REPORT #1175

TAX SECTION

New York State Bar Association

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January 20, 2009

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

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

Re: Report on Revenue Procedure 2008-51

Dear Sirs:

We write to suggest some supplemental guidance to Revenue Procedure 2008-51.

In Revenue Procedure 2008-51, the Internal Revenue Service provided that, under certain circumstances, it will not treat a debt instrument that has an issue price that is less than the amount loaned to the borrower as an "applicable high yield discount obligation" ("AHYDO").

The Revenue Procedure contemplates the situation where a lender makes a term loan to a borrower. Subsequently, market conditions deteriorate and, while acting in the capacity of an underwriter for purposes of Treasury regulations section 1.1273-2, the lender sells a substantial amount of the term loan to third parties for an amount that is significantly less than the amount loaned to the borrower under the term loan. Under Section 4.01 of the Revenue Procedure 2008-51, if certain conditions are satisfied, the IRS will not treat the loan as an AHYDO.

The Revenue Procedure also contemplates the situation where lender makes a temporary ("bridge") loan to a borrower, and by reason of deteriorations in market conditions, the borrower is not able to refinance the bridge loan. Subsequently, the bridge loan is modified or exchanged for another debt instrument issued by the borrower in order to facilitate the syndication by the lender. If the modifications to the loan or the exchange of the loan constitute a "significant modification" of the loan within the meaning of Treasury regulations section 1.1001-3, and the "new" debt instrument is treated as traded on an established securities market under Treasury regulations 1.1273-2, the issue price of the "new" debt instrument may be significantly less than the amount initially loaned to the borrower. Under Sections 4.02 and 4.03 of the Revenue Procedure 2008-51, if certain conditions are satisfied, the IRS will not treat the "new" debt instrument as an AHYDO.

Although Revenue Procedure 2008-51 was designed to provide relief to borrowers, it fails to address the potential recognition of cancellation of indebtedness income ("CODI") by borrowers described in Sections 4.02 and 4.03 of the Revenue Procedure and, therefore, is not as helpful as it might be. We offer several suggestions to address the potential CODI recognition in these situations. First, the IRS could permit the CODI recognized by a borrower described in Section 4.02 or 4.03 of the Revenue Procedure to be amortized into income over the term of the debt instrument as an offset to the corresponding amount of original issue discount ("OID") deductions that arise as a result of the issue price of the debt instrument being less than the amount initially loaned to the borrower. We believe that the IRS has regulatory authority under section 446(b) to provide for this treatment. However, if this treatment is adopted, we note that taxpayers that are not described in the Revenue Procedure may take the position that they can amortize the CODI that arises from consensual modifications of their debt.

Alternatively, the lender could be treated as a "principal" and not as an "underwriter" for purposes of Treasury regulations section 1.1273-2. If the lender is treated as a principal, and the modifications to the loan or the exchange of the loan do not constitute a "significant modification" of the loan within the meaning of Treasury regulations section 1.1001-3, then the issue price of the loan would be the amount loaned to the borrower, and neither CODI nor OID would arise. However, this solution would result in the debt purchased by a third party as having been acquired with market discount, rather than OID. Market discount is not generally required to be accrued and included in income currently. Nevertheless, treatment of the discount as market discount does not appear inconsistent with the lender's recognition of an economic (and tax) loss from the transaction.

Another alternative would be to suspend application of Treasury regulations section 1.1273-2(f)(4), (f)(5) and (f)(6) to the situations described in the Revenue Procedure. However, this alternative may be difficult to justify where the debt clearly is traded on an established market. A third alternative would be to modify application of Treasury regulations section 1.1001-3 in the situations described in the Revenue Procedure. However, this alternative may be difficult to justify from a policy perspective, particularly where material changes are made to the debt instrument.

We note that, because the Revenue Procedure does not affect the OID issue price rules, a borrower that applies Section 4.01 of the Revenue Procedure appears to obtain a tax windfall in the form of OID deductions that do not economically reflect an increased cost of the borrowing to the borrower. We believe this windfall is inappropriate. A possible solution to avoid the windfall would be to require a borrower that applies Section 4.01 of the Revenue Procedure to amortize into income the difference between the amount loaned and the OID issue price as an offset to the corresponding OID deductions. We believe that the IRS has regulatory authority under section 446(b) to provide for this treatment.

We also address some issues that arise when an initial bridge loan is replaced with permanent financing pursuant to a securities demand (which generally requires the borrower to issue replacement "demand securities" to the initial lender or one of its affiliates). We suggest that the Revenue Procedure could be clarified to indicate that it applies to demand securities.

Finally, we offer certain other technical comments on the Revenue Procedure.

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

Respectfully submitted,

David S. Miller
Chair

Enclosure

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