# NEW YORK STATE BAR ASSOCIATION TAX SECTION
# REPORT ON PROPOSED TREASURY REGULATION SECTION 1.1502-13(g) RELATING TO INTERCOMPANY OBLIGATIONS

March 6, 2008

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# NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON PROPOSED TREASURY REGULATION SECTION 1.1502-13(g) RELATING TO INTERCOMPANY OBLIGATIONS

This Report[1] comments on proposed Treasury regulation section 1.1502-13(g) relating to intercompany obligations (the "proposed -13(g) regulations").[2] Currently, Treasury regulation section 1.1502-13(g) (the "existing -13(g) regulations")[3] generally provides that if a member realizes an amount (other than zero) of income, gain, deduction, or loss from the assignment or extinguishment of its rights or obligations under an intercompany obligation (an "IO"), the IO is treated for federal income tax purposes as satisfied under a so-called "deemed satisfaction rule" and, if it remains outstanding, reissued under a so-called "deemed reissuance rule."[4] The proposed -13(g) regulations would, among other things, (i) revise the mechanics of the deemed satisfaction and reissuance models found in existing -13(g) regulations and (ii) add a number of exceptions to the deemed satisfaction and reissuance rules for various types of transactions if certain conditions are met. We generally support these changes and, in particular, applaud the efforts by IRS and Treasury to clarify the operation of the deemed

[1] This report was prepared by the Consolidated Return Committee of the New York State Bar Association Tax Section. David H. Schnabel was the principal drafter of this Report. Substantial contributions were received from Kathleen L. Ferrell, Larry Garrett, Serge Mezhburd, David S. Miller, and Michael L. Schler. Helpful comments were received from Stuart J. Goldring.

[2] The proposed -13(g) regulations were issued on September 28, 2007. Notice of Proposed Rulemaking (REG-107592-00) and withdrawal of proposed regulations (REG-105964-98), 72 F.R. 55139 (2007).

[3] The existing -13(g) regulations were issued in 1995 (TD 8597) and in 1998 the IRS and Treasury proposed certain changes to those regulations (the "1998 proposed -13(g) regulations").

[4] Treas. Reg. § 1.1502-13(g)(3).

satisfaction and reissuance rules and to narrow the universe of transactions that trigger the application of those rules. However, as described below, we recommend that certain changes be made to the proposed -13(g) regulations, including significant changes to the so-called "material tax benefit rule,"[5] which would generally trigger the application of the deemed satisfaction and reissuance rules in cases where one of the exceptions would otherwise apply if it was reasonably foreseeable that the shifting of intercompany items resulting from the underlying transaction would secure a material tax benefit for the group.[6]

The proposed -13(g) regulations also include a so-called "off-market issuance rule." The off-market issuance rule would, in certain cases involving the issuance of an "off-market" IO, deem the obligation to have been issued for cash equal to the obligation's fair market value and, where necessary, deem other payments to have been made among the group (such as deemed distributions or contributions) equal to the difference between the amount nominally paid for the obligation and its fair market value. We believe that the off-market issuance rule should be revised so that it applies in a more limited category of cases.

This report is divided in five parts. Part I summarizes our principal comments and recommendations. Part II provides some background concerning the intercompany transaction rules applicable to intercompany obligations. Part III describes and

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5 See Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(C).

6 Prop. Treas. Reg. § 1.1502-13(g)(4)(iii).

comments on the proposed -13(g) regulations applicable to intragroup transactions and outbound transactions. Part IV describes and comments on the proposed -13(g) regulations applicable to inbound transactions. Part V describes and comments on the proposed off-market issuance rule.

**Part I. Principal Comments and Recommendations.**

**Intragroup and Outbound Transactions**

- Deemed Satisfaction and Reissuance Rule. We strongly support the revisions to the deemed satisfaction and reissuance rules, including (i) determining the deemed satisfaction and reissuance amount based on the fair market value of the IO rather than under Section[7] 1274 principles, (ii) having the deemed reissuance be considered to occur immediately prior to the triggering transaction (rather than immediately after), and (iii) treating the deemed satisfaction and reissuance as a transaction that is separate from the triggering transaction.

- Triggering Transaction. We strongly support the efforts by the IRS and Treasury to narrow the universe of transactions that trigger the deemed satisfaction and reissuance rules, including in particular the exceptions for (i) internal tax-free reorganizations and liquidations and (ii) outbound distributions of newly-created IOs in the spinoff context.

- Material Tax Benefit Rule. We recommend that the material tax benefit rule be revised so that it resembles a more typical intent-based anti-abuse rule. Specifically, we believe that the material tax benefit rule should apply to a transaction only if a principal purpose of the transaction is to secure a material tax benefit that would not otherwise be enjoyed by shifting IO items of built-in gain, loss, income or deduction between members. However, we think it would be appropriate to create certain pro-IRS presumptions[8] for cases where the facts suggest such a principal purpose, such as where:

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7 Unless otherwise provided, all section references in this report are to the sections of the Internal Revenue Code of 1986, as amended.

8 For the avoidance of doubt, we recommend that all of the presumptions recommended by this Report be rebuttable by the taxpayer.

(i) an above-market IO is transferred in a tax-free transaction to a member with losses limited under the SRLY or other rules,

(ii) an above-market IO is transferred to another member in exchange for stock in such member in a tax-free transaction if within some period (*e.g.*, two years) the gain on the IO is triggered in a manner that increases the tax basis of other shares that are sold but the shares received in exchange for the IO are retained, and

(iii) an IO is transferred to or assumed by another member if within some period (*e.g.*, two years) there is a direct or indirect disposition of the stock of the transferee in a transaction in which the group recognizes a loss that is not disallowed.

- Determination of FMV. We recommend that in appropriate circumstances a taxpayer's good faith determination of the fair market value of an IO be presumed to be correct. Moreover, if the IRS and Treasury are less concerned with IOs with a below-market interest rate, we believe the final regulations should provide that in appropriate circumstances the fair market value of an IO be deemed to equal its adjusted issue price. However, these special valuation conventions should not apply in the potentially abusive situations described above (in the context of the material tax benefit rule) or if a principal purpose of the transaction is otherwise to secure a material tax benefit by shifting IO items.

- Exception for Tax Free Exchanges. The exception for certain tax free exchanges should be revised to (i) clarify that the carve out for transactions in which income, gain, loss or deduction is recognized applies only if such an item is recognized in respect to the IO itself (rather than another asset), (ii) clarify the interaction of Treasury regulation section 1.1001-3 (relating to deemed exchanges of debt) with the exception in cases where an IO is assumed under circumstances that trigger such a deemed exchange, and (iii) clarify the application of the exception in the case of Section 332 liquidations.

- Separate Treatment. As noted above, we support the treatment of the deemed satisfaction and reissuance of the IO as a transaction separate from the underlying transaction. We recommend that the final regulations expand upon this concept by providing that the deemed satisfaction and reissuance are (i) also treated as separate from any other transaction (even if related to the triggering transaction) and (ii) ignored in determining whether any other transaction is afforded tax-free treatment, including as to the determination of whether any IO is treated as a security for tax purposes.

- Internal Distributions of IOs in Spinoff Context. We recommend that the final regulations provide that an internal distribution of an IO is not a triggering

transaction in cases where (i) a member (D) that is a party to a reorganization exchanges property in pursuance of the plan of reorganization for a newly issued IO of another member that is a party to the reorganization (C), (ii) the IO is distributed to another member in a transaction to which Section 361(c) applies, (iii) C is (directly or indirectly) distributed to a nonmember, and (iv) the IO is within a relatively short period transferred to a nonmember.

**Inbound Transactions**

- We recommend that the final regulations be revised so that, in the case of an inbound acquisition of the debtor in a transaction that triggers cancellation of debt income, the attributes of the acquiring group (other than the debtor member and its subsidiaries) not be adjusted under Treasury regulation section 1.1502-28.

**Off-Market Issuance Rules**

- We recommend that the off-market issuance rule be narrowed so that it applies only in cases where a principal purpose of the issuance of the IO or the setting of the interest rate was to secure a material tax benefit that would not otherwise be enjoyed by shifting IO items between members. Again, we believe that such a principal purpose should be presumed in the potentially abusive situations described above.

- Further, we recommend that if a taxpayer, upon issuance of an IO, makes a good faith determination that the interest rate of the IO is a market rate, such rate should be presumed to be a market rate for the IO so long as securing a material tax benefit by shifting items between members was not a principal purpose for the issuance of the IO (or the setting of the rate). We recommend that such a principal purpose be presumed to exist in cases where (i) the IO is issued by or to a member with losses limited under the SRLY or other rules or (ii) within some period (*e.g.*, two years) after the issuance of the IO by or to a member, there is a direct or indirect disposition of the stock of such member in a transaction in which the group recognizes a loss that is not disallowed. Similarly, absent such conditions, we recommend that the interest rate on a newly-issued IO be deemed to be a market rate if the rate equals or is based on the parent's third-party borrowing rate (provided that the consolidated group generally uses such a rate for its IOs).

## Part II. Background Relating to the Intercompany Obligation Regulations.

### A. In General.

Treasury regulation section 1.1502-13 (the "intercompany transaction regulations") provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income ("CTI") (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).[9] Under the intercompany transaction regulations, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under the intercompany transaction regulations to produce the effect of transactions between divisions of a single corporation (single entity treatment).[10]

The principal rules applicable under the intercompany transaction regulations that implement single entity treatment are the "matching rule" and the "acceleration rule."[11] Under the matching rule, the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect

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[9] Treas. Reg. § 1.1502-13(a)(1).

[10] Treas. Reg. § 1.1502-13(a)(2).

[11] Treas. Reg. § 1.1502-13(a)(6)(i).

on CTI (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions.[12] The acceleration rule provides additional rules for taking the items into account.[13]

In the case of an IO, the matching and acceleration rules generally treat each payment or accrual of interest on the IO as a separate intercompany transaction in which the interest income is matched with the interest deduction so that there is no net effect on CTI.[14] Similar rules also apply when an IO is repaid.

In addition to these basic rules, the intercompany transaction regulations include a special set of rules under -13(g) for transactions in which (i) the rights or obligations under an IO are transferred between members of a consolidated group or an IO is extinguished (an "intragroup transfer"),[15] (ii) an IO becomes an obligation that is not an IO (*e.g.*, the borrower member or the creditor member is deconsolidated) (an "outbound transfer")[16] or (iii) an obligation that is not an IO becomes an IO (an "inbound transfer").[17] As explained in more detail below, when these events occur, the IO is generally treated for federal income tax purposes as satisfied under a so-called "deemed

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[12] Treas. Reg. § 1.1502-13(c)(1).

[13] Treas. Reg. § 1.1502-13(a)(6)(i).

[14] Treas. Reg. § 1.1502-13(c) and Treas. Reg. § 1.1502-13(d).

[15] Treas. Reg. § 1.1502-13(g)(3).

[16] *Id.*

[17] Treas. Reg. § 1.1502-13(g)(5).

satisfaction rule" and, if it remains outstanding, reissued under a so-called "deemed reissuance rule."

**B. Purposes Served by the Application of the Deemed Satisfaction and Reissuance Rule to Internal Transactions.**

The deemed satisfaction and reissuance rules serve a variety of purposes in the context of an internal transaction. First, in the case of a taxable intragroup transaction in which income, gain, loss or deduction is recognized, it is necessary to apply the matching and acceleration rules to eliminate any net impact on CTI. The deemed satisfaction and reissuance rules allow the matching and acceleration rules to be applied between the debtor member and the creditor member. The preamble to the proposed -13(g) regulations (the "Preamble")[18] notes that the IRS and Treasury concluded that this was simpler than applying the matching and acceleration rules to the transferor member and the transferee member.[19]

[18] 72 F.R. 55139 (2007).

[19] Specifically, the Preamble notes that "the IRS and the Treasury Department have considered whether, with respect to intragroup transactions, the objectives of §1.1502-13(g) could be better accomplished without a deemed satisfaction-reissuance model, and could instead be achieved solely through the matching and acceleration principles of §1.1502-13. After considering this approach, it was determined that special rules (in addition to the matching rule of §1.1502-13(c) and the acceleration rule of §1.1502-13(d)) would be necessary to ensure that transactions involving intercompany obligations clearly reflect consolidated taxable income. For example, if an intercompany obligation is sold to another member, the special rules and elections of the various debt regimes (that is, the rules for original issue discount, market discount, and acquisition premium) would have to be reconciled with the intercompany transaction rules through coordinating adjustments among the selling creditor, debtor, buying creditor, and any subsequent member creditors. The IRS and the Treasury Department have concluded that the deemed

Second, in the case of a tax-free intragroup transaction, the deemed satisfaction and reissuance rules can prevent the inappropriate use of losses of a member of a consolidated group that are subject to limitations under the separate return limitation year ("SRLY") rules or other similar rules.[20] For example, a member holding an above-market IO could transfer the IO to a member with losses subject to the SRLY rules in a Section 351 transaction.

Third, the deemed satisfaction and reissuance rules can prevent groups from reducing future gain on the sale of stock of a member by transferring an IO to the member prior to the sale. For example, suppose that P owns 100% of S, P has a zero basis in the S stock, and the S stock has a FMV of $900. X is another member of the group that holds an appreciated IO issued by yet another member with an issue price and stated principal amount of $90 but a FMV of $100. Assume X transfers the IO to S in exchange for 10% of the outstanding S stock in a Section 351 transaction. Then, the IO is satisfied for $100, which causes S to have $10 of gain. Under the investment adjustment rules, the $10 of gain increases P's tax basis in its S stock from $0 to $9 and

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satisfaction-reissuance model is preferable to the complexity inherent in any such special rules."

[20] Other rules that limit the circumstances where a group member's losses may be used by the group include rules that are specifically applicable to groups that include foreign insurance companies that have made a Section 953(d) election to be taxed as a domestic entity and groups that include both life-nonlife groups. See Section 953(d)(3); Treas. Reg. § 1.1502-47; Sections 1503(c) and 1503(d).

increases X's tax basis in its S stock from $90 to $91.[21] Then, P sells its S stock but X retains its S stock. The net impact is that the transfer of the appreciated IO by X, coupled with X's retention of its S stock, allows the group to defer $9 of CTI until X sells its S stock. By contrast, no such deferral would exist if X sold its S stock at the same time as P.

Fourth, the deemed satisfaction and reissuance rules preserve the location of built-in IO items for purposes of applying other rules. For example, the location of an item in a particular member could impact the application of the proposed loss-disallowance rules to that member or a (direct or indirect) parent of that member.

### C. <u>The Existing -13(g) Regulations</u>.

1. <u>Triggering Events</u>. As noted above, the existing -13(g) regulations provide that if a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an IO, the IO is treated for all federal income tax purposes as satisfied under a so-called "deemed satisfaction rule" and, if it remains outstanding, reissued under a so-called "deemed reissuance rule."[22] Similar principles apply if a member realizes any such amount, directly or indirectly, from a comparable

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[21] Note that the same result would arise under the deemed satisfaction and reissuance rule applicable to outbound transfers if the IO were still outstanding at the time S were transferred outside of the group.

[22] Treas. Reg. § 1.1502-13(g)(3)(i)(A).

transaction (for example, a marking-to-market of an obligation or a bad debt deduction) and in the case of an outbound transfer or an inbound transfer.[23]

2. Deemed Satisfaction Rule. The deemed satisfaction rule provides that if a creditor member sells an IO for cash, the debt is treated as satisfied by the debtor immediately before the sale for the amount of the cash.[24] For other transactions, "similar principles apply to treat the intercompany debt as satisfied immediately before the transaction. Thus, if the debt is transferred for property, it is treated as satisfied for an amount consistent with the amount for which the debt is deemed reissued under the deemed reissuance rule, and the basis of the property is also adjusted to reflect that amount."[25] In cases where the debtor or creditor becomes a nonmember, the deemed satisfaction rule provides that the obligation is treated as satisfied for cash in an amount equal to its fair market value immediately before the debtor or creditor becomes a nonmember.[26] Similar principles apply to IOs other than debt.[27]

3. Deemed Reissuance Rule. The deemed reissuance rule provides that if a creditor member sells intercompany debt for cash, the debt is treated as a new debt (with a new holding period) issued by the debtor immediately after the sale for the amount of

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23 *Id.*

24 Treas. Reg. § 1.1502-13(g)(3)(ii)(A).

25 *Id.*

26 *Id.*

27 *Id.*

cash.[28] For other transactions, "if the intercompany debt remains outstanding, similar principles apply to treat the debt as reissued immediately after the transaction. Thus, if the debt is transferred for property, it is treated as new debt issued for the property. See, for example, section 1273(b)(3) or section 1274."[29] In cases where the debtor or creditor becomes a nonmember, the deemed reissuance rule provides that the debt is treated as new debt issued for an amount of cash equal to its fair market value immediately after the debtor or creditor becomes a nonmember.[30] Similar principles apply to IOs other than debt.[31]

**D. <u>Certain Issues Under the Existing -13(g) Regulations</u>.**

The application of the deemed satisfaction rule and the deemed reissuance rule under the existing -13(g) regulations can be problematic in cases where intercompany debt is exchanged in an intragroup transfer for non-publicly traded property, including cases where the exchange is effected as part of an internal restructuring such as an internal reorganization or liquidation. In these cases, the existing -13(g) regulations provide that the deemed new debt is treated as having been issued in exchange for the underlying property and indicate that Section 1274 principles apply in determining the amount for which the intercompany debt is treated as having been satisfied and reissued.

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[28] Treas. Reg. § 1.1502-3(g)(3)(iii).

[29] *Id.*

[30] *Id.*

[31] *Id.*

Two primary issues arise. First, notwithstanding the fact that the existing -13(g) regulations indicate that Section 1274 principles apply in determining the amount for which the intercompany debt is treated as having been satisfied and reissued, it may be necessary to apply substance-over-form and Section 482 principles to the transaction. As explained below, these principles may require a valuation of both the property and the IO and trump the application of Section 1274 principles. Second, the deemed reissuance rule provides that the new debt is treated as having been newly issued for the underlying property. This intertwines the deemed satisfaction and reissuance with the underlying transaction in ways that can create substantial uncertainty.

1. Application of Section 1274 Principles in the Related Party Context.

Section 1274 generally provides that if an acquirer issues debt in exchange for non-publicly traded property, the issue price of the debt is generally equal to its stated principal amount so long as the debt bears adequate stated interest (which generally requires that the interest rate on the debt equal or exceed the applicable federal rate).[32] Under Treasury regulation section 1.1001-1(g)(1), the seller's amount realized in respect of the receipt of the debt equals the issue price of the debt. Accordingly, if A sells non-

[32] If there is not adequate stated interest, the issue price equals the imputed principal amount (which generally equals the sum of the present values of all payments due under the debt). Section 1274(a)(2). However, in the case of a "potentially abusive situation," the imputed principal amount will generally equal the fair market value of the property exchanged for the debt. A potentially abusive situation generally includes a tax shelter (as defined in Section 6662(d)(2)(C)(iii)) and any other transaction arising by virtue of recent sales transactions, nonrecourse financing, financing with a term in excess of the economic life of the property or a debt instrument with clearly excessive interest. Treas. Reg. § 1.1274-3(a).

publicly traded property to B in exchange for a B note that bears adequate stated interest and has a $100 stated principal amount, the issue price of the note will equal its $100 stated principal amount and A's amount realized on the sale (and B's initial tax basis in the property) will equal that $100 issue price.

However, different concerns may apply if A and B bear some other relationship, such as a parent-subsidiary relationship or an employment relationship. For example, proposed Treasury regulation section 1.1012-2(a) provides:

> in the case of a sale or exchange of property in which the relationship between the seller and the buyer is such that the sale or exchange is not necessarily an arm's-length transaction, the transaction shall be examined to determine whether the value of the consideration provided by the buyer is greater than or less than the value of the property. If the value of the consideration exceeds the value of the property, the excess is not to be treated as relating to the sale or exchange and is recharacterized according to the relationship between the parties. For example, if the value of the property exceeds the value of the consideration, the excess is generally treated as transferred from the seller to the buyer based on the relationship between the parties and not as transferred in exchange for the debt instrument.[33]

Further, in cases where the consideration paid for property consists of a debt instrument issued by the buyer as to which the issue price is determined under Section 1274, proposed Treasury regulation section 1.1012-2(b) provides that in applying the

[33] Prop. Treas. Reg. § 1.1012-2(a). See proposed Treasury regulation section 1.1012-2(c)(Exs. 1 and 2) for an example of the application of these principles to intragroup transfers of property in exchange for newly issued debt when the fair market value of the consideration (including the value of the debt as determined under the principles of Section 1274) is different from the fair market value of the transferred property.

bifurcation rule described above the debt instrument is treated as having a value equal to its issue price.[34]

The existing -13(g) regulations are silent as to how (if at all) the principles reflected in proposed Treasury regulation section 1.1012-2(a) must be taken into account in applying the deemed satisfaction rule.

> Example 1 Assume that P and S are members of a consolidated group and that P is the sole shareholder of S. S sells non-publicly traded property with a fair market value of $100 to P in exchange for an IO of another member of the group that was previously issued to P. The IO does not bear adequate stated interest, has a principal amount of $100 and a fair market value of $80. If the note were issued today in a third-party transaction in exchange for property, the issue price under Section 1274 would be $90.

If the deemed satisfaction and reissuance rule under the existing -13 regulations were applied without regard to the principles reflected in proposed Treasury regulation section 1.1012-2(a), it appears that (i) the issue price of the deemed new debt would be $90,[35] (ii) the old debt would be treated as having been satisfied for $90[36] and (iii) S's amount realized for the property (and P's adjusted basis for the property) would be $90.

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[34] Prop. Treas. Reg. § 1.1012-2(b)(1).

[35] As described above, the reissuance rule in the existing -13(g) regulations provides that "if the debt is transferred for property, it is treated as new debt issued for the property. See, for example, section 1273(b)(3) or section 1274". Treas. Reg. § 1.1502-13(g)(3)(iii).

[36] The satisfaction rule in the existing -13(g) regulations provides that if the debt is transferred for property, it is treated as satisfied for an amount consistent with the amount for which the debt is deemed to be reissued under the reissuance rule. Treas. Reg. § 1.1502-13(g)(3)(ii)(A).

By contrast, if the principles of proposed Treasury regulation section 1.1012-2 applied (including the provision which treats debt as having a value equal to its issue price for purposes of bifurcating the transaction), it appears that (i) the transaction would be bifurcated into a distribution of a $10 interest in the property and a sale of a $90 interest in the property in exchange for the IO, (ii) the issue price of the deemed new debt would still be determined under Section 1274 principles and therefore would still be $90, (iii) the old debt would still be treated as having been satisfied for $90, and (iv) S's amount realized for the property (and P's adjusted basis for the property) would be $100 ($90 from the sale and $10 from the deemed distribution).

However, apart from the fact that proposed Treasury regulation section 1.1012-2 does not have the force of law, the provision in that proposed Treasury regulation which treats debt as having a fair market value equal to its issue price for purposes of bifurcating the transaction may not apply because in the underlying transaction (as opposed to the deemed transaction) the debt was preexisting and was not originally issued in exchange for the property in a transaction governed by Section 1274. Accordingly, it may be appropriate to bifurcate the transaction using the $80 fair market value of the IO and bifurcate the transaction into a distribution of a $20 interest in the property and a sale of an $80 interest in the property in exchange for the IO. In this case, absent another controlling principle, it appears that (i) the issue price of the deemed new debt would still be computed using Section 1274 principles and therefore would still be $90, (ii) the old debt would still be treated as having been satisfied for $90, and (iii) S's

amount realized for the property (and P's adjusted basis for the property) would be $110 ($90 from the sale and $20 from the deemed distribution).

However, some commentators[37] have noted that Section 482 principles may trump Section 1274 principles in cases where the issue price determined under Section 1274 does not equal the fair market value of the debt. If this were true, then (i) the transaction would be bifurcated into a distribution of a $20 interest in the property and a sale of a $80 interest in the property in exchange for the IO, (ii) the issue price of the deemed new debt would be $80, (iii) the old debt would be treated as having been satisfied for $80, and (iv) S's amount realized for the property (and P's adjusted basis for the property) would be $100 ($80 from the sale and $20 from the deemed distribution). We note that this is the most accurate reflection of the underlying economics of the transaction.

2. Interaction of Deemed Satisfaction and Reissuance with Underlying Transactions.

The second primary source of confusion stems from the fact that the existing -13(g) regulations treat the deemed reissuance transaction as part of the actual transaction. The following example from Dubroff illustrates some of the areas of confusion:

> *Intercompany reorganization of creditor member.* (a) On January 1 of Year 1, *P* borrows $100 from *S* in return for *P* 's note providing for $10 of

[37] *See generally* Andrew J. Dubroff, Jerred G. Blanchard, Jr., John Broadbent and Kevin Duvall, FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS (hereinafter Dubroff), § 33 (2007).

interest annually at the end of each year, and repayment of $100 at the end of Year 5. At the end of Year 3, when the *P* note is worth $110, *S* merges into *B* in a reorganization described in Section 368(a)(1)(A) and (D). *S* recognizes no gain or loss under Section 361 on its transfer of assets, but it *realizes* $10 of gain on the intercompany obligation of *P*. Under Treasury regulation section 1.1502-13(g)(3)(ii), *P* apparently is treated as retiring the obligation for its $110 fair market value immediately before *S* 's transfer, and under Treasury regulation section 1.1502-13(g)(3)(iii) as issuing a new *P* obligation with a $110 issue price and $100 redemption price directly to *B* in exchange for the property acquired by *S* in the actual transfer of the obligation (i.e., *B* stock in the reorganization). *P* 's acquisition of the *B* shares is likely treated as a Section 351 transaction. Under Section 362, *B* succeeds to *P* 's basis in its own obligation, and *B* might therefore take a zero basis in the obligation, while *P* takes a zero basis in the *B* stock under Section 358. The recast required by the regulations does not account for the fact that *B* does not actually hold the retirement proceeds of the original *P* obligation following the merger with *S* , so an additional recast must be assumed. *B* must be treated as redeeming the additional *B* shares acquired by *P* for an amount equal to the proceeds treated as received from *P* in the deemed retirement. This redemption should be treated under Section 302(d) as equivalent to a dividend and, if *P* and *B* each take the zero basis, *P* 's basis in the remaining *B* stock is reduced by the amount of the deemed redemption, while *B* will take gain into account when principal payments are received on *P* 's obligation. Any gain that *B* recognizes from a payment might result in a subsequent retirement and reissuance under Treasury regulation section 1.1502-13(g)(3), with *B* 's gain taken into account under the matching and acceleration rules. The gain should be recharacterized as excluded from gross income in order to prevent distortion of consolidated taxable income.[38]

## Part III. Intragroup and Outbound Transactions Under the Proposed -13(g) Regulations.

### A. <u>Description of Proposed Regulations.</u>

1. <u>Definition of Intercompany Obligation</u>. Like the existing -13(g) regulations, the proposed -13(g) regulations include a broad definition of intercompany

[38] Dubroff Chapter 33.03[3] Example 3.

obligation. Specifically, the proposed regulations (1) define an intercompany obligation as any "obligation" between members (for the period during which both parties are members),[39] (2) define obligation of a member to mean a "debt" or "security" of a member,[40] (3) define debt of a member to mean any obligation of the member constituting indebtedness under general principles of federal income tax law (but not an executory obligation to purchase or provide goods or services)[41] and (4) define security of a member as any security of the member described in Section 475(c)(2)(D) or (E), and any commodity of the member described in Section 475(e)(2)(A), (B), or (C) (but not if the security or commodity is a position with respect to the member's stock).[42]

2. Deemed Satisfaction and Reissuance. The proposed -13(g) regulations generally provide that if a "triggering transaction" occurs with respect to an IO that constitutes debt, the debt is treated for all federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to its fair market value, and then as

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39 Prop. Treas. Reg. § 1.1502-13(g)(2)(ii).

40 Prop. Treas. Reg. § 1.1502-13(g)(2)(i).

41 Prop. Treas. Reg. § 1.1502-13(g)(2)(i)(A).

42 Prop. Treas. Reg. § 1.1502-13(g)(2)(i)(B). Sections 475(c)(2)(D) and (E) define a "security" as (i) an interest rate, currency or equity notional principal contract and (ii) evidence of an interest in, or a derivative (including option, forward, short position, or similar financial instrument) in, a security such as a share of a corporation, a partnership interest in a widely held or publicly traded partnership or trust, a security described in clause (i) above, or any currency. Sections 475(e)(2)(A), (B), and (C) define a "commodity" as (i) an actively traded commodity, (ii) a notional principal contract with respect to a commodity, and (iii) any evidence of an interest in, or a derivative (including option, forward, short position, or similar financial instrument) in, a commodity.

having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction.[43]

However, under the proposed -13(g) regulations, if (x) a member holding such IO realizes an amount in the triggering transaction that differs from the debt's fair market value (*e.g.*, upon a sale of the IO) and (y) the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member,[44] then the debt is treated for all federal income tax purposes as having been satisfied by the debtor for cash in an amount equal to such amount realized, and reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash, immediately before the triggering transaction.[45]

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43 Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(A). By contrast, as noted above the existing -13(g) regulations (i) use Section 1274 principles to determine the deemed satisfaction and reissuance amount in certain cases, (ii) treat the new debt as having been issued for the underlying property in certain cases, and (iii) otherwise treat the new debt as having been issued immediately after the triggering transaction.

44 We understand that this requirement is intended to apply when a member exchanges one IO for another IO, even if the IOs have different issuers. It would be helpful if this point were clarified in the final regulations.

45 Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(A) provides that if the triggering transaction is a mark to fair market value under Section 475, then the IO will be deemed satisfied and reissued for its fair market value (as determined under Section 475 and applicable regulations) and "Section 475 will not otherwise apply with respect to that triggering transaction". The Preamble indicates, "[h]owever, [that] the rules of section 475 will continue to apply to the newly-reissued obligation with respect to future events." See also Prop. Treas. Reg. § 1.1502-13(g)(7)(ii) *Example 11*. We believe it would be appropriate and helpful for the final regulations or the preamble thereto to provide additional guidance or explanation as to the interaction of the deemed satisfaction and reissuance rule and Section 475.

If the IO is a security[46] of a member, the proposed -13(g) regulations provide that "similar principles apply (with appropriate adjustments) to treat the security as having been satisfied and reissued immediately before the triggering transaction."[47]

3. Treatment as a Separate Transaction. Under the proposed -13(g) regulations, the deemed satisfaction and reissuance is treated as "a separate transaction from the triggering transaction."[48] Further, the proposed -13(g) regulations specify that the deemed satisfaction and reissuance will not cause "debt to be recharacterized as other than debt for federal income tax purposes…."[49] The existing -13(g) regulations do not include a similar rule.

4. Definition of Triggering Transaction. The proposed -13(g) regulations have a broad definition of "triggering transaction" that initially picks up essentially all intragroup and outbound transactions.[50] However, that broad definition is then cut back by eight exceptions that exclude various types of transactions from the definition of triggering transaction.

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46 As noted above, the proposed -13(g) regulations include a definition of "security".

47 Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(A).

48 Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(B).

49 More specifically, the proposed -13(g) regulations provide that the deemed satisfaction and reissuance will not cause the debt "to be recharacterized as other than debt for federal income tax purposes immediately before the triggering transaction." Prop. Treas. Reg. § 1.1502-13(g)(3)(ii)(B) (emphasis added). We find the words "immediately before the transaction" to be confusing and recommend that they be deleted.

50 Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(A).

(A) General Rule. In general, a triggering transaction is defined to include: (1) any intercompany transaction in which a member realizes an amount,[51] directly or indirectly, from the assignment or extinguishment[52] of all or part of its remaining rights or obligations under an IO or any comparable transaction in which a member realizes any such amount, directly or indirectly, from an IO (for example, a mark to fair market value of an obligation or a bad debt deduction),[53] and (2) any transaction in which an IO becomes an obligation that is not an IO.

(B) Exceptions. Under the proposed -13(g) regulations, a transaction will not be treated as a triggering transaction if it meets one of eight exceptions described below. However, if a creditor or debtor "realizes an amount" in a transaction in which a creditor assigns all or part of its rights under an IO to the debtor, or a debtor assigns all of or part of its obligations under an IO to the creditor, the transaction is treated under the proposed -13(g) regulations as an extinguishment and will be excluded from the deemed

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[51] Consistent with the 1998 proposed -13(g) regulations, the proposed -13(g) regulations eliminate the requirement that the transaction give rise to some amount (other than zero) of income, gain, loss or deduction.

[52] The use of the term "extinguishment" may not be precise in that transactions involving the debtor entail an assumption of the debtor's obligations but not an extinguishment of those obligations, which would generally require a novation. That said, an assumption is in any case presumably treated as a comparable transaction.

[53] However, a reduction of the basis of an IO pursuant to Sections 108 and 1017 and §1.1502-28 (basis reductions upon the exclusion from gross income of discharge of indebtedness) or any other provision that adjusts the basis of an IO as a substitute for income, gain, deduction, or loss, is not a comparable transaction.

satisfaction and reissuance rule only if the extinguishment exception applies or the routine modification exception applies.[54] Both exceptions are discussed below.

(1) *Intragroup Section 332, 351, or 361 exchange*. The transaction is an intercompany exchange to which Section 332 or Section 361 applies in which no amount of income, gain, deduction or loss is recognized by the creditor or debtor, or an intercompany exchange to which Section 351 applies in which no such amount is recognized by the creditor (unless Section 362(e)(2) applies to the exchange). However, this exception is not available if the material tax benefit rule (discussed below) applies.

(2) *Intragroup assumption transaction*. All of the debtor's obligations under an IO are assumed in connection with the debtor's sale or other disposition of property (other than money) in an intercompany transaction to which Section 1001 applies. However, this exception is not available if the material tax benefit rule applies.

(3) *Exceptions to the application of Section 108(e)(4)*. The obligation became an IO by reason of an event described in §1.108-2(e) (exceptions to the application of Section 108(e)(4)).[55]

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[54] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1).

[55] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(3). Section 108(e)(4) generally treats the acquisition of indebtedness by a person related to the debtor from a person unrelated to the debtor like an acquisition by the debtor for purposes of determining cancellation of indebtedness income. Treasury regulation section 1.108-2(e) provides exceptions for (i) indebtedness with a maturity within a year of the acquisition date and (ii) certain acquisitions of indebtedness by dealers that acquire such indebtedness in connection with their business of selling securities to customers. This exception is also found in the existing -13(g) regulations. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(1).

(4) *Reserve accounting.* The amount realized is from reserve accounting under Section 585.[56]

(5) *Intragroup extinguishment transaction.* All or part of the rights and obligations under the IO are extinguished in an intercompany transaction (other than an exchange or deemed exchange of an IO for a newly-issued IO), the adjusted issue price of the obligation is equal to the creditor's basis in the obligation, and the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (g)(4)(i)(C) of the proposed -13(g) regulations)[57] with respect to the obligation offset in amount. However, this exception is not available if the material tax benefit rule applies.[58]

(6) *Routine modification of intercompany obligation.* All of the rights and obligations under the IO are extinguished in an intercompany transaction that is an exchange (or deemed exchange) for a newly-issued IO, and the issue price of the newly-

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[56] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(4). Section 585 allows certain financial institutions a deduction for a reasonable addition to a reserve for bad debts. This exception is also found in the existing -13(g) regulations. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(2).

[57] Proposed Treasury regulation section 1.1502-13(g)(4)(i)(C) provides that, for purposes of applying the matching rule and the acceleration rule to a transaction involving an IO (other than a transaction to which paragraph (g)(5) of the proposed -13(g) regulations applies (i.e. inbound transactions)), any income, gain, deduction, or loss from the IO is not subject to Section 108(a), Section 354, Section 355(a)(1), Section 1091, or, in the case of an extinguishment of an IO in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, Section 351(a).

[58] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5).

issued obligation equals both the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation. However, this exception is not available if the material tax benefit rule applies.[59]

(7) *Outbound distribution of newly issued intercompany obligation.* The IO becomes an obligation that is not an IO in a transaction in which a member that is a party to the reorganization exchanges property in pursuance of the plan of reorganization for a newly issued IO of another member that is a party to the reorganization and distributes such IO to a nonmember shareholder or nonmember creditor in a transaction to which Section 361(c) applies.[60]

(8) *Outbound subgroup exception.* The IO becomes an obligation that is not an IO in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognizes any income, gain, deduction, or loss with respect to the IO, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction.[61]

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[59] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(6).

[60] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(7). This exception seems directed at transactions in which D transfers assets to C in exchange for C stock and C securities, D distributes the C stock to its shareholders outside of the group and D distributes the C securities to its creditors outside of the group. Assuming that the basic transaction is otherwise tax free under Sections 355 and 368(a)(1)(D), the distribution of the C securities to D's creditors would generally be tax-free under Section 361(c).

[61] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(8). An "intercompany obligation subgroup" is defined in proposed Treasury regulation section 1.1502-13(g)(2)(iii) as

5. Material tax benefit rule. If an assignment or extinguishment of an IO in an intercompany transaction would otherwise be excepted from the definition of triggering transaction under the exceptions described in (1), (2), (5), or (6) above, but at the time of the assignment or extinguishment "it is reasonably foreseeable that the shifting of items of built-in gain, loss, income, or deduction from the obligation from one member to another member will secure a material tax benefit … that the group or its members would not otherwise enjoy in a consolidated or separate return year, then the assignment or extinguishment will be a triggering transaction to which the deemed satisfaction and reissuance rule applies."[62] A "material tax benefit" is defined as the benefit of, for federal tax purposes, a material net reduction in income or gain, or a material net increase in loss, deduction, credit, or allowance. A material tax benefit includes, but is not limited to, the use of a built-in item or items from an intercompany

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two or more members that include the creditor and debtor on an IO if the creditor and debtor bear the relationship described in Section 1504(a)(1) to each other through an intercompany obligation subgroup parent. An "intercompany obligation subgroup parent" is generally the corporation (including either the creditor or debtor) that bears the same relationship to the other members of the intercompany obligation subgroup as a common parent bears to the members of a consolidated group. Prop. Treas. Reg. §1.1502-13(g)(2)(iv).

[62] Prop. Treas. Reg. §1.1502-13(g)(3)(i)(C). Although presumably not intended, this rule seems to say that if the material tax benefit rule applies to a particular transaction, the deemed satisfaction and reissuance rule applies even if the transaction qualifies for another exception as to which the material tax benefit rule was not relevant, such as the exception for obligations that became an IO by reason of an event described in Treasury regulation section 1.108-2(e) or the exception for amounts realized from reserve accounting under Section 585 (described, respectively, in Parts II.A.4.(b)(3) and II.A.4.(b)(4) above).

obligation to materially reduce gain or increase loss on the sale of member stock, or to create or absorb a material tax attribute of a member or subgroup.[63]

**B. Comments.**

1. In General. The three primary changes relating to intragroup and outbound transactions made by the proposed -13(g) regulations are (i) the addition of a variety of exceptions that are intended to exclude a significant number of transactions from the deemed satisfaction and reissuance rule, (ii) the treatment of the deemed satisfaction and reissuance as a transaction separate from the triggering transaction (and in some instances the timing of that separate transaction), and (iii) the use of fair market value (rather than Section 1274 principles) under the deemed satisfaction and reissuance rule in cases where an IO is exchanged for property.

In general, we support these changes and, in particular, the effort by the IRS and Treasury to clarify the operation of the deemed satisfaction and reissuance rule and to narrow the scope of transactions that trigger the deemed satisfaction and reissuance rule. As discussed above, the application of the deemed satisfaction and reissuance rule under the existing -13(g) regulations can be extremely complicated and uncertain. The proposed -13(g) regulations significantly clarify the operation of the rules.

Nevertheless, as acknowledged in the Preamble, the application of the deemed satisfaction and reissuance rule will still prove time consuming and complicated in many cases and require the valuation of the IO, notwithstanding the fact that most IOs are very

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[63] Prop. Treas. Reg. § 1.1502-13(g)(2)(v).

difficult to value. While IOs certainly present the potential for tax avoidance in light of the ease with which they can be created, transferred and extinguished, our experience indicates that the vast majority of transactions involving IOs are effected for commercial reasons and not with a view towards achieving a material tax benefit. Accordingly, we agree with the determination expressed in the Preamble that the deemed satisfaction and reissuance rule should be limited to those "transactions that have the greatest potential to create distortions of CTI and to exclude those transactions where the administrative burdens of either requiring precise valuation of IOs or requiring the additional mechanics of the deemed satisfaction-reissuance model outweigh the benefits of increased precision."

2. Material Tax Benefit. The material tax benefit rule is a key aspect of the proposed -13(g) regulations since all of the exceptions for intragroup transactions added by the proposed -13(g) regulations are rendered unavailable if the material tax benefit rule applies. In subjecting such exceptions to the material tax benefit rule, the Preamble notes that:

> Although these proposed regulations provide exceptions to the deemed satisfaction-reissuance model, the IRS and the Treasury Department remain concerned that the shifting of built-in items from intercompany obligations can give rise to significant potential for distortion. Intercompany obligations present special concerns because debt between members never increases or diminishes the wealth of the group (one member's economic gain is matched by the other's economic loss) and because, in comparison to other types of property, they can be easily created, transferred, modified, and extinguished within the group at little or no economic cost.

The Preamble further notes that the material tax benefit rule is directed at intragroup transactions that would have a distortive effect on members' attributes or the basis of member stock using built-in items from IOs and "generally applies to an intragroup assignment or extinguishment that would otherwise be excepted from the deemed satisfaction-reissuance model if, at the time of the transaction, it is reasonably foreseeable (regardless of intent) that the shifting of items of built-in gain, loss, income, or deduction from an intercompany obligation between members will secure a material tax benefit that would not otherwise be enjoyed." (Emphasis added).

The proposed -13(g) regulations include two examples applying the material tax benefit rule in this context. Both examples involve the transfer of an IO to a subsidiary with SRLY losses in a Section 351 transaction.[64]

We believe that, as drafted, the material tax benefit rule will be difficult for taxpayers and the IRS to apply and may not serve the role it seems designed to play under the proposed -13(g) regulations.

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[64] In one example, T is a member with a material SRLY loss. S holds a materially appreciated B note which it transfers to T as part of what would otherwise be a Section 351 transaction. In a variation on the same example, S has a SRLY loss that exceeds, and will expire prior to, that of T. In the first variation, the material tax benefit rule applies because it was reasonably foreseeable that the shifting of the built-in income or gain from the obligation would secure a material tax benefit that the group or its members would not otherwise enjoy (*i.e.*, T could offset income inclusions with respect to the IO with its SRLY losses). In the second variation, the material tax benefit rule does not apply because S itself has a SRLY loss that can offset the income inclusions with respect to the IO. Prop. Treas. Reg. §1.1502-13(g)(7)(ii)(Ex. 8).

The material tax benefit rule is intended to be objective and not depend on the taxpayer's intent. As a general matter, objective tests may be preferable in a variety of ways to subjective tests. First, an objective test may avoid difficult issues of proof that can arise when a rule turns on the taxpayer's intent. Second, an objective test applicable at the time a transaction is entered into can curtail the ability of taxpayers to take a "wait-and-see" approach. Third, an objective test that looks to reasonably foreseeable tax benefits can create greater parity between a taxpayer who unwittingly finds itself with a material tax benefit and a taxpayer who structured a transaction with a principal purpose of attaining the same benefit.

However, an objective test will attain these benefits only if the results of the test will be fairly clear at the time the test is applied. We are concerned that this may not be true in the case of the material tax benefit rule. First, although the IRS and Treasury may have been focused on mirror-type transactions and the inappropriate use of SRLY losses in writing the material tax benefit rule, the rule itself is not limited to these types of transactions. As a result, in applying the material tax benefit rule, taxpayers and the IRS would need to consider whether those types of considerations could be implicated, as well as any other circumstance in which the shifting of items could secure a material tax benefit. Such other circumstances may include, for example, a son-of-mirrors type transaction to which the loss disallowance rules are directed.[65]

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[65] The complexity of the proposed loss disallowance rules underscore the myriad circumstances that can trigger a son-of-mirrors type concern.

Second, the consolidated return regulations (including the rules applicable in the case of a deemed satisfaction and reissuance) are obviously long, complicated and uncertain in various respects. As a result, it will be difficult for taxpayers to easily forecast the reasonably foreseeable tax consequences assuming, in the alternative, that the underlying transaction occurs and the underlying transaction does not occur. Further, some taxpayers have true in-house experts (or regularly hire true outside experts) who devote substantially all of their time to consolidated return issues, whereas many other taxpayers rely on tax advisors that are not so specialized. As a result, we expect that there will be a wide range in what different taxpayers are able to foresee.

Third, whether an inappropriate shifting will occur will often depend on whether other transactions take place or do not take place (*e.g.*, a subsidiary will be sold). As a result, the determination of whether a material tax benefit is reasonably foreseeable will often depend on whether it is reasonably foreseeable that the taxpayer will or will not engage in another transaction. This, however, is essentially an intent question.

Moreover, in cases where a transaction in fact results in a material tax benefit, we believe it will be virtually impossible to demonstrate (with the benefit of hindsight) that the material tax benefit was not reasonably foreseeable. As a result, the material tax benefit rule is likely to hold open for some period the question of whether a transaction qualifies for one of the added exceptions.

In light of the foregoing, we believe that the material tax benefit rule should be revised so that it resembles a more typical intent-based anti-abuse rule.[66] Specifically, we recommend that the material tax benefit rule be revised so that it applies only if a principal purpose of the transaction is to secure a material tax benefit from an IO that would not otherwise be enjoyed by shifting items of built-in gain, loss, income, or deduction between members. As noted in the Preamble, the factor distinguishing IOs from other types of property that are not subject to a satisfaction and reissuance type rule is the ease with which IOs can be manipulated within a consolidated group with an eye towards reducing CTI. We believe this supports the use of an anti-abuse rule that targets transactions in which the taxpayer intended to use an IO in a manipulative manner.

However, we think it would be appropriate to create certain pro-IRS presumptions for cases where the facts suggest such a principal purpose, such as where (i) an above-market IO is transferred in a tax-free transaction to a member with losses limited under the SRLY or other rules, (ii) an above-market IO is transferred to another member in exchange for stock in such member in a tax-free transaction if within some period (*e.g.*, two years) the gain in the IO is triggered in a manner that increases the tax basis of other shares that are sold but the shares received in exchange for the IO are retained and (iii) an

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[66] See, e.g., Treasury regulation section 1.1502-13(h)(1), which states that "if a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section." Treasury regulation section 1.1502-13(h)(2) contains numerous examples illustrating the application of this intent-based anti-abuse rule. Treasury regulation section 1.1502-13(h)(1) specifically applies to intercompany obligations.

IO is transferred to or assumed by another member if within some period (*e.g.*, two years) there is a direct or indirect disposition of the stock of the transferee member in a transaction in which the group recognizes a loss that is not disallowed.[67]

3. Use of FMV in Applying the Deemed Satisfaction and Reissuance Rule. We support the use of the fair market value of an IO (rather than Section 1274 principles) in applying the deemed satisfaction and reissuance rule. The deemed satisfaction and reissuance rule will generally result in a clearer reflection of income and a better preservation of location only if it is applied using the fair market value of an IO. While it is typically very difficult to estimate the fair market value of an IO and while the application of Section 1274 principles can effectively operate as a proxy for fair market value, we support the determination by the IRS and Treasury that Section 1274 principles are simply too rough of a proxy to be used in this context since Section 1274 principles will generally treat an IO with an interest rate above the AFR as having a fair market value equal to its stated principal amount. Further, as discussed above in Part II.D., various principles may require a valuation in any case and the application of Section 1274 principles can lead to substantial complication. Accordingly, we support the elimination of the use of Section 1274 principles in applying the deemed satisfaction and reissuance

[67] At noted above, Treasury section 1.1502-13(h)(1) includes an anti-abuse rule similar to our proposed material tax benefit rule. However, our proposed material tax benefit rule would (i) be bolstered by a variety of presumptions designed to target potentially abusive situations, (ii) specifically prescribe what happens if it is violated, (iii) be focused on reductions in CTI arising from shifts in IO items of built-in gain, loss deduction and income, and (iv) make it is easier for the IRS to assert its application and alert taxpayers to its potential application.

rule. However, as discussed below, we think that in appropriate circumstances a taxpayer's good faith determination of the fair market value of an IO should be presumed to be correct and that in certain cases it would be appropriate to deem an IO to have a fair market value equal to its adjusted issue price.

4. Determination of FMV. As noted above, the basic theory of the proposed -13(g) regulations is that deeming an IO to have been satisfied and reissued for cash equal to its fair market value upon a movement of the IO within the group will result in a clearer reflection of CTI for the group and a better preservation of the location of the items associated with the IO. However, this theory is predicated upon taxpayers and the IRS being able to accurately value an IO. To the extent the valuation is inaccurate, the deemed satisfaction and reissuance rule could distort CTI and location rather than preserve it. Moreover, in many cases, the attributes of the members of a consolidated group may be such that the application of the deemed satisfaction and reissuance rule will have no net impact on CTI, whether or not the IO is valued correctly.

We think it is important to keep these points in mind because in many cases it will be extremely difficult to value an IO with any measure of accuracy. First, in many cases a member's credit rating or third-party borrowing costs are simply not known. Second, the consolidated group often will not have the type of audited separate company financial information typically used by third parties in setting an interest rate. Third, many (if not most) IOs do not reflect many of the non-economic terms found in a third-party debt instrument (*e.g.*, representations and covenants relating to coverage ratios, limitations on

asset dispositions and distributions).[68] Since IOs generally are not designed to be sold to a third party, and since a third-party typically would not buy an IO without adding a significant assortment of additional rights, it is hard to know how to take into account (if at all)[69] the lack of such terms in valuing an IO.[70] Indeed, in many instances IOs may be merely reflected by book entries. Fourth, even if an IO does include third-party terms and even if the taxpayer is equipped with all of the information typically used by a third-party in fixing an interest rate, it would still be difficult to value an IO. There is often a significant range in the interest rates and terms offered to a borrower by different third-part lenders.

In light of the foregoing, we think it would be appropriate and helpful for the proposed -13(g) regulations to provide that a taxpayer's good faith valuation of an IO in an intragroup transfer will generally be presumed to be correct so long as securing a

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68 Although these aspects of a typical IO are consistent with the Preamble's concern about the ease with which IOs can be issued, transferred and extinguished, in our experience the vast majority of transactions involving IOs are effected for commercial reasons and not with a view towards achieving a material tax benefit.

69 Treasury regulation section 1.482-2(a)(2)(i), which generally governs what is considered an arm's-length rate of interest for Section 482 purposes, provides that (i) an arm's-length rate of interest shall be a rate of interest which was charged or would have been charged at the time the debt arose in independent transaction between unrelated parties under similar circumstances and (ii) all relevant factors shall be considered, including the principal amount and the duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

70 We note that if the lack of third-party terms is taken into account in valuing an IO it will inflate the imputed interest rate under the IO. This may facilitate rather than curtail the ability of taxpayers to use IOs in a manipulative manner.

material tax benefit by shifting items between members was not a principal purpose for the transaction. A somewhat similar rule can be found in Notice 2004-37, which provides that the IRS will not challenge a consolidated group's position that the value test of Section 1504 is satisfied if (among other things) the group makes a good faith determination that the value requirement is satisfied.[71] We think that such a good faith valuation should be presumed to be correct for all purposes, including (for example) the determination of whether a sale by a creditor member of an IO to another member results in gain.[72]

The examples in the proposed -13(g) regulations that illustrate the material tax benefit rule all involve IOs that have materially appreciated, which indicates that they

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[71] Section 1504 generally treats corporations as part of an "affiliated group" if a common parent owns directly stock, in at least one of the other corporations in a chain, that possesses at least 80% of the total voting power of the stock of such other corporation and has a value equal to at least 80% of the total value of the stock of such corporation. Section 1504(a)(5)(C) directs the Secretary to prescribe regulations that provide that the value requirement will be treated as met if the affiliated group, in reliance on a good faith determination of value, treats it as met. Notice 2004-37 provides interim relief until such regulations are promulgated.

[72] However, similar to the presumptions applicable under our proposed material tax benefit rule, we believe that these special valuation conventions should not apply where (i) an above-market IO is transferred in a tax-free transaction to a member with losses limited under the SRLY or other rules, (ii) an above-market IO is transferred to another member in exchange for stock in such member in a tax-free transaction if within some period (*e.g.*, two years) the member is disposed off outside of the group but the shares received in exchange for the IO are retained, (iii) an IO is transferred to or assumed by another member if within some period (*e.g.*, two years) there is a direct or indirect disposition of the stock of the transferee in a transaction in which the group recognizes a loss that is not disallowed or (iv) a principal purpose of the transaction is to otherwise secure a material tax benefit by shifting IO items.

have above-market interest rates.[73] This suggests that the IRS and Treasury may be more concerned with IOs with above-market interest rates than IOs with below market interest rates.[74] Assuming this is correct, we believe it would also be appropriate and helpful in the context of an intragroup transaction for the final regulations to generally treat an IO as having a fair market value equal to its adjusted issue price[75] so long as (i) the interest rate under the IO equals or is based on the parent's third-party borrowing rate (provided that the consolidated group generally uses such a rate for its IOs) or (ii) the rate would be respected under Section 482 if the IO were newly issued.[76]

5. Additional Comments on Triggering Transactions.

(A) *Exception for Intragroup Section 332, 351 or 361 Exchanges.* As noted above, under the proposed -13(g) regulations, an intercompany exchange is not treated as a triggering transaction if it is (i) an exchange to which Section 332 or Section 361 applies in which no amount of income, gain, deduction or loss is recognized by the creditor or debtor or (ii) an intercompany exchange to which Section 351 applies in

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[73] See Prop. Treas. Reg. § 1.1502-13(g)(7)(ii)(Ex. 8 and 9).

[74] Section 7872 and the regulations thereunder impute interest with respect to loans that bear a stated rate of interest lower than the applicable federal rate (below-market loans). The IRS may view Section 7872 as providing adequate protection against abusive transactions featuring obligations with below-market rates. Moreover, Section 362(e) provides some protection in the case of transfers of an IO with a below-market interest rate and a built-in loss.

[75] It may be appropriate to exclude cases where the IO's adjusted issue price does not equal the creditor member's adjusted basis in the IO.

[76] Again, we believe it would be appropriate for these special valuation conventions to be inapplicable in situations that are considered potentially abusive. See Note 72.

which no such amount is recognized by the creditor (unless Section 362(e)(2) applies to the exchange). However, this exception is not available if (i) the material tax benefit rule applies or (ii) the underlying transaction is between the creditor member and the debtor member.[77] This exception is referred to below as the "Tax Free Exchange Exception."

i. Revise so that Gain or Loss Must be in Respect of the IO. The exception for intercompany exchanges to which Section 332 or 361 applies is available only if "no amount of income, gain, deduction or loss is recognized by the creditor or debtor" and the exception for intercompany exchanges to which Section 351 applies is available only if "no such amount is recognized by the creditor (unless Section 362(e)(2) applies to the exchange)." It is not entirely clear whether the carveout for exchanges that result in income, gain, deduction or loss is designed to (i) allow the matching and acceleration rule to apply between the debtor and the creditor member (rather than between the transferor member and the transferee member) by triggering the deemed satisfaction and reissuance rule in cases where such an item is recognized in respect of the IO or (ii) limit the Tax Free Exchange Exception to cases where it is not necessary to value the IO. If the carveout is primarily related to the first objective, it would be appropriate and helpful for the final regulations to clarify that the carveout for exchanges in which income, gain, deduction or loss is recognized applies with respect to the IO in question rather than some other asset that is part of the overall exchange.[78]

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[77] See Part III.A.4.(B), above.

[78] Note that proposed Treasury regulation section 1.1502-13(g)(7)(ii)(Ex. 4) could be read to suggest that the exception may not be available if an IO and another asset are

ii. Assumptions. The application of the Tax Free Exception to an assumption of an IO is complicated by the fact that the assumption may give rise to a deemed exchange of the IO under Treasury regulation section 1.1001-3.[79]

> Example 2 D is the issuer of an IO that is held by C. D is merged with and into A (another member) in a tax free reorganization. As a result of a change in payment expectations, the merger triggers a deemed exchange of the IO under Treasury Regulation 1.1001-3.

If such a deemed exchange is treated as a separate transaction for purposes of applying the proposed -13(g) regulations, then the deemed exchange itself will be treated as a triggering transaction unless one of the exceptions applies to the deemed exchange.[80] As

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transferred in a Section 351 transaction and gain is recognized in the other asset but not the IO. In that example, the creditor transfers an appreciated IO as well as other appreciated assets and cash to NewCo in a transaction that would otherwise qualify for Section 351. The example points to the total gain (in both the IO and the other assets) in concluding that the transfer is not eligible for the exception under the proposed -13(g) regulations for Section 351 transactions.

79 Specifically, Treasury regulation section 1.1001-3 provides that the assumption of indebtedness will generally trigger a deemed exchange of the debt unless (i) "the acquiring corporation" (within the meaning of section 381) becomes the new obligor pursuant to a transaction to which section 381(a) applies, the transaction does not result in a change in payment expectations, and the transaction (other than a reorganization within the meaning of section 368(a)(1)(F)) does not result in a significant alteration or (ii) the "new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration."

80 The proposed -13(g) regulations include only one example involving an assumption. The example involves an assumption in the context of a taxable acquisition of substantially all of the assets of a business in exchange for the assumption of an IO and cash. The example concludes that the assumption qualifies for the taxable assumption exception (discussed below) and that the IO is not treated as satisfied and reissued under the deemed satisfaction and reissuance rule. Although the example states that the IO is fully recourse, it does not specify whether substantially all of the

noted above, the proposed -13(g) regulations provide that where "a creditor or debtor realizes an amount in a transaction in which a creditor assigns all or part of its rights under an intercompany obligation to the debtor, or a debtor assigns all of or part of its obligations under an intercompany obligation to the creditor, the transaction will be treated as an extinguishment and will be excepted from the definition of 'triggering transaction' only if" the extinguishment exception applies or the routine modification exception applies. Since the extinguishment exception does not apply to an exchange (or deemed exchange) of an IO for a newly issued IO, the deemed exchange resulting from the assumption will be treated as a triggering event unless the routine modification exception applies. The routine modification exception applies if (i) all of the rights and obligations under the intercompany obligation are extinguished in an intercompany transaction that is an exchange (or deemed exchange) for a newly issued intercompany obligation, (ii) the issue price of the newly issued obligation[81] equals both the adjusted issue price of the extinguished obligation and the creditor's basis in the extinguished obligation and (iii) the material tax benefit rule does not apply.

If the deemed exchange is a triggering transaction, then the deemed satisfaction and reissuance rule will apply and it generally should not matter whether the assumption qualifies for the Tax Free Exchange Exception. If the deemed exchange is not treated as

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debtor's assets are acquired in the transaction and does not discuss the application or impact of Treasury regulation 1.1001-3.

[81] See Treasury regulation section 1.1274-5 for the determination of the issue price in the case of a deemed exchange under Treasury regulation section 1.1001-3.

a triggering transaction because the deemed exchange qualifies for the routine modification exception, then it is necessary to determine whether the Tax Free Exchange Exception applies to the assumption.[82]

We believe that it would be appropriate and helpful for the final regulations to confirm the interaction between Treasury regulations section 1.1001-3 and the rules defining when an assumption will be treated as a triggering event.

iii. Section 332 Exception. We assume that the reference to Section 332 in the Tax Free Exchange Exception is generally designed to pick up the complete liquidation of a member that is the creditor or debtor of an IO. Because Section 332 governs the shareholders of the liquidating corporation in this context, but Sections 336 and 337 govern the liquidating corporation itself, the scope of this exception is not entirely clear.[83] It would be appropriate and helpful if the final regulations confirmed that the Section 332 exception generally:[84]

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[82] It would be helpful for the final regulations to confirm that, where an assumption gives rise to a deemed exchange under Treasury regulation section 1.1001-3 but the deemed exchange qualifies for the routine modification exception, the assumption can still qualify for the Tax Free Exchange Exception even though it triggers another transaction which is treated under the proposed -13(g) regulations as an extinguishment transaction.

[83] Section 332 generally provides that no gain or loss is recognized by a corporate shareholder that receives property in exchange for its stock in a liquidating corporation. However, Section 332 generally applies to a shareholder only if (among other things) it owns stock in the liquidating corporation meeting the requirements of Section 1504(a)(4) (that is, generally 80% of the stock by vote and value). Section 337 generally provides for tax free treatment to a liquidating subsidiary that transfers property to a shareholder that meets the 80% stock ownership requirement set forth in Section 332(b). Although Treasury regulation section 1.1502-34 provides that in determining the stock ownership of a member of the group in another corporation for

(1) includes the case where the liquidating corporation is the debtor of an IO and the IO is assumed by a shareholder of the corporation, including a shareholder that needs to rely upon Treasury regulation section 1.1502-34 to meet the 80% stock ownership requirement, so long as any deemed exchange of the IO resulting from the assumption qualifies for the routine modification exception;

(2) includes the case where the liquidating corporation is the creditor of an IO and the IO is transferred to a shareholder in a transaction in which no gain or loss is recognized by the liquidating corporation either under Section 337 (because the shareholder actually meets the 80% stock ownership requirement) or under Section 336 (which provides for the non-recognition of loss in certain cases); and

(3) excludes the case where the liquidating corporation is the creditor an of IO and the IO is transferred to a shareholder that owns less than 80% of the liquidating corporation in a transaction in which gain or loss is recognized by the liquidating corporation under Section 336.

(B) *Exceptions for Assumptions of IOs.* As noted above, under the proposed -13(g) regulations, a transaction will not be treated as a triggering transaction if

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purposes of Section 332(b)(1) there shall be included stock owned by all other members of the group in such corporation, this aggregate rule does not apply for purposes of Section 337. As a result, if appreciated property is transferred by a liquidating subsidiary to a member that does not directly meet the 80% stock ownership requirement, the liquidating member will recognize gain in the transaction but the stockholder member will not. Treas. Reg. § 1.1502-13(j)(9)(Ex. 7).

[84] As noted above, the exception does not apply to cases where the material tax benefit rule applies and to exchanges between the creditor member and the debtor member.

"[a]ll of the debtor's obligations under an IO are assumed in connection with the debtor's sale or other disposition of property (other than money)[85] in an intercompany transaction to which Section 1001 applies.[86] However, this exception is not available if (i) the material tax benefit rule applies or (ii) the underlying transaction is between the creditor member and the debtor member.

The Preamble states that this exception is limited to "taxable intragroup sales of assets where IOs are assumed as part of the transaction" and explains that

> where indebtedness is assumed incident to a sale of assets, in most cases, the location of gain or loss from an intercompany obligation is appropriately reflected in increased or reduced sales proceeds for the assets. Such transactions generally present less potential for distortion of CTI.

Contrary to the suggestion in the Preamble, the exception as drafted arguably is not limited to taxable transactions. Although the exception requires that Section 1001 apply to the transaction, the language appears to require only the realization of gain or loss and not the recognition of it. Accordingly, if the IRS and Treasury intend for the exception to be limited to taxable assumptions, the exception should be revised accordingly.[87]

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85 Note that proposed Treasury regulation section 1.1502-13(g)(7)(ii)(Ex. 5) involves a transfer of money (together with a trade or business) in exchange for an assumption of the IO by the transferee but nevertheless concludes that the transaction is not a triggering transaction.

86 See Part III.A.4.(B), above.

87 Similar to the issue discussed above in the context of the Tax Free Exchange Exception, an assumption of an IO in a taxable sale may give rise to a deemed exchange of the IO under Treasury regulation section 1.1001-3. We believe it would

(C) *Exceptions for Intragroup Extinguishment Transactions*. As noted above, under the proposed -13(g) regulations, a transaction generally will not be considered a triggering transaction if (i) all or part of the rights and obligations under the IO are extinguished in an intercompany transaction (other than in an exchange or deemed exchange of an IO for a newly issued IO), (ii) the adjusted issue price of the obligation is equal to the creditor's basis in the obligation, and (iii) the debtor's corresponding item and the creditor's intercompany item (after taking into account the special rules of paragraph (4)(i)(C) of the proposed -13(g) regulations)[88] with respect to the obligation offset in amount.[89] However, this exception is not available if the material tax benefit rule applies. The Preamble notes that:

> Where an intercompany obligation is extinguished, the Code and regulations will cause the creditor and debtor to recognize their respective items from the obligation, and thus, preserve the location of such items. In such cases, a deemed satisfaction-reissuance model is not necessary.

We note that, in cases where the creditor member owns the debtor member, groups would generally be free to decide whether to extinguish the IO in a transaction governed by Section 108(e)(6) or a transaction governed by Section 108(e)(8). Section

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be appropriate for the final regulations to confirm the interaction of the exception for taxable assumptions with Treasury regulation section 1.1001-3.

[88] Proposed Treasury regulation section 1.1502-13(g)(4)(i)(C) provides that, for purposes of applying the matching rule and the acceleration rule to a transaction involving an IO (other than an inbound transaction), any income, gain, deduction, or loss from the IO is not subject to Section 108(a), Section 354, Section 355(a)(1), Section 1091, or, in the case of an extinguishment of an IO in a transaction in which the creditor transfers the obligation to the debtor in exchange for stock in such debtor, Section 351(a).

[89] See Part III.A.4.(B), above.

108(e)(6) provides that where a debtor corporation acquires its debt from a shareholder as a contribution to capital, the amount of cancellation of debt ("COD") income is computed as though the debt were satisfied for an amount equal to the shareholder's adjusted basis. By contrast, Section 108(e)(8) provides that where debt is satisfied in exchange for stock of the debtor, the amount of COD income is computed as though the debt were satisfied for cash equal to the fair market value of the stock. In either case, Section 351 does not apply to the shareholder's transfer of the IO to the debtor corporation if the IO is not evidenced by a security[90] or if the debtor is bankrupt and issues stock to satisfy the IO.[91]

If the transaction is structured as a contribution to capital, the availability of the exception would be subject to the application of the material tax benefit rule.[92] We note, in this regard, that the amount of COD income may impact the application of the proposed loss disallowance rules.[93]

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90 Section 351(d)(2).

91 Section 351(e)(2).

92 While the availability of the exception would also be subject to the material tax benefit rule in cases where Section 108(e)(8) applied, the application of the deemed satisfaction and reissuance rule generally should not have a material impact.

93 The proposed loss disallowance rules, which are principally contained in proposed Treasury regulation section 1.1502-36, apply when stock of a consolidated subsidiary is disposed of at a loss. One of the mechanisms for loss disallowance contained in the proposed regulations is a "basis reduction rule", which would reduce the member's basis in the loss share (but not below its value) by the lesser of the share's "net positive adjustment" (*i.e.*, the sum of all investment adjustments reflected in the basis of the share, excluding distributions) and its "disconformity amount" (the excess of the basis in the loss share over the share's allocable portion of the subsidiary's net inside attribute amount). COD income triggered by the extinguishment of intercompany debt where the creditor is the parent of the debtor

6. Additional Comments on Separate Transaction Treatment. As noted above, under the proposed -13(g) regulations the deemed satisfaction and reissuance is treated as a transaction separate from the triggering transaction. Further, the proposed regulations provide that the deemed satisfaction and reissuance of a member's debt will not cause the debt to be recharacterized as other than debt for federal income tax purposes. According to the Preamble:

> by separating the deemed satisfaction and reissuance from the actual transaction in which the obligation is transferred, the new model avoids confusion regarding whether or how the deemed satisfaction proceeds are integrated with the actual transaction. The new model operates to trigger all built-in items arising from the obligation, and then reissue the obligation with an issue price equal to its basis (and generally, its fair market value) before the actual transaction.

We support the treatment of the deemed satisfaction and reissuance as a transaction separate from the triggering transaction. However, it would be appropriate and helpful for the final regulations to expand upon this concept by providing that the deemed satisfaction and reissuance are (i) also treated as separate from any other transaction (even if related to the triggering transaction) and (ii) ignored in determining

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produces a positive investment adjustment in the parent's basis in the debtor stock and could therefore limit the parent's loss on the disposition of such stock, even if the circumstances giving rise to the cancellation of the intercompany debt produced an economic loss. In December 2007, the Tax Section issued a report on the proposed loss disallowance regulations in which it identified this issue and recommended that the final loss disallowance regulations exclude from the calculation of the net positive adjustment any COD income or bond redemption premium from intercompany debt the incurrence of which (i) did not itself create an item of deduction or asset basis taken into account in determining the net positive adjustment and (ii) resulted in a reduction in stock basis. See the New York State Bar Association Tax Section Report on Proposed Consolidated Return Stock Loss Regulations, Part V.A. (Dec. 19, 2007).

whether any other transaction is afforded tax-free treatment, including as to the determination of whether any IO is treated as a security for tax purposes.[94]

7. Divisive D Reorganization and Section 355 Transactions. The Preamble notes that the proposed -13(g) regulations include an exception for outbound transfers of IOs where the obligation is newly issued in an intragroup reorganization and is then distributed to a nonmember shareholder or creditor in a transaction to which Section 361(c) applies "but do not provide an exception for such transactions where the newly issued obligation is distributed within the group to a member shareholder or creditor."[95]

This language seems directed at transactions in which D transfers assets to C in exchange for C stock and C securities, D distributes the C stock to its shareholders and D distributes the C securities to its creditors. Assuming that the basic transaction is otherwise tax free under Sections 355 and 368(a)(1)(D), the distribution of the C securities to D's creditors would generally be tax-free under Section 361(c).[96]

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94 For example, if a security was issued shortly prior to an intragroup reorganization, a deemed satisfaction and reissuance of such security could arguably jeopardize the qualification of such a security as a security for purposes of Section 354 or 361. See also Rev. Rul. 2004-78 (debt instruments of an acquiring corporation with two years to maturity issued in reorganization in exchange for securities of target bearing same terms (other than interest rate) are considered continuation of security holder's investment in target in substantially same form and so qualify as "securities" within meaning of Section 354).

95 We note that (contrary to the assertion in the Preamble), the reference to Section 361 in the Tax Free Exchange Exception appears to generally exclude intragroup distributions of IOs that are tax-free under Section 361(c) from the deemed satisfaction and reissuance rule.

96 Section 361(c) allows a tax-free distribution of "qualified property" to creditors in connection with a reorganization. "Qualified property" includes any stock or

We strongly support the exception for outbound transfers and believe it will eliminate a vast amount of uncertainty. We also strongly support the effort by the Treasury and the IRS to clarify the application of the -13(g) regulations in the internal context. We believe that the -13(g) regulations generally should not be used to police or override the rules generally applicable to divisive D reorganizations and Section 355 transactions in cases where the transaction involves a distribution outside the group or is part of a larger transaction involving such a distribution. First, while it is generally easy for taxpayers to manipulate IOs, doing so in the context of the detailed rules applicable to divisive D reorganization and Section 355 transactions is more difficult where the transaction directly or indirectly involves an external distribution. Second, while the proposed -13(g) regulations are focused on preventing consolidated groups from shifting items within the group, very different concerns underlie the rules applicable to tax-free spinoffs. Third, where an IO is issued and distributed in connection with such a transaction, it is simply counter-intuitive to think that the proposed -13(g) regulations would impact the tax-free nature of the transaction.

Accordingly, we recommend that the final regulations provide an additional exception for internal distributions of an IO in cases where (i) a member (D) that is a party to a reorganization exchanges property in pursuance of the plan of reorganization for a newly issued IO of another member that is a party to the reorganization (C), (ii) the

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obligation of the distributing corporation or any stock or obligation of another party to the reorganization if such stock or obligation was received by the distributing corporation as part of the reorganization.

IO is distributed to another member in a transaction to which Section 361(c) applies, (iii) C is (directly or indirectly) distributed to a nonmember, and (iv) the IO is within a relatively short period transferred to a nonmember.

8. <u>Deferral of Loss or Deduction with Respect to Nonmember Indebtedness Acquired in Certain Debt Exchanges</u>.

Under the proposed -13(g) regulations, if a creditor transfers an IO to a nonmember (former IO) in exchange for newly-issued debt of a nonmember (nonmember debt), and the issue price of the nonmember debt is not determined by reference to its fair market value (for example, the issue price is determined under Section 1273(b)(4) or 1274(a) or any other provision of applicable law), then any loss of the creditor otherwise allowable on the subsequent disposition of the nonmember debt, or any comparable tax benefit that would otherwise be available in any other transaction that directly or indirectly results from the disposition of the nonmember debt, is deferred until the date the debtor retires the former IO.[97]

According to the Preamble, this rule is designed to prevent indirect acceleration of a loss from an IO through the sale of the obligation to a nonmember in exchange for a newly-issued obligation (the issue price of which is determined under Section 1273(b)(4) or Section 1274(a)) followed by a sale of the nonmember obligation at a loss.

For example, assume Member B issues a note to S for $100, the fair market value of the note subsequently declines to $80 and S transfers the B note to X (an unrelated

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97 Prop. Treas. Reg. § 1.1502-13(g)(4)(iv).

third party) in exchange for X's note with a face value of $100 and a fair market value of $80. Although the transfer to X would be treated as a triggering transaction, S's amount realized on the transfer would generally equal $100 under Section 1274 and, in this somewhat limited circumstance, the deemed satisfaction and reissuance amount would be $100 (which is S's amount realized). If S then sold the X note for $80, it would have effectively accelerated the loss on the original IO without triggering a corresponding item of consolidated income.

Because this rule is directed at a specific transaction that is not entirely obvious upon reading the rule, we think it would be helpful for the final regulations to include an example illustrating the application of the rule.

**Part IV. Inbound Transactions under the Proposed -13(g) Regulations.**

**A. Description of the Proposed Regulations.**

Paragraph (g)(5) of the proposed -13(g) regulations prescribes a similar set of rules for inbound transactions (the "Inbound Regulations").[98] The proposed Inbound Regulations are very similar to the existing -13(g) regulations governing inbound transactions.[99] The key differences are noted below.

1. Transaction Covered by the Inbound Regulations. The Inbound Regulations generally apply whenever an obligation that is not an IO becomes an IO. However, the Inbound Regulations do not apply if either (i) the obligation becomes an IO

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[98] Prop. Treas. Reg. § 1.1502-13(g)(5).

[99] Treas. Reg. § 1.1502-13(g)(4).

by reason of an event described in Treasury regulation section 1.108-2(e)[100] or (ii) the obligation becomes an IO in a transaction in which the members of an intercompany obligation subgroup cease to be members of a consolidated group, neither the creditor nor the debtor recognize any income, gain, deduction, or loss with respect to the IO, and such members constitute an intercompany obligation subgroup of another consolidated group immediately after the transaction (the "Inbound Subgroup Exception").[101]

2. Deemed Reissuance Rule. The Inbound Regulations include a similar deemed satisfaction and reissuance rule. Specifically, if the Inbound Regulations apply and the IO is debt of a member, then the debt is treated for all federal income tax purposes, immediately after it becomes an IO, as having been satisfied by the debtor for cash in an amount determined under the principles of Treasury regulation section 1.108-2(f), and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash.[102] Under Treasury regulation section 1.108-2(f), the relevant amount will generally equal the fair market value of the debt unless the holder acquired the debt by purchase within the last six months, in which case the relevant amount will equal the holder's basis in the debt.

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[100] Prop. Treas. Reg. § 1.1502-13(g)(5)(i)(B)(1). Treasury regulation section 1.108-2(e) provides exceptions for (i) indebtedness with a maturity date within a year of the acquisition date and (ii) certain acquisitions of indebtedness by dealers that acquire such indebtedness in connection with their business of selling securities to customers. This exception is also found in the existing -13(g) regulations.

[101] Prop. Treas. Reg. § 1.1502-13(g)(5)(i)(B)(2).

[102] Prop. Treas. Reg. § 1.1502-13(g)(5)(ii)(A).

If the IO is a security of a member, similar principles apply (with appropriate adjustments) to treat the security, immediately after it becomes an IO, as satisfied and reissued by the debtor for cash in an amount equal to its fair market value.[103]

3. Treatment as a Separate Transaction. The deemed satisfaction and reissuance is treated as a separate transaction from the transaction in which the debt becomes an IO, and the tax consequences of the transaction in which the debt becomes an IO must be determined before the deemed satisfaction and reissuance occurs. (For example, if the debt becomes an IO in a transaction to which Section 351 applies, any limitation imposed by Section 362(e) on the basis of the IO in the hands of the transferee member is determined before the deemed satisfaction and reissuance.) The deemed satisfaction and reissuance of a member's debt will not cause it to be recharacterized as other than debt for federal income tax purposes.[104]

**B. Comments.**

We generally support the proposed -13(g) regulations applicable to inbound transactions. We have previously commented on the possible character mismatch between the creditor and debtor items in inbound transactions. We said then:

> [the current -13(g) regulations] justify separate entity treatment for the creditor corporation on the basis that its gain or loss accrued economically while it was not a member of the group. That is, of course, true, and it is further true that a direct retirement of the debt from the creditor would typically involve the same mismatch of ordinary cancellation of indebtedness income for the debtor and a capital loss for the creditor. We believe a different result is justified under the

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103 Prop. Treas. Reg. § 1.1502-13(g)(5)(ii)(A).

104 Prop. Treas. Reg. § 1.1502-13(g)(5)(ii)(B).

> deemed retirement rule, however, given that the rule both accelerates the debtor's and creditor's tax consequences and places them within the same group. Thus, it seems unnecessary, if not gratuitously harsh, to accelerate the tax treatment of offsetting economic positions in a manner that would often produce a negative tax liability. We, therefore, believe the creditor's loss and debtor's income should match not only in timing but in character.[105]

If the IRS and Treasury continue to believe that inbound transactions require separate entity treatment to produce tax consequences equivalent to the tax consequences that would have resulted if the obligation had been retired immediately prior to the inbound transaction, other provisions of the consolidated return regulations that are possibly triggered by the deemed satisfaction and reissuance of the IO should be revised so that they also apply on a separate entity basis. For example, Treasury regulation § 1.1502-28 provides special rules for the application of Section 108(a) (generally excluding discharge of indebtedness from the taxable income of the debtor in certain circumstances) in the consolidated return context. In general, the member with the excluded COD income reduces its own tax attributes.[106] However, to the extent the excluded COD income is not applied to reduce the tax attributes of the member or, in certain circumstances, its subsidiaries, the amount is applied to reduce the remaining consolidated tax attributes of the group.[107] If an obligation is retired at a discount immediately prior to an acquisition of the debtor by a consolidated group, the tax

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[105] New York State Bar Association, Tax Section, *Report on Proposed Intercompany Transaction Consolidated Return Regulations* (Dec. 16, 1994).

[106] Treas. Reg. § 1.1502-28(a)(2)(i).

[107] Treas. Reg. § 1.1502-28(a)(4).

attributes of the group would not be affected. Accordingly, we believe that the proposed -13(g) regulations should be revised so that the attributes of the group (other than the debtor member and its subsidiaries[108]) are not affected when a note is deemed to be satisfied and reissued at a discount in an inbound transaction where the debtor member is being acquired.

## Part V. Off-Market Issuance Rule in the Proposed -13(g) Regulations

### A. Description of the Off-Market Issuance Rule.

The existing -13(g) regulations do not prescribe any rules relating to the original issuance of an IO. Rather, the tax treatment associated with the original issuance of an IO is governed under more general rules, such as Sections 482, 483, 1271-1275 and 7872.

The proposed -13(g) regulations include an off-market issuance rule that overrides the application of the more general rules.[109] Under the off-market issuance rule, if (i) an IO[110] is issued at a rate of interest that is materially off-market (an "off-market obligation") and (ii) at the time of issuance, it is reasonably foreseeable that the shifting of items of built-in gain, loss, income, or deduction from the obligation from one member

[108] More specifically, attribute reduction should be limited to those members which would have experienced attribute reduction if the COD income were recognized prior to the time the debtor joined the group.

[109] Prop. Treas. Reg. § 1.1502-13(g)(4)(iii).

[110] Although the offmarket issuance rule refers to IOs with a "rate of interest," it is not otherwise limited to debt obligations. If the rule is retained, it would be helpful if the final regulations clarified either (i) that the rule is limited to debt obligations or (ii) that the rule also applies to securities (in which case the regulations should also provide how it applies in the case of a security).

to another member will secure a material tax benefit, then the IO will be treated, for all federal income tax purposes, as originally issued for its fair market value, and any difference between the amount loaned and the fair market value of the obligation will be treated as transferred between the creditor and the debtor at the time the obligation is issued. For example, if S lends $100 to B in return for an off-market B note with a value of $130, and at that time, it is reasonably foreseeable that a material tax benefit will be secured by the shifting of items from the note, then the B note will be treated as issued for $130. The $30 difference will be treated as a distribution or capital contribution between S and B (as appropriate) at the time of issuance, and this amount will be reflected in future payments on the note as bond issuance premium.

The proposed -13(g) regulations further provide that an adjustment to an off-market obligation under the off-market issuance rule will be made without regard to the application of, and in lieu of any adjustment under, Sections 467 (certain payments for the use of property or services), 482, 483, 1274, or 7872.[111]

**B. Comments on the Off–market Issuance Rule.**

For the reasons discussed above, (i) we have serious doubts about the ability of taxpayers and the IRS to determine the "market rate" of an IO with any measure of accuracy and (ii) we think it will be difficult for taxpayers and the IRS to apply the reasonably foreseeable material tax benefit test under the off-market issuance rule. Moreover, the IRS already has the ability under Section 482 to challenge the rate on an

[111] Prop. Treas. Reg. § 1.1502-13(g)(4)(iii).

IO except in somewhat limited circumstances.[112] In light of the foregoing, we believe that the off-market issuance rule should be narrowed so that it applies only in cases where a principal purpose of the issuance of the IO or the setting of the interest rate was to secure a material tax benefit that would not otherwise be enjoyed.[113]

Moreover, beyond limiting the off-market issuance rule, we recommend that if a taxpayer upon issuance of an IO makes a good faith determination that the interest rate under the IO is a market rate, such rate be presumed to be a market rate for the IO so long as securing a material tax benefit by shifting items between members was not a principal purpose for the issuance of the IO (or the setting of the rate). We recommend that such a principal purpose be presumed to exist in cases where (i) the IO is issued by or to a member with losses limited under the SRLY or other rules or (ii) within some period (*e.g.*, two years) after the issuance of the IO by or to a member, there is a direct or

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[112] Treasury regulation section 1.482-2(a)(1) generally gives the district director power to make appropriate allocations to reflect an arm's-length rate of interest on related party loans. As described in Part III.B.4, above, the regulations provide a safe harbor if interest rate set by the taxpayer is not less than 100% of the applicable federal rate and not greater than 130% of the applicable federal rate. Treas. Reg. §1.482-2(a)(2)(iii)(B).

[113] Again, we think it would be appropriate to create certain pro-IRS presumptions for cases where the facts suggest such a principal purpose, such as where (i) an IO is issued to a member with losses limited under the SRLY or other rules, (ii) an IO is issued or to or by member if within some period (*e.g.*, two years) the member is disposed of outside of the group shares in the member are retained, (iii) an IO is issued to or by a member if within some period (*e.g.*, two years) there is a direct or indirect disposition of the member in a transaction in which the group recognizes a loss that is not disallowed.

indirect disposition of the stock of such member in a transaction in which the group recognizes a loss that is not disallowed.

Moreover, assuming that the IRS and Treasury are less concerned with below-market interest rates than above-market interest rates, we recommend that the interest rate on a newly-issued IO be deemed to be a market rate if the rate equals or is based on the parent's third-party borrowing rate (provided that the consolidated group generally uses such a rate for its IOs and the potentially abusive conditions described above are not present).

C. **Special Rules for Newly–Issued IO in Intragroup Exchange**.

The proposed -13(g) regulations also provide that if an IO is exchanged (or is deemed exchanged) for a newly-issued IO and the exchange (or deemed exchange) is not a routine modification of an IO,[114] then the newly-issued obligation will be treated for all federal income tax purposes as having an issue price equal to its fair market value.[115] Thus, if member A holds an IO issued by member B (the "original IO") and member A transfers the original IO to member C in exchange for an IO issued by member C (the "new IO"), the issue price of the new IO will be deemed to equal its fair market value.[116] The theory of this rule is that it is not necessary to apply normal Section 1274 principles

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[114] Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(B)(6). The exception is described in Part III.A.4(B)(6), above.

[115] Prop. Treas. Reg. § 1.1502-13(g)(4)(ii).

[116] At the same time, the deemed satisfaction and reissuance rule will apply to the old IO and treat it as having been satisfied and reissued for cash equal to its fair market value.

since the parties were required to determine the value of the property transferred in exchange for the new IO in applying the deemed satisfaction and reissuance rule.

Because this rule is directed at a specific transaction that is not entirely obvious upon reading the rule, we think it would be helpful for the final regulations to include an example illustrating the application of the rule.