NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON AMBIGUITIES AND UNCERTAINTIES IN THE ORIGINAL ISSUE DISCOUNT REGULATIONS

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Report No. 1212

New York State Bar Association Tax Section

Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations[1]

I. Introduction

Sections 1271 through 1275 of the Internal Revenue Code[2] and the regulations thereunder set forth rules (the "OID regulations" or "OID rules") governing the inclusion and deduction of original issue discount ("OID") that accrues on certain debt instruments. The OID regulations were issued in 1994[3] (other than the contingent debt and integration regulations which were issued in 1996).[4]

While we agree with the general approach of the OID regulations, we have encountered in our collective years of practice a number of ambiguities and uncertainties regarding the application of the OID regulations to certain common types of financial instruments. We have also encountered cases in which a literal application of the OID regulations would be inconsistent with the economics of the underlying financial instrument or would lead to a tax result that is inappropriate and was likely unintended by the drafters of the OID regulations. We are particularly concerned that taxpayers may be taking inconsistent positions in some of these cases with issuers and holders taking tax positions that are most beneficial to their particular circumstances. We are also concerned that uncertainty regarding the application of the OID regulations to common financial instruments impairs the capital markets because holders and issuers often avoid investing in or issuing a financial instrument if the tax treatment of the instrument is uncertain.

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[1] This report was prepared by an *ad hoc* committee of the Tax Section of the New York State Bar Association. The principal drafters of this report were Jeffrey Hochberg and Jay Klein, and Kevin Salinger assisted in the preparation of this report. Helpful comments were provided by Peter Blessing, Douglas Borisky, Michael Farber, Metin Ismailov, Bruce Kayle, Stephen Land, Jiyeon Lee-Lim, Andrew Needham, Erika Nijenhuis, Michael Schler and Willard Taylor.

[2] Except as otherwise noted, "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to regulations are to the Treasury Regulations promulgated thereunder.

[3] T.D. 8517 (Jan. 27, 1994).

[4] T.D. 8674 (June 11, 1996).

This report of the New York State Bar Association Tax Section sets forth some of the more common uncertainties regarding the application of the OID regulations to certain types of financial instruments and makes recommendations regarding the guidance that we believe should be issued regarding the tax treatment of such instruments. Our comments are narrow in scope and focus on the resolution of specific uncertainties that, in our experience, arise in practice with some regularity.[5] This report does not address the rules governing short-term notes, convertible debt, market discount notes, foreign currency notes and the "integration" of notes with qualifying hedges. Furthermore, other than the discussion below regarding pricing date/settlement date issues and a request for guidance regarding certain timing contingencies, this report does not discuss the rules governing contingent payment debt instruments ("CPDIs") that are subject to the special rules set forth in Reg. § 1.1275-4 or the rules governing variable rate debt instruments ("VRDIs") that are subject to the special rules set forth in Reg. § 1.1275-5.

This report does not discuss foundational or theoretical issues, and does not make proposals or address issues that are likely to be controversial or difficult to implement. Indeed, many of our proposals would merely confirm the consensus current practice among tax professionals.

This report is divided into four parts. In addition to this introductory section, Part II summarizes the recommendations in this report, Part III provides a general overview of the OID regulations and Part IV contains a detailed discussion of our recommendations.

II. Summary of Recommendations

A. A debt instrument should not fail to qualify as a short-term obligation merely because its maturity date may be extended beyond one year due to a market disruption event as long as: (i) the possibility of a market

[5] We considered addressing a number of additional topics in the OID regulations for which we and many of our members believe guidance would be helpful. However, we chose to limit our discussion to the issues that often arise in practice and/or for which guidance would be most helpful and relatively simple to provide. We want to make it clear, however, that this report is not intended to address every uncertain topic in the OID rules for which guidance would be helpful. In particular, we note that that we have previously commented on other portions of the OID regulations in New York State Bar Association, Tax Section, *Comments on Proposed Rules for Interest-Only Interests in REMICs* (Feb. 3, 2005) and that we have very recently commented on the meaning of "traded on an established market" in New York State Bar Association, Tax Section, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273* (March 30, 2010).

disruption event occurring is remote, (ii) a payment may never be deferred for more than five business days and (iii) no additional interest (or other compensation) is payable in respect of the deferred period.

B. A debt instrument that provides for annual interest payments should not be treated as issued with OID solely because one or more of the annual payments will be deferred beyond one year if the annual interest payment date is not a business day.

C. The pre-issuance accrued interest election should only be made by the issuer of a note and such election, if made, should be binding on holders of the notes.

D. The consideration that is deemed paid for tax purposes in the case of an issuer that issues a note in a qualified reopening in exchange for property should be equal to the fair market value of the note on the date of the reopening rather than the issue price of the note.

E. The special rules governing notes that provide for "alternative payment schedules" should apply to a note if a single payment schedule under the terms of the note is "significantly more likely than not to occur" even if there is an infinite number of possible alternative payment schedules under the terms of the note.

F. The issue price of debt sold for money should generally be determined on the first date on which one or more purchasers agree to acquire a substantial amount of the debt at a fixed price as opposed to the issue date. In addition, we recommend that the IRS issue guidance regarding the determination of a "substantial amount" for purposes of determining the issue price of a note. We specifically recommend that any such guidance provide that the relative percentage amount of notes that are sold should be taken into account in determining whether the "substantial amount" test is satisfied. In addition, we recommend adopting a safe harbor that would treat 10% of the aggregate principal amount of a debt issuance as constituting a "substantial amount."

G. The comparable yield and projected payment schedule of a contingent payment debt instrument should be determined as of the pricing date for the note rather than on the issue date for the note.

H. The presumption in the VRDI rules under which the value of an initial fixed rate and a subsequent variable rate are treated as intended to approximate each other if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than 25 basis points should be determined on the pricing date for the notes as opposed to the issue date for the notes.

I. The "option rule" in the OID regulations should apply to a VRDI and should be applied after the application of the "fixed rate substitute rule" in the VRDI regulations.

J. Guidance should be issued regarding the appropriate tax treatment of discount loans that have a contingent yield because they have an excess cash sweep feature under which any available cash is required to be used to repay the principal of the loan.

III. Overview of the OID Regulations

This section contains a brief general overview of the OID regulations.[6] The discussion below is not a comprehensive discussion of the OID regulations and it does not address many important provisions. Some of the rules that are briefly mentioned below will be discussed in more detail in later sections of this report.

If a note[7] with a term in excess of one year is issued with more than a *de minimis* amount of OID, a holder of the note will generally be required to accrue the OID on a constant yield basis over the term of the note irrespective of the holder's method of accounting.[8] A note will be treated as issued with an amount of OID that is equal to the excess of the note's "stated redemption price at maturity" ("SRPM") over its issue price.[9] The SRPM of a note equals the sum of all amounts payable in respect of the note other than amounts that constitute "qualified stated interest" ("QSI").[10] QSI is "stated interest that is unconditionally payable in cash or in property or that will be constructively received under Section 451, at least annually at a single fixed rate."[11] Interest is "unconditionally payable" for this purpose only if reasonable legal remedies exist to compel timely payment or the note otherwise provides for terms and conditions that make a likelihood of late payment or nonpayment a remote contingency.[12]

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6 The OID regulations are generally found in Reg. §§ 1.1271-1 to 1.1275-7.

7 Throughout this report we use the terms "note," "debt" and "debt instrument" interchangeably.

8 Section 1272(a); Reg. § 1.1272-1.

9 Section 1273(a); Reg. § 1.1273-1.

10 Reg. § 1.1273-1(b); *see* Section 1273(a)(2).

11 Reg. § 1.1273-1(c)(1)(i).

12 Reg. § 1.1273-1(c)(1)(ii).

A note issued with a *de minimis* amount of OID will be treated as if issued without OID.[13] In general, a note is issued with a *de minimis* amount of OID if the amount of OID on the note is less than the product of (i) .0025, (ii) the SRPM of the note and (iii) the number of complete years between the issue date of the note and the maturity date of the note.[14] For example, a note with a two-year term that has an issue price of $99.51 and an SRPM of $100 will not be treated as issued with OID because the amount of OID on the note would fall within the *de minimis* threshold.

The OID rules do not apply in certain special circumstances, and there are certain exceptions to the rules described above. For example, notes with a term of one year or less are not subject to the OID rules,[15] and special rules apply in computing the SRPM of a note that provides for interest holidays, teaser rates and special interest rates for the first and last accrual period of a note.[16] In addition, special rules apply to notes that provide for contingent payments such as VRDIs[17] and CPDIs.[18] Rules similar to the OID rules require holders of a CPDI to accrue interest based on the yield at which the issuer would have issued a fixed rate non-contingent note.[19]

The amount of OID on a note is determined when the note is issued and the amount of OID on the note carries over to subsequent purchasers of the note irrespective of the amounts paid by the future purchasers. Therefore, notes that are presented to investors as economically fungible and identical (usually with the same CUSIP number) must have the same amount of OID for tax purposes. If the notes do not have the same amount of OID for tax purposes, holders that purchase the notes in the secondary market will be in different tax

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13 Section 1273(a)(3); Reg. § 1.1273-1(d).

14 Section 1273(a)(3); Reg. § 1.1273-1(d)(2).

15 Section 1272(a)(2)(C).

16 Reg. § 1.1273-1(d)(4).

17 *See* Reg. § 1.1275-5.

18 *See* Reg. § 1.1275-4.

19 *See id.*

positions depending upon which notes they purchase. It is therefore critical that the OID rules enable issuers and holders to properly determine the amount of OID on a note and to properly ensure that notes with identical terms have the same amount of OID in appropriate cases, so that issuers and holders know whether such notes can be presented to the market as fungible for tax purposes.

Under rules governing "qualified reopenings," notes that otherwise would have a different amount of OID than previously issued notes with the same terms could be treated as having the same amount of OID as the previously issued notes, notwithstanding that the price at which the new notes are sold differs from the price at which the original notes were sold.[20]

Based on the rules above, the OID rules will apply to many different types of notes beyond the classical case in which a note is issued at a discount to the stated principal amount of the note. For example, a note that has a stepped-up interest rate, that provides for irregular interest payment periods or that provides that interest on the note may be deferred in circumstances that are not remote, may be treated as issued with OID. In addition, as mentioned above, notes that are subject to the CPDI rules will generally be subject to a tax regime that is similar to notes that are issued with OID.

IV. Discussion

A. Treatment of Short-Term Obligations Subject to Extension Upon the Occurrence of Certain Remote Market Disruption Events

Section 1272 generally requires taxpayers (including taxpayers on the cash method of accounting) to currently accrue OID in respect of a discount debt instrument that has a fixed maturity date of more than one year.[21] The regular OID accrual rules do not apply to notes that have a term of one year or less,[22] and therefore the tax treatment of holders that own such notes is materially different than that of holders that own notes with OID that have a term in excess of one year. For example, cash-basis taxpayers are generally not required to currently

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20 *See* Reg. § 1.1275-2(k).

21 Sections 1272(a)(1) and (2)(C).

22 Section 1272(a)(2)(C).

accrue interest in respect of such notes.[23] The normal OID interest accrual rules are presumably inapplicable to short-term notes because the complexity of the OID rules is unwarranted where holders could only achieve a maximum deferral of one year.

In determining whether a debt instrument should be treated as having a fixed maturity date of not more than one year, the regulations provide that for certain limited purposes the maturity date of a debt instrument is deemed to be "the last possible date that the instrument could be outstanding under the terms of the instrument."[24] The regulations further provide that the last possible date that the instrument could be outstanding is determined by taking into account "remote" or "incidental" contingencies.[25]

The OID regulations would thus treat a debt instrument that would otherwise be a short-term obligation as having a fixed maturity date in excess of one year even where the maturity date may be extended only in highly remote circumstances. Aside from this special rule, the OID regulations generally ignore remote or incidental contingencies.[26] This is presumably based on the principle that a contingency should not affect the required interest accruals in respect of a note unless such contingencies are material since accounting for remote or incidental contingencies could lead to economically inappropriate interest accruals and deductions.

Notwithstanding the general rule that ignores remote and incidental contingencies for OID purposes, remote and incidental contingencies that may extend the maturity of a debt instrument are presumably taken into account for purposes of determining whether the note is subject to Section 1272 because the primary effect of accounting for such contingencies is that the note would be subject to current accrual of interest under the OID accrual rules. This result may add complexity in terms of applying the applicable interest accrual rules, but such interest

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23 *See* Section 1281(b). However, cash-basis taxpayers must defer any interest deductions allocable to the acquisition of a short-term debt instrument to the extent such deductions exceed accrued interest that is not yet included in income. Section 1282.

24 Reg. § 1.1272-1(f)(2).

25 *Id*.

26 *See*, *e.g*., Reg. § 1.1275-2(h) (generally ignores remote or incidental contingencies for all debt instruments unless such contingency actually occurs).

accrual would generally be economically appropriate. Furthermore, the government may have been concerned that taxpayers could (in the absence of a special rule) inappropriately avoid the OID rules by structuring a short-term note with a purportedly "remote" timing contingency that in reality has a significant chance of causing the note to have a term in excess of one year.

While we agree with the approach described above under which remote or incidental contingencies are taken into account in determining the maturity of a note for OID purposes, we think this approach can lead to inappropriate results in the case of notes that contain limited market disruption event provisions that are commonly included in many structured notes. Broadly speaking, a structured note is a debt instrument (for legal and financial accounting purposes) that provides for one or more payments that are contingent on the performance of one or more specified assets such as stocks, commodities, currencies or indices that track such assets. Since the OID regulations were issued in 1994, the structured notes market has grown exponentially and it is now a significant component of the securities market.

A market disruption provision typically provides that an amount that is otherwise currently payable in respect of a note may be temporarily postponed upon the occurrence of an event that makes current valuation of the underlying asset impossible or otherwise impracticable. For example, a market disruption event would include the unexpected suspension of trading on the public exchange on which the underlying reference asset trades. An extension due to a market disruption is typically limited to a maximum of five business days and the likelihood of such an event occurring is generally extremely remote. In addition, debt holders are generally not entitled to any additional compensation to reflect a delay in payment as a result of a market disruption event.

It is not clear how a note should be treated if the payment at maturity is normally due within one year of the note's issue date but such payment could potentially be deferred to a day that is more than one year from the note's issue date upon the occurrence of a market disruption event. A literal application of Reg. § 1.1272-1(f)(2) would require taxpayers to treat the debt as long-term and therefore subject to the OID rules. We understand, however, that many taxpayers take the position that remote timing contingencies that are in the nature of a *force majeure* and that relate to general market events should not cause a note that would

otherwise be short-term to be treated as long-term, and that therefore a market disruption event provision should generally not be taken into account in determining the term of a note for OID purposes.

Because of this uncertainty, it is possible that issuers may treat the notes described in the previous paragraph as subject to a current accrual regime and consequently take current interest deductions[27] while holders of the same notes may treat such notes as short-term and therefore defer the corresponding interest inclusions.[28] To resolve this uncertainty, we recommend that guidance be issued to the effect that certain types of limited market disruption event provisions should not be taken into account in determining whether a note is a short-term obligation. More specifically, we recommend that a "market disruption event contingency" that would extend the term of a note beyond one year should not be taken into account for OID purposes if (1) there is no more than a remote chance that the contingency will occur, (2) the maturity of the note can be extended no more than five business days and (3) no additional amounts are paid to compensate holders for any delay upon the occurrence of a market disruption event. We also recommend that the term "market disruption event contingency" with respect to a note be defined to mean a "disruption in the normal market conditions with respect to an actively traded (as defined in Section 1092) asset, index or position to the extent that such disruption makes the accurate valuation of the relevant asset, index or position impracticable."

We have considered whether our recommendation is appropriate in light of the general rule under which remote or incidental contingencies are taken into account in determining the maturity of a note for OID purposes. For the following reasons, we believe that a special rule is appropriate in the case of the market disruption event contingencies that are described above.

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[27] If an issuer treats a note with a market disruption provision as having a term in excess of one year for purposes of the OID rules then the note could be treated as issued with OID or, more likely, as a CPDI. *See infra* note 30 and accompanying text.

[28] Although non-exempt holders would receive a Form 1099-OID if the issuer treats the note as subject to the OID rules, a holder would nevertheless be permitted to take an inconsistent position. Furthermore, many investors would not receive the Form 1099 if they are exempt recipients that are not subject to information reporting.

First, the inclusion of a market disruption provision is mandated by market exigencies because the amount payable to a holder of a note may not be calculable in the case of a market disruption event. Without such a provision, an issuer could be required to make a payment upon the redemption or maturity of a note based on an inappropriate valuation of the asset underlying the note due to temporary and extraordinary market conditions. Thus, unlike a typical timing contingency, a market disruption contingency is designed to simply support an accurate determination of the redemption or maturity payment for a note rather than as a contingent change in the economic terms of a note.

Second, a typical timing contingency in a note relates specifically to the terms of the note or to facts that relate specifically to the issuer or holder of the note.[29] In contrast, a market disruption event is generally a market-wide occurrence that makes accurate valuation of the relevant asset impractical for all market participants, and such trigger is not specific to the particular note. Put differently, a market disruption contingency is in the nature of a *force majeure* that relates to extraordinary general market events and is thus more external to the terms of a note than in the case of a typical timing contingency.

Third, notes that provide for a market disruption event contingency will generally be subject to the special rules governing CPDIs if they are treated as short-term debt instruments.[30] The consequences of accounting for remote market disruption provisions are therefore more significant than in the case of a note that would be subject to the general OID rules (as opposed to the CPDI rules) if a remote timing contingency is taken into account.

Finally, market disruption contingencies of the type described above are not subject to abuse because such events are (i) typically extremely remote, (ii) based on objective market conditions which are beyond the control of the relevant parties, and (iii) limited to a maximum maturity extension of five business days.[31] Furthermore, holders are not entitled to

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[29] Examples of such contingencies are extension options that are very unlikely to be exercised or extensions that occur as a result of an unexpected change in the issuer's economic condition.

[30] This is because notes that contain a market disruption provision typically provide for at least one contingent payment that is not remote.

[31] Moreover, potentially abusive situations could be addressed by the current OID anti-abuse rule. *See* Reg. § 1.1275-2(g).

any additional compensation in respect of the time value of money attributable to the delay in a required payment.[32] We therefore believe that there is no policy reason to take into account such contingencies in determining the term of a note for purposes of the OID regulations.[33]

B. Notes that Provide for Annual Interest Payments

A debt instrument will generally be treated as issued with an amount of OID equal to the excess of the debt instrument's SRPM over its issue price.[34] A debt instrument's SRPM is equal to the sum of all amounts payable in respect of the debt other than amounts that are QSI.[35] The regulations define QSI as "stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under section 451, at least annually at a single fixed rate."[36] Thus, the regulations provide that interest paid on a debt instrument will technically not be treated as QSI if all such interest is not paid (or constructively received) "at least annually."[37] There are no exceptions to this requirement in either Section 1273 or its regulations.

If interpreted literally, this rule could cause many debt instruments that provide for annual payments of interest to nonetheless be treated as not paying QSI, in which case such

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[32] In this regard, we note that a basic feature of debt is that a lender is "compensat[ed] for the use or forbearance of money." *Deputy v. Du Pont*, 308 U.S. 488 (1940). It is therefore generally appropriate to disregard a period during which a holder is not being compensated for the use of its money since the "debt" is missing a key feature during such period.

[33] The tax law generally disregards periods during which a taxpayer holds an asset where it does not have economic exposure to the asset. For example, a taxpayer's holding period with respect to an asset is tolled to the extent it enters an offsetting position under the straddle rules. Reg. § 1.1092(b)-2T(a). Similarly, we believe that extensions that result in a "non-economic" extension should generally not be taken into account in determining the term of a note in a case in which there is no concern that such a rule could lead to abusive results.

[34] Reg. § 1.1273-1(a).

[35] Reg. § 1.1273-1(b).

[36] Reg. § 1.1273-1(c)(1)(i).

[37] *Cf.* Section 1273(a)(2) (interest is excluded from the SRPM if unconditionally payable at "periodic intervals of 1 year or less"); Reg. § 1.1275-5(a)(3) (to qualify as a VRDI, a "debt instrument must not provide for any stated interest other than stated interest (compounded or paid at least annually) at [qualfied rates]").

debt instruments would be treated as issued with OID.[38] Specifically, this concern arises where a debt instrument provides for annual payments and at least one interest payment cannot be paid on the scheduled payment date because such date is not a business date (*e.g.*, generally any weekend day). In such a case, since interest is scheduled to be paid exactly once during each annual period, a deferral for any reason and for only one day would technically mean that interest on the note is not paid or constructively received (within the meaning of Section 451)[39] at least annually.

Notwithstanding the definition of QSI in the Code and the regulations, we understand that many issuers treat annual interest payments as QSI even if an interest payment date will be deferred because it does not fall on a business day. We also understand that some issuers have applied the regulations literally in similar situations and have therefore treated such debt instruments as issued with OID despite the fact that the note in form provided for annual interest payments.[40] Consequently, there is uncertainty as to whether such interest payments should be QSI and this uncertainty has led to the inconsistent treatment of similar instruments in the market.

We recommend that the IRS issue guidance to eliminate this ambiguity. We specifically recommend that guidance be issued that would treat payments of interest that are deferred because of a business day convention as paid for QSI qualification purposes on the scheduled payment date as long as holders are not entitled to any additional interest as a result of such deferral (which we understand is typically the case).

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[38] If the debt instrument would have qualified as a VRDI but for the deferral of interest and the interest does not compound during such deferral period, then the debt instrument would instead be treated as a CPDI. *See id.*

[39] The interest in such case should not be treated as constructively received for purposes of Section 451. The regulations under Section 451 include an analogous example where a dividend that is mailed by check at the end of one year is not treated as received until the check is actually received in the following year. *See* Reg. § 1.451-2(b).

[40] Some issuers attempt to address this issue by providing that any interest payable on a non-business day is accelerated (as opposed to deferred), but this fix may not guarantee QSI treatment because there may be a gap of more than one year between future interest payments (and therefore interest may not be payable at least annually, under one interpretation of this requirement).

We have considered whether this rule could lead to an inappropriate deferral of interest where an interest payment to a cash-basis taxpayer in one taxable year is deferred to the next taxable year. While this scenario is certainly possible (*e.g.*, where the interest is payable on December 31), we believe it is appropriate that such deferred interest is only taxed in the year that it is actually received. In fact, regulations under Section 451 specifically provide that dividends paid in one year are not constructively received until the recipient has access to the cash.[41]

C. Pre-Issuance Accrued Interest Election Under Reg. § 1.1273-2(m)

1. Overview of the Pre-Issuance Accrued Interest Election

If a note is issued with an initial short accrual period, the note will generally either pay a reduced interest payment for the short period or it will provide for what is commonly known as "pre-issuance accrued interest." This could be illustrated by an example in which a note with a term of five years and a principal amount of $1,000 that provides for annual interest payments of $120 on November 30 of each year is issued on January 1 for $1,000 (the "Example"). In order to account for the fact that the initial accrual period will only be 11 months, the note can either provide for an initial interest payment on November 30 of $110, or alternatively the note could provide for an increased issue price that includes the pre-issuance accrued interest on the note. In the latter case, the note would provide for a $120 interest payment on November 30, and the investor would pay an additional $10 upon the purchase of the note to account for the pre-issuance accrued interest.

The OID regulations provide that an election may be made to exclude the pre-issuance accrued interest from the issue price of the note (the "PAI Election").[42] If the PAI Election is made, the portion of the first interest payment that represents a return of the pre-issuance accrued interest ($10 in the Example) would be treated as a return of the pre-issuance accrued interest and would not be deductible by the issuer or includable in income by the holder. The holder would compute its basis and issue price in the note as well as the SRPM of the note without taking into account the portion of the purchase price for the note that is attributable to

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41 *See supra* note 39.

42 Reg. § 1.1273-2(m)(2).

pre-issuance accrued interest. In addition, the holder would not include the payment of the pre-issuance accrued interest on the first interest payment date in income and it would not reduce its basis in the note by the amount of such payment.[43]

Alternatively, if a PAI Election is not made with respect to the note, the issue price of the note would include the amount paid by the investor in respect of the pre-issuance accrued interest ($1,010 in the Example), and as discussed in the following paragraph, the amount attributable to the pre-issuance accrued interest would not be QSI. Accordingly, the SRPM of the note would correspondingly be increased by the amount of the pre-issuance accrued interest.[44] As discussed below, however, the tax consequences to an issuer and holder of a note that is issued with pre-issuance accrued interest and that does not have more than a *de minimis* amount of OID will be the same irrespective of whether a PAI Election is made.

More specifically, if a PAI Election is not made, the initial interest payment on a note would only be treated as interest for tax purposes to the extent that interest is treated as having accrued in respect of the note.[45] QSI accrues ratably for tax purposes at the stated rate of interest for the applicable accrual period.[46] Interest that is not QSI generally accrues under rules similar to those set forth in Sections 1272 and 1275 for accruing OID.[47] Accordingly, in the Example, the first $110 payment of interest (and each subsequent $120 payment of interest) would be QSI since such interest is payable at a single fixed rate in respect of the principal amount of the note (*i.e.*, 10%, compounded annually). The "extra" $10 that is paid on the first interest payment date would not be QSI since such amount exceeds the $110 that accrued at the single fixed rate in respect of the principal amount of $1,000. Consequently, the $10 payment that is attributable to pre-issuance accrued interest would be subject to the general rules under

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43 *See id.*

44 *See* Reg. § 1.1273-1(b); Section 1273(a)(2).

45 Reg. § 1.446-2(a)(1).

46 Reg. § 1.446-2(b).

47 Reg. § 1.446-2(c). It is important to note in this regard that the single fixed rate that is used for the QSI determination is determined by reference to the principal amount of the note (i.e., $1,000 in the Example) rather than the issue price of the note (i.e., $1,010 in the Example).

Sections 1272 and 1275.[48] Pursuant to the OID payment ordering rules under the Section 1275 regulations, a payment that is not QSI is first treated as OID to the extent of accrued but unallocated OID and is then treated as a payment of principal.[49] Accordingly, the $10 portion of the initial interest payment in the Example that is attributable to pre-issuance accrued interest would be treated as a return of capital (since no OID accrued in respect of the note) and the note's adjusted issue price would be reduced by an equivalent amount.[50]

Based on the discussion above, a PAI Election will be irrelevant in the case of a note that does not have more than a *de minimis* amount of OID. This is because the "extra" interest payment that is attributable to the pre-issuance accrued interest will not be treated as interest for tax purposes in both cases. If a PAI Election is made, the regulations explicitly mandate that the pre-issuance accrued interest is not deductible by the issuer or includible in income by the holder. Likewise, when the PAI Election is not made and the note is not issued with OID, the payment of the pre-issuance accrued interest is treated as a return of capital, which is not deductible by the issuer or includible in income by holders.[51] However, as discussed further below, the OID accruals in respect of a note will be affected depending upon whether a PAI Election is made.

The OID regulations do not specifically provide whether the PAI Election should be made by the issuer or by the holders of the note. The regulations also do not address whether the issuer and holder could make different elections for this purpose or whether different holders can make different elections and therefore these points remain uncertain. In light of this uncertainty, we recommend in the discussion below that guidance be issued to provide that the PAI Election is made by the issuer of the note and that the issuer's election is binding on holders.

The discussion of this section is divided into three parts. In addition to this introductory part, the second part addresses the fungibility issue that could arise if the PAI

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48 Reg. § 1.446-2(c).

49 Reg. § 1.1275-2(a). Such payment should not be treated as prepaid interest. *Id.*

50 Reg. § 1.1275-1(b)(1)(ii) (adjusted issue price is decreased by payments that are not QSI).

51 *See* Reg. §§ 1.446-2(a)(1) and 1.163-1(a).

Election can be made by each holder of a note. The third part sets forth our recommendation in respect of the PAI Election.

2. Fungibility Issue if the PAI Election is a Holder Election

As discussed earlier in this report, notes will only be fungible with each other for tax purposes (and thus can have the same CUSIP number) if they have the same amount of OID because a note's OID accrual schedule carries over to subsequent purchasers of notes. If each initial purchaser of a note could decide whether or not to make a PAI Election with respect to its note, then notes for which a holder has made a PAI Election may not be fungible for tax purposes with notes for which a holder has not made a PAI Election.

Specifically, notes that are issued with more than a *de minimis* amount of OID would have different OID accrual schedules depending upon whether the holder makes the PAI Election. Such notes would therefore not be fungible with each other if different elections are made. This could be illustrated by the facts in the Example above if one assumes that the note in the Example is issued for $960 instead of $1,010, in which case the note would be issued with more than a *de minimis* amount of OID (the "OID Example"). If a holder makes the PAI Election in such a case, the note would have an issue price of $950 ($960 minus the $10 attributable to pre-issuance accrued interest) and an SRPM of $1,000, and would therefore be treated as issued with $50 of OID. The SRPM of the note would be equal to $1,000 because $10 of the first interest payment would be treated as a return of the excluded pre-issuance accrued interest and effectively disregarded, and the remaining stated interest payments would be QSI which is not added to the SRPM.

If a holder does not make a PAI Election in the OID Example, the note would have an initial issue price of $960 and an SRPM of $1,010 because, as discussed above, the additional $10 would not be treated as QSI, and therefore the note's SRPM would correspondingly be increased by $10.[52] Accordingly, whether or not the PAI Election is made, the note would be treated as issued with the same $50 of OID. However, the yield to maturity and OID accrual schedule of each note would differ slightly because the note with a PAI Election

[52] *See supra* note 47 and accompanying text.

would have an issue price of $950 and an SRPM of $1,000 and the note that is not subject to a PAI Election would have an issue price of $960 and an SRPM of $1,010.[53] Even though the *amount* of OID that a holder would accrue over the term of a note would be $50 in either case, the *timing* of the OID accruals would differ for each note since, when the PAI Election is not made, OID accrues in respect of the additional prepayment until such amount is paid on the first interest payment date.[54] Put differently, the OID accrual schedule of a note that is not subject to a PAI Election would be slightly accelerated as opposed to the OID accrual schedule of a note that is subject to a PAI Election. Thus, a subsequent purchaser of the notes in the OID Example would be in a different tax position depending upon whether it purchases its note from a holder that made a PAI Election or a holder that did not make a PAI Election. The notes would therefore not be fungible for tax purposes despite the fact that the notes otherwise have the same economic terms and the same absolute amount of OID.

In addition to the fungibility issue described above, we think that it would not be appropriate to allow each holder and the issuer the option to make a PAI Election because such approach would be inconsistent with the general approach of the OID regulations under which issuers and holders generally may not make inconsistent elections or determinations with respect to the application of the OID rules to their notes.[55]

3. Recommendation

In light of the discussion above, we recommend that guidance be issued that would provide that the PAI Election can only be made by the issuer of a note and that such election, if made, will be binding on holders of the notes. This approach would have the

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[53] We note that the "*de minimis* amount" threshold generally would be the same even though a note's SRPM will differ depending upon whether or not a PAI Election is made because such note would be an "installment obligation" and therefore the "*de minimis* amount" would be calculated based on the weighted average maturity of the note as opposed to the number of complete years to maturity from the issue date. *See* Regs. §§ 1.1273-1(d)(1), (2) and (3); (e)(1) and (3).

[54] That is, the "yield to maturity" or YTM (and therefore the effective daily portions of OID) would be different in each case. Reg. § 1.1272-1(b)(1)(i) defines YTM as "the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument." While the total discount will be the same, the discount rate (*i.e.*, the YTM) would be higher in respect of a lower issue price.

[55] *See* Reg. § 1.1275-2(e).

advantage of avoiding the fungibility issues described above with respect to a holder election and it would also eliminate the issuer/holder inconsistency described above.

If our recommendation that an issuer PAI Election should be binding on holders is adopted, an issuer would then be required to inform holders whether it made the election. Specifically, the OID regulations state that where "the issuer's determination of an item controls the holder's treatment of an item . . . the issuer must provide the relevant information to the holder in a reasonable manner."[56] An affirmative obligation to inform holders whether a PAI Election is made should generally not impose an administrative burden on issuers. This is because an issuer would not be required to independently notify holders whether or not it makes the election where a note is not issued with more than a *de minimis* amount of OID since, as described above, the election would be irrelevant in such a case. Furthermore, even for notes that are issued with OID, an issuer would presumably not be required to affirmatively inform holders whether it made a PAI Election to the extent a holder could reasonably be expected to determine whether the issuer made the election based on information contained in other documents required to be prepared by the issuer. For example, if an issuer is required to file an IRS Form 8281 with respect to a particular note, it should not have an additional obligation to inform holders whether it made a PAI Election for such note because such information would be evident from the information that is otherwise included on the Form.[57] However, in order to enable holders to more easily identify whether a PAI Election was made in respect of a note, we recommend that Form 8281 should be amended to provide for a box in which an issuer would indicate whether or not it has made a PAI Election.

D. Issue Price of Notes that are Issued in Exchange for Property Pursuant to a Qualified Reopening

1. Introduction

As discussed above, the amount of OID, if any, on a note is based in part on the issue price of the note. The issue price of a note is also relevant for determining the amount

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56 *Id*.

57 By looking at the relevant IRS Form 8281, a holder could determine whether an election was made based on the reported issue price (Box 8) and the required OID accruals (based on the attached OID schedule for Box 14).

realized upon a sale of property in exchange for a note issued by the purchaser of the property. Specifically, the amount realized in a sale or other disposition of property is generally equal to the amount of money received plus the fair market value of any property received.[58] If the consideration includes a note that is issued by the purchaser of property, the regulations provide that "the amount realized that is attributable to the debt instrument is the issue price of the debt instrument as determined under the OID regulations."[59] Similarly, upon a repurchase of outstanding debt for its newly issued debt, an issuer must calculate the amount of any cancellation of indebtedness income or redemption premium based on the difference between the issue price of the newly issued debt and the adjusted issue price of the old debt that is extinguished in the exchange.[60]

As discussed in this section, the Section 1001 regulations and the Section 108 rules presumably use the issue price of a note as a proxy for the fair market value of the note because the issue price of a note that is publicly traded or is issued for cash is generally equal to the fair market value of the note.[61] However, the issue price of notes that are issued pursuant to the "qualified reopening" regulations described below will generally not equal the fair market value of the reopened notes. We will therefore recommend that the Section 1001 and Section 108 rules be modified to provide that the amount realized upon a sale of property in exchange for a publicly traded note that is issued in a qualified reopening should equal the fair market value of the note on the date of the sale rather than the issue price of the note.

The discussion in this section is divided into four parts. In addition to this introductory part, the second part discusses the rules governing the determination of the issue price of a note and the qualified reopening rules. The third part illustrates how the issue price of a note that is issued in a qualified reopening will often differ from the fair market value of the note, thereby leading to inappropriate tax results. Finally, the fourth part sets forth our

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58 Section 1001(b).

59 Reg. § 1.1001-1(g).

60 *See* Section 108(e)(10); Reg. § 1.61-12(c)(2).

61 Reg. §§ 1.1273-2(a) and (b).

recommendation as to how the Section 1001 and Section 108 rules should be modified to address this issue.

2. Issue Price and Qualified Reopenings

The issue price of a note is generally determined under one of four rules. The issue price of a note, a substantial amount of which is sold for money, is the first price at which a substantial amount of the debt instrument is sold for money.[62] If the note is not sold for money, and the newly issued notes are "publicly traded," then the issue price of the newly issued note is equal to the fair market value of the note.[63] If the newly issued note is not sold for money and is not publicly traded but is issued in exchange for stock or securities that are publicly traded, then the issue price of the newly issued note will equal the fair market value of the notes that are surrendered in exchange for the new notes.[64] If none of the three rules apply to the newly issued notes, the issue price of the new notes will equal the principal amount of the notes if the notes provide for "adequate stated interest."[65] Based on these rules, the issue price of a note that is issued for cash, that is publicly traded or that is issued for publicly traded notes will generally equal the fair market value of the note on the issue date for the note.

Special rules apply for purposes of determining the issue price of notes that are issued in a "qualified reopening" pursuant to Reg. § 1.1275-2(k). The qualified reopening rules allow an issuer to reopen an existing issue of notes (the "original notes") and issue "reopened notes" that are fungible with the original notes. In the absence of the qualified reopening rules, the original notes and the reopened notes may not be fungible with each other for tax purposes if they are issued with different amounts of OID. This is because, as discussed above, the OID accrual schedule for a note carries over to subsequent purchasers of the notes and therefore holders would be required to account for different amounts of OID in respect of notes that are otherwise indistinguishable. The qualified reopening rules enable an issuer to avoid this fungibility problem by treating reopened notes that otherwise would have a different amount of

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62 Reg. § 1.1273-2(a)(1).

63 Reg. § 1.1273-2(b)(1).

64 Reg. § 1.1273-2(c)(1).

65 Reg. § 1.1273-2(d)(1); Section 1274.

OID than the original notes as having the same issue price and yield to maturity as the original notes, notwithstanding that the fair market value of the reopened notes when issued differs from the issue price of the original notes.[66]

The qualified reopening rules only apply if certain requirements are satisfied. Specifically, the qualified reopening rules provide that if the reopened notes are issued within six months of the issuance of the original notes and the original notes are treated as "publicly traded" for tax purposes, the reopened notes will generally be treated as part of the same "issue" as the original notes as long as the yield of the original notes (based on their fair market value) on the date the price of the reopened notes is established (or, if earlier, the "announcement date") is not more than 110% of the yield of the original notes on their issue date (or, if the original notes were issued with no more than a *de minimis* amount of OID, the annual coupon rate of the original notes).[67] For this purpose, the "announcement date" is the later of (i) seven days before the date on which the price of the reopened notes is established or (ii) the date on which the issuer's intent to issue the reopened notes is publicly announced.[68] If these rules are satisfied, the reopened notes will have the same issue price and yield to maturity as the original notes, notwithstanding the fact that the fair market value of the reopened notes on the date of the reopening could significantly differ from its issue price (or, if applicable, its adjusted issue price) under the qualified reopening rules.

3. Illustration of Problem

The inappropriate tax result that could arise in a case in which a note is issued in a qualified reopening in exchange for property can be illustrated by an example in which an investor holds a note with a principal amount and basis of $100, but that currently has a fair market value of $150. Assume that the investor exchanges the note for a new note of the same issuer in a taxable exchange (*i.e.*, an exchange that constitutes a "significant modification" under Reg. § 1.1001-3) that also has a fair market value of $150 and a principal amount of $100. Assume further that the newly issued note was issued in a qualified reopening in which the

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66 Reg. § 1.1275-2(k)(1).

67 Reg. §§ 1.1275-2(k)(1); (k)(3)(ii).

68 Reg. § 1.1275-2(k)(2)(iv).

originally issued note had an issue price of $100. Thus, under the qualified reopening rules, the issue price of the new note that is issued in the qualified reopening would also have an issue price of $100. Under a literal reading of current law, the investor would not recognize any gain on the exchange, and the issuer would not recognize any redemption premium on the exchange, because the issue price of the new note is $100.[69] This would be the case despite the fact that both the old note and the new note are publicly traded and the fair market value of the old note and the new note is $150 at the time of the exchange.

By contrast, if the new note in the example above had not been issued in a qualified reopening, the investor would have recognized $50 of gain (*i.e.*, the difference between its $100 basis in the old note and the $150 fair market value of the new note that is received in the taxable exchange).[70] Similarly, if the note had not been issued in a qualified reopening, the issuer of the note would have realized $50 of premium deduction in connection with the exchange. There is no policy reason why notes issued in a qualified reopening in exchange for property should have such a dramatically different tax treatment than newly issued publicly traded notes that are issued in exchange for property in an issuance that does not constitute a qualified reopening.

Conversely, there would also be an inappropriate tax result if notes that are issued in a qualified reopening have an issue price that exceeds the fair market value of the notes on the date of the exchange.[71] In such a case, the investor would not be permitted to recognize a loss on the exchange because the issue price of the notes would be artificially high, and the issuer would inappropriately not recognize cancellation of indebtedness income for the same reason.

4. Recommendation

The tax consequences described above are obviously not an appropriate tax result and some tax practitioners have taken the view that the investor in the example above should be

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69 *See* Reg. § 1.1001-1(g); Reg. § 1.61-12(c)(2)(iii); Section 108(e)(10).

70 Reg. § 1.1001-1(g).

71 The distortive effects in this latter scenario should be relatively limited since the reopening rules limit qualified reopenings in cases where the issue price will exceed the debt's fair market value. *See supra* notes 67-68 and accompanying text.

treated as receiving an amount of consideration in the exchange that is equal to the fair market value of the notes that are issued in the exchange.[72] We believe that the inappropriate and distortive tax results illustrated in the above example were not intended by the drafters of the Code or the Section 1001 regulations. We note in this regard that the rules that treat the issue price of a publicly traded note as the amount realized upon the exchange of property for the note were enacted before the qualified reopening regulations were first proposed in 1999.[73] The drafters of the qualified reopening regulations presumably did not realize the effect that the special issue price rules for notes that are issued in a qualified reopening would have in determining the amount realized in the context of Section 1001 and Section 108 when a note is issued in a qualified reopening in exchange for property.

We recommend that guidance be issued under Sections 1001 and 108 that would provide for an exception, in the case of a qualified reopening, to the general rule that treats the issue price of a publicly traded note as the amount realized for Section 1001 purposes and as the amount paid by the issuer for Section 108 purposes in a debt-for-debt exchange. The exception should provide that the amount realized by an investor that sells property in exchange for a note of the purchaser that is issued in a qualified reopening should equal the fair market value of the note on the date of the exchange, notwithstanding that such amount differs from the issue price of the note. Similarly, the amount paid by an issuer that issues notes in a qualified reopening in exchange for property should equal the fair market value of the newly issued notes on the date of the exchange, notwithstanding that such amount differs from the issue price of the note on the date of the exchange.[74]

We note that, under our recommendation, the issue price of the notes issued in the qualified reopening will differ from the investor's tax basis in the notes because the investor's tax basis in the notes would equal the amount that it realized in the exchange—*i.e.*, the fair

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[72] Section 108(e)(10).

[73] Reg. § 1.1001-1(g), in its current form, was promulgated in 1996. T.D. 8674 (June 11, 1996). Section 108(e)(10) was added to the Code in 1990 (as old Section 108(e)(11)). P.L. 101-508. The final version of Reg. § 1.1275-2(k) was promulgated in 2001. T.D. 8934 (Jan. 11, 2001).

[74] We note that this reliance on fair market value leads to the same result that would be achieved if the amount realized/repurchase price was determined under Section 1273 without taking into account the qualified reopening rules.

market value of the note on the date of the exchange. This differential generally occurs as a result of a reopening because the acquirer of the reopened notes will generally have a basis equal to the fair market value of such notes (or a carryover basis if acquired in a tax-free reorganization). Such basis, however, will rarely equal the issue price of the reopened notes, which is determined solely by reference to the issue price of the original notes and is not influenced by the fair market value of the reopened notes.

The discrepancy between issue price and basis should not lead to an inappropriate tax result as regulations already contemplate cases in which an investor's tax basis in a note that is issued in a qualified reopening differs from the issue price of the note.[75] For example, specific regulations provide that the issuer must adjust its deductions in respect of debt issued in a qualified reopening to the extent the price paid by the acquirer of the reopened notes is more or less than the adjusted issue price of the original notes.[76] In addition, the market discount and acquisition premium rules would likewise govern inconsistencies between a holder's basis in a note and the note's adjusted issue price.[77]

E. Alternative Payment Schedule Rules

1. Introduction

Debt instruments that provide for contingent payments are, subject to certain exceptions, generally classified as either VRDIs or CPDIs. The OID regulations, however, create an exception to this rule under which a note that provides for alternative payment schedules will not be treated as providing for contingent payments "[i]f, based on all the facts and circumstances as of the issue date, a single payment schedule . . . is significantly more likely than not to occur."[78] The yield and maturity of such a note is determined for OID purposes as if the note provided for the single fixed schedule that is significantly more likely than not to occur

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75 In addition, this discrepancy will not give rise to any fungibility issues since all outstanding notes will have the same issue price.

76 *See* Reg. § 1.163-7(e).

77 *See* Section 1278; Section 1272(a)(7) and Reg. § 1.1272-2.

78 Reg. § 1.1272-1(c)(2).

(the "SMLTN Presumption").[79] Thus, a note that provides for alternative payment schedules and is subject to this rule will generally not be subject to the CPDI rules.

The SMLTN Presumption, however, technically only applies "if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date" (the "Alternative Schedules Requirement").[80] As discussed below, the requirement that "the timing and amounts of the payments that comprise each payment schedule are known as of the issue date" has created a significant amount of uncertainty and differences of opinion among tax practitioners. Specifically, it is unclear whether the Alternative Schedules Requirement is only satisfied in a case in which the note sets forth specified alternative payment schedules, or whether it is also satisfied in a case in which the note does not provide for specified alternative payment schedules but a finite or infinite number of payment schedules can be computed under the terms of the note.

The discussion in this section is divided into four parts. In addition to this introductory part, the second part sets forth three examples that illustrate some of the uncertainties regarding the application of the Alternative Schedules Requirement. The third part addresses some of the background related to the development of the Alternative Schedules Requirement and its relevance to the current interpretation of the requirement. Finally, the fourth part sets forth our recommendation that rules be issued that would provide that the Alternative Schedules Requirement is satisfied if a single payment schedule under the terms of the note is "significantly more likely than not to occur" even if there is an infinite number of possible alternative payment schedules under the terms of the note.

2. Examples Illustrating Uncertainty

The following are three examples that illustrate the uncertainties regarding the application of the Alternative Schedules Requirement. First, consider a principal-protected note with a term of two years is issued for $1,000 and provides for a payment at maturity of (i) $1,050 or (ii) $1,150 if the S&P 500 increased by more than a specified amount over the term of the debt

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79 *Id*.

80 Reg. § 1.1272-1(c)(1).

instrument. The Alternative Schedules Requirement would definitely be satisfied here because the note explicitly provides for two alternative payment schedules.

It is not entirely clear, however, whether the Alternative Schedules Requirement is satisfied in the case of a note that does not separately enumerate multiple payment schedules but for which the potential amount of any contingent payment is mathematically limited. For example, assume the same facts discussed in the preceding paragraph except that the payment at maturity will equal the greater of (i) $1,050 or (ii) an amount equal to 50% of the positive increase in the S&P 500 over the term of the debt instrument, but subject to a maximum return of $1,200 in all cases. While this note does not in form set forth a fixed number of alternative payment schedules, the cap on the amount that a holder can receive at maturity means that the note mathematically provides for a finite number of payment schedules as of the issue date and the timing and amount of each possible payment can be computed at such time. Although not entirely clear, it is our understanding that most practitioners take the position that the Alternative Schedules Requirement should be treated as satisfied in such a case.

Finally, there is a significant amount of uncertainty as to whether a note that has an infinite number of payment schedules can satisfy the Alternative Schedules Requirement. For example, assume the same facts discussed in the preceding paragraph except that the payment at maturity is not limited by a cap (*i.e.*, the note will participate in 50% of the uncapped appreciation in the S&P 500). The better technical argument is that under current law such a note does not satisfy the Alternative Schedules Requirement because it provides for an infinite number of payment schedules and thus "the timing and amounts of the payments that comprise each payment schedule" are not known as of the issue date. However, one may also be able to argue that as practical matter such a note implicitly provides for a number of alternative payment schedules the timing and amount of which are known because all reasonably possible outcomes can still be known as of the issue date.[81]

[81] That is, technically one cannot "know" an infinite set of numbers, but all payment schedules that could reasonably be expected to potentially occur can be known. This interpretation relies upon a liberal interpretation of the regulations, but as discussed below, we believe that a contrary interpretation could lead to inappropriate results.

In light of the uncertainty regarding the application of the Alternative Schedules Requirement, taxpayers may take inconsistent positions in similar situations, which can lead to a result in which the government gets whipsawed. For example, this outcome may arise where the holder of a debt instrument takes the position that the Alternatives Schedule Requirement is satisfied but the issuer takes the opposite position. In such a case, the holder may, relying on the application of the Alternative Schedules Requirement and the SMLTN Presumption, accrue interest at a below-market rate (assuming a payment schedule that produces such below-market yield is significantly more likely than not to occur) while the issuer would treat the same debt instrument as a CPDI and accrue current deductions at its higher comparable yield.

3. History of the Alternative Schedule Requirement

In considering the appropriate application of the Alternative Schedules Requirement, we have considered the evolution of the current language in the regulations in order to understand the underlying policy of the regulations.

We note in this regard that a 1994 amendment to the proposed regulations under Reg. § 1.1272-1(c) contained language limiting the Alternative Schedules Requirement to "debt instruments that provide for an alternative payment schedule (or a *reasonable number* of schedules)."[82] The 1996 amendment to the final regulations (presently in effect) contains no such limitation.[83] The preamble to the final regulations does not discuss why the amended final regulations omitted the "reasonable number" limitation, but this affirmative change implies that Treasury intended for the regulations to apply to debt instruments that provide for a large number of payment schedules.

Furthermore, the original 1994 final regulations contemplated a "most likely to occur" standard.[84] The 1996 final regulations (presently in effect) enacted a heightened

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82 Proposed Rules: Debt Instruments With Original Issue Discount; Contingent Payments, FI-59-91 (Dec. 16, 1994) (emphasis added).

83 T.D. 8674 (June 11, 1996).

84 Specifically, the regulation reads as follows: "if, based on all the facts and circumstances as of the issue date, it is *more likely than not* that the debt instrument's stated payment schedule will not occur, then the yield and maturity of the debt instrument are computed based on the payment schedule *most likely to occur*." T.D. 8517 (Jan. 27, 1994) (emphasis added).

"significantly more likely than not" standard. In the preamble to the 1996 final regulations, Treasury explains the reason behind this change:

> The general rules in § 1.1272-1(c) produce a reasonable result when a debt instrument has one stated payment schedule that is very likely to occur and one or more alternative payment schedules that are unlikely to occur. In this case, *adherence to the stated payment schedule will result in accruals on the debt instrument that reasonably reflect the expected return on the instrument*. The rules can lead to *unreasonable results*, however, if a debt instrument provides for a stated payment schedule and one or more alternative payment schedules that differ significantly and that have a comparable likelihood of occurring. In this case, the accruals based on the payment schedule identified as most likely to occur could differ significantly from the expected return on the debt instrument, which would reflect all the payment schedules and their relative probabilities of occurrence.
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> Because the general rules of § 1.1272-1(c) *could produce unreasonable results*, these rules have been modified.[85]

The preamble clearly states that the primary (if not the only) reason for the higher threshold in applying the SMLTN Presumption is to address the concern that, absent the change, the previous rule could have been applied in a manner that could produce unreasonable results.[86] The preamble also indicates that the overriding policy of the regulations is that the SMLTN Presumption should apply to produce accruals that reasonably reflect the expected return on the debt instrument. The language in the preamble also helps explain the deletion of the "reasonable number" limitation, as such a limitation would not be consistent with the goal of ensuring that issuers and holders accrue amounts on a note based on its expected payment schedule even if there are more than a "reasonable" number of payment schedules under the terms of the note.

4. Recommendation

In light of the uncertainties described above, we recommend that guidance be issued that would address the scope of the Alternative Schedules Requirement. Based on the regulatory history discussed above and the apparent rationale behind the SLMTN Presumption, we recommend that rules be issued to clarify that the Alternative Schedules Requirement should

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85 T.D. 8674 (June 11, 1996) (emphasis added).

86 *See also* New York State Bar Association, Tax Section, *Report on the Final Original Issue Discount Regulations* (Aug. 5, 1994) (suggesting this change for this reason).

be satisfied even if the note does not explicitly provide for specific alternative payment schedules and even if there is an infinite number of theoretical payment schedules under the terms of the note. This would be consistent with regulatory history described above which effectively states that the SMLTN Presumption should apply to produce accruals that reasonably reflect the expected return on a note when the note provides for a specific payment schedule that is significantly more likely than not to occur. This rationale applies equally irrespective of whether the possible payment alternatives are part of a large finite set of possibilities or an infinite set of possibilities.

Moreover, if the Service were disposed to provide guidance to confirm that the Alternative Schedules Requirement is met where there is a large but finite number of payment schedules, we would note that there is absolutely no policy reason to distinguish a roughly equivalent case that technically provides for an infinite number of payment schedules. To illustrate, in the examples discussed above, the tax treatment should not depend upon whether or not the return on the debt instrument is subject to a cap.[87] In this regard, we note that—as often happens when technical rules override economic reality—a more restricted interpretation of the SMLTN Presumption could open the door to abuse by allowing taxpayers to "elect into" CPDI characterization.[88]

We believe that the IRS should generally encourage a broad application of the SMLTN Presumption if a single payment schedule is in fact significantly more likely than not to occur because the alternative would generally be to treat the debt instrument as a CPDI. Such treatment would generally require issuers to calculate the comparable yield and projected payment schedule for the debt instrument and require holders to accrue interest and make adjustments in accordance with such comparable yield and projected payment schedule.[89] This

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[87] This distinction would be particularly artificial where the cap is set at a level that is not reasonably expected to be reached during the term of the note.

[88] For example, in an attempt to generate higher deductions, an issuer may be motivated to add a relatively insignificant contingency that would cause the note to have an infinite number of payment schedules in order to convert a note that may have otherwise been subject to the SMLTN Presumption at a particular effective yield into a CPDI with a higher comparable yield.

[89] Assuming the debt is issued for money or publicly traded property; although the accrual method applicable to a CPDI issued for non-publicly traded property is hardly straightforward. *See* Reg. § 1.1275-4(b) and (c).

approach offers only rough justice for all parties and it compels the issuer and debt holders to comply with the complex noncontingent bond method.[90]

Finally, if guidance is issued on this point, we would further recommend that such guidance clarify that an issuer's determination that the SMLTN Presumption applies to a debt instrument that is appropriately supported by contemporaneous documentation is binding on the holders of such debt instrument absent a finding that the issuer's determination is unreasonable.[91] Such clarification would ensure that the issuer is required to reasonably inform holders of its determination that the SMLTN Presumption is applicable to their debt instrument[92] and could generally prevent issuers and holders from taking inconsistent positions with respect to the application of the SMLTN Presumption to a particular note.

F. Determination of Issue Price Under Reg. § 1.1273-2

As discussed above, the amount of OID on a note is equal to the excess of the SRPM of the note over the issue price of the note. This section discusses two uncertainties regarding the determination of the issue price of a note. The first uncertainty is whether the issue price of notes that are sold for money should be determined based on the initial sale on the pricing date of the notes or on the issue date (*i.e.*, settlement date) for the notes. The second uncertainty concerns the meaning of the term "substantial amount" as used in the issue price section of the OID regulations.

1. Pricing Date or Issue Date

In the case of a publicly traded debt instrument issued for cash, the Code provides that "the issue price is the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments was sold."[93] The Code also

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[90] In drafting regulations, Treasury generally prefers to avoid complexity where possible. *See*, *e.g.*, T.D. 8400 (March 17, 1992) (preamble and final regulations to Section 988, rejecting a commentator's recommendation in part because it would "create greater computational complexity").

[91] *Cf.* Reg. § 1.1275-4(v) (issuer's determination of a debt instrument's comparable yield and projected payment schedule will be respected if supported by the requisite contemporaneous documentation unless such determination is unreasonable).

[92] *See* Reg. § 1.1275-2(e).

[93] Section 1273(b)(1).

provides that the issue price for "other debt instruments not issued for property" (*i.e.*, non-publicly traded debt issued for cash) is "the price paid by the first buyer of such debt instrument."[94] The regulations effectively combine these two categories into one and provide that the issue price of a debt instrument a substantial amount of which is sold for money is "the first price at which a substantial amount of the debt instruments is sold for money."[95] For this purpose, sales to underwriters, brokers and similar entities are ignored.[96]

While the regulations provide that issue price is based on the first price at which a substantial amount of the debt instruments is "sold", it is unclear *when* the debt instruments are actually first "sold." One possibility is that a note is not "sold" until the closing or settlement of the sale on the issue date (the "Issue Date Method").[97] Under an alternative approach, a note should be treated as "sold" for issue price purposes at the time that a person agrees to purchase the note, which is typically on the pricing date for the note (the "Pricing Date Method").[98]

The Issue Date Method is supported by a literal reading of the regulations because a note does not technically exist, and therefore arguably cannot be sold, prior to the settlement date for the notes. Furthermore, a holder's holding period in a note does not begin until the settlement date. On the other hand, the Pricing Date Method is supported by the focus in the Code and the regulations on the precise time at which notes are "sold." For example, the Code refers to the "*initial* offering price"[99] and the "price paid by the *first* buyer"[100]; and the regulations similarly look to the "*first* price at which a substantial amount of the debt instruments

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94 Section 1273(b)(2).

95 Reg. § 1.1273-2(a)(1). *See* T.D. 8517 (Jan. 27, 1994) (preamble explains that, at the suggestion of commentators, rule was unified for both publicly offered and non-publicly offered issues).

96 Reg. § 1.1273-2(e).

97 *Cf.* Reg. §§ 1.1273(a)(2), (b)(2), (c)(2) and (d)(2).

98 While the mechanics of an actual debt offering vary widely based on the particular circumstances, the "pricing date" generally refers to the point in time when the debt issuer and the underwriter(s) agree on the material terms of the debt instrument. As a general matter, the underwriter(s) will agree on such terms based on an understanding that investors would be willing to purchase debt issued with the terms agreed to on the pricing date.

99 Section 1273(b)(1) (emphasis added).

100 Section 1273(b)(2) (emphasis added).

is sold."[101] This focus on timing implies a date prior to settlement since there typically is no "first in time" concept on the settlement date. In contrast, for debt instruments that are not issued for money, the regulations unequivocally provide that the issue price is determined on the issue date with no "first in time" wording.[102]

We believe that both methods constitute reasonable interpretations of the regulations, which has caused uncertainty regarding the appropriate method for determining the issue price for notes that are sold in variable price offerings. We therefore recommend that guidance be issued as to the date upon which notes are "sold" for issue price purposes. We further recommend that, for the reasons described below, any such guidance should provide that the Pricing Date Method should be used for purposes of determining the issue price of notes that are issued in variable price offerings.

First, as mentioned above, the "first in time" concept by and large has no meaning on the settlement date since multiple "sales" would generally occur at the exact same time as a legal matter (even though one purchaser may have agreed to acquire the debt before the other purchasers that acquired the debt on the settlement date). As a result, the Issue Date Method could lead to additional uncertainty since the issue price may be indeterminate where two or more purchasers acquire the debt at the same moment (*i.e.*, the moment that the settlement/closing legally occurs) at different prices. In such case, the issue price may be governed by the price at which more of the debt was sold, although this approach may not provide an answer where the debt was sold for equal amounts at different prices.[103] Alternatively, the issue price may be based on the weighted average of the price at which the

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101 Section 1.1273-2(a)(1) (emphasis added).

102 *See*, *e.g.*, Reg. §§ 1.1273-2(b)(1) (the issue price of certain publicly traded debt is the fair market value of the debt on the issue date), 1.1273-2(c)(1) (issue price of certain debt issued for publicly traded property is equal to the fair market value of the property on the issue date) and 1.1274-2(b)(2) (issue price of certain debt instruments under Section 1274 is based on the imputed principal amount, determined as of the issue date).

103 If future guidance clarifies that the issue price of debt issued for money is determined on the issue date then such guidance should also provide that the issue price should be the price at which more of the debt is sold on the issue date. We would recommend the guidance further provide that, in a case where an equal amount of debt is sold on the issue date at different prices, the issue price is based on the price at which a purchaser of such amount of the debt first agreed to purchase the debt.

debt is sold on the issue date. There are no clear answers to these questions if we are to assume that the issue price for debt instruments issued for money is properly determined on the issue date.

Second, the fact that one purchaser's acquisition of a debt instrument occurs (due to administrative or operational factors) moments before other purchases of the same debt instrument on the same date should not affect the debt instrument's issue price. There is no substantive policy reason to encourage such interpretation, which could lead to an artificially engineered issue price if such nominal differences were allowed to control. By contrast, the Pricing Date Method is consistent with the "first sale" focus of the Code and regulations, and the timing at which purchasers commit to purchase a note would have meaningful economic consequences as opposed to minor differences in the time of settlement on the issue date for the note.

Finally, under the Pricing Date Method, the potential exists for a taxpayer that initially agrees to purchase a debt instrument at a price that would not give rise to OID to ultimately be treated as acquiring a debt instrument that is issued with OID as a consequence of subsequent events beyond the initial purchaser's control. For example, assume Party A agrees on January 1 to pay $19,800,000 for $20,000,000 principal amount of 5-year fixed-rate debt (*i.e.*, 99% of principal, a *de minimis* amount of OID).[104] On January 2 Party B agrees to pay $98,000,000 for $100,000,000 principal amount of the same debt (*i.e.*, 98% of principal) and the debt is issued to both parties at the agreed upon prices on January 5. If the issue price is determined on the issue date (and is determined based on the largest notional purchase), the entire issue would presumably be treated as issued with OID of 2%. Thus, Party A would be forced to currently accrue its 1% discount[105] even though Party A fully expected to treat such discount as *de minimis* OID (which is generally not accrued currently) when it committed to purchase the debt. Under the Pricing Date Method, however, the inequity described above may be minimized since an initial purchaser would generally control the issue price and subsequent

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104 *See* Reg. § 1.1273-1(d)(2). For the purposes of this example, we assume this amount to be a substantial amount of the debt instruments.

105 The other 1% of discount would be offset by an equivalent amount of acquisition premium. *See* Section 1272(a)(7).

purchasers could discover whether prior sales would cause the debt to be treated as issued with OID.

2. Clarification of "Substantial Amount"

For purposes of determining the issue price (and issue date) of a debt instrument, the regulations repeatedly invoke the standard of a "substantial amount" of the debt instruments.[106] There is little explanation as to what constitutes a "substantial amount" in this context.[107] This has caused a significant amount of uncertainty regarding the determination of a note's issue price in the case of variable price note offerings. We therefore recommend that guidance be issued that would enable taxpayers to conclusively determine the proper issue price of a note that is issued at variable prices.

We also recommend that the guidance be issued that would clarify whether the "substantial amount" test should be applied on a relative basis rather than an absolute basis. An "absolute" approach might provide that a sale of $20 million, for example, would always be considered a substantial amount. On the other hand, using a "relative" approach, $20 million may not be a substantial amount in the context of a debt issuance with an aggregate principal amount of $1 billion. We believe that an issuance that is merely 2% of the total issue price should generally not be considered a "substantial amount" even though $20 million may be substantial in many issuances. Accordingly, we recommend that any guidance clarify that the "substantial amount" determination should be made under a "relative" paradigm.

Finally, to encourage certainty in the market, we recommend instituting a safe harbor that would treat 10% of the aggregate principal amount of a debt issuance as constituting

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106 *See*, *e.g.*, *supra* note 93; Reg. § 1.1273-2(a)(2) (issue date based upon when a substantial amount of the debt instruments is sold); Reg. § 1.1273-2(b)(1) (looks to whether a substantial amount of the debt instruments is traded on an established securities market).

107 Some commentators have suggested that 10% or even less may constitute a substantial amount. *See*, *e.g.*, Steven D. Conlon & Vincent M. Aquilino, Comments on Revised Proposed Regulations Regarding Debt Instruments with Original Issue Discount, republished in 93 Tax Notes Today 26-57 (Jan. 25, 1993) (referencing Section 148); David C. Garlock, Federal Income Taxation of Debt Instruments, 5th Ed., ¶ 203.03 (2006) ("it would seem that as little as 5 percent of an issue or, if less, $5 million of debt should constitute a 'substantial amount' of debt instruments, provided the sale is a bona fide arm's-length transaction"); Todd F. Maynes & Thad Davis, TAXES, Distressed Debt in Disorderly and Dysfunctional Markets (Mar. 1, 2009) ("taxpayers generally take the position that amounts as low as 10 percent traded on an established market" meet the standard).

a "substantial amount." This amount is consistent with current market practice and commentator guidance,[108] and is consistent with the "substantial amount" standard that applies in the tax-exempt bond arbitrage regulations.[109]

G. Timing of Determination of Comparable Yield and Projected Payment Schedule for Contingent Payment Debt Instruments[110]

A debt instrument that provides for contingent payments, subject to certain exceptions, is treated as a CPDI.[111] A CPDI issued for money or publicly traded property is subject to the noncontingent bond method.[112] Under the noncontingent bond method, holders are required to accrue interest based on a comparable yield and projected payment schedule.[113] The comparable yield is the yield at which the issuer would issue a noncontingent fixed rate debt instrument with terms and conditions similar to the contingent debt. In determining the comparable yield, if there is a § 1.1275-6 hedge available, the comparable yield generally is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the § 1.1275-6 hedge.[114]

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108 *Id*.

109 *See* Reg. § 1.148-1(b) ("Issue price means, except as otherwise provided, issue price as defined in section 1273 and 1274. Generally, the issue price of bonds that are publicly offered is the first price at which a substantial amount of the bonds is sold to the public. *Ten percent is a substantial amount*.") (emphasis added).

110 Although this report generally does not discuss ambiguities or uncertainties in the CPDI rules, sections IV.F. and H. of the report address whether certain determinations should be made on either the pricing date or issue date. We therefore thought that it would be appropriate to discuss the following analogous issue in the context of the CPDI rules.

111 Reg. § 1.1275-4(a).

112 Reg. § 1.1275-4(b).

113 *See* Reg. § 1.1275-4(b)(3).

114 Reg. § 1.1275-4(b)(4)(i)(A). A § 1.1275-6 hedge is defined in the regulations as "any financial instrument (as defined in [the applicable section]) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under §1.1275-5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest)." Reg. § 1.1275-6(b)(2).

In general, the projected payment schedule for a CPDI is based on forward prices for any contingent payments to be made in respect of the debt, if available, or otherwise the expected value of such payments; such prices are then adjusted so that the projected payments produce the comparable yield.[115] Positive or negative adjustments are made to the extent actual payments differ from the projected amount of the contingent payments.[116]

While mechanically complex, the noncontingent bond method generally offers relative certainty in its application. However, it is not clear whether the comparable yield and projected payment schedule must be calculated based on market conditions that exist on the issue date or on the pricing date. More specifically, applicable regulations provide that the issuer should determine the comparable yield and projected payment schedule as of the debt instrument's issue date.[117] The regulations describe the comparable yield as "the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions."[118] The aforementioned language can be interpreted in one of two ways. Under a literal interpretation, the comparable yield would take into account the market conditions that exist on the issue date in which case the comparable yield (and by necessity, the projected payment schedule) could not be determined until the issue date.[119] Alternatively, since the economic terms of a note are generally fixed on the pricing date for the note (which is typically three business days prior to the issue date), the comparable yield should arguably be based on the conditions that exist on such date.[120] Put differently, the yield at which an issuer would issue a fixed rate note on July 10

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115 Reg. § 1.1275-4(b)(4)(ii).

116 Reg. § 1.1275-4(b)(3)(iv).

117 Reg. §§ 1.1275-4(b)(3)(i) and (ii).

118 Reg. § 1.1275-4(b)(4)(i).

119 However, as discussed below, one could argue under a literal reading that the comparable yield and projected payment schedule are required as of the issue date but may nevertheless be calculated prior to such date.

120 In this regard, we note that prior to the finalization of Reg. § 1.1275-4, multiple commentators suggested that the comparable yield and projected payment schedule should be determined by reference to the pricing date. *See*, *e.g.*, New York State Bar Association, Tax Section, *Report on Proposed Regulations Concerning the Treatment of Contingent Payment Debt Instruments* (May 11, 1995) (focusing on the fact

would typically be determined based on the market and pricing conditions for the issuer on July 7 (the pricing date) and not based on the market and pricing conditions on July 10. The "determination" of the yield at which an issuer would issue a fixed rate note on July 10 (*i.e.*, the comparable yield) should thus arguably be made based on the pricing and market conditions that are in effect on July 7.

This second interpretation finds some support in the preamble to the final regulations which states that "a taxpayer computes interest accruals . . . by *setting* a payment schedule as of the issue date."[121] This language arguably illustrates that the primary goal is to ensure that the accruals and projected payments be fixed as of the issue date but that they may be calculated before such date. In addition, the language in Reg. § 1.1275-4(b)(4) (defining comparable yield and projected payment schedule) is in substance focused on a "reasonable" standard as opposed to applying a rigid mechanical rule.[122]

In light of this uncertainty and for reasons set forth below, we recommend that guidance be issued to clarify that the comparable yield and projected payment schedule of a CPDI should be based on the issuer's market and pricing conditions on the pricing date for the CPDI as long as the debt is issued within a reasonable time thereafter and the arrangement is not structured to reach an unreasonable result.[123]

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that the final documentation is printed prior to the issue date); American Bar Association, Committees on Financial Transactions, Tax Exempt Financing and Foreign Activities of U.S. Taxpayers, *Comments on Proposed Regulations on Debt Instruments with Original Issue Discount; Contingent Payments* (May 15, 1995) (noting that the economic terms are fixed as of the pricing date). The preamble to the final regulations did not directly respond to the commentators that raised this issue.

121 T.D. 8674 (June 11, 1996) (emphasis added).

122 For example: the supporting contemporaneous documentation must show that the comparable yield and projected payment schedule are "reasonable." Reg. § 1.1275-4(b)(4). The comparable yield must be "reasonable" for the issuer. Reg. § 1.1275-4(b)(4)(i)(A). Adjustment of non-market-based payments must "reasonably reflect" the expected value of payments. Reg. § 1.1275-4(b)(4)(ii)(C). Issuer's determination to be respected unless "unreasonable." Reg. § 1.1275-4(b)(4)(v).

123 Note that any attempt to reach an unreasonable result should be caught under the current OID anti-abuse rule. *See* Reg. § 1.1275-2(g). For example, we believe this rule should be applied even where the parties are technically not bound to enter into a transaction on the date the terms are fixed (which we understand can typically occur in certain non-registered transactions) as long as the transaction is not being structured to reach an unreasonable tax result.

First, the comparable yield accrual methodology is used as a proxy to accurately value the contingencies inherent in the debt instrument. However, if the comparable yield is to accurately reflect the values of the debt's contingencies, the yield must be calculated on the same date such contingencies are priced. In other words, if the contingent amounts are fixed on the pricing date for the note but the issuer's comparable yield is based on the pricing and market conditions on the issue date, the comparable yield would not accurately reflect the value of the contingent payments if market conditions changed in the interim. By contrast, a determination of the comparable yield based on market and pricing conditions on the pricing date for a CPDI would accurately reflect the market value of the contingent payments under the CPDI.

Second, the regulations provide that if there is a § 1.1275-6 hedge available, the comparable yield is the yield on the synthetic fixed-rate debt instrument that would result if the issuer entered into the § 1.1275-6 hedge. As a practical matter, however, we understand that taxpayers that hedge a CPDI generally price the § 1.1275-6 hedge when the debt instrument's terms are set on the pricing date. It would be incongruous for the comparable yield to be determined based on the pricing of a § 1.1275-6 hedge on the issue date for a CPDI when any actual hedge would be based on the pricing of a § 1.1275-6 hedge on the pricing date for the CPDI. It would therefore be appropriate to determine the comparable yield for a CPDI for which a § 1.1275-6 hedge is available based on the market and pricing conditions for the § 1.1275-6 hedge that are in effect on the pricing date for the CPDI. If that is the case, then the comparable yield for a CPDI for which a § 1.1275-6 hedge is not available should also be based on the issuer's market and pricing conditions on the pricing date for the CPDI.

Third, if the comparable yield is based on the issue date, debt holders could be subject to significantly higher interest accruals relative to the expected value of the contingent payments. This result is inconsistent with the general policy goal that investors should have the ability to know the tax consequences of an investment when they commit to enter into such investment. For example, assume a purchaser commits to acquire a note on July 7 and that the note would have a comparable yield of 5% as of such date. The 5% yield reflects the expectation that the underlying contingent payments would result in a yield of 5% per annum over the life of the CPDI. On July 9, the issuer's credit is downgraded and on July 10 the issuer's comparable yield is 8%. If the comparable yield must be based on the conditions in effect on the issue date,

the debt holder would unexpectedly be required to accrue interest at a rate of 8% even though the expected yield of the notes is still 5% if market conditions have not otherwise changed in the interim.[124]

Finally, calculation of the comparable yield on the issue date introduces an additional layer of administrative complexity. Issuers are required to provide the comparable yield and projected payment schedule to holders "in a reasonable manner"[125] since an issuer's determination generally binds holders.[126] Issuers generally comply with this requirement in practice by including in the relevant documentation (*e.g.*, the final pricing supplement) on the issue date either (i) the comparable yield and projected payment schedule or (ii) contact information (*e.g.*, a telephone number) via which holders may obtain such information from the issuer. Many issuers prefer to include the required information in the documents distributed to holders on the issue date to avoid a continuing obligation to provide such information over the life of the debt instrument.[127] However, such documents are frequently prepared and printed in advance of the issue date and therefore it is often not possible to include the comparable yield and projected payment schedule in the disclosure documentation if such information must be based on financial information available only on the issue date.

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[124] We note that the adverse effects of the uneconomically high interest accruals may be minimized or altogether avoided as the result of negative adjustments in certain circumstances, but the investor may nevertheless be subject to significant adverse-timing tax consequences if the debt instrument does not provide for annual contingent payments or if the projected payments are expected to increase over the term of the debt.

[125] Reg. § 1.1275-2(e).

[126] Reg. § 1.1275-4(b)(4)(v)(A). While the issuer's determination generally controls, any such determination would not be binding to holders if it is unreasonable, as specifically defined. Reg. § 1.1275-4(b)(4)(v)(B).

[127] We would note that the alternative approach effectively requires the issuer to make one or more employees available to provide the information to debt holders upon request. This process entails added administrative costs to the issuer and could lead to unintentional inconsistent reporting since the information may be conveyed by different people at different times over a significant period of time.

H. 25 Basis Points Presumption for Variable Rate Debt Instruments[128]

A note that provides for contingent payments may be treated as a VRDI (and not a CPDI) if, among other requirements, all stated interest on the note is at (1) one or more "qualified floating rates" ("QFRs"), (2) a single fixed rate and one or more QFRs, (3) a single "objective rate" or (4) a single fixed rate and a single objective rate that is an inverse QFR.[129] For purposes of determining whether these requirements are satisfied, an initial fixed interest rate that applies for no more than one year may be treated as a part of the subsequent QFR or objective rate if "the value of the variable rate on the issue date is *intended* to approximate the fixed rate."[130] In addition, there is a conclusive presumption that the value of the fixed and variable rates are intended to approximate each other "if the value of the variable rate on the issue date does not differ from the value of the fixed rate by more than 25 percentage points (25 basis points)" (the "25 Basis Points Presumption").[131]

For purposes of applying the 25 Basis Points Presumption, it is not entirely clear that the "value of the variable rate on the issue date" must be based on the actual value on the issue date. In the alternative, similar to the discussion above regarding the determination of the comparable yield of a CPDI, one could argue — particularly in light of the reasons discussed below — that the value of the variable rate that exists on the issue date is actually based on the relevant circumstances on the date the variable rate is fixed. In this regard, we note that the regulations first look to the issuer's intention that the "variable rate on the issue date" is meant to approximate the fixed rate even though the issuer's intention is irrelevant on the issue date since all rates are fixed on the pricing date. Accordingly, the language "variable rate on the issue date" arguably means that the issuer's intention when it sets the term of the note (i.e., the pricing date) was that the fixed rate and the floating rate would approximate each other when the note is

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128 Although this report does not otherwise discuss ambiguities or uncertainties in the VRDI rules, sections IV.F. and G. of the report address whether certain determinations should be made on the pricing date or the issue date of a note issuance. We therefore thought that it would be appropriate to discuss the following analogous issue in the context of the VRDI rules.

129 Reg. § 1.1275-5(a)(3)(i). *See* Reg. §§ 1.1275-5(b) and (c) for the definitions of QFRs, inverse QFRs and objective rates.

130 Reg. § 1.1275-5(a)(3)(ii) (emphasis added).

131 *Id*.

issued. The identical language when used in context of the 25 Basis Points Presumption arguably should likewise be interpreted to refer to the pricing date, although that would constitute a strained reading of the text of the regulations.

This special rule that treats an initial fixed rate as part of the variable rate accounts for the market reality that floating rate notes are regularly issued with an initial fixed rate. The initial rate is often fixed simply so that an investor will know the initial rate when it commits to purchase the note; in such cases the initial fixed rate is usually intended to approximate the expected floating rate. On the other hand, the issuer may fix the initial rate at a "teaser" level that is higher—and potentially significantly higher—than the expected value of the variable rate. In the former case, the regulations acknowledge that the fixed rate is really just set as a matter of convenience and the rate should not affect the VRDI characterization because the parties intend for the note with an initial fixed rate to perform similarly to a note that does not provide for a fixed rate. In the latter case, the note with a fixed rate is not intended to pay a yield that is approximately equivalent to a note without the fixed rate and therefore in such a case the fixed rate would generally be treated as a separate independent rate for VRDI purposes.

The 25 Basis Points Presumption is presumably intended to provide for an objective treatment of the fixed rate, particularly because the "intention" of the issuer is a subjective matter that cannot be easily proven. However, if the 25 Basis Points Presumption is based on the value of the floating rate on the issue date, the 25 Basis Points Presumption could apply even in cases in which the issuer does not intend for the fixed rate to approximate the value of the variable rate. For example, an issuer and investors could price a note that has a fixed rate that is not intended to approximate the subsequent floating rate on the note and that has a value that differs by more than 25 basis points from the value of the floating rate on the pricing date for the note. The parties to such a note would expect that the note would be treated as a CPDI, and not as a VRDI, for tax purposes. However, if the value of the floating rate changes between the pricing date and the issue date, the two rates could be within 25 basis points of each other and in such case, based on a more literal reading of the regulations, the note would unexpectedly qualify as a VRDI for tax purposes.

We believe that it would be more appropriate to apply the 25 Basis Points Presumption on the pricing date and not the issue date for the following reasons. First, the regulations are clearly focused on the intention of the issuer and the issuer's intention would be most accurately captured based on the rates in effect when the issuer agreed to the fixed rate (*i.e.*, the pricing date). A change in the variable rate between pricing and issuance by definition cannot reflect the intention of the issuer since the issuer has no control over such rates.[132] As discussed above, it would be anomalous if the 25 Basis Points Presumption were to treat an initial fixed rate and a subsequent floating rate as approximating each other based on market conditions on the issue date even if the parties to the note did not intend that such rates should approximate each other as evidenced by the fact that the two rates were not within 25 basis points of each other on the pricing date for the notes.

Second, as an equitable matter, a taxpayer should be able to determine how its debt instrument will be characterized for tax purposes when it commits to issue/acquire the debt instrument since different tax characterizations may have different economic consequences. To illustrate, a holder may be responsible for increased taxes in the case of a note with an above-market initial rate if a note that it believed would be treated as a CPDI is ultimately presumed to be a VRDI. If the note is treated as a VRDI, the holder could be required to pay taxes upfront on the full amount of an initial above-market coupon in accordance with its regular method of accounting[133] while, if the note is alternatively treated as a CPDI, the holder would only be required to pay taxes based on the lower comparable yield.[134]

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132 *See*, *e.g.*, Reg. § 1.1275-5(c)(1)(ii) ("an objective rate does not include a rate based on information that is within the control of the issuer [or a related party] or that is unique to the circumstances of the issuer [or a related party]").

133 Where a note provides for an initial above-market fixed rate followed by a QFR, the 25 Basis Points Presumption could apply to treat the two rates as a single QFR. Reg. § 1.1275-5(a)(3)(ii). All stated interest in respect of a debt instrument that provides for interest at a single QFR is QSI (Reg. § 1.1275-5(e)(2)(i)) and all such QSI is effectively allocated to an accrual period to the extent the QSI is paid in such accrual period. *See* Reg. § 1.1275-5(e)(2)(ii) and (iii). Consequently, holders are required to include the entire amount of an initial above-market interest rate in income when such interest is received.

134 *See generally* Reg. §§ 1.451-1 and 1.1275-4(b)(3).

Finally, if it is possible that the tax treatment of a note will change based on facts that will not be known until the issue date, it may not be feasible to prepare accurate and informative tax disclosure for purchasers of the debt.

In light of the discussion above, we recommend that guidance be issued that would provide that the 25 Basis Points Presumption should be determined based on the value of the floating rate on the pricing date for the notes as opposed to the issue date for the notes.

I. Applicability of the "Option Rule" to Variable Rate Debt Instruments

The OID regulations provide for special rules for determining the amount and accrual of OID and QSI in the case of a VRDI that provides for multiple floating rates. Specifically, the regulations "convert the debt instrument into a fixed rate debt instrument and then apply the general OID rules to the debt instrument."[135] The equivalent fixed rate debt instrument is generally created by replacing each variable rate with its "fixed rate substitute" (the "fixed rate substitute rule").[136] The fixed rate substitute for a variable rate that is not an objective rate is the value of the variable rate on the issue date for the note.[137] Once the fixed rate substitutes are calculated, the amount of QSI and OID with respect to the equivalent fixed rate debt instrument are determined "under the rules applicable to fixed rate debt instruments."[138] As discussed below, there is some uncertainty as to whether the fixed rate substitute rule also applies for purposes of applying the "option rule" described below to a VRDI.

The option rule in the OID regulations states that, for purposes of determining the yield and maturity of a debt instrument that has a holder call option and/or an issuer call option, both the issuer and holder are generally presumed to exercise (or not exercise) their options in a manner that minimizes or maximizes the yield of a debt instrument, respectively.[139] The option rule technically only applies to debt instruments where "the timing and amounts of the payments

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135 Reg. § 1.1275-5(e)(1).

136 Reg. § 1.1275-5(e)(3)(i).

137 *Id*.

138 Reg. § 1.1275-5(e)(3)(iii).

139 *See* Reg. § 1.1272-1(c)(5).

that comprise each payment schedule are known as of the issue date."[140] A VRDI, in the absence of the application of the fixed rate substitute rule, would not satisfy this requirement because the interest payments on the note are contingent. Most practitioners, however, are of the view that the option rules should apply to a VRDI based on the position, as explained in more detail below, that the option rule should only be applied after the contingent payments under the VRDI are converted into fixed payments under the fixed rate substitute rule.

The relevance of the application of the option rule to a VRDI can be illustrated by an example in which a three-year note is issued for $1,000 and the note provides for interest at a rate of LIBOR plus 2% for the first three years followed by interest at a rate of LIBOR plus 3% for the last three years. In addition, assume that the note has a principal amount of $1,000 and that the issuer has an option to call the debt instrument at par at the end of the first three years. If LIBOR is at 4% as of the issue date, the equivalent fixed rate debt instrument would be a six-year instrument that provides for a 6% interest rate per annum ($60) for three years and that provides for a 7% interest rate per annum ($70) for the remaining three years.[141] After the application of the fixed rate substitute rule, and if the option rule could not be applied to a VRDI, the note would have an SRPM of $1,030 because $10 of interest in each of the last three years exceeds the interest that is payable in respect of the note at a single fixed rate.[142] Accordingly, the note would be treated as issued with more than a *de minimis* amount of OID.[143] If, however, the option rule could be applied to a VRDI after the application of the fixed rate substitute rule, the note would be treated as having a term of only three years and providing for interest at a single fixed rate of 6% (since the issuer would be presumed to exercise its call option to minimize the yield on the note). The note would therefore not be treated as issued with OID.[144]

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140 Reg. § 1.1272-1(c)(1).

141 Reg. § 1.1275-5(e)(3)(i) (the fixed rate substitute of each QFR is "the value of each rate as of the issue date").

142 *See supra* note 47 and accompanying text.

143 A note with a term of six years will be treated as issued with more than a *de minimis* amount of OID if it is issued at a discount of 1.5% or more. *See* Reg. § 1.1273-1(d)(2).

144 If, contrary to the assumption based on the option rule, the note was not actually called after three years, then solely for purposes of Sections 1272 and 1273, the notes would be deemed to be retired and reissued on the day that the assumption is shown to be incorrect. Reg. § 1.1272-1(c)(6).

We believe that the option rule should apply to a VRDI after the application of the fixed rate substitute rule for two reasons. First, we believe that a plain reading of the regulations supports this interpretation. Specifically, as stated above, the regulations state that the amount of QSI and OID "*for the equivalent fixed rate debt instrument* are determined under the rules applicable to fixed rate debt instruments"[145] and the option rule clearly applies to a fixed rate debt instrument. Similarly, the regulations provide that the taxpayer should "convert the debt instrument into a fixed rate debt instrument and *then* apply the general OID rules to the debt instrument."[146] That is, once the fixed rate instrument is constructed, all the relevant OID rules (which presumably include the option rule) should be applied.[147]

Second, we believe this approach will generally lead to more appropriate results that are more consistent with the economics of the transaction. This could be illustrated by an example in which one assumes that the note in the example described above provided for interest at the rate of LIBOR plus 2% for the first three years followed by a rate of LIBOR plus 8% for the remainder of the term of the note. If the option rule applies to such a note after the application of the fixed rate substitute rule, the OID regulations would assume that the issuer would call the note before the interest rate step-up and therefore the note would not be issued with OID. However, if the option rule could not be applied to such a note because the VRDI provides for contingent payments, then subject to the potential application of the OID anti-abuse rule and assuming there is more than a remote possibility that the issuer would not call the note,[148] the issuer would be entitled to take higher deductions based on the assumption that the

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145 Reg. § 1.1275-5(e)(3)(iii) (emphasis added).

146 Reg. § 1.1275-5(e)(1) (emphasis added).

147 In contrast, we do not believe that the option rule can be invoked to cause an instrument that would not otherwise qualify as a VRDI to so qualify. For example, a debt instrument that provides for two objective rates cannot qualify as a VRDI, which may only have one objective rate. *See* Reg. § 1.1275-5(a)(3)(i). We do not believe that the option rule can be used to treat the note as providing for a single objective rate even if the second rate would produce a higher rate than the first and the issuer could call the note before the rates switch. This is because the VRDI regulations mandate the construction of a hypothetical fixed rate instrument to which the option rule could apply only once a note qualifies as a VRDI. However, absent the option rule, the note would not qualify as a VRDI in the first place and therefore the hypothetical fixed rate debt instrument to which the option rule may apply would never be constructed.

148 *See* Reg. § 1.1275-2(g).

note would remain outstanding over the entire term even though such eventuality is presumably very unlikely.

We believe that the correct interpretation of the OID regulations is that the option rule should apply after the application of the fixed rate substitute rule and that the option rule should therefore apply to a VRDI. However, in light of the lack of explicit authority on this point and the existence of some uncertainty in the market as whether the option rule applies to a VRDI, we recommend that guidance be issued that would provide that the option rule applies to a VRDI after the application of the fixed rate substitute rule.

J. Discount Notes that have an "Excess Cash Flow Sweep" Feature

As discussed above, this report does not make any specific recommendations regarding the CPDI regulations except in respect of the pricing date/settlement date issue that is discussed more generally in this report. However, we would like to briefly bring to the government's attention the need for guidance regarding the tax treatment of discount notes that provide for a contingent yield because they include an excess cash flow sweep provision. While we believe that guidance is sorely needed in this area, this report does not make any specific recommendations as to how such notes should be treated because any such recommendations would require a comprehensive discussion of the tax treatment of timing contingencies in general, which would be beyond the intended scope of this report.

We understand that bank loans are ordinarily issued at a discount and typically contain an "excess cash flow sweep" requirement. In general, this requirement obligates the borrower to repay the principal of the loan to the extent of the borrower's "available" cash. The yield on such a note is therefore contingent on the timing of the principal repayments as the discount on the loan is the same irrespective of when the principal is repaid.[149]

We understand that some taxpayers and their advisors have been treating these loans as subject to the CPDI regulations while others have been treating such loans as fixed-rate

[149] If a note contained an excess cash flow sweep but was not issued at a discount, then the excess cash flow sweep would be disregarded and the note would be treated as a noncontingent fixed rate debt instrument since the debt instrument would have the same yield under all possible payment schedules notwithstanding the fact that the payments of principal are contingent as to time. *See* Reg. § 1.1272-1(d).

debt instruments issued with OID (in an amount that may exceed the *de minimis* amount) that are not subject to the CPDI regulations. The former approach is based on the fact that such loans contain a timing contingency that affects the yield on the note. Thus, according to this view, such a loan should be subject to the CPDI regulations notwithstanding that the CPDI regulations expressly reserve on the appropriate treatment of debt instruments that provide for payments that are contingent as to time.[150]

The latter approach is based on two possible arguments. First, some practitioners have taken the position that such debt instruments could reasonably not be treated as subject to the CPDI regulations based on an analogy to the mandatory sinking fund provision exception included in the OID rules. More specifically, the OID regulations provide that, notwithstanding the general OID rules (including the SMLTN Presumption), "a mandatory sinking find provision . . . is ignored for purposes of computing the yield and maturity of a debt instrument if the use and terms of the provision meet reasonable commercial standards."[151] A mandatory sinking provision will be covered by this special rule if:

> (i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.
>
> (ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).
>
> (iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.[152]

By providing for this specific exception, the regulations provide that — at least in this limited scenario — the ability to require early repayment of principal does not cause an

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150 Reg. § 1.1275-4(b)(9)(iii). We note that under this approach there would still be uncertainties regarding the application of the CPDI regulations to these types of loans in the absence of regulations regarding the application of the CPDI regulations to timing contingencies. For example, there are no rules as to how the term of a loan described in this section should be computed for purposes of determining the comparable yield of the loan.

151 Reg. § 1.1272-1(c)(3).

152 *Id*.

instrument to be treated as subject to the CPDI rules.[153] Although not strictly covered by Reg. § 1.1272-1(c)(3), we understand that some practitioners have taken the position that discount debt instruments with an excess cash flow sweep could similarly not be treated as subject to the CPDI rules (*i.e.*, that the excess cash flow sweep contingency should be disregarded), particularly in light of the fact that the Treasury has reserved the regulations relating to timing contingencies. This position is based on the argument that a mandatory early redemption pursuant to an excess cash flow sweep should be treated no worse than a mandatory redemption pursuant to a sinking fund provision that is at least partially in the discretion of the issuer.[154]

Second, some have taken the position that the fact the Treasury explicitly reserved the regulations regarding timing contingencies in the CPDI regulations arguably indicates that notes with timing contingencies that do not have any non-timing contingencies are not subject to the noncontingent bond method set forth in the CPDI regulations as long as the section in such regulations relating to timing contingencies is reserved.

As described above, we request that guidance be issued regarding the tax treatment of the debt instruments that are described in this section, particularly because these debt instruments are very frequently issued in the bank loan market and because we understand that taxpayers have been taking inconsistent positions regarding the appropriate tax treatment of such debt instruments.

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153 *See* Reg. § 1.1275-4(a)(2)(iii) (excluding debt instruments subject to Reg. § 1.1272-1(c)(2) from CPDI characterization).

154 That is, there is more discretion in the case of a mandatory sinking fund provision because, while an issuer is required to redeem a portion of the notes, the redemption may occur at any time prior to maturity (as opposed to a mandatory repayment to the extent of available cash) and, in the sinking fund context, the issuer can choose to repurchase its debt on the open market instead of pursuant to the sinking fund provision.