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Report No. 1447
January 25, 2021

The Honorable Mark Mazur
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The Honorable Charles P. Rettig
Commissioner
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The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
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Washington, DC 20224

Re: *Report No. 1447 – Report on Section 163(j) and the COD Income Rules*

Dear Messrs. Mazur, Rettig, and Paul:

I am pleased to submit our Report No. 1447 commenting on issues involving the interaction of the interest limitation rules of Section 163(j) and the rules relating to cancellation of indebtedness ("COD") income.

We commend the Internal Revenue Serivce and the Department of the Treasury for their thoughtful guidance in the final and proposed regulations that have been issued thus far under Section 163(j). Guidance has not yet been issued regarding the extent to which COD income can be offset by disallowed business interest expense carryforwards. This report sets forth our views on the subject.

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

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assist in any way.

Respectfully submitted,

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Report No. 1447

New York State Bar Association

Tax Section

Report on Section 163(j) and the COD Income Rules

January 25, 2021

CONTENTS

I. INTRODUCTION

This report ("**Report**") of the New York State Bar Association Tax Section requests guidance from the Internal Revenue Service (the "**IRS**" or "**Service**") and the Department of the Treasury (together with the IRS, "**Treasury**") on issues relating to the interaction of Section 163(j)[1] and the rules relating to cancellation of indebtedness ("**COD**") income.[2] In particular, this Report addresses whether, and to what extent, COD income should be treated as interest income for purposes of Section 163(j), and whether any exclusions, such as Sections 108(e)(2) or 111, or tax benefit principles should apply in the case of COD income related to prior accruals of interest which were disallowed under Section 163(j).

II. SUMMARY OF RECOMMENDATIONS

1. Subject to the recommendations below, we recommend that Treasury confirm that COD income is not treated as interest income *per se* for purposes of the Section 163(j) limitation. Although we believe that there are reasonable arguments as to why COD income can, and should, be characterized as interest income for this purpose, we believe that the definitions of interest income and interest expense should be symmetrical. Since the final regulations under Section 163(j)[3] (the "**Final Regulations**") generally define interest expense in a manner consistent with general tax principles as compensation for the use or forbearance of money, we believe that the definition of interest income should not be broader.

2. We recommend that Treasury permit taxpayers to use disallowed business interest expense ("**BIE**") carryforwards[4] to offset COD income that represents a "recapture" of certain prior accruals of BIE. We did not reach a complete consensus, however, on the proper scope of relief. Views differed on two issues.

   The first concerned the nature of COD income that can be fairly viewed as "recapturing" prior accruals of BIE. A majority of the Tax Section's executive committee (the

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[1] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended as of the date hereof (the "**Code**"), and all "Reg. §" and "Reg. §" references are to the Treasury regulations promulgated or proposed to be promulgated thereunder.

[2] The principal author of this report is Shane Kiggen, with substantial contributions from James Coss and Christina Tacoronti. Helpful comments were received from Michael Alcan, William Alexander, Kim Blanchard, Andy Braiterman, Benjamin Brookstone, Stuart Goldring, Larry Garrett, Andrew Herman, Kevin Jacobs, Stephen Land, Jiyeon Lee-Lim, John Lutz, Jeff Maddrey, William McRae, Michael Mollerus, Yaron Reich, Jason Sacks, Michael Schler, Linda Swartz, Shun Tosaka, Philip Wagman, and Gordon Warnke. This report reflects solely the views of the New York State Bar Association Tax Section and not those of the NYSBA Executive Committee or the House of Delegates.

[3] T.D. 9905.

[4] For convenience, this Report treats a disallowed BIE carryforward as including current-year BIE that would be disallowed under Section 163(j).

"**Executive Committee**") favor defining the "recapture" portion of COD income broadly to include COD income attributable to the cancellation of either accrued-but-unpaid BIE or principal. Under this broad view, COD income from a given debt instrument would be considered as "recapturing" all prior accruals of BIE on the instrument, regardless of whether the accrued interest had been paid. A minority, however, favor limiting the "recapture" portion of COD income to COD income attributable to the cancellation of accrued-but-unpaid BIE.[5] Under this narrow view, COD income from a given debt instrument would be considered as "recapturing" only prior accruals of unpaid BIE on the instrument.

The second issue concerned whether, and how, taxpayers with multiple debt instruments should be required to establish that the "recapture" portion of COD income (however defined) is reflected in a disallowed BIE carryforward. Some members would allow a taxpayer to use a disallowed BIE carryforward to offset "recapture" COD income whether or not the BIE that gave rise to the "recapture" COD income is reflected in the carryforward. But other members believe that some form of tracing is necessary to limit the scope of relief to situations in which the BIE giving rise to the "recapture" COD income produced no tax benefit. There was no clear majority view with respect to this second issue.

Thus, in principle, a disallowed BIE carryforward could be permitted to offset COD income arising on a given debt instrument to the extent of—

- Accrued-but-unpaid BIE on the instrument that is reflected in the disallowed BIE carryforward ("**Alternative #1**");
- All accrued-but-unpaid BIE on the instrument ("**Alternative #2**");
- Accrued BIE on the instrument that is reflected in the disallowed BIE carryforward ("**Alternative #3**"); or
- All accrued BIE on the instrument ("**Alternative #4**").

Although a majority of the Executive Committee favored Alternative #3 or #4, all agreed that the scope of relief should extend, at a minimum, to Alternative #1.

3. We recommend that Treasury issue guidance clarifying that Section 108(e)(2) applies to exclude the cancellation of BIE from gross income to the extent that payment of the BIE would have given rise to a disallowed BIE carryforward. Alternatively, if Treasury believes Section 108(e)(2) does not apply to the cancellation of deferred BIE, we recommend that

[5] For the avoidance of doubt, any reference to COD income from the cancellation of accrued-but-unpaid BIE includes COD income from the repurchase of a debt instrument with original issue discount ("**OID**") for an amount less than its adjusted issue price, to the extent of the accrued OID.

Treasury issue regulations or other guidance clarifying that tax benefit principles apply to exclude COD income attributable to the cancellation of deferred BIE.

4. Consistent with our recommendations in a prior report,[6] we recommend that Treasury modify the timing and character of COD income incurred in an actual or deemed debt-for-debt exchange to match any corresponding OID deductions.

5. We recommend that Treasury issue regulations subjecting the disallowed BIE carryforward to attribute reduction under Section 108(b), if it believes it has authority to do so. If Treasury does not believe it has the authority to add the disallowed BIE carryforward to the list of attributes in Section 108(b), we request that Treasury seek authority to do so. Although we make no recommendation as to the order in which the disallowed BIE carryforward should be reduced relative to other attributes under Section 108(b) and Reg. §1.108-7, we outline various alternatives.

III. BACKGROUND

A. Section 163(j)[7]

Section 163(j) limits the amount of BIE that may be deducted in a given taxable year to the sum of (i) business interest income ("**BII**") for the taxable year,[8] (ii) 30 percent of adjusted taxable income ("**ATI**") for the taxable year,[9] and (iii) floor plan financing interest for the taxable year.

Consistent with general U.S. federal income tax principles, the Final Regulations define "interest" as an "amount paid, received or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement."[10] "Interest expense" is interest that is paid or accrued, or treated as paid or accrued, for the taxable year.

BIE is defined as "interest expense that is properly allocable to a non-excepted trade or business or that is floor plan financing interest expense."[11] Any BIE not allowed as a deduction

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[6] New York State Bar Association Tax Section, Rep. No. 1443, *Report on Tax Consequences to Issuers of Debt Modifications and Exchanges* (Oct. 15, 2020).

[7] A detailed discussion of Section 163(j) and the Final Regulations is beyond the scope of this Report.

[8] BII does not include investment income within the meaning of Section 163(d).

[9] The Coronavirus Aid, Relief, and Economic Security (CARES) Act (the "**CARES Act**") changes the ATI limitation from 30 percent to 50 percent for taxable years that begin in 2019 or 2020.

[10] Reg. §1.163(j)-1(b)(22)(i). The Final Regulations also include in the definition of interest certain other deductible expenses. *See* 1.163(j)-1(b)(22).

[11] For purposes of Section 163(j), "business interest" does not include investment interest (as defined in Section 163(d)).

as a result of the Section 163(j) limitation is carried forward as business interest paid or accrued in the succeeding taxable year and treated as BIE in such succeeding taxable year.[12] Thus, the definition of BIE also includes "disallowed business interest expense carryforwards (as defined in paragraph (b)(11) of [Reg. §1.163(j)-1])."[13] Section 163(j)(6) and the Final Regulations define BII as "interest income includible in the gross income of a taxpayer for the taxable year which is properly allocable to a non-excepted trade or business."

A taxpayer's ATI is generally computed by taking the taxpayer's taxable income (determined without regard to the application of Section 163(j)) and making adjustments as set forth in the Final Regulations.[14] Thus, under current law, ATI is a category of residual income. ATI for each applicable taxable year is calculated without regard to a taxpayer's BIE and BII.[15] Section 163(j)(8)(B) further grants the Secretary authority to adjust the calculation of ATI.

Section 163(j) and the Final Regulations provide limited guidance on the treatment of items of income realized by an issuer with respect to its own debt. The Final Regulations provide rules treating as BII bond issuance premium (in excess of interest expense), income recognized on a contingent payment debt instrument (including a nonfunctional currency contingent payment debt instrument) and inflation-index debt instrument.[16] However, the Final Regulations do not contain similar rules for other items of income realized by an issuer with respect to its own debt—most significantly, COD income. Thus, by default, such items, including COD income, are taken into account as a component of ATI, unless treated as income attributable to an excepted trade or business.

B. <u>Cancellation of Indebtedness</u>

In *United States v. Kirby Lumber*,[17] the Supreme Court established that cancellation of a taxpayer's debt is generally includable in the taxpayer's gross income. In *Kirby*, the taxpayer was able to repurchase its own bonds for less than the amount the taxpayer received upon issuance of those bonds earlier in the year. The Supreme Court found that the taxpayer had experienced "an accession to income" to the extent of the difference between the value of property received upon issuance and the amount paid to retire the bonds. The Court's rationale, which is sometimes referred to as the "freeing-of-the assets" or "net worth" theory, is grounded in the observation that

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[12] Reg. §1.163-2(c)(1).

[13] Reg. §1.163(j)-1(b)(3).

[14] Reg. §1.163(j)-1(b)(43)

[15] Section 163(j)(9)(A)(ii).

[16] *See* Reg. §1.163(j)-1(b)(22)(iii)(A), (B).

[17] 284 U.S. 1 (1931).

the taxpayer in *Kirby* experienced an increase in net worth because the taxpayer was relieved of an obligation that encumbered certain assets of the taxpayer.

Congress codified the principles behind *Kirby Lumber* in Section 61(a)(11),[18] requiring current recognition in gross income forgiven principal and interest on indebtedness absent an exception.[19] The amount of COD income included in gross income generally equals the adjusted issue price ("**AIP**") of the cancelled debt over the sum of the cash, the issue price of any debt instrument, and the fair market value of any other property delivered in exchange for the debt.[20]

C. <u>Section 108</u>

Section 108 provides various exceptions to the general rule that COD income is included in gross income. In relevant part, Section 108 provides that gross income does not include amounts of cancelled indebtedness if "the discharge occurs in a title 11 case" (the "**Bankruptcy Exception**")[21] or the discharge occurs when the taxpayer is insolvent (the "**Insolvency Exception**").[22] However, except in limited circumstances, the exclusion of COD income under these exceptions is not permanent; the tax price for exclusion is a reduction of the tax attributes listed in Section 108(b).

Section 108(b) and Reg. §1.108-7 provide rules for the reduction of attributes and enumerate the attributes to be reduced. In general, the following attributes are reduced, in the following order, by the amount of excluded COD income: net operating losses ("**NOLs**"), general business credits, minimum tax credits, capital losses, tax basis, passive activity losses, and foreign tax credits.[23] Section 108(b) was not amended by the legislation informally known as the Tax Cuts

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[18] *See also* Reg. §1.61-12(a).

[19] In the context of final payments in settlement of distressed debt, as discussed further below, it is not entirely clear which portion of the COD income should be attributable to cancelled interest and which portion should be attributable to cancelled principal.

[20] *See* Section 108(e)(2)(A); Reg. §1.61-12(c)(2)(ii).

[21] A "title 11 case" is a case under title 11 of the United States Code (relating to bankruptcy), but only if the discharge of indebtedness relates to the bankruptcy case. Section 108(d)(2).

[22] Section 108(a)(1)(A), (a)(1)(B). Section 108(d)(3) provides that, for purposes of the Insolvency Exception, "insolvent" means the excess of liabilities over the fair market value of assets, determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. Prior to the enactment of Section 108, an insolvent taxpayer or a taxpayer in a bankruptcy proceeding generally would exclude COD income from gross income under case law and prior statutory law. *See* Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Law – Reorganizations, Carryovers and the Effects of Debt Reduction*, 29 TAX. L. REV. 228 (1974) (discussing the history of COD income rules and the exceptions for bankruptcy and insolvency under prior law).

[23] *See* 108(b)(1). A taxpayer can elect to reduce the basis of depreciable property first. *See* Section 108(b)(2); (b)(5). If the amount of COD income exceeds the taxpayer's attributes, there are generally no additional tax consequences (often referred to as "black-hole" COD)

and Jobs Act of 2017 (the "**Act**")[24] to include a disallowed BIE carryforward arising under Section 163(j).

In addition, Section 108(e)(2) provides an exclusion from gross income for the cancellation of a liability the payment of which would give rise to a deduction. The theory underlying Section 108(e)(2) is that there is no reason for the taxpayer to recognize income with respect to a deductible liability because the income and the lost deduction would wash. Additionally, discharge of a liability that is excluded under Section 108(e)(2) does not give rise to an attribute reduction under Section 108(b).

D. <u>Section 111</u>

Section 111 codifies the exclusionary prong of the common law tax benefit rule.[25] The tax benefit rule has historically been a rule of both inclusion and exclusion: (i) when an item has provided a tax benefit (*e.g.*, a deduction) and is later recovered it must be included in income; and (ii) when an item has not provided any tax benefit, the recovery of that item should be excluded from income.[26] As stated by the Supreme Court in *Hillsboro National Bank v. Commissioner*, the purpose of the tax benefit rule is to "achieve rough transactional parity" and eliminate distortions that would otherwise arise under the annual accounting system.[27]

Section 111(a) provides that "[g]ross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."[28] Section 111(c) provides that an increase in an unexpired carryover is "treated as reducing tax imposed by this chapter."

The Supreme Court in *Hillsboro* noted that Section 111 does not limit the application of the tax benefit rule, suggesting that both the inclusionary and exclusionary prongs of the tax benefit rule may apply in the certain circumstances in which Section 111 does not apply.[29] Thus, Section 108(e)(2), Section 111, and the tax benefit rule each can operate to exclude income when the taxpayer did not get the benefit of a deduction.

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[24] The Act is formally known as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", P.L. 115-97.

[25] *See, e.g., Barnett v. Commissioner*, 39 B.T.A. 864, 867 (1939); *South Dakota Concrete Prods. Co. v. Commissioner*, 26 B.T.A. 1429, 1432 (1932).

[26] *See Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 n. 10 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979).

[27] *Hillsboro Nat. Bank. v. Comm'r*, 460 U.S. 370, 387 (1983). The Supreme Court in *Hillsboro Nat. Bank* emphasized that the purpose of the tax benefit rule is to "approximate the results produced by a tax system based on transactional rather than annual accounting." *Id.* at 381.

[28] Section 111(a).

[29] *Id* at 383.

IV. DISCUSSION

A. Treatment of COD Income as BII *Per Se*

Some members of the Executive Committee believe that as a matter of statutory interpretation and policy, COD income should be treated as BII *per se* (the "**Per Se View**").

The rationale underlying the Per Se View is grounded in the structure and purpose of Section 163(j). Generally, Section 163(j)(1) provides that the amount of BIE allowed as a deduction for any taxable year shall not exceed the sum of 30 percent of the ATI of the taxpayer *plus* the BII of the taxpayer for that taxable year *plus* floor plan financing interest of such taxpayer for such taxable year.[30] This limitation is an aggregate determination that applies at the level of the taxpayer.[31] In addition, under Section 163(j)(7)(A), certain trades or businesses (an "**excepted trade or business**") are considered outside the scope of Section 163(j).[32]

Thus, Section 163(j) is a taxpayer-level aggregate calculation which limits the amount of any *net* BIE (i.e., the excess of BIE over BII) that can be deducted to 30 percent of a taxpayer's ATI.[33] To achieve this, Section 163(j) bifurcates those items of income and expense generated from the taxpayer's non-excepted trade or business from those items of interest or expense generated from the taxpayer's financing activities. Under Section 163(j)(8)(A), the starting point for calculating ATI is the taxable income of the taxpayer, computed without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a non-excepted trade or business, (ii) any BIE or BII, (iii) the amount of any NOL under Section 172, (iv) the amount of any deduction allowed under Section 199A, and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.[34] Thus, as noted, ATI is essentially a residual category of income with the result that, unless an item is specifically excepted from ATI, it is categorized as ATI.

Conversely, an item of income or expense is only BII or BIE if it is defined as such. Section 163(j)(5) provides that "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business.[35] Reg. §1.163(j)-1(b)(3)(i) further provides that BIE is interest expense that is properly allocable to a non-excepted trade or business, including disallowed

[30] Floor plan financing interest is essentially a component of BIE that is fully deductible under Section 163(j).

[31] Section 163(j)(1). *See also* Section 163(j)(4) (application at partnership or S corporation level); Reg. §1.163(j)-4(d)(2)(i) (application at consolidated group level).

[32] *See also* Reg. §1.163(j)-1(b)(44)(ii).

[33] Floor plan financing interest is essentially a component of BIE that is fully deductible under Section 163(j). In general, floor plan financing interest is not discussed in this report.

[34] In addition, Section 163(j)(8)(B) authorizes the Secretary to provide other adjustments to the computation of ATI.

[35] Business interest does not include investment interest within the meaning of Section 163(d).

BIE carryforwards under Reg. §1.163(j)-1(b)(11).[36] Similarly, under Section 163(j)(6), BII is 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.

Thus, the purpose of Section 163(j) can be described as limiting the extent to which a taxpayer can offset income generated from non-excepted trades or businesses with deductions attributable to the cost of capital deployed in such trades or businesses. In revising and broadening Section 163(j), Congress was concerned that "the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system."[37] Thus, Section 163(j) is intended to narrow the disparities that existed with respect to debt-financed versus equity-financed businesses, and the economic distortions that attended this preference.

Consequently, under the rationale of the Per Se View, all COD income should be treated as BII because this is the result most consistent with the structure and purpose of Section 163(j). Under this view, characterization of COD income as BII is more appropriate since COD income is an item of income arising from the taxpayer's financing activities. Stated differently, COD income is properly viewed as an adjustment to the overall cost of the issuer's debt capital. Conversely, characterization as ATI is not appropriate since the COD income is not generated in the course of the taxpayer's trade or business. Moreover, this treatment is consistent with the structure and purpose of Section 163(j), as characterization of COD income as BII does not permit the taxpayer to offset an increased amount of income generated in a non-excepted trade or business with deductions from its financing activities—rather, it permits an increased amount of deductions from the taxpayers financing activities to offset income from those financing activities (i.e., the COD income). Furthermore, such treatment is not violative of Congressional intent in enacting Section 163(j) as characterization of COD income as BII would generally not cause a taxpayer to undertake more leverage or distort choices regarding how to fund the taxpayer's business operations.[38]

However, a substantial majority of the members of the Executive Committee believe that the Per Se View is inconsistent with the current definition of interest expense in the Final Regulations under Section 163(j). As described above, Section 163(j) does not define the term "interest", but the legislative history indicates that "any amount treated as interest for purposes of the Internal Revenue Code is interest for the purposes of [Section 163(j)]."[39] In a prior report, we interpreted this as expressing an intent to apply new Section 163(j) more narrowly than its

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[36] As noted, BIE also includes floor plan financing interest expense, which is not generally discussed in this report.

[37] H.R. Rep. No. 115-409, 115th Cong., 1st Sess. (2017), p. 247.

[38] Presumably, any attempted abuse whereby a taxpayer intentionally would intentionally create COD income for purposes of avoiding or increasing its Section 163(j) limitation could be addressed by an anti-abuse rule, if not already covered.

[39] H.R. Rep. No. 115-409, 115th Cong., 1st Sess. (2017), p. 248.

predecessor, and recommended that Treasury and Service issue guidance confirming that Section 163(j) applies only to amounts treated as interest under the Code.[40] Moreover, while we noted that there are reasonable policy arguments that deductions for expenses that are the functional equivalent of interest ought to be limited in the same manner as interest deductions under Section 163(j), we recognized that it was difficult to determine the proper scope of such equivalents and questioned whether there would be authority for guidance applying new Section 163(j) to interest equivalents, absent a statutory amendment.[41] We also noted that there did not seem to be a principled justification for adopting an asymmetrical approach in determining the contours of what would be considered BIE and BII under Section 163(j).

Notwithstanding this commentary, the proposed regulations under Section 163(j) defined interest expense broadly to include amounts "that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis."[42] Consequently, loan commitment fees, debt-issuance costs, and guarantee payments would have been treated as interest under these proposed regulations. Commentators, including us, recommended narrowing the broad definition of "interest" in the proposed regulations in certain respects and continued to question whether Treasury possessed the authority to define interest as broadly as it did under the proposed regulations.[43]

Subsequently, the Final Regulations narrowed the definition of interest, excluding loan commitment fees, debt-issuance costs, and guarantee payments. While certain of our recommendations to narrow the definition of BIE could arguably be distinguished as not inconsistent with the broad interpretation of BII urged by the Per Se View,[44] the fact remains that a narrowed interpretation of BIE was urged and adopted in the Final Regulations and, as a result, the broad definition of BII necessary under the Per Se View could be viewed as an asymmetrical approach to the definition of BII and BIE that inures solely to the benefit of taxpayers.

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[40] *See* New York State Bar Association Tax Section, Rep. No. 1393, *Report on Section 163(j)* (March 28, 2018).

[41] *Id* at 12-13.

[42] T.D. 9905 (Sept. 14, 2020)

[43] *See* New York State Bar Tax Section, Rep. No. 1412, *Report on Proposed Section 163(j) Regulations* (Feb. 26, 2019).

[44] For example, in the context of fees related to the issuance of debt, we distinguished between payments made to a lender versus payments made to non-lenders. *Id* at 3 ("We believe that fees related to the issuance of debt that are paid to persons other than the lender should not be treated as interest and that fees paid to a lender should be treated as interest for Section 163(j) purposes if such fees are treated as creating or increasing original issue discount on the debt."). Similarly, in the context of hedges, we noted our concerns were rooted in questions of administrability. *Id* ("With respect to hedges we recommend several possible approached that are intended to provide a clear administrable standard for when a derivative has a close enough connection to a debt obligation to fall within the scope of Section 163(j).").

As a counter argument, supporters of the Per Se View note that, while the definition of BIE was pared back in the Final Regulations under Section 163(j), the preamble to those regulations clearly indicates that this was not due to any concerns regarding Treasury's authority to define BIE broadly.[45] In addition, because COD income arises directly from a transaction with the lender, it can be argued that the broad interpretation of BII urged under the Per Se View is not wholly inconsistent with our prior recommendations or the definition of BIE under the Final Regulations. Moreover, the Final Regulations contain an anti-avoidance rule, which can operate to characterize an item of expense that is "economically equivalent to interest" as BIE even though such item is not within the general definition of BIE.[46] In describing the purpose for this anti-avoidance rule, Treasury stated that "it would be inconsistent with the purpose of section 163(j) to allow transactions that are essentially financing transactions to avoid the application of section 163(j)." COD income arises directly from a transaction with the lender. The converse proposition is that it is inconsistent with the purpose and structure of Section 163(j) to limit the extent to which a taxpayer may offset income from its financing activities with deductions from its financing activities and, as a result, Treasury should adopt a similarly flexible and results-oriented approach for purposes of characterizing COD income. Consequently, the members supporting the Per Se View feel that this is the most appropriate approach in light of the purpose and structure of Section 163(j).

On balance, while we believe that there are credible arguments in favor of treating COD income as BII for purposes of Section 163(j), we believe that the definitions of interest income and interest expense should be symmetrical. Since the Final Regulations generally define interest expense in a manner consistent with general tax principles as compensation for the use or forbearance of money, the definition of interest income should be no broader and, consequently, we do not recommend adoption of the Per Se View.

B. <u>Availability of Disallowed BIE Carryforward to Offset "Recapture" COD Income</u>

Although we do not believe that COD Income should be treated as BII *per se,* we do believe that taxpayers should be permitted to use disallowed BIE carryforwards to offset COD income that

[45] 85 Fed. Reg. 56686, 56702 (Sep. 3, 2020) ("Contrary to the assertions made by many of the commenters, the Treasury Department and the IRS have the authority to prescribe rules relating to interest equivalents and an anti-avoidance rule. As noted in the preamble to the proposed regulations, there are no generally applicable regulations or statutory provisions addressing when financial instruments are treated as indebtedness for Federal income tax purposes or when a payment is 'interest.' Therefore, a regulatory definition of interest is needed in order to implement the statutory language of section 163(j).").

[46] Reg. §1.163(j)-1(b)(22)(iv)(A). In addition, under Reg. §1.163(j)-1(b)(22)(iv)(B), the corresponding amount of income to the interest equivalent is treated as BII, notwithstanding that such income is not technically within the definition of BII.

represents a "recapture" of prior accruals of BIE in appropriate circumstances. We did not reach complete agreement on the proper scope of relief, though. Our views differed as to two issues.

The first concerned the nature of COD income that can be fairly viewed as "recapturing" a prior accrual of BIE. All members of the Executive Committee agree that "recapture" COD income should comprise COD income attributable to the cancellation of accrued-but-unpaid BIE. However, opinions differed as to the limit of the concept. Some members would determine the "recapture" portion of COD income on a given debt instrument solely with reference to the cancellation of accrued-but-unpaid BIE on the instrument (*i.e.*, Alternative #1 and Alternative #2). Other members would go further and include not only cancellation of accrued-but-unpaid BIE but also cancellation of principal, to the extent of prior BIE payments on the instrument (*i.e.*, Alternative #3 and Alternative #4).

The second issue on which views diverged concerned whether, and to what extent, taxpayers with multiple debt instruments should be required to trace the "recapture" portion of COD income (however defined) to the disallowed BIE carryforward. Some members of the Executive Committee believe that tracing would be unnecessary and unduly complex; these members would allow a taxpayer to use a disallowed BIE carryforward to offset "recapture" COD income whether or not the BIE that gave rise to the "recapture" COD income is traceable to the carryforward (*i.e.*, Alternative #2 and Alternative #4). Other members of the Executive Committee, however, consider some form of tracing necessary to limit the scope of relief to situations in which the BIE giving rise to the "recapture" COD income produced no tax benefit (*i.e.*, Alternative #1 and Alternative #3).

While the Executive Committee did not reach a consensus on all these issues, all members agreed that, at a minimum, taxpayers should be permitted to use a disallowed BIE carryforward to offset COD income that represents a "recapture" of certain prior accruals of BIE that produced no tax benefit due to the application of Section 163(j) (*i.e.*, Alternative #1). On balance, we favor adoption of Alternative #3 or Alternative #4 (i.e., the broader definition of "recapture" COD income over the narrower definition in Alternative #1 and Alternative #2.

This section of the report is divided into two main parts. Part IV.B.1 focuses on COD income attributable to cancellation of accrued-but-unpaid BIE. Specifically, it first addresses the rationale for treating such COD income as "recapturing" prior accruals of such BIE and then takes up the question of whether taxpayers with multiple debt instruments should be required to trace cancelled BIE to their disallowed BIE carryforward (*i.e.*, Alternative #1 versus Alternative #2). Part IV.B.2 focuses on COD income attributable to cancellation of principal. It first addresses the arguments for and against treating such COD income as "recapture" COD income, and then concludes with a discussion of tracing question in the context of cancellation of principal (*i.e.*, Alternative #3 versus Alternative #4).

1. Cancellation of Accrued-But-Unpaid Interest

i. Rationale for Offsetting COD Income Attributable to the Cancellation of Accrued-But-Unpaid BIE with Disallowed BIE Carryforward

As a matter of policy, we believe that COD income attributable to the cancellation of accrued-but-unpaid BIE can be fairly viewed as "recapturing" prior accruals of that BIE. As such, we believe taxpayers should be permitted to offset such COD income with a disallowed BIE carryforward, at least where the cancelled BIE is reflected in the carryforward. Current law, however, does not allow for this result. To illustrate, consider the following case.

> *Case 1: Cancellation of BIE subject to Section 163(j) limitation*. In Year 1, Issuer accrues but does not pay $50 of BIE with respect to its sole outstanding debt. Issuer's Section 163(j) limitation for Year 1 is zero; thus, Issuer's accrued BIE of $50 is disallowed as a deduction in Year 1 and carried forward as a disallowed BIE carryforward. In Year 2, Issuer is discharged of its obligation to pay the $50 of BIE that accrued in Year 1.

Even though the cancelled BIE has yielded no tax benefit to Issuer, it cannot be excluded from Issuer's gross income under tax benefit principles. Section 111 does not apply because (i) the cancelled BIE has not been deducted[47] and (ii) the cancelled BIE continues to be reflected in Issuer's disallowed BIE carryforward. The judicially developed tax benefit rule, though broader than Section 111,[48] does not apply for similar reasons.[49]

Moreover, to the extent that Issuer's COD income is taxable, it is characterized as a component of ATI. As such, it can be offset by at most 30 percent of Issuer's disallowed BIE carryforward.[50] So, unless, in Year 2, Issuer generates sufficient ATI from other sources to absorb the balance of the disallowed BIE carryforward, the *timing* of Issuer's income will be distorted. Further, Issuer might never generate sufficient ATI (or BII) in a future year to absorb the balance

[47] *See* Section 163(j)(2) (noting that the amount of any business interest expense not allowed as a *deduction* is carried forward).

[48] *See Hillsboro Nat. Bank. v. Comm'r*, 460 U.S. 370, 388 (1983) ("[Section] 111 does not *limit* the application of the exclusionary aspect of the tax benefit rule.").

[49] Issuer's COD income cannot be excluded under Section 108(e)(2). That provision generally provides an exception to the recognition of COD income "to the extent that payment of the liability would have given rise to a deduction." Issuer cannot avail itself of the benefit of Section 108(e)(2) because Issuer accrued the BIE.

[50] As mentioned, the CARES Act changes the ATI limitation from 30 percent to 50 percent for taxable years that begin in 2019 or 2020.

of the disallowed BIE carryforward attributable to the cancelled BIE—a potential distortion in the *amount* of Issuer's income.[51] To the extent that the COD income is excludable from Issuer's gross income under the Bankruptcy Exception or the Insolvency Exception, Issuer must reduce certain specified tax attributes in the order and manner specified in Section 108(b) and Reg. §1.108-7. Because disallowed BIE carryforwards are not among such attributes, Issuer may be required to reduce attributes unrelated to the COD income or may recognize so-called "black-hole" COD income (*i.e.*, excluded COD income that does not result in any attribute reduction), again potentially distorting the timing and amount of Issuer's income.

Thus, in Case 1, because the COD income cannot be excluded under tax benefit principles, Issuer's income may be distorted if it is treated as a component of ATI for purposes of Section 163(j).

In a prior report,[52] we briefly noted two potential alternatives for mitigating such distortions:

- Exclude Issuer's cancellation of accrued-but-unpaid BIE from income and reduce Issuer's disallowed BIE carryforward by the excluded amount (the "**Exclusion Approach**"); or

- Characterize Issuer's COD income attributable to the cancellation of accrued-but-unpaid BIE as BII to the extent of the disallowed BIE carryforward, thereby "unlocking" an amount of Issuer's disallowed BIE carryforward sufficient to offset its COD income (the "**BII Approach**").

The rationale for the Exclusion Approach is rooted in tax benefit principles: no income should arise from the cancellation of accrued-but-unpaid BIE that did not give rise to a tax benefit. The rationale for the BII Approach is based on a related transactional accounting concept: the "relation-back" doctrine first developed in *Arrowsmith v. Commissioner*.[53] We discuss each alternative in detail below.

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[51] As noted in the preamble to the Final Regulations, Section 163(j) is not a method of accounting. It does not provide a mechanism "to ensure that, in every situation, a taxpayer will be able to deduct the business interest expense that the taxpayer was not permitted to deduct in one taxable year and was required to carry forward to succeeding taxable years."

[52] *See* New York State Bar Association Tax Section, Report on Select Issues Under Section 382 and 108 Involving Carryforwards of Recognized Built-in Losses and Business Interest (December 4, 2019); *see also* American Bar Association Section of Taxation, Comments Concerning Proposed Regulations under Section 163(j) and its Interaction with Section 108 (May 13, 2019).

[53] 344 U.S. 6 (1952). Specifically, in *Arrowsmith*, the shareholders of the corporation reported long-term capital gain upon the receipt of a distribution in complete liquidation of a corporation. In a later year, the shareholders were required to make a payment to the corporation's creditors. The shareholders argued that this payment should be deductible as an ordinary loss. However, the Supreme Court ruled that the payments were more appropriately treated as capital losses, as the liability of the shareholders "was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." Thus, because the prior liquidation was integrally related to the subsequent

(1) The Exclusion Approach

As mentioned, tax benefit principles do not apply to the cancellation of accrued-but-unpaid BIE disallowed under Section 163(j) because the disallowed BIE persists as a potential deduction in the form of a disallowed BIE carryforward. However, Treasury could remove this impediment by issuing regulations reducing a taxpayer's disallowed BIE carryforward. With the taxpayer's disallowed BIE carryforward denuded of the cancelled BIE, the tax benefit principles could be applied to exclude the cancellation of accrued-but-unpaid BIE from gross income.

The main attraction of the Exclusion Approach is that it would fully neutralize the accrual of nondeductible BIE in one year and cancellation of the BIE in a subsequent year, eliminating the potential distortion of the taxpayer's income that exists under current law.

In addition, the Exclusion Approach would fill a lacuna in the current-law treatment of cancellation of BIE excluded under the Bankruptcy Exception or the Insolvency Exception. As discussed above, as a toll charge for excluding COD from income under those provisions, taxpayers must reduce certain enumerated tax attributes in the order and manner specified in Section 108(b). Disallowed BIE carryforwards are not among the enumerated attributes. Thus, under current law, if a taxpayer has cancellation of accrued-but-unpaid BIE that is subject to a Section 163(j) limitation and the cancellation of BIE is excluded under the Bankruptcy Exception or the Insolvency Exception, the taxpayer's disallowed BIE carryforward is not subject to reduction under Section 108(b)—even though in such a case the disallowed BIE carryforward is the most logical attribute to reduce. The Exclusion Approach would eliminate this issue: the cancellation of BIE would be excluded from income (under tax benefit principles) and the disallowed BIE carryforward would be reduced (under regulations pursuant to Section 163(j)) producing the same overall effect as if the cancellation of BIE were excluded under Section 108(a) and the disallowed BIE carryforwards were included in the list of attributes subject to reduction in Section 108(b).

The Exclusion Approach would require a method for distinguishing cancellation of BIE from cancellation of principal if Alternative #1 or Alternative #2 is adopted. Under current law, there is uncertainty with respect to the application of the payment ordering rule, set forth in Reg. §1.446-2(e) (the "**payment ordering rule**"), on final and interim payments on distressed debt. While we take no position on how the payment ordering rule would apply if Treasury and the

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payments, transactional accounting principles dictated that the characterization of the subsequent item should be made by reference to the prior transaction that gave rise to that subsequent item.

See also Rev. Rul. 83-73 (indemnity payments made by a target company's shareholders characterized as capital contributions under "relation-back" doctrine); Rev. Rul. 2002-1 (applying "relation-back" doctrine to the treatment of options and restricted stock issued in connection with a spin-off).

Service adopt the Exclusion Approach, we nevertheless do recommend that Treasury and the Service resolve the issue with respect to distressed debt. Three options exist:

- <u>Follow the payment ordering rule</u>: One option would be to follow the payment ordering rule, which provides that a payment on a debt instrument is first interest to the extent of any accrued but unpaid interest and then principal.[54] However, as applied to unscheduled payments in satisfaction of a distressed debt, the payment ordering rule can produce inequitable results.[55] For example, a literal interpretation of the rule would require payment in settlement of a debt instrument to be included first as ordinary income to the extent of accrued interest and then to principal, causing the holder to realize ordinary gain and capital loss.[56] This approach may also create inappropriate results for issuers and would be contrary to, and override, the approach taken by many debtors in bankruptcy plans of reorganization where debtors designate payments as principal.

- <u>Permit parties to designate payments as principal or interest</u>. A second option would be to turn off the payment ordering rule for this purpose, reverting to the common law rule that generally respected the parties' designation as a payment of interest or principal.[57] This approach, however, would potentially be subject to abuse, such as the parties designating a greater amount of the payment as interest than what was accrued for purposes of maximizing the exclusion of COD income, absent a rule limiting a taxpayer's ability to designate interest beyond the amounts actually accrued.

- <u>Reverse the payment ordering rule</u>. A third option would be to reverse the payment ordering rule, so that final payments on a debt instrument would be treated first as a repayment of principal even if labeled as "interest" by the parties.[58] There is limited case law supporting this approach in the context of distressed debt.[59]

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[54] The payment ordering rule treats every payment under a debt instrument first as a payment of interest to the extent of any accrued but unpaid interest and then as a payment of principal. Section 446; Reg. §1.446-2(e). However, an exception exists for pro rata prepayments. *See* Reg. §§1.446-2(e)(4) and 1-1275-2(f).

[55] *See, e.g.,* New York State Bar Association Tax Section, Report on the Taxation of Distressed Debt (2011); David C. Garlock, *How to Account for Distressed Debt*, 2010 TAX. LAW. 37 (2010).

[56] Most practitioners believe this is the wrong result. *See, e.g.*, Garlock, *supra* note 55.

[57] *See, e.g., Mason v. US*, 453 F. Supp. 845 (N.D. Cal. 1978); *Greenwood v. Comm'r*, 34 B.T.A. 1209 (1936); Rev. Rul. 63-57, 1963-1 C.B. 103.

[58] Prior reports of the New York State Bar Association Tax Section have suggested this approach for final payments on distressed debt instruments. *See* New York State Bar Association Tax Section, *supra* note 37.

[59] *See, e.g., Drier v. Helvering*, 72 F.2d 76 (D.C. Cir. 1934); *Manhattan Mutual Life Ins. Co. v. Comm'r*, 37 B.T.A. 1041 (1938); *Manufacturer's Life Ins. Co. v. Comm'r*, 43 B.T.A. 867 (1974); *Newhouse v. Comm'r*, 59 T.C. 783 (1973); *Lackey v. Comm'r*, 1977-213 T.C. Memo; *Petit et al.*, 8 T.C. 228 (1947).

(2) The BII Approach

As an alternative to excluding the cancellation of BIE from income under tax benefit principles, Treasury could issue regulations under Section 163(j) treating Issuer's cancellation of accrued-but-unpaid BIE as BII to the extent of its disallowed BIE carryforward. Treating such COD income as BII would "unlock" an equal amount of the taxpayer's disallowed carryforward, leaving the taxpayer with offsetting items of income and deduction.[60]

As an initial matter, we believe that the definition of "interest" for purposes of Section 163(j) does not rule the BII Approach out of bounds. The question of whether an item of income realized by an issuer with respect to its own debt is "interest" in the first instance is different from the question of whether such an item, though not "interest" as defined in the regulation, should still be treated as such for purposes of Section 163(j) on account of its integral relationship to a prior BIE accrual. The latter question implicates the "relation-back" doctrine; the former does not.[61]

The "relation-back" doctrine makes plain that the tax characteristics of an item of income received by a taxpayer in one year may be determined by reference to the tax characteristics of an item of expense arising from an integrally related transaction in a prior year. We believe that the creation of the obligation in one year and its cancellation in a subsequent year are integrally related parts of a single transaction. Viewed in the light of the entire transaction, COD income attributable to the cancellation of accrued-but-unpaid BIE can be seen simply as the "reversal" of the prior accrual. Given the integral relationship between the items, under the "relation-back" doctrine, the tax characteristics of COD income should be determined with reference to the tax characteristics of the BIE accrual. If the accruals were characterized as BIE, the COD income should take an offsetting character (*i.e.*, BII).

[60] This approach would allow the taxpayer to use its Section 163(j) on a dollar-for-dollar basis as opposed to a reduced rate if the COD income were included in ATI.

[61] 344 U.S. 6 (1952). Specifically, in *Arrowsmith*, the shareholders of the corporation reported long-term capital gain upon the receipt of a distribution in complete liquidation of a corporation. In a later year, the shareholders were required to make a payment to the corporation's creditors. The shareholders argued that this payment should be deductible as an ordinary loss. However, the Supreme Court ruled that the payments were more appropriately treated as capital losses, as the liability of the shareholders "was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." Thus, because the prior liquidation was integrally related to the subsequent payments, transactional accounting principles dictated that the characterization of the subsequent item should be made by reference to the prior transaction that gave rise to that subsequent item.

See also Rev. Rul. 83-73 (indemnity payments made by a target company's shareholders characterized as capital contributions under "relation-back" doctrine); Rev. Rul. 2002-1 (applying "relation-back" doctrine to the treatment of options and restricted stock issued in connection with a spin-off).

Support for applying the "relation-back" doctrine to COD income can be found in analogous contexts. First, regulations under Section 163(j) treat items of gross income realized by an issuer from the reversal of prior BIE accruals on contingent payment debt instruments as BII.[62]

Second, for purposes of various other Code provisions, the Service has determined the tax characteristics of COD income with reference to the tax characteristics of prior accruals of interest. In Revenue Ruling 92-92,[63] the Service applied transactional accounting principles to rule that COD income should be characterized as income from a passive activity for purposes of Section 469 to the extent that a cancelled debt has been allocated to a passive activity expenditure under the rules of Reg. §1.163-8T. Under the facts of the ruling, the issuer recognized COD income upon the satisfaction of its obligation at a discount. At the time of discharge, 60 percent of the loan had been allocated to passive activity expenditures. Accordingly, the Service ruled that 60 percent of the COD income should be characterized as passive activity income because it was appropriate to "treat the income allocated to an expenditure as income from the activity to which the expenditure relates." Similarly, in Private Letter Ruling 9522008,[64] the Service ruled that COD income should be characterized as investment income to the extent that the interest expense has been allocated to investment income under Section 163(d). In the ruling, the taxpayer had incurred debt to acquire and maintain investment property and a portion of the interest expense had been carried over under Section 163(d). The Service, invoking the reasoning of Revenue Ruling 92-92, ruled that the COD income should be characterized as investment income within the meaning of Section 163(d) because "both the interest expense resulting in the carryover and the interest expenditure resulting in the COD income" had been allocated to investment income.[65]

Compared to the Exclusion Approach, the relief afforded by the BII Approach is imperfect in two respects. First, unlike the Exclusion Approach, the BII Approach would not necessarily neutralize the effect of the entire transaction on the affected taxpayer's overall tax liability. This is so because the BII Approach results in items of income and deduction that can have tax effect. As one example, whether a taxpayer is subject to the BEAT is determined in part on the basis of the taxpayer's gross receipts (as opposed to net income).[66] Furthermore, as discussed in greater detail in Part IV.B.1.ii, where some but not all of a taxpayer's BIE is due to related parties, the BII

[62] Reg. §1.163(j)-1(b)(22)(iii)(B) (treating as BII ordinary income recognized by an issuer with respect to (i) a negative adjustment with respect to a contingent debt instrument or (ii) a deflation adjustment with respect to inflation-indexed debt instrument). See also Reg. §1.163(j)-1(b)(22)(iii)(A)(1) (excess of bond issuance premium over interest expense treated as BII). Admittedly, the treatment of this non-COD reversal income could be viewed as animated by policy concerns distinct from those applicable to the treatment of COD income arising from fixed debt. For example, the treatment of negative adjustments for contingent payment debt instruments and deflation adjustments for dual-currency debt instruments may present more appropriate circumstances for the application of transactional accounting principles due to the inherent contingencies in such instruments. The same considerations do not apply to fixed debt.

[63] 1992-2 C.B. 103.

[64] (February 22, 1995).

[65] *See also* Priv. Ltr. Rul. 200952018 (Sep. 17, 2009) (reaching similar conclusion without analysis).

[66] Section 59A(e)(1)(B); Reg. §1.59A-2(d)(1).

Approach would require coordination with the BEAT rules to prevent the inappropriate "double counting" of related-party BIE. As another example, there is uncertainty as to the sourcing and basketing of COD income from the cancellation of cross-border debt.[67] Unless the COD income is sourced with reference to the interest expense apportionment rules (*i.e.*, Reg. §1.861-9T or Reg. §1.882-5), the taxpayer's income may be distorted to some degree.[68]

Second, the BII Approach would not resolve distortions resulting from the omission of disallowed BIE carryforwards from Section 108(b). Under the BII Approach, to the extent COD income attributable to accrued-but-unpaid BIE is excluded under Section 108(a), a taxpayer would not be able to "unlock" (and reduce) the corresponding attribute—the disallowed BIE carryforward. To rectify this issue, Treasury might consider treating the excluded BII as a notional item of income, solely for the purposes of creating BII to "unlock" the disallowed BIE carryforward. Doing so would at least put these taxpayers in the same position as if they actually had includable BII to the extent of the COD income attributable to the cancelled BIE.

Like the Exclusion Approach, the BII Approach would require a method for distinguishing cancellation of BIE versus cancellation of principal if Alternative #1 or Alternative #2 is adopted.

ii. Is Some Form of Tracing Required?

(1) Relevance of Other Ordering Provisions

For purposes of coordinating Section 163(j) with other provisions of the Code and regulations, current law contains ordering rules that allocate, to a certain degree, a taxpayer's total BIE to particular kinds of debts.[69] Should these rules dictate the extent to which a taxpayer should be permitted to use a disallowed BIE carryforward to offset COD income?

An example is the Base Erosion and Anti-Abuse Tax ("**BEAT**") rules of Section 59A. Very generally, Section 59A imposes a minimum tax on certain large domestic corporations that make significant deductible payments to foreign related parties (such payments, "**base erosion payments**"). To compute its base erosion payments, a Section 163(j)-limited corporate taxpayer that has BIE paid or accrued to both related and unrelated parties generally must determine how much of its deductible BIE is attributable to its related-party BIE. To facilitate this determination, Section 59A and the regulations thereunder provide ordering rules specifying how the amount of

[67] *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); New York State Bar Association Tax Section, Report on the Tax Consequences to Issuers of Debt Modifications and Exchanges (October 15, 2019).

[68] *See* New York State Bar Association Tax Section, Report on the Tax Consequences to Issuers of Debt Modifications and Exchanges (October 15, 2019).

[69] *See, e.g.,* Section 59A(c)(3); Reg. §1.163(j)-5.

BIE allowed under Section 163(j) is allocated between related-party and unrelated-party BIE.[70] Among them is Section 59A(c)(3), which generally provides that the amount of BIE allowed under Section 163(j) in a given year is treated first as related-party BIE (apportioned between foreign and domestic related parties) and then as unrelated-party BIE.[71] The effect is to accelerate the portion of deductible BIE that is added back for BEAT purposes, as the following example demonstrates.

> *Case 2: Interaction with BEAT ordering rules*. Issuer, a corporation subject to the BEAT, has outstanding two debts: Debt A, which is owed to a related party and Debt B, which is owed to an unrelated party. In Year 1, Issuer accrues but does not pay $50 of BIE with respect to each debt ($100 in total). Issuer's Section 163(j) limitation for Year 1 is $70; thus, $70 of Issuer's accrued BIE is allowed as a deduction in Year 1 and the remaining $30 is carried forward as a disallowed BIE carryforward. In Year 2, Issuer is discharged of its obligation to pay the $50 of BIE that accrued with respect to Debt A (the related-party debt) in Year 1.

Under the BEAT ordering rules, Issuer's $70 of BIE allowed under Section 163(j) is allocated first to its related-party BIE and then to its unrelated-party BIE. As result, for purposes of the BEAT, all of Issuer's $50 of related-party BIE, and $20 of Issuer's $50 of unrelated-party BIE, is treated as deducted in Year 1, and the remaining $30 of unrelated-party BIE is carried forward as a disallowed BIE carryforward. Given that, for BEAT purposes, the cancelled BIE on Debt A was treated as fully deducted in Year 1, should Issuer be permitted to offset its COD income from the cancellation of that BIE?

At first blush, it would seem that the BEAT ordering rules should have no bearing on the treatment of Issuer's COD income. Even if Issuer's ability to offset its COD income with its disallowed BIE carryforward should be conditioned on its ability to trace the cancelled BIE to its disallowed BIE carryforward, the BEAT ordering rules are not a suitable tracing mechanism. The goal of tracing is to identify the "true" source of the disallowed BIE carryforward, and the BEAT ordering rules, insofar as they arbitrarily prioritize the deductibility of related-party BIE over unrelated-party BIE, are antithetical to that goal. Furthermore, since most taxpayers will never be subject to the BEAT, allowing the BEAT ordering rules to control the treatment of COD income is particularly difficult to justify.

However, under the BII Approach, if taxpayers were permitted to offset COD income attributable to the cancellation of BIE that was deducted for BEAT purposes, additional rules would be required to prevent the "double-counting" of related-party BIE. To illustrate, suppose that a tracing approach is adopted for purposes of determining the extent to which disallowed BIE carryforwards can offset "recapture" COD income. Suppose further that this tracing approach

[70] Section 59A(c)(3); Reg. §1.59-1(b)(11).

[71] *See also* Reg. §1.59-1(b)(11).

deviates from the BEAT ordering rules by allocating on a pro rata basis the amount of BIE allowed under Section 163(j) in a given year. Thus, for purposes of applying the BEAT, all $30 of Issuer's disallowed BIE carryforward is allocated to Debt B; whereas for purposes of determining the characteristics of Issuer's COD income, half of Issuer's $30 disallowed BIE carryforward is allocated to Debt A and half to Debt B. Because $15 of Issuer's COD income is attributable to BIE that is treated as reflected in Issuer's disallowed BIE carryforward, $15 of Issuer's COD income is characterized as BII. As a result, Issuer can "unlock" $15 of its disallowed BIE carryforward. Absent a uniform method for identifying the source of the disallowed BIE carryforward, the question will arise whether, for purposes of the BEAT, the "unlocked" BIE should be treated as related-party BIE from Debt A (as implied by the BII Approach) or non-related-party BIE from Debt B (as implied by the BEAT ordering rules). We believe that the latter is the only sensible result. If the "unlocked" BIE is treated as from Debt A for BEAT purposes, then Issuer may be subject to BEAT in two separate years on the same related-party BIE.

Such inappropriate "double-counting" could be avoided in one of several ways. For starters, the Exclusion Approach could be adopted in lieu of the BII Approach. As mentioned, under the Exclusion Approach, "recapture" COD income is excluded from gross income and the related portion of the disallowed BIE carryforward is simply eliminated (as opposed to deducted). Thus, the potential for duplicative deductions of the same related-party BIE never arises. Within the context of the BII Approach, the "double-counting" of related-party BIE could be avoided by either (i) precluding taxpayers from characterizing as BII COD income attributable to the cancellation of BIE that was treated as deducted for BEAT purposes, or (ii) by specifying that any "unlocked" BIE that was previously treated as deducted for BEAT purposes will be treated as unrelated-party BIE for purposes of the BEAT. Neither option is wholly satisfactory. As discussed, the former option is lacking because the BEAT ordering rules seem ill-suited for purposes of determining the extent to which a taxpayer should be permitted to offset COD income with a disallowed BIE carryforward. The latter, however, would create considerable complexity, as taxpayers would be required separately track the composition of their disallowed BIE carryforward for purposes different Code provisions.

(2) Alternative Approaches

The Executive Committee did not reach a consensus on whether, and to what extent, taxpayers should be required to trace the cancelled BIE to the disallowed BIE carryforward. Below we consider three alternative approaches: the "**Aggregate Disallowed BIE Approach**", the "**With-and-Without Approach**", and the "**Pure Tracing Approach**". As discussed at IV.B.2 below, these approaches are also relevant to cancellation of principal to the extent that rules permit such cancelled payment obligations to be treated as recapturing previously accrued and deducted BIE.

(a) The Aggregate Disallowed BIE Approach

Under the Aggregate Disallowed BIE Approach, a taxpayer can use a disallowed BIE carryforward to offset COD income attributable to the cancellation of accrued-but-unpaid BIE whether or not the cancelled BIE is traceable to the carryforward. Thus, under the Aggregate Disallowed BIE Approach, COD income attributable to cancellation of accrued-but-unpaid BIE from one debt instrument could be freely offset by a disallowed BIE carryforward attributable to a different debt instrument.

The rationale behind the Aggregate Disallowed BIE Approach, according to its proponents, is three-fold.

First, tracing is unnecessary. The point of tracing is to distinguish that portion of a taxpayer's cancelled BIE which was allowed as a deduction from that portion which was disallowed and carried forward under Section 163(j). Distinguishing between these two amounts may be relevant under tax benefit principles but not on a "relation-back" analysis. For instance, suppose that a taxpayer accrues but does not pay of $100 of BIE on a given debt instrument in Year 1. Of that $100 of BIE, $60 is deducted in Year 1 and $40 is carried forward as a disallowed BIE carryforward. In Year 2, the $100 of accrued-but-unpaid BIE is cancelled. The $60 of cancelled BIE that was deducted cannot be excluded under tax benefit principles. However, the entire $100 of cancelled BIE can still be treated as BII under "relation-back" principles. The application of "relation-back" principles turns solely on whether there is an adequate nexus between the BIE accrual and the COD income to determine the character of the COD income with reference to the character of the accrual. In the case of COD income from the cancellation of accrued-but-unpaid BIE, the nexus between the COD income and the accrual could hardly be tighter. In some situations, characterizing the taxpayer's COD income in Year 2 as BII may have the collateral consequence of permitting the taxpayer to deduct BIE arising from a different debt that otherwise would have been disallowed under Section 163(j). However, according to the proponents of the Aggregate Disallowed BIE Approach, this is beside the point: application of the "relation-back" principles yields the appropriate result in the sense that it leads to a correct measurement of the net lifetime BIE from the debt that gave rise to the COD income.

Second, even if relief should be available only to the extent the cancelled BIE relates to a taxpayer's disallowed BIE carryforward, the Aggregate Disallowed BIE Approach does a tolerable job of achieving this objective. As the discussion below demonstrates, the Aggregate Disallowed BIE Approach reaches the same result as the With-and-Without Approach, a form of tracing approach, in many cases.

Third, the Aggregate Disallowed BIE Approach would be easier for the Service to administer, and for taxpayers to comply with, than would either of the tracing approaches discussed below.

However, other members of the Executive Committee reject these rationales. According to these members, allowing a disallowed BIE carryforward arising from one debt instrument to offset COD income arising on a different debt instrument is inconsistent with "relation-back" principles, to the extent the taxpayer is left better off than if it had never incurred the debt giving rise to the COD income in the first place. As discussed below, the Aggregate Disallowed BIE Approach can have this effect in cases where COD income attributable to the cancellation of BIE that was deducted in one year "unlocks" disallowed BIE arising from a different instrument in a later year. For this reason, opponents of the Disallowed BIE Approach believe that one of the following two alternative approaches should apply for determining the extent to which disallowed BIE carryforwards can offset "recapture" COD income.

(b) The With-and-Without Approach

The With-and-Without Approach is a limited form of tracing. It would identify the extent to which the cancelled BIE is reflected in the taxpayer's disallowed BIE carryforward by reference to the difference in the taxpayer's disallowed BIE carryforward with and without the cancelled BIE (the "**With-and-Without Approach**"). Specifically, a taxpayer would first recompute its disallowed BIE carryforward as if the cancelled BIE had never been accrued in the first place. The taxpayer would then compare its actual disallowed BIE carryforward (computed with the cancelled BIE) to its recomputed disallowed BIE carryforward (computed without the cancelled BIE). Arguably, the difference between these two amounts reflect the portion of the cancelled BIE attributable to the disallowed BIE carryforward.

The logic of the With-and-Without Approach is that COD income attributable to accrued-but-unpaid BIE on a given debt instrument can be conceptualized as an adjustment to the yield of that debt instrument. That is, had the parties known at the outset what the actual cash flows relating to the debt instrument would be, then the taxpayer would have accrued less BIE, and, thus, less disallowed BIE carryforward. Essentially, the With-and-Without Approach measures the marginal effect of the cancelled BIE on the amount of the taxpayer's disallowed BIE carryforward.

(c) The Pure Tracing Approach

The Pure Tracing Approach is a more thoroughgoing form of tracing than the With-and-Without Approach. It would involve an allocation of the taxpayer's disallowed BIE carryforward to the particular debts that gave rise to it. Specifically, under our formulation of the Pure Tracing Approach, the total amount of disallowed BIE in a given year would be allocated to particular debt instruments by treating (i) current-year BIE as deducted before any disallowed BIE carryforwards; (ii) disallowed BIE carryforwards as deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year; and (ii) the total amount of deductible BIE in a given year as allocated to particular debt instruments in proportion to their BIE accruals.[72] The cancelled BIE from a particular debt instrument would be deemed reflected in the portion of the disallowed BIE carryforward allocated to that debt.

Supporters of the Pure Tracing Approach believe that the scope of relief should be strictly limited to situations in which the cancelled BIE produced no tax benefit to the taxpayer. In their view, a rigorous tracing method, such as the Pure Tracing Approach, is needed to confine the scope of relief to its intendment. Under this view, the Aggregate Disallowed BIE Approach and the With-and-Without Approach are deficient because, in substance, each allows COD income attributable to the cancellation of BIE on one debt to be offset by BIE on another debt. Critics of the Pure Tracing Approach note, in addition to the policy arguments in favor of the other approaches, that the particular method chosen to associate disallowed BIE carryforwards with particular debt instruments is to some degree arbitrary.

(3) Illustration of the Alternative Approaches

The three approaches differ in key respects. To explore these differences, we compare and contrast the application of each approach in a series of cases.

(a) Section 163(j) Limitation Exceeds Total BIE in Single Year

Consider first a situation in which a Section 163(j)-limited taxpayer accrues BIE on multiple instruments in a single year.

> *Case 3.* Issuer has outstanding two debt instruments: Debt A and Debt B. In Year 1, Issuer accrues but does not pay $50 of BIE on each of Debt A and Debt B. Issuer's Section 163(j) limitation for Year 1 is $40; thus, $40 of Issuer's $100 of accrued BIE is allowed as a deduction in Year 1 and $60 is carried forward as a

[72] Insofar as it prioritizes the deduction of current-year BIE over disallowed BIE carryforwards and of older vintages of disallowed BIE carryforwards over newer ones, this formulation of the Pure Tracing Approach is consistent with the ordering rules coordinating the application of Section 163(j) and various other Code provisions. We note that other plausible alternatives exist. As one example, it could be argued that, given the fungibility of interest expense and the fact that the statute generally treats disallowed BIE carryforwards in the same manner as BIE incurred in a later year, prioritizing the deductibility absorption of older vintages of disallowed BIE carryforwards over newer ones will distort the true source of the carryforward. According to this argument, in lieu of such prioritization, total deductible BIE within a year should be allocated among the various vintages on a pro rata basis. Although this would minimize distinctions among BIE, we believe that there are countervailing administrability considerations that favor accelerating the use of older disallowed BIE carryforwards; in particular, this ordering method is similar to the approach taken in Section 172 with respect to NOLs, and since taxpayers are familiar with such ordering rules, we see no compelling reason to introduce different rules here. Moreover, this formulation is probably the simplest ordering method to apply in conjunction with Section 382 following an ownership change.

disallowed BIE carryforward. At the beginning of Year 2, Issuer's obligation to pay $50 of accrued BIE on Debt B is forgiven.

Application of Aggregate Disallowed BIE Approach. Under the Aggregate Disallowed BIE Approach, Issuer can offset its $50 of COD income from Debt B to the extent of its entire disallowed BIE carryforward, regardless of whether BIE accrued on Debt B gave rise to the carryforward or not. Thus, Issuer can use $50 of its disallowed BIE carryforward to offset its $50 of COD income.

Application of With-and-Without Approach. Under the With-and-Without Approach, Issuer can offset its $50 of COD income from Debt B to the extent of the difference in the Issuer's disallowed BIE carryforward with and without the cancelled BIE. Had Issuer not accrued any BIE on Debt (*i.e.*, the cancelled BIE) in Year 1, Issuer would have had $50 of total BIE for the year. Because Issuer's Section 163(j) limitation for Year 1 is $40, Issuer would have been allowed to deduct $40 of the BIE accrued on Debt B and would have carried forward the remaining $10 of BIE. Thus, since the difference in the taxpayer's disallowed BIE carryforward with the cancelled BIE ($60) and without the cancelled BIE ($10) is $50, the entire $50 of cancelled BIE from Debt B would be deemed reflected in the disallowed BIE carryforward. Thus, Issuer would be permitted to use $50 of its disallowed BIE carryforward to offset its COD income. This leaves Issuer in the same position that it would have been in had it never incurred the obligation to pay the cancelled BIE in the first place.

This case illustrates two general points. First, like the Aggregate Disallowed BIE Approach, the With-and-Without Approach effectively treats the first dollar of COD income attributable to accrued-but-unpaid BIE as reflected in the disallowed BIE carryforward. The justification for this ordering rule is that it is necessary to place the taxpayer in the same position it would have been in had it not incurred the cancelled BIE in the first place. Second, the With-and-Without Approach yields the same result as the Aggregate Disallowed BIE Approach where for all years in the "look-back period" the spread between a taxpayer's recomputed BIE and its actual BIE is less than the amount of its disallowed BIE that would otherwise be carried forward from that year.

Application of Pure Tracing Approach. Under the Pure Tracing Approach, Issuer can offset its $50 of COD income from Debt B only to the extent that the cancelled BIE is allocated to its disallowed BIE carryforward. For this purpose, Issuer would prorate its $60 of total disallowed BIE in Year 1 between Debt A and Debt B on the basis of their relative shares of Issuer's total BIE (*i.e.*, 50/50). Thus, of the $60 of current-year BIE reflected in Issuer's disallowed BIE carryforward, $30 would be allocated to Debt B. Accordingly, since only $30 of Issuer's cancelled BIE is treated as reflected in its carryforward, Issuer can exclude or treat as BII just $30 of its disallowed BIE carryforward—less than in the two foregoing approaches.

(b) Cancelled BIE Not Reflected in Disallowed BIE Carryforward – No Transactional Nexus

An important distinction between the Pure Tracing Approach and each of the other two approaches is that the Pure Tracing Approach would ensure that COD income on a particular debt is not offset to the extent that BIE on that debt has been deducted and not limited under Section 163(j), which may be relevant depending on one's view regarding the proper scope of relief. To illustrate this distinction, consider the following situation:

> *Case 4*. In Year 1, Issuer has outstanding a single debt instrument, Debt A, on which it accrues and pays $50 of BIE, all of which is disallowed as a current deduction under Section 163(j) and carried forward as a disallowed BIE carryforward.
>
> At the beginning of Year 2, Issuer issues a second debt instrument, Debt B, with an issue price of $800 and a stated redemption price at maturity of $1,000 (*i.e.*, Debt B has $200 of OID). In Year 2, Issuer accrues and pays $50 of BIE on Debt A and accrues (but does not pay) $50 of BIE on Debt B. Issuer's Section 163(j) limitation for Year 2 is $100; thus, of Issuer's $150 of available BIE (consisting of $100 of current-year BIE and $50 carried forward from Year 1), $100 is allowed as a deduction in Year 2 and the remaining $50 is carried forward as a disallowed BIE carryforward.
>
> At the beginning of Year 3, Issuer repurchases Debt B for $800, realizing $50 of COD income (excess of $850 AIP over $800 repurchase price).

<u>Application of Aggregate Disallowed BIE Approach</u>. Under the Aggregate Disallowed BIE Approach, Issuer can offset its $50 of COD income from Debt B to the extent of its entire disallowed BIE carryforward, even though none of the BIE accrued on Debt B gave rise to the carryforward.

<u>Application of With-and-Without Approach</u>. Under the With-and-Without Approach, Issuer can offset its $50 of COD income from Debt B to the extent of the difference in the taxpayer's disallowed BIE carryforward with and without the cancelled BIE. Had Issuer not accrued the cancelled BIE in Year 2, Issuer's would have had $100 of available BIE ($50 accrued in Year 2 and $50 carried from Year 1). Because Issuer's Section 163(j) limitation for Year 2 is $100, Issuer would have been allowed to deduct all $100 of its available BIE. Thus, since the difference in the taxpayer's disallowed BIE carryforward with the cancelled BIE ($50) and without the cancelled BIE ($0) accrued is $50, the entire $50 of cancelled BIE would be deemed reflected in the disallowed BIE carryforward. Thus, Issuer can offset its COD income in full—the same result as under the Aggregate Disallowed BIE Approach.

<u>Application of Pure Tracing Approach</u>. Under the Pure Tracing Approach, Issuer can offset its $50 of COD income from Debt B only to the extent that the cancelled BIE is allocated to its

disallowed BIE carryforward. In Case 4, Issuer's $50 disallowed BIE carryforward was created when BIE accrued on Debt A was disallowed in Year 1. In Year 2, all $100 of Issuer's deductible BIE in Year 2 would be allocated to its current-year BIE; thus, all of Issuer's $50 of disallowed BIE carryforward attributable to BIE accrued on Debt A in Year 1, and no BIE accrued on Debt B, would be carried forward to Year 3. Since none of Issuer's $50 disallowed BIE carryforward is traceable to Debt B, Issuer cannot exclude or treat as BII its COD income from Debt B.

(c) Cancelled BIE Not Reflected in Disallowed BIE Carryforward – Transactional Nexus

While the Pure Tracing Approach would ensure that COD income on a particular debt does not offset BIE on that debt that has been deducted and not limited under Section 163(j), it would also operate to deny relief in situations where relief is arguably warranted because a suitable transactional nexus between a disallowed BIE carryforward and COD income exists. By contrast, the With-and-Without Approach and the Aggregate Disallowed BIE Approach would afford relief.

By way of background, case law establishes that transactional accounting principles may extend to situations in which a taxpayer has contracted with multiple parties through separate agreements. In *Freedom Newspapers, Inc. v. Commissioner*,[73] the Tax Court examined a situation where the taxpayer was interested in acquiring certain newspaper assets which were only offered as part of a package which included newspaper assets that the taxpayer did not want to acquire. The seller of the newspapers had engaged a broker to handle the disposition. In order to induce the sale, the broker entered into a separate agreement with the taxpayer whereby the broker agreed to either sell the unwanted newspaper assets within a specified timeframe or provide the taxpayer with $100,000. Ultimately, the broker was unable to sell the unwanted assets and paid the taxpayer $100,000. Even though the taxpayer's agreement with the broker was not part of the original sales agreement between the purchaser and seller, the Tax Court ruled that the $100,000 should be treated as an adjustment to the purchase price rather than as ordinary income (in the nature of liquidated damages) as the Service argued. Thus, in certain circumstances, transactional accounting principles may appropriately extend to characterize an item of income or expense by reference to distinct agreements between the taxpayer and different parties. At the same time, in *Freedom Newspapers*, it was relevant that the taxpayer would not have entered into the purchase agreement with the seller if it had not made the separate agreement with the broker, thereby establishing an overarching integral link between the separate agreements. Thus, the lesson of *Freedom Newspapers* is that transactional accounting principles may potentially apply in a situation involving multiple parties and separate agreements, if there is an appropriate connection between them.

[73] 36 T.C.M. 1755 (1977).

To understand how the Pure Tracing Approach may operate to deny relief in situations where a suitable transactional nexus between disallowed BIE carryforward and COD income arguably exists, consider the following situation:

> *Case 5: Refinancing*. At the beginning of Year 1, Issuer issues Debt A, a $1,000 debt instrument providing for annual interest payments of 5 percent. On the last day of Year 1, Issuer issues Debt B, a $1,050 debt instrument, and uses the proceeds to repurchase Debt A, including the $50 claim for accrued-but-unpaid interest. Issuer's Section 163(j) limitation for Year 1 is $0; thus, all $50 of Issuer's BIE is disallowed as a current deduction under Section 163(j) and carried forward as a disallowed BIE carryforward.
>
> In Year 2, Issuer has a Section 163(j) limitation of $50. Issuer therefore deducts but does not pay $50 of BIE on Debt B and carries forward the $50 disallowed BIE arising with respect to Debt A in Year 1.
>
> In Year 3, Issuer's obligation to pay the $50 of BIE on Debt B that was deducted in Year 2 is forgiven.

For the reasons discussed in Case 4, the Issuer would be permitted to offset all of its COD income from Debt B with its disallowed BIE carryforward under each of the Aggregate Disallowed BIE Approach and the With-and-Without Approach. With respect to the Aggregate Disallowed BIE Approach, the amount of COD income does not exceed Issuer's $50 disallowed BIE carryforward. With respect to the With-and-Without Approach, as in Case 4, the difference in Issuer's disallowed BIE carryforward with the cancelled BIE is $50 and without the cancelled BIE would be $0, for a difference of $50, and, thus, Issuer can similarly offset its $50 of COD income.

By contrast, under the Pure Tracing Approach, none of Issuer's $50 of COD income would qualify for relief because the BIE that gave rise to the COD income relates to Debt B, whereas the BIE reflected in Issuer's disallowed BIE carryforward relates to Debt A. The correctness of this result is debatable. On one hand, the BIE arose on two formally different debt instruments, and in determining tax consequences of a transaction, form often prevails over substance. On the other hand, given the close factual connection between the two debts—Debt B is, from Issuer's perspective, a continuation of the obligation represented as Debt A—a compelling argument can be made that there is a sufficiently close link between Issuer's disallowed BIE carryforward and COD income to warrant treating the latter as "recapturing" the former under transactional accounting principles.

(d) Carryforward of Section 163(j) Capacity

As the following case demonstrates, a significant difference between the Aggregate Disallowed BIE Approach, on the one hand, and the With-and-Without Approach and Pure

Tracing Approach, is that the latter approaches limit the extent to which taxpayers can effectively carry forward Section 163(j) limitation from one year to another year.

> *Case 6*. Issuer has outstanding two debt instruments: Debt A and Debt B. In Year 1, Issuer accrues but does not pay \$50 of BIE on each of Debt A and Debt B (\$100 total), none of which is disallowed under Section 163(j).
>
> At the beginning of Year 2, Issuer is forgiven of its obligation to pay the \$50 of BIE on Debt B. In Year 2, Issuer accrues but does not pay \$50 of BIE on Debt A. Issuer's Section 163(j) limitation for Year 2 (computed without regard to the COD income) is zero.

<u>Application of Aggregate Disallowed BIE Approach</u>. Under the Aggregate Disallowed BIE Approach, Issuer can offset its \$50 of COD income from Debt B to the extent of its entire disallowed BIE carryforward arising from Debt A in Year 2, even though none of the BIE accrued on Debt B gave rise to the carryforward and Debt B was not even outstanding when the Year 2 interest on Debt A accrued. Because the forgiven interest was deducted in Year 1, the overall effect is similar to a shifting of Issuer's Section 163(j) capacity from Year 1 to Year 2. As noted below, this result is not unique to the Aggregate Disallowed BIE Approach; the same phenomenon arises, albeit to a lesser extent, under the With-and-Without Approach and the Pure Tracing Approach.

<u>Application of With-and-Without Approach</u>. Under the With-and-Without Approach, Issuer can offset its \$50 of COD income from Debt B to the extent of the difference in the taxpayer's disallowed BIE carryforward with and without the cancelled BIE. Had Issuer not accrued the cancelled BIE in Year 1, its disallowed BIE in Year 2 would still have been \$50. Since there is no difference in the Issuer's disallowed BIE carryforward with the cancelled BIE (\$50) and without the cancelled BIE (\$50), Issuer cannot exclude or treat as BII any of its \$50 of its disallowed BIE carryforward. Issuer can, however, partially offset its COD income with its disallowed BIE carryforward, to the extent the COD income increases Issuer's ATI. Thus, even under the With-and-Without Approach, the creation and the cancellation of Issuer's obligation has the effect of enhancing its Section 163(j) capacity relative to what it would have been if the obligation to pay interest on Debt B had not been incurred in the first place.

<u>Application of Pure Tracing Approach</u>. Under the Pure Tracing Approach, Issuer can offset its \$50 of COD income from Debt B to the extent of the difference in the taxpayer's disallowed BIE carryforward with and without the BIE accrued on Debt B. Since none of the BIE reflected in Issuer's disallowed BIE carryforward is attributable to Debt B, Issuer cannot exclude or treat as BII any of its \$50 of COD income—the same result as under the With-and-Without Approach.

2. Cancellation of Principal

A majority of the Executive Committee believe that COD income attributable to the cancellation of principal can be fairly viewed as "recapturing" prior payments of BIE under transactional accounting principles. Below we first discuss the arguments for and against this view. Then we consider the implications of expanding the scope of "recapture" COD income for the application of the Aggregate Disallowed BIE Approach, the With-and-Without Approach, and the Pure Tracing Approach.

i. Arguments for and Against Offsetting COD Income Attributable to the Cancellation of Principal with Disallowed BIE Carryforward

As context for the discussion of whether "recapture" COD income should include certain forms of COD income from the cancellation of principal, consider the following case.

> *Case 7*. On January 1, Year 1, Issuer issues a $1,000 debt instrument that provides for annual payments of interest at a rate of 10 percent. In Year 1, Issuer accrues and pays $100 of interest on the debt. Issuer's Section 163(j) limitation for Year 1 is zero; thus, Issuer's $100 of accrued BIE is disallowed as a deduction in Year 1 and carried forward as a disallowed BIE carryforward. On January 1, Year 2, Issuer repurchases the debt for $800.

In Case 7, Issuer realizes $200 of COD income attributable to the cancellation of principal from a debt instrument on which incurred $100 of disallowed BIE. Is the link between the Issuer's COD income and the prior accrual of disallowed BIE sufficiently close to justify viewing a portion of the former as "recapturing" the latter under the "relation-back" doctrine?

Proponents of a narrow view of the "relation-back" doctrine think not; they believe that the payment of the BIE in Year 1 effectively severs the link between the COD income and the prior BIE accrual. On this view, it is not relevant that the $200 of COD income exceeds Issuer's economic profit of $100.[74] Although transactional accounting principles may operate to provide equitable results in appropriate circumstances, those principles are inapplicable once the requisite link between the accrued BIE and the COD income has been severed through payment of the BIE. Accordingly, proponents of the narrow view believe that none of Issuer's COD income should be treated as BII.

A majority of the Executive Committee, however, views the "relation-back" doctrine more broadly. They believe that the portion of the Issuer's COD income that does not exceed its prior BIE accrual (*i.e.*, $100 of COD income) is integrally related to the prior BIE accrual because both items have their origin in the same debt. Their rationale for this broad view is three-fold.

First, as discussed in Part IV.B.1.i, consistent with the "relation-back" doctrine, administrative guidance in other contexts provides that the tax characteristics of COD income may be determined with reference to the tax characteristics of prior accruals of interest, without regard to whether the COD income is attributable to the cancellation of interest or principal.

[74] $1,000 from issuance - $100 interest payments - $800 repurchase price = $100 profit.

Second, applying the "relation-back" doctrine provides an equitable result that is consistent with both the spirit of transactional accounting principles and the rationale for the taxation of COD income generally. As mentioned, in Case 7, Issuer realizes an economic profit of $100 from the issuance and repurchase of its debt instrument. Characterizing $100 of Issuer's $200 of COD income as BII would permit Issuer to "unlock" its $100 disallowed BIE carryforward, leaving Issuer with $100 of net income for tax purposes. Thus, Issuer's true income from the entire transaction would be clearly reflected.

Third, excluding COD income from the cancellation of principal from the scope of "recapture" COD income would treat issuers of debt instruments with OID more favorably than issuers of non-OID instruments.

However, we acknowledge that expanding the scope of "recapture" COD income to include COD income from the cancellation of principal would add further complexity, as discussed below.

ii. Implications for Disallowed BIE Approach, With-and-Without Approach, and Pure Tracing Approach

Assuming that, in principle, COD income attributable to the cancellation of principal can be characterized as "recapturing" prior payments of BIE on the same debt under the "relation-back" doctrine, the question arises as to whether, and to what extent, taxpayers should be required to trace the "recapture" portion of COD income to the disallowed BIE carryforward. This question implicates the same fundamental issues discussed above in connection with COD income attributable to the cancellation of accrued-but-unpaid BIE. However, the operation of the With-and-Without Approach would be more complex in this context. To illustrate the three approaches, consider the following case:

> *Case 8 – Multiple debt instruments*. At the beginning of Year 1, Issuer issues two debt instruments (Debt A and Debt B). Each of Debt A and Debt B is issued for $1,000, matures at the end of Year 5, and has a stated principal amount of $1,000, payable at maturity. Further, each of Debt A and Debt B provides for payments of interest at an annual rate of 5 percent, payable at the end of each year. In each of Years 1 through 3, Issuer accrues and pays $50 of BIE on each of Debt A and Debt B. Issuer's Section 163(j) limitation in each year is $40; thus, in each year, $40 of Issuer's accrued BIE is allowed as a deduction in Year 1 and $60 is carried forward, leaving Issuer with a $180 disallowed BIE carryforward at the end of Year 3. At the beginning of Year 4, Issuer repurchases Debt B for $700, realizing $300 of COD income.

Based on the principles discussed above, the "recapture" portion of Issuer's COD income from Debt B is the lesser of (i) Issuer's COD income ($300) and (ii) Issuer's lifetime BIE accruals on Debt B ($150), or $150. The extent to which Issuer can offset its "recapture" COD income with its disallowed BIE carryforward may vary depending on whether the Aggregate Disallowed BIE Approach, the With-and-Without Approach, or the Pure Tracing Approach applies.

Application of Aggregate Disallowed BIE Approach. Under the Aggregate Disallowed BIE Approach, Issuer can offset its $150 of "recapture" COD income from Debt B to the extent of its disallowed BIE carryforward, regardless of whether BIE accrued on Debt B gave rise to the carryforward or not. Because the amount of the disallowed BIE carryforward ($180) exceeds the "recapture" portion of Issuer's COD income, all $150 of Issuer's "recapture" COD income can be offset by the carryforward.

Application of With-and-Without Approach. Under the With-and-Without Approach, Issuer can offset its $180 of "recapture" COD income from Debt B to the extent of the difference in its disallowed BIE carryforward with and without the BIE associated with the "recapture" COD income.

- *Step 1: Adjust the yield on the debt to account for the COD.* At the beginning of Year 1, based on the issue price and projected payment schedule, the expected yield on Debt B was 5 percent. But a crucial premise on which the expected yield was computed—that Debt B would be paid in full at maturity—proved false, and so the actual yield was negative.

- *Step 2: Recompute the BIE accruals on the cancelled debt using the actual yield*. If, in Year 1, the parties had perfect foresight as to the payments that ultimately would be made on Debt B, then Issuer would have accrued no BIE on Debt B.[75]

- *Step 3: Recompute the disallowed BIE carryforward using the recomputed BIE accruals on the cancelled debt*. Had Issuer accrued no BIE on Debt B, Issuer's total BIE in each of Years 1 through 3 would have been $50. Issuer's Section 163(j) limitation in each of those years was $40; thus, in each year, $10 of Issuer's BIE would have been disallowed under Section 163(j) and carried forward as a disallowed BIE carryforward.

[75] Because the scope of relief is limited to the "recapture" portion of COD income, for purposes of applying the With-and-Without Approach, Issuer is treated as issuing an instrument with a yield of zero (as opposed to an instrument with a negative-yield). However, we note that the regulations under Section 163(j) do not specifically address the treatment of income realized by an issuer from negative yielding debt. In an analogous situation, the regulations under Section 163(j) treat bond issuance premium as BII to the issuer and, where the issue price of the negative yielding debt exceeds the stated redemption price at maturity, this rule appears to literally apply. Reg. §1.163(j)-1(b)(22)(iii)(A). Similarly, if the negative yielding debt is a contingent payment debt instrument, inflation-indexed, or dual-currency, the income is treated as BII. Reg. §1.163(j)-1(b)(22)(iii)(B). Yet, because the regulations do not independently address negative yielding debt and, because the statute essentially defines ATI as a residual category of income, income generated from negative yielding debt could be characterized ATI where it does not fall within the scope of the preceding rules.

- *Step 4: Compare Issuer's disallowed BIE carryforward with and without the yield adjustment*. The difference between Issuer's actual disallowed BIE carryforward ($180) and Issuer's recomputed disallowed BIE carryforward ($30) is $150. Therefore, all $150 of Issuer's "recapture" COD income can be offset by its disallowed BIE carryforward.

We note, however, that calculations under the With-and-Without Approach are potentially more complicated where the COD income is less than the amount of previously paid and accrued interest. In such circumstances, the actual yield, though less than the expected yield, would still be positive. So, application of the With-and-Without Approach would effectively require a determination of the extent to which particular prior interest payments should be treated as recaptured; this would entail recharacterizing a portion of each of the earlier interest payments as payments of principal, presumably on a constant yield-to-maturity basis. For purposes of determining the disallowed BIE carryforward under the "without" portion of the calculation, only the portions of the prior "interest" payments that are recharacterized as principal would be eliminated. The detailed mechanics become relevant in a situation such as Case 6 where shifting of Section 163(j) limitation capacity is a potential issue.

Application of Pure Tracing Approach. Under the Pure Tracing Approach, Issuer can offset its $150 of "recapture" COD income from Debt B only to the extent that the "recaptured" BIE is allocated to its disallowed BIE carryforward. For this purpose, Issuer would prorate its $60 of total disallowed BIE in each year between Debt A and Debt B on the basis of their relative shares of Issuer's total BIE (*i.e.*, 50/50). Thus, $90 of Issuer's $180 disallowed BIE carryforward would be allocated to Debt B. Accordingly, since only $90 of Issuer's cancelled BIE is treated as reflected in its carryforward, Issuer can use just $90 of its disallowed BIE carryforward to offset its $180 of COD income—again, less than in the two foregoing approaches. As in the case of the With-and-Without Method, if the total COD income is less than the previously paid and accrued BIE, it would be necessary to identify which portions of the BIE are treated as having been recaptured.

C. Special Cases

1. Cancellation of Deferred BIE

Another example where the mismatch between the inclusion of COD income arising from the cancellation of BIE produces particularly harsh results occurs when a Section 163(j)-limited taxpayer is discharged of its obligation to pay BIE that would have been allowed as a deduction only when paid—for example, BIE incurred by an accrual-method taxpayer that is deferred until paid under another Code provision.[76] Because non-Section 163(j) interest deferral provisions generally apply before the application of Section 163(j), the amounts forgiven are not reflected in

[76] *See, e.g.,* Section 163(e)(3); Section 163(e)(5) (providing for deferral of interest on applicable high-yield discount obligations); Section 267(a)(2)(providing for deferral of related-party interest).

the taxpayer's disallowed BIE carryforward.[77] From a tax policy perspective, recognition of COD income in this case is hard to justify: not only has the taxpayer not deducted interest that otherwise would have been deductible if paid; it received no potential compensating benefit in the form of a deferred BIE carryforward. We believe that this result is inconsistent with clear-reflection-of-income principles.

As discussed above, Section 108(e)(2) generally provides an exception to the recognition of COD income "to the extent that payment of the liability would have given rise to a deduction."[78] Under current law, it is not clear whether Section 108(e)(2) applies to the cancellation of deferred BIE of a Section 163(j) limited taxpayer because payment of the cancelled BIE would give rise not to a deduction but rather to a disallowed BIE carryforward (*i.e.*, a potential *future* deduction).

The Tax Court's reasoning in *Brooks v. Commissioner*[79] suggests that Section 108(e)(2) might not apply in such a situation. In *Brooks*, an individual (*i.e.*, cash basis) taxpayer was discharged of his obligation to pay interest and principal on a loan. At issue was whether the cancellation of interest was excluded from the taxpayer's gross income under Section 108(e)(2), which turned on whether the taxpayer would have been able to deduct the accrued interest on the loan had he paid it. The taxpayer asserted that the purpose of the loan was "to give him a stake to showcase his skills as a stockbroker to produce income for himself and his wife,"[80] and therefore interest on the loan was investment interest, deductible under Section 212, rather than nondeductible personal interest. The Tax Court disagreed. For starters, the court found that the taxpayer failed to produce evidence that the loan proceeds were used to purchase stock or securities, and thus that the interest could have been deductible under Section 212. Moreover, the court added, even if the taxpayer had been entitled to claim an interest deduction under Section 212, that deduction would been limited by the investment interest limitations under Section 163(d): "the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year." Similar to the carryforward rule of Section 163(j)(2), Section 163(d) provides that the amount not allowed as a deduction for a taxable year is carried forward to subsequent taxable years. Under a similar analysis, it is possible that Section 108(e)(2) is not applicable in the case of cancellation of interest that is not deductible because payment of the liability would give rise only to disallowed BIE carryforward and not a current deduction.

[77] Reg. §1.163(j)-3(b)(3) provides that "Code provisions that defer the deductibility of interest expense, such as section 163(e)(5)(A)(ii) . . . apply before the application of section 163(j)." *See also* Reg. §1.163(j)-3(c) Ex. 1 (including BIE deferred under Section 267(a)(2) in the Section 163(j) calculation until the year a deduction is allowed under Section 267(a)(2).

[78] Section 108(e)(2).

[79] T.C. Memo. 2012-25.

[80] *Id.*

However, we believe that Section 108(e)(2) need not be interpreted so narrowly.[81] The plain language of Section 108(e)(2) does not preclude its application in cases in which a deduction would not be allowed in the year of payment of the forgiven amount but would give rise to another tax attribute.

Furthermore, the Service has interpreted the concept of a deductible liability broadly in analogous contexts. Section 357(c)(3)(A) excludes from the Section 357(c)(1) determination liabilities "the payment of which would give rise to a deduction."[82] In Revenue Ruling 95-74,[83] the Service considered whether contingent environmental liabilities assumed by a transferee in a Section 351 exchange in Year 1 would be excluded from the Section 357(c)(1) determination when the liability did not given rise to a deduction or resulted in the creation of, or increase in, basis until Year 3. Noting that Congress had enacted Section 357(c)(3) to avoid an overstatement of liabilities and "potential inappropriate gain recognition" because the transferor had not received the corresponding tax benefit, the Service held that the contingent environmental liabilities assumed by the transferee were properly excluded from the Section 357(c)(1) math. Specifically, Revenue Ruling 95-74 states—

> While [Section] 357(c)(3) explicitly addresses liabilities that give rise to deductible items, the same principles apply to liabilities that give rise to capital expenditures as well. Including in the [Section] 357(c)(1) determination those liabilities that have not yet given rise to capital expenditures (and thus have not yet created or increased basis) with respect to the property of the transferor prior to the transfer also would result in an overstatement of liabilities.

A similar reading could be applied to Section 108(e)(2). Interpreting the phrase "payment of the liability would give rise to a deduction" to include payment of a liability that would give rise to a tax attribute (*i.e.*, a potential future deduction), forgiveness of an amount that if paid would have been deferred interest would be excluded COD income under Section 108(e)(2).

Granted, there is a difference between a liability that gives rise to *basis* and a liability that gives rise to a *disallowed BIE carryforward*. Except in highly unusual circumstances, basis will eventually give rise to a benefit, either in the form of a deduction or an offset to amount realized. A disallowed BIE carryforward, however, might not. So, the broad interpretation of Section 108(e)(2) above may result in the exclusion of COD income attributable to BIE that, had it been

[81] Some commentators believe that it is reasonably clear that Section 108(e)(2) applies to interest expense deductions that are deferred under the applicable high-yield discount obligation rules of Section 163(e)(3). *See* American Bar Association Section of Taxation, *Comments Concerning Proposed Regulations under Section 163(j) and its Interaction with Section 108* (May 13, 2019). However, the Service's arguments in *Brooks v. Commissioner*, T.C. Memo. 2012-25, suggests that the Service may take a different position.

[82] Section 357(c). Section 108(e)(2) employs practically identical language: "payment of the liability would have given rise to a deduction".

[83] 1995-46 I.R.B. 6.

paid, would have been indefinitely deferred. This result could be viewed as inconsistent with case law holding that Section 108(e)(2) does not apply to cancellation of nondeductible amounts.[84]

However, we think that the case of indefinite deferral is distinguishable from permanent disallowance. First, there are different policy reasons for deferring a taxpayer's deduction in one case but permanently disallowing it in another.[85] Second, there is no reliable basis for predicting whether a disallowed BIE carryforward will eventually be used in the future. This appears to be a situation to which the maxim "hard cases make bad law" applies. The mere possibility that, in certain cases, Section 108(e)(2) might apply to the cancellation of BIE that, had it been paid, would have given rise to a disallowed BIE carryforward that would never be utilized, is not sufficient grounds for withholding relief generally.

Accordingly, we recommend that Treasury issue guidance clarifying that Section 108(e)(2) applies to the cancellation of a liability if the payment of that liability would give rise to either a current deduction or a tax attribute such as a BIE carryforward. This clarification would be a relatively simple solution to the inequities that appear to result under the current rules. If, however, Treasury and the Service do not believe that Section 108(e)(2) applies to these situations, we believe Treasury and the Service can issue regulations clarifying that tax benefit principles apply, allowing for exclusion of the COD income because there has been no associated tax benefit.

2. COD Income from Debt Exchanges That Will Be Reversed by Future OID Accruals

When a debt issuer exchanges (or is deemed under Reg. §1.1001-3 to exchange) a new debt for depreciated debt, and the principal amount of the new debt is the same as the existing debt, the issuer may realize COD income that will be offset by future OID accruals. Consider the following situation.

> *Case 9: Reversal of future accrual.* Issuer has outstanding a single debt instrument with an issue price and stated redemption price at maturity of $1,000. When the debt is trading at $800, the parties modify the debt in a manner that constitutes a significant modification within the meaning of Reg. §1.1001-3. The issue price of

[84] *See Payne v. Comm'r*, T.C. Memo. 2008-66 (2008) (holding that taxpayer had COD income when relieved of obligations to pay nondeductible interest); *Hahn v. Comm'r*, T.C.M. 2007-75 (2007) (same).

[85] For example, Section 162(f) permanently disallows deductions for certain fines or penalties paid to the government in relation to the violation of law. Reasons for the denial of a deduction are grounded in "sharply defined national or State policies proscribing the particular types of conduct." *See* SEN. REP. NO. 91-552 AT 261 (1969) (citing *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30 (1958)). In contrast, Section 162(d) merely defers deductions for investment interest expense to prevent taxpayers from sheltering business income by deducting interest related to property on which appreciation has not been recognized. *See* Staff on Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 263 (Comm. Print 1987).

> the modified debt is $800 (*i.e.*, its trading value),[86] and Issuer recognizes $200 of COD income.[87] In addition, the new debt has $200 of OID (*i.e.*, $1,000 SRPM - $800 AIP).

In Case 9, Issuer has $200 of COD income and $200 of OID. However, these items of income and expense do not offset. First, there is a timing mismatch—the COD income is includable in the year of the exchange, but the OID deductions are taken over the life of the instrument.[88] This issue was recently discussed in a prior report of the New York State Bar Association, and we continue to believe that this timing mismatch should be corrected.[89]

In addition, as discussed above, if treated as ATI, the COD income will only offset 30 percent of the OID.[90] We think that this result is inappropriate. Case 9 presents an equally tight nexus between the COD income and the OID accrual as that in Case 1, with the only difference being that the sequence of the interest accrual and the COD event is reversed. From a transactional accounting perspective, the sequence of these events does not diminish the integral link between them. Consequently, in addition to addressing the timing mismatch to ensure that these amounts offset (as BII cannot be carried forward), we think the COD income in Case 9 should be characterized as BII for the same reasons that this treatment is appropriate in Case 1 (involving COD income attributable to accrued OID).

D. Attribute Reduction under Section 108(b)

Under Section 108, COD income of an insolvent taxpayer is generally excluded, but the taxpayer must also reduce certain of its tax attributes. Section 108(b) enumerates the attributes that are reduced as a result of the exclusion of COD income; the Regulations provide ordering rules for attribute reduction.[91] However, Section 108(b) was not amended to include disallowed BIE carryforwards in the list of attributes to be reduced. Moreover, despite the broad grant of authority in Section 163(j), it is not clear whether Treasury has the authority to add the disallowed BIE carryforward.

This Report expresses no view on Treasury's authority to add the disallowed BIE carryforward to the list of attributes in Section 108(b). We have previously recommended that, if

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[86] *See* Reg. §1.1273-2.

[87] *See* Section 108(e)(10).

[88] Reg. §1.163-7(a).

[89] New York State Bar Tax Section, Rep. No. 1443, *Report on Tax Consequences to Issuers of Debt Modifications and Exchanges* (Oct. 15, 2020).

[90] As mentioned, the CARES Act changes the ATI limitation from 30 percent to 50 percent for taxable years that begin in 2019 or 2020.

[91] Reg. §1.108-7.

Treasury does not believe it has the authority to add the disallowed BIE carryforwards to Section 108(b), it should request that Congress do so.[92] The omission of disallowed BIE carryforwards from Section 108(b) produce inappropriate results (often to the detriment of the taxpayer) and is generally inconsistent with the policy of deferring tax on the excluded COD income underlying Section 108(b). For example, subject to a taxpayer's election to reduce tax basis of depreciable property first, NOLs are the first attribute to be reduced under Reg. §1.108-7. Absent inclusion of disallowed BIE carryforwards in Section 108(b), a taxpayer loses all or a portion of its NOL upon realizing excludable COD income that is attributable to the forgiven BIE.[93] The disallowed BIE carryforward, which the taxpayer may never be able to utilize, would remain untouched.

If disallowed BIE carryforwards are added to Section 108(b), additional rules would be required to determine the order in which the disallowed BIE carryforward would be reduced in relation to the taxpayer's other attributes. There are several different alternatives. First, Treasury and the Service could provide that the disallowed BIE carryforward is reduced in full before reducing any NOL. This ordering rule would arguably be more taxpayer-friendly if the taxpayer expects to be able to utilize its NOLs in the near term (or is not limited under Section 382) but does not expect to be able to utilize its disallowed BIE carryforward. Note that this approach is also consistent with the absorption of the annual limitation in that business interest is absorbed before NOL carryovers.[94] Presumably, this approach would also be subject to Section 108(b)(5) and allow for taxpayers to reduce tax basis first.

A second alternative would be for Treasury to issue regulations providing for the reduction of the disallowed BIE carryforward from a particular year before any NOL carryforward from that year. For instance, suppose a taxpayer has a $50 disallowed BIE carryforward and $50 NOL carryforward from each of Year 1 and Year 2. If a taxpayer realizes $100 of excluded COD income in Year 3, then its $50 disallowed BIE carryforward and $50 NOL carryforward from Year 1 would each be reduced to zero, and its Year 2 attributes would be unaffected. As with the option discussed above, this would allow the taxpayer to preserve a more usable attribute while reducing the disallowed BIE carryforward, but it would also deplete at least a portion of the NOL when the disallowed BIE carryforward is insufficient to absorb all the COD income.

A third alternative would be for Treasury to issue regulations reducing the disallowed BIE carryforward and the NOL for a given year on a pro rata basis. Because the deduction would have

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[92] *See* New York State Bar Association Tax Section, Report on Select Issues Under Section 382 and 108 Involving Carryforwards of Recognized Built-in Losses and Business Interest (December 4, 2019).

[93] Absent the Act's amendments to Section 163(j), the deductions would have increased the taxpayer's NOLs. While Section 108(b) intends to defer tax on the excluded COD income, reducing the NOL of a taxpayer instead of reducing a less utilized disallowed BIE carryforward is in apparent contrast to Congress's intention to providing the taxpayer a "fresh start" when enacting Section 108. *See* S. Rep. No. 1035, 96th Cong., 2d. Sess. 9-10 (1080) ("To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside of bankruptcy) is not burdened with an immediate tax liability.").

[94] Reg. §1.383-1(d)(2).

otherwise been a part of the taxpayer's NOL, a pro-rata approach arguably would put the taxpayer in a similar position to that which would apply absent the Act's amendments to Section 163(j).

Finally, a fourth alternative would be to reduce the disallowed BIE carryforward by the amount of COD income attributable to forgiven interest or the amount of "recapture" COD income. This approach would have the advantage of linking the deferred income inclusion (*i.e.*, reduction of the disallowed BIE carryforward) with the benefit of excluding the COD income attributable to the BIE; however, Section 108(b) does not otherwise attempt to trace COD income to attributes, and so it could be argued that there is no reason to deviate from this approach.