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Mr. Michael Mundaca
Deputy Assistant Secretary –
International Tax Affairs
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 the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(5)(F)

Dear Sirs:

We write to provide recommendations for guidance under Sections 108(i) and 163(e)(5)(F), which were enacted as part of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5. Sections 108(i) and 163(e)(5)(F) are designed (among other things) to help taxpayers who choose to reduce their outstanding debt by repurchasing the debt at a discount and taxpayers who need to modify (or otherwise restructure) the terms of their outstanding debt but wish to do so outside of bankruptcy.

Section 108(i) has four main components. First, Section 108(i)(1) permits a taxpayer to elect to defer cancellation of debt income ("COD income") in connection with a "reacquisition" of an "applicable debt instrument" (an "ADI") and include the COD income ratably over a five-year period generally beginning in 2014. Second, if a taxpayer makes a Section 108(i) election with respect to the reacquisition of an ADI, Section 108(i)(2) requires the taxpayer to defer all or a portion of any "original issue discount" ("OID") arising on any newly issued debt instrument ("DI") if (i) the DI was issued in exchange for the reacquired ADI or (ii) the proceeds of the DI were used to effect the reacquisition of the ADI (the "OID Deferral Rule"). Third, Section 108(i)(5)(D) accelerates the deferred COD income and the deferred OID deductions upon certain events. Fourth, Section 108(i)(6) provides that in the partnership context (i) when the COD income is recognized, it must be allocated among the partners in the manner the COD income would have been allocated if it had not been deferred (the "Allocation Rule") and (ii) the deemed distribution under Section 752(b) resulting from a reacquisition is reduced to the extent that such deemed distribution would have given rise to gain under Section 731 (the "Section 731 Gain Deferral Rule").1 Finally, Section 163(e)(5)(F) (the "AHYDO Turnoff Rule") turns off the OID deferral and disallowance rules otherwise applicable under Section 163(e)(5) in the case of certain "applicable high yield discount obligations" ("AHYDO").2

Sections 108(i) and 163(e)(5)(F) facilitate the reacquisition of ADIs by allowing taxpayers to defer the resulting COD income and improving alignment between the COD income realized in a debt exchange and the additional OID deductions created in such an exchange. Sections 108(i) and 163(e)(5)(F) are likely to serve an extremely important role as taxpayers seek to reduce their debt loads and modify the terms of their debt in light of current market conditions.

Our report includes over 35 separate recommendations for guidance. The most significant of those recommendations are:

1. Extent of the Electivity. Guidance should interpret Section 108(i) to allow a Section 108(i) election with respect to only a portion of the COD income resulting from a single reacquisition of a single ADI.

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[1] Section 108(i) applies only to "reacquisitions" after December 31, 2008 and before January 1, 2011.

[2] Section 163(e)(F)(5) generally only apples to AHYDOs issued during the period beginning on September 1, 2008 and ending on December 31, 2009. However, the Secretary is authorized to apply Section 163(e)(5)(F) with respect to DIs issued thereafter if the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets.

2. Applicable Debt Instruments. Guidance should explain when a DI issued by a person other than a C corporation will be treated as issued in connection with the conduct of a trade or business by such person and therefore will be treated as an ADI. We recommend that guidance provide that a DI issued by a person other than a C corporation be treated as an ADI if interest on the DI is treated as trade or business interest under Treas. Reg. § 1.163-8T and Notice 89-35 (with certain variations discussed in the Report), including where a person issues a DI to fund the acquisition of an interest in a partnership that is conducting a trade or business. We recommend that such guidance also provide that a DI be treated as an ADI in its entirety if (i) at least 50% of the interest on the ADI is treated as Section 163(h) trade or business interest (determined using the variations referred to above) or (ii) it was issued by an entity that is primarily engaged in the conduct of a trade or business, such as an entity (A) whose trade or business expenditures for the year exceed 50% of its total expenditures or (B) whose trade or business assets represent at least 50% of its total assets (applying the principles of Notice 89-35).

3. Protective Elections. Guidance should confirm that a taxpayer may make a protective Section 108(i) election on the original return for the year of the reacquisition even if the taxpayer takes the position that an underlying transaction does not result in COD income. Guidance should similarly allow a taxpayer that makes a Section 108(i) election with respect to a reacquisition to provide that the election applies to all (or an increased portion) of the COD income resulting from the reacquisition if the IRS determines that the reacquisition resulted in more COD income than was reflected on the original return. Although less important, it would be helpful for guidance to confirm that a taxpayer may condition a Section 108(i) election, or its scope, on other factors, like the extent of the taxpayer's insolvency or the amount of its net operating losses.

4. Earnings & Profits. Guidance should provide that where a corporation realizes COD income as a result of a reacquisition that reduces the stated principal amount of the corporation's debt, any COD income deferred under Section 108(i) is generally taken into account in the year of the reacquisition in computing earnings & profits ("E&P"). Guidance should further provide that, where the COD income results from a significant modification of a corporation's debt but the stated principal amount of the corporation's debt is unchanged (or where the corporation otherwise effects a debt exchange but the COD income exceeds the reduction in the stated principal amount of the corporation's debt), the corporation is required to take deferred COD income into account for E&P purposes but only to the extent it exceeds the amount of related OID that is subject to deferral under the OID Deferral Rule and has not been recognized (computed, for this purpose, without regard to the five-year limitation in Section 108(i)(2)(A)(i)(I)). Guidance should provide a separate E&P rule for real estate investment trusts and regulated investment companies.

5. Directly or Indirectly. Guidance should provide that the principles in Treas. Reg. § 1.279-3(b) will apply in determining whether the proceeds of a new DI were used "directly or indirectly" to reacquire an ADI.

6. Debt Issued by an Affiliate to Fund a Reacquisition. Guidance should provide that the OID Deferral Rule will apply to defer OID deductions on a DI issued by one

member of a consolidated group if the proceeds of the DI (or the DI itself) are used directly or indirectly to reacquire an ADI issued by another member of the group if a Section 108(i) election is made with respect to the reacquisition.

7. Application of the OID Deferral Rule at the Partner or the Partnership Level. When a partnership that has made a Section 108(i) election admits a new partner, guidance is needed to address the effect of that admission on the deferral of OID (which will be allocated in part to the new partner) in light of the fact that deferred COD income will continue to be allocated to the original partners. Guidance is also needed to address how the deferral rules will work when a partnership interest is transferred or the same person is a partner in multiple partnerships, for example in a tiered partnership structure.

Approximately half of the members of the Executive Committee believe that the OID Deferral Rule should be applied at the partner level and guidance should provide that the OID deductions required to be deferred by any (direct or indirect) partner in respect of any reacquisition under the OID Deferral Rule will not exceed the COD income deferred by that (direct or indirect) partner in respect of that reacquisition. Applying the OID Deferral Rule at the partner level should also mean that debt issued by one partnership will be subject to the OID Deferral Rule if the proceeds are used to reacquire an ADI of a different related partnership.

Approximately half of the members of the Executive Committee believe that the OID Deferral Rule should instead be applied at the partnership level—meaning that a partner's share of any OID will be subject to the OID Deferral Rule even if the partner is not allocated any deferred COD income under Section 108(i)—in order to preserve the approximate matching of deferred COD income with deferred OID deductions that Section 108(i) generally provides for.

However, the Executive Committee as a whole believes that, if guidance provides that the OID Deferral Rule is generally applied at the partnership level, it is important for guidance to include a rule (similar to the remedial method under Section 704(c)) that would allow a partnership to elect to accelerate each year a portion of the deferred COD income of the partners who were allocated deferred COD income in an amount corresponding to the OID allocated to those partners who were not allocated any of the deferred COD income. Acceleration of this portion of the deferred COD income would then permit the new partner to deduct the corresponding OID as if it had not been deferred. This election would also be available to the extent that a partner's share of the deferred OID exceeds the partner's share of the deferred COD. However, if this approach is adopted, we believe that either (i) the OID Deferral Rule should similarly be applied at the partnership level for purposes of determining which DIs are subject to the OID Deferral Rule (meaning that a DI issued by an upper-tier partnership to fund the reacquisition of an ADI issued by a lower-tier partnership would not be subject to the OID Deferral Rule) or (ii) guidance should extend this alternative to tiered arrangements.

8. Transfer of Stock of Corporations (Other Than Pass-Thru Entities). Guidance should provide that the transfer of stock of a corporation (other than a pass-thru entity) generally will not accelerate the items deferred by the entity pursuant to a Section 108(i)

election, even if the corporation joins or leaves a consolidated group. Special rules may be appropriate if (1) one member of a consolidated group issues a new DI and the proceeds are used (directly or indirectly) to fund the reacquisition of an ADI issued by another member of the group, (2) the OID Deferral Rule is applied to defer OID deductions on the new DI (as per recommendation 6 above) and (3) one of the two members leaves the group.

9. Asset Reorganizations. Guidance should provide that the disposition of substantially all of the assets of a corporate taxpayer (other than a pass-thru entity) in a transaction to which Section 381 applies (such as an A, C or D reorganization or a Section 337 liquidation) generally will not be considered an acceleration event. Again, where the corporation leaves a consolidated group, it may be appropriate to include the special rules referred to in recommendation 8 above.

10. Special Rule for Deemed Distributions that Would Cause Section 731 Gain. Guidance should provide that the deemed distribution to a partner under Section 752(b) resulting from a reacquisition of an ADI will be reduced (but not below zero) to the extent necessary to cause the partner to recognize the same amount of gain under Section 731(a) for the taxable year of the reacquisition that the partner would have recognized in the absence of the Section 108(i) election. In general, this would reduce (but not below zero) the deemed distribution to a partner resulting from the reacquisition by the lesser of (i) the partner's share of the deferred COD income realized in such reacquisition (applying the Allocation Rule) and (ii) the total amount of gain that the partner would have recognized under Section 731(a) in the taxable year of the reacquisition in the absence of the Section 731 Gain Deferral Rule. We would also support a rule that extends this principle to Section 731 gain that would otherwise be recognized in a later taxable year but that would not have been recognized in such later year if a Section 108(i) election had not been made.

11. Transfer of a Partnership Interest as an Acceleration Event. It is important for guidance to confirm that the transfer of an interest in a partnership by a partner accelerates only the deferred items associated with the transferred interest.

12. Allocation of Deferred COD Income by S Corporations. Guidance should treat deferred COD income of an S corporation as deferred at the shareholder level rather than at the S corporation level, similar to the deferral of losses under Section 1366(d), so that the S corporation shareholders at the time of the reacquisition will ultimately include the deferred COD income based on their ownership at that time even if there are changes to the ownership of the S corporation prior to the time the deferred COD income is recognized under Section 108(i).

13. Allocation of OID Subject to the OID Deferral Rule. Guidance should provide that (i) OID will be allocated based on each partner's share of the OID as it accrues based on normal Section 704(b) principles, (ii) such OID will reduce such partner's Section 704(b) capital account as it accrues, and (iii) each partner will recognize its share of the deferred OID during the recognition period (or upon an acceleration event).

14. We recommend that the IRS and Treasury consider whether the existing rules relating to debt modifications and exchanges should be revised. More specifically, we recommend that the IRS and Treasury consider seeking a legislative change (or using the

regulatory authority granted by Section 1275(d)) either to revise the existing issue price rules applicable to debt exchanges or otherwise change the rules relating to debt exchanges to better align the timing of the resulting COD income and OID deductions.

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,

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Chair

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