NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

TAX SECTION

2019-2020 Executive Committee

DEBORAH L. PAUL
Chair
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York,. NY 10019
212/403-1300
ANDREW H. BRAITERMAN
First Vice-Chair
212/837-6315
GORDON E. WARNKE
Second Vice-Chair
212/997-0500
ROBERT CASSANOS
Secretary
212/859-8278
COMMITTEE CHAIRS:
Bankruptcy and Operating Losses
Daniel M. Dunn
Stuart J. Goldring
Compliance, Practice & Procedure
Elliot Pisem
Bryan C. Skarlatos
Consolidated Returns
William Alexander
Shane J. Kiggen
Corporations
Daniel Z. Altman
Michael T. Mollerus
Cross-Border Capital Markets
Philip R. Wagman
Andrew R. Walker
Cross-Border M&A
Joshua M. Holmes
Ansgar A. Simon
Debt-Financing and Securitizations
John T. Lutz
Michael B. Shulman
Estates and Trusts
Austin Bramwell
Alan S. Halperin
Financial Instruments
Lucy W. Farr
Jeffrey Maddrey
"Inbound" U.S. Activities of Foreign Taxpayers
Peter J. Connors
Peter F. G. Schuur
Individuals
Megan L. Brackney
Steven A. Dean
Investment Funds
James R. Brown
Pamela L. Endreny
Multistate Taxation
Arthur R. Rosen
Jack Trachtenberg
New York City Taxes
Sherry S. Kraus
Irwin M. Slomka
New York State Taxes
Paul R. Comeau
Joshua E. Gewolb
"Outbound" Foreign Activities of U.S. Taxpayers
William A. Curran
Andrew P. Solomon
Partnerships
Phillip J. Gall
Sara B. Zablotney
Pass-Through Entities
Edward E. Gonzalez
Amanda H. Nussbaum
Real Property
Marcy Geller
Jonathan R. Talansky
Reorganizations
Neil J. Barr
Peter A. Furci
Spin Offs
Tijana J. Dvornic
Lawrence M. Garrett
Tax Exempt Entities
Stuart Rosow
Richard R. Upton
Taxable Acquisitions
David W. Mayo
Richard Nugent
Treaties and Intergovernmental Agreements
Lee E. Allison
David R. Hardy

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:

Jason R. Factor
Meyer H. Fedida
Andrew M. Herman
Elizabeth T. Kessenides
Adam Kool
Brian Krause
Stuart E. Leblang
Jiyeon Lee-Lim
William L. McRae
Kara L. Mungovan
Eschi Rahimi-Laridjani
Yaron Z. Reich
David M. Rievman
David M. Schizer
Stephen E. Shay
Eric B. Sloan
Eric Solomon
Linda Z. Swartz
Dana L. Trier
Eric Wang

Report No. 1431
January 16, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1431 – Report on Technical Debt Modification Issues under Treasury Regulation Section 1.1001-3*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1431 proposing technical revisions to Treasury Regulation Section 1.1001-3, with particular focus on the application of those rules to consent solicitations and exchange offers. The Regulations address whether a modification to the terms of a debt obligation results in a "significant modification" and therefore a deemed exchange of the unmodified debt for the modified debt. A deemed exchange results in the realization of gain or loss on the deemed disposition of the unmodified debt and a deemed issuance of the modified debt. The Regulations are well-drafted and address most of the common questions

FORMER CHAIRS OF SECTION:

Peter L. Faber
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Herbert L. Camp
Arthur A. Feder
James M. Peaslee
Peter C. Canellos
Michael L. Schler
Carolyn Joy Lee
Richard L.Reinhold
Steven C. Todrys
Harold R. Handler
Robert H. Scarborough
Samuel J. Dimon
Andrew N. Berg
Lewis R. Steinberg
David P. Hariton
Kimberly S. Blanchard
Patrick C. Gallagher
David S. Miller
Erika W. Nijenhuis
Peter H. Blessing
Jodi J. Schwartz
Andrew W. Needham
Diana L. Wollman
David H. Schnabel
David R. Sicular
Stephen B. Land
Michael S. Farber
Karen Gilbreath Sowell

that arise in debt modification transactions. However, we suggest a number of areas in which the Regulations could be improved.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

John Cross
Associate Tax Legislative Counsel
Department of the Treasury

Michael Novey
Associate Tax Legislative Counsel
Department of the Treasury

Erika Nijenhuis
Senior Counsel
Department of the Treasury

Helen Hubbard
Associate Chief Counsel (Financial Institutions & Products)
Internal Revenue Service

David B. Silber
Special Counsel
Internal Revenue Service

William E. Blanchard
Senior Counsel to Associate Chief Counsel
Internal Revenue Service

Jeffrey T. Rodrick

Special Counsel to the Associate Chief Counsel
Internal Revenue Service

Diana Imholtz
Special Counsel to the Associate Chief Counsel
Internal Revenue Service

Report No. 1431

New York State Bar Association

Tax Section

Report on Technical Debt Modification Issues under Treasury Regulation Section 1.1001-3

January 16, 2020

W/3639265v4

New York State Bar Association Tax Section

Report on Technical Debt Modification Issues under Treasury Regulation Section 1.1001-3[1]

I. Introduction

This report of the New York State Bar Association Tax Section addresses possible technical revisions to Treasury Regulation Section 1.1001-3 (the "Regulations"), with particular focus on the application of those rules to consent solicitations and exchange offers.[2] The Regulations apply when determining whether a modification to the terms of a debt obligation, including through the means of an exchange offer, results in a "significant modification" and therefore a deemed exchange of the unmodified debt for the modified debt. A deemed exchange results in the realization of gain or loss on the deemed disposition of the unmodified debt, and a deemed issuance of the modified debt.

The Regulations are well-drafted and address most of the common questions that arise in debt modification transactions. However, there are a number of areas in which they could be improved. We recommend changes to the Regulations -- primarily to the "change in yield" rules described below -- to bring the Regulations closer to economic reality and to clarify a number of issues.[3]

---

[1] The principal author of this report is Erika W. Nijenhuis (prior to September 2019), with substantial assistance from David Stuckey and Jesse Boretsky. Helpful comments were received from Howard Adams, Bora Bozkurt, Andrew Braiterman, Ann Creed, Michael Farber, Stuart Goldring, Craig Horowitz, Robert Kantowitz, Stephen B. Land, Jiyeon Lee-Lim, Jeffrey Maddrey, Deborah Paul, Eschrat Rahimi-Laridjani, Arvind Ravichandran, Yaron Reich, Eric Remijan, Michael Schler and David Sicular. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Citations to sections are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder.

[3] We recently issued a Report discussing the tax "fungibility" of debt instruments, a topic also discussed in this Report. New York State Bar Association Tax Section, *Report on Tax Fungibility of Debt Instruments* (Report No. 1425, November 5, 2019), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1425_Tax_Report.html [hereinafter, NYSBA *Tax Fungibility Report*]. As well, our recent Report on proposed regulations relating to the phase-out of "interbank offered rates" discussed consent fees, a topic also discussed in this Report. New York State Bar Association Tax Section, *Report on IBOR Transition Proposed Regulations* (Report No. 1430, December 27, 2019), *available at* https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/Report_1430.html . A number of other commentators have also discussed many of the points made in this report. *See*, *e.g.*, American Bar Association Tax Section Committee on Financial Transactions, *Proposals for Revisions to the Regulations Dealing with Significant Modifications of Debt Instruments*, *available at* 2017 TAX NOTES TODAY 44-28 (Mar. 7, 2017); Jiyeon Lee-Lim & Y. Bora Bozkurt, *Significant Modification of Debt Instruments: Case Study*, TAX FORUM NO. 677 (Nov. 7, 2016); David H. Shapiro, Michael Yaghmour & Ryan Schneider, *A Tax Field Guide to Debt-Related 'Fee' Income*, 2014 TAX NOTES TODAY 106-8 (June 3, 2014); and Gordon E. Warnke*, The Federal Income Tax*

The Regulations operate first by determining whether a "modification" has taken place, and then whether the modification is "significant."[4] We assume for purposes of this Report that the changes to the terms of a debt instrument that we refer to are modifications. The Regulations provide specific rules to determine whether certain changes to the timing of payments on a debt instrument, or a change in yield, or modifications to certain covenants or certain other specified changes to the terms of a debt instrument are treated as "significant." The Regulations also have a default rule for modifications not specifically addressed, which tests whether those modifications are "economically significant."

II. Description of Consent Solicitations and Exchange Offers

Issuers of debt may have a number of reasons to want to modify the terms of their outstanding debt instruments, including: (i) deferring and/or reducing payments if the issuer is in financial trouble, (ii) eliminating covenants that would prohibit a specific action, for example an action necessary to restructure the issuer's operations, (iii) eliminating covenants that are no longer necessary to protect investors if the issuer's credit rating has improved, and (iv) improving the liquidity of its debt, which reduces the yield on the debt and thereby lowers financing costs for future issuances. Modest changes, for example amending a few covenants, typically take place through a consent solicitation. More dramatic changes often take place through a formal offer to exchange the existing debt for new debt with different terms. In the case of an issuer that is in financial distress, commercially significant changes may be made to its outstanding loans or bonds in a work-out or other negotiated transaction.

A. *Consent Solicitations*

The amendment clauses of bonds typically permit modification of terms by majority (or similar) consent, but require consent by each affected holder for terms adversely affecting payment conditions (*e.g.,* interest rate, maturity date). In a consent solicitation, the issuer typically seeks holders' consent to amend terms of the instrument that do not require unanimous consent. Those terms generally are in the portion of the indenture labeled "Covenants" but that is not always the case.

A holder generally will not consent to remove a restriction on the issuer or to accept more detrimental payment terms without receiving consideration (a "consent fee"). Even in cases where a modification is trivial, investors generally must be paid something to incentivize them to participate in the transaction. Payment of the fee to a holder is contingent on the issuer obtaining all the necessary consents to the amendment. If the necessary threshold for consent is reached, the amendments are made to all outstanding bonds, including to bonds held by non-consenting holders.

Consequences of Debt Consent Solicitation Payments, TAX FORUM NO. 545 (Dec. 4, 2000). We have included only the issues we thought were most significant.

[4] Treas. Reg. § 1.1001-3(c) (modifications), -3(e) (significance). The discussion in this report primarily addresses bonds. While loans are also amended, typically those amendments are more clearly significant modifications.

In our experience, the amount of a consent fee generally does not give rise to a "change in yield" under the rules described below, but there are consent solicitations that do give rise to a "change in yield" under those rules. As a commercial matter, investors and issuers view the modified bond as the same bond as the unmodified bond. From a tax perspective, it is therefore generally desirable for the modification not to be treated as "significant."

A similar transaction is an "exit tender," in which the issuer both tenders for the bonds and requests consents to modify the bonds. Because the goal of an exit tender is to redeem the bonds, the issuer often seeks to eliminate as many holder-favorable provisions as it can, in order to give holders an incentive to tender their bonds. An issuer may or may not pay a stated consent fee in an exit tender. Often it does not.

As a U.S. securities law matter, we understand that tender offers and exchange offers generally are required to be held open for 20 business days. Issuers typically prefer to wind up as much of the transaction as possible within 10 business days. There is thus a market practice of offering different consideration for early tendering and late tendering holders. The consideration offered to early tendering holders is usually whatever the issuer and its advisors believe is necessary to induce investors to participate, and it is typically the case that most investors who wish to tender or exchange bonds will do so within the 10 business day period. For securities law reasons, the difference between the consideration offered to early and late tendering holders is often expressed as a premium for early tendering and not as a discount for tendering late.

B. *Exchange Offers*[5]

In an exchange offer, an issuer offers to exchange one or more existing bonds for one or more newly issued bonds. In a simple exchange offer, an issuer might offer to exchange, for example, old 5% bonds due 2020 for new 4% bonds due 2025, to reduce the coupon to current market levels and to extend the maturity of its debt. In a complex exchange offer, an issuer might offer to exchange, for example, any of 20 series of old debt for 3 newly issued debt instruments, in order to create larger and more liquid "benchmark" bonds with yields that will serve as references for pricing debt issued in the future. As described above, typically the issuer will offer one package of consideration for investors who tender early, meaning at the end of 10 business days, and a lesser package of consideration for investors who tender late, meaning after the 10 business days. The consideration offered may be entirely new bonds, or some mixture of new bonds and cash. Except in the case where an issuer is in financial distress, the new bonds typically are issued at or near par.

In the more complex example described above, there could be up to 60 different pairs of old and new bonds for early tendering investors, although typically the number of pairs is somewhere between (in this example) 20 and 60. Because the old and new bonds have different values, depending on their maturities and coupons, the exchange ratio for each pair will be different. For example, if an old bond with a face amount of $1000 is worth $1200 because its

---

[5] In any exchange offer, the new bond that is issued may be a reopening of an existing bond. Transactions of that kind raise additional issues that are not discussed in this report. *See* NYSBA *Tax Fungibility Report*, *supra* note 3.

coupon is now above market, it may be exchanged for roughly 1.2 new publicly traded bonds with a par value and a face amount of $1200 in the aggregate.[6] Alternatively, if the issuer wishes to reduce the amount of outstanding debt as well as to modify its terms, the issuer might deliver one new bond with a face amount and value of $1000, plus $200 cash. Late tendering holders might be offered, hypothetically, $1170 of value rather than $1200 of value. Thus, this exchange offer potentially has a total of 120 pairs of old and new bond exchanges, taking into account both early and late tendering holders.

As a commercial matter, the issuer and investors view the new bond as a different bond from the old bond. Investors may or may not recognize gain or loss, depending on several factors including whether the exchange qualifies as a recapitalization under section 368(a)(1)(E). In transactions involving publicly traded bonds, our experience is that the principal tax issue that is of concern to investors is whether all of the new bonds have the same tax attributes (generally referred to as all of the new bonds being "fungible" for tax purposes). This is in large part attributable to the fact that most tax practitioners will advise that, if multiple old bonds are exchanged for one new bond, and one of the pairs of old and new bonds does not qualify as a significant modification and the "new" bond would consequently have unfavorable tax attributes such as original issue discount ("OID"), those new bonds must be issued under a different CUSIP (or other identification number) because that is the only way to be sure that investors know that they have an OID bond and pay tax on the OID. Issuing some bonds under a separate CUSIP is directly contrary to one of the reasons for exchange offers, namely to create larger, more liquid bonds. Consequently, in an exchange offer of this kind, in our experience investors are willing to accept gain or loss on the disposition of the old bond, if that is the means to ensuring that all new bonds are fungible with each other.

By contrast, if debt issued by a U.S. borrower that is in financial distress is modified, there is often a strong preference for the modifications not to be treated as giving rise to a deemed exchange under section 1001. Generally if a borrower is distressed, the fair market value of its existing debt will be significantly below the adjusted issue price of the debt. Since the purpose of a work-out is to restore the borrower to financial health while maximizing the recovery to lenders, the modified debt may have a smaller principal amount, a lower interest rate, a longer maturity or other terms that provide some breathing room to the borrower. If the work-out is treated as a significant modification, the modification is likely to give rise to cancellation of indebtedness income to the borrower. The resulting taxes could exceed the borrower's ability to pay, and will in any event drain resources from the borrower and undermine the non-tax goals of the work-out.

Consequently, there is a tension in terms of the desired tax treatment depending on whether the commercial imperative is for fungible new debt instruments to be issued or for a work-out of distressed debt to be as successful as possible. Our recommendations below take this tension into account.

---

[6] This is a simplified example, as partial bonds are not issued. In the real case, the investor might tender $1 million of face amount of old bonds and receive about $1.2 million face amount of new bonds, with cash delivered instead of any partial bond that would otherwise be due. This fractional bond payment is treated as if the partial bond had been issued and then immediately redeemed. *Cf.* Treas. Reg. § 1.305-3(c)(2).

III. **Recommendations**

A. Recommendations Related to the Change in Yield Test

1. *De Minimis OID.* Revise Treasury Regulation Section 1.1001-3(e)(2)(iii) to clarify that where the unmodified debt instrument was issued with *de minimis* OID or at a premium, the issue price of the modified instrument should be determined by increasing or decreasing the adjusted issue price of the unmodified instrument by accruing the *de minimis* OID or bond premium on a constant-yield basis.

2. *CPDIs.* Modify the change in yield rules so that consent payments paid with respect to CPDIs subject to the non-contingent bond method are no longer excluded from the scope of the rules.

3. *Effect of Prior Consent Fees.* Adopt a rule that treats prior consent fees consistently without the need to trace whether particular investors received them.

4. *Effect of Cash Paid in Connection with Exchange Offer.* Clarify the Regulations to explicitly treat cash paid in connection with an exchange offer as consideration for the modification for purposes of the change in yield test.

B. Recommendations Related to Changes to the Timing of Payments

5. *Safe Harbor for Payment Deferrals.* Retain the deferral safe harbor rule in Treasury Regulation Section 1.1001-3(e)(3)(ii) in its current form.

6. *Acceleration of Payments.* Clarify how an acceleration of payments is treated in the Regulations.

C. Recommendations Related to Additional Issues Affecting Consent Solicitations

7. *Scope of Covenant Safe Harbor.* Expand the scope of the safe harbor for "customary accounting and financial covenants" under Treasury Regulation Section 1.1001-3(e)(6) to include modifications to other covenants and similar provisions not affecting the timing or amount of payments or other terms that are the subject of specific rules in the Regulations.

8. *Character of Consent Payments where Modification is Not Significant.* Clarify that consent payments paid to modify both CPDIs and non-CPDIs, where there is no significant modification to the terms of the debt instrument, are taxed as additional interest.

9. *Character of Consent Payments where Modification is Significant.* For consent payments paid in circumstances where there has been a significant modification, clarify that such payments are treated as part of the amount realized by the holder on the deemed exchange.

D. Recommendation Related to the Economic Significance Test

10. *Economic Significance Test.* Clarify several aspects of the general economic significance test under Treasury Regulation Section 1.1001-3(e)(1), including the fact that economic significance should be measured according to its expected effect on a meaningful number of holders, that the test should not consider accounting and tax consequences to holders, and that in a consent solicitation, the economic significance of a modification generally should be measured by reference to the amount of any consent fee paid.

E. Recommendation Related to Consequences of Modifications that are not Significant Modifications

11. *Consequences of Modifications that are not Significant Modifications.* Expand the rule in Treasury Regulation Section 1.1275-2(j) to provide for a deemed reissuance of debt, solely for OID and similar purposes, for all modifications that are not significant, not just non-significant deferrals of payments.

IV. **Change of Yield Test**

Treasury Regulation Section 1.1001-3(e)(2) sets forth the change in yield test. The change in yield test compares the cash flows on the unmodified debt instrument to the cash flows as modified in order to determine whether the yield on the debt instrument changes by more than a specified *de minimis* amount. This is a yes/no test – if one can calculate a change in yield, the Regulations provide that there either is, or is not, a significant modification. (If the answer is no, it may still be necessary to carry out other "significance" tests.)

A. *De Minimis OID*.

Under Treasury Regulation Section 1.1001-3(e)(2), a modification of a debt instrument is a significant modification if the annual yield of the modified instrument varies by more than the greater of 25 basis points or 5% of the annual yield of the unmodified instrument.[7] The yield of the modified instrument is calculated using an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification.

Generally these calculations are relatively straightforward. However, it is not clear how to apply the change in yield rules when an old bond was issued with *de minimis* OID. From an

[7] A 25 basis point (0.0025) increase/decrease in the applicable interest rate is a very common change in financing agreements. If a debt instrument that pays 5% or less in annual interest is issued at a price equal to par, then a 25 basis point increase/decrease is just at, but not over, the threshold for significance. If, however, the debt is issued at a discount, even a slight one, a 25 basis point increase/decrease in the stated coupon changes the yield by more than 25 basis points, because the adjusted issue price of the debt is lower and so the relative magnitude of the 25 basis points change is higher. While we believe the rules are clear in this regard, taxpayers do not always appreciate the distinction between the at-par and almost-at-par cases since the difference is not relevant for most other purposes. It might be useful to include examples illustrating those cases.

economic perspective, and under the rules applicable to issuers, that *de minimis* OID has accreted. Under the OID rules applicable to holders, the *de minimis* OID does not accrue, unless a holder elects to do so. As explained in our 2010 letter,[8] Treasury Regulation Section 1.1001-3(e)(2) is unclear whether the adjusted issue price of the unmodified instrument for purposes of the yield calculation should take the economic accretion of the *de minimis* OID into account. The effect of carrying out a change in yield analysis without accreting the *de minimis* OID can give rise to significant distortions in the calculation of yield on the modified instrument.

Recommendation

For the reasons set forth in our 2010 letter, we believe that Treasury Regulation Section 1.1001-3(e)(2)(iii) should be revised to clarify that where the unmodified instrument was issued with *de minimis* OID or at a premium, the issue price of the modified instrument should be determined by (a) increasing the adjusted issue price of the unmodified instrument by the OID that would have accreted on the unmodified debt without regard to the *de minimis* rule or (b) decreasing the adjusted issue price of the unmodified instrument by any bond premium that would have been amortized, as applicable. The accrual should be determined using the constant yield method, so that the accrual of *de minimis* OID is treated in the same manner as non-*de minimis* OID.

We considered recommending that *de minimis* OID be treated as accruing based on an election, if any, by the issuer under Treasury Regulation Section 1.163-7(b)(2), but concluded that it is preferable to have a rule that is economic and consistent with non-*de minimis* OID, and that does not depend on an election that investors have no knowledge of.

B. *CPDIs*

Under Treasury Regulation Section 1.1001-3(e)(2)(i), contingent payment debt instruments that are subject to the rules of Treasury Regulation Section 1.1275-4 ("CPDIs") are excluded from the scope of the change in yield test. Instead, whether a change in yield of a CPDI is a significant modification is tested under the general economic significance rule in Treasury Regulation Section 1.1001-3(e)(1).

Under the change in yield test of Treasury Regulation Section 1.1001-3(e)(2), an amount paid as consideration for a modification – that is, a consent fee – is taken into account in determining whether a change of yield has taken place. The Internal Revenue Service (the "Service") has extended this approach under Treasury Regulation Section 1.1001-3(e)(1) to a CPDI governed by the non-contingent bond method in a 2014 private letter ruling to determine whether a consent payment on the CPDI was economically significant. PLR 201431003 applies this test by comparing the "go-forward yield," based on the adjusted issue price of the unmodified note at the time that the notes are modified and reduced by any consent payment, to the original yield of each outstanding note. The PLR specifies that the projected payment

[8] New York State Bar Association Tax Section, *Effect of de Minimis OID under Reg. § 1.1001-3(e)(2)* (Report No. 1226, December 22, 2010), *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2010/1226_letter.html .

schedule on the hypothetical modified note consists of the remaining payments on the original projected payment schedule. The same analysis was used in PLR 201546009.

Recommendation

We recommend that the rule in Treasury Regulation Section 1.1001-3(e)(2)(i) be modified, consistent with the framework adopted by the Service in PLRs 201431003 and 201546009, so that consent payments paid with respect to CPDIs subject to the non-contingent bond method are no longer excluded from the standard change in yield rules in Treasury Regulation Section 1.1001-3(e)(2).

Consideration should be given to how the projected payment schedule on the original and hypothetical modified notes is determined for purposes of the yield comparison. The PLRs use the original projected payment schedule for both the original and the hypothetical modified notes and the adjusted issue price of the original notes at the time of the modification, reduced by the consent fee in the case of the hypothetical modified notes.

An alternate approach would be to redetermine the projected payments at the time of the modification, and use that schedule for both the original and hypothetical modified notes. The latter would provide a more economically accurate measure of the effect of the consent fee. For example, if at the time of the consent solicitation the bond is expected to pay significantly less than was anticipated at the time of issuance, a consent fee that is modest compared to the original payment schedule and comparable yield may be significant as an economic matter compared to the economically-projected future payments at the time of the modification. However, redetermining the projected payment schedule and therefore the comparable yield for the original bonds at the time of the modification is inconsistent with the manner in which the change in yield rule otherwise applies.

Issuers are already required to calculate the yield of CPDIs for other purposes, so this modification would not be particularly novel or burdensome. Further, it would provide significantly more certainty to the significant modification analysis as applied to CPDIs.

C. *Effect of Prior Consent Fees*

Treasury Regulation Section 1.1001-3(e)(2)(iii)(I) takes into account "payments made to the … holder as consideration for the modification" in determining the adjusted issue price of a modified bond. Thus, a consent fee payable to holders reduces the adjusted issue price for this purpose.

Under Treasury Regulation Section 1.1001-3(f)(3), multiple modifications that take place within a 5-year period are analyzed as if they took place simultaneously. Consequently, if an issuer carries out a consent solicitation in Year 1, and then wishes to carry out a second consent solicitation or an exchange offer in Year 4, the Year 1 consent fee must be taken into account in carrying out the Year 4 change in yield calculations. However, there may have been non-consenting holders that did not receive the consent fee. For bonds that are held in book-entry form, it is not possible to know whether investors holding the bonds in Year 4 did or did not receive a consent fee, or are even the same investors as in Year 1.

Recommendation

We recommend that a rule be adopted that will treat prior consent fees consistently without the need to trace whether particular investors received them. One possibility would be to treat all investors as having received the consent fee in full, or a pro rata portion of the aggregate consent fee paid, given that most investors typically do receive a consent fee if the consent solicitation is successful. Another possibility would be to disregard prior consent fees for the purposes of the 5-year lookback rule unless the consent solicitation was part of a single plan with the exchange offer.

D. *Effect of Cash Paid in Connection with Exchange Offer*

As described earlier, the consideration offered in an exchange offer may consist partly of new bonds and partly of cash.[9] In applying the change in yield test, it is essential to know how to treat the cash payment. If the cash paid is taken into account as "consideration for the modification" it reduces the adjusted issue price of the old bond on a dollar-for-dollar basis.[10] Alternatively, the cash might be treated as redeeming a fraction of the bond equal to the cash amount over the total value of the bond, with the change of yield analysis then starting based on the remaining adjusted issue price of the bond.

By way of illustration, to continue with the example given in Part II.B, assume that the original bond had an adjusted issue price of $1000 and a fair market value of $1200 at the time when it is exchanged for a new publicly traded bond with a value of par and a face amount of $1000, plus $200 cash. If the $200 paid is treated as consideration for the modification, it reduces the $1000 adjusted issue price of the bond by $200 to $800.[11] If instead the $200 is treated as a partial redemption of the old bond that takes place prior to carrying out the change in yield analysis, then the starting point for determining the yield of the new bond is an adjusted issue price of $833.[12] The difference between those two numbers can have a significant effect on the change in yield calculation. In the case of publicly held bonds, where it is typically the case that the parties wish to treat the exchange as a 1001 event, issuers may affirmatively use a cash payment of this kind in order to satisfy the change in yield test.

---

[9] Exchange offers also frequently include a payment of cash for accrued interest on the original bonds. We believe the rules are clear that such a payment should be treated as a payment of interest. Treas. Reg. § 1.446-2(e)(1). The discussion in this section regarding payments of cash is therefore in reference to cash payments other than payments of accrued interest.

[10] Treas. Reg. § 1.1001-3(e)(2)(iii)(A)(1) (yield of modified bond is determined based on an issue price equal to adjusted issue price of unmodified instrument … decreased to reflect payments made to the holder as consideration for the modification).

[11] *Cf.* Treas. Reg. § 1.1001-3(g), Example 3. The example appears to describe a transaction equivalent to a redemption of a portion of the bond for zero, but the analysis in the example does not take that approach.

[12] The calculation is as follows. If the sole event taking place were a partial redemption of the original bond, investors would tender 1/6 of the original bond (= $200 cash/$1200 bond value) in exchange for the $200. One-sixth of the original bond's $1000 adjusted issue price is $167. Therefore, $1/6^{th}$ of the original bond, with a basis and adjusted issue price of $167, is treated as repurchased for $200. The remainder of the original bond has an adjusted issue price of $833.

For the avoidance of doubt, the discussion above relates solely to the mechanics of the change in yield analysis. Once it is determined that a 1001 event has taken place, the normal rules of the Code apply, and the investor would be treated as disposing of its original bond for $1200 of amount realized.

Recommendation

We recommend that the Regulations be clarified to treat cash paid in connection with an exchange offer as consideration for the modification, perhaps through an example. That would be consistent with the concept that the change in yield rules do not take into account subsequent changes in the value of the debt instrument and that they should take all cash payments relating to the bond into account. This interpretation would avoid any concerns about drawing lines between payments that are and are not taken into account as consideration for the modification. It would also be consistent with the approach that we believe most practitioners are currently taking.

V. Changes to the Timing of Payments

A. *Safe Harbor for Payment Deferrals*

Treasury Regulation Section 1.1001-3(e)(3)(ii) provides that a deferral of one or more scheduled payments within a safe harbor period will not be considered a significant modification if the deferred payments are unconditionally payable within the safe harbor period. The safe harbor period begins on the original maturity date of the instrument and extends for a period equal to the lesser of five years or 50 percent of the original maturity. Deferrals of scheduled payments beyond the scope of the safe harbor period are tested for significance under the facts and circumstances analysis in Treasury Regulation Section 1.1001-3(e)(3)(i).[13]

Prior to the issuance of Treasury Regulation Section 1.1001-3(e)(3), there was a body of law and guidance standing for the proposition that an extension of the maturity date of a debt instrument would not, by itself, trigger a deemed exchange.[14] We understand that this question most frequently arose in the distressed debt context, in which an issuer and holder would agree to an extension of maturity in order to avoid a default on the existing debt. Had the extension of maturity been treated as a significant modification, in many cases it would have given rise to cancellation of indebtedness income which would in turn create more stress on the issuer's

---

[13] We note that Example 4 of Treas. Reg. § 1.1001-3(g) treats a ten-year deferral of interest as a significant modification, and can be taken therefore as providing certainty for ten-year deferrals. However, deferrals of that length are fairly unusual. As a result, there is uncertainty whether a deferral that is just outside the safe harbor period gives rise to a deemed exchange, or whether a deferral that is clearly outside the safe harbor period, for example 6 years, but on a very long-dated bond is sufficient.

[14] *See, e.g.*, *West Missouri Power Co.,* 18 T.C. 105 (1952), *acq.*, 1952-2 C.B. 3; *Motor Products Corp.*, 47 B.T.A. 983 (1942), *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944), *acq.*, 1946-1 C.B. 3; Rev. Rul. 73-160, 1973-1 C.B. 365. *But see Thomas Watson*, 8 T.C. 569 (1947), *acq*., 1947-2 C.B. 5, Private Letter Ruling 8346104 (Aug. 18, 1983) and G.C.M. 37884 (March 19, 1979), each of which indicate that an extension of maturity might trigger a deemed exchange under certain circumstances.

finances. However, in other contexts a substantial extension of maturities would seem, as an economic matter, to be clearly significant.

The rule in its current form reflects an awareness of and intent to mitigate the potentially adverse effects of treating an extension of maturity of distressed debt as a deemed exchange, as described in more detail below. As an economic matter, however, for non-distressed debt, the rule in its current form creates seemingly arbitrary distinctions, as described below. Accordingly, we considered whether to recommend a change to the rules for changes in timing of payments.

As originally proposed, the timing rule included a general rule treating material deferrals of payments as significant modifications, and a "reverse safe harbor" treating an extension of final maturity of a debt instrument as a significant modification if it exceeded the lesser of five years or 50 percent of the original term of the instrument. These proposed rules were widely criticized, on several grounds. First, the proposed rules were viewed as reversing prior law. Second, and relatedly, a number of commentators expressed concern about the effect of the rule on work-outs. The commentators urged that the regulations be revised in order to avoid creating realization events for work-outs unless other material terms of the debt instrument were modified as part of the work-out. That is, merely deferring payments should not give rise to a significant modification, absent abuse.[15]

The regulations were promulgated in final form in 1996.[16] The change of timing rule was retained, but significant changes were made to it and other parts of the regulations in response to the comments received. Provisions elsewhere in the regulations addressing temporary waivers of creditor rights were made more generous, in order to give taxpayers time to agree to the terms of a work-out.[17] In addition, the second rule relating to extensions of maturities was revised to read as it does today. It also was relabeled "Safe-harbor period," and the wording was revised to make clear that if a maturity extension is within the safe harbor period, the second rule governs. It seems apparent that the purpose of these changes was to respond to commentators' concerns about not changing the rules for deferrals of payments in connection with work-outs.[18] That understanding would be consistent with the language of the preamble to the final regulations, which states that the final regulations "allow" deferral within the safe harbor period.[19]

---

[15] *See*, e.g., American Bar Association, *Comments on Proposed Regulation Section 1.1001-3 Relating to Modification of Debt Instruments* (April 26, 1993) (noting the reversal of prior law and suggesting changes to the proposed rule, including recasting the second rule as a safe harbor within which there is no significant modification); Association of the Bar of the City of New York, *Comments on Proposed Regulation Section 1.1001-3 Relating to Modification of Debt Instruments* (April 14, 1993) (noting the reversal of prior law, expressing concern about the effect on work-outs, and making technical comments); Letter from Vincent M. Aquilino et al. to the Commissioner of Internal Revenue Service (January 26, 1993) (same); Letter from Richard M. Lipton to Mary Harmon, Special Counsel to the Chief Counsel (May 17, 1993) (expressing concern about effect on work-outs).

[16] T.D. 8675, Modifications of Debt Instruments, 1996-2 C.B. 60.

[17] *See* Treas. Reg. § 1.1001-3(c)(4)(ii).

[18] In particular, the changes to the second rule follow the recommendations made in the ABA comment cited in note 15, *supra*.

[19] T.D. 8675, 1996-2 C.B. 63.

Treasury Regulation Section 1.1001-3(e)(3)(ii) therefore took a nuanced approach to deferrals, by creating a one-way safe harbor for what would not be considered a significant modification in order to provide certainty for extensions of time within a fixed period, without imposing a firm rule for when a deferral outside that period would be considered a significant modification.

As an economic matter, however, the deferral safe harbor rule in its current form does not reflect what we understand to be the market's approach to determining the significance of a deferral. For many investors, if a bond has a remaining term of two years, it does not matter whether it was issued three years ago (in which case the safe harbor period would be 2.5 years) or thirteen years ago (in which case the safe harbor period would be 5 years). Rather, what matters is that the investor has remaining exposure to the credit of this issuer, and remaining rights to a specified cash flow, for two more years. Under the current rules, if an issuer has two bonds outstanding of the kind described above, and wishes to exchange them both for new bonds with a 6-year maturity, the analysis is quite different for the original 5-year bond and the original 15-year bond, because the 4-year extension is outside the safe harbor for the first bond but within the safe harbor for the second bond.

In light of this, some tax practitioners have suggested altering the rules for testing payment deferrals, including the American Bar Association's Tax Section Committee on Financial Transactions in its 2017 report.[20] That report suggests generally focusing on the difference between the remaining maturity of the bond and the extended term of the bond. The report also recommends, *inter alia*, that the deferral rule should be changed to a *per se* rule, so that deferrals of payments beyond the scope of the safe harbor period are automatically treated as significant modifications. A bright line rule of this sort would provide certainty and, because it would result in more exchanges being treated as significant modifications under the payment deferral rules, it could help solve some of the fungibility issues that arise in complex exchange offers.[21]

Recommendation

In light of the competing considerations discussed above, we recommend that the current rules in Treasury Regulation Section 1.1001-3(e)(3)(ii) not be abandoned or substantially modified. They serve an important function that would be impaired if more debt modifications were treated as 1001 events as a result of an extension of maturity. In order to address the concerns of issuers that wish their exchange offers to be treated as 1001 events in order to ensure the fungibility of all of the new bonds issued in the exchange offer, we refer you to our recent report on the tax fungibility of debt instruments.[22]

---

[20] American Bar Association Tax Section Committee on Financial Transactions, *Proposals for Revisions to the Regulations Dealing with Significant Modifications of Debt Instruments*, *supra* note 3.

[21] *See* Part II.B and NYSBA *Tax Fungibility Report*, *supra* note 3, for explanations of this fungibility problem.

[22] NYSBA *Tax Fungibility Report*, *supra* note 3.

B. *Acceleration of Payments*

It is common for an old bond to be exchanged for a new bond with a shorter maturity in an exchange offer. For example, an issuer may offer to exchange all bonds maturing in 2021-2026 for a single new 5-year bond maturing in 2024. The maturity of the new 2024 bond is shorter than that of the old bonds maturing in 2025 and 2026, and possibly old bonds maturing in 2024.

It is not clear under current law which part of the Regulations applies to the exchanges of longer-dated bonds for the new 2024 bond. Treasury Regulation Section 1.1001-3(e)(3) is titled "Changes in Timing of Payments." However, the substantive language of the rule addresses only significant modifications as a result of a *deferral* of payments, and the history described above reflects consideration only of deferrals when the regulations were originally drafted. Some practitioners believe that accelerations of maturity are never a significant modification in and of themselves, because the default "economic significance" test does not apply to modifications that are addressed in Treasury Regulation Section 1.1001-3(e)(2) through -3(e)(6) and the heading of Treasury Regulation Section 1.1001-3(e)(3) indicates that it addresses all changes of timing of payments. Other practitioners believe that accelerations of maturity are not addressed by Treasury Regulation Section 1.1001-3(e)(3) because the substantive rule addresses only deferrals, and that accelerations therefore are subject to the economic significance test.

One could debate the right approach as a policy matter. Arguably, an acceleration of maturity is similar to a prepayment, which is a realization event when the prepayment is made but otherwise not a separate 1001 event. Alternatively, the shortening of the maturity of a bond to a less-distant date in the future can be significant as an economic matter and should be tested under a materiality or economic significance test.

Recommendation

We recommend that the Regulations be revised to provide certainty about the appropriate treatment of accelerations of payments on a debt instrument.

VI. Additional Issues Affecting Consent Solicitations

This part of the report addresses several issues that affect primarily consent solicitations and that are not addressed in other parts of the report.

A. *Scope of Covenant Safe Harbor*

Treasury Regulation Section 1.1001-3(e)(6) provides that any modification that adds, deletes, or alters "customary accounting or financial covenants" does not constitute a significant modification. If a covenant that is modified is not classified as a customary accounting or financial covenant, the modification must be tested under the general economic significance rule in Treasury Regulation Section 1.1001-(e)(1).

While there are many covenants that are clearly within the scope of Treasury Regulation Section 1.1001-3(e)(6), there are terms that are often stripped in certain types of transactions as to which the application of the regulation is unclear. There is no consensus, and the Regulations

provide no guidance, regarding the outer boundaries of the terms "customary" or "accounting or financial" in this context. The fact that Treasury Regulation Section 1.1001-3(d), Examples 5 and 6 refer to "restrictive" covenants adds to the confusion as to whether that is intended to be a different category of covenant. As a result, taxpayers and their advisors must carry out discussions with financial advisors regarding the economic significance of modifications of terms that are covenant-like but might not qualify for the safe harbor. In our experience, it is usually the case that financial advisors view the terms as not economically significant to investors. The ambiguity in the regulation thus creates inefficiencies and produces needless uncertainty.

By way of example, we believe that there would be general agreement that a covenant restricting the incurrence of specified types of liens; or restricting payments by certain subsidiaries; or prohibiting the incurrence of additional debt unless certain financial accounting tests are met, are customary financial or accounting covenants. We believe that a provision allowing the issuer to call a bond or a holder to put a bond should not be viewed as a covenant, since a call or put right directly affects payments on the bond.[23] There may be less certainty about provisions like the requirement for an issuer to maintain an office; to maintain its existence; not to merge, consolidate or transfer substantially all of its assets unless the obligations under the debt are also transferred; or a waiver of an event of default (often when it is uncertain whether the company has breached a covenant, or when the company has breached a covenant but the breach is not considered material by investors). Other categories of provisions that raise uncertainty are cross-defaults (which trigger a default on the debt instrument if there is a default on other liabilities of the issuer or, if relevant, a guarantor); other events of default that are not based on failure to pay, for example an event of default for failure to comply with covenants; and "collective action clauses," which are clauses that permit investors to modify the terms of a bond if a majority (or other less-than-unanimous subset of investors) agree to do so.

Recommendation

We recommend that Treasury Regulation Section 1.1001-3(e)(6) be amended to provide taxpayers with greater clarity regarding the types of covenants that are within the scope of the rule, and that the rule be interpreted expansively.[24] Specifically, we think that all terms that are

---

[23] *See* Treas. Reg. § 1.1001-3(g), Example 1 (modification of call right is tested under economic significance test); *see also* T.D. 8675, 1996-2 C.B. 60, 62 ("With the addition of the general significance rule, certain specific rules of the proposed regulations have not been included in the final regulations. For example, under the proposed regulations, whether the addition or deletion of a put or call right is a significant modification depends on the value of the put or call. . . . [This rule has] not been included in the final regulations because the general significance rule provides adequate guidance").

[24] The rules of Treas. Reg. § 1.1001-3(e) are based on the law prior to *Cottage Savings*, which did not, to our knowledge, take covenants or similar provisions into account, and on recommendations made in several bar association reports. For example, a New York State Bar Association Tax Section report recommended that changes in covenants, other than those relating to the payment of principal or interest, not be treated as giving rise to deemed exchanges. New York State Bar Association Tax Section, *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges* 43 (Report No. 686, March 25, 1991), *available at* http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_1991/Tax_Section_Report_686.html; *see also* Association of the Bar of the City of New York, *Letter to the Acting Commissioner of the Internal Revenue Service Recommending Changes to Proposed Treasury Regulation Section 1.1001-3*, 93 TAX NOTES TODAY 87-22

similar to accounting and financial covenants should be within the scope of the covenant safe harbor in Treasury Regulation Section 1.1001-3(e)(6). That should not include any terms that affect who the obligor on the debt instrument is; the timing or amounts of payments on the debt instrument; collateral or security for the debt instrument; or the nature of the debt instrument (that is, matters of the kind dealt with by the specific rules found in paragraphs (2) through (5) of Treasury Regulation Section 1.1001-3(e), even if they are not actually within the scope of one of those rules, like a call option). We therefore suggest amending Treasury Regulation Section 1.1001-3(e)(6) to read as follows, and including some examples selected from the previous paragraph illustrating what is and what is not within the scope of the language:

> Accounting or financial covenants. A modification that adds, deletes, or alters customary accounting or financial covenants *or other similar provisions not affecting the timing or amount of payments or other matters covered in paragraphs (2) through (5) of this Section,* is not a significant modification.

B. *Character of Consent Payments where Modification is Not Significant*

The U.S. federal income tax treatment of consent fees which do not result in a modification that is significant and that are paid by an issuer to a holder in exchange for the holder's consent to amend a term of the debt instrument is unclear under current law. No formal guidance addresses this issue, and, while the Service has considered the character and treatment of consent payments in a number of private letter rulings, its conclusions have not been universally adopted by taxpayers.

In PLR 201105016, an issuer sought to pay a consent payment to modify a debt instrument as part of a restructuring plan. The issuer stipulated to the Service that the consent payment was made in a manner that did not defer payments and was not a significant modification under the 1.1001-3 Regulations. The Service held that the consent payment was a payment on the debt instrument, and that, under Treasury Regulation Section 1.446-2(e)(1), it should be treated first as interest to the extent of any accrued but unpaid interest and then as a payment of principal.[25]

In PLR 201431003, the Service concluded that a payment made to modify a CPDI to which the non-contingent bond method applied should be accounted for as a positive adjustment within the meaning of Treasury Regulation Section 1.1275-4(b)(6). As a result, the payment would be treated as additional OID income in the hands of the holders.

We agree that it is appropriate to treat a consent payment as a payment on a debt instrument. However, we have several concerns with the conclusion reached in PLR 201105016. First, it is not administrable. Treating a consent payment as described in that ruling means that taxpayers must (a) treat the next coupon as partly a return of capital, if any interest had accrued at the time that the consent payment is made, and (b) treat the amount paid at maturity as giving

---

(Apr. 14, 1993); and Association of the Bar of the City of New York, *Letter to the Commissioner of the Internal Revenue Service Interpreting Cottage Savings v Commissioner*, 92 TAX NOTES TODAY 126-26 (June 19, 1992).

[25] *See also* LAFA 20151704F, which treats a consent payment in the same manner.

rise to gain to the extent of that return of capital.[26] We doubt that most taxpayers do so. Second, the ruling's approach raises the question as to whether the debt must be retested to determine whether it has more than *de minimis* OID, since the stated redemption price at maturity of the debt instrument has been increased. More generally, we do not believe that current law requires the answer in the ruling – that is, we do not believe that the treatment of a consent payment under Treasury Regulation Section 1.1001-3(e)(2)(iii)(1) as a payment on the bond under the change in yield test compels treatment of the payment as something other than a current interest payment on the bond. We also note that Treasury Regulation Section 1.446-2(e)(1) says that a payment of "additional interest" is not subject to the rule that the payment is treated first as a payment of accrued interest, and while that appears to refer to a different kind of payment we think a similar rule is appropriate here.

Current market practice does not follow the conclusion in PLR 201105016, both because it is only a private letter ruling and because its conclusion is not administrable. Instead, taxpayers and their advisors conventionally treat consent payments as a separate amount payable to the holders for consenting to the amendments, which is taxable immediately as ordinary income. The character of this ordinary income is not clear. In particular, it is not clear whether the payment is exempt from U.S. withholding tax as portfolio interest under Sections 871(h) and 881(c).

Recommendation

We believe that it would be more efficient and administrable if guidance provided, consistent with PLR 201431003, that a consent payment is taxed as additional interest for both CPDIs and non-CPDIs. We believe that this is appropriate for non-CPDIs because the consent payment is made in consideration of changes to the terms of the bond that typically have some bearing on the issuer's credit quality, and interest rates on debt generally reflect an issuer's credit quality.

C. *Character of Consent Payments where Modification is Significant*

A consent payment may be sufficiently large to trigger a deemed exchange under the change in yield rules contained in Treasury Regulation Section 1.1001-3(e)(2), or it may be paid in connection with a modification that already, or in conjunction with the consent payment, constitutes a significant modification. As a result of the significant modification, for U.S. federal income tax purposes the holder is deemed to exchange the existing debt instrument for a new debt instrument. PLR 201105016 treats a consent fee paid in connection with a tender offer in effect as part of the amount paid by the issuer to redeem the bond, and presumably therefore as part of the amount realized for investors. There is currently no guidance concerning the correct

---

[26] To give an example, assume that a bond pays $6 interest semi-annually. The issuer pays a $1.50 consent fee at a time when $3 of interest has accrued. Under the rule in the PLR, (i) the $1.50 is treated as interest, (ii) when the next $6 coupon is paid, since $1.50 of that amount has already been taken into account as interest income, only $4.50 of the coupon should be treated as interest; the rest should be treated as a mini-installment payment that reduces the adjusted issue price of the bond and the investor's basis therein; and therefore (iii) when the investor receives the par amount of the bond at maturity, it should take into account $1.50 of gain.

treatment of a consent payment paid in connection with a deemed retirement of a bond rather than an actual one.

Recommendation

We believe that in the case of a consent payment paid as part of a modification that is a significant modification, the payments should be treated as part of the amount realized by the holder on the deemed exchange.[27]

VII. Economic Significance Test

Under the general economic significance rule in Treasury Regulation Section 1.1001-3(e)(1), a modification is a significant modification only if, based on all facts and circumstances other than those described in other provisions of Treasury Regulation Section 1.1001-3(e), the legal rights or obligations that are altered and the degree to which they are altered are economically significant. The Regulations do not specify whether the assessment of the economic significance of a modification should be based on its significance to the issuer, to the holders, or to both parties. Further, the Regulations do not specify the manner in which the economic significance of a modification is to be measured or what factors are relevant to the analysis. If there are multiple holders of a debt instrument, it is not clear whether or how to take into account the fact that different holders may have different views as to the economic significance of a modification. For example, should economic significance be determined by reference to a hypothetical objective holder and looking just to the terms of the debt instrument? Or should it be determined taking into account issues of concern to actual holders of the actual bond, including liquidity, duration, and market and economic conditions?

Recommendation

We believe Treasury Regulation Section 1.1001-3(e)(1) should be amended to provide taxpayers with greater clarity regarding the factors that are relevant in testing the economic significance of a modification. First, the regulations should be clarified to state that economic significance should be measured from a holder's perspective. This is consistent with the fact that section 1001 is a rule addressed to investors, since it applies to dispositions of property. Because economic significance could vary from holder to holder and the issuer of publicly-traded debt ordinarily will not have, and nor can it reasonably get, sufficient insight into each holder's situation, we think the rule should be based on the expected economic significance to a meaningful number of actual holders, rather than a hypothetical objective holder. We do not think a numeric threshold should be set as it is inherently difficult to know exactly who the investors in publicly-traded debt are.

It would also be useful to clarify that Treasury Regulation Section 1.1001-3(e)(1) does not take into account tax or accounting consequences to the issuer and holders. With respect to tax consequences, the rule would be circular if they are taken into account.

---

[27] Although not otherwise addressed in this report, this is logically the same characterization that should apply to the payment of an early tender premium as part of a tender offer.

Finally, we believe that Treasury Regulation Section 1.1001-3(e)(1) should specifically provide that if a consent fee is paid to investors, the amount of that consent fee determines whether the modifications are treated as economically significant, subject to certain conditions. We think that the benefits of such a rule are substantial. First, we think the truest measure of economic significance generally is the price paid. Second, information of this kind is objective and easily available, thereby providing a test that cannot be easily manipulated.

The rule should apply only if the payment is made to unrelated holders; the amount of the payment fairly reflects the value of the modifications; and all of the modifications favor (or disfavor) the issuer, so that there is no netting of value. Subject to those conditions, we think there should be a *per se* rule that the modification is not economically significant if the amount of the consent payment would not give rise to a change in yield under Treasury Regulation Section 1.1001-3(e)(2). Conversely, if the amount of the consent payment gives rise to a change in yield under Treasury Regulation Section 1.1001-3(e)(2), the amendments should be treated as economically significant to non-consenting holders who do not receive the consent payment. The current qualitative economic significance test should continue to apply in cases that do not meet the conditions we propose.

VIII. Consequences of Modifications that are not Significant Modifications

Treasury Regulation Section 1.1275-2(j) provides for the deemed reissuance of debt, solely for OID purposes, if payments are deferred but the deferral is not significant. There is no comparable rule for other modifications that are not significant.

Recommendation

We believe that the rule should be expanded to apply to other changes of timing or amount of payments.

Similarly, we believe that it should be clarified that changes in timing or amounts of payments that are not significant modifications affect market discount and bond premium accruals. For example, if a holder purchases debt with significant market discount, an extension of maturity on the debt could significantly alter the holder’s accrual schedule.