interest not to be penalized (and for no remedies to exist to compel payment) if the reason for such late or non-payment is that interest has not been received by the issuer on the underlying collateral. It would unnecessarily complicate tax-reporting if OID were considered to arise in these transactions.

In light of the above, the definition of qualified stated interest should be clarified to assure that a security has qualified stated interest (assuming all other requirements are met) if substantially all the payments made on the security are derived by the issuer from debt obligations paying qualified stated interest and the issuer is obligated to pass through interest payments to the extent received on the underlying obligations. This rule would be consistent with and analogous to the rule in Code Section 871(h)(4)(C)(iii), under which the “contingent interest” exception to portfolio interest does not apply to interest whose amount is determined by reference to any other amount of non-contingent interest. Thus, the interest in question would not be contingent for purposes of Section 871(h), and should likewise be qualified stated interest for purposes of the OID rules.

6. Reg. § 1.1273-2(a)(1): Definition of Issue Price and De Minimis OID. When debt is publicly offered, an issuer will not expect the debt to have OID if the amount paid for the debt by the underwriters exceeds the lowest price at which the debt could be sold to the public without creating non-de-minimis OID (“the OID de minimis price”). While unlikely, there can be no

assurance that the debt will not ultimately be sold for less than the OID de minimis price as a result of intervening changes in market prices. It would not be practical for the issuer to prepare and distribute disclosure documents after the instruments were sold. Moreover, it would greatly complicate issuing documents for debt if every debt instrument not expected to be issued with OID was nevertheless required to have complex OID disclosure because of a remote chance that the instrument might ultimately have non-de-minimis OID.

In light of the above, consideration should be given to a safe harbor under which, solely for purposes of determining that the instrument has no OID or de minimis OID, the issue price of the instrument will not be less than the amount paid for the debt by the underwriters. A holder paying less than the OID de minimis price would still be subject to the market discount rules. This rule would only be available where underwriters intend to distribute the instrument within a reasonable period of time. While this rule would not literally be consistent with the statutory definition of issue price, we believe that providing such a rule would be an appropriate exercise of regulatory authority under Section 1275(d). Cf. comment 1. above, dealing with rules which permit holders to adopt daily accrual periods, and which permit issuers to accrue more interest than holders; these rules of convenience are likewise not literally consistent with the relevant statutes.

7. Reg. § 1.1275-5(a)(2): VRDIs Issued at a Premium. The Final Regulations appear to have adopted taxpayer recommendations that VRDI treatment be extended to debt instruments issued at a premium. The amount of the premium may not exceed 15% of the total non-contingent payments, and we

understand that this limitation is designed to distinguish between debt instruments issued at a premium and contingent installment obligations which might be dealt with under Reg. § 1.1275-4.

The Final Regulations contain a further limitation, however, that the premium not exceed 1.5% of the total non-contingent payments multiplied by the number of complete years to maturity (times the total non-contingent payments). This further limitation seems unduly confining and effectively limits any meaningful extension of VRDI treatment to long-term premium bonds. A three-year debt instrument, or even a one-year debt instrument, issued for $115 and promising at least $100 at maturity is not in the nature of a contingent installment obligation. Under the further limitation, however, the issue price could not exceed $104.50 in the case of a three-year instrument, or $101.50 in the case of a one-year instrument.

In any event, we do not see the need for either a 15% aggregate limitation or a 1.5% annual limitation. The simplicity afforded by VRDI treatment is to the mutual advantage of the Commissioner and the taxpayer. In the case of an instrument providing for interest at a single qualified floating or objective rate and not designed to produce any front or back-loading of interest, we are aware of no abuse which could come of applying VRDI treatment. As discussed in our prior reports, amortization of the amount paid or received for such an instrument over the life of the instrument in reduction of the interest otherwise accruing under the VRDI rules is the simplest and most logical means of dealing with the instrument. We therefore recommend, in connection with the impending revision of Reg. § 1.1275-4, that the VRDI rules be expanded to encompass any

debt instrument issued at a premium which otherwise meets the requirements of Reg. § 1.1275-5.

Taxpayers are also in need of collateral guidance concerning amortization of acquisition premium on a VRDI, which should be forthcoming for the issuer under Reg. § 1.61-12(c), and for the holder in regulations under Section 171 of the Internal Revenue Code. Issuers and holders generally amortize acquisition premium on a yield-to-maturity basis over the life of the obligation. For this purpose, taxpayers should probably be directed to proceed under a so-called snapshot approach, i.e., as though the relevant variable or objective rate were fixed on the date of issuance at its value as of that date and construct on that basis an amortization schedule to be used regardless of what the variable or objective rate payments actually turn out to be. Cf. Reg. § 1.1275-5(e)(3), providing for the accrual of OID on a VRDI based on fixed-rate equivalents.

8. Reg. § 1.1275-5(a)(3)(ii): Initial Fixed Rates on Variable Rate Instruments. This section contains a safe harbor which treats an initial fixed rate followed by a single qualified floating rate or objective rate as a single qualified floating rate or a single objective rate if the value of the variable rate on the closing date is within 25 basis points of the fixed rate. We believe this safe harbor is very helpful. Because the safe harbor refers to the value of the variable rate on the issue date, however, the safe harbor may not be available for many public offerings of debt securities where the pricing date occurs prior to the issue date. Although the securities will be issued on the terms fixed on the pricing date, a movement in the relevant index between the pricing date and the issue date can cause the value of the initial fixed rate, which may have been

within 25 basis points of the value of the variable rate on the pricing date, to differ from the value of the variable rate by more than 25 basis points on the issue date. For example, if an instrument provides for a rate of 6% for the first month and LIBOR thereafter, the existing safe harbor would not apply if LIBOR were 5.80% on the pricing date but 5.74% on the issue date. Accordingly, we recommend that the safe harbor apply as of the pricing date if the pricing date precedes the issue date and the instrument is issued with terms that are established on the pricing date.

9. Reg. § 1.1275-5(b)(1): Definition of Qualified Floating Rate. It would be helpful to clarify that certain formulas or mechanisms for determining the amount of interest to be paid on a debt instrument which are not interest “rates” per se are nevertheless “qualified floating rates” because they can reasonably be expected to measure current values in the cost of funds. The principal example is the periodic dutch auction, under which holders bid to acquire or retain outstanding debt instruments based on the holders' minimum required rates of return for the next succeeding interest period. The resulting rate for each interest period is by definition the arm's length market rate of interest for current funds. Cf. Notice 88-27, 1988-1 C.B. 496, establishing that such an instrument is not subject to the contingent payment rules of Reg. § 1.1275-4. It also would be helpful to clarify that the 25 basis point presumption in Reg. § 1.1275-5(b)(1) for treating two or more qualified floating rates as a single qualified floating rate may be applied as of the pricing date of an instrument rather than as of the issue date.

10. Reg. § 1.1275-5(c)(1): Definition of Objective Rate. Further guidance is requested as to the meaning of “based on one or more qualified floating rates”. Apparently this includes, for example, a fixed rate minus a qualified floating rate (otherwise, there would no such thing as “an objective rate that is a qualified inverse floating rate”); this would not have been apparent, however, in the absence of specific guidance.

11. Reg. § 1.446-2(e): Payment Ordering Rule. Under this regulation, every payment under a debt instrument is treated first as a payment of interest to the extent of any accrued but unpaid interest and then as a payment of principal. We recommend that this payment ordering rule not apply to a payment which cancels a debt instrument in its entirety. Under limited case law dealing with accrued interest on par bonds, a payment in cancellation of a bond with accrued but unpaid interest is apparently treated first as a payment of principal.[4/] In effect, to the extent the final payment is less than the aggregate of the principal balance and accrued interest, the holder reverses the inclusion of accrued but unpaid interest.[5/] Application of the payment ordering rule in the regulations to these cases would force lenders to treat accrued interest as fully paid and thus to permanently accrue income that was never received, with any shortfall being allocated entirely to principal and allowed only as a capital loss on the bond.[6/]

[4/] Drier v. Helvering, 72 F.2d 76 (D.C. Cir. 1934); Manhattan Mutual Life Ins. Co. v. Comm'r, 37 BTA 1041 (1938); Manufacturer's Life Ins. Co. v. Comm'r, 43 BTA 867 (1941); Newhouse v. Comm'r, 59 TC 783 (1973); Lackey v. Comm'r, 1977-213 T.C. Mem.; PLR 8821018 (municipal bond).

[5/] See Rev. Rul. 80-361, 1980-2 C.B. 164 (accrued but unpaid interest eligible for Section 166 bad debt deduction).

[6/] It would also cause non-U.S. holders of debt to be subject to withholding tax on non-portfolio interest that was economically a return of principal.

It would also permit the obligor on the instrument to deduct accrued but unpaid interest and recognize offsetting forgiveness of indebtedness income, which would be a favorable result if Section 108 applied to eliminate the latter.[7/]

[7/] If this suggested revision to the Section 446 regulation is adopted, it would be logical to make a conforming change to Reg. § 1.1275-2(a), thereby creating another exception to that "OID first" rule for a payment canceling an OID obligation in its entirety. Such a change would have less significance to issuers and holders, however. Regardless of the characterization of such a payment as "principal" or accrued OID, the holder would seem to have a capital loss (because its basis was increased by the OID accrual) and the issuer would seem to have forgiveness of indebtedness income based on the adjusted issue price of the debt. Nevertheless, if the debt is held by a non-U.S. person, and accrued OID on the debt is subject to withholding tax, the suggested rule would avoid withholding tax on payments that are economically a return of capital.