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Report No. 1492
May 21, 2024

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Acting Assistant Secretary (Tax Policy)
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The Honorable Daniel I. Werfel
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The Honorable Marjorie A. Rollinson
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The Honorable William M. Paul
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Re: Report No. 1492 - Report on Proceeds-Issue Price Disparities

Dear Mses. Aron-Dine and Rollinson, and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1492 of the Tax Section of the New York State Bar Association, which discusses disparities between proceeds and issue price of debt and related topics.

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

Respectfully Submitted,

Jiyeon Lee-Lim
Chair

Enclosure

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Report No. 1492

New York State Bar Association Tax Section

Report on Proceeds-Issue Price Disparities

May 21, 2024

Report No. 1492

New York State Bar Association Tax Section

Report on Proceeds-Issue Price Disparities

I. Introduction

This Report[1] comments on certain situations where an issuer of debt receives proceeds from the issuance that differ from the debt's "issue price."[2]

The time-value provisions of the Code and regulations provide detailed tax accounting rules for both issuers and holders of debt.[3] These rules generally treat the excess of the amounts due under the debt instrument over the "issue price" as interest income to the holders and interest expense to the issuer.

The time-value provisions specifically contemplate that holders may acquire individual debt instruments at various times and at various prices. For each situation where a holder's initial basis differs from the debt instrument's then-current adjusted issue price ("***AIP***"),[4] there is a specific set of rules addressing precisely how the holder is to account for the basis/AIP disparity for tax purposes. If the holder's basis is less than the AIP, the holder generally accounts for the difference under the market discount (or de minimis discount) rules. If the

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[1] The principal drafters of this report were Jeff Maddrey and Y. Bora Bozkurt. Substantial assistance was provided by Tyler Arbogast. Helpful comments were provided by Matthew G. Brigham, Robert Cassanos, Ann Creed, Michael Farber, Edward E. Gonzalez, Craig Horowitz, Jiyeon Lee-Lim, John Lutz, Michael Mollerus, Daniel Nicholas, Richard Nugent, Deborah Paul, Yaron Reich, Michael L. Schler, Peter Schuur, Shun Tosaka, and Andrew Walker. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] The issue price of a debt instrument is a measure of the amount loaned. It is defined in Treas. Reg. § 1.1273-2.

[3] The time-value provisions include sections 1271 through 1275 (original issue discount), sections 163 (interest expense) and the regulations thereunder. Except as otherwise indicated, all references to "section" refer the Internal Revenue Code of 1986, as amended.

[4] AIP can be thought of as the current balance of the debt for tax purposes. On the issue date, the AIP is the issue price (*i.e.*, the amount loaned). Thereafter, AIP increases as original issue discount ("***OID***") accrues and decreases as payments (other than payments of qualified stated interest) are made. *See* Treas. Reg. § 1.1275-1(b).

holder's basis is greater than the AIP, the holder generally accounts for the difference under the acquisition premium or amortizable bond premium rules.[5]

On the issuer side, there is no equivalent set of rules reconciling the issuer's specific tax position to that of the instrument. Except in the case of a qualified reopening,[6] the regulations effectively presume that an issuer's proceeds from a debt issuance will equal the issue price. Where a proceeds-issue price disparity arises outside of the reopening contest, there are no specific regulations addressing how the issuer is to tax account for the disparity.

Proceeds-issue price disparities can often arise outside of the reopening context. Specifically, whenever an issuer issues debt for cash to the investors via an underwriter, there is a potential for a proceeds-issue price disparity.[7] In this case, there are two transfers of the debt instruments – (i) the initial transfer from the issuer to the underwriter, and (ii) the subsequent transfer from the underwriter to the initial holders. The first transfer determines the issuer's proceeds.[8] The second transfer determines the issue price.[9] Whenever the amount of the issuer's proceeds (determined by the issuer-underwriter transaction) differs from the debt's issue price

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[5] See sections 1276 through 1278 (market discount) and section 171 (amortizable bond premium) and the regulations thereunder.

[6] Treas. Reg. § 1.1275-2(k)(2). A qualified reopening exists where, more than 12 days after the issue date of a debt issuance, the issuer issues additional debt instruments having terms that are in all respects identical to the debt instruments making up the original issue and certain other requirements are met. The qualified reopening rules generally treat the additional debt instruments as if they were part of the original issuance for tax purposes by treating them as having the same issue date, issue price, and with respect to holders, AIP. The qualified reopening rules specifically acknowledge that the issuer's proceeds from the issuance of the additional debt instruments may differ from the then-current AIP. The regulations require the issuer to take into account the difference as an adjustment to the issuer's interest expense over the life of the debt under constant yield principles. *See* Treas. Reg. § 1.163-7(e).

[7] For purposes of this Report, we use the term "underwriter" to refer to an intermediary that purchases debt for resale to the ultimate investors, regardless of whether the intermediary would constitute an "underwriter" within the meaning of the Securities Act of 1933. For example, in transactions governed by Securities and Exchange Commission Rule 144A, such an intermediary is typically referred to as an "initial purchaser."

[8] Proceeds from a debt issuance are not income to the issuer. *Comm'r v. Indianapolis Power and Light*, 493 U.S. 203 (1990) ("[I]t is settled that receipt of a loan is not income to the borrower."); *see also* Treas. Reg. § 1.61-12(c)(i) ("An issuer does not realize gain or loss upon the issuance of a debt instrument.").

[9] Treas. Reg. §§ 1.1273-2(a)(1) and 1.1273-2(e).

(determined by the underwriter-initial holder transaction), there will be a proceeds-issue price disparity.[10]

In many cases, the proceeds-issue price disparity will be minimal or non-existent. In a best-efforts underwriting, the underwriter promises to remit to the issuer the proceeds of the debt issuance less agreed-upon underwriting fees.[11] If each of the individual debt instruments making up the debt issue is sold to the initial holders at a single uniform price, the issuer's proceeds would equal the issue price. Even if individual debt instruments were sold at different prices such that a proceeds-issue price disparity were to exist, the magnitude of such disparities is often minimal.

A proceeds-issue price disparity can be quite significant, however, in a firm commitment underwriting – an underwriting where the underwriter guarantees certain proceeds to the issuer regardless of the price at which the underwriter is ultimately able to sell the instruments to the investors. In firm commitments in connection with acquisitions, the issuer may obtain the underwriter's commitment to underwrite a debt issuance on specific terms months in advance of the actual issuance. If the market for the issuer's debt deteriorates between the time the underwriter's commitment is obtained and the debt is issued pursuant to the commitment, the issuer's proceeds (determined by the terms of the commitment contract negotiated before the deterioration in the market) may significantly exceed the issue price (determined by arm's-length purchases of the debt after the deterioration in the market). In this case, the underwriter's commitment functions as a forward contract or put option in the issuer's hands – it allows the issuer to obtain proceeds from the sale of its debt to the underwriter for a price that may exceed the debt's then-current value (as evidenced by the price at which the underwriter can sell the debt to the investors).

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[10] In this Report, we assume that underwriting fees are properly characterized as fees for underwriting services that are accounted for by the issuer as debt issuance costs and not as adjustments to the proceeds received. Thus, the references to "proceeds" are to gross proceeds before underwriting fees. In general, an issuer is required to account for debt issuance costs over the life of the debt issuance "as if" the debt issuance costs reduced the issue price of the debt. Treas. Reg. § 1.446-5.

[11] *Cf. Helvering v. Union Pac. R.R.*, 293 U.S. 282 (1934) (noting that commissions paid for marketing certain bonds represented "a loss to the taxpayer definite as to its date and amount. and represents a part of the cost of the borrowed capital during each year of the life of the bond issue").

Although there are no rules specifically addressing proceeds-issue price disparities outside of the reopening context, the issuer must nevertheless account for the disparity. We believe the disparity should be taken into account over the life of the debt issuance as an adjustment to the issuer's interest expense. To confirm this treatment, we suggest certain changes to the regulations. Specifically, we suggest that the regulations addressing reopening-related proceeds-issue price disparities be broadened to cover disparities arising outside of the reopening context. In addition, we believe clarifying regulations would be helpful if they could address the issuer's application of the applicable high yield discount obligation ("***AHYDO***") rules to the relevant debt instrument[12] as well as the issuer's determination of cancellation of indebtedness income ("***CODI***") or bond repurchase premium expense upon the repurchase/retirement of the debt, each as discussed further below.

This Report also considers two situations where proceeds-issue price disparities are attributable to a separation in time between the issuer's receipt of proceeds from the underwriting banks and the banks' later sale of debt to the public. The first situation involves a syndicated bank loan that contains a post-close market flex provision. In this case, one or more arranger banks agree to extend credit to the issuer under a term loan that the banks intend to syndicate to third-party holders. Where there is expected to be a material amount of time between the time date on which the arranger banks extend the loan and the date on which the banks intended to syndicate the debt, the banks may negotiate for a "post-closing market-flex" term that gives them the right to change the pricing of the debt (for example, by increasing the stated interest rate or imposing a one-time fee, subject to an overall cap) to the extent necessary to facilitate a syndication at par. If market conditions deteriorate after the loan is extended and prior to the syndication, the banks will exercise the market-flex provision and increase the yield on the debt. In some cases, the overall cap on the market-flex provision may prevent the banks from being able to increase the yield sufficient for the debt to be syndicated at par. In these cases, the banks may syndicate the debt for an amount less than par, thereby suffering a loss. Under current law, there is a risk that the exercise of the market-flex provision results in a significant modification and therefore a debt-for-debt exchange. We believe that, as a policy matter, the exercise of a market flex option should not result in a debt-for-debt exchange. Accordingly, we recommend

[12] Section 163(e)(5) and 163(i).

that regulations specifically provide that the exercise of a post-closing market flex term does not result in a modification.

The second situation involves another form of committed financing – a bridge loan coupled with a securities demand provision. In this structure, one or more banks agree to underwrite debt securities (*i.e.*, notes) for an issuer in the future. Prior to the issuer formally issuing the notes, the banks lend money to the issuer on a temporary, or bridge, basis. Under the arrangement, the banks have the right to demand that the issuer issue debt securities, effectively replacing the bridge loans with notes that the banks (or their affiliates) will sell to third-party holders. We believe that it would be inappropriate as a policy matter for this type of transaction to be characterized in a manner that would result in the issuer realizing CODI upon the retirement of the bridge loans. Accordingly, we likewise recommend that regulations clarify that the issuer does not realize CODI upon the retirement of the bridge loans in such situation.

For the avoidance of doubt, we do not envision the holders' tax treatment in these transactions would be impacted by the recommendations in this Report. We view the existence of the proceeds-issue price disparity as issuer specific. The suggested regulatory changes discussed herein would generally only impact the issuer's tax treatment.

II. Summary of Recommended Regulatory Changes

We recommend the following specific changes to the regulations:

1. The rule of Treasury Regulations Section 1.163-7(e)(4) should be broadened to cover proceeds-issue price disparities beyond those caused by reopenings. Regardless of its origin, an issuer should account for a proceeds-issue price disparity over the life of the debt on constant yield principles. In effect, an issuer should compute an issuer-specific issue price (and, thereafter, AIP) and yield for purposes of determining the issuer's interest and OID accruals.

2. The repurchase/retirement rule in Treasury Regulations Section 1.61-12(c) should be changed so that CODI and bond repurchase premium are measured by reference to the issuer's issuer-specific AIP rather than the instrument's AIP.

3. Regulations should clarify that a debt instrument's AHYDO status is determined by reference to the issuer-specific issue price (and yield), rather than the instrument's issue price (and yield).

4. Regulations should clarify that a change in the terms of a debt instrument pursuant to a market-flex or securities demand provision included in the original financing commitment does not result in a modification within the meaning of Treasury Regulations Section 1.1001-3(c).

III. Background

A. Time-Value Rules

1. In General

The time-value provisions of the Code and regulations provide detailed tax accounting rules for both issuers and holders of debt. Under these rules, each debt instrument has an "issue price"[13] and a "stated redemption price at maturity" ("***SRPM***").[14] The issue price is generally the amount loaned under the debt instrument and the SRPM is the sum of all payments due under the instrument other than payments of "qualified stated interest" ("***QSI***").[15] Where all interest payments due under the debt are QSI, the SRPM will equal the principal amount.

From the issuer's perspective, the difference between SRPM and issue price, if any, is accounted for as an adjustment to the issuer's interest expense. Where the SRPM exceeds the issue price, the debt has either OID or de minimis OID. Where the SRPM is less than the issue price, the debt is considered issued with bond issuance premium. The issuer treats OID or de minimis OID as interest expense. The issuer accrues OID over the life of the debt using constant yield principles[16] and takes de minimis OID under one of several methods.[17] If the issue price

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[13] Treas. Reg. § 1.1273-2.

[14] Treas. Reg. § 1.1273-1(b).

[15] QSI is interest that is unconditionally payable at least annually at a single fixed (or qualifying variable) rate. Treas. Reg. § 1.1273-1(c).

[16] Treas. Reg. § 1.163-7(a).

[17] Treas. Reg. § 1.163-7(b)(2).

exceeds SRPM, the debt has bond issuance premium, which the issuer treats as an offset to otherwise deductible QSI expense, determined under constant yield principles.[18]

From the holder's perspective, the rules are more detailed as they take into account both the terms of the instrument as well as any disparity between the holder's initial basis in the instrument and the instrument's AIP. The holder generally takes into account QSI as interest income under its normal method of accounting.[19] If the instrument has OID and the holder's initial basis is equal to or less than the instrument's then-current AIP, the holder accrues the OID as interest income under constant yield principles, regardless of the holders' overall method of accounting. In addition, the holder must generally account for the excess, if any, of the AIP over the holder's basis under the market discount rules.[20] If the instrument has OID and the holder's initial basis is greater than the then-current AIP but less than the SRPM, the holder accrues a portion of the instrument's OID into income under the "acquisition premium" rules.[21] If the holder's initial basis is greater than the instrument's SRPM, the holder holds the debt at a premium and generally may elect to amortize this premium as an offset to interest income.[22] In short, there are a number of rules that specifically address the disparity between the holder's initial basis and the debt's then-current AIP. These rules generally treat the difference as an adjustment to the holder's interest income from the debt instrument over its term.

2. Issue Price

The issue price rules seek to measure the amount loaned. Where a debt is issued for money, the issue price is determined by reference to the amount of money paid by the initial holder.[23] Where debt is issued for property and either the debt instrument or the property it is issued in exchange for is "traded on an established market"[24] such that the value of the newly

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[18] Treas. Reg. § 1.163-13.

[19] Treas. Reg. § 1.446-2.

[20] Sections 1276 through 1278.

[21] Treas. Reg. § 1.1272-2.

[22] Section 171 and the regulations thereunder.

[23] Treas. Reg. § 1.1273-2(a)(1).

[24] "Traded on an established market" is a regulatory term of art. Despite the nomenclature, there is no requirement the debt or property trade or even that a specific market exist. Debt or property generally will be considered to meet the definition if price information is readily available to market

issued debt or the property it is issued in exchange for can be easily observed, the issue price is determined by referenced to the observed value of the debt or property.[25] Finally, if debt is issued for property and neither the debt nor the property is traded on an established market, the issue price generally is deemed to be the principal amount of the debt.[26]

3. Underwriter Rule

Where a debt issuance is facilitated by one or more banks acting in their capacity as underwriters, the issuance involves two separate transfers – the issuer's transfer of the debt instruments to the banks and the banks' transfer to the initial investors. The instrument's issue price and issue date are determined by reference to the transaction between the underwriting banks and the initial investors, not the potentially earlier-in-time and different-in-price transaction between the issuer and the underwriting banks.[27] The statute and regulations clearly contemplate the issuer having proceeds from the transaction between the issuer and the underwriter that differ in amount from the issue price set by the transaction between the underwriter and the investors. The regulations also contemplate the issuer receiving proceeds from the underwriter on a different date than the date on which the investors purchase the debt from the underwriter.

4. Debt Issuance

Treasury Regulations Section 1.1275-1(f) provides that debt instruments that are issued "within a period of thirteen days beginning with the date on which the first debt instrument that would be part of the issue is issued to a person other than a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent, or wholesaler" are treated as the same "issue," so long as they have the same credit and payment terms and they are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions.

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participants. Debt issuances with an outstanding principal amount of $100 million or less are automatically considered not traded on an established market. *See* Treas. Reg. § 1.1273-2(f).

[25] Treas. Reg. § 1.1273-2(b) and (c).

[26] Treas. Reg. § 1.1273-2(d).

[27] See section 1273(b)(1) and Treas. Reg. § 1.1273-2(e).

5. Reopenings

In order for individual debt instruments to be considered part of the same debt issuance, the individual debt instrument comprising the debt issuance must be economically fungible (the same payment and credit terms) and tax fungible (the same OID accrual schedule for tax purposes). If the debt instruments comprising an issue did not have the same OID accrual schedule for tax purposes, holders that purchase the debt instruments in the secondary market could potentially have different tax results depending upon which specific debt instruments they purchase.

The qualified reopening rules were developed to facilitate an issuer's ability to issue additional debt instruments subsequent to the original issue date that would be considered tax fungible with the existing instruments that comprise the issue. They operate as an overlay to the regular issue price rules modifying the issue price and issue date of an additional debt instrument under certain limited circumstances to match the issue price, issue date, and with respect to the holders, same AIP, of an outstanding debt instrument in order to achieve the same OID profile (and thereby tax fungibility) among the additional debt and existing debt instruments, notwithstanding that the price at which the additional debt instruments are sold differs from the price at which the original notes were sold (or, if the existing debt instruments were sold with OID, the AIP of such existing debt instruments at the time of the qualified reopening).[28]

B. Section 163(j)

Section 163(j) provides that a taxpayer cannot deduct business interest expense for a taxable year to the extent that such interest exceeds the sum of (a) the business interest income of such taxpayer for such taxable year, (b) 30% of the taxpayer's adjusted taxable income for such taxable year and (c) the taxpayer's floor plan financing interest for such taxable year.

The section 163(j) statute includes definitions for business interest expense ("**BIE**"), business interest income ("**BII**"), and adjusted taxable income ("**ATI**"). BIE means any interest paid or accrued on indebtedness properly allocable to a non-excepted trade or business. The term does not include investment interest (within the meaning of section 163(d)). BII means the amount of interest includible in the gross income of the taxpayer for the taxable year which is

[28] Treas. Reg. § 1.1275-2(k)(1).

properly allocable to a non-excepted trade or business. The term does not include investment income (within the meaning of section 163(d)). ATI means the taxable income of the taxpayer computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, any BIE or BII, the amount of any net operating loss deduction under section 172, the amount of any deduction allowed under section 199A, and, in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as provided by the Treasury.

For these purposes, while OID is included under the "interest" definition and would be considered BIE if properly allocable to a non-excepted trade or business, CODI is not considered interest income and would not be included under BII, but rather would be accounted for as part of ATI.[29]

C. CODI

Section 108(e)(10) provides that, for purpose of determining whether an issuer recognizes CODI upon issuance of a debt instrument (the "**New Debt**") in satisfaction of another debt instrument (the "**Old Debt**"), such as under a deemed exchange due to a significant modification under Treasury Regulations Section 1.1001-3, the issuer is treated as having satisfied the Old Debt with an amount of money equal to the issue price of the New Debt. Section 108(e)(10) indicates that the issue price of the New Debt is generally determined under sections 1273 and 1274.[30] As discussed above, if substantial amount of the New Debt is not issued for money but a substantial amount of the New Debt is traded on an established market, the issue price of the New Debt is its fair market value on its issue date. If a substantial amount of the New Debt is not issued for money or traded on an established market but a substantial amount of the Old Debt is so traded, the issue price of the New Debt is the fair market value of the Old Debt on the issue dale of the New Debt.

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[29] Such position would be consistent with NYSBA's prior recommendations. See NYSBA Tax Section Report No. 1447, Report on Section 163(j) and the COD Income Rules (Jan. 25, 2021).

[30] See generally Treas. Reg. § 1.61-12(c) (repurchase of a debt instrument by an issuer includes the exchange of the debt instrument for a newly issued debt instrument, including an exchange under Section 1001).

D. AHYDO

Under section 163(i), a debt instrument issued by a corporation is treated as an AHYDO if it has (i) a term exceeding five years, (ii) "significant original issue discount" and (iii) a yield that equals or exceeds the applicable federal rate ("***AFR***") plus 5%.[31] A debt instrument has significant OID if, as of the end of any accrual period ending after the date that is five years from issuance, the accrued but unpaid OID exceeds an amount equal to the product of the issue price and the yield to maturity. For purposes of determining whether a debt instrument is an AHYDO, (x) any payment under the instrument is assumed to be made on the last day permitted under the instrument and (y) any payment to be made in the form of another obligation of the issuer (or a related person within the meaning of section 453(f)(1)) is assumed to be made when such obligation is required to be paid in cash or property (other than the obligation). The AHYDO rules limit an issuer's ability to deduct interest on debt to which the rules apply. Where the rules apply, portion of yield in the form of OID that is in excess of AFR+6% is permanently disallowed. Remaining yield in the form of OID is deductible only when paid in cash or property (other than debt of the issuer).[32] The purpose of these rules was to limit the deductibility of interest on bonds Congress believed had a resemblance to equity.[33]

Since the application and the impact of AHYDO is based on the amount of OID on a debt instrument, and in particular because the determination of significant OID is based on the amount of interest includible by a holder, the strong implication is that issuers have to refer to the "issue price" in determining whether debt instruments have significant OID and, where applicable, whether AHYDO rules require a portion of the OID deductions to be deferred or denied altogether. AHYDO rules have limited relevance for holders – the only holder-side tax consequence of AHYDO treatment is that interest disqualified from deductibility by issuer can be treated as a distribution eligible for purposes of the dividend received deduction.[34]

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[31] For a fuller discussion of the AHYDO rules as well as recommendations regarding potential regulations, see NYSBA Tax Section Report No. 1366, Report on Possible Regulations Interpreting Rules Governing Applicable High Yield Discount Obligations (March 10, 2017).

[32] Because the AHYDO rules apply only to OID, interest that constitutes QSI is not affected by the AHYDO rules.

[33] See H.R. Conf. Rep. No. 101-386, at 553 (1989) (Conf. Rep.) (the "Conference Report").

[34] Section 163(e)(5)(B).

AHYDO rules provide explicit authorization for the issuance of regulations. Section 163(i)(5) provides that "[t]he Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of [section 163(i) and (c)(5)], including . . . regulations providing for modifications to the provisions of [section 163(i) and (e)(5)] in the case of . . . other circumstances where such modifications are appropriate to carry out the purposes of [section 163(i) and (e)(5)]."

The IRS has historically provided reprieve from the application of AHYDO for certain firm commitment underwritings, but such guidance has been limited in scope. Rev. Proc. 2008-51[35] addressed three fact patterns in which the IRS would not impose AHYDO treatment. These fact patterns were briefly as follows: (1) a debt instrument issued for money pursuant to a financing commitment obtained by the issuer before January 1, 2009; (2) a debt instrument issued pursuant to a pre-2009 financing commitment and exchanged for a new debt instrument within 15 months of the initial issuance of the old debt instrument; and (3) a debt instrument issued pursuant to a pre-2009 financing commitment that is indirectly exchanged for a debt instrument within fifteen months of the initial issuance of the old instrument. Notably, Rev. Proc. 2008-51 required the determination of whether the debt instrument issued in these scenarios are considered AHYDO based on cash proceeds received by the issuer, as opposed to issue price. The requested guidance in this Report is generally consistent with the approach used in such prior IRS guidance.

IV. Detailed Discussion

A. Proceeds-issue price disparities arising under the framework of the regulations

It is possible that an issuer of debt can receive proceeds from a debt issuance that differ in amount from the debt instrument's issue price (as determined under Treasury Regulations Section 1.1273-2). There are several situations in which a disparity can arise.

1. Uniform Issue Price Rule

First, a proceeds-issue price disparity can arise from the application of the uniform issue price rule in Treasury Regulations Section 1.1273-2(a)(1). Under this rule, if a substantial

[35] 2008-2 C.B. 562.

amount of the debt instruments that constitute an issue are issued for money, the issue price of each debt instrument in the issue is set at a uniform amount. Specifically, the issue price of each instrument is determined to be "the first price at which a substantial amount of the debt instruments is sold for money." To the extent that some of initial holders pay different prices, the issuer will have an amount of proceeds from the entire debt issuance that differs from the aggregate issue price of the entire debt issuance because only one of the prices can set the issue price. The current time-value rules do not specifically address how an issuer is to take this particular proceeds-issue price disparity into account.

2. Reopening Rule

Second, a proceeds-issue price disparity can arise from a qualified reopening. In general, an "issue" of debt consists of multiple individual debt instruments that have the same payment and credit terms, that are acquired by the initial holders at approximately the same time,[36] and that are issued pursuant to a common plan or as part of a series of related transactions.[37] In certain cases, an issuer that has an existing debt issue outstanding can issue additional debt instrument having payment and credit terms identical to those of an existing outstanding issuance. Where the additional debt issuance meets certain conditions, the additional debt issuance is characterized as a "qualified reopening" of the original issuance.[38] In this case, the additional debt instruments are considered part of the original issuance (and therefore not a separate issuance). An issuer of reopened debt will have a proceeds-AIP disparity to the extent that the proceeds from the sale of the additional debt instruments differs from the date-of-sale AIP of the original debt instruments.[39] The regulations specifically acknowledge the potential for such a disparity and provide that the issuer is to account for the disparity as an adjustment to the issuer's lifetime interest expense arising from the issuance over the remaining term of the

[36] Each debt instrument in the original issuance must be acquired by the initial holders within the thirteen-day period that begins with the date on which the first instrument is acquired by an initial holder. For this purpose, holders acting in the capacity of an underwriter, placement agent, or wholesaler do not count as original holders. Treas. Reg. § 1.1275-1(f).

[37] Treas. Reg. § 1.1275-1(f).

[38] Treas. Reg. § 1.1275-2(k)(1).

[39] As written, Treas. Reg. § 1.163-7(e)(1) could be interpreted to only apply to a situation where the additional debt instruments are issued for cash because it states that it applies "if a holder *pays* more or less than the adjusted issue price of the original debt instruments" (emphasis added).

entire issue.[40] Specifically, the regulations provide that, as of the reopening date, the issuer must redetermine the yield of the debt issuance on a go-forward basis using an issuer-specific AIP for the entire issue. The issuer-specific AIP for the entire issue is calculated by aggregating AIPs of the various debt instruments in the issue and allowing the issuer to determine its deductions of OID based on the difference between the aggregate AIPs of the debt instruments in the issue and the SRPMs of the debt instruments in the issue.[41]

3. Underwriter Rule

Third, a proceeds-issue price disparity can arise where debt is issued through an underwriter. In this case, as discussed above, there are two separate transactions – (i) the issuer's sale of debt to the underwriter and (ii) the underwriter's sale of the debt to the initial holders. The issuer's proceeds are established by the first transaction; the issue price by the second. Per the underwriter rule of Treasury Regulations Section 1.1273-2(e), the transaction between the issuer and underwriter is ignored for purposes of determining the issue price. To the extent the issuer's proceeds from the sale of the debt to the underwriter differ from the issue price determined upon the underwriter's sale to the initial holders, there will be a proceeds-issue price disparity. As in the case of disparities caused by the application of the uniform issue price rule, the current time-value rules do not address how an issuer is to take this particular proceeds-issue price disparity into account.

4. Deduction of De Minimis OID

Fourth, a debt may be issued with less than de minimis OID. Under Treasury Regulations Section 1.163-7(b), issuers of a debt instrument are able to deduct de minimis OID even if, under the OID rules[42], the de minimis OID is not includible into income and does not increase the adjusted issue price. The accrual of de minimis OID would mean the issuer has taken a tax benefit from the debt instrument that exceeds the issue price of the debt instrument, creating a disparity. In determining repurchase premium or CODI from an issuer perspective, it would

[40] Treas. Reg. § 1.163-7(e)(1).

[41] Treas. Reg. § 1.163-7(e)(4).

[42] Treas. Reg. § 1.1275-1(b).

make sense to rely on the issuer-specific issue price, which, for this purpose, would equal the issuer specific issue price plus the de minimis OID that the issuer has deducted previously.

B. Forward Financing Commitment

A proceeds-issue price disparity can be quite substantial in amount where an issuer obtains a financing commitment from a group of banks well in advance of the actual debt issuance.[43] Typically, the forward financing commitment contract will obligate the banks to raise a specific amount of debt capital on specific terms. Although the specific terms of forward financing commitments can vary, the commitment typically operates to locks in a worst-case all-in cost of funds for the taxpayer that is not to exceed an agreed-upon rate. If market conditions deteriorate between the time the parties entered into the financing commitment contract and the time the financing commitment contract is settled, the issuer can force the banks to honor their financing commitment by requiring that they deliver the agreed amount of funds to the issuer, regardless of the price at which the banks can sell the issue's debt to the initial holders. This can drive a significant proceeds-issue price disparity, as the following example illustrates.

> ***Example 1***. *Forward Financing Commitment – Issuer's proceeds exceed issue price*. The issuer intends to acquire a target corporation for cash. In anticipation of the acquisition, the issuer and the banks enter into a forward financing commitment contract. Under the contract, in return for paying certain customary fees, the issuer obtains the commitment of the banks to provide proceeds of $1 billion (principal amount) which the banks intend to raise by selling 6-year loans, with interest payable semiannually in cash at a fixed rate. The contract anticipates that the loans will be issued substantially contemporaneously with the closing of the acquisition (within approximately six months to a year after the financing commitment contract is entered into). The contract provides that the banks will remit $1 billion (less customary underwriting fees specified in the contract) to the issuer at closing. Most importantly, the contract provides that the parties will agree to set the interest rate on the loans at a market rate as of the time the contract is entered into, not to exceed 8.5%.

[43] The forward financing commitments can be more complex than described herein. For example, under a pre-closing reverse flex, an issuer can agree with the banks to reduce the yield so as to avoid above-par pricing in connection with a syndication.

> Assume that, during the time the forward commitment contract is open, there is an increase in risk-free market interest rates and/or an increase in the issuer's anticipated credit spread to risk-free rates such that the debt should be issued with a rate of 15% to be issued at par. However, because of the contract terms, the debt will be issued at the maximum rate allowed under the contract – 8.5%.
>
> At settlement, the issuer issues to the banks $1 billion (principal amount) of 6-year senior debt bearing coupon interest of 8.5%. In exchange, the banks deliver to the issuer the agreed-upon $1 billion of cash proceeds (less customary underwriting fees specified in the contract). Assume further that the banks immediately sell the loans to the investors for $750 million (i.e., the market value of a 6-year debt instrument bearing 8.5% interest where the yield is approximately 15%).

In this case, there is a proceeds-issue price disparity of $250 million. Although the issuer received $1 billion of proceeds in exchange for issuing the loans, the issue price of the loans is only $750 million – the price at which the first holders (other than the banks) acquired the loans. Because the banks acquired the loans in their capacity as underwriters, the price they paid to the issuer is ignored in determining the issue price.[44] The issue price of the issue is set at the price the investors paid the banks – $750 million.[45]

1. Potential Approaches: Unitary or Bifurcated

There are no rules directly addressing how the issuer should take into account the proceeds-issue price disparity in this case. Conceptually, there are two possible ways to address the disparity.

Under what we will refer to as the ***Unitary Approach***, the issuer would simply treat the entire amount of proceeds received as proceeds from the issuance of the debt. After all, in form, the issuer did receive $1 billion of cash in exchange for the issuance of the loans. Under this approach, the issuer would have an amount of proceeds ($1 billion) that differs from the issue price ($750 million). It necessarily follows that the issuer would reflect the debt obligation as a liability on its tax-basis balance sheet having a day-one amount of liability of $1 billion.

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[44] Treas. Reg. § 1.1273-2(e).

[45] Treas. Reg. § 1.1273-2(a)(1).

Although the debt issuance has $250 million of OID, the issuer would not take the OID into account as a deduction. Instead, the issuer would determine an issuer-specific amount of OID by treating the proceeds as an issuer-specific issue price. Because the issuer-specific issue price ($1 billion) equals the SRPM ($1 billion), the issuer would have no OID. Over the term of the debt instrument, the issuer would be entitled to deduct as interest expense only the coupon interest paid. This approach is consistent with the treatment of proceeds-issue price disparities under the reopening rules.

Alternatively, under what we will refer to as the ***Bifurcation Approach***, the issuer could bifurcate the $1 billion of proceeds into two amounts – proceeds equal to the $750 million issue price would be respected as proceeds from the debt issuance; the remaining $250 million of proceeds would be a stand-alone item of gross income. The Bifurcation Approach effectively avoids having a proceeds-issue price disparity by simply characterizing the difference between proceeds and issue price as something other than proceeds – in the case, a stand-alone item of gross income. Presumably, under the bifurcation approach, the stand-alone item of gross income would be characterized as gain from the deemed cash settlement of the forward commitment contract.[46]

But for the impact of section 163(j) and the AHYDO rules, the two approaches would produce identical *net* impact to the issuer's taxable income in each period. Under the Unitary Approach, the issuer would be entitled to deduct $85 million of coupon interest expense in each year. Although the debt issue would have $250 million of OID (the excess of the $1 billion SRPM over its $750 million issue price), the issuer would not experience this OID and therefore would not deduct it. From the Issuer's perspective, it obtained debt proceeds of $1 billion in exchange for undertaking an economic obligation to pay $1 billion of principal plus 6-years of interest at 8.5% with respect to the $1 billion of principal. Stated another way, if the issuer's $1 billion of proceeds were viewed as what is effectively an issuer-specific issue price, the issuer

[46] Indeed, the parties could have achieved the same cash and property flows by documenting the $1 billion cash flow from the banks to the Issuer as consisting of two discrete items – a $250 million cash-settlement payment with respect to the cash settlement of the forward commitment contract and a $750 million remittance of the proceeds of a best-efforts underwriting.

would not have OID. Thus, the issuer would be entitled to deduct only the $85 million of coupon interest per year.

Under the Bifurcated Approach, the issuer would deduct the same $85 million of coupon interest expense per year. However, it would have two additional items – (1) $250 million of OID expense, deductible over the 6-year term of the debt and (2) $250 million of stand-alone gross income from the deemed cash settlement of the forward commitment contract. Importantly, although the $250 million item of stand-alone gross income would be considered realized at the inception of the borrowing, under the hedge timing rules of Treasury Regulations Section 1.446-4, it would be required to be taken into account in the same periods that the $250 million of OID expense is taken into account, effectively offsetting the OID expense dollar-for-dollar. Under Treasury Regulations Section 1.446-4(e)(4), gain realized from the cash settlement of an anticipatory hedge of a future borrowing is required to be taken into account over the life of the borrowing "as if it . . . increased the issue price of the debt instrument." In other words, the Bifurcated Approach forces the stand-alone item of gain to be taken into account in a manner that produces the same net taxable income results on a period-by-period basis as would be obtained under the Unitary Approach.

Importantly, the consequences of the two approaches differ markedly once the impact of section 163(j) is factored in. Under the Unitary Approach, the issuer has only coupon interest expense on these facts. It follows that for section 163(j) purposes the debt issuance results in gross interest expense to the issuer in each year equal to the $85 million of interest paid each year ($510 million over 6 years). Assuming this gross interest expense is BIE, the issuer can deduct this amount to the extent it has section 163(j) capacity to do so.

Under the Bifurcated Approach, the issuer has gross interest expense of $760 million ($510 million of coupon interest plus $250 million of OID) over the term of the debt instrument. The issuer also has gross income of $250 million over the same period – the gain from the anticipatory hedge termination. Although the hedge timing rules "match" the timing of the hedge gain to that of the associated OID expense, neither they nor the section 163(j) regulations treat the hedge gain as BII (or negative BIE). Thus, assuming the issuer's ATI without regard to the borrowing and hedge gain is a positive amount, the $250 million of hedge gain would increase the issuer's ATI by $75 million (30% × $250 million). In order to fully deduct its

interest expense under the Bifurcation Approach, the issuer would need to have section 163(j) capacity sufficient to cover $685 million of interest expense ($510 million of coupon interest expense plus $250 million of OID less $75 million of ATI generated by the hedge gain).

The impact of the AHYDO rules must also be considered. Under the Bifurcation Approach, the debt issuance would be considered an AHYDO absent the inclusion of a "catch-up clause." Under the Unitary Approach, the debt issuance may or may not technically be an AHYDO, depending on whether AHYDO status is determined by reference to the instrument's issue price (in which case the instrument would be an AHYDO) or by reference to the issuer-specific issue price (in which case it would not be an AHYDO). As a practical matter, the AHYDO status of the instrument does not matter to an issuer applying the Unitary Approach on these facts as the issuer is not seeking an OID expense deduction.

2. Unitary Approach is better supported

Under current law, the Unitary Approach is better supported. From the issuer's perspective, the forward financing commitment functions as a put option or forward contract. Pursuant to the forward financing commitment, the issuer has the right to "put" to the banks $1 billion of debt for a strike price of $1 billion. Absent a special rule to the contrary, when an option or forward contract is gross settled pursuant to its terms (that is, the property is delivered in exchange for payment of the strike price), the option or forward contract is not separately accounted for – it resolves into a purchase and sale at the contractual price paid/received (with strike price adjusted for earlier premiums), which coincidentally would be the then-current fair market value ("***FMV***").[47]

In this situation there is little (if any) economic difference between the gross settlement of a forward contract or option (where the contract resolves into a purchase/sale at the contractual price) and an alternative transaction where the parties agree (i) to "cash-settle" the forward or option for its date-of-settlement value and (ii) to purchase/sell the property for its date-of-settlement value. Both transactional "forms" produce the same cash flows to the parties. In the

[47] See Rev. Rul. 78-182, 1978-1 C.B. 265. In this ruling the IRS considered the treatment of the gross physical settlement of put and call options. In each case, the IRS held that the seller's amount realized, and the buyer's basis, were determined by reference to the price paid pursuant to the option (the strike price adjusted for prior premiums paid/received).

example we have been using, the issuer delivered property (the debt instruments) having a date-of-delivery value of $750 million to the underwriters in exchange for $1 billion. The parties could have achieved the same cash and property flows by structuring the settlement in two parts – (i) the issuer delivers debt having a value of $750 million for $750 million of cash, and (ii) the issuer accepts $250 million in cash settlement of the forward commitment contract.

In this context, the two forms are economically equivalent. The form of settlement governs the taxation of a forward contract or option transaction in the absence of specific legislation otherwise. That explains why, in five narrowly circumscribed instances Congress has enacted legislation to force a party to a forward contract or option to account for the gross physical settlement of the contract on a bifurcated approach – that is, rather than respect the gross physical settlement as a purchase or sale at the contractually agreed price to bifurcate that transaction into (i) a purchase/sale at the then-current FMV of the referenced property and (ii) a cash settlement payment in respect of the forward or option contract.[48] None of those exception is applicable here. Thus, it appears that in this case, unitary or bifurcated treatment is a function of the form chosen. Where the parties settle the forward commitment physically according to its terms, the issuer should be treated as having proceeds from the issuance of its debt equal to the cash received.

Furthermore, at a fundamental level, we do not think the issuer's tax consequences should be impacted by the ultimate resale price by the Underwriters to the investors in a situation

[48] See (1) section 988(c)(5)(a physically settled forward or option contract over foreign currency must be bifurcated into a purchase/sale at the current FMV and a cash-settlement of the forward or option), (2) section 1234(c)(in the case of an option contract referencing an underlying section 1256 contract, the gross physical settlement of the option must be bifurcated into a purchase/sale of the underlying section 1256 contract at the then-current FMV and a deemed cash settlement of the option contract), (3) section 1256(c)(1)(taking or making delivery under a section 1256 contract is bifurcated into a purchase or sale of the underlying property at the then-current FMV and a deemed cash settlement of the section 1256 contract), (4) section 1092(d)(8)(a taxpayer that physically settles a contract or option to sell property by delivering the underlying property into the contract is required to bifurcate the transaction into a sale of the property at its then-current FMV and the deemed cash settlement of the contract or option where (i) the property and the contract or option constitutes a straddle, and (ii) immediately before the settlement, the contract or option is held at an unrealized loss), and (5) section 1260(f)(a taxpayer that takes delivery under a forward or option contract to acquire equity in a pass-through entity must bifurcate the transaction into a purchase of the underlying property at the property's then-current FMV and a deemed cash settlement payment with respect to the forward or option contract where the forward or option contract constitutes a constructive ownership transaction in the taxpayer's hands).

where the issuer has entered into a single economic arrangement which allows the issuer to be protected from any discount resulting in the resale price of the debt. From the perspective of the issuer, the financing arrangement is a single unitary financing transaction. While many financing transactions can be bifurcated into various components whose aggregate tax treatment is different than unitary treatment, the tax rules should generally not impose bifurcated treatment when the transaction is a unitary transaction.[49]

3. Suggested Regulatory Clarifications

a. Under the Unitary Approach

We recommend that regulations confirm the Unitary Approach result. To do so, several changes to the existing regulations are needed.

First, it is necessary to clarify that proceeds-issue price disparities (arising outside of the reopening context) ought to be taken into account by the issuer as an adjustment to yield. To clarify and confirm the issuer's tax accounting for the proceeds-issue price disparity in this case and any other case where an issuer receives proceeds that differ from principal amount, we recommend that the IRS propose and finalize regulations making clear that whenever the issuer receives proceeds in an amount different than the issue price of the debt, the issuer would account for the proceeds as an adjustment to the go-forward yield of the debt by computing an issuer-specific issue price and issuer-specific constant yield. We believe the most straightforward way to do so is to expand the scope of existing Treasury Regulations Section 1.163-7(e). Currently, this provision is limited by its term to proceeds-issue price disparities caused by reopenings (and potentially, only reopenings where the additional debt instruments are issued for cash). We suggest that the regulations be amended to remove the limitations, effectively generalizing the rule so that a proceeds-issue price disparity must, regardless of its origin, be taken into account using the same issuer-specific issue price mechanic.

[49] For example, convertible debt instruments are taxed as a unitary debt instrument, instead of being bifurcated into an equity option and a debt instrument issued with a deductible discount representing the premium of the built-in equity option. *Chock Full o'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971). Even more simplistically, the tax rules would not require a debt instrument bearing fixed rate interest to be bifurcated into a deemed floating rate debt and an interest rate hedge for US tax purposes in determining its tax consequences.

Under the Unitary Approach, for purposes of section 163(j), the issuer's interest expense arising from the debt over its term would be determined by reference to its issuer-specific issue price. Thus, we do not believe a special rule or change is required for section 163(j).

Under the Unitary Approach, it would be appropriate to clarify or change the measurement of CODI or bond repurchase premium expense, and we believe this can be achieved in Treasury Regulations Section 1.61-12(c). Under current law, CODI or bond repurchase premium expense is determined by comparing the repurchase price to the AIP. Presumably, the reference to AIP in the current regulations is a reference to the AIP of the instrument and not the issuer-specific AIP. If the issuer is computing its interest expense accrual by reference to an issuer-specific AIP, it would be logical to compute CODI and bond repurchase premium upon the repurchase/retirement of the debt by reference to the same issuer-specific AIP. We believe that doing so would more logically consistent with the concept of CODI.

Finally, if the Unitary Approach is adopted, we recommend that regulations be issued to clarify that AHYDO determinations be made by reference to the issuer-specific issue price rather than the instrument's issue price.

b. Under the Bifurcated Approach

It is possible to achieve the same results employing the Bifurcated Approach; however, several additional rules would be needed. Under the Bifurcated Approach, there is no proceeds-issue price disparity; the excess cash received is treated as a stand-alone item of income – gain from the deemed cash-settlement of the forward financing commitment contract. Because this gain would clearly qualify as realized gain from an anticipatory hedging transaction, there would no need for additional rules addressing its timing.[50] Under the hedge timing rules, it must be taken into account in the same period or periods that the corresponding items of OID expense are taken into account.

To ensure that the Bifurcated Approach produces appropriate results under section 163(j), additional rules would be needed. Absent a change to the regulations under section 163(j), the

[50] One general prerequisite for hedge treatment to apply is for the taxpayer to have a trade or business. See section 1221(b)(2). We expect such requirement to be generally met where forward commitments are utilized.

Bifurcated Approach would create a section 163(j) mismatch – in each period, the issuer would have equal and offsetting amounts of OID interest expense and hedge gain income amortization but, because the hedge gain income items are considered non-interest income, they would not offset each other for purposes of section 163(j). To ensure the hedge gain income and OID expense offset each other for purposes of section 163(j), it would be necessary to create a new rule deeming hedge gain income to be treated as BII when it operates to offset BIE.[51]

Finally, under the Bifurcated Approach, consideration would need to be given to rules addressing the impact of AHYDO. Under the Bifurcated Approach, the issued debt would have OID and therefore may constitute an AHYDO on a stand-alone basis. A set of regulatory rules could be crafted to address AHYDO treatment where the issuer's interest expense deduction attributable to OID is offset by hedge gain amortized over the same period.

If Bifurcated Approach is adopted, additional changes would also be necessary to address the other fact patterns where proceeds-issue price disparities that were discussed above (i.e., the disparities arising under the uniform issue price rule and the disparities arising from issuer's deduction of de minimis OID).

C. Post-Closing Market Flex

In certain syndicated loan transactions, the arranging banks lend money to the issuer in advance of syndication. In some cases, the arranging banks negotiate for the right to make certain adjustments to the terms of the loan if necessary to facilitate a subsequent syndication to third-party holders. Specifically, the banks may negotiate for a "market flex" provision that gives the bank the right to change the pricing of the debt, for example, by changing coupon or

[51] In the NYSBA Tax Section Report No. 1393, Report on Section 163(j) (March 28, 2018) ("***2018 Report***"), we observed that "it seems questionable whether there would be authority for guidance applying section 163(j) to interest equivalents, absent a statutory amendment." 2018 Report, at 13. In the NYSBA Tax Section Report No. 1393, Report on Proposed Section 163(j) Regulations (February 26, 2019) ("***2019 Report***"), commenting on the then-proposed regulations, we supported the view that hedge gain/loss could be treated as interest income/expense for purposes of section 163(j) and focused on the concern that the final rule be both clear and administrable. 2019 Report, at 28. The final regulations do not treat hedge gain/loss as interest income/expense even though they, by definition, have the effect of altering the issuer's effective cost of borrowing. Finally, it is worth noting that if an exception to the final regulations is adopted in this case, it is likely to be perceived as inherently taxpayer favorable – treating hedge gain as interest income for purposes of section 163(j) is always favorable for a section 163(j) constrained taxpayer.

interest rate or by charging a one-time fee, subject to an overall cap, to the extent necessary to facility a syndication at par (or as close to par as possible with the overall cap on yield). In some transactions, such market flex right can be exercised after the loan is funded. If the loan is extended by the banks and the market for the issuer's debt deteriorates, the banks may exercise their market flex right to increase the yield of the loan up to the capped rate. In such case, if the loans are syndicated for a price less than par even after the changes under the market flex, the transactional pattern presents an issue similar to the proceeds-issue price disparity issue discussed above. Consider the following example.

> ***Example #2*** *– Post-Closing Market Flex*. The issuer obtains the commitment of the banks to provide proceeds of $1 billion (less customary fees) which the banks intend to raise by selling issuer's 6-year loans to the investors at an interest rate of 8.5%. If the market is not receptive to the loans, the banks have the ability to increase the interest rate on the loans up to 10% within the first 90 days after funding. The banks fund the loans with a rate of 8.5% and, 60 days after funding, the banks exercise the market flex to increase the interest rate to 10% and sell the loan to the market at $750m. The loans are prepayable at any time, although certain prepayment premium may apply depending on when the prepayment occurs.

Very technically, the bank's exercise of their market-flex option may result in a "significant modification" under Treasury Regulations Section 1.1001-3 and therefore a debt-for-debt exchange. If so, the issue price of the "new" debt would be $750 million. In such case, because the issue price of the new debt is used to determine the repurchase price of the old debt,[52] the issuer would realize $250 million of current CODI upon the retirement of the old debt and have $250 million of OID expense over the life of the new debt.

The significant modification analysis turns on whether the bank's exercise of its market flex option to increase the yield constitutes a "modification" within the meaning of Treasury Regulations Section 1.1001-3(c). If so, the modification would be considered significant under the change-in-yield rule of Treasury Regulations Section 1.1001-3(e)(2). In general, change in the terms of a debt instrument (such as an increase in the yield pursuant to a market-flex option of the underwriter) would be considered a "modification" unless it were pursuant to the exercise

[52] Section 108(e)(10) provides that for purposes of measuring CODI upon a debt-for-debt exchange, the issue price of the new debt is deemed to be the repurchase price of the old, retired debt.

of a "unilateral option" of one of the parties.[53] A holder option is considered "unilateral" for this purpose if only if the issuer does not have the right to repurchase the debt at the time of holder's option is exercised.[54] As a technical matter, the issuer usually has the right to repay the debt (even if it is at a premium), and therefore the bank's exercise of the market-flex option appears to be a modification that would be considered a significant modification. Under such interpretation, as a technical matter, the banks' exercise of the market-flex option to increase the yield triggers a debt-for-debt exchange and, therefore current CODI and corresponding future OID expense.

This technical result feels inappropriate in this context. The issuer indeed has a technical legal right to repay the debt at the time the banks exercise the market-flex option to increase the yield to the agreed-upon capped rate. But, for the precise reasons the banks are compelled to exercise their option to increase the yield, the issuer is economically compelled to not prepay the debt. Even after the increase in rate, the banks cannot syndicate the debt at par. The bank's inability to syndicate at par is irrefutable evidence that the issuer's cost of borrowed funds at the time of the market-flex/syndication is greater than the capped rate on the fully-market flexed borrowing. In order to repay this borrowing, the issuer would have to obtain funds from another source at a higher rate. In other words, the capped rate the issuer negotiated with the banks is a more favorable rate than a current market rate for the issuer. Put still another way, the Issuer would never return its $1 billion in borrowed cash so as to avoid becoming liable on debt having a below-market interest rate, since it would be better off letting the debt issuance go forward and then buying back that debt at the market price of less than $1 billion. As a result, the issuer cannot exercise its option to repay without suffering material economic disadvantage, and it would be counterfactual to view the issuer as having a true option to repay.[55] Ignoring the

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[53] Treas. Reg. § 1.1001-3(c)(1)(iii).

[54] Treas. Reg. § 1.1001-3(c)(3)(i).

[55] Historically, in connection with the repeal of section 1275(a)(4), NYSBA has advocated, under a so-called "substitution of obligation" theory, that it would be inappropriate to create OID and CODI in a debt-for-debt exchange transaction. See NYSBA Tax Section Report 686, Report Of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges (March 25, 1991). We are not re-advancing those arguments. However, we do believe fact patterns where existing debt instruments appear to be modified or taken out by new debt instruments through a pre-existing firm commitment underwriting arrangements (as in the case of market flex and securities demand transactions) are distinguishable from transactions where issuers go to the market to

issuer's option to prepay in such case would be analogous to other contexts where issuers are deemed to exercise an option only if such exercise is in their economic interest.[56]

This situation bears a close resemblance to the forward financing commitment situation discussed above. In both cases, the issuer negotiated for and obtained the commitment of banks to arrange debt financing for the issuer on terms that were "market" at the time the terms were negotiated. In both situations, between the time the issuer and banks agreed to the all-in capped rate and the time the banks ultimately placed the debt with initial holders, the market deteriorated such that the issuer's capped financing rate appears favorable to the issuer. The only difference is the timing of the sale to the initial holders – in the forward commitment example, the market for the issuer's credit deteriorates prior to the funding of the issuer; in this post-close market-flex example, the market for the issuer's credit could decline even after the funding. This timing difference should not make a difference as to the ultimate result to the issuer – in both cases, the issuer is enjoying the use of funds on the contractually agreed-upon terms, terms that were market when initially negotiated. In the end, the issuer has received $1 billion in proceeds and the debt was ultimately sold to the third-party investors at $750 million, in each case, pursuant to the overall financing arrangement entered into between the issuer and the banks at the inception.

It makes little policy sense to force the issuer to realize current CODI and corresponding future OID in the post-close market-flex fact pattern if the issuer does not realize current gross income and corresponding future OID in the forward commitment situation. Moreover, in the post-close market-flex situation, the current CODI/future OID expense result appears to be a function of an overly mechanical application of the definition of "modification" in Treasury Regulations Section 1.1001-3(c). The obvious concept underpinning the unilateral option rule is that an option is not truly "unilateral" if, upon one party's exercise of the option, the other party can make other changes or simply unwind the transaction. This makes sense and produces reasonable results in most situations – where the exercise of one party's option is accompanied

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modify or exchange their existing debt instruments. It does not make much policy sense to analyze a transaction that occurs through existing contractual arrangements that issuer has entered into with a financial institution as a deemed exchange or debt-for-debt exchange.

[56] For example, under Treas. Reg. § 1.1272-1(c)(5), in determining OID schedule of a debt instrument, an issuer would be assumed to exercise an option that it has only if such exercise would reduce the yield of a debt instrument.

by the other party's ability to accept the change or terminate the deal, it is quite fair to conclude that the exercise of the option accompanied by the other party's choice to leave the deal in place reflects a new "agreement" between the parties. Where, as is the case here, the second party's option would result in such second party to suffer material economic disadvantage, the first party's option should be considered unilateral for this purpose.

In our view, the unilateral option rule should be clarified to make clear that the arranging bank's exercise of a market flex provision is considered unilateral whenever the issuer would suffer material economic disadvantage if it were to exercise its right to repay.[57] In such a case, the economic compulsion prevents the option from functioning as an option in the true sense of the word – regardless of whether the arranging banks exercise their market-flex option, the issuer has strong economic incentive keep the debt outstanding. For this purpose, the issuer could be deemed to suffer material economic disadvantage when exercising its right to repay whenever the debt is syndicated at a yield that is greater than the all-in capped rate. Assuming our recommendation is accepted and there is no deemed reissuance, to complete the analysis, the syndication immediately after the exercise of the market flex would set the issue price of the debt to the initial holders, [58] meaning the holders would be purchasing debt issued with $250 million of OID.[59] As in the case of the sale of debt pursuant to a forward financing commitment, the issuer would treat the loan proceeds it initially received as giving rise to an issuer-specific issue

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[57] We do not think changes that occur prior to the sale of the debt to the investors (either under the post-closing market flex provisions discussed here or under the securities demand provisions discussed later in this Report) should be considered to result in contingent payment debt instrument concerns. Such changes are more in the nature of purchase price adjustments prior to the terms of the debt are established as opposed to bona fide changes in the yield of the debt while it is already being held by the intended investors.

[58] Under the applicable Treasury regulations, as with the definition of "issue price", the issue date of this debt instrument would be the date on which the debt has been sold by the banks to the holders. In the past, NYSBA has recommended changes to clarify that, subject to an anti-abuse rule, the "issue date" of an instrument should be the date on which it is treated as issued under general U.S. federal income tax principles (which we envision, under these facts, would be its funding date), even if the issue *price* of the debt instrument is established upon a subsequent sale by the banks acting in the capacity as underwriters. See NYSBA Tax Section Report No. 1425, Report on Tax Fungibility of Debt Instruments (November 5, 2019), at 28-30. We reiterate those recommendations here.

[59] Even though the banks have held onto the debt instruments for 60 days post-closing, we do not envision their status as underwriters for purposes of determining the issue price of the debt instruments should change by passage of time alone under the relevant facts. As such, their sale to the holders would set the issue price of the debt instruments.

price. The issuer's OID expense, if any, and AHYDO consequences, if any, would be determined by reference to this issuer-specific issue-price.

D. Committed Bridge Loans with Securities Demand

Another transaction closely related to the post-closing market flex situation is that of a committed bridge loan with a securities demand. In order to ensure the ability to close on an acquisition, as a backstop to a planned regular note offering, the acquiring party may also obtain a financing commitment from banks under which the banks agree to provide the issuer with a certain amount of proceeds which the bank plans to raise by selling the issuer's debt to the market on certain terms. Typically, the commitment agreement contemplates two scenarios. Under one scenario, the commitment functions like the forward financing commitment described above – the contract between the issuer and the banks obligates the banks to purchase debt securities from the issuer at the time the acquisition closes. The banks purchase the securities per the commitment, delivering the agreed-upon proceeds and immediately sell the securities to the initial holders. To the extent the proceeds to the issuer exceed the issue price established by the initial holder's purchase, this scenario is the same as the forward financing commitment scenario described above.

Under the second scenario, the banks fulfill their commitment by initially lending the agreed-upon funds to the issuer in "bridge loan" form at the time the acquisition is closed. The agreements contemplate that within a year from the close of the acquisition, the banks will be entitled to make a "securities demand" of the issuer. Pursuant to the demand, the issuer will transfer debt securities (in note, rather than loan, form) to the banks. The banks will sell the securities to third-party holders. when the securities are delivered to the banks, the issuer's obligation under the bridge loan will be retired.

> ***Example** #3 – Bridge Loan Taken Out by Securities Demand*. The issuer hires the banks to undertake a note offering transaction on a best-efforts basis. However, in the event such offering cannot be successfully placed into the market, the issuer also obtains the banks' commitment to provide the issuer with $1 billion of a bridge loan at or around the time the issuer's contemplated acquisition is to close – expected to be 6-8 months after the commitment is obtained. The bridge loan matures one year from the date of issuance, provides for quarterly interest at SOFR plus a fixed spread that increases each quarter.

In the event a bridge loan is made, the banks have the right to make a "securities demand" of the issuer within the first year. When the banks make this demand, the issuer is obligated to deliver to the banks (or their affiliates) $1 billion of fixed-rate notes that mature on the 6-year anniversary of the closing of the acquisition and that bear interest at a market rate, not to exceed an agreed-upon overall cap. The banks (or their affiliates) will sell the securities to unrelated investors and the bridge loan will be deemed fully repaid.

If the banks do not make the securities demand within the first year, the bridge loan will automatically morph into a fixed-rate loan that matures on the 6-year anniversary of the closing of the acquisition and that provides for a fixed-rate of interest at the capped rate.

At closing, due to deteriorating market for the issuer's debt, the best efforts offering cannot be successfully completed. Instead, the issuer calls on the banks' commitment and issues a $1 billion bridge loan to the banks in exchange for $1 billion of proceeds (less customary fees). The bridge loan provides for interest at SOFR plus a spread where the spread increases every quarter. The bridge loan provides for an overall interest-rate cap on 10%. The bridge loan matures on the one-year anniversary of the closing but extends to 6 years automatically with an interest rate set at a cap of 10%.

The notes will provide for a fixed rate of interest (subject to the 10% cap) that is designed so that the banks can sell them to unrelated holders for their face amount to the extent possible.

Shortly after the bridge loan is funded, the banks exercise the securities demand, and the notes are issued with a 10% interest coupon. Immediately after acquiring the notes, the banks sell the notes to third-party holders for $750 million. The bridge loan is automatically retired.

This fact patterns presents several issues. As a threshold matter, it is necessary to characterize the arrangement in one of three ways:

1. ***Debt-for-debt exchange***. Under this characterization, the issuer is viewed as having two sequential debt instruments (bridge loan followed by notes) where the second debt instrument is issued in a debt-for-debt exchange.
2. ***Single Continuing Debt***. Under this characterization, the issuer is viewed as having a single 6-year debt instrument that starts as a loan and is morphing to notes.

3. ***Cash-issuance/cash-retirement***. Under this characterization, the issuer is viewed as having two sequential debt instruments (bridge loan followed by notes) where the second debt instrument is issued for cash and the first debt instrument is retired for cash.

If the arrangement is viewed as a debt-for-debt exchange, the banks' exercise of the securities demand may result in a "significant modification" under Treasury Regulations Section 1.1001-3 and therefore a debt-for-debt exchange (e.g., by reason of the change in yield). If so, the issue price of the "new" debt (i.e., the notes) would be $750 million. Because the issue price of the notes is used to determine the repurchase price of the old debt,[60] the issuer would realize $250 million of current CODI upon the retirement of the old debt and have $250 million of OID expense over the life of the new debt. This treatment would result in the section 163(j) income/interest expense mismatch and potential AHYDO treatment issues discussed above.

Single continuing debt treatment may be possible if the exercise of the securities demand is determined not to result in a "modification" within the meaning of Treasury Regulations Section 1.1001-3. As discussed in the post-closing market flex context, the banks' exercise of securities demand does not appear to qualify as a unilateral option, because the issuer is able to terminate the bridge loan by prepaying it. However, the analysis here is analogous to the analysis in post-closing market flex in that the issuer's option to prepay the bridge loan under these circumstances is not without serious adverse consequences. The issuer would suffer material economic disadvantage if it were to prepay a bridge loan in this type of circumstance where the banks are unable to find a market for the issuer's notes at a price close to or equal to par. As such, the banks' option to make a securities demand really should be considered a unilateral option that does not trigger a "modification" for Treasury Regulations Section 1.1001-3 purposes. Assuming that a single debt instrument continues, to complete the analysis, the syndication immediately after the exercise of the securities demand would set the issue price of the debt to the initial holders. As in the case of the sale of debt pursuant to a forward financing commitment and post-closing market flex, the issuer would treat the loan proceeds it initially received as giving rise to an issuer-specific issue price. The issuer's OID expense, if any, and

[60] Section 108(e)(10).

AHYDO consequences, if any, would be determined by reference to this issuer-specific issue-price.

One final alternative is to view this arrangement as two separate sequential financing arrangements where the bridge loan is deemed paid at a cash price equal to the proceeds originally received by the issuer by a note offering subject to a Forward Financing Commitment. Since the bridge loan would be deemed paid at a price at or close to par, the issuer would not have any material CODI. The note offering itself would then be analyzed under one of the unitary or bifurcated approaches detailed above in the Forward Financing Commitment discussion. This approach would be justified on the basis of the form of the transaction as a repayment of a bank loan with a securities offering with different investors where the investors are presented with the option to invest in newly issued securities and the economics of the transaction where the banks (along with their affiliates) have assumed the loss that arises in the sale of the notes to the investor at a price below par.

In sum, in our view, this transaction should be either viewed as a single continuing debt or a cash issuance and cash retirement of bridge loan. Again, it makes little policy sense to force the issuer to realize current CODI and corresponding future OID in the securities demand fact pattern assuming, as discussed above, the issuer does not realize current gross income and corresponding future OID in the forward commitment situation. Viewing the transaction as a whole, we do not think issuer's tax consequences should be impacted by the ultimate resale price by the banks to the investors in a situation where the issuer has entered into a single economic arrangement which allows the issuer to be protected any discount resulting in the resale price of its notes. As between these two alternatives, our view is that the post-closing market flex and the securities demand fact patterns are comparable and as such both fact patterns should ideally be analyzed as a single continuing debt by modifying the definition of "unilateral option" for purposes of Treasury Regulations Section 1.1001-3 to cover these fact patterns.

E. Collateral Consequences

We do not envision the changes advocated under this Report – namely, the adoption of issuer-specific AIP to govern the tax consequences of debt transactions to an issuer – to change the tax treatment of debt instruments generally. As discussed previously, the time-value provisions specifically contemplate that holders may acquire individual debt instruments at

various times and at various prices. For each situation where a holder's initial basis differs from the debt instrument's then-current AIP, the market discount, acquisition premium and bond premium rules address how the holder is to account for the basis/AIP disparity. However, those rules do not change the character of the debt instrument itself. For example, if a holder acquires a debt instrument that is issued with OID at a price that has a premium above par, the holder generally does not accrue that OID. However, the fact that a holder does not accrue that premium does not change the character of the debt instrument as having OID. Similarly, we do not envision the fact that an issuer may have an issuer-specific AIP that is different from the issue price of a debt instrument would change the tax treatment of the debt instrument generally.

One instance where this distinction may make a difference is in determining whether or not a debt instrument has undergone a significant modification. Under Treasury Regulations Section 1.1001-3, a change in yield of an outstanding debt instrument may be treated as a deemed exchange if the yield change exceeds the greater of 25bps or 5% of existing yield. If our proposal is adopted, in the circumstances outlined earlier in this Report, where a debt instrument has a discrepancy between its issue price (or AIP) and issuer-specific AIP, we believe that the issue price (or AIP) of the debt instrument itself (and not the issuer-specific AIP) should govern the yield change deemed exchange determination.

With that said, if there were indeed a deemed exchange, the issuer would determine its own US tax consequences – i.e., whether it has any CODI or repurchase premium – based on its issuer-specific AIP. This approach is analogous to how a holder is treated in a deemed exchange, as they would determine their own tax consequences based on their own tax attributes with respect to the debt instrument.

> **Example #4A** -- *Transactions Subsequent to Firm Commitment Underwritings*. Same facts as Example 1. However, one month after issuance, for unforeseen reasons, the debt instrument's coupon is increased by 60bps through an amendment and other changes that are on their own not significant modifications (e.g., changes in customary financial covenants) are made.

In this example, whether the yield change for purposes of Treasury Regulations Section 1.1001-3 is determined based on issue price or issuer-specific issue price may determine whether the debt instrument has undergone a deemed exchange. Since the debt instrument has an issuer-

specific issue price of par, its yield from the perspective of the issuer is equal to the coupon rate at 8.5%. As such, a 60bps change in the yield of the debt instrument would exceed 5% of 8.5% and be sufficient for a yield change deemed exchange. However, since the debt instrument has an issue price of $750 million, as discussed previously, its actual yield is approximately 15%. We believe whether the debt instrument has undergone a yield change deemed exchange should be determined based on a yield of 15%. As such, under these facts, since the yield change would be less than 5% of 15%, there would be no yield change deemed exchange.

> ***Example 4B*** -- *Transactions Subsequent to Firm Commitment Underwritings*. Same facts as Example 1. However, one month after issuance, for unforeseen reasons, the debt instrument's coupon is increased by 1% through an amendment and other changes that are on their own not significant modifications (e.g., changes in customary financial covenants) are made. The debt continues to trade at $750 million upon the amendment.

In this example, since a yield change of 1% would exceed 5% of 15%, we believe the debt instrument should be treated as undergoing a deemed exchange. The deemed new issue price would be determined based on the trading value as of the time of the amendment, which is $750 million. The issuer would then determine its tax consequences based on its issuer-specific adjusted issue price of $1 billion and incur CODI in the amount of $250 million.

Another instance where the use of issuer-specific adjusted issue price as opposed to issue price may change the general taxation of a debt instrument is in analyzing the treatment of options under the alternative payment schedule rules.[61] These rules provided that, in determining the OID schedule of a debt instrument, an issuer is generally assumed to exercise an option if the exercise reduces the yield.

> **Example #5** -- *Transactions Subsequent to Firm Commitment Underwritings*. Same facts as Example 1. The debt instrument that is ultimately issued has an optional "PIK" feature, whereby the issuer has the right to pay the interest payments in additional debt instruments. The PIK rate is the same as the rate that applies to cash interest payments.

[61] Treas. Reg. § 1.1272-1(c)(5).

As discussed in the examples that accompany these rules, if a debt instrument allows the issuer of the debt instrument to make the interest payments in PIK at the same rate as cash interest payments, the issuer would be deemed to exercise the PIK option only if the debt instrument is issued at a discount.[62] In this example, the debt instrument has an issuer-specific issue price that is at par whereas the actual issue price of the debt instrument has significant OID. As such, whether the issuer is assumed to make the interest payments in PIK in determining OID accruals would depend on whether issue price or issuer-specific issue price is utilized in the analysis.

We believe the regular issue price (and not issuer-specific issue price) should govern the determination of whether the issuer exercises its option. As such, in the example above, the issuer should be assumed to exercise its option to pay the interest payments in PIK. As discussed, the issuer-specific issue price construct is intended to reconcile the taxation of the issuer with the economics of a particular transaction, and not to change the overall taxation of debt instruments. Furthermore, the option rule is intended to be a simplification to allow the OID schedule to be computed in a reasonable manner, even if the application of the rule results in a counterfactual outcome. For example, the option rule may envision an issuer to pay the interest payments on a debt instrument in PIK even in a situation where the issuer has no plans to use its PIK option (and vice versa). As such, our view is that there is not a basis to modify the regular application of this rule and thereby create additional complexity.

[62] Treas. Reg. § 1.1272-1(j), Examples 7 and 8.