Report No. 1443
October 15, 2020

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Chairman
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Re: *Report No. 1443 – Report on Tax Consequences to Issuers of Debt Modifications and Exchanges*

Gentlemen:

I am pleased to submit our Report No. 1443 commenting on federal income tax issues involving consequences to issuers of exchanges of and modifications to debt instruments. The report suggests possible legislative and regulatory changes to current rules with respect to cancellation of indebtedness income, including rules relating to timing of inclusions and ancillary issues affecting limitations on interest deductions and foreign tax credits.

We believe that addressing these issues is timely in light of current economic conditions that have resulted in an increased number of distressed debtors who may be required to recognize income as a result of debt resturcturings. A futher reason for reexaming these issues now is that in the years since the 2008-2009 financial crisis, regulatory changes have broadened the circumstances in which debt restructurings can result in debt cancellation income without any actual reduction in indebtedness, and changes made by the Tax Cuts and Jobs Act of 2017 have expanded the range of adverse consequences resulting from recognition of such income.

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,

Andrew H. Braiterman
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Enclosure

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Report No. 1443

New York State Bar Association

Tax Section

Report on Tax Consequences to Issuers of Debt Modifications and Exchanges

October 15, 2020

I. Introduction

This Report[1] addresses cancellation of debt ("COD") income and related adverse tax consequences that affect debt issuers which exchange new debt for, or modify the terms of, their outstanding debt the value of which is less than its adjusted issue price (which we refer to in this Report as "depreciated debt"). In addition to having a potentially harsh impact on debt issuers, most significantly on troubled companies, these adverse consequences can serve as a deterrent to making debt modifications that may benefit issuers, holders, and the economy as a whole.

This problem is not new,[2] but when markets are distressed, as is currently the case, the number of distressed issuers increases, the magnitude of the problem becomes greater and the need for a solution becomes more urgent. Facing a similar situation during the 2008-2009 financial crisis, Congress enacted Sections[3] 108(i) and 163(e)(5)(F).[4] However, these were temporary provisions, both of which have since expired.[5]

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[1] The principal authors of this Report are Lucy W. Farr and Mark Schwed, with substantial drafting assistance from Irene Kim, Steven Ort, Bradford Sherman and Mark Terrell. Helpful comments were made by Andrew Braiterman, Robert Cassanos, Michael Farber, Stuart Goldring, David Hardy, Craig Horowitz, Robert Kantowitz, Jiyeon Lee-Lim, John Lutz, Jeffrey Maddrey, William McRae, David Miller, Vadim Novik, Deborah Paul, Yaron Reich, David Rievman, Richard Reinhold, Michael Schler, Eric Sloan, Linda Swartz, Auri Weitz and Sara Zablotney. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

[2] The Tax Section has frequently commented on COD income issues in the past, including in NY State Bar Ass'n Tax Section Report No. 445, *Report on Related Party Debt Acquisitions Under Section 108(e)(4) of the Code* (April 12, 1984); NY State Bar Ass'n Tax Section Report No. 686, *Report of Ad Hoc Committee on provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges* (March 25, 1991) (the "1990 Act Bar Report"); NY State Bar Ass'n Tax Section Report No. 693, *Report on Acquisitions of Discount Debt by Related Parties Under the New Section 108(e)(4) Regulations* (June 21, 1991); NY State Bar Ass'n Tax Section Report No. 1070, *Report on Source, "Effective Connection" of COD Income in Cross-Border Financings* (November 5, 2004); and NY State Bar Ass'n Tax Section Report No. 1182, *Report on the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(5)(F)* (April 27, 2009) (the "Section 108(i) Bar Report"). The authors of this Report would like to thank the authors of these prior reports and acknowledge the prior scholarship in this area, particularly with respect to the evolution of the rules applicable to COD income, much of which is incorporated in this Report and without which this Report would not have been possible.

[3] Unless otherwise stated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treasury Regulations" or "Treas. Reg. §" are to the regulations issued thereunder.

[4] These statutory provisions are discussed below at Part III.e.i.–III.e.ii.

[5] The portion of the statute granting regulatory authority to suspend the application of the applicable high yield debt obligation ("AHYDO") rules is still effective. *See* Section 163(e)(5)(F)(iii).

Moreover, since the financial crisis, both the range of transactions which can result in recognition of COD income and the range of potential adverse consequences resulting from COD income have expanded. Treasury Regulations finalized in 2012,[6] defining "publicly traded" debt, expanded the scope of the problem by increasing the universe of debt instruments affected by the concerns discussed in this Report, and certain changes enacted under the Tax Cuts and Jobs Act (the "TCJA")[7] expanded the range of adverse consequences to issuers engaging in debt-for-debt exchanges.[8] In some instances, distressed issuers have even filed for bankruptcy to ensure that their COD income qualifies for more favorable treatment available to debt discharged in a title 11 case, resulting in far greater expense than would have been incurred in an out-of-court restructuring.[9] Thus, the current economic situation and the effects of recent statutory and regulatory changes present a compelling case for revisiting these issues and our prior recommendations.[10]

We note that the tax consequences of modifying debt to holders of the debt are also worthy of consideration by Congress and Treasury, and previous Tax Section reports have made recommendations regarding these consequences as well as other issues affecting holders of

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[6] Treas. Reg. § 1.1273-2(f).

[7] The TCJA is formally known as "An Act to Provide for the Reconciliation to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," Pub. L. 115-97. Among other things, it significantly revised Section 163(j) (limiting the deductibility of interest deductions) and added Section 951A (an anti-deferral regime taxing certain foreign income), both of which have implications for distressed issuers.

[8] *See* Part IV.b. and c., discussing (i) how Section 163(j) exacerbates the effects of the timing mismatch created in a debt-for-debt exchange between COD income and original issue discount ("OID") deductions, by limiting the OID deductions, and (ii) how Section 904 causes an artificial reduction in foreign tax credits as a result of the COD income and corresponding OID.

[9] Section 108(a)(1)(A) of the Code. Issuers that are insolvent, even if not in bankruptcy, may also be eligible for certain favorable treatment in respect of COD income under Section 108(a)(1)(B) of the Code. However, depending on the facts, issuers may not be able to establish insolvency, as defined for purposes of Section 108, with a high level of certainty. Members of the Tax Section are aware of instances where this uncertainty has caused issuers to file for bankruptcy to ensure they avoid the harsh consequences arising from the recognition of COD income.

[10] As discussed in note 9 above, Section 108(a) provides for exclusions of certain categories of COD income that would otherwise be required to be included in gross income, most importantly where the taxpayer is insolvent, or the discharge occurs in a title 11 case. Accordingly, the issues addressed in this Report are less significant for bankrupt or insolvent issuers, although those issuers are generally required to reduce their tax attributes by an amount equal to the excluded COD income.

distressed debt.[11] However, we believe that the importance of addressing the irrational and often significantly adverse consequences to issuers of debt modifications and exchanges is so significant that Congress or Treasury should seek to ameliorate these consequences regardless of whether they also choose to revise the rules relating to the treatment of holders. As a result, this Report focuses on issuer treatment and not on holder treatment except where our recommendations regarding the treatment of issuers also impact the treatment of holders (as in Part V.a.i).

Part II of this Report provides a summary of our recommendations. Part III outlines the historical background and how attempts to curtail certain transactions that were viewed as abusive led to the current state of the law. Part IV illustrates practical issues with how current law taxes certain issuers of depreciated debt that have undergone a taxable modification of that debt but have not experienced a legal or economic reduction in liability. Part V contains a detailed analysis and discussion of our recommendations.

II. Summary of Recommendations

A. Reinstatement and Expansion of Former Section 1275(a)(4). We recommend that Congress adopt a new, expanded version of former Section 1275(a)(4) providing for the issue price of debt issued in an actual or deemed exchange to be equal to the least of (1) the adjusted issue price of the exchanged debt instrument, (2) the stated principal amount of the new debt instrument and (3) the imputed principal amount of the new debt instrument, with such rule applying to both taxable exchanges as well as exchanges that qualify as reorganizations under Section 368(a).

B. Matching COD Income and OID. As an alternative to the recommendation above, we recommend that Congress adopt a permanent provision, akin to former Sections 108(i)(1) and (2), to match the timing of COD income and OID deductions that arise in connection with an actual or

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[11] For a discussion of the issues affecting holders, *see* NY State Bar Ass'n Tax Section Report No. 1248, *Report on the Taxation of Distressed Debt* (November 2011), at 13 (the "2011 Distressed Debt Bar Report"); 1990 Act Bar Report; Amer. Bar Ass'n, Section of Taxation, *Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code*, at 4-21 (Dec. 2, 2011); Deborah L. Paul, *The Taxation of Distressed Debt Investments: Taking Stock*, 64 The Tax Lawyer 37, 56-64 (2010); Ethan Yale, *Taxing Market Discount on Distressed Debt*, 138 Tax Notes 85 (Jan. 7, 2013).

deemed exchange of debt instruments. We also recommend that Congress suspend the AHYDO rules that could otherwise be applicable to the modification of a non-AHYDO debt instrument and harmonize the consequences of COD income and related OID deductions in the context of the Section 163(j) rules and the foreign tax credit limitation rules.

C. Regulatory Recommendations. In the absence of Congressional action, we recommend that Treasury issue regulations modifying the timing of inclusion of COD income incurred in an actual or deemed debt-for-debt exchange to match the corresponding OID deductions. In addition, we recommend that Treasury suspend the AHYDO rules that could otherwise be applicable to the modification of a non-AHYDO debt instrument and exercise regulatory authority to harmonize the consequences of COD income and related OID deductions in the context of the Section 163(j) rules and the foreign tax credit limitation rules.

III. Historical Background

The amount of COD income that results from a debt modification or exchange is determined by the intersection of several tax rules, including (i) Section 108, which determines the amount of COD income recognized upon a debt that is reacquired for newly issued debt[12]; (ii) Treas. Reg. § 1.1001-3, which determines whether alterations to a debt instrument constitute modifications and whether those modifications are significant enough to result in a tax event; and (iii) Sections 1273 and 1274, which establish the issue price of the newly-issued (or deemed newly-issued, in the case of a modification) debt instrument.

This Part III describes the history of changes to these rules, which have had the overall effect, over time, of expanding the universe of issuers that recognize COD income as a result of debt modifications. Many of the changes were made in response to specific problems and may have been necessary or appropriate in the context of other rules and economic conditions that existed at

[12] *See also* Treas. Reg. § 1.61-12(c)(2)(ii) (providing that an issuer of debt realizes income upon the repurchase of the debt for an amount less than its adjusted issue price, and referring to Section 108(e)(10) to determine the repurchase price of debt that is repurchased through the issuance of new debt).

the time, even if their collective effect has arguably been contrary to sound tax policy as applied to many debt modifications. As a result, we believe that this history provides a useful backdrop for evaluating potential solutions to the tax problems associated with debt modifications and exchanges.

a. *Pre-1990 Law*

Early cases found that there was no accession to wealth and, thus, no income to an issuer upon the repayment of its outstanding debt at a discount.[13] However, the Supreme Court in *Kirby Lumber* upset this early view in finding, in a terse, two paragraph opinion, that a company "realized within the year an accession to income" when it had repurchased its own bonds for less than par.[14] However, though this recognition of income generally applied to discharges of debt, it did not extend to all situations involving the retirement of debt, such as certain debt-for-debt or stock-for-debt exchanges.

Section 112(b)(3) of the Revenue Act of 1936[15] excluded an "exchange solely in kind" as part of a reorganization from causing the recognition of gain or loss to either issuers or holders of debt obligations; this exclusion applied to certain stock-for-stock, stock-for-securities and securities-for-securities exchanges.[16] From this statutory scheme, courts created a line of cases which held that a debt-for-debt exchange (in which the principal amount of the newly-issued debt equaled or exceeded the principal amount of the debt being replaced) or a stock-for-debt exchange was a continuation of the pre-exchange obligation and thus there was properly no recognition of gain or

[13] *See, e.g.*, Meyer Jewelry Co. v. Comm'r, 3 B.T.A. 1319, 1322-23 (1926) (finding that there was no income recognized even though the issuer's "balance sheet will disclose a more favorable financial condition" through repayment of liabilities at a 40% discount pursuant to an agreement between the issuer and its creditors); Comm'r v. Simmons Gin Co., 43 F.2d 327, 329 (10th Cir. 1930) (finding that there was no income recognized to the debtor when debt was forgiven pursuant to an agreement between the debtor and its creditors). However, the Internal Revenue Service (the "IRS") asserted a view contrary to the holdings in these cases. *See* Reg. 45, Art. 544 (1921). This Report provides a brief discussion of the development of the concept of COD income; however, there are other sources that discuss these developments more comprehensively. *See, e.g.*, James S. Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 Tax L. Rev. 225, 226-31 (1959); Donald J. Heng Jr. & Richard L. Parker, Tax-Free Debt Repurchase Using Stock-for-Debt Exchanges, 60 Taxes 527, 528-33 (1982).
[14] United States v. Kirby Lumber, 284 U.S. 1, 3 (1931).
[15] Pub. L. No. 740.
[16] *Id.* at § 112(b)(3).

loss to either issuers or holders of debt obligations upon the exchange.[17] Ultimately, the IRS acquiesced to this view and accepted that there would be no cancellation of indebtedness income to the issuer where stock or new debt (with the same principal amount) was issued in exchange for existing debt as it "merely continue[d] the obligation in another form."[18] The exception for debt-for-debt exchanges did not, however, extend to exchanges in which the principal amount owed was reduced; in that situation, the issuer was required to recognize COD income to the extent of the reduction.[19]

Congress eventually adopted a different approach -- a "cash equivalence" theory -- for both stock-for-debt and debt-for-debt exchanges. Congress repealed the stock-for-debt exception in 1984 by enacting the predecessor to current Section 108(e)(8), which treated an issuer that satisfies its debt obligation with stock as having satisfied the debt with an amount of money equal to the fair market value of the stock issued.[20] Congress similarly repealed the debt-for-debt exception in 1990, with the result that an issuer may realize COD income in a debt-for-debt exchange where the issue price of the new debt is less than the principal amount of the old debt even if their principal amounts are the same.[21] As discussed further below, the 1990 change was enacted simultaneously with changes to the rules for determining the issue price of a debt instrument, which had also developed over time.

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[17] *See* Comm'r v. Capento Sec. Corp. 140 F.2d 382, 385 (1st Cir. 1944) (finding no recognition on a stock-for-debt exchange on debt bought back by an affiliate at a discount); Great Western Power Co. v. Comm'r, 297 U.S. 543, 546 (1936) (finding that the unamortized expense on an original bond issuance carried over to the bonds that were issued in exchange for the original bonds); Alcazar Hotel v. Comm'r, 1 T.C. 872, 879 (1943) (finding no cancellation or reduction of indebtedness in the conversion of a mortgage loan to capital stock); Tower Bldg. Corp. v. Comm'r, 6 T.C. 125, 134-35 (1946) (finding no cancellation or reduction of indebtedness in a stock-for-debt exchange).

[18] GCM 25277 (finding a stock-for-debt exchange "merely continue[d] the obligation in another form").

[19] *See, e.g., Comm'r v. Stanley Co. of America*, 185 F.2d 979 (2nd Cir. 1951) (finding $240,000 of COD income was realized upon the exchange of bonds with a face amount of $2.4 million for bonds with a face amount of $2.16 million); *Comm'r v. Coastwise Transportation Corp.*, 71 F.2d 104 (1st Cir. 1934), *cert. denied*, 293 U.S. 595 (1934) (holding $81,300 of COD income was realized when $456,300 of notes were exchanged for bonds with a principal amount of $375,000); *see also* Rev. Rul. 77-437, 1977-2 C.B. 28 (discussed below at note 29 and accompanying text).

[20] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 59(a) (enacting then-Section 108(e)(10) to repeal the common-law stock-for-debt exception).

[21] See the discussion of Section 108(e)(10) and its history below.

Prior to 1990, the general principles for determining the issue price of a debt instrument were broadly similar to the principles that exist under current law, but, as described below, the consequences of debt modifications to issuers were less severe because of how Treasury interpreted the issue price rules as well as other differences affecting the calculation of COD income.

In the case of a debt instrument issued in exchange for outstanding debt of an issuer, if either the new debt or the existing debt was publicly traded, the issue price of the new debt would generally be governed by its fair market value (that is, its trading price).[22] If neither debt instrument was publicly traded, the issue price of the new debt instrument would generally equal its stated principal amount so long as it bore adequate stated interest; if it did not, the issue price would be determined by using the applicable federal rate ("AFR") to discount to present value all payments due under the new debt instrument.[23]

The resemblance of these general issue price rules to current law belies the significant developments that changed the landscape for distressed issuers seeking relief on their debt. First, as discussed below, the definition of "traded on an established securities market" has been broadened substantially by regulation since 1990; consequently, many more debt instruments issued in 2020 have an issue price determined by reference to fair market value than did debt instruments issued in 1990. Second, the intervening *Cottage Savings*[24] decision and the "significant modification" rules under Treas. Reg. § 1.1001-3 substantially broadened the circumstances in which changes to economic terms, even those that do not result in a principal reduction, result in a deemed exchange for tax purposes. Third, Section 108(e)(10) now specifies that, in the case of a debt-for-debt exchange, the amount of COD income is determined as if the issuer had satisfied the existing debt with an amount of cash equal to the issue price of the new debt, while the proper method of computing an issuer's COD income under prior law was not clear. Finally, there was considerable uncertainty around the application of the general issue price rules to debt-for-debt

[22] *See* Section 1273(b)(3).
[23] *See* Section 1274.
[24] *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991).

exchanges prior to the Revenue Reconciliation Act of 1990 (the "1990 Act").[25] This Part III.a. examines the relevant major developments in the rules for determining the issue price of a debt instrument leading up to the repeal of Section 1275(a)(4).

i. Prior to 1982

Until 1982, former Section 1232(b)(2) contained an exception to the general rule that the issue price of a publicly traded debt instrument issued in exchange for property is its fair market value. If the debt was issued in a reorganization, including in a debt-for-debt exchange that qualified as a recapitalization pursuant to Section 368(a)(1)(E), the issue price was its stated redemption price at maturity ("SRPM"). This rule (the "Reorganization Exception") prevented a debt instrument issued in a reorganization from having OID or bond issuance premium, even if it was issued in exchange for a debt instrument that had OID or bond issuance premium.[26]

The Reorganization Exception was introduced in 1969, apparently to prevent issuers from deducting OID on debt instruments issued in exchange for carryover-basis property. In a taxable purchase of depreciated property in exchange for debt, the issuer's basis in the property would equal its fair market value at the time of purchase. In the context of a reorganization, however, the same issuer would receive a double tax benefit: along with inheriting a built-in loss on the acquired assets, the issuer would benefit from what economically amounted to amortization deductions, albeit in the form of OID on the debt.[27] For example, suppose an issuer exchanged a publicly traded debt instrument with a face amount of $100 for property held by a transferor with a basis of $100 and a

[25] The 1990 Act was enacted on November 5, 1990 as Title XI of the Omnibus Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

[26] Regulations mitigated the consequences of this rule for issuers by providing that OID would carry over from the old debt instrument to the new debt instrument in a debt-for-debt exchange, but they did not address bond issuance premium. *See* TD 7213, 37 Fed. Reg. 21,991–993 (final regulations were issued as Treas. Reg. §§ 1.1273-3 and 1.1273-3A).

[27] *See* GCM 36627 (Mar. 15, 1976) ("Under these circumstances, original issue discount should not be taken into account to give the transferee corporation an amortization deduction as a result of the issuance of its bonds in the reorganization. Although in non-reorganization situations the issuing corporation pays a price where there is original issue discount because the basis of the assets is their lower value at the time the bonds are issued rather than the face amount of the bonds, in a reorganization this "leveling" factor does not exist and there is every reason for the issuing corporation to claim a low value for the assets to increase its amortization deduction for bond discount if such a deduction is allowed").

fair market value of $90. In a taxable transaction, the issuer would take an adjusted tax basis in the acquired property of $90 and would be entitled to $10 of OID deductions over the remaining term of the issued debt instrument. In this same fact pattern, if the fair market value of the property were $85, the issuer's tax basis in the property received would be reduced to $85 and the OID on the issued debt instrument would be increased to $15. This "leveling" effect would prevent a whipsaw effect to the government in a taxable transaction, thereby reducing an issuer's incentive to inflate OID by claiming a lower value in the property received. In contrast, in the context of a reorganization (such as a reorganization pursuant to Section 368(a)(1)(A) where the consideration is stock and a newly issued debt instrument), the issuer would receive a carryover tax basis in the property received. Thus, absent the Reorganization Exception, an issuer that acquired built-in loss property in exchange for discounted debt in a reorganization would get the benefit of both the OID deductions on the issued debt and the built in loss on the property.[28]

The Reorganization Exception deserves mention because it was part of the backdrop for Revenue Ruling 77-437,[29] an important IRS pronouncement on the subject of COD income in the context of debt-for-debt exchanges. The facts of Revenue Ruling 77-437 involved a domestic corporation that had issued bonds with a face amount of $1,000 and a stated interest rate of 6%. When the value of the original bonds had declined to $450, the corporation issued new bonds with a face amount of $430 and an interest rate higher than 6% in exchange for the original bonds. The exchange of old bonds for new bonds qualified as a recapitalization. The IRS ruled that the issuer realized COD income of $570—"the difference between the face amounts of the old and new obligations."[30] By focusing on the reduction in face amount (and because the face amount and issue price of the new debt were the same), the ruling avoided addressing the conceptual question of how

[28] *Id.* at 5.
[29] 1977-2 C.B. 28.
[30] *Id.* (citing *Comm'r v. Coastwise Trans. Corp*., 71 F.2d 104 (1st Cir. 1932)).

the new debt instrument's issue price and fair market value should factor into the determination of COD income if they were different from its face amount.[31]

Congress eventually repealed the Reorganization Exception, apparently to target the behavior of corporations issuing deferred-interest debentures in exchange for depreciated outstanding debt—behavior deemed abusive because the issuer took deductions while the holder had no corresponding income. The deferred interest feature inflated the SRPM of the new debt because the interest was not qualified stated interest. Issuers took the position that the excess of the new debt's SRPM (which equaled its issue price under the Reorganization Exception) over the old debt's issue price was bond repurchase premium. Under this view, the issuer was entitled to deduct the bond repurchase premium over the life of the new debt, while the holder was not required to include any amount in income until the interest was finally paid.[32] (It was impossible for the new debt to have OID because, under the Reorganization Exception, the new debt's issue price was equal to its SRPM.) The legislative history explains:

> New obligations exchanged for a corporation's outstanding obligations in a recapitalization may provide for the deferral until maturity of payments exceeding both the issue price of the outstanding obligations and their fair market value at the time of the exchange. Such deferred payments are not within the definition of original issue discount and are not taxable to a holder under the original issue discount rules of section 1232A. Some issuers have claimed entitlement to deductions prior to payment and without regard to the limitations that would apply if such deferred amounts were original issue discount. The claimed treatment would produce a substantial mismatching between the timing of the issuer's deduction and the holder's income inclusion, producing a substantial revenue loss to the Treasury. Present law is unclear as to the proper treatment of such amounts.[33]

[31] Although not stated in the ruling, the issue price of the new debt would have been $430 (the SRPM) under the Reorganization Exception.
[32] *See* Lee A. Sheppard, *Is There Cancellation of Indebtedness Income in Debt-for-Debt Exchanges?*, 47 TAX NOTES 900 (May 21, 1990) ("The prior rule stated that the issue price of debt issued in a reorganization was its stated redemption price at maturity, so that debt issued in a reorganization would never have OID or bond issuance premium. Issuers took the position that they were entitled to deduct the difference between the old debt's adjusted issue price and the new debt's stated redemption price at maturity as bond retirement premium ratably over the life of the new debt. Holders concomitantly maintained that they were not required to include it in income until actual receipt. Exxon Shipping apparently did this transaction.").
[33] Technical Corrections Act of 1982, H. REP. NO. 986, 97th Cong., 2d Sess. 20 (1982).

ii. 1982 to 1990[34]

Congress repealed the Reorganization Exception in the Technical Corrections Act of 1982. As applied to the perceived abuse described in the legislative history, the repeal reinstated the general rule for publicly traded debt that the issue price of the new debt equaled its fair market value, preventing the issuer from creating artificial repurchase premium by manipulating the SRPM of the new debt. In the case of debt issued in a Section 368(a) reorganization, newly enacted Section 1275(a)(4) also imposed an issue-price floor equal to the adjusted issue price of the old debt, as described below. Taken together, these amendments rectified the targeted abuse while continuing to prevent the creation of new OID in a debt-for-debt exchange. Unlike the Reorganization Exception, they also allowed the new debt to have OID if the old debt had OID.[35]

Section 1275(a)(4) applied when a corporation issued debt in a debt-for-debt exchange pursuant to a plan of reorganization under Section 368(a). Under this special rule, the issue price of the new debt instrument could not be less than the "adjusted issue price"[36] of the old debt instrument. As a result, Section 1275(a)(4) prevented the creation of OID in a debt-for-debt exchange that qualified as a reorganization, regardless of the fair market value of the debt instruments, as long as the SRPM of the new debt instrument was not greater than the adjusted issue price of the old debt instrument. Section 1275(a)(4) provided as follows:

> (4) Special rule for determination of issue price in case of exchange of debt instruments in reorganizations.
>
> > (A) In general. If—
> >
> > > (i) any debt instrument is issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) for

[34] See 1990 Act Bar Report for additional discussion of the developments leading up to the enactment and subsequent repeal of Section 1275(a)(4).

[35] The committee report simply explains: "Under the amendment, original issue discount will be limited to the excess of the redemption price of the obligations, when they are exchanged for outstanding obligations, over the issue price of such outstanding obligations increased for previously deducted discount." *Id.* at 21.

[36] For this purpose, the "adjusted issue price" of the old debt instrument was "its issue price, increased by the portion of any original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(7) or (b)(4) of Section 1272 (or the corresponding provisions of prior law))." This special definition did not take into account the accrual of bond premium, which would typically reduce the adjusted issue price of a debt instrument over time.

> another debt instrument (hereinafter in this paragraph referred to as the "old debt instrument"), and
>
> (ii) the amount which (but for this paragraph) would be the issue price of the debt instrument so issued is less than the adjusted issue price of the old debt instrument,
>
> then the issue price of the debt instrument so issued shall be treated as equal to the adjusted issue price of the old debt instrument.

While Section 1275(a)(4) (when combined with the repeal of the Reorganization Exception) was effective in shutting down the deferred-interest abuse described above, it did not resolve the primary uncertainty reflected in Revenue Ruling 77-437: whether the issuer's COD income should be determined by reference to the new debt instrument's issue price or its face amount. The interaction of Revenue Ruling 77-437 and Section 1275(a)(4) also created several new uncertainties, illustrated by the following example in the House Committee Report to proposed legislation eventually enacted in the 1990 Act,[37] which repealed Section 1275(a)(4):

> Example 1. A corporation issued for $1,000 a bond that provided for annual interest payments at a market rate of interest and that was and is publicly traded. Sometime later, when the old bond is worth $600, the corporation exchanges (in a reorganization) the old bond for a new publicly traded bond that has a SRPM of $750.[38]

The issue presented by the example is whether COD income is created as a result of this exchange and, if so, in what amount. The views of the tax community were divided among at least three different approaches for how to analyze this fact pattern under then-existing law.[39] One view was that Revenue Ruling 77-437 and related authorities should control the COD income consequences of the debt-for-debt exchange by reference to the reduction in principal amount, with the result that the issuer would recognize $250 of COD income. This interpretation would create a disconnect for the issuer going forward, because Section 1275(a)(4), if applied literally, would treat the issue price of the new debt instrument as equal to $1,000, generating $250 of bond issuance

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[37] The amendments effected by Section 11325(a) of the 1990 Act generally applied to debt instruments issued after October 9, 1990 in satisfaction of indebtedness.
[38] H.R. Rep. No. 881, 101st Cong. 2d Sess. 353-54, Examples 1 and 2 (1990) (the "House Committee Report").
[39] *See* Sheppard in note 32 above; 1990 Act Bar Report.

premium that would reduce the issuer's interest deductions. To reconcile this problem, advocates of this first view read Section 1275(a)(4) as containing an implicit cap on the issue price of the new debt based on the maximum amount the issuer would be required to pay (i.e., the principal amount of the new debt); under this reading, the issue price would be $750. The result, therefore, of this first approach was that the issuer would have $250 of COD income and no bond issuance premium.

Under a second view, the issuer should have $250 of bond issuance premium and no COD income. Section 1275(a)(4) would be applied literally to cause the new debt to have an issue price of $1,000 and bond issuance premium of $250, equal to the excess of the issue price over the SRPM. The issue price of the new debt would also be used to calculate the amount of COD income realized, in this case zero. As a consequence, Section 1275(a)(4) would convert COD income into bond issuance premium that would reduce the issuer's interest deductions. The benefit to the issuer was that bond issuance premium was taken into account over the life of the new debt, whereas the entire amount of COD income would have been includible in the year of the exchange.

The third and final view was that the issuer should have $400 of COD income and the new debt should have $150 of OID because Section 1275(a)(4) should be applied with a ceiling on the issue price of the new bond equal to the maximum amount that a bankruptcy court would allow a holder of the new debt to recover. This view was primarily based on two controversial bankruptcy cases that misconstrued the OID rules in the course of limiting a holder's allowable claim in bankruptcy to the fair market value of the debt.[40] Under this view, the new debt would have an issue price of $600, equal to its fair market value, and $150 of OID, and the issuer would recognize $400 of COD income in the exchange.

This significant ambiguity likely explains the short life of Section 1275(a)(4).

[40] *In re Chateaugay Corp.*, 109 B.R. 51 (Bankr. S.D.N.Y. 1990); *In re Allegheny Int'l Inc.*, 100 B.R. 247 (Bankr. W.D. Pa. 1989). *See* 1990 Act Bar Report for further discussion of these cases.

b. *Repeal of Section 1275(a)(4) and Introduction of Section 108(e)(11) (now Section 108(e)(10))*

Section 11325(a) of the 1990 Act amended the Code by repealing Section 1275(a)(4) and introducing Section 108(e)(11). Section 108(e)(11) was re-designated as Section 108(e)(10) in 1993[41] with no substantive changes; we use the designation "Section 108(e)(10)" throughout this Report to refer to former Section 108(e)(11). Section 108(e)(10) provides that, for purposes of determining COD income of an issuer resulting from the issuance of a debt instrument in satisfaction of outstanding indebtedness, the debtor is treated as having satisfied the existing debt with an amount of money equal to the issue price of the new debt instrument. Section 108(e)(10) applies to both debt-for-debt exchanges as well as deemed exchanges resulting from a significant modification. The issue price of the new debt is determined under the general rules of Sections 1273 and 1274, with the exception that Section 1273(b)(4) is applied by excluding any portion of the SRPM that is treated as interest.[42] As a result of the repeal of Section 1275(a)(4), under Section 108(e)(10), a debt-for-debt exchange generates COD income if the issue price of the new debt is less than the adjusted issue price of the old debt, even if the exchange does not cause a reduction in principal amount owed.

Section 108(e)(10) synchronized the COD and OID rules, and therefore clarified the interpretive issues highlighted by Example 1 above "to ensure similar treatment for taxpayers undertaking similar transactions."[43] Recall that in Example 1 of the House Committee Report, a corporation issued debt with a face amount of $750 in satisfaction of outstanding publicly traded debt with a face amount and issue price of $1,000 at a time when both debt instruments had a fair market value of $600. Under Section 108(e)(10), the corporation would be treated as having satisfied its

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[41] The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.
[42] *See* Sections 108(e)(10) and 1273(b)(4). Typically, the issue price of the new debt would be determined under Section 1273(b)(3) (if either the old debt or the new debt is publicly traded) or Section 1274 (if neither is publicly traded). Section 1273(b)(4) would apply only if (1) neither the old debt nor the new debt is publicly traded, and (2) Section 1274 does not apply to the new debt.
[43] H.R. Rep. No. 881, 101st Cong. 2d Sess. 353-54 (1990).

existing debt with an amount of money equal to the issue price of the new debt.[44] With the repeal of Section 1275(a)(4), the general rule of Section 1273(b)(3) would determine the issue price of the new debt by reference to its fair market value. The new debt would have an issue price of $600, a SRPM of $750, and $150 of OID, and the issuer would recognize $400 of COD income.[45] These results are consistent with the third approach for analyzing Example 1.

The primary deficiency of former Section 1275(a)(4) seems to have been that the text of the rule did not draw any connection between the remaining principal amount of outstanding debt and the issue price of new debt issued in the exchange. This created the potential for no COD income to be realized in cases involving actual debt relief. The legislative history does not explain why Congress concluded that the appropriate solution was to repeal Section 1275(a)(4) rather than, for instance, clarifying that the issue price of the new debt would be capped at the principal amount of the new debt, consistent with the first approach to Example 1.[46]

The House Committee Report does not explicitly outline the policy considerations behind the repeal of Section 1275(a)(4), but it reflects a general concern regarding an issuer's ability to engineer its own tax results by selectively choosing whether or not to be subject to the OID rules.[47]

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[44] As previously noted in 1990 Act Bar Report, a significant conceptual underpinning of Section 108(e)(10) and the repeal of Section 1275(a)(4) appears to have been that, for purposes of determining COD income and OID, a debt-for-debt exchange should be treated as if new debt were issued for cash equal to the issue price of the new debt (determined under Sections 1273 and 1274), and the cash proceeds used to retire the old debt (referred to as the "hypothetical cash exchange theory"). The 1990 Act Bar Report also discussed an alternative way to view a debt-for-debt exchange as a substitution of one obligation for another (referred to as the "substitution of obligation theory"); under this view, policy considerations might have suggested that such a debt exchange should not be viewed as an appropriate time to assess whether an issuer has COD income. Section 108(e)(10) strongly resembles former Section 108(e)(10) (1984), which repealed an exception from COD income recognition (which exception was based on the "substitution of obligation theory") that applied to solvent debtors that issued their own stock to cancel their debt. The principal purpose for enacting former Section 108(e)(10) was to eliminate the disparity between issuances of stock to discharge debt and the issuance of stock for cash, followed by the use of cash to discharge debt. Although the legislative history to the 1990 Act does not expressly refer to former Section 108(e)(10), the changes brought about by the 1990 Act seem to create greater parity between stock-for-debt and debt-for-debt exchanges.

[45] H.R. Rep. No. 881, 101st Cong. 2d Sess. 355, Example 1 (1990).

[46] The House Committee Report confirmed that "the OID rules, as modified by the bill, provide the appropriate framework for determining the issue price of a new obligation" and the determination of COD income created in a debt-for-debt exchange is properly determined by comparing the adjusted issue price of the old debt to the issue price of the new debt.

[47] H.R. Rep. No. 881, 101st Cong. 2d Sess. 353-54 (1990). For a more comprehensive discussion of this point, see the 1990 Act Bar Report.

The ambiguity around the application of Section 1275(a)(4) permitted an issuer to vary the principal amount of a debt instrument issued in a debt-for-debt exchange qualifying as a reorganization and to make adjustments to other terms (e.g., maturity or stated interest rate), enabling the taxpayer to select the amount of COD income and OID while maintaining a constant fair market value.[48] It may also be that Congress was concerned about the administrative and litigation costs that could result from the interpretive ambiguity of Section 1275(a)(4).[49] An outright repeal of Section 1275(a)(4) was not the only solution to these policy concerns (which could have been addressed with a technical correction to the language of former Section 1275(a)(4)), but it was the one Congress chose.

Following the repeal of Section 1275(a)(4), the determination of the issue price of a debt instrument in the context of a debt-for-debt exchange where the new debt instrument is part of an issue a portion of which is "traded on an established securities market" is governed by Section 1273(b)(3), which prescribes that the issue price is determined by the fair market value of the debt instrument being issued.[50]

c. *Issuance of Regulatory Guidance on Debt Modifications Resulting in Deemed Exchanges*

Treas. Reg. § 1.1001-1(a) provides that gain or loss is recognized from "the exchange of property for other property differing materially either in kind or in extent." Even prior to the enactment of Treas. Reg. § 1.1001-3, the IRS had published administrative guidance stating that, for purposes of Section 1001, an "exchange" in the context of debt instruments does not require an actual exchange and can occur when changes to the terms of a debt instrument "are so material as to amount virtually to the issuance of a new security."[51] During that time, the determination of whether one or more changes to the terms of a debt instrument resulted in a deemed exchange was

[48] *Id*.
[49] *Id*.
[50] Notably, if neither the existing nor newly issued debt instrument is publicly traded and the interest rate on the new debt is at least equal to AFR, the new debt has an issue price equal to the stated principal amount and no COD income or OID would be created. *See* Sections 1273(b)(4), 1274(a).
[51] Rev. Rul. 73-160, 1973-1 C.B. 365; *see also* Rev. Rul. 81-169, 1981-1 C.B. 429.

largely based on facts and circumstances, a state of affairs that created much uncertainty for taxpayers.

The guidance leading up to the adoption of Treas. Reg. § 1.1001-3 culminated in the Supreme Court decision in *Cottage Savings Association v. Commissioner*.[52] In *Cottage Savings*, the Supreme Court held that a savings and loan association was entitled to recognize a tax loss when it exchanged a pool of mortgages for another pool of mortgages because the two groups of property were sufficiently "different in kind or extent" as a legal matter on account of the different obligors and collateral, despite the two pools of mortgages being economically identical. The Court also observed that trying to evaluate material differences based on economic entitlements would require a test that would result in administrative complexity.

Treas. Reg. § 1.1001-3 was issued in proposed form in December 1992[53] in response to *Cottage Savings* (which involved an actual exchange) and, more generally, in order to clarify when a modification of a debt instrument resulted in a deemed exchange of properties that "differ materially either in kind or in extent" within the meaning of Treas. Reg. § 1.1001-1(a).[54] The regulations were finalized in June 1996.

In light of the history of case law and rulings in this area, and the resulting uncertainty regarding when a taxable modification had occurred, the Treasury Department and the IRS expressed a desire to provide clarity and certainty as the guiding objective behind Treas. Reg. § 1.1001-3.[55] However, commentary by practitioners on the proposed regulations acknowledged that

[52] 499 U.S. 554 (1991).
[53] Notice of Proposed Rulemaking: Modifications of Debt Instruments, 57 FR 57034 (Dec. 2, 1992).
[54] TD 8675, Modifications of Debt Instruments, 1996-2 C.B. 60 (June 26, 1996).
[55] Notice of Proposed Rulemaking: Modifications of Debt Instruments, 57 FR 57034, 57034 (Dec. 2, 1992) ("In response to the issues raised by the *Cottage* [*Savings*] decision, and in an effort to provide certainty, the Service proposes to expand the regulations under Section 1001 of the Code to deal explicitly with the modification of debt instruments"); TD 8675, Modifications of Debt Instruments, 1996-2 C.B. 60 (June 26, 1996) ("The IRS and Treasury considered adopting a single, general rule instead of several detailed rules. That approach, while providing less guidance, would have the advantage of reducing complexity and avoiding anomalies that can result from bright-line rules (for example, different results for economically similar transactions). Nevertheless, after considering that approach, the IRS and Treasury concluded that both taxpayers and the IRS would benefit from regulations specifically addressing the treatment of certain modifications. A debt modification that results in an exchange may have a variety of consequences, and parties contemplating a change to a debt instrument should be able to determine whether that change will result in an exchange.")

guidance in the form of bright-line rules, as opposed to safe harbors or a facts and circumstances determination, might also result in "unfair, harsh and/or unintended consequences."[56] Consider again the facts of Example 1, which involved publicly traded debt with a face amount of $1,000 that was issued at par but trading at $600 at the time of the exchange. As a commercial matter, a distressed issuer would generally seek to work with its creditors to manage its debt liability, typically by modifying the terms of the debt (whether by extending the maturity date, deferring interest, changing the interest rate, or relaxing certain financial covenants) without changing the $1,000 principal amount. If these modifications resulted in a "significant modification" within the meaning of Treas. Reg. § 1.1001-3, then the issuer would be treated as having retired a $1,000 obligation for a new obligation worth $600, and the issuer, already in financial distress, would be required to recognize $400 of COD income despite not having experienced any relief from the ultimate liability under the debt instrument. The difference between the $600 issue price and the $1,000 SRPM would be treated as OID, but the resulting deductions are mismatched with the COD income because they are taken into account over time, and may potentially be disallowed altogether for reasons discussed below.[57]

d. *Change to Definition of "Traded on Established Securities Market"*

The history of the "issue price" rules reflects a general policy view that it is desirable for the issue price of a debt instrument issued in exchange for property to be the debt instrument's fair market value, provided that fair market value can be determined accurately and objectively. For one thing, the issue price determines the amount of OID (or bond issuance premium) on the debt instrument,[58] and therefore a fair market value issue price best reflects the economic OID earned by the holders and borne by the issuer over the debt instrument's term. Moreover, a fair market value

[56] *See, e.g.*, NY State Bar Ass'n Tax Section Report No. 779, *Report on Proposed Regulation § 1.1001-3 Relating to Modification of Debt Instruments* at 7-9 (Jan. 20, 1994).
[57] *See* Part IV. below.
[58] *See* Section 1273(a)(1).

issue price better aligns the consequences of debt issued for property with otherwise identical debt issued for cash.

Prior to 2011, regulations limited the definition of "traded on an established market" (and thus the application of the fair market value rule for determining issue price) to property that was (1) exchange listed property, (2) property traded on a board of trade or an interbank market, or (3) property appearing on a quotation medium and debt instruments for which price quotations are reasonably identifiable.[59]

Regulations proposed in 2011 (the "2011 Proposed Regulations")[60] and finalized in largely the same form in 2012 (the "2012 Final Regulations") substantially broadened the publicly traded definition, treating a debt instrument as publicly traded if there is a single sales price or quote available for the instrument within a thirty-one day period ending fifteen days following the issue date of the instrument, with an exception for debt issued at or below a specified size ($100 million in the 2012 Final Regulations).[61] Under these rules, a single publicly available sales price or quote establishes the issue price of the debt instrument by reference to its fair market value, rather than its stated principal amount, as the single quote or sales price indicates that there is both an "established market" and "public trading" of the property.[62] The 2011 Proposed Regulations created new categories of quotes—"firm quotes" and "indicative quotes"—each of which conveyed the degree of uncertainty with respect to the quote's reflection of fair market value. A firm quote is one at which a person receiving the quote could purchase or sell the property and that has either been designated as a firm quote or is otherwise in the same form as would typically be used when market participants make a quote to buy or sell at the quoted price, even if the party providing the quote is not legally

[59] Debt Instruments With Original Issue Discount; Imputed Interest on Deferred Payment Sales or Exchanges of Property, 59 Fed. Reg. 4801 (preamble of language to be codified at Treas. Reg. § 1.1272-2(f)).
[60] *See* generally New York State Bar Ass'n Tax Section Report No. 1237, *Report on Proposed Regulations on the Definition of Public Trading* (April 6, 2011) (the "2011 Public Trading Bar Report").
[61] Property Traded on an Established Market, 76 Fed. Reg. 1,104 (proposed to be codified at Treas. Reg. § 1.1273-2(f)).
[62] *Id*.

obligated to purchase or sell at that price.[63] An indicative quote is one that is available from "at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property" and that is not a firm quote.[64]

The 2012 Final Regulations struck the exchange-traded provision from the issue price calculation, leaving the issue price determined solely based on the availability of sales prices or firm or indicative quotes for the debt instrument.[65] The changes made by the 2012 Final Regulations were intended to bring the issue price rules in step with the operation of the capital markets, where most debt that was widely held was not actually listed on an exchange but rather traded in "over the counter" markets.

The operation of the regulations makes it very difficult for tax advisors to conclude, particularly in advance of a debt exchange or modification, that a debt issue is not publicly traded, unless its outstanding principal amount is no greater than $100 million or it is truly closely held by a single holder or small number of holders. For one thing, such a conclusion depends on proving a negative, that is, that no securities dealers or pricing services are providing quotes. Second, pricing services such as Bloomberg and IHS Markit provide indicative quotes for many debt issues, even those for which there is no evidence of actual trading or market-making.[66] Finally, because the window during which a quote can be observed extends for fifteen days following an exchange or modification, an issuer must often operate under the worst-case assumption that a debt issue will be publicly traded even if no quotes have surfaced before the event.

All in all, the 2012 Final Regulations had the effect of substantially increasing the universe of debt instruments that are "traded on an established market," with the result that an issuer will realize

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[63] *Id.*
[64] *Id.*
[65] Property Traded on an Established Market, 77 Fed. Reg. 56,534 (citing that both exchange listing and trading are infrequent in debt instruments and that other types of property would likely be covered under other regulations such that it would not need to be captured in this regulation).
[66] If there is only an indicative quote and the issuer determines that the quote (or an average of quotes) materially misrepresents fair market value, then the debt instrument will still be treated as publicly traded but the issuer can use any method that it reasonably establishes to more accurately reflect fair market value. *See* Treas. Reg. § 1.1273-2(f)(5)(ii). However, the ability to override the indicative quote may provide little solace to the issuer if the fair market value it establishes is significantly less than the principal amount.

COD income on a debt-for-debt exchange of depreciated debt, even when the issuer's repayment obligation remains unchanged.

e. *Prior legislative relief for debt-for-debt exchanges*

i. <u>Section 108(i)</u>

The American Recovery and Reinvestment Act of 2009[67] included a new Section 108(i), which provided temporary relief to mitigate the effect of COD income, including in the event of a significant modification or a debt-for-debt exchange. This provision permitted taxpayers to elect to defer COD income on the "reacquisition" of an "applicable debt instrument" that occurred during 2009 or 2010. Under the election, the COD income would be spread over five taxable years beginning in either the fifth or fourth taxable year following the year of reacquisition, depending on whether the reacquisition occurred in 2009 or 2010, respectively.[68] A "reacquisition" is defined as any acquisition of an applicable debt instrument by the issuer of the applicable debt instrument or a person related to the issuer.[69] Acquisition is defined to include not only the acquisition of an applicable debt instrument for cash but also its acquisition in exchange for another debt instrument (including one deemed to result from a modification of the prior debt instrument), its acquisition in exchange for corporate stock or a partnership interest, the contribution of a debt instrument to capital and the complete forgiveness of the applicable debt instrument by its holder.[70] An applicable debt instrument is defined as any debt instrument issued by a subchapter C corporation or any other person in connection with the conduct of a trade or business by that person, and a debt instrument is defined as a bond, debenture, note, certificate or any other instrument or contractual arrangement constituting indebtedness, as defined under Section 1275(a)(1).[71]

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[67] American Recovery and Reinvestment Act of 2009 § 1231; Section 108(i).
[68] Section 108(i)(1).
[69] Section 108(i)(4)(A).
[70] Section 108(i)(4)(B).
[71] Section 108(i)(3).

In connection with an election to defer COD income in the context of a debt-for-debt exchange, the amount of OID on the new debt instrument that accrues prior to the first year in the five-taxable-year period in which the COD income is included, and does not exceed the amount of such COD income, is deferred and allowed ratably as a deduction for the duration of the OID deferral period.[72] This rule prevented issuers from enjoying the benefits of OID deductions prior to the recognition of the corresponding COD income. As a result, the OID and the COD income generally offset each other during the five-taxable-year COD income inclusion period, reducing the timing mismatch posed by a debt-for-debt exchange in a distressed environment.

ii. Section 163(e)(5)(F)

Under current law, Section 163(e)(5) limits the deductibility of interest paid or accrued on debt instruments that are AHYDOs.[73] As will be discussed in more detail below in Part IV.a., the AHYDO rules can adversely impact an issuer undertaking a debt modification by limiting the deductibility of the OID generated by the exchange.

In connection with the American Recovery and Reinvestment Act of 2009, Congress enacted Section 163(e)(5)(F), which provided that a debt instrument issued between September 1, 2008 and December 31, 2009 in exchange for another debt instrument that was not treated as an AHYDO would not be treated as an AHYDO.[74] Additionally, the Secretary is authorized to extend this exclusion to time periods following December 31, 2009 if it is "appropriate in light of distressed conditions in the debt capital markets."[75]

[72] Section 108(i)(2)(A).
[73] Section 163(e)(5)(A). An AHYDO is generally defined as a debt instrument which has (a) a term of more than five years, (b) has a yield-to-maturity exceeding the AFR in effect for the calendar month plus five percentage points, and (c) generally defers the payment of more than one year of interest at any time after the end of the first accrual following the fifth anniversary of issuance. Section 163(i). For a corporate issuer, OID on an AHYDO is deductible only when actually paid and is disallowed to the extent the yield-to-maturity on the AHYDO exceeds the AFR plus six percentage points. Section 163(e)(5)(A)(i).
[74] American Recovery and Reinvestment Act of 2009 § 1232(a); Section 163(e)(5)(F)(i).
[75] Section 163(e)(5)(F)(ii).

IV. Summary of Practical Issues under Current Law Pertaining to Debt-for-Debt Exchanges

This Part IV describes various adverse consequences to issuers arising from debt modifications and debt-for-debt exchanges, including the recognition of COD income as well as a number of other ancillary consequences.

To illustrate these consequences, we will use a variant of Example 1 above as the paradigm example (Example 2). In Example 2, assume a publicly traded debt instrument issued for $1,000 is significantly modified when its fair market value is $600 but the modification does not change the debt's principal amount. The issuer is treated as satisfying the $1,000 existing debt instrument for a debt instrument with an issue price of $600, triggering the recognition of $400 of COD income. Because the principal amount of the new debt instrument remains $1,000, the new debt instrument is treated as issued with $400 of OID that will be taken into account over its life.

It is worth emphasizing that, in the long legislative and regulatory history outlined above, the consequences below do not appear to align specifically with any policy articulated by Congress or Treasury, at least as applied to the paradigm case of Example 2. These consequences generally appear to have been incidental results of Congress's and Treasury's responses to the various perceived abuses described in Part III. above.

a. *Timing Mismatch Between COD income and OID; AHYDO*

Under current law, as discussed above, an issuer of a publicly traded debt instrument may be required to recognize COD income because of an actual or deemed exchange of the debt instrument under Treas. Reg. § 1.1001-3 to the extent that the debt instrument issued in exchange has a fair market value that is below the adjusted issue price of the existing debt instrument.[76] In addition, to the extent that the SRPM of the newly issued debt instrument exceeds its fair market value, the debt instrument will be treated as being issued with OID. When the principal amount of the existing debt instrument and that of the newly issued debt instrument are the same, the amount

[76] Treas. Reg. § 1.1001-3; Section 1273(b)(3); Treas. Reg. § 1.1273-2(b), (c).

of COD income should equal the amount of OID. Therefore, assuming the issuer can deduct all of the OID, the OID deductions will correspond to the COD income inclusion. However, as illustrated below, there is a timing difference because the COD income is included in the issuer's taxable income immediately whereas the OID is only deducted over time.

For instance, using the facts of Example 2, the issuer is required to include $400 immediately but is only entitled to recognize the offsetting $400 of OID deductions over time. As discussed above in note 9 and the accompanying text, an issuer that is sufficiently distressed that it does not have the wherewithal to pay the cash tax liability arising from the $400 COD income inclusion, but is not clearly insolvent for purposes of Section 108, may be forced to file for bankruptcy so that the COD income occurs under a title 11 case and will thus be eligible to be excluded from income under Section 108.

In addition to the timing issue discussed above, if a publicly traded debt instrument issued in an actual or deemed exchange of debt has a fair market value that is meaningfully below its principal amount and has more than five years remaining to maturity on the date of the exchange, the newly issued debt instrument is likely to be an AHYDO.[77] Under those circumstances, the issuer's ability to deduct OID on the newly issued debt instrument will likely be disallowed in part or, at a minimum, deferred. Thus, the AHYDO rules may result in permanent disallowance of a portion of the deferred OID deductions discussed above.

b. *Section 163(j)*

Section 163(j), which was enacted in 2017 as part of the TCJA, provides, in pertinent part and subject to the exceptions enumerated therein, that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year and (b) 30 percent of the taxpayer's adjusted

[77] See the discussion above in Part III.e.ii. regarding Section 163(e)(5)(F).

taxable income ("ATI") for such taxable year.[78] Temporary relief under the CARES Act increased the 30 percent limitation to 50 percent for taxable years beginning in 2019 and 2020.[79]

Similar to the AHYDO discussion above, if the publicly traded rules in the 2012 Final Regulations apply to an actual or deemed exchange of an existing debt instrument, the exchange will generally (i) cause the issuer to recognize COD income equal to the difference between the adjusted issue price of the existing debt instrument and the fair market value of the new debt instrument on the exchange date and (ii) cause the new debt instrument to have OID (in addition to any stated interest) equal to the amount of the COD income. It is likely that a distressed issuer will have relatively low (or zero) ATI, making it more likely that Section 163(j) will limit the deductibility of interest, including OID, on the new debt instrument. Additionally, because (i) the COD income recognized in the year of debt modification cannot be carried forward under Section 163(j) to increase the amount of ATI in subsequent years and (ii) each dollar of COD income is generally treated as ATI (and not business interest income) and thus increases the interest deduction limitation in that year by only 30% (50% for the specified years under the CARES Act), the COD income provides a limited benefit to the issuer under Section 163(j). In effect, there is both a timing and amount mismatch in the Section 163(j) context between COD income recognized on a debt modification and the related OID created by the modification.

c. *Section 904*

Section 904 of the Code generally limits the amount of foreign tax credits a taxpayer can claim to a percentage of such taxpayer's foreign-source taxable income (the "FTC Limitation").[80] Deductions that are allocated or apportioned to a taxpayer's foreign-source gross income

[78] Section 163(j)(1). For this purpose, business interest means "any interest paid or accrued on indebtedness properly allocable to a trade or business" that is not investment interest; business interest income means "the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business" that is not investment income; and ATI is taxable income as adjusted pursuant to Section 163(j)(8) to exclude, *inter alia*, (i) income, gain, deduction or loss not properly allocated to a trade or business, (ii) business interest income, (iii) net operating losses and (iv) for taxable years beginning before January 1, 2022, depreciation, amortization or depletion deductions.

[79] Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, Sec. 2306 (2020).

[80] Section 904(a).

correspondingly reduce a taxpayer's FTC Limitation. Regulations provide that a U.S. issuer's interest expense is allocated between U.S.-source income and foreign-source income.[81] Consequently, when a debt instrument is modified and treated as reissued at fair market value with OID, the amount of such OID is allocated between a taxpayer's U.S.-source and foreign-source income in the same way as any other interest expense.[82] We note that there is no statutory or regulatory rule that addresses the source of COD income. If a category of income is not described by an existing category of income within the statutory framework and has no appropriate analogue, as is the case for COD income, then it is appropriate to apply first principles (e.g., where the income is produced, how it originated, where the relevant transactions occurred) to determine how to source the sui generis category of income.[83] While the appropriate sourcing of COD income for a foreign borrower is understood to be an open question,[84] the COD income of a U.S. borrower is generally treated as U.S.-source ordinary income.[85] Thus, in addition to an issuer incurring current tax expense as a result of recognizing COD income, a portion of the corresponding OID may reduce net foreign-source income and as a result may artificially limit the issuer's post-modification foreign tax credit utilization.

V. Recommendations

Should either Congress or Treasury and the IRS wish to address the issues described above, there are several potential modifications of the existing framework applicable to debt-for-debt exchanges that could be considered. Part V.a. of this discussion compares two potential legislative approaches to the problems associated with the recognition of COD income, each of which is based on prior legislation or legislative proposals. Part V.b. of this discussion considers potential regulatory

[81] Treas. Reg. §§ 1.861-9, 1.861-9T.
[82] Treas. Reg. § 1.861-2(a)(4) (OID is treated as interest for purposes of the sourcing rules).
[83] *See* Andrew Walker, *Exceptions in Search of a Rule: The Source and Taxability of "None of the Above" Income*, Columbia University: Tax Policy Colloquium (October 8, 2009).
[84] *See id*. at 10.
[85] Section 61(a)(11); Treas. Reg. § 1.1001-1(a). There have also been cases in which COD income recognized by a foreign borrower was determined to be U.S. source. See e.g., *Corporacion de Ventas de Salire y Yoda de Chile*, 44 B.T.A. 393 (1941), rev'd on other grounds, 130 F.2d 141 (2d Cir. 1942); *Big Hong Ng, et al. v. Comm'r*, 73 T.C.M. 2900 (1997).

approaches that Treasury and the IRS could undertake to mitigate certain aspects of the concerns raised above.

a. *Legislative proposals*

This Part V.a. describes and evaluates two potential legislative approaches to the issue of COD income upon a debt-for-debt exchange: one approach, based on prior Section 1275(a)(4) and 2014 proposed legislation, that would eliminate COD income in many debt-for-debt exchanges, and another, loosely based on Section 108(i), that would allow the issuer to spread the COD income over a specified period of time and match it with the corresponding OID deductions.

i. Reinstate an Expanded Version of Former Section 1275(a)(4)

We have previously advocated for the reenactment of a modified version of Section 1275(a)(4),[86] and we believe that such an approach would elegantly resolve the key concerns raised in this Report. By setting an appropriate floor for the new debt instrument's issue price, this approach would avoid the creation of COD income as well as the corresponding OID. In doing so, this approach would avoid the need for additional companion rules to address related issues as discussed above, including AHYDO, Section 163(j) and the FTC Limitation. We would propose the following changes to former Section 1275(a)(4): (1) the issue price of the new debt would not exceed the principal amount of the debt, to address the concerns that led to the repeal of Section 1275(a)(4); and (2) the rule would apply to any debt-for-debt exchange involving a single issuer, whether or not the exchange qualifies as a reorganization under Section 368(a) and whether or not the issuer is a corporation.[87]

The House Ways and Means Committee released a discussion draft of potential legislation on February 21, 2014 (the "Discussion Draft"), which included a modified version of former Section

[86] *See, e.g.*, 1990 Act Bar Report at 6; Section 108(i) Bar Report at 96.
[87] We would also suggest clarifying that this provision applies to "mixed consideration" exchanges where the holder receives consideration in addition to a new debt instrument, with the value of the other consideration reducing the adjusted issue price of the existing debt instrument in prong (1) of Proposed Section 1274B.

1275(a)(4), in proposed Section 1274B, that met the parameters we identify above.[88] This same rule was introduced in H.R. 1 in December 2014 (together with the Discussion Draft, the "Camp Proposal").[89] We would recommend a rule similar to what was contemplated by the Camp Proposal in proposed section 1274B ("Proposed Section 1274B"):

> In the case of an exchange (including by significant modification) by an issuer of a new debt instrument for an existing debt instrument issued by the same issuer, the issue price of the new debt instrument shall be the least of − (1) the adjusted issue price of the existing debt instrument, (2) the stated principal amount of the new debt instrument, or (3) the imputed principal amount of the new debt instrument.[90]

By providing a floor for the new debt's issue price equal to the adjusted issue price of the old debt (except where the principal amount has been reduced or the new debt does not bear adequate stated interest), a distressed issuer would generally not be required to recognize COD income in cases where it has not been relieved of any liability as measured by the stated principal amount.[91] Additionally, Proposed Section 1274B would avoid the concerns raised by former Section 1275(a)(4) by limiting the issue price on the new debt instrument when there has in fact been a reduction of the stated principal amount of the issuer's legal obligation.

As noted above, a statutory provision similar to the Camp Proposal would solve not only the OID-COD income timing mismatch, but by eliminating the COD income entirely it would simultaneously solve the related issues addressed in this Report (AHYDO, Section 163(j), and the FTC Limitation issue).

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[88] House Ways and Means Committee Print, Tax Reform Act of 2014, 113th Cong. 2d Sess., as released on February 26, 2014 (WCMP 113-6, Sept. 2014), available at http://www.gpo.gov/fdsys/pkg/CPRT-113WPRT89455/pdf/CPRT-113WPRT89455.pdf

[89] Tax Reform Act of 2014, H.R. 1, 113th Cong. 2d. (2014).

[90] The inclusion of clause (3) is a reference to Section 1274, which requires that where a debt instrument is issued for non-publicly traded property, the debt's issue price will be its face amount unless stated interest is less than AFR. If the interest rate is lower than AFR, then the issue price must account for imputed interest (in the form of OID) to meet the minimum statutory requirement, requiring a downward adjustment of the issue price to its "imputed principal amount."

[91] *See* New York State Bar Ass'n Tax Section Report No. 1318, *Report on the House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments and Corresponding Proposals by the Obama Administration* (March 6, 2015) (the "Camp Proposal Bar Report") for a more comprehensive discussion that includes considerations such as electivity and related-party debt acquisitions described in Section 108(e)(4).

One potential downside of this approach is that it would create inconsistency between the treatment of a retirement of debt for cash, equity or other property, which would still generate COD income approximately based on the fair market value of the debt so retired, and debt exchanged for new debt of the issuer. However, this divergent tax treatment may be justified based on the view that the issuer's economic position has changed less when it is still liable for the same principal amount of debt--even if it has amended certain terms of that debt--than when it has eliminated that debt entirely through a cash repurchase, equitization or delivery of other property to the holders.

Another potential concern raised by this approach is its adverse impact on certain holders of the debt in the context where the exchange is not a recapitalization under Section 368(a). Proposed Section 1274B would prevent original holders (generally, holders that bought the debt at its principal amount) from realizing a loss on the existing debt in most debt-for-debt exchanges, because the holder's amount realized on the exchange would typically equal the adjusted issue price of the existing debt (rather than the fair market value of the debt, as under current law). Instead, that loss would be deferred. The deferral in this context may be justified by the same reasoning underlying the elimination of COD income for the issuer: because the debt's principal amount has not changed, at least in a paradigm case like that of Example 2, the holder remains in a similar position to its position prior to the modification.

But consider an investor in the distressed debt markets that purchases a bond originally issued at par (e.g., $1,000) (with adequate stated interest) for its fair market value, which is a steep discount from par (e.g., $600). Under Proposed Section 1274B, a later debt modification that results in a deemed exchange, but with no reduction of principal, would result in an issue price of the new debt instrument equal to the adjusted issue price of the existing instrument (i.e., $1,000), and the investor would be treated as having an amount realized of $1,000[92] in exchange for a debt instrument with a basis of $600, resulting in $400 of phantom gain recognition (unless the exchange qualified as a recapitalization pursuant to Section 368(a)).

[92] *See* Treas. Reg. § 1.1001-1(g).

In the remainder of this Part V.a. we describe two potential ways that Congress could address these inappropriate holder consequences: (1) enact a version of Section 1275(a)(4)/Proposed Section 1274B that applies only to issuers or (2) also enact companion holder rules similar to those contained in the Camp Proposal. On balance, we recommend the first of these two approaches for the reasons described below.

The first approach for addressing unintended consequences to holders would be to enact a version of Proposed Section 1274B that applies solely for purposes of calculating the issuer's COD income and related OID, but does not otherwise change the issue price of the modified debt instrument relative to the rules that exist today. Such a rule could, for example, be incorporated into Sections 108(e)(10) and 163 instead of Section 1275, so that it would affect the calculation of the issuer's income and deductions rather than the basic tax calculations for the debt instrument. We refer to such an approach as the "decoupling approach" because it would have the effect of decoupling the consequences to the issuer from the consequences to the holder.

The decoupling approach would provide Congress with greater flexibility: Congress could mitigate the problems that afflict issuers seeking to modify their debt while constructing (either contemporaneously or at a later point) a separate, appropriate framework for addressing the treatment of holders. While Congress has, at times, expressed a preference for issuer-holder symmetry,[93] the reality is that, both because of different factual circumstances as well as the operation of the existing rules, the tax consequences to holders and issuers of debt modifications are often very different. Therefore, there are strong arguments in favor of crafting solutions for each category of taxpayer that take into account those different circumstances and consequences.

Under current law, a debt modification can affect the issuer and corresponding holder in different ways. Because a holder may purchase debt at a discount or premium in the secondary

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[93] Issuer-holder symmetry was one of the principles guiding the legislative and regulatory changes that are described in Part III. above. While it is obviously important to account for any consequences to holders that would arise from any legislative or regulatory change aimed at issuers, both those that are adverse to holders as well as those that could invite abuse or whipsaw the government, we believe that issuer-holder symmetry is less important an objective than ensuring that the rules treat each group appropriately.

market, a holder's built-in gain or loss on a debt instrument is often completely different from the COD income (or debt repurchase premium) that the issuer would recognize upon a taxable modification. In addition, if the debt modification is a recapitalization under Section 368, a holder may have tax-free treatment while the modification is fully taxable to the issuer.

Adopting the decoupling approach would not be charting new territory. There are many provisions in the current rules applicable to debt instruments that require a holder or an issuer to adjust its interest (or OID) inclusion or deduction to be an amount different from the standard amount that would be calculated based on the adjusted issue price and the remaining payments on the debt instrument. For issuers, these include Treas. Reg. § 1.163-7(c), under which repurchase premium in certain debt-for-debt exchanges is amortized over the term of the new debt instrument as if it were OID, and Treas. Reg. § 1.163-7(e), under which an issuer must adjust its interest deductions in connection with qualified reopenings. For holders, interest and/or OID inclusions may be adjusted by reason of acquisition premium or amortizable bond premium; in the case of contingent payment debt instruments, differences between basis and adjusted issue price also give rise to OID adjustments. For either a holder or an issuer, integrating a debt instrument with a hedge under Treas. Reg. §§ 1.1275-6 or 1.988-5 can cause the taxpayer's interest inclusions or deductions to differ from those of the other party to the debt instrument.[94]

On balance, therefore, we believe that a decoupling approach could allow Congress to tailor a solution to the problems of debt issuers undergoing debt modifications while not adversely impacting holders. Although the decoupling approach would create some asymmetry between holders and issuers, this would not be a true change from current law and, in fact, would arguably generate more appropriate results given the different considerations applicable to the two groups.

However, should Congress reject the decoupling approach described above, it could enact a version of Proposed Section 1274B along with a companion rule for holders providing relief from

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[94] Although issuers and holders would recognize different amounts of OID under a decoupling approach, that fact should not adversely impact information reporting to the holder. The required amount of OID to be reported could still be calculated based on the adjusted issue price as determined under current rules.

noneconomic gain recognition that could result from the application of Proposed Section 1274B. To this end, the Camp Proposal included a new Section 1037 of the Code that would mitigate the potential gain recognition to holders that would result from application of Proposed Section 1274B to the determination of issue price ("Proposed Section 1037"). Proposed Section 1037 would provide that:

> [n]o gain or loss shall be recognized to the holder of a debt instrument if such existing debt instrument is exchanged solely for a new debt instrument (whether by exchange or significant modification) issued by the same issuer.

We note that under current law, significant modifications of debt already qualify for nonrecognition treatment to the holder in cases where both the modified and unmodified debt qualify as "securities," Proposed Section 1037 would expand nonrecognition to include all debt exchanges and deemed exchanges, including debt issued by partnerships and debt that does not qualify as a security.

In the context of debt-for-debt exchanges by distressed issuers, Proposed Section 1037 would prevent holders from recognizing gain by reference to the original issue price (typically the face amount) of a debt instrument that might never be paid in full. In that case, Proposed Section 1037 would operate as intended. However, Proposed Section 1037 would also apply to situations in which an investor purchased publicly traded debt of an issuer (whether or not financially distressed) with market discount (or bond premium), and the debt either undergoes a significant modification or is exchanged for other debt of the same issuer. The holder in any such case would be able to defer taking market discount that accrued prior to the exchange into income until the debt matures, which may in the context of non-distressed debt be contrary to tax policy given that market discount in that context functions like interest.[95] Should Congress consider enacting a provision similar to prior Proposed Section 1037, it should consider these consequences and potential fixes.[96] Nonetheless,

[95] We noted in a prior report that Proposed Section 1037 could, theoretically, enable a non-distressed issuer and holder of debt with market discount to enter into an abusive arrangement whereby they would agree to successive extensions of the debt in order to defer the inclusion of market discount indefinitely. *See* Camp Proposal Bar Report.

[96] The Camp Proposal also proposed a new Section 1278, which would require secondary market purchasers of debt instruments to accrue market discount, subject to a cap, into income, replacing the existing elective regime. The concept of a cap would serve to prevent holders from being required to accrue market discount that is not interest-like but instead reflects the speculative nature of the debt. An alternative approach could be to require recognition, at the time of the debt exchange rather than as it

we do not believe these considerations detract materially from the appeal of the Camp Proposal, including Proposed Section 1037, as a solution to the concerns described in this Report.

ii. Expand 108(i) and 163(e)(5)(F) to address timing mismatches directly.

Alternatively, Congress could enact legislation along the lines of Sections 108(i) and 163(e)(5)(F) to address the timing mismatch created when a debt instrument is deemed to be reissued at a discount. As discussed above in Part III.e.i. of this Report, the deferral of the COD income inclusion afforded by Section 108(i)(1) coupled with the deferral of corresponding OID deductions pursuant to Section 108(i)(2) resulted, in most cases, with the temporal matching of COD income recognized with respect to the original debt instrument and the OID deductions on the new debt instrument. In connection with this rule, Section 163(e)(5)(F) suspended the otherwise applicable AHYDO provisions that would have disallowed the deduction of OID on a new debt instrument issued between September 1, 2008 and December 31, 2009 in exchange for a non-AHYDO debt instrument. The combination of these two provisions facilitated the reacquisition of depreciated debt instruments by reducing the tax mismatches that would otherwise arise from such acquisitions.

By itself, Section 108(i) would represent only a partial solution to the issues described above in Part IV of this Report, in that it would only mitigate the timing mismatch between COD income and corresponding OID. However, as long as the issuer recognizes both COD income and has OID deductions, even if those items are in the same year, the application of the AHYDO rules, Section 163(j) and the FTC Limitation rules may result in adverse consequences unless the COD income and OID deductions are treated in a parallel manner for these purposes.

Accordingly, should Congress pursue an approach similar to the one used in Section 108(i), it should couple those changes with legislation that would mitigate the impact of the AHYDO rules and to direct Treasury to allow the COD income recognized to offset the OID on the instrument for

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accrues, of market discount that has accrued to the date of the exchange, subject to a cap similar to that in the Camp companion proposal.

purposes of the Section 163(j) limitation and FTC Limitation. As a result, adopting an approach along the lines of Section 108(i) would require several additional technical provisions (or grants of regulatory authority, perhaps combined with a directive) to be inserted into the Code, which would introduce additional complexity into an area where certainty is critical to taxpayers. As a result, we believe that a legislative approach based on former Section 108(i) would be inferior to an approach based on the reinstatement of a version of Section 1275(a)(4) along the lines of the Camp Proposal.

To address the AHYDO issues, Congress could re-enact Section 163(e)(5)(F) along with Section 108(i).[97] If Congress were to view Section 163(e)(5)(F) as too taxpayer-favorable, Congress could consider a limited version of Section 163(e)(5)(F) that applies to prevent the disallowance of OID only to the extent related COD income was taken into account in the debt-for-debt exchange. However, the complexity associated with such an approach might militate in favor of retaining the original Section 163(e)(5)(F) design without such a limitation.

One design question that would arise if Congress were to pursue an approach based on prior Section 108(i) would be the length of time for which the issuer is permitted to defer the recognition of COD income. As noted above, Section 108(i) allowed the issuer to defer the COD income over a fixed period of five years (beginning 4 or 5 years from the reacquisition date, depending on when the election was made). Such a rule would be simple and easy for the IRS to administer. On the other hand, if the new debt has a term that extends beyond this period, the deferral period might not be sufficient to enable the desired matching. One possibility would be to require the issuer to take deferred COD income into account over a period of time that matches the term of the new debt instrument, potentially subject to a limit on the number of years from the date of the exchange.

Another design question would be whether such a rule would apply only to debt-for-debt exchanges or would also apply to COD income arising in other contexts (e.g., repurchases for cash,

[97] While Section 163(e)(5)(F)(iii) provides the Secretary with authority to suspend the AHYDO rules in periods where the Secretary determines that the application of the AHYDO rules is inappropriate *in light of distressed conditions in the debt capital markets*, we believe that such relief is justified and appropriate regardless of the state of macroeconomic conditions.

equity or other property). Section 108(i) was not limited to debt-for-debt exchanges, but applied more broadly; on the other hand, a new version of Section 108(i) could be drafted to apply only to debt-for-debt exchanges where the COD income matches newly-created OID.

Section 108(i) was enacted as a temporary relief provision, as was Section 163(e)(5)(F) (subject to the discretion of the Secretary to extend such relief to later years where warranted due to the state of the debt capital markets). The temporary nature of Section 108(i) reflects the fact that it was specifically meant to deal with the macroeconomic conditions of the financial crisis. However, we note that the legislative history does not express a specific policy rationale for limiting relief to those years.[98] In fact, the IRS and Treasury understood the deferral rules of Section 108(i) to be generally "intended to facilitate debt workouts and to alleviate taxpayer liquidity concerns by deferring the tax liability associated with COD income," which concerns are not limited to times that the capital markets are in distress.[99] Our proposal would be for any proposed legislation offering relief similar to Section 108(i) to apply irrespective of the macroeconomic environment and whether or not the issuer is distressed.

One advantage of a Section 108(i)-based approach is that it could be enacted without upending the existing legal framework for debt exchanges described above, including the issue price rules, the significant modification rules of Section 1001 and the rules defining COD income. As a result, it would not affect the treatment of holders and would therefore not require any holder-specific companion rules, in contrast to the Section 1274B proposal discussed above.[100]

b. *Avenues for Administrative Relief*

This Part V.b. describes administrative actions that the Treasury Department and the IRS can take to alleviate the issues described above in the absence of Congressional action. We believe that the Treasury Department and the IRS could issue regulations under Section 446(b) to permit the

[98] *See* H.R. Rep. No. 16, 111th Cong., 1st Sess. 561-565 (2009).
[99] Preamble to Treasury Decision 9497 (8/13/2010).
[100] We note that we have previously suggested changing the treatment of holders in our reports. *See* 1990 Act Bar Report at 83-90; 2011 Distressed Debt Bar Report at 13 (proposing a general rule to match the character and timing of inclusions and deductions in a debt-for-debt exchange).

recognition of the COD income on a schedule that matches that of the related OID deductions accruing on a modified instrument.[101] Additionally, we believe that the Secretary has the authority to once again suspend the application of the AHYDO rules by application of Section 163(e)(5)(F) as well as the authority to issue regulations to suspend the AHYDO rules in debt-for-debt exchanges pursuant to Section 163(i)(5).[102] We also believe there is authority under Section 163(j) for Treasury to promulgate regulations that would solve at least some of the Section 163(j) issues described above, which the Tax Section will address in an upcoming report on the final regulations recently issued under Section 163(j). Finally, we would encourage the Treasury Department and the IRS to adopt regulations that would source the COD income in the same manner as interest expense is apportioned for purposes of the FTC Limitation. These regulatory changes would mitigate the adverse impacts on issuers from debt-for-debt exchanges without requiring legislative relief.

i. Timing

First, we recommend that the Treasury Department and the IRS consider a rule pursuant to Section 446(b) under which the recognition of COD income created as a result of a debt-for-debt exchange would be taken into account on a constant yield basis over the term of the new debt instrument.[103] We believe that when an exchange of a publicly traded debt instrument for a new debt instrument creates both COD income and OID deductions in an equal amount, matching the inclusion of the income and the corresponding deductions is consistent with a clear reflection of income. But for the public trading of the debt instrument, the issuer would not have incurred the COD income or the OID deductions.

We strongly believe that Treasury has regulatory authority under Section 446(b) to permit issuers to amortize any COD income realized in a debt-for-debt exchange over the term of the new

[101] Note that this Report only recommends this approach with respect to a debt-for-debt exchange with respect to the portion of the COD income that corresponds to OID deductions on the newly issued or deemed newly issued debt instrument.
[102] *See* Section 163(i)(5)(F)(iii). However, the statutory language could be read to limit the authority to extend the applicability of Section 108(i) to periods immediately following December 31, 2009.
[103] See 2011 Public Trading Bar Report for discussion of a prior recommendation along these lines.

debt instrument so as to align the recognition of COD income with the accrual of OID on the debt instrument.[104] Section 446(b) provides that if the method of tax accounting used by a taxpayer does not clearly reflect income, taxable income is computed under such method as, in the determination of the Commissioner, clearly reflects income.[105] The Treasury Department has broad authority to establish methods of tax accounting that clearly reflect income,[106] both overall methods of accounting as well as specific methods with respect to any item of income or expense.[107] Treasury's authority to require a method of accounting that results in a clear reflection of income applies even if the method of accounting is not expressly authorized by the Code.[108]

The Treasury Department and the IRS have issued regulations under the authority of Section 446(b) to require specific methods of accounting for certain types of transactions. For example, a set of intricate rules contained in Treas. Reg. § 1.446-3 governs the timing of income, deductions, gains and losses on notional principal contracts; under these rules, nonperiodic payments must be

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[104] The Tax Section has articulated this position in at least three prior reports. *See* New York State Bar Ass'n Tax Section Report No. 1175, *Report on Revenue Procedure 2008-51* (January 20, 2009); New York State Bar Ass'n Tax Section Report No. 1209, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273 and Related Issues* (March 30, 2010); 2011 Public Trading Bar Report.

[105] Treas. Reg. § 1.446-1(b).

[106] *United States v. Hughes Properties, Inc*., 476 U.S. 593 (1986); *Thor Power Tool Co., v. Comm'r*, 439 U.S. 522 (1979); *Hansen v. Comm'r,* 360 U.S. 446 (1959); *Lucas v. American Code Co.*, 280 U.S. 445 (1930).

[107] *See Thor Power Tool*, 439 U.S. at 531; *Wal-Mart Stores Inc., et al v. Comm'r*, TC Memo (RIA) 1997-1 aff'd 153 F.3d 650 (8th Cir. 1998). *See also Charles Morgan, Bridge Loans-Confronting Tax Issues Triggered by the Recent Economic Downturn*, J. Tax. Fin. Prod., Vol. 7, Iss. 4 (2009) (suggesting that Treasury has ample authority to promulgate regulations under Section 446(b) to require that COD income recognized in connection with debt-for-debt exchanges be amortized into income as an offset to OID over the duration of the new debt instrument).

[108] *See e.g., Johnson v. Comm'r,* 184 F.3d 786 (8th Cir. 1999) (IRS did not exceed its authority in requiring taxpayer to recognize income with respect to vehicle service contracts when the contracts were sold, rather than when the services were performed or the contract was terminated, even though taxpayer's method was not irrational); *In re EWC, Inc. v. IRS*, 114 F.3d 1071 (10th Cir. 1997) (affirming a decision by the District Court for the Western District of Oklahoma that although Section 448 of the Code prohibited the taxpayer from using the cash accounting method, it did not prohibit the IRS from treating the taxpayer as a cash method taxpayer in its audit and assessment of tax where the taxpayer prepared its return under the cash accounting method, that method had always been used by the taxpayer and the method clearly reflected income); *see also* Rev. Proc. 2001-10, modifying Rev. Proc. 2000-22 (permitting the IRS to exercise discretion under Section 446(b) and Section 471 to except certain taxpayers from the requirement to account for inventories and to allow them to use the cash method of accounting to account for sales of merchandise, which normally must be accounted for on an accrual basis).

taken into account over the term of the contract, rather than at the time of payment or receipt.[109] Similarly, Treas. Reg. § 1.446-4, which applies to hedging transactions, requires that income, deduction, gain, and loss match the timing of the income, deductions, gains or losses from the hedged item rather than being recognized when realized.[110]

The preamble to Treas. Reg. § 1.446-4 in its proposed form indicated that "the proposed regulations invoke the Commissioner's authority under Sections 446(b), 451, and 461 to require that a taxpayer's method of accounting for hedging transactions clearly reflect income" and that "[i]n general, the proposed regulations require a taxpayer that enters into a hedging transaction as defined in [Treas. Reg. §] 1.1221-2(b) to reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged."[111]

In a debt-for-debt exchange resulting in COD income, the COD income is realized solely because of the operation of Section 108(e)(10) and the 2012 Final Regulations relating to the definition of issue price; similarly, OID on the new debt results solely from the issue price rules. The outstanding principal amount of the new debt instrument, however, may remain unchanged from the outstanding principal amount of the old debt instrument and the issuer may be legally obligated to repay the same amount after the exchange. Thus, requiring the issuer to recognize COD income upon the occurrence of the exchange may not result in the "clear reflection of income."

We believe that a regulation requiring amortization of COD income to match the related OID deductions would not conflict with the congressional intent behind the 1990 repeal of Section 1275(a)(4) and adoption of Section 108(e)(10). The main reason expressed by Congress for these statutory changes was to address concerns about taxpayer electivity. Nothing in the legislative history of the repeal of Section 1275(a)(4) or the enactment of Section 108(e)(10) indicates that

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109 Treas. Reg. Section 1.446-3(f)(2) (nonperiodic payments generally must be recognized over the term of a notional principal contract); Preamble to Prop. Treas. Reg. Section 1.446-3, 2004-1 C.B. 655 (addressing method of accounting for contingent nonperiodic payments).
110 Treas. Reg. § 1.446-4(b).
111 Preamble to Prop. Treas. Reg. § 1.446-4, 1993-2 C.B. 615.

Congress focused on the current inclusion by the issuer of the entire amount of COD income measured by the depreciation in value of the debt and the creation of a corresponding amount of OID.[112]

We note that, if the principles of Section 446(b) are used to alleviate the COD burden on an issuer, they should apply equally when a debt instrument in a debt-for-debt exchange results in bond repurchase premium and related amortizable bond premium on the new debt. The new rule would require amortization of any such repurchase premium over the term of the new debt instrument, which would essentially offset the reduction in the interest deductions on the new debt instrument arising from the associated amortizable bond premium.[113]

ii. Section 163(e)(5)

Although relief under Section 163(e)(5)(F) generally applied to AHYDOs issued from September 1, 2008 to December 31, 2009, Section 163(e)(5)(F)(iii) granted the Secretary the authority to apply this exclusion to debt instruments issued after December 31, 2009 if the Secretary determines that such application is "appropriate in light of distressed conditions in the debt capital markets."[114] We believe that such relief is justified and appropriate regardless of the state of macroeconomic conditions. However, should Treasury view this statutory language as limiting, we note that Section 163(i)(5) expressly grants the Secretary the authority to issue regulations "as may be appropriate to carry out the purposes of […] subsection (e)(5) [...]." Section 163(e)(5) was enacted to regulate highly leveraged buyouts and recapitalizations in cases where the issuer does not have adequate current cash flow to support the creation of such leverage. It was not meant to punish issuers that are restructuring outstanding non-AHYDO indebtedness and whose OID is

[112] See 2011 Public Trading Bar Report.
[113] *See* Treas. Reg. § 1.163-7. Retirement premium is already required to be amortized if the issue price of the debt is determined under Section 1273(b)(4) or 1274.
[114] Section 163(e)(5)(F)(iii). We note that in Notice 2010-11, Treasury extended the temporary suspension of the AHYDO rules to debt issued in 2010, but with the added requirement that the new debt instrument would not be an AHYDO if its issue price were increased by the amount of any COD income realized by the issuer
upon the exchange; this effectively limited relief to cases where restructured debt was subject to the AHYDO rules solely due to value depression.

created as a technical matter due to the quirks of the issue price rules rather than by reason of the economic terms of the modified debt.[115] We believe that the Secretary has authority under Section 163(i)(5) to mitigate the inappropriate application of the AHYDO rules to debt-for-debt exchanges and deemed exchanges involving depreciated debt.[116]

iii. Section 163(j)

The final Section 163(j) regulations treat ordinary income on a debt instrument as interest income of the issuer when the income arises with respect to one of three types of debt instruments: a contingent payment debt instrument subject to the noncontingent bond method; a nonfunctional currency contingent payment debt instrument subject to Treas. Reg. § 1.988-6; or an inflation-indexed debt instrument subject to Treas. Reg. § 1.1275-7.[117]

Absent a special rule, COD income would be included in an issuer's ATI for the taxable year, generally increasing the issuer's Section 163(j) limitation for that year by 30% of the amount of COD income (and by 50% for taxable years beginning in 2019 and 2020).[118] In the case of a debt-for-debt exchange that produces COD income and offsetting OID, we believe that it is more appropriate to increase the issuer's Section 163(j) limitation dollar for dollar by the amount of COD income taken into account in each year in order to prevent a potential whipsaw to an issuer from inclusion of the COD income coupled with limited deductibility of the related OID. However,

[115] *See* H.R. Rep. No. 247, 101st Cong. 1st Sess. 1220 (1989) ("The committee believes that certain high-yield, long-term OID instruments and instruments that make payments in instruments of the issuer (e.g., so-called "payment-in-kind" (PIK) bonds) resemble equity for tax purposes. Other factors being equal, interest accruing in the form of OID or paid in other instruments of the issuer is riskier than interest paid currently in cash since ultimate payment of the interest is deferred. Likewise, long-term instruments bear greater risk of default than short-term instruments. Finally, the presence of a high return suggests that payment on the instrument depends on the profitability of the issuer's underlying business. Thus, high yield, long-term instruments that postpone the payment of interest have significant characteristics of equity. The committee believes that such obligations sufficiently resemble equity to be treated as preferred stock for Federal income tax purposes.").

[116] The legislative history contains no indication that Section 163(e)(5)(F) was meant to limit the scope of authority granted to the Secretary under Section 163(i)(5); however, if Treasury is concerned that the later-issued grant of regulatory authority pursuant to Section 163(e)(5)(F) does limit the scope of the broader grant of authority in Section 163(i)(5), Treasury can request that Congress issue a clarifying technical correction.

[117] Treas. Reg. § 1.163(j)-1(b)(22)(iii)(B).

[118] *See* Section 163(j)(10)(A)(i).

because the Tax Section intends to address the interaction between the COD rules and Section 163(j) comprehensively in a forthcoming report on the final Section 163(j) regulations, the Tax Section does not make a definitive recommendation with respect to Section 163(j) at this time.

iv. Section 904

As discussed above, OID created by a debt-for-debt exchange is required to be apportioned under the rules applicable to interest expense. If all of the related COD income is treated as U.S.-source income of the issuer (which is the general approach under current law in the absence of a specific source rule), the proportion of the issuer's taxable income allocated to foreign sources is artificially reduced for purposes of the FTC Limitation. We believe this mismatch calls for a solution similar to the one proposed to address the Section 163(j) issue discussed above: essentially treating COD income as negative interest expense for purposes of the FTC Limitation.

We recommend that, along with our timing recommendation in Part V.b.i., the Treasury Department and the IRS require a U.S. issuer to source COD income arising in a debt-for-debt exchange in accordance with the principles of the interest expense apportionment rules of Treas. Reg. § 1.861-9T.[119] Such a rule could be modeled on expired Treas. Reg. § 1.861-9T(b)(6), which generally treats income from transactions that alter the effective cost of borrowing as reducing the taxpayer's interest expense that must be apportioned. For example, if a taxpayer issued floating-rate debt and entered into a floating-to-fixed interest rate swap, the taxpayer could treat income on the swap as reducing the interest expense on the debt.

We believe that, at least in the case of a debt-for-debt exchange of publicly traded debt, the resulting COD income and corresponding OID are sufficiently related to justify netting them in this manner for purposes of the FTC Limitation.[120] We note, however, that absent a change to the timing rules, our proposal would not fully alleviate the FTC Limitation issues posed by the creation of COD income and OID deductions resulting from debt-for-debt exchanges because the increases and

[119] Our proposed sourcing rule could be extended to apply to all COD income.
[120] We note that this approach only solves the issue if Treasury also adopts a timing rule along the lines of the one proposed in Part V.b.i above.

decreases to the FTC Limitation would occur in different years and there is no ability to carry forward or carry back excess foreign tax credits in the Section 951A category and excess foreign tax credits in the other categories can only be carried back one year and forward ten years.[121]

[121] Section 904(c).