NEW YORK STATE BAR ASSOCIATION
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August 19, 2008

Honorable Eric Solomon
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3000 IR
Washington, DC 20224

Re: **Guidance on Economic Downturn Issues**

Dear Sirs:

The current economic downturn has given rise to a significant number of bankruptcies and out-of-court restructurings. Debt instruments are trading at deep discounts, borrowers are unable to make current payments on their loans, and lenders and borrowers alike seek to restructure the loans so that borrowers may again keep current on their payments. We write to highlight some of the most significant unanswered tax questions faced by creditors and debtors in the current economic environment. We hope that you will be able to include them on the current business plan and otherwise consider the issues that are raised in this letter.

I. Ownership Changes Under Section 382.

A. In General.

Section 382 limits a loss corporation's use of its net operating loss ("NOL") carryforwards following an "ownership change" of the loss corporation's stock.[1] Very generally, an ownership change occurs if, immediately after certain specified testing dates, the percentage of stock owned by one or more "5% shareholders" (as specially defined) has increased by more than 50 percentage points over the lowest percentage of the stock owned by the 5% shareholders over the prior three year rolling period. Following an ownership change, the loss corporation's ability to use its NOL carryforwards existing on the ownership change date is generally limited to an annual amount equal to the product of (i) the long-term tax-exempt rate in effect for the month of the ownership change and (ii) the equity value of the loss corporation immediately prior to the ownership change.

B. Issues Relating to Ownership Changes Under Section 382.

1. Treatment of Multiple Funds Managed by a Common Investment Advisor. In determining whether a loss corporation has undergone a Section 382 ownership change, the loss corporation must first determine its 5% shareholders. In determining its 5% shareholders, a loss corporation must identify each "entity" that owns 5% or more of the loss corporation's stock. Treasury Regulation Section 1.382-3(a) defines an entity as "[A] group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock. A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members." It is unclear whether all of the stock owned by investment funds with a common investment advisor is treated as owned by a single entity. This concern is amplified by the fact that an investment advisor is required to file a public disclosure if it is in control of more than 5% of the equity of a publicly traded company. Private letter rulings have held that stock controlled by an investment advisor on behalf of funds with differing investors will generally not be aggregated for Section 382 purposes.[2] However, taxpayers may not rely on private letter rulings. It would be very helpful if the IRS and Treasury could issue guidance that may be relied upon by taxpayers (such as regulations or a revenue ruling or revenue procedure).[3]

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[1] All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

[2] PLR 200818020, 200713015, 9725039.

[3] We do not expect that the requested guidance would apply to alternative investment vehicles of a fund or parallel funds as such entities generally invest together pursuant to the underlying fund

(continued..)

2. *Application of Segregation Rules Under Treasury Regulations Sections 1.382-2T(j)(2)-(3) and 1.382-3(j).* The regulations under Section 382 contain certain segregation rules that deem 5% shareholders to be created for purposes of Section 382. The current rules present some apparent anomalies. For instance, direct issuances by a loss corporation may benefit from application of the "small issuance" and "cash issuance" rules under Treasury Regulations Section 1.382-3(j)(2)-(3), while no such rule appears to be available for sales of loss company stock by first-tier or higher-tier entities. This seems odd as a policy matter because the rationales for the small issuance rule (little likelihood of loss trafficking given the size of the stock being sold) and the cash issuance rule (recognition that there is likely some overlapping holders between current public group(s) and public shareholders purchasing from the company) are equally applicable to sales into the market by first-tier and higher-tier entities. In fact, direct issuances by the loss corporation increase the assets, and presumably the earning power, of the loss corporation (and therefore increases the likelihood that the loss corporation will be able to use its NOLs), while secondary sales by first-tier or higher-tier entities do not. Moreover, we believe that the segregation rules, as applied to sales of loss company stock by first-tier or higher-tier entities, impose significant record-keeping burdens on loss corporations and may influence decisions in such matters as the size of direct stock offerings by loss corporations in a manner that is arguably undesirable as a policy matter and unnecessary to prevent "loss trafficking" of the kind that requires policing. Finally, consideration might be given to extending the "cash issuance" rule for direct offerings to issuances of loss corporation stock in exchange for debt of the loss corporation.

II. Issues Arising Under Section 382(l)(5) and Section 382(l)(6).

A. In General.

Ownership changes often result from bankruptcy reorganizations where creditors receive all or a significant portion of a debtor corporation's stock. Because a debtor loss corporation in bankruptcy is generally insolvent immediately before its creditors receive stock that gives rise to an ownership change, the equity value of the debtor at such time will be zero (or close to zero). Under the general Section 382 limitation calculation, this would result in the reorganized debtor being denied use of its pre-ownership change NOLs. To ameliorate this effect, Sections 382(l)(5) and (l)(6) provide alternative methods of applying the Section 382 limitation to an ownership change that occurs pursuant to a bankruptcy plan. We refer to these alternative methods as the "(l)(5) exception" and the "(l)(6) exception," respectively.

The (l)(5) exception applies only if the shareholders and certain creditors of the debtor loss corporation own, after the ownership change and as a result of being shareholders or creditors of the debtor loss corporation before the ownership change, 50% or more of the stock of the debtor loss corporation. Stock issued to creditors is taken into account in determining whether the loss corporation qualifies for the (l)(5)

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documents and, therefore, may well be considered an "entity" within the meaning of Treasury Regulation Section 1.382-3(a).

exception only if (i) the creditor held the debt for which it is receiving stock since at least 18 months prior to the filing of the loss corporation's bankruptcy case or (ii) the debt being exchanged for stock arose in the ordinary course of the debtor loss corporation's business and the debt was held by the creditor at all times that the debt was outstanding, or (iii) under certain circumstances described in the Section 382(l)(5) regulations, the creditor owns less than 5% of the loss corporation's stock after the ownership change. We refer to creditors that are described in clauses (i)-(iii) as "qualified creditors".

If an ownership change qualifies for the (l)(5) exception, absent an "election out" of (l)(5) by the loss corporation, a corporation's NOL carryforwards are not limited as a result of the (l)(5) ownership change, but the loss corporation must recalculate its NOL carryforwards assuming that no deductions were allowed for interest (i) paid or accrued during each taxable year ending during the three years preceding the taxable year in which the ownership change occurs and (ii) attributable to the portion of the current taxable year ending on the ownership change date, in each case, in respect of debt converted into stock pursuant to the bankruptcy case. We refer to this recalculation of the loss corporation's NOL carryforwards as the "interest haircut."

If the (l)(5) exception does not apply to an ownership change occurring in connection with an exchange of debt for stock in a bankruptcy proceeding (including by reason of a taxpayer electing out of (l)(5)), the (l)(6) exception may provide some relief from the general Section 382 limitation calculation. If the (l)(6) exception applies to an ownership change, the debtor loss corporation generally determines its Section 382 limitation by using its equity value after taking into account any cancellation or surrender of debt pursuant to the bankruptcy plan (rather than determining the Section 382 limitation using the equity value of the debtor loss corporation immediately prior to the ownership change). (However, the loss corporation's value for purposes of (1)(6) may not exceed the value of the assets held by the debtor loss corporation prior to the ownership change.)

B. Issues Under Section 382(l)(5) and (l)(6).

1. *Treatment of Stock Received on Exercise of Equity Subscription Rights for Purposes of Qualifying Under the (l)(5) Exception.* As described above, a creditor will be treated as a qualified creditor for purposes of the (l)(5) exception if the stock is received by the creditor as a result of being a creditor in the debtor loss corporation and certain other conditions are satisfied. Companies emerging from bankruptcy are often in need of cash to pay certain claims and fund certain operating costs after the reorganization. It is common for companies to raise this cash by issuing creditors equity subscription rights. These rights typically provide specified creditors with an option, exercisable *prior to* the bankruptcy plan effective date, to subscribe for equity in the reorganized company (generally at a discount to the estimated market value of the equity). These rights can be provided to all creditors in a class, only certain creditors that commit to satisfying the company's financial needs (a so-called backstop purchaser), or a combination of both. It is unclear whether stock issued to creditors pursuant to the exercise of these equity subscription rights should be treated as stock received by the creditor as a result of being a creditor for purposes of testing qualification

under the (l)(5) exception. The only authority to date on this topic is a recent private letter ruling (PLR 200818020) which concluded, without detailed analysis, that stock issued to creditors in connection with the exercise of certain equity subscription rights issued pursuant to a bankruptcy plan will be treated as received by the creditor as a result of being a creditor of the debtor loss corporation. We would welcome guidance whether and under what circumstances creditors receiving equity subscription rights may qualify as qualified creditors.

2. *Clarification Regarding When a Creditor Will be Treated as Participating in Formulating a Plan of Reorganization For Purposes of Treasury Regulation Section 1.382-9(d)(3)(i).* The Treasury Regulations provide that, in determining whether a loss corporation qualifies for the (l)(5) exception, there is a presumption that a creditor receiving equity pursuant to a bankruptcy reorganization is a qualified creditor so long as the creditor is not a 5% shareholder (or an entity through which a 5% shareholder holds an interest in the loss corporation) immediately after the reorganization. The applicable regulations go on to provide that this presumption will not apply with respect to "indebtedness beneficially owned by a person whose participation in formulating a plan of reorganization makes evident to the loss corporation (whether or not the loss corporation had previous knowledge) that the person has not owned the indebtedness for the requisite period" necessary to treat the person as a qualified creditor.[4]

There is no authority regarding the types or extent of actions that constitute "participation in formulating a plan or reorganization" for this purpose. It would be particularly helpful for guidance to indicate whether a creditor that is part of an official court appointed creditors' committee or an informal committee is treated as participating in formulating a plan of reorganization for this purpose. Furthermore, if a creditor is treated as participating in formulating a plan of reorganization, it would be helpful for guidance to indicate how that participation makes evident to the loss corporation that the creditor has not held its claim for the requisite period. For example, if a debtor is aware that a portion of a creditor's claim has not been held for the requisite period but is not aware of the portion of the claim that has not been so held, are the creditor's short-held claims now tainted, such that the debtor has to establish the precise portion that has been so held?

3. *Calculation of 'Interest Haircut' Where Debt is Satisfied with Equity and Other Consideration.* If the (l)(5) exception applies, the interest haircut reduces the loss corporation's NOLs for certain interest in respect of a portion of the creditor's claim that is converted into equity. Where a creditor receives stock and other consideration in satisfaction of its claim, there is no clear authority on the portion of the creditor's claim that is converted to equity for purposes of calculating the interest haircut. For example, if a creditor with a $100 claim receives debt with an issue price of $20 and stock with a fair market value of $20 in satisfaction of its claim, does the interest haircut apply to $80 of the claim (the portion of the claim remaining after $20 of new debt is applied to the $100 claim), $50 of the claim (treating the new debt and new equity as

[4] Treasury Regulation Section 1.382-9(d)(3)(i).

being used to satisfy the $100 claim in proportion to the relative fair market values (or issue price) of the new debt and new equity), or some other portion of the debt?

The legislative history[5] to the former stock for debt exception and Revenue Ruling 92-52[6] (which interprets it) conclude that the taxpayer should first allocate non-stock consideration to the creditor's claim with any stock consideration then satisfying the remainder of the claim. However, following repeal of the stock for debt exception, stock is treated like any other consideration for purposes of determining a debtor corporation's cancellation of debt income. Accordingly, cancellation of debt income equals the excess of the adjusted issue price of a claim over the sum of the fair market value of stock and the issue price of any debt issued in satisfaction of the claim. Therefore, it is unclear whether the methodology suggested by Revenue Rule 92-52 is appropriate for applying the interest haircut. Guidance on this issue would be helpful.

4. *Application of the (l)(5) and (l)(6) Exceptions in the Consolidated Group Context.* There are a number of issues relating to the application of the (l)(5) and (l)(6) exceptions where an ownership change occurs with respect to one or more entities that are part of an affiliated group filing a consolidated federal income tax return. For example, in determining whether the (l)(5) exception applies, must all members of the consolidated group be under the jurisdiction of a court in a title 11 (bankruptcy) case or is it sufficient that only some of the members are in bankruptcy (e.g., members that contributed to the consolidated NOL, the member issuing stock that triggers the ownership change, etc.)? Presumably, the (l)(6) exception applies if the parent of the group is in bankruptcy, regardless of whether other members of the group are under the protection of a bankruptcy court. However, how should a group determine its pre-change gross asset value for (l)(6) purposes when less than all members of the group are in bankruptcy?

Treasury Regulation Section 1.1502-97 and -97A currently reserve on the application of the special bankruptcy rules under Section 382 in the context of a consolidated federal income tax group. Guidance on application of these rules in the consolidated group context would be useful. Although comprehensive regulations would be ideal, we understand that there may be many issues to consider and, in the interim, would welcome temporary guidance, such as a Notice similar to Notice 2003-65. (Notice 2003-65 was issued pending promulgation of comprehensive regulations regarding application of the Section 382 built-in gain/loss rules.)

III. Liquidating Trusts and Disputed Claims Reserves.

A. Liquidating Trusts.

Liquidating trusts are a useful tool in bankruptcy proceedings for satisfying creditor claims with illiquid assets. These trusts are primarily used either when

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[5] S. Rep. No. 1035 at 17.

[6] 1980-2 C.B. at 629.

illiquid assets are expected to be sold over an extended period of time for the benefit of creditors and either (i) the debtor is liquidating and will not remain in existence long enough to dispose of the assets or (ii) the debtor is reorganizing and, as part of the reorganization, seeks to sever its relationship with its former creditors. Liquidating trusts are generally treated as grantor trusts for federal income tax purposes.

The IRS issued two Revenue Procedures providing guidelines in order for a trust to receive a private letter ruling regarding its status as a liquidating trust. The first, Revenue Procedure 82-58, provides general guidelines. The second, Revenue Procedure 94-45, applies specifically to trusts formed pursuant to a chapter 11 bankruptcy plan. Revenue Procedure 94-45 generally follows the guidelines set forth in Revenue Procedure 82-58, but is more liberal with respect to certain of the restrictions established by Revenue Procedure 82-58.

If the policy reason for less restrictive provisions for a trust formed pursuant to a chapter 11 plan is to facilitate workouts of troubled companies, there may be additional situations in which it is appropriate to apply the less restrictive guidelines of Revenue Procedure 94-45. For example, trusts are often used in out-of-court restructurings. In these situations, the trusts operate similarly to those formed pursuant to chapter 11 plans. We request consideration as to whether the liberalized requirements of Revenue Procedure 94-45 should be applied equally to trusts formed in out-of-court restructurings.

B. Disputed Claims Reserves.

Bankruptcy plans typically provide for the establishment of a disputed claims reserve to hold assets that, pursuant to the bankruptcy plan, are allocable to claims that are being disputed (either by the debtor or other creditors). If a disputed claim is subsequently allowed, the assets in the reserve allocable to that claim are distributed to the creditor. If a disputed claim is disallowed, a portion of the assets allocable to that disputed claim are generally distributed to holders of allowed claims and the remainder of the assets are reserved for the remaining disputed claims pending resolution of those claims.

Treasury Regulation Section 1.468B-9 generally provides that a "disputed ownership fund" will be treated for federal income tax purposes as a C corporation or, if all of the fund's assets are passive, a qualified settlement fund taxable at rates applicable to trusts and estates. Many practitioners believe that the definition of a "disputed ownership fund" for purposes of these regulations was intended to include the typical disputed claims reserve created pursuant to a bankruptcy plan. However, this is not entirely clear. For example, the definition of disputed ownership fund requires that a court approve of the payment of money or the distribution of other property from the fund. Frequently, disputed claims reserves vest the power to resolve disputed claims and determine the manner in which property is distributed in a trustee or plan administrator, with the court retaining continuing jurisdiction over unsettled disputes. The trustee or administrator derives its power from the plan of reorganization approved by the

bankruptcy court, which some have interpreted as being sufficient to satisfy the "court approval" requirement, while others have expressed reservations. In addition, a disputed claims reserve is not treated as a disputed ownership fund if it is "a bankruptcy estate (or part thereof) resulting from the commencement of a case under title 11 of the United States Code."[7] Some practitioners have interpreted this language narrowly, concluding that it was not intended to apply to a trust or fund established pursuant to a confirmed plan of reorganization while others believe that it was.

If a disputed claims reserve is treated as a disputed ownership fund that is treated as a C corporation, Treasury Regulation Section 1.468B-9(c)(6) generally provides that any unused operating losses, capital losses and credit carryforwards of the fund are allocated to the claimant/claimants on termination of the fund. If a single reserve is created for multiple disputed claims and the claims are resolved over time, these rules appear to provide that the last person receiving a distribution from the reserve succeeds to all of the tax attributes of the disputed ownership fund as of such date. This approach, while easy to administer, does not reflect the fact that persons that are not claimants at the time of the final distribution may have economically borne a portion of the fund's losses and other attributes existing upon termination of the reserve. Guidance would be welcome on the allocation of tax attributions among current and past claimants of a disputed ownership fund.

IV. Application of Section 1001 "Modification" Rules to Cure Payment During Temporary Forbearance.

Treasury Regulation Section 1.1001-3(c)(4) provides that, unless there is an agreement to alter the terms of a debt instrument, a holder's temporary forbearance of its right to accelerate payment or exercise other similar default rights does not constitute a modification of the debt instrument. Treasury Regulation Section 1.1001-3(e)(3) provides that a modification that changes the timing of payments under a debt instrument constitutes a significant modification if, based on all the facts and circumstances, it results in a material deferral of scheduled payments.

Although a creditor's agreement to forbear exercise of certain remedies during the period permitted by the regulations does not constitute a modification for purposes of determining whether there is a deemed sale or exchange of the debt, there is some uncertainty as to whether the payment of an amount which was previously due, but is stayed during forbearance (i.e., a "cure payment"), prior to expiration of the forbearance period must be tested under the rules governing deferred payments to determine whether the payment gives rise to a significant modification. In effect, is the "temporary" forbearance now "permanent" when the creditor accepts the payment and foregoes the default or, as many practitioners believe to be the case, is the making of the cure payment consistent with the temporary forbearance rule such that the payment is not tested under the regulations. Guidance confirming the latter approach would be useful.

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[7] Treasury Regulation Section 1.468B-9(b)(1)(iv).

V. Workouts and Section 864(b)(2).

Foreigners are subject to federal income tax on income that is effectively connected with a United States trade or business.[8] Under Section 864(b)(2), a foreigner is not to be treated as engaged in a United States trade or business if the foreigner (i) trades in stocks or securities through a resident broker, commission agent, custodian, or other independent agent or (ii) trades in stocks or securities for the taxpayer's own account. We are concerned that the trading exception described in the preceding sentence may not apply if the foreigner originates loans and that the creation of a new debt instrument pursuant to a deemed exchange of debt under Section 1001 might be treated as a loan origination that disqualifies the taxpayer from the Section 864(b)(2) safe harbor. Guidance would be helpful as to whether and when a foreigner (or its U.S. investment manager) that renegotiates a debt instrument with a distressed borrower under circumstances that give rise to a substantial modification of the debt instrument will be treated as engaged in a trade or business in the United States.

Guidance would also be helpful as to whether foreigners that have held the debt of a debtor and make debtor-in-possession financing during the term of a chapter 11 case, an exit loan in connection with emergence from bankruptcy, or similar advances for out-of-court workouts are engaged in a trade or business in the United States. On the one hand, these advances could be viewed as lending activities sufficient to give rise to origination. On the other hand, it may be argued that these investments are merely incidental to the foreigner's investment in the distressed debt and are aimed at preserving the foreigner's original debt investment. The latter characterization appears most likely if the foreigner has no expectation that it will make an advance when it acquires the debt, and the advance is in fact aimed at preserving that original investment.

VI. Tax Accounting Issues Relating to Debt Instruments.

A. Allocation of Payment to Principal and Interest Where Debt is Not Paid in Full.

In bankruptcies and out-of-court restructurings, creditors often are not repaid the entire outstanding balance of their loan (principal plus accrued interest). Case law prior to the promulgation of Treasury Regulation Section 1.446-2(e) provided that if less than the full amount owing is paid in satisfaction of a debt instrument, the borrower and lender could agree on the relative allocation of payments between principal and interest. Absent an agreement, payments made on debt before retirement were generally applied first to accrued unpaid interest and then to principal, and payments made at maturity were applied proportionately to accrued unpaid interest and principal. Courts have also held that if the final payment does not entirely repay outstanding principal, the final payment may be allocated solely to principal.

Treasury Regulation Section 1.446-2(e) provides that a payment on a debt instrument must be allocated first to accrued and unpaid interest and then to principal. It

[8] Sections 871(b) and 882(a).

is unclear whether the regulation contemplates the situation where less than all principal will be repaid. Most bankruptcy plans effectively take the position that Treasury Regulation Section 1.446-2(e) does not apply to such a situation and provide that payments to creditors pursuant to the plan will be allocated first to principal and that the parties all agree to treat payments consistent with that approach for federal income tax purposes. There is no assurance that the IRS will follow this approach and, from time to time, the IRS has adopted a different position in bankruptcy and insolvency situations. Accordingly, guidance on this issue would be welcome.

B. Clarification of the Definition of "Public Trading" for Purposes of Section 1273.

Section 1273 and its regulations provide rules for determining the "issue price" of a debt instrument. The issue price of a debt instrument is important in determining the amount of cancellation of debt income (if an outstanding debt obligation is satisfied, in whole or in part, with a new debt obligation), the amount of gain or loss recognized where property is exchanged in whole or in part for a debt instrument, and the amount of original issue discount with respect to the debt instrument. If a debt instrument is issued for cash, its issue price is equal to the cash paid. A debt instrument issued for property will have an issue price equal to (i) the fair market value of the debt instrument if such instrument is "traded on an established market" (publicly traded), (ii) the fair market value of the property for which the debt is issued if (i) doesn't apply and the property is publicly traded or (iii) if (i) and (ii) do not apply, the face amount of the debt instrument (assuming the debt instrument provides for adequate interest).

The regulations defining when an instrument is "traded on an established market" were issued in 1994. The trading market for debt instruments has developed significantly in the past 14 years. New and constantly evolving systems for trading and disseminating information regarding debt instruments has created uncertainties on the application of the existing rules. Guidance, including possibly identifying existing markets and trading systems that will be treated as established markets for Section 1273 purposes, would be useful. We issued a report on the definition of public trading as used in Section 1273; the report described the then state of bond trading and the various mediums on which bonds trade, and made a number of suggestions.[9]

C. Accrual of Original Issue Discount ("OID") and Market Discount Where There is No Reasonable Expectation of Payment.

Case law authorizes accrual method taxpayers holding non-OID debt instruments to stop accruing interest income when there is no reasonable expectation that

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[9] NYSBA Tax Section Report 1066, Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273, August 12, 2004, http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/rpt1066.pdf

the interest will be paid.[10] However, no court has addressed the similar issue that arises for OID and market discount. The IRS has most recently taken the position in a 1995 technical advice memorandum[11] that a taxpayer holding an OID instrument must continue to accrue OID even if future OID accruals will not be collected as a result of the obligor's financial condition. The TAM concluded that Section 1272 provides that OID "shall" be included in gross income and that there are no exceptions under the Code or applicable regulations for the accrual of OID on debt instruments that are unlikely to be repaid pursuant to their terms. The TAM suggests that the policy behind requiring taxpayers to accrue OID without exception is based on the desire to match the timing of the issuer's deduction with the holder's income inclusion. Many of us believe that accrual of OID on a debt instrument issued by a troubled debtor does not appear to be required under the statute and the TAM's stated policy reason does not reflect the reality that troubled debtors are unlikely to derive current tax benefits from deducting OID, which reality mitigates the practical impact of any potential timing mismatches with income inclusions. Similar issues exist with respect to market discount.[12]

D. Timing of Losses With Respect to Unpaid OID

In Technical Advice Memorandum 9538007, the IRS stated its position that unlike accrued interest on non-OID debt, a claim for accrued OID can not be severed from the underlying instrument for purposes of determining when a taxpayer can claim a loss with respect to accrued OID that is not paid. The inability to sever accrued OID from the underlying instrument for purposes of determining whether a taxpayer can recognize a loss is inconsistent with the legislative history surrounding Section 354(a)(2)(B) and the treatment of non-OID interest for accrual method taxpayers. In light of the legislative history and the general treatment of accrued interest, practitioners have questioned the IRS's position in the TAM and taxpayers have taken differing positions regarding the timing of losses with respect to accrued OID that is not satisfied.

E. Character Mismatches on Accrued Interest, OID and Market Discount -

Taxpayers that accrue interest, OID and market discount currently pay tax on the interest, OID or market discount at ordinary income tax rates. If that interest, OID or market discount is ultimately not paid and the taxpayer is entitled to claim a loss, there

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[10] *Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930), *Jones Lumber Co. v. Comm'r*, 404 F.2d 764 (6th Cir. 1968), Rev. Rul. 80-361, 1980-2 C.B. 164

[11] TAM 9538007 (September 22, 1995).

[12] In the President's Budget Proposal for fiscal year 2000, filed on February 1, 1999, the Clinton Administration proposed requiring all accrual basis taxpayers to include market discount income as it accrues, and on June 22, 1999 we issued a report on The Clinton Administration's market discount proposal.

is uncertainty regarding whether the loss should be ordinary or capital in character. A loss that is capital in character can generally only be used to offset capital gains, which may limit its utility and, in any event, prevents the loss from being used to offset the interest income previously accrued. As a result of these rules, taxpayers are required to pay tax on amounts that exceed their economic income. This treatment is particularly problematic if, as asserted in Technical Advice Memorandum 9538007, discussed above, the holder of an OID instrument must continue to accrue income even after it becomes apparent that the OID will not be paid.

There is no evident tax policy that would support this result and these rules are inconsistent with general principles of tax law that consider prior related events in determining the tax consequences of a transaction.[13] Furthermore, these rules have the effect of encouraging creditors of troubled debtors to sell their debt instruments to tax-exempts, foreigners and other tax indifferent parties. Guidance allowing taxpayers ordinary losses for amounts attributable to interest, OID and market discount that is included in income but never realized will remedy this punitive result.

F. Accrual of Market Discount on High Yield Bridge Loans[14]

A high yield bridge loan is a high yield loan that is taken out until permanent financing can be arranged. The interest rate for the bridge loan is typically a variable rate (such as LIBOR plus a fixed spread) or a fixed rate, each of which, subject to a cap, typically increases at specified intervals (such as quarterly) after a specified number of months (*e.g.*, six months) following issuance. A high yield bridge loan typically has an "initial" term of one year. During the initial term, the borrower may repay the loan at any time without any premium. At the one year anniversary, the bridge loan automatically converts into an "extended loan" with a longer maturity (*e.g.*, an additional seven years), provided that certain conditions are met, such as that the borrower pays a specified fee and that the borrower is solvent. The extended loan has an interest rate that continues to increase at specified intervals, subject to a cap, and may be repaid by the borrower at any time without any premium. The extended loan differs from the initial term loan in that a holder of the extended loan has the option to exchange the loan for an "exchange note." The exchange note generally has an interest rate fixed at the rate of the extended loan at the time that the holder exchanges the extended loan for the exchange note and the same maturity as the extended loan. The exchange note may not be repaid prior to maturity (or a year or two preceding maturity) without a premium that is typical for a high yield bond (e.g. a make-whole for the initial three to four years and then a premium equal to the fixed rate on the bond declining to zero a year or two preceding maturity).

In the current economic environment, it is very common for interests in a high yield bridge loan to be acquired at a significant discount to the loan's face amount.

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[13] *Cf. Arrowsmith v. Comm'r*, 344 U.S. 6 (1952).

[14] The bridge loan terms described in this section are common to high yield bridge loans and may not be applicable to other loans.

The acquisition of a bridge loan at a discount raises issues regarding the period over which market discount should be accrued. Specifically, should an acquirer that purchases a bridge loan during the initial term accrue market discount over the remaining portion of the initial term or over the period until maturity of the extended loan? Some practitioners are concerned that Treasury Regulation Section 1.1272-1(c)(5) (the Option Rule) could be applied by analogy and require all market discount on a bridge loan to be accrued over the period until the next interest payment date (or perhaps over an even shorter period, such as a day or an instant). This result appears inconsistent with economic reality as the discounted purchase price paid for the bridge loan implies that the loan likely will not be repaid shortly. Some practitioners believe that the Option Rule does not apply for market discount purposes or, if it is applicable, it should be applied to calculate yield to maturity by reference to the market discount purchase price of the bridge loan.[15] If the Option Rule is applied in this manner, the issuer will often be deemed to retire the bridge loan at the end of the extended loan period for purposes of accruing market discount, because retirement at the end of the extended loan period will often minimize the yield, calculated by reference to the market discount purchase price. Guidance confirming the proper period over which to accrue market discount under facts similar to those described above would be useful.

G. Applicable High Yield Discount Obligations[16]

Under Section 163(i), a debt instrument issued by a corporation will be treated as an applicable high yield discount obligation ("AHYDO") if it has (i) a term exceeding five years, (ii) "significant original issue discount" (this would be the case if as of the first accrual period ending after the date that is 5 years from issuance the accrued but unpaid OID exceeds an amount equal to the first year's yield on the instrument) and (iii) a yield that exceeds the applicable federal rate ("AFR") plus 5%. Section 163(e)(5) provides that the issuer's deductions for OID on an AHYDO in excess of AFR plus 6% will be permanently disallowed, and the remaining deductions for OID will be deferred until the OID is actually paid in cash or other property other than debt of the issuer. The AHYDO rules were aimed at long-term high-yield instruments that postpone payment of interest (i.e., interest accrues in the form of OID or is "paid in kind") because such instruments have characteristics of equity, and these rules were also intended to minimize tax incentives for the use of these types of instruments in highly levered corporate acquisitions and restructurings.[17]

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[15] Such approach is supported by Section 1276(b)(2)(A), which provides that market discount accrues under the OID rules as if the bond had been "originally issued on the date on which such bond was acquired by the taxpayer, for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition."

[16] Recently released Revenue Procedure 2008-51 describes certain situations where the IRS will not apply the AHYDO rules. While the Revenue Procedure is very helpful, the Revenue Procedure is limited to only a few specific fact patterns. For the reasons described in the text, we believe more comprehensive guidance would be helpful.

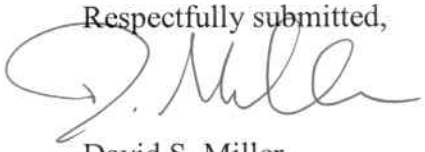
[17] H.R. Rep 101-247, 101st Cong, 1st Sess (Sept. 29, 1989) at 1220.

In the current economic conditions, debt instruments are trading at deep discounts, which increase their yields to secondary market purchasers, while rates on U.S. Treasury obligations have remained relatively low (for debt issued in July 2008 with a maturity greater than 3 years, but not greater than 9 years, and semi-annual compounding, the AFR is 3.42%). This results in publicly traded distressed debt that is restructured being subject to the AHYDO rules when the debt is deemed reissued under Treasury Regulation Section 1.1001-3 (e.g., because of an extension of the maturity date or a reduction in the interest rate that is a "significant modification" under those regulations). Similar results can arise where distressed debt is purchased by a related party at a deep discount to its face amount because, under Treasury Regulations Section 1.108-2(g), the instrument is deemed reissued for income tax purposes with an issue price equal to the related party's purchase price.

There is no evident tax policy for treating as AHYDOs restructured or repurchased distressed debt instruments that were not originally AHYDOs but that are deemed reissued and meet the AHYDO definitional tests by reason of market conditions coupled with relatively low interest rates on Treasury obligations. In these cases, at least for purposes of the AHYDO rules, the discount at which these instruments are deemed reissued is more analogous to market discount, rather than OID.

We appreciate your consideration of our suggestions. Please let me know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully submitted,



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