New York State Bar Association Tax Section

Report on the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(5)(F)

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Report No. 1182

New York State Bar Association Tax Section

Report on the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(5)(F)

This Report[1] provides recommendations for guidance under Sections[2] 108(i) and 163(e)(5)(F), which were enacted as part of the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (the "Stimulus Bill"). Sections 108(i) and 163(e)(5)(F) are designed (among other things) to help taxpayers who choose to reduce their outstanding debt by repurchasing the debt at a discount and taxpayers who need to modify (or otherwise restructure) the terms of their outstanding debt but wish to do so outside of bankruptcy.

Section 108(i) has four main components. First, Section 108(i)(1) permits a taxpayer to elect to defer cancellation of debt income ("COD income") in connection with a "reacquisition" of an "applicable debt instrument" (an "ADI") and include the COD income ratably over a five-year period generally beginning in 2014. Second, if a taxpayer makes a Section 108(i) election with respect to the reacquisition of an ADI, Section 108(i)(2) requires the taxpayer to defer all or a portion of any "original issue

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[1] The principal drafter of this Report was David H. Schnabel. Substantial contributions were made by Daniel Backenroth and Erin Cleary. Helpful comments were received from Howard Adams, John Barrie, Andy Berg, Kim Blanchard, Micah Bloomfield, Andy Braiterman, Michael Bretholz, James Brown, Ivan Chebotariov, Henry Cohn, Peter Connors, Michael Farber, Patrick Gallagher, Marcy Gellar, Kevin Glenn, Stuart J. Goldring, Edward E. Gonzalez, Arthur Hazlitt, Jack Heinberg, David Higgins, Hillel Jacobson, John Kaufmann, Elizabeth Kessenides, Russell Kestenbaum, Eschi Rahimi-Laridjani, Carolyn Lee, Lisa Levy, Jiyeon Lee-Lim, Vadim Mahmoudov, David Miller, Steve Mills, John Narducci, Andrew Needham, Erika Nijenhuis, Debbie Paul, Albena Petrakov, Richard Reinhold, Burt Rosen, Larry Salva, Joel Scharfstein, Michael Schler, Jodi Schwartz, Daniel Shefter, Marc Silberberg, Eric Sloan, Eric Solomon, Karen Gilbreath Sowell, Peter Ulrich, Jon Zelnik and Lee Zimet.

[2] All references in this Report to "Section" and "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to the regulations issued thereunder (the "Treasury Regulations"). References to the "IRS" are to the Internal Revenue Service, references to "Treasury" are to the United States Department of the Treasury, and references to "Secretary" are to the Secretary of the Treasury.

discount" ("OID") arising on any newly issued debt instrument ("DI") if (i) the DI was issued in exchange for the reacquired ADI or (ii) the proceeds of the DI were used to effect the reacquisition of the ADI (the "OID Deferral Rule"). Third, Section 108(i)(5)(D) accelerates the deferred COD income and the deferred OID deductions upon certain events. Fourth, Section 108(i)(6) provides that in the partnership context (i) when the COD income is recognized, it must be allocated among the partners in the manner the COD income would have been allocated if it had not been deferred (the "Allocation Rule") and (ii) the deemed distribution under Section 752(b) resulting from a reacquisition is reduced to the extent that such deemed distribution would have given rise to gain under Section 731 (the "Section 731 Gain Deferral Rule").[3] Finally, Section 163(e)(5)(F) (the "AHYDO Turnoff Rule") turns off the OID deferral and disallowance rules otherwise applicable under Section 163(e)(5) in the case of certain "applicable high yield discount obligations" ("AHYDO").[4]

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

This Report is divided into six parts. Part I is a summary of our recommendations for guidance. Part II provides some of the technical background against which Sections 108(i) and 163(e)(5)(F) were enacted and some of the issues faced by taxpayers that modify the terms of their outstanding debt. Part III is a brief summary of Section 108(i), Section 163(e)(5)(F) and certain related provisions. Part IV discusses Section 108(i) in greater length, identifies areas where we believe the IRS and Treasury should issue guidance and offers recommendations relating to such guidance. Part V discusses Section 163(e)(5)(F) and identifies two issues as to which we believe the IRS and Treasury should issue guidance. Part VI discusses other potential changes to the rules governing debt modifications and exchanges which could provide a more permanent

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

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

solution to the problems faced by taxpayers that modify the terms of their outstanding debt or otherwise engage in a debt exchange.[5]

This Report generally does not discuss how Section 108(i) should be applied to taxpayers subject to special tax regimes, such as financial institutions and insurance companies. However, Part IV.F of this Report discusses the application of Section 108(i) to regulated investment companies ("RICs") and real estate investment trusts ("REITs").

I. Summary of Our Recommendations

A. Most Significant Recommendations Relating to Section 108(i)

Election Eligibility and Mechanics

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

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

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[5] As discussed below, while Sections 108(i) and 163(e)(5)(F) provide a temporary solution to the basic problem faced by most taxpayers that modify the terms of their debt, these Sections do not address the fundamental technical issue giving rise to that problem—that is, the requirement under current law that the issue price of debt issued in an actual or deemed debt exchange equal the fair market value of the debt in certain cases even where the principal amount of the debt is not reduced.

3. Protective Elections. Guidance should confirm that a taxpayer may make a protective Section 108(i) election on the original return for the year of the reacquisition even if the taxpayer takes the position that an underlying transaction does not result in COD income. Guidance should similarly allow a taxpayer that makes a Section 108(i) election with respect to a reacquisition to provide that the election apply to all (or an increased portion) of the COD income resulting from the reacquisition if the IRS determines that the reacquisition resulted in more COD income than was reflected on the original return. Although less important, it would be helpful for guidance to confirm that a taxpayer may condition a Section 108(i) election, or its scope, on other factors, like the extent of the taxpayer's insolvency or the amount of its net operating losses. Part IV.A.4.

Timing Issues

4. Earnings & Profits. Guidance should provide that where a corporation realizes COD income as a result of a reacquisition that reduces the stated principal amount of the corporation's debt, any COD income deferred under Section 108(i) is generally taken into account in the year of the reacquisition in computing earnings & profits ("E&P"). Guidance should further provide that, where the COD income results from a significant modification of a corporation's debt but the stated principal amount of the corporation's debt is unchanged (or where the corporation otherwise effects a debt exchange but the COD income exceeds the reduction in the stated principal amount of the corporation's debt), the corporation is required to take deferred COD income into account for E&P purposes but only to the extent it exceeds the amount of related OID that is subject to deferral under the OID Deferral Rule and has not been recognized (computed, for this purpose, without regard to the five-year limitation in Section 108(i)(2)(A)(i)(I)). Part IV.B.1. As discussed below, guidance should enact a separate E&P rule for real estate investment trusts and regulated investment companies.

OID Deferral Rule

5. Directly or Indirectly. Guidance should provide that the principles in Treas. Reg. § 1.279-3(b) will apply in determining whether the proceeds of a new DI were used "directly or indirectly" to reacquire an ADI. Part IV.C.2.

6. Debt Issued by an Affiliate to Fund a Reacquisition. Guidance should provide that the OID Deferral Rule will apply to defer OID deductions on a DI issued by one member of a consolidated group if the proceeds of the DI (or the DI itself) are used directly or indirectly to reacquire an ADI issued by another member of the group if a Section 108(i) election is made with respect to the reacquisition. Part IV.C.2.

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

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

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

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

We recommend that guidance also clarify how the OID Deferral Rule will apply in cases where a shareholder of an S corporation is allocated OID that is potentially subject to the OID Deferral Rule but is not allocated any of the deferred COD income.

Acceleration Rules

8. Transfer of Stock of Corporations (Other Than Pass-Thru Entities). Guidance should provide that the transfer of stock of a corporation (other than a pass-thru entity) generally will not accelerate the items deferred by the entity pursuant to a Section 108(i) election, even if the corporation joins or leaves a consolidated group. Special rules may be appropriate if (1) one member of a consolidated group issues a new DI and the proceeds are used (directly or indirectly) to fund the reacquisition of an ADI issued by another member of the group, (2) the OID Deferral Rule is applied to defer OID deductions on the new DI (as per recommendation 6 above) and (3) one of the two members leaves the group. Part IV.D.1.

9. Asset Reorganizations. Guidance should provide that the disposition of substantially all of the assets of a corporate taxpayer (other than a pass-thru entity) in a transaction to which Section 381 applies (such as an A, C or D reorganization or a Section 337 liquidation) generally will not be considered an acceleration event. Again, where the corporation leaves a consolidated group, it may be appropriate to include the special rules referred to in recommendation 8 above. Part IV.D.2.

Special Rules for Partnerships and Other Pass-Thru Entities

10. Special Rule for Deemed Distributions that Would Cause Section 731 Gain. Guidance should provide that the deemed distribution to a partner under Section 752(b) resulting from a reacquisition will be reduced (but not below zero) to the extent necessary to cause the partner to recognize the same amount of gain under Section 731(a) for the taxable year of the reacquisition that the partner would have recognized in the absence of the Section 108(i) election. In general, this would reduce (but not below zero) the deemed distribution to a partner resulting from the reacquisition by the lesser of (i) the partner's share of the deferred COD income realized in such reacquisition (applying the Allocation Rule) and (ii) the total amount of gain that the partner would have recognized under Section 731(a) in the taxable year of the reacquisition in the absence of the Section 731 Gain Deferral Rule. We would also support a rule that extends this principle to Section 731 gain that would otherwise be recognized in a later taxable year but that would not have been recognized in such later year if a Section 108(i) election had not been made. Part IV.E.1.b.

11. Transfer of a Partnership Interest as an Acceleration Event. It is important for guidance to confirm that the transfer of an interest in a partnership by a partner accelerates only the deferred items associated with the transferred interest. Part IV.E.1.c.

12. Allocation of Deferred COD Income by S Corporations. Guidance should treat deferred COD income of an S corporation as deferred at the shareholder level rather than at the S corporation level, similar to the deferral of losses under Section 1366(d), so that the S corporation shareholders at the time of the reacquisition will ultimately include the deferred COD income based on their ownership at that time even if there are changes to the ownership of the S corporation prior to the time the deferred COD income is recognized under Section 108(i). Part IV.E.2.

13. Allocation of OID Subject to the OID Deferral Rule. Guidance should provide that (i) OID will be allocated based on each partner's share of the OID as it accrues based on normal Section 704(b) principles, (ii) such OID will reduce such partner's Section 704(b) capital account as it accrues, and (iii) each partner will recognize its share of the deferred OID during the recognition period (or upon an acceleration event). Part IV.E.3.

B. Additional Recommendations Relating to Section 108(i)

Election Eligibility and Mechanics

1. Additional Guidance Relating to Definition of Applicable Debt Instrument. Guidance should confirm that the status of a DI as an ADI will not be adversely impacted by changes following the issuance date but prior to the reacquisition date and that the impact (if any) of such changes will be addressed (if at all) through the application of the acceleration rules. Part IV.A.2.b. It would be appropriate for guidance to confirm that (i) debt issued by an entity disregarded as separate from its owner is treated under Section 108(i) as having been issued by its owner and (ii) where the owner is a person other than a C corporation, the determination of whether the DI was issued "in connection with the trade or business of such person" will take into account any trade or business of such owner. Part IV.A.2.c. It would also be helpful to provide guidance on whether a DI issued by a partnership with a C corporation as a partner will always be treated as an ADI under Section 108(i)(3)(A) with respect to that partner. Part IV.A.2.d.

2. Meaning of "Acquisition". Guidance should confirm that the term "acquisition" is not limited to the list set forth in Section 108(i)(4) and specifically that the term also includes any other acquisition of an ADI, such as an

acquisition of an ADI for other types of property, so long as the underlying transaction gives rise to COD income. Part IV.A.3.a.

3. Guidance Regarding Indirect Acquisitions. Guidance should confirm that an indirect acquisition under Section 108(e)(4) that gives rise to COD income will be eligible for deferral under Section 108(i) so long as the COD income is realized with respect to an ADI. Part IV.A.3.a.

4. Section 108(i) Elections by Taxpayers Which Do Not File Returns. It would be helpful for guidance to provide a procedure for a Section 108(i) election to be made with respect to an ADI issued by a taxpayer which does not file a U.S. federal income tax return. Part IV.A.5.

Timing Issues

5. Treatment of Deferred Items under Sections 382 and 384. Guidance should confirm that the principles of Notice 90-27 and Notice 2003-65 apply to COD income and OID deductions deferred under Section 108(i). In addition, guidance should clarify how items deferred under Section 108(i) are taken into account in computing "net unrealized built-in gain" for purposes of Sections 382 and 384 and "net unrealized built-in loss" for purposes of Section 382. Part IV.B.2.

OID Deferral Rule

6. Interaction with Other Interest Deferral Rules. Guidance should (i) explain how the OID Deferral Rule interacts with the other rules that defer or disallow the deduction for OID and (ii) provide that OID will be considered "otherwise allowable" for purposes of the OID Deferral Rule even if it is deferred or disallowed under a different rule. Part IV.C.1.

7. Application of the OID Deferral Rule to Intercompany Debt. Guidance should confirm the application of the OID Deferral Rule and the matching rule in the case of debt issued between members of a consolidated group. Part IV.C.3.a.

Acceleration Rules

8. Asset Transfers that Do Not Involve a Liquidation of the Taxpayer. Guidance should confirm that the determination of whether there has been a sale of substantially all the assets of the taxpayer should be made on a look-through basis. Guidance should also provide that if a taxpayer transfers assets in a tax-free transaction in exchange for other property and the taxpayer does not liquidate (or distribute the other property received in exchange), the transfer should

essentially be ignored in determining the application of the acceleration rules. Part IV.D.3.

9. Acceleration upon Bankruptcy. It may be appropriate to treat the commencement of a bankruptcy proceeding as an acceleration event unless the taxpayer agrees to extend the statute of limitation on assessment during the pendency of the bankruptcy proceeding. In addition, it would be helpful for guidance to (i) explain the purpose behind the special acceleration rule relating to the commencement of a bankruptcy proceeding and (ii) provide that interest will not be charged to a taxpayer in cases where the special rule relating to bankruptcy proceedings is triggered. Part IV.D.4.

10. Change in Status. It may be appropriate for guidance to explain whether various changes in status are treated as an acceleration event, such as (i) when an S corporation becomes a C corporation (or vice versa) and (ii) when a consolidated group terminates but is not acquired by another group. Part IV.D.5.

11. Acceleration Events and Foreign Corporations. If a controlled foreign corporation ("CFC") makes a Section 108(i) election, it may be appropriate to treat the transfer of an interest in the CFC by a 10% U.S. shareholder as an acceleration event with respect to any COD income which would be treated as subpart F income. Similarly, depending upon when COD income deferred under Section 108(i) increases E&P for purposes of Section 1248 and for purposes of the "qualified electing fund" inclusion rules, it may be appropriate to treat a transfer of an interest by a 10% U.S. shareholder of a CFC or a shareholder of a passive foreign investment company that has a QEF election in place as an acceleration event (but only with respect to the transferred interest). Parts IV.D.6 and IV.D.7.

12. Cessation of Business. It would be helpful if guidance confirmed that a C corporation will not be treated as having ceased business for purposes of the acceleration rules unless and until the C corporation liquidates for purposes of Section 331. It would also be helpful for guidance to confirm the extent (if any) to which the principles of Revenue Procedure 97-27, which require the acceleration of Section 481 adjustments when a taxpayer is considered to have ceased to be engaged in a trade or business, apply for purposes of Section 108(i). Part IV.D.8.

Special Partnership Rules

13. Allocation of the COD Income. It would be helpful for guidance to explain whether in allocating COD income under the Allocation Rule the partnership is required to close its books immediately after the reacquisition. Part IV.E.1.a.i.

14. Treatment of Deferred Items for 704(b) Book Purposes. Guidance should confirm that the deferred items will be treated as current items of book income or book deduction for purposes of Section 704(b) and the Treasury Regulations thereunder. Part IV.E.1.a.ii.

15. Section 751(b). It would be helpful for guidance under Section 108(i) to confirm that the deemed distribution resulting from a reacquisition (including a reacquisition effected as an exchange of debt for equity) will not trigger the application of Section 751(b). Part IV.E.1.b.vi.

16. Additional Recommendation Regarding Transfers of Partnership Interest as Acceleration Event. Guidance should provide that certain transactions involving a transfer of an interest in a partnership will not be treated as acceleration events. Part IV.E.1.c.

17. OID Accruing After a Transfer. It would be helpful if guidance confirmed that, following a transfer of an interest in a pass-thru entity which triggers the acceleration rule, the transferee's share of any OID accruing after the date of transfer is not subject to the OID Deferral Rule.

18. Tiered Arrangements. It is important for guidance to explain how Section 108(i) operates in the context of tiered arrangements, such as where a partnership makes a Section 108(i) election and interests in the partnership are held by an upper-tier partnership or an S corporation. Part IV.E.4.

RICs and REITs

19. RICs and REITs. Guidance should confirm how Section 108(i) applies in the context of RICs and REITs, including (i) that COD income deferred under Section 108(i) is not taken into account in computing "investment company taxable income" or "real estate investment trust taxable income" until such income is includible in income under Section 108(i) and (ii) that RICs and REITs are not "pass-thru entities" for purposes of Section 108(i). In addition, guidance should provide that, in order to ensure that a RIC or REIT always has sufficient E&P to claim a dividends paid deduction in the year the COD income is recognized under Section 108(i), the E&P of a RIC or a REIT will not be increased until the COD income is recognized. Part IV.E.4.

C. Recommendation Relating to Section 163(e)(5)(F)

1. Guidance should explain whether the related party exception to Section 163(e)(5)(F)(i) applies (i) only if the AHYDO is issued pursuant to a transaction governed by Section 108(e)(4) or (ii) whenever the AYHDO is issued

to a related party (as that term is used in Section 108(e)(4)) even if the debt is not issued in a transaction to which Section 108(e)(4) applies. Part VI.

2. If our recommendation in I.A.6. above is adopted so that the OID Deferral Rule applies where (for example) an ADI of one member of a consolidated group is reacquired by another member of the group in exchange for a DI of such other member, guidance should provide that the AHYDO Turnoff Rule will similarly apply to the DI issued by such other member. Part V.B.

D. Recommendations for More Fundamental Changes

We recommend that the IRS and Treasury consider whether the existing rules relating to debt modifications and exchanges should be revised. More specifically, we recommend that the IRS and Treasury consider seeking a legislative change (or using the regulatory authority granted by Section 1275(d)) either to revise the existing issue price rules applicable to debt exchanges or otherwise change the rules relating to debt exchanges to better align the timing of the resulting COD income and OID deductions. In addition, we recommend that the IRS and Treasury consider revising (i) the Treasury Regulations under Section 1273 to allow taxpayers greater certainty in determining whether those rules apply to a debt exchange and (ii) the potentially abusive situation rules to clarify whether and to what extent those rules apply to a debt exchange that is not governed by the Publicly Traded Rules. Part VI.

II. Background

A. Basic Rules Relating to Cancellation of Debt Income

When a taxpayer borrows money, the taxpayer does not have income because the taxpayer is obligated to repay the money. However, if a taxpayer's obligation to repay the money is later cancelled in whole or in part, the taxpayer generally recognizes income at that time.[6] Specifically, if debt is satisfied with a cash payment that is less than the adjusted issue price of the debt, the issuer generally has COD income equal to the difference.[7] For example, if a company has $100 of debt outstanding and repurchases the

[6] Section 61(a)(12). The theoretical underpinning of this rule is that the satisfaction of a liability at a discount enriches the debtor and is therefore an accession to wealth. See United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

[7] Treas. Reg. § 1.61-12(c)(2)(ii). The adjusted issue price of a debt instrument is defined as its issue price increased by the portions of original issue discount previously includible in the gross income of any holder and reduced by the amounts of any payments previously made on the debt instrument other than payments of qualified stated interest. Treas. Reg. § 1.1275-1(b)(1).

debt for $60, the company generally recognizes $40 of COD income at the time of the repurchase.

Similar principles apply if debt is repaid with property that has a fair market value below the debt's adjusted issue price.[8] If debt is satisfied with the borrower's equity, the COD income is generally determined as if the issuer satisfied the debt with cash equal to the fair market value of the equity.[9] If a debtor issues a new debt instrument in satisfaction of existing indebtedness, the debtor is treated as having satisfied the existing indebtedness with an amount of money equal to the issue price of the new DI.[10]

In various situations, the tax law provides relief from the recognition of COD income. Section 108(a)(1) provides that gross income does not include any amount which would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if (A) the discharge occurs in a title 11 case, (B) the discharge occurs when the taxpayer is insolvent[11] (but not in excess of the amount by which the taxpayer is insolvent),[12] (C) the indebtedness is qualified farm indebtedness,[13] (D) in the case of a taxpayer other than a C corporation, the indebtedness is qualified real property business indebtedness,[14] or (E) the discharge occurs before January 1, 2013 and the indebtedness is qualified principal residence indebtedness. If a taxpayer's COD income is excluded under the title 11, insolvency or qualified farm indebtedness

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[8] See, e.g., Treas. Reg. § 1.1001-2(c) ex. 8.

[9] Section 108(e)(8).

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

[11] For this purpose, a taxpayer is insolvent to the extent that its liabilities exceed the fair market value of its assets, measured immediately before the discharge of indebtedness. Section 108(d)(3). Liabilities are valued at adjusted issue price, regardless of market or credit discounts. See Merkel v. Comm'r, 192 F.3d 844 (9th Cir. 1999).

[12] Section 108(a)(3).

[13] Section 108(a)(1)(C). Qualified farm indebtedness is indebtedness incurred directly in connection with a farming trade or business by a person 50% or more of whose gross receipts in the three taxable years preceding the taxable year of discharge are attributable to that business. Section 108(g)(2).

[14] Section 108(a)(1)(D). Generally, qualified real property business indebtedness is indebtedness, with respect to which the taxpayer makes an election, that is incurred or assumed by the taxpayer in connection with, and that is secured by, real property used in a trade or business in order to acquire, construct, renovate, or improve such property.

provisions, the taxpayer is required to reduce various beneficial tax attributes, such as net operating losses (and loss carryovers), tax credits, capital losses (and loss carryovers), and the tax basis in the taxpayer's property.[15]

B. Modifications of Debt Instruments

Under Section 1001, gain or loss is generally required to be recognized whenever property is converted into cash or exchanged for other property differing materially either in kind or in extent.[16] A modification of a pre-existing DI results in a deemed exchange of the pre-existing DI for a deemed new DI if the modification is considered a "significant modification" under Treas. Reg. § 1.1001-3.[17]

As noted above, upon an exchange (including a deemed exchange under Section 1001) of a pre-existing DI for a new DI, the issuer will generally recognize COD income to the extent that the adjusted issue price of the pre-existing DI exceeds the issue price of the new DI.

C. Issue Price of New DIs Issued in Exchange for Existing DIs

Section 1274 generally provides that the issue price of a DI issued for property (including existing debt) is equal to (i) the DI's stated principal amount (if there is adequate stated interest) or (ii) the DI's imputed principal amount (in any other case).[18]

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[15] Section 108(b)(2).

[16] Treas. Reg. § 1.1001-1(a).

[17] A change to the terms of a DI is considered a significant modification if (i) it is considered a "modification" of the DI under Treas. Reg. § 1.1001-3(c) and (ii) the modification is considered "significant" under Treas. Reg. § 1.1001-3(e). With certain limited exceptions, a modification of a DI generally means any alteration of a legal right or obligation of the issuer or the holder of a DI, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties or otherwise. In general, a modification is considered significant if, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are "economically significant." However, specific rules are provided for determining whether certain types of modifications are "significant," including modifications which change the yield of the DI, change the timing of payments due under the DI, change the obligor or security under the DI, or change the nature of the DI as something other than debt. A modification that adds, deletes or alters customary accounting or financial covenants is not a significant modification.

[18] Section 1274(a)(1).

Since DIs generally have adequate stated interest in the commercial setting, in most debt exchanges, the issue price of the new DI will equal its stated principal amount unless an exception applies.

There are two basic exceptions that can cause the general rule of Section 1274 not to apply when a DI is issued in exchange for property and cause the issue price of the DI to equal its fair market value. Specifically, the general rule of Section 1274 does not apply if (i) the issue price of the DI is determined under Section 1273 or (ii) the potentially abusive transaction rule applies.

1. Section 1273 and Public Trading

If a substantial amount of the DIs in an issue is traded on an established market (within the meaning of Treas. Reg. § 1.1273-2(f)), the issue price of each DI in the issue is equal to the fair market value of the DI as of the issue date.[19] Similarly, if a substantial amount of the DIs in an issue is issued for property (including pre-existing debt) that is traded on an established market (within the meaning of Treas. Reg. § 1.1273-2(f)), the issue price of each DI in the issue is equal to the fair market value of the property as of the issue date.[20] Under Treas. Reg. §1.1273-2(f)(1), property (including a DI) is treated as traded on an established market ("Publicly Traded") if, at any time during the 60-day period ending 30 days after the issue date, the property is described in Treas. Reg. § 1.1273-2(f)(2), (f)(3), (f)(4), or (f)(5). These rules are collectively referred to in this Report as the "Publicly Traded Rules."

Accordingly, in the case of an exchange (or deemed exchange) of a pre-existing DI for a new debt (including a deemed exchange arising from a significant modification), the issue price of the new debt will generally equal the fair market value of the debt on the exchange date if the new debt meets the definition of Publicly Traded during the 30-day period following the exchange or if the pre-existing debt met that definition during the 30-day period preceding the exchange.

In some cases, it is clear that the pre-existing DI met the definition of Publicly Traded (or that the new DI will meet that definition) during the relevant period. In these cases, it is clear that the Publicly Traded Rules apply in the case of an actual (or deemed) exchange of the pre-existing debt. However, in many other cases, it is extremely difficult to know with a high degree of confidence whether the Publicly Traded Rules apply.

[19] Treas. Reg. § 1.1273-2(b). This rule does not apply if a substantial amount of the DIs in the issue is issued for money.

[20] Treas. Reg. § 1.1273-2(c). This rule does not apply if a substantial amount of the DIs in the issue is issued for money or if Treas. Reg. § 1.1273-2(b) applies.

First, in many cases it is difficult for an issuer to know with a high degree of confidence whether its currently outstanding debt meets the definition of Publicly Traded.[21] Debt will meet the definition of Publicly Traded if:

> [I]t appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium). A quotation medium does not include a directory or listing of brokers, dealers, or traders for specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions.[22]

For a variety of reasons, it is often difficult for an issuer to conclude that its outstanding debt does <u>not</u> meet this definition. First, there is no comprehensive and reliable list of systems of general circulation that potentially meet this definition and, as a

[21] <u>See</u> N.Y. State Bar Ass'n, Tax Section, "Report on Definition of 'Traded on an Established Market' Within the Meaning of Section 1273" (Aug. 12, 2004).

[22] Treas. Reg. § 1.1273-2(f)(4). Property (including a DI) will also be considered publicly traded if (1) it is listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (15 U.S.C. § 78f), an interdealer quotation system sponsored by a national securities association registered under Section 15A of the Securities Exchange Act of 1934 (15 U.S.C. § 78o-3); or the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, the Tokyo Stock Exchange, or any other foreign exchange or board of trade that is designated by the Commissioner in the Internal Revenue Bulletin, (2) it is of a kind that is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market, or (3) price quotations are readily available from dealers, brokers, or traders (unless (A) no other outstanding debt instrument of the issuer (or of any person who guarantees the debt instrument) is considered publicly traded), (B) the original stated principal amount of the issue that includes the debt instrument does not exceed $25 million; (C) the conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (*e.g.,* the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or (D) the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer's other traded debt).

result, an issuer can never know for sure that its debt does not fall within this definition. Second, at least one system of general circulation is apparently available only to subscribers to the system and therefore, even if an issuer knows about the particular system, it may not have the ability to access the system to ascertain whether the debt is listed on the system or whether the system includes enough information to cause the debt to meet the definition. Third, even if a system of general circulation includes recent price quotations or recent sales information, it is often difficult to know whether that information "provides a reasonable basis to determine fair market value." It is not uncommon for there to be relatively few quotes or recent sales or for those quotes or recent sales to involve relatively small amounts of the debt.[23]

Second, even if an issuer is reasonably confident that its existing debt is not traded on an established market, it is generally impossible to know with a high degree of confidence that the new debt will not become traded on an established market during the 30-day period following the exchange.[24]

2. <u>Potentially Abusive Transaction Rules</u>

Even if the Publicly Traded Rules do not apply to determine the issue price of a DI issued in an actual or deemed debt exchange, the issue price of the new DI would still equal its fair market value if the potentially abusive situation rules apply. Specifically, under Section 1274(b)(3), if a DI is issued in exchange for property in a "potentially abusive situation," the issue price of the DI equals the fair market value of the property. Under Section 1274(b)(3)(B)(ii)(I) and Treas. Reg. § 1.1274-3(a)(2)(i), a potentially

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[23] Although the Publicly Traded Rules generally require that a substantial amount of the DIs in an issue be traded on an established market or that a substantial amount of the DIs in an issue be issued for property that is traded on an established market, it is not clear what is considered "a substantial amount" for this purpose or even how exactly these limitations are intended to be applied in some cases. For example, it is not clear how the "substantial amount" qualifier applies if price quotes are available but not expressly limited to a certain amount of DIs. Although a price quote may theoretically apply to any single DI in an issue (or any portion of the DIs in an issue), it may not represent the price at which the holders of a substantial amount of the debt would be willing to sell the debt or represent the price at which buyers would be willing to acquire a substantial amount of the debt. Moreover, while a system of general circulation may include prices from recent sales transactions, it is not clear how many such transactions are needed, whether they need to represent a certain percentage of the total debt in an issue, or how those principles are applied when there are multiple recent sales of the same portion of an issue.

[24] We note that under Treas. Reg. § 1.1273-2(f)(6), a temporary restriction placed on trading for purposes of avoiding the Publicly Traded Rules will automatically cause the property to be treated as traded on an established security market.

abusive situation includes any situation involving "recent sales transactions."[25] While it is generally believed that recent sales of DIs that do not amount to Public Trading under the Publicly Traded Rules typically do not trigger the application of the potentially abusive situation rules, the lack of express authority in this regard can create some uncertainty.[26]

D. Related Party Purchases

If a taxpayer has debt outstanding and a person "related" to the taxpayer acquires the debt for less than the adjusted issue price of the debt, the taxpayer is generally deemed to have COD income equal to the difference between the adjusted issue price and the purchase price, and the debt is deemed to have been reissued for an amount equal to the purchase price.[27]

E. The AHYDO Rules

Section 163(e)(5) limits the deductibility of OID on a DI if the DI is treated as an "applicable high yield discount obligation" ("AHYDO").[28] An AHYDO is generally defined as a DI that (i) has a term of more than five years, (ii) has a yield to maturity that equals or exceeds the "applicable federal rate" ("AFR") in effect for the calendar month of issuance plus five percentage points, and (iii) (in general) defers the payment of more

[25] While Section 1274(b)(3)(B)(ii)(I) refers to recent sales transactions, Treas. Reg. § 1.1274-3(a)(2)(i) refers to a recent sales transaction.

[26] Although the application of the potentially abusive situation rules is beyond the scope of this Report, guidance as to how those rules (and the recent sales transaction rule in particular) apply in the case of an actual or deemed debt exchange would be welcome. We note that if the potentially abusive situation rules do apply to a debt exchange whenever there has been a recent sale of the existing debt prior to the exchange, the potentially abusive situation rule would largely swallow the rule in Treas. Reg. § 1.1273-2(c). We also note that if a recent sale of a particular DI did trigger the potentially abusive transaction rules, it is not entirely clear whether those rules would apply to determine the issue price of only the particular DIs that were the subject of the recent sales transaction or all of the DIs that are part of the same issue.

[27] Treas. Reg. § 1.108-2.

[28] A DI has OID to the extent its stated redemption price at maturity exceeds its issue price. Section 1273(a)(1). Stated redemption price at maturity means the sum of all payments provided by the DI other than payments of qualified stated interest. Treas. Reg. § 1.1273-1(b). Any OID must generally be taken into account by a holder of a DI on the basis of a constant yield to maturity. Treas. Reg. § 1.1272-1(b)(1).

than one year of interest at any time after the first five years.[29] In the case of a corporate issuer of an AHYDO (or a corporate partner of a partnership that issues an AHYDO),[30] (1) the OID on the AHYDO is deductible only when it is actually paid and (2) if the yield to maturity on the AHYDO exceeds the AFR plus six percentage points, the OID in excess of that amount is permanently disallowed (even when paid).

If the Publicly Traded Rules apply to an actual (or deemed) exchange of a pre-existing DI, the exchange will generally (i) cause the issuer to have COD income equal to the difference between the issue price of the pre-existing DI and the fair market value of the debt on the exchange date and (ii) cause the new DI to have additional OID equal to the amount of the COD income. In light of the depressed prices of most corporate debt, the amount of additional OID is likely to cause the new DI to be treated as an AHYDO unless either the remaining term of the DI not more than five years or the DI includes prepayment provisions that prevent status as an AHYDO.

> <u>Example 1</u> Corporation has $100 of Publicly-Traded debt outstanding due in 10 years. The debt does not have any OID. At a time when the debt is trading at $40, the corporation agrees to a 6% increase in the interest rate in order to induce the holders to agree to waive a covenant default. The change to the interest rate is a significant modification that gives rise to a deemed exchange of the debt. As a result of the deemed exchange, (i) (absent an election under new Section 108(i)) the corporation would recognize $60 of COD income upon the deemed exchange, (ii) the deemed new debt would have $60 of OID and be considered an AHYDO, and (iii) (absent new Section 163(e)(5)(F)), none of the OID would be deductible until paid and a portion of the OID would be permanently disallowed.

F. <u>Existing Rules Related to Modifications Create Substantial Problems for Taxpayers</u>

The current rules applicable to debt modification create substantial problems for taxpayers.[31] First, in light of the global economic downturn, many taxpayers need to significantly modify the terms of their outstanding debt. In many cases, the amount owed by the taxpayer actually increases as a result of the modification, such as where a taxpayer agrees to increase the interest rate under a DI to induce the lenders to waive a covenant default. It is counterintuitive that a change to a DI which increases the issuer's

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[29] Section 163(i).

[30] <u>See</u> Treas. Reg. § 1.701-2(f).

[31] <u>See also</u> Todd F. Maynes and Thad Davis, <u>Distressed Debt in Disorderly and Dysfunctional Markets</u>, 87 Taxes 55 (Mar. 2009).

financial obligation could create COD income to the issuer. Second, in light of the discounts at which business-related debt (including bank debt) is currently exchanging hands, a significant modification of a DI can trigger substantial amounts of COD income to the taxpayer if the Publicly Traded Rules apply. In many cases, the potential amount of COD income is so large that it would render the taxpayer insolvent if it were currently taxable.[32] Moreover, the application of the AHYDO rules adds a further substantial cost to effecting a significant modification of Publicly Traded debt. Third, the number of systems of general circulation has increased and those systems now provide information about bank debt. As discussed above, it is impossible for a taxpayer to know until 30 days after debt is significantly modified that the Publicly Traded Rules will not apply to the resulting deemed exchange. Moreover, even after that 30 day period, it is often difficult for taxpayers to know with a high degree of confidence that the Publicly Traded Rules do not apply.

While the current financial crisis has magnified these problems, they originate with the requirement that the issue price of the "new debt" arising in a deemed exchange be determined by reference to the fair market value of the debt if the Publicly Traded Rules apply. Prior to its repeal by the Revenue Reconciliation Act of 1990, former section 1275(a)(4) generally provided that the issue price of a DI issued in exchange for existing debt would not be less than the adjusted issue price of the exchanged debt so long as the exchange qualified as a reorganization.

III. Brief Explanation of the Provisions

A. New Section 108(i)

1. Election to Defer COD Income

Under Section 108(i)(1), at the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument is includible in gross income ratably over the five-taxable-year period (the "Recognition Period") beginning with (A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and (B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs.

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[32] Although the tax law may treat the taxpayer as having reduced its debt, that fiction is limited to tax. Thus, a taxpayer that significantly modifies Publicly Traded debt owes both (i) the stated principal of the debt and (ii) a 35% tax on the COD income.

2. Meaning of "Applicable Debt Instrument"

The term "applicable debt instrument" ("ADI") is defined to mean any "debt instrument" which was issued (i) by a C corporation or (ii) by any other person in connection with the conduct of a trade or business by such person.[33] The term "debt instrument" is defined to mean a "bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1))."[34]

3. Meaning of "Reacquisition"

The term "reacquisition" is defined to mean, with respect to any ADI, any acquisition of the debt instrument by the debtor which issued (or is otherwise the obligor under) the debt instrument, or by a person related to such debtor.[35] The term "acquisition" is defined, with respect to any ADI, to include an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital. Such term also includes the complete forgiveness of the indebtedness by the holder of the debt instrument.[36] The determination of whether a person is related to another person is made in the same manner as under Section 108(e)(4).[37]

4. Election Mechanics

An election under Section 108(i) with respect to any ADI is made by including with the return of tax imposed by chapter 1 of the Code, for the taxable year in which the reacquisition of the DI occurs, a statement which clearly identifies such instrument and includes the amount of income to which Section 108(i)(1) applies and such other information as the Secretary may prescribe.[38] Once made, the election is irrevocable.[39]

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[33] Section 108(i)(3)(A).

[34] Section 108(i)(3)(B).

[35] Section 108(i)(4)(A).

[36] Section 108(i)(4)(B).

[37] Section 108(i)(5)(A).

[38] Section 108(i)(5)(B)(i).

[39] Section 108(i)(5)(B)(ii).

In the case of a partnership, S corporation, or other pass-thru entity, the election is made by the partnership, the S corporation, or other entity involved.[40]

5. Coordination with Other Exclusions

If a taxpayer elects to have Section 108(i) apply to an ADI, Section 108(a)(1)(A) (title 11 case), (B) (insolvency), (C) (qualified farm indebtedness), and (D) (qualified real property indebtedness) do not apply to the COD income for the taxable year of the election or any subsequent taxable year.[41]

6. Requirement that Related OID Deductions be Deferred

a. In General

If, as part of a reacquisition to which Section 108(i)(1) applies, any DI is issued for the ADI being reacquired (or is treated as so issued under Section 108(e)(4) and the Treasury Regulations thereunder) and there is any OID with respect to the DI so issued, no deduction "otherwise allowable" is allowed to the issuer of such debt instrument with respect to the portion of such OID which (i) accrues before the Recognition Period and (ii) does not exceed the COD income with respect to the DI being reacquired (the "OID Deferral Rule").[42] However, the aggregate amount of OID deductions disallowed under the OID Deferral Rule is allowed as a deduction ratably over the Recognition Period.[43]

If the amount of the OID accruing before the Recognition Period exceeds the COD income with respect to the ADI being reacquired, the deductions are disallowed under the OID Deferral Rule in the order in which the OID is accrued.[44]

If any DI is issued by an issuer and the proceeds of such DI are used "directly or indirectly" by the issuer to reacquire an ADI of the issuer, the DI so issued is treated as issued for the ADI being reacquired for purposes of applying the OID Deferral Rule. If only a portion of the proceeds from a DI are so used, the OID Deferral Rule applies to the

[40] Section 108(i)(5)(B)(iii).

[41] Section 108(i)(5)(C).

[42] Section 108(i)(2)(A)(i).

[43] Section 108(i)(2)(A)(ii).

[44] Section 108(i)(2)(A) (flush language).

portion of any OID on the newly issued DI which is equal to the portion of the proceeds from such instrument used to reacquire the outstanding instrument.[45]

b. <u>Lack of Alignment of the Deferred OID with Deferred COD</u>

The OID Deferral Rule seems intended to prevent taxpayers from actually improving their tax position by making a significant modification to Publicly Traded debt (or engaging in an actual exchange of such debt), realizing COD income and making a Section 108(i) election. Since such a modification (or exchange) would generally create additional OID on the new debt equal to the deferred COD income, taxpayers would (absent the OID Deferral Rule) be able to deduct the OID over the life of the DI (including in years prior to the Recognition Period) even though the corresponding COD income would be recognized ratably over the Recognition Period.

The OID Deferral Rule is somewhat inexact. Assuming a Section 108(i) election is made, a significant modification of a Publicly Traded DI that is trading below its issue price may put the issuing taxpayer in a better position or a worse position (as compared with no deemed exchange), depending upon the remaining term of the DI and the amount of the pre-existing OID (if any).[46]

> <u>Example 2 (Where Taxpayer is Worse Off)</u> On January 1, 2009, Corp (a calendar-year taxpayer) significantly modifies a Publicly-Traded DI with a coupon rate of 5%, a stated redemption price and adjusted issue price of $1,000, and a fair market value of $800. The term of the DI, which is unchanged, ends on December 31, 2018. Corp realizes $200 of COD income and will accrue $200 of offsetting OID over the remaining term of the DI. Corp elects to defer the $200 of COD income under Section 108(i). The accrued OID prior to the commencement of the Recognition Period equals $81.04.[47] The accrued OID for the remaining years ranges from $20.29 in 2014 to $27.58 in 2018.

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[45] Section 108(i)(2)(B).

[46] If there is a deemed exchange of a pre-existing DI that has OID, the OID on the resulting new DI will generally equal the COD income realized in the deemed exchange plus the amount of unaccrued OID on the pre-existing DI. The OID Deferral Rule will apply to all of the OID accruing on the new DI prior to the Recognition Period (up to the amount of the deferred COD income) and thus in some sense will defer each year a portion of the OID that resulted from the deemed exchange and a portion of the original OID.

[47] For simplicity’s sake, these two examples use annual compounding.

Corp will recognize $40 of deferred COD income in each of the five taxable years from 2014 through 2018. However, Corp will recognize only $36.49 of OID deductions in 2014 (20% of $81.04 plus $20.29), $38.11 of OID deductions in 2015, $39.86 of OID deductions in 2016, $41.75 of OID deductions in 2017 and $43.78 of OID deductions in 2018.

Example 3 (Where Taxpayer is Better Off) On January 1, 2009, Corp (a calendar-year taxpayer) significantly modifies a Publicly-Traded DI with a coupon rate of 5%, a stated redemption price and adjusted issue price of $1,000, and a fair market value of $800. The term of the DI, which is unchanged, ends on December 31, 2014. Corp realizes $200 of COD income and will accrue $200 of offsetting OID over the remaining term of the DI. Corp elects to defer the $200 of COD income under Section 108(i). The accrued OID prior to the commencement of the Recognition Period equals $158.65. The accrued OID in 2014 equals $41.35.

Corp will recognize $40 of deferred COD income in each of the five taxable years from 2014 through 2018. However, Corp will recognize $73.08 of OID deductions in 2014 (20% of $158.65 plus $41.35), and $31.73 of OID deductions in each of 2015 through 2018.

c. Payment of the OID

Section 108(i) creates a meaningful disparity between cases where the new debt has qualified stated interest and cases where the new debt has OID. While Section 108(i) does not defer any deductions for qualified state interest, it defers OID deductions even if they are paid on a current basis. For example, if the terms of the new debt permit the issuer to pay the interest in cash or as a payment in kind ("PIK"), all of the interest is treated as OID (whether or not in fact paid in cash on a current basis). As a result, Section 108(i) may defer the deduction for the interest even if the issuer pays the interest in cash on a current basis. We note that this will obviously encourage taxpayers to structure terms of new debt so that as much interest as possible is treated as qualified stated interest.

7. Acceleration of Deferred Items

Section 108(i)(5)(D)(i) provides that, in the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under Section 108(i) (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed). Acceleration is also required in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity[48] by a partner, shareholder, or other person holding an ownership interest in such entity.[49]

8. Additional Special Rules for Partnerships

In the case of a partnership, any income deferred under Section 108(i) is required to be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under Section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge is not taken into account for purposes of Section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under Section 731. Any decrease in partnership liabilities deferred under the preceding sentence is required to be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under Section 108(i) is recognized.[50]

9. Grant of Authority for Guidance

Section 108(i)(7) provides that the Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying new Section 108(i), including: (A) extending the application of the acceleration rules to other circumstances where appropriate, (B) requiring reporting of the election (and such other information as the Secretary may require) on returns of tax for subsequent taxable years, and (C) rules for the application of Section 108(i) to partnerships, S corporations, and other pass-thru entities, including for the allocation of deferred deductions.

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[48] Section 108(i) does not include a definition of "pass-thru entity." There are numerous definitions of "pass-thru entity" and "pass thru entity" in the Code. See, e.g., Section 1(h)(10) (pass-thru entity includes a partnership, S corporation, estate or trust, common trust fund, RIC, REIT, or PFIC with a QEF); Section 267(e) (pass-thru entity includes a partnership or S corporation); Section 860E(e)(6)(B) (pass-thru entity includes a partnership, estate or trust, common trust fund, RIC, REIT, and a farmer's cooperative (and certain other coops)); Section 1202(g)(4) (pass-thru entity includes a partnership, S corporation, common trust fund, or RIC); Section 1260(c) (pass-thru entity includes a partnership, S corporation, trust, common trust fund, RIC, REIT, PFIC (without regards to Section 1297(d)), or REMIC, and the legislative history provides that a PFIC is deemed to include an investment company that is also a CFC); and Section 1281(b)(2)(D) (pass-thru entity includes a partnership, S corporation, trust "or other pass-thru entity").

[49] Section 108(i)(5)(D)(ii).

[50] Section 108(i)(6).

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

1. AHYDO Disallowance Turnoff Rule

Section 163(e)(5)(F)(i) provides that Section 163(e)(5) does not apply to any AHYDO issued during the period beginning on September 1, 2008, and ending on December 31, 2009, in exchange (including an exchange resulting from a modification of the DI) for an obligation which is not an AHYDO and which has an issuer (or obligor) which is the same as the issuer (or obligor) of such AHYDO. However, the general rule of new Section 163(e)(5)(F) does not apply to any obligation the interest on which is interest described in Section 871(h)(4) (without regard to subparagraph (D) thereof) or to any obligation issued to a related person (within the meaning of Section 108(e)(4)).

2. Successive Application

If Section 163(e)(5)(F)(i) applies to an obligation, then such obligation is not treated as an AHYDO for purposes of applying Section 163(e)(5)(F)(i) to any other debt issued in exchange for such obligation.[51]

3. Authority to Extend Suspension

Section 163(e)(5)(F)(iii) authorizes the Secretary to apply Section 163(e)(5)(F) with respect to DIs issued in periods following December 31, 2009 if the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets.

4. Change in Rate Used Under the AHYDO Rules

Amended Section 163(i)(1) permits the Secretary to raise the rate to be used for the purpose of determining whether a DI is an AHYDO above the AFR if the Secretary determines that such rate is appropriate in light of distressed conditions in the debt capital markets. This provision only applies for obligations issued after December 31, 2009, with respect to taxable years ending after such date.[52]

[51] Section 163(e)(5)(F)(ii).

[52] Stimulus Bill, Section 1232(c).

IV. Comments on Section 108(i)

A. Election Eligibility and Mechanics

1. Extent of Electivity

Various provisions in Section 108(i) contemplate that a Section 108(i) election is made "with respect to" a given DI or a given ADI.[53] It is not clear whether this language was intended (i) to impose some sort of consistency rule requiring that a Section 108(i) election made with respect to a given DI apply to all COD income arising from the reacquisition of the DI or (ii) merely to identify the DI from which the COD income arises to ensure that it is an ADI and therefore that a Section 108(i) election is available.

We recommend that guidance interpret Section 108(i) to allow a Section 108(i) election with respect to only a portion of the COD income resulting from a single reacquisition of a single ADI. For example, if a taxpayer reacquires a single ADI (*e.g.*, a single $100 note) from a single holder in exchange for $40, we believe that guidance should permit the taxpayer to effectively bifurcate the transaction and make a Section 108(i) election with respect to some of the COD income but not all of the COD income.[54] Thus, in this example, guidance would permit the taxpayer effectively to treat the transaction as involving the reacquisition of a $25 ADI for $10 that gives rise to $15 of COD income and the reacquisition of a $75 ADI for $30 that gives rise to $45 of COD

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[53] See, e.g., Sections 108(i)(1) (providing that the election is made for COD income in connection with the "reacquisition of an applicable debt instrument"); 108(i)(2)(A) ("there is any original issue discount . . . with respect to the debt instrument so issued"); 108(i)(2)(A)(i)(II) ("the income from the discharge of indebtedness with respect to the debt instrument being reacquired . . ."); 108(i)(2)(A) (flush language) ("the income from the discharge of indebtedness with respect to the applicable debt instrument being reacquired . . ."); 108(i)(4)(A) ("the term 'reacquisition' means, with respect to any applicable debt instrument . . ."); 108(i)(4)(B) ("the term 'acquisition' shall, with respect to any applicable debt instrument, include . . ."); 108(i)(5)(B)(i) ("An election . . . with respect to any applicable debt instrument . . . ."); and 163(e)(5)(F)(iii) ("The Secretary may apply this paragraph with respect to debt instruments issued . . . .").

[54] If Section 108(i) is interpreted so that, if a taxpayer reacquires a single $100 ADI, the taxpayer must make the election for all of the COD arising from that $100 ADI (*e.g.,* a single bond), guidance should be provided as to how to apply Section 108(i) to the reacquisition of a loan, which typically is not issued in the form of separate minimum-denomination-sized components.

income and to make a Section 108(i) election with respect to only the $45 of COD income.[55]

A number of factors underlie this recommendation. First, Section 108(i) is a taxpayer-favorable provision that is elective and is designed to provide taxpayers considerable flexibility[56] and to facilitate the reacquisition of ADIs by allowing taxpayers to elect to defer COD income arising from reacquisitions of ADIs. Increased flexibility as to the scope of a Section 108(i) election will enhance the ability of taxpayers to reacquire their outstanding ADIs. Moreover, the legislative history of Section 108(i) is devoid of any suggestion that the words "with respect to" an ADI were intended to impose some sort of consistency requirement or that any limits on electivity under Section 108(i) were intended (other than that the election be made on the taxpayer's tax return for the year of the reacquisition and that the election be irrevocable once made).[57]

Second, if this recommendation is not adopted, then (depending on guidance interprets what constitute a separate ADI) some taxpayers may be forced to reduce their outstanding debt by effecting multiple reacquisitions rather than a single reacquisition in order to achieve the same level of electivity. A rule that would force multiple reacquisitions with the attendant transaction costs and complexity does not seem

[55] This would allow, for example, (i) a taxpayer with a net operating loss that is less than the COD income to elect Section 108(i) treatment for the amount of COD income that exceeds the taxpayer's NOL, (ii) a taxpayer to make a Section 108(i) election for a DI without worrying that the election will apply to later reacquisitions when the taxpayer may be insolvent or in bankruptcy, and (iii) a taxpayer that is insolvent to make a number of reacquisitions in sequence, and have Section 108(i) apply only to the reaquisitions that were effected after the taxpayer was rendered solvent.

[56] The intended flexibility of Section 108(i) is further reflected by the fact that the taxpayer does not even need to decide whether to make a Section 108(i) election until it files its tax return for the year of the discharge. Section 108(i)(5)(B)(i).

[57] Although Section 108(i)(1)(A) refers to COD income "in connection with" the reacquisition of an ADI, we think this language was merely intended to broaden the reach of Section 108(i) and was not intended to impose any sort of consistency requirement. Similarly, although Section 108(i)(5)(C) provides that if a taxpayer elects to have Section 108(i) apply to an ADI, Sections 108(a)(1)(A), (B), (C), and (D) do not apply to <u>the income from the discharge of such indebtedness</u> for the taxable year of the election <u>or any subsequent taxable year</u>, we believe that the reference to any "subsequent taxable year" is merely intended to mean that the Section 108(a) exceptions are not available when the deferred COD income is recognized during the Recognition Period or upon an acceleration event and that the reference was not designed to create any sort of consistency rule.

necessary or appropriate. Moreover, we do not see what tax policy is served by interpreting Section 108(i) in a manner that would benefit taxpayers which engage in multiple reacquisitions rather than a single reacquisition and doing so would seem inconsistent with Section 108(i)'s goal of facilitating the reacquisition of ADIs.

Third, if this recommendation is not adopted, then (depending on guidance interprets what constitute a separate ADI) it will advantage taxpayers whose ADIs are widely held or issued in small denominations over taxpayers whose ADIs happen to be held by fewer holders (or a single holder) or happen to have been issued in larger denominations. Taxpayers in the former category would have the option to deleverage by effecting multiple reacquisitions and electing to have Section 108(i) apply to some but not all of the reacquisitions, whereas taxpayers in the latter category would not have the same level of flexibility, even if the total amount of their respective outstanding ADIs were identical. We do not believe any tax policy would be served by distinguishing between these two groups of taxpayers and nothing in Section 108(i) or its legislative history suggests that the electivity under Section 108(i) was intended to turn on the number of holders of an ADI or the size of the denomination of the ADIs (that is, whether the taxpayer issued one note with a face amount of $1 million or issued one thousand notes each of which has a face amount of $1,000). We note, in this regard, that Section 108(i) affects only the issuer's tax treatment, and an issuer is generally otherwise indifferent as to whether it issues or reacquires a single note or multiple notes, or effects a reacquisition from one holder or more than one holder. Accordingly, we do not believe that the application of Section 108(i) should turn on such factors.

Fourth, this approach would generally obviate the need for guidance as to what constitutes a separate ADI for purposes of Section 108(i) and when a Section 108(i) election made with respect to one reacquisition of an ADI will apply to a different reacquisition of the same ADI. We note, in this regard, that physical notes are almost never issued in today's market and in some cases it may be difficult for an issuer to know exactly who holds its debt. For bonds, one or more global notes are typically issued to be deposited on behalf of Delaware Trust Corporation ("DTC") and registered in the name of Cede & Co. as nominee of DTC, and ownership in the bonds is shown and the transfer of ownership is effected through records maintained by DTC or its nominee. DTC participants also often are nominees holding the interest in their street names for beneficial owners. Similarly, for loans, physical notes are rarely issued and the beneficial ownership in the loan is reflected in a register maintained by the administrative agent. Lenders also often sell participations in the loan they hold, which can effectively transfer the beneficial ownership in the loan to the participants for tax purposes.

As a result of the manner in which DIs are actually issued, a taxpayer that reacquires its outstanding debt may not know the identity of the ultimate beneficial owner or holder from whom the debt is being reacquired. Accordingly, if a single DI were defined as the rights held by a single beneficial owner or holder in a global note or a loan, an issuer that reacquires its outstanding debt often would not know whether it is reacquiring one DI or more than one DI. Moreover, as noted above, defining a single DI based on denominations or physical notes would be somewhat arbitrary and encourage amendments to create smaller denominations or exchanges with physical notes solely to create more flexibility in connection with a Section 108(i) election.

Fifth, if Section 108(i) were interpreted to include a consistency rule, we believe it would be important for guidance to address how that consistency rule applies in general and in the following situations:

Different Holders but One Overall Transaction. Suppose that two holders each hold an ADI issued by the taxpayer, the two ADIs are part of the same "issue" and the taxpayer reacquires both ADIs in the same transaction. We assume that a Section 108(i) election may be made with respect to one acquisition and not the other, but it would be helpful for guidance to confirm this.

One Holder with Two ADIs. Suppose instead that a single holder holds multiple ADIs issued by the taxpayer, the ADIs are part of the same issue and the taxpayer reacquires two of the ADIs from the single holder. Again, we assume that a Section 108(i) election may be made with respect to one of the reacquisitions and not the other, even if the two reacquisitions are part of the same transaction. It would be helpful for guidance to (i) confirm that this is the case and (ii) provide guidance as to when a holder will be treated as holding one DI or more than one DI when the DIs are part of the same issue. If this is not the case, it would be helpful for guidance to explain whether it is possible to make a Section 108(i) election with respect to one reacquisition of a DI but not a later reacquisition of another DI held by the same holder where such later reacquisition is effected (i) in a separate transaction that is not "in connection with" the first reacquisition, (ii) in a later taxable year that is still covered by Section 108(i) (*e.g.*, in 2010), or (iii) in a later taxable year that is no longer covered by Section 108(i) (*e.g.*, in 2011).

One Holder, One DI and Two Reacquisitions. Suppose instead that a holder holds a single ADI issued by the taxpayer, the taxpayer reacquires a portion of the ADI in one transaction and the remainder of the ADI in a different transaction. We believe that where one reacquisition is not made "in connection with" another reacquisition, the taxpayer should be permitted to make a Section 108(i) election with respect to one reacquisition but not the other reacquisition even if the two reacquisitions involve portions of the same ADI. It would be helpful for guidance to confirm whether this is the case and, if it is not the case, whether it matters if the second acquisition was effected (i) in a later taxable year that is still covered by Section 108(i) (*e.g.*, in 2010) or (ii) in a later taxable year that is no longer covered by Section 108(i) (*e.g.*, in 2011).

Election for Second but not the First. Suppose instead that the taxpayer reacquires a portion of an ADI in 2009 and does not make a Section 108(i) election and then reacquires an additional portion of the same ADI in 2010. We assume that the taxpayer is permitted to make a Section 108(i) election with respect to the 2010 reacquisition and that any such election will not apply to the 2009 reacquisition. Again, it would be helpful for guidance to confirm whether this is the case.

2. Meaning of "Applicable Debt Instrument"

The term "applicable debt instrument" is defined to mean any DI which was issued (i) by a C corporation or (ii) by any other person in connection with the conduct of a trade or business by such person.[58]

a. DI Issued by Taxpayers Other than C Corporations

It would be appropriate and helpful for guidance to explain when debt issued by a person other than a C corporation will be treated as having been issued "in connection with the conduct of a trade or business by such person."

i. Tracing

Section 163(h) generally provides that, in the case of a taxpayer other than a corporation, no deduction is allowed for "personal interest." Personal interest is generally defined as any interest other than certain types of interest that are excluded from the definition of personal interest. The types of interest excluded from the definition of personal interest include (among others), (i) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee) ("Section 163(h) Trade or Business Interest") and (ii) investment interest under Section 163(d).

Treas. Reg. § 1.163-8T prescribes rules for allocating interest expense for purposes of applying Sections 163(d), 163(h) and 469. Under those rules, (i) interest expense is generally allocated in the same manner as the debt to which such interest expense relates, (ii) debt is generally allocated by tracing disbursements of the debt proceeds to specific expenditures, and (iii) interest expense allocated to a "trade or business expenditure" is generally treated as Section 163(h) Trade or Business Interest. For purposes of Treas. Reg. § 1.163-8T, a "trade or business expenditure" means any expenditure (other than a passive activity expenditure or an investment expenditure) "in connection with the conduct of any trade or business" (other than the trade or business of performing services as an employee).[59]

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[58] Section 108(i)(3)(A).

[59] Under the Treas. Reg. § 1.163-8T rules, (i) "investment expenditure" means an expenditure (other than a passive expenditure) properly chargeable to capital account

Notice 89-35 prescribes a number of special rules for applying the Treas. Reg. § 1.163-8T rules in the context of partnerships and other "passthrough entities." For example, Notice 89-35 provides that if debt proceeds are traced under Treas. Reg. § 1.163-8T to a purchase of an interest in a "passthrough entity" (including a contribution to capital of the entity), the debt proceeds (and the associated interest) are allocated among the assets of the entity using any reasonable method. Reasonable methods of allocating the debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt already allocated to such assets.[60] The determination of whether a particular method is reasonable depends on the facts and circumstances and proceeds must be reallocated as the assets of the entity (or the use of such assets) changes.

Notice 89-35 further provides that debt of a passthrough entity (and the associated interest expense) must be allocated under the rules of Treas. Reg. § 1.163-8T. However, when debt proceeds of a passthrough entity are allocated under Treas. Reg. § 1.163-8T to a distribution to an owner of the entity, such debt proceeds generally must be allocated in accordance with the owner's use of such debt proceeds. If an owner's share of a passthrough entity's interest expense on debt allocated to distributions to owners exceeds the entity's interest expense on the portion of the debt proceeds distributed to that particular owner, the entity allocates the owner's excess interest expense using any reasonable method. Alternatively, a passthrough entity may allocate distributed debt proceeds (and the associated interest expense) to one or more expenditures (other than distributions) of the entity that are made during the same taxable year of the entity as the distribution, to the extent that debt proceeds are not otherwise allocated to such expenditures.[61]

Section 108(i)(3)(A)(ii) and Section 163(h)(2) each defines when debt issued by a taxpayer other than a C corporation will be considered business related.[62] In light of the

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with respect to property held for investment (within the meaning of Section 163(d)(5)(A)) or an expenditure in connection with the holding of such property and (ii) "passive expenditure" generally means an expenditure that is taken into account under Section 469 in computing income or loss from a passive activity of the taxpayer.

[60] Under Notice 89-35, when debt proceeds are contributed to capital, the debt may also be allocated by tracing the use of the proceeds after their contribution.

[61] However, distributed debt proceeds must be allocated under the general allocation rule applicable to distributions (*i.e.*, based on the owner's use of the proceeds) to the extent that the distributed debt proceeds exceed the entity's expenditures (other than distributions) for the taxable year to which debt proceeds are not otherwise allocated.

[62] Similarly, Treas. Reg. § 1.707-5 uses Treas. Reg. § 1.163-8T to determine whether a distribution is attributable to borrowed funds.

similarities between the two Sections, we recommend that guidance provide that a DI issued by a person other than a C corporation will be treated as an ADI if (i) the interest on the DI is treated as Section 163(h) Trade or Business Interest under Treas. Reg. § 1.163-8T and Notice 89-35 or (ii) interest on the DI would have been treated as Section 163(h) Trade or Business Interest but for the fact that (A) the expenditure funded with the DI was not treated as a trade or business expenditure merely because it was treated as an investment expenditure or a passive expenditure[63] or (B) under Notice 89-35, the proceeds of the DI were not treated as allocated to a trade or business expenditure merely because it was treated as allocated to an investment expenditure or a passive expenditure.[64]

ii. Simplifying Rule

The Section 108(i)(3)(A)(ii) test (was debt issued "in connection with the conduct of a trade or business by such person") is broader (at least in certain respects) than the tracing rule of Section 163(h)(2)(i) (was debt allocable to a trade or business). Various authorities have given a very broad interpretation to the words "in connection with." For example, in Snow v. Comm'r, 416 U.S. 500 (1974), the Supreme Court considered whether certain expenditures were deductible under Section 174 as experimental expenditures which were paid or incurred "in connection with [the taxpayer's] trade or business." The Supreme Court held that the expenditures in question met this definition even though they were incurred several years before a trade or business was actually established.[65]

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[63] Thus the DI at issue in Revenue Ruling 2008-12, 2008-10 I.R.B. 520, would be treated as an ADI even though the interest on the DI was treated as investment interest rather than Section 163(h) Trade or Business Interest.

[64] Unlike Section 163, the definition of ADI under Section 108(i) does not exclude cases where the debt is allocable to a passive activity or investment asset (so long as the debt is issued in connection with the conduct of a trade or business of such person). Accordingly, we believe that the carve outs under Section 163 for passive activity expenditures and investment asset expenditures should not apply so long as the expenditure is a trade or business expenditure. It would be similarly appropriate to apply Section 163(h) without regard to its exclusion of a trade or business of performing services as an employee, since this limitation is not found in Section 108(i)(3)(A).

[65] Subsequent courts construing Section 174 have concluded that there must be a "realistic prospect" at the time a person incurs expenses that such person will in the future be engaged in a trade or business utilizing the fruits of such expenses. See, e.g. Levin v. Comm'r, 832 F.2d 403 (7th Cir. 1987). A partner in a partnership that invests in another business, which is the developer and producer of the technology, may not claim a

Similarly, in Huntsman v. Comm'r, 905 F.2d 1182 (8th Cir. 1990), the Eighth Circuit construed "in connection with" broadly, stating that:

> When Congress adopted 'in connection with' for use in section 461(g)(2), it was aware of the Supreme Court's interpretation of the same language in Snow. Therefore, it is reasonable to assume that they intended the same broad interpretation to be given to section 461(g)(2).[66]

The Huntsman court concluded that for two things to be "in connection with" each other, they need only have an "association" or a "relation" with each other, but need not be "directly related" to each other. Accordingly, the court held that points paid on a mortgage taken out to refinance a short-term loan were paid "in connection with" the purchase of the taxpayer's home where the short-term loan was an "integrated step in securing the permanent financing to purchase the home."

The Tax Court has suggested a slightly narrower definition in reviewing whether certain expenses were "paid or incurred by the taxpayer, in connection with the performance by him of services as an employee . . . ." for purposes of Section 62(a)(2). According to the Tax Court, it is not sufficient that an expense have its origins in the performance of services as an employee. Instead, an expense must be "integral" to the performance of services by a taxpayer as an employee. At issue were legal fees of an employee incurred to pursue a wrongful termination lawsuit. The court held that they lacked the requisite connection to the trade or business of being an employee because they were not incurred on behalf of the employer.[67] After reviewing the authorities, the Tax Court stated that:

> The foregoing authorities obviously support a broad reading of "in connection with," but that is by no means a reading without limits. The cases acknowledge as much by articulating the bounds of the phrase. Specifically, Fort Howard Corp v. Comm'r and Huntsman v. Comm'r

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deduction under Section 174 because he is merely a passive investor, which is not a trade or business under the Code. Kantor v. Comm'r, 998 F.2d 1514 (9th Cir. 1993).

[66] The IRS adopted this reasoning in Tech. Adv. Mem. 200014007 (Apr. 10, 2000). Notably, that technical advice memorandum relates to the definition under Section 108 of "qualified real property business indebtedness" (defined as indebtedness which (among other things) was incurred or assumed by the taxpayer "in connection with real property used in a trade or business" and is secured by such real property).

[67] Biehl v. Comm'r, 118 T.C. 467 (2002).

found a "connection" existed when the expenditure at issue was "integrated" or "integral to" that to which it is allegedly connected.[68]

In light of the expansive meaning of the words "in connection with" in Section 108(i)(3)(A)(ii), we believe guidance should provide that a DI may be treated as an ADI even if some (or all) of the interest on the DI is not Section 163(h) Trade or Business Interest (and would not be even if the modifications described above applied).

The application of Section 108(i) would be complicated if a DI issued by a partnership (or other non-C corporation) always had to be broken up for purposes of Section 108(i) into one piece that is considered an ADI and one piece that is not considered an ADI, depending upon how the partnership (or other entity) used the proceeds from the DI or, in the case of a debt financed distribution, how the partners used the proceeds.[69] While it may make sense to trace the proceeds of debt to a partner's use of the proceeds for purposes of determining whether that partner may deduct the interest, it seems impractical to apply a similar rule for purposes of determining whether the debt is considered an ADI under Section 108(i) (which can affect all of the partners). Section 108(i) by its terms does not require that the proceeds of a DI be traced to expenditures used in connection with a trade or business but rather only requires that the DI be issued in connection with the conduct of a trade or business of such person.

Accordingly, we believe that guidance should provide that a DI will be treated as an ADI in its entirety if (i) at least 50% of the interest on the ADI is treated as Section 163(h) Trade or Business Interest (determined using the principles described above) or (ii) it was issued by an entity that is primarily engaged in the conduct of a trade or business, such as an entity (A) whose trade or business expenditures for the year of issuance exceed 50% of its total expenditures or (B) whose trade or business assets in the year of issuance represent at least 50% of its total assets (applying the principles of Notice 89-35).[70]

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[68] Id. at 481.

[69] Moreover, we think that it would be unduly restrictive to treat a DI as an ADI only if all of the proceeds were used (or allocable) to trade or business expenditures so that all of the interest were treated as Section 163(h) Trade or Business Interest.

[70] If our recommendation is adopted, it would be helpful if guidance confirmed that where a new DI is incurred to refinance a pre-existing DI, the status of the new DI as an ADI will be determined taking into account the principles of Treas. Reg. § 1.163-8T(e). See Treas. Reg. § 1.707-5(c) (applying the refinancing rule of Treas. Reg. § 1.163-8T(e) to the disguised sale rules).

iii. Debt Incurred to Acquire an Interest in a Pass-thru Entity that is Conducting a Trade or Business

Under Section 108(i)(3)(A)(ii), when a DI is issued by a person other than a C corporation, the DI is treated as an ADI only if it was issued "in connection with the conduct of a trade or business by such person" (emphasis added).[71] This could be read to mean that a DI will be treated as an ADI only if the DI was issued in connection with a trade or business directly conducted by the issuer. Under this reading, debt incurred by a partner to finance a capital contribution to a partnership or to buy a partnership interest arguably would not be treated as an ADI unless (i) the partner was otherwise conducting a trade or business and (ii) the acquisition was connected with that trade or business.

In Revenue Ruling 2008-39,[72] the IRS addressed a situation where an upper-tier partnership owned several lower-tier partnerships. Although the lower-tier partnerships were engaged in a trade or business, the upper-tier partnership's activities did not amount to a trade or business unless the activities of the lower-tier partnership were attributed to the upper-tier partnership. The upper-tier partnership and the lower-tier partnerships each paid management fees. Based on its determination that the management fees of the upper-tier partnership were its expenses (rather than expenses of the lower-tier partnership), the IRS concluded that the management fees paid by the upper-tier partnership were investment expenses deductible under Section 212 rather than trade or business expenses deductible under Section 162. In reaching this conclusion, the IRS reviewed several authorities suggesting that a partnership is permitted to deduct expenses under Section 162 only if the partnership itself is engaged in a trade or business.

On balance, we believe that guidance should provide that a DI issued by a taxpayer to acquire an interest in a partnership or other pass-thru entity ("Partnership Acquisition Debt") that is conducting a trade or business may be treated as an ADI under the principles described above (see Parts IV.A.2.a.i. and ii) even if the taxpayer is not otherwise conducting a trade or business. Moreover, we believe that such guidance would not be inconsistent with Revenue Ruling 2008-39.

First, the issue in Revenue Ruling 2008-39 was whether certain expenses were deductible by the taxpayer under Section 162, whereas the issue here relates to the definition of an ADI and whether the broad relief afforded by Section 108(i) will be available to a DI issued in a narrow circumstance.

[71] Similar words do not appear in Section 163(h). However, the definition of "trade or business expenditure" under Treas. Reg. § 1.163-8T does refer to expenditures in connection with the conduct of a trade or business.

[72] 2008-31 I.R.B. 252.

Second, unlike the amounts involved in Revenue Ruling 2008-39, the deductibility of interest on Partnership Acquisition Debt under Sections 163(d) and (h) is determined by looking at the activities of the acquired partnership rather than the activities of the acquiring partner. When a taxpayer buys an interest in a partnership that is engaged in a trade or business, Notice 89-35 effectively treats the taxpayer as if it bought the underlying assets of the partnership for purposes of determining the extent to which the proceeds of the debt will be treated as allocable to trade or business expenditures. Similarly, a taxpayer that buys an interest in a partnership is in some ways treated as if it bought an interest in the assets of the partnership under a variety of provisions, such as Sections 743 and 751. Moreover, in a variety of other areas, a taxpayer will be treated as engaged in a trade or business by virtue of being a partner in a partnership that is engaged in a trade or business (at least with respect to that partnership).[73]

Third, as discussed later in this Report, we believe that various aspects of Section 108(i) should be applied using aggregate concepts rather than entity concepts, including the application of the OID Deferral Rule and certain of the acceleration rules.

Fourth, the definition of ADI seems designed merely to weed out personal debt (such as home mortgage debt and credit card debt) and investment debt. Neither issue is present when a partner incurs debt to finance the acquisition of an interest in (or contribution to) a partnership that is conducting a trade or business.[74]

Fifth, it seems reasonable to interpret the words "by such person" in Section 108(i)(3)(A) as merely providing some limitation on Section 108(i)(3)(A)'s use of the words "in connection with." Thus, a DI issued by a taxpayer should not be treated as an ADI merely because the taxpayer is a partner in a partnership that is conducting a trade or business unless the debt was used to acquire an interest in the partnership (or otherwise relates to the partnership).

Section 108(i)(7) includes a specific grant of authority for the Secretary to prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying new Section 108(i), including rules for the application of

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[73] See, e.g., Section 875 and Rev. Rul. 2007-42, 2007-28 I.R.B. 44 (so holds for purposes of Section 355 as long as the partnership interest is significant).

[74] While debt incurred to acquire a passive investment in a partnership that is engaged in a trade or business may resemble debt incurred to acquire stock, Section 163 treats the two differently. Thus, interest on debt incurred to buy a passive interest in a partnership that is engaged in a trade or business is generally considered Section 163(h) Trade or Business Interest whereas interest on debt incurred to buy stock is generally treated as investment interest.

Section 108(i) to partnerships, S corporations, and other pass-thru entities. We believe that guidance under Section 108(i)(3) should use that authority to interpret the definition of ADI to include debt incurred to finance the acquisition of an interest in (or contribution to) a partnership that is conducting a trade or business.

b. Time for Testing Status

The definition of "applicable debt instrument" indicates that the status of a DI as an ADI is tested at the time the DI was originally issued. However, there are situations where the facts underlying the status of a DI as an ADI may change. For example, a corporation may convert from a C corporation to an S corporation while it has debt outstanding, and in this circumstance, the debt will continue to be considered an ADI even if it was not issued in connection with the conduct of a trade or business (apart from the fact that all C corporations are effectively treated as engaged in business). Similar circumstances could arise where a partnership assumes the debt of a C corporation (including a passive REIT) in a transaction that does not constitute a significant modification under Treas. Reg. § 1.1001-3 (as could be the case if the partnership acquired substantially all of the assets of the corporation).[75] Similar issues could arise where debt is incurred by a partnership in connection with the conduct of a trade or business and the partnership ceases to be in business prior to the reacquisition of the debt. Conversely, an S corporation that is not conducting a trade or business could issue a DI but convert to a C corporation prior to the time the DI is reacquired. Similarly, a disregarded LLC that issued a DI at a time when it was owned by a C corporation could become taxable as a partnership.

We expect that, in most situations, it will not matter whether the status of a DI as an ADI is tested as of the issue date or the reacquisition date. Moreover, we believe that it is generally sensible to test the status as of the issuance date and the statutory definition of ADI does not really work well as applied on the reacquisition date rather than on the issuance date.[76] Accordingly, we believe it would be appropriate and helpful for guidance to confirm that the status of a DI as an ADI will not be adversely impacted by changes following the issuance date and that the impact (if any) of such changes will be addressed (if at all) through the application of the acceleration rules.

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[75] Where a person assumes debt but does not acquire substantially all of the assets of the original issuer, the assumption will generally be treated as a new issuance of the debt unless Section 381 applies to the transaction. Treas. Reg. § 1.1001-3(e)(4).

[76] In the case of a DI issued by persons other than C corporations, the test is whether the DI was issued "in connection with the conduct of a trade or business by such person." This test seems to clearly look to the facts as of the issuance date and not the reacquisition date. Section 108(i)(3)(A).

c. <u>DIs issued by Disregarded Entities</u>

It would be appropriate and helpful for guidance to confirm that (i) debt issued by an entity disregarded as separate from its owner is treated under Section 108(i) as having been issued by its owner and (ii) where the owner is a person other than a C corporation, the determination of whether the DI was issued "in connection with a trade or business of such person" will take into account any trade or business of such owner.[77]

d. <u>DI Issued by a Partnership with a C corporation Partner</u>

It would also be helpful to provide guidance on whether a DI issued by a partnership with a C corporation as a partner will always be treated as an ADI under Section 108(i)(3)(A) with respect to that partner. Although the AHYDO rules by their terms appear to apply only to debt issued by a corporation, Treas. Reg. § 1.701-2(f) provides that, where a partnership with one or more corporate partners issues debt, each partner is treated as issuing its share of the debt for purposes of applying the AHYDO rules. Accordingly, a corporate partner's share of the OID deductions accruing on partnership debt is subject to the AHYDO deferral and disallowance rules as though the corporate partner had issued the debt.

> <u>Example 4</u> A is a C corporation and B is an individual. A and B are partners in a partnership. The partnership holds stock of a single corporation acquired as a long-term investment. The partnership previously issued a DI and used the proceeds to purchase the stock. The partnership does not conduct any other activities.

Absent an extension of Treas. Reg. § 1.701-2(f) (or other similar principles) to Section 108(i), the DI in this example would not be treated as an ADI with respect to A or B. However, it seems somewhat inappropriate not to treat the DI as an ADI as to A since (i) for the purposes of the AHYDO rules, A will be treated as having issued its share of the DI and (ii) the DI would have been treated as an ADI if A had issued its share of the DI directly. Although treating the DI as an ADI as to A would entail some complexity, it is hard to see why treating A as the issuer of a portion of the DI for purposes of applying Section 108(i) is any more complicated than treating A as having issued a portion of the DI for purposes of the AHYDO rules. If guidance provides that

[77] <u>See</u> Priv. Ltr. Rul. 200630002 (Apr. 24, 2006) (where an issuer of a DI converted from a corporation to an LLC as part of an F reorganization, the IRS looked to state law and held that the transaction did not result in a change in the recourse nature of the DI for purposes of Treas. Reg. § 1.1001-3(c)(2) since the conversion did not change the legal rights and obligations of the issuer (that is, the LLC) and the holders); <u>see also</u> Priv. Ltr. Rul. 200315001 (Sept. 19, 2002).

Section 108(i) is available in this circumstance, it should further provide whether the election is still made by the partnership.

Extension of the principles of Treas. Reg. § 1.701-2(f) to Section 108(i) is not inconsistent with the Allocation Rule (which seems to envision that each partner of a partnership that makes a Section 108(i) election be allocated a portion of the deferred COD income) and Section 108(i)(5)(B)(iii) (which provides that in the case of a partnership, S corporation, or other pass-thru entity, a Section 108(i) election shall be made by the partnership, S corporation or other pass-thru entity). Both of those rules are premised on the partnership being treated as the issuer of the ADI and as permitted to make a Section 108(i) election that would apply to all of the partners. The concerns underlying those rules seem less warranted where, as in the example above, the allocable share of the COD income of certain partners is not eligible for Section 108(i) deferral. Moreover, various aspects of Section 108(i) potentially apply at the partner level notwithstanding the fact that a Section 108(i) election is required to be made at the partnership level, including (i) the allocation of the deferred COD, (ii) the application of the OID Deferral Rule, and (iii) the application of the Section 731 Gain Deferral Rule.[78]

3. Meaning of the terms "Acquisition" and "Reacquisition"

Section 108(i)(4) provides that the term acquisition shall, "with respect to any applicable debt instrument, include" an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital. Such term also includes the complete forgiveness of the indebtedness by the holder of the debt instrument.[79]

a. "Includes" Means "Includes but is Not Limited to

It would be appropriate and helpful for guidance to confirm that the term "acquisition" is not limited to the list set forth in Section 108(i)(4) and specifically that the term also includes any other acquisition of an ADI, such as an acquisition of an ADI for other types of property, so long as the underlying transaction gives rise to COD income. We note, in this regard, that Section 7701(c) specifically provides that when the word "include" is used in the definition of a term, the word "include" shall not be deemed

[78] We note that, unlike the AHYDO rules, the definition of ADI has a specific rule for determining whether a DI issued by a partnership is treated as an ADI. However, that rule seems designed solely to expand the availability of Section 108(i) and does not seem designed to limit its availability.

[79] Section 108(i)(4)(B).

to exclude other things otherwise within the meaning of the term being defined. Moreover, the legislative history of Section 108(i) confirms that, when Congress used the word "include" in Section 108(i)(4), it meant include without limitation.[80] Indeed, the laundry list of items in Section 108(i)(4)(B) expresses a clear intent for an expansive definition rather than a narrow one.[81]

b. Technical Issue with Indirect Acquisitions

It would also be helpful for guidance to confirm that COD income resulting from an "indirect acquisition" under Section 108(e)(4) is eligible for deferral under Section 108(i). Under Section 108(e)(4), an indirect acquisition is a transaction in which a holder of outstanding debt becomes related to the debtor and acquires the debt in anticipation of becoming related.[82] Thus, an indirect acquisition involves the acquisition of the holder of the DI rather than the DI itself.

By contrast, the definition of "acquisition" for purposes of Section 108(i) seems limited to acquisitions of the DI itself and does not appear to extend to acquisitions of a holder of a DI. This creates some uncertainty as to whether COD income recognized as a result of an indirect acquisition under Section 108(e)(4) is eligible for deferral under Section 108(i).

However, under Section 108(e)(4), when an indirect acquisition results in the realization of COD income by the taxpayer, the debt is treated as new indebtedness issued by the debtor to the related holder with an issue price equal to the amount used to compute the debtor's COD income. It would appear that such a deemed reissuance should be treated as an "acquisition" (and therefore a "reacquisition") of the underlying ADI for purposes of Section 108(i).[83] To eliminate any doubt, it would be helpful if

[80] H.R. Rep. No. 111-16, at 564 (2009) (Conf. Rep.).

[81] Under Section 108(i)(4)(B), the term "acquisition," with respect to any ADI, includes an acquisition of the ADI for cash, an exchange of the ADI for another DI (including an exchange resulting from a modification of the ADI), the exchange of the ADI for corporate stock or a partnership interest, the contribution of the ADI to capital, and the complete forgiveness of the ADI by its holder.

[82] Treas. Reg. § 1.108-2(c)(1).

[83] We note that under the framework of the Section 108(e)(4) regulations, it is the indirect acquisition (rather than the deemed reissuance) that triggers the COD income. Thus, if Section 108(i) were limited to COD income resulting from a reacquisition of an ADI, it may not apply to indirect acquisitions under Section 108(e)(4). However, since Section 108(i)(1) applies to "income from the discharge of indebtedness in connection with the

guidance confirmed that COD income arising under the Section 108(e)(4) indirect acquisition rules is eligible for deferral under Section 108(i) so long as the underlying DI is an ADI.

4. Protective Elections

As discussed above, a change to the terms of a DI generally gives rise to COD income if (i) the change is considered a significant modification under Treas. Reg. § 1.1001-3; (ii) the Publicly Traded Rules apply; and (iii) the fair market value of the 'new' DI is less than the adjusted issue price of the 'old' DI. While there are certainly cases where it is clear that both of these conditions exist, as discussed in Part II, in many other cases it is not clear whether changes to a DI are considered a significant modification and in many cases it may not be clear whether the Publicly Traded Rules apply. Moreover, even if it seems clear that the Publicly Traded Rules do not apply, it may not be absolutely clear that the potentially abusive transaction rule for recent sales transactions does not apply. Finally, even if it is clear that a reacquisition results in some COD income, since the amount of COD income may depend on the fair market value of the debt, the taxpayer's determination as to the amount of the resulting COD income may be susceptible to challenge.

As a result of the financial crisis, many companies have substantial debt outstanding which is being sold for prices that are substantially below the issue price of the debt. In many cases, the tax liability resulting from a deemed exchange of this debt would likely render the company insolvent if the issue price had to be determined under the Publicly Traded Rules or the potentially abusive situation rules.

In light of the foregoing, we believe that even if a taxpayer reports a given transaction as not giving rise to COD income, the taxpayer should be permitted to file a protective Section 108(i) election in case the taxpayer's determination is challenged. This could occur, for example, where the taxpayer reasonably (but erroneously) determined that no COD income arose from a particular transaction based on a conclusion that (i) a change to an ADI was not a significant modification, (ii) the Publicly Traded Rules did not apply, or (iii) the potentially abusive transaction rules did not apply. It could also occur if the taxpayer reports a given amount of COD income based on its determination as to the fair market value of the debt but the IRS challenges that valuation.

In order to eliminate any doubt about the ability of taxpayers to make a protective election, we believe it is important that guidance expressly allow taxpayers to make a protective Section 108(i) election on the original return for the year of the reacquisition even if the taxpayer takes the position that the transaction did not result in COD income.

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reacquisition" of an ADI, it appears that Section 108(i) is broad enough to apply to COD income arising from an indirect acquisition under Section 108(e)(4).

We believe that guidance should similarly allow taxpayers which make a Section 108(i) election to have the election apply to all (or an increased portion) of the COD income resulting from the reacquisition if the IRS determines that the reacquisition resulted in more COD income than was reflected on the original return. If this approach is adopted, the IRS and Treasury should consider requiring a taxpayer who makes such a protective Section 108(i) election to extend the statute of limitations[84] with respect to any OID deductions that are claimed based on the position taken by the taxpayer but which are later disallowed in connection with an adjustment to the amount of COD income deferred under Section 108(i) as a result of the protective election.[85]

In addition to allowing a protective election for cases where there is uncertainty about the existence or amount of the COD income, it would be helpful if guidance permitted a taxpayer to condition a Section 108(i) election (or the scope of a Section 108(i) election) on other factors. For example, it would be helpful for a taxpayer to be able to elect deferral under Section 108(i) only to the extent that the COD income exceeds the taxpayer's NOL or the extent of the taxpayer's insolvency.

It may also be appropriate to allow a taxpayer to make a Section 108(i) election (or expand the scope of a Section 108(i) election previously made) on an amended return. Consistent with Section 108(i)(5)(B)(ii), a taxpayer would not have the ability to revoke a Section 108(i) election made on a prior return. An additional benefit of this approach is that it would provide relief for taxpayers which inadvertently fail to make a Section 108(i) election. However, the IRS has generally taken the position in the past that it lacks the authority to grant an extension of time to make an election when the time for making the election is specified by statute.[86]

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[84] Under the PFIC rules, taxpayers who wish to preserve their ability to later file a retroactive QEF election must generally (i) file a "protective statement" setting forth the basis for their reasonable belief that the foreign corporation in question is not a PFIC and (ii) agree to extend the periods of limitations for the assessment of all PFIC-related taxes. Treas. Reg. § 1.1295-3. Taxpayers who fail to file such a protective statement may be able to file a retroactive election if they agree to pay any amount necessary to eliminate prejudice to the United States arising from the expiration of any periods of limitations. Treas. Reg. § 1.1295-3(f).

[85] Conversely, it would be helpful for guidance to provide some sort of relief to taxpayers if they overestimate the amount of COD income and as a result do not claim OID deductions under the OID Deferral Rule and learn that the COD income was overstated (and therefore that too much OID was deferred) after the statute of limitations for the years in which additional OID deductions could have been claimed has expired.

[86] See Treas. Regs. §§ 301.9100-2 and 301.9100-3; Priv. Ltr. Rul. 94-30-003 (Apr. 22, 1994) ("The Commissioner does not have authority under Section 301.9100-1 of the

5. Section 108(i) Elections by Taxpayers Who Do Not File Returns

It would also be helpful for guidance to provide a procedure for a Section 108(i) election to be made with respect to an ADI issued by a taxpayer that does not file a U.S. federal income tax return. This would be relevant, for example, if (i) a "passive foreign investment company" (a "PFIC") realizes COD income in connection with a reacquisition of an ADI, (ii) a shareholder of the corporation makes a "qualified electing fund" ("QEF") election with respect to the corporation for the year of the reacquisition and (iii) all or a portion of the deferred COD income has not yet increased earning and profits (see Part IV.B.1 below).[87] It could also be relevant in the case of a controlled foreign corporation where a portion of the COD income is treated as subpart F income.[88] Finally, it could be relevant to non-U.S. partnerships that do not file U.S. federal income tax returns.

B. Timing Issues

1. Earnings and Profits

It is important for the IRS and Treasury to provide guidance on the effect of a Section 108(i) election on the computation of a corporation's earnings and profits

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procedure regulations for granting extensions of time for making statutory elections"). But see Hefti, T.C. Memo 1988-22 (allowing untimely Section 195 election); Field Serv. Adv. 1999-1189 (characterizing the IRS's stipulation in Hefti as "erroneous"). See also J. E. Riley Inv. Co. v. Comm'r, 311 U.S. 55 (1940) (taxpayer unaware of unavailability of percentage depletion when filing the return in which such election should have been made could not later elect such method by filing an amended return).

[87] If a taxpayer makes a QEF election for a PFIC, the taxpayer is required to include in gross income the shareholder's pro rata share of (i) the "ordinary earnings" of the PFIC for the year and (ii) the net gain of the PFIC for the year. Section 1293(a). For this purpose, ordinary earnings are defined as the excess of the E&P of the PFIC for the year over its net capital gain for the year. Section 1293(e)(1). However, notwithstanding Section 312(n)(5), E&P is generally computed for this purpose by excluding any gain that has not been recognized under the installment sale rules. Section 1293(e)(3).

[88] In Private Letter Ruling 9729011, the IRS ruled that the COD income recognized by a controlled foreign corporation generally would not be considered subpart F income. However, the IRS provided in the ruling that the corporation may be treated as earning subpart F income in the year of the discharge in an amount equal to any subpart F income previously reduced by accrued but unpaid interest.

("E&P").[89] Specifically, when and to what extent should E&P be adjusted in respect of COD income and OID deductions that are deferred under Section 108(i)?[90]

a. <u>Background</u>

The amount of a corporation's E&P as of the end of a given taxable year can have a variety of significant tax consequences. For example, distributions of property by a corporation are treated as dividends for tax purposes to the extent made out of the corporation's E&P.[91] The treatment of a distribution as a dividend can affect, among other things, (i) whether the distribution results in dividend income to the recipient or is either a tax-free recovery of basis or a capital gain, (ii) the tax rate imposed on the resulting income or gain, (iii) whether the distribution is subject to withholding tax, (iv) whether the dividends received deduction is available to a corporate recipient, and (v) whether the distribution brings up foreign tax credits of the issuer. Similar consequences can arise under Section 1248, which generally provides that gain recognized by a 10% U.S. shareholder of a controlled foreign corporation ("CFC") from the sale or exchange of stock in the CFC is treated as a dividend to the extent of the CFC's E&P.[92] E&P can also impact (i) the taxation of a shareholder of a PFIC which makes a QEF election with respect to the PFIC,[93] (ii) the inclusion of subpart F income under Section 951,[94] and (iii) the amount required to be included under Section 956.[95]

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[89] The COD deferral bill originally proposed by Senator Ensign specifically provided that deferred COD income would not increase E&P until it was recognized.

[90] As noted above, this Report does not discuss how Section 108(i) should be applied to taxpayers subject to special taxing regimes, such as financial institutions and insurance companies. This includes whether there should be special rules relating to how items deferred under Section 108(i) should be taken into account in computing the E&P of such taxpayers. Part IV.F.3 includes a separate recommendation for how deferred COD income should be taken into account in computing the E&P of a RIC or a REIT.

[91] Section 316; Section 301(c)(1).

[92] The Treasury Regulations include a complex set of rules for calculating the E&P properly attributable to stock held by a ten-percent shareholder. Treas. Reg. §§ 1.1248-2 and 1.1248-3.

[93] <u>See</u> Part IV.A.5.

[94] Section 952(c)(1)(A) generally provides that the subpart F income of any CFC for any taxable year shall not exceed the E&P of the corporation for the year. However, notwithstanding Section 312(n)(5), E&P is generally computed for this purpose by

Given its importance to the taxation of corporations and their shareholders, it is surprising that the term "earnings and profits" is not actually defined in the Code or the Treasury Regulations. Indeed, although it is generally accepted that taxable income is typically the logical starting point for the calculation of E&P,[96] there are substantial differences between the two concepts, and neither the Code nor the Treasury Regulations provides comprehensive guidance as to how to derive E&P from taxable income. Instead, guidance as to the treatment of specific items of income and expense in computing E&P has developed by piecemeal statutory provisions, judicial decisions, regulation, and published rulings.

The development of E&P has been guided in part by the use of E&P as the measure of when a distribution of property is attributable to corporate earnings rather than to a return of the shareholders' investment. Accordingly, E&P has developed to a meaningful degree as an economic concept intended "to approximate a corporation's power to make distributions which are more than just a return of investment."[97] Thus, E&P encompasses many items of income, gain, expense, and loss that are not taken into account in calculating taxable income. For instance, E&P is increased by interest received on state and local bonds which is exempt from gross income under Section 103,[98] and is decreased by items such as federal taxes that are not deductible for taxable

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excluding any gain that has not been recognized under the installment sale rules. See Section 952(c)(3).

[95] See Section 956(a)(2).

[96] Arthur R. Albrecht, *"Dividends" and "Earnings or Profits"*, 7 Tax L. Rev. 157, 184 (1952). Section 312 and the Treasury Regulations, for example, take this approach, specifying items of income and expense whose treatment for purposes of calculating earnings and profits differs from that taken for purposes of calculating taxable income.

[97] Henry C. Beck Co., 52 T.C. 1, 6 (1969) (citing Albrecht, *supra* at 183).

[98] Treas. Reg. § 1.312-6(b). E&P is also decreased by expenses or losses incurred with respect to tax-exempt bonds, even though not allowed under the Code. For example, amortizable bond premium on tax-exempt bonds reduces E&P even though it is not deductible pursuant to Section 171(a)(2). Rev. Rul. 71-165, 1971-1 C.B. 111. Similarly, E&P is reduced by expenses and interest relating to tax-exempt income even though they are non-deductible pursuant to Section 265. See Priv. Ltr. Rul. 8722108 (Mar. 5, 1987) (noting that Section 852(c), which provides that E&P of a RIC is not reduced by any amount not allowable as a deduction in computing taxable income, "prohibits deductions in [a RIC's E&P] for amounts disallowed as deductions under Sections 265 and 171(a)(2)").

income purposes.[99] Although these items are not taken into account for purposes of calculating taxable income, they nevertheless have a real economic impact on the corporation's ability to distribute corporate earnings and therefore impact E&P.

Gains and Losses That Have Not Been Recognized for Tax Purposes. In developing E&P as a measure of the power of a corporation to pass on income to shareholders, the law has not gone so far as to adjust a corporation's E&P by the unrealized appreciation or depreciation in its assets.[100] Rather, gains and losses are generally taken into account for E&P purposes only when they are recognized for tax purposes. As the Supreme Court stated:

> Congress has determined that in certain types of transactions the economic changes are not definitive enough to be given tax consequences . . . . It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits.[101]

Accordingly, unrealized gain (and realized gain that is not recognized under Section 351, 354, 361, 1031, or 1033) does not have a current impact on E&P.

Accounting Methods. In general, the accounting methods used by a taxpayer in computing taxable income must also be used in computing the taxpayer's E&P. Treas. Reg. § 1.312-6(a) provides that:

> [T]he amount of the earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income . . . . For instance, a corporation keeping its books and filing its income tax returns . . . on the cash . . . basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 453 shall, with respect to the installment transactions, compute earnings and profits on such basis . . . .

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[99] See Comm'r v. James, 49 F.2d 707, 708 (2d Cir. 1931). Non-deductible bribes paid to officials of foreign countries, for instance, decreased E&P until such treatment was specifically proscribed by Section 964(a) of the Code. Rev. Rul. 77-442, 1977-2 C.B. 264; see also Section 162(c).

[100] Falkoff v. Comm'r, 604 F.2d 1045, 1050-51 (7th Cir. 1979) (distribution made by corporation out of proceeds of loan secured by substantially appreciated property is not made out of E&P); see also Treas. Reg. § 1.312-7(b)(1).

[101] Comm'r v. Wheeler, 324 U.S. 542, 546 (1945).

The term "method of accounting" is broadly defined to mean the taxpayer's overall plan of accounting for items of income and deduction as well as the taxpayer's method for determining the proper time for the deduction or inclusion in income of any item.[102] The IRS has sometimes looked to this definition for purposes of determining the treatment of an item for purposes of E&P. For example, in Revenue Ruling 79-68,[103] the IRS cited this definition in ruling that advance payments subject to deferral under Revenue Procedure 71-21[104] do not increase E&P when received.[105] Similarly, in Revenue Ruling 79-165,[106] in discussing the E&P impact of deductions formerly available to certain insurance companies under former Sections 809(d)(5) and (d)(6), the IRS cited Treas. Reg. §§ 1.312-6(a) and 1.446-1(a)(1) and concluded that "[a]s there is no statutory authority to the contrary, the accounting treatment of this tax-deferred item must be the same for earnings and profits purposes as for tax purposes."[107]

Other examples involve methods of accounting that essentially treat a transaction as not having taken place. For example, (i) under Treas. Reg. § 1.312-7(b)(1), E&P is not decreased by a loss effectively deferred under the wash sale rules of Section 1091,[108] (ii) under Tech. Adv. Mem. 95-38-002 (Sept. 22, 1995), a payment made by a corporation to

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[102] Treas. Reg. § 1.446-1(a) (definition of "method of accounting"); Treas. Reg. § 1.1446-1(e)(2)(ii)(a) (defining "change in the method of accounting").

[103] 1979-1 C.B. 133.

[104] 1971-2 C.B. 549.

[105] See also Priv. Ltr. Rul. 200817029 (Apr. 25, 2008) (holding likewise for advance payments deferred under Rev. Proc. 2004-34, 2004-1 C.B. 991).

[106] 1979-1 C.B. 136.

[107] A change in accounting method must be taken into account for purposes of computing E&P. Specifically, when a taxpayer changes its method of accounting pursuant to Section 446, an adjustment to taxable income may be required under Section 481 to prevent amounts from being duplicated or omitted. To minimize distortions to taxable income caused by these adjustments, the Secretary will generally require the taxpayer to spread out this adjustment over several taxable years. Treas. Reg. § 1.446-1(e)(3)(i); Rev. Proc. 79-47, 1979-2 C.B. 528. To minimize distortion to E&P, any such adjustment must be taken into account for E&P purposes over the same period. Id.

[108] See Hanlin v. Comm'r, 108 F.2d 429, 430 (1939) (noting, in a case that did not consider the E&P treatment of a wash sale, that "[t]he wash sales provision is designed to eliminate fictitious losses. As losses are a matter of economics, so the fiction lies in the lack of any change in economic position on the part of the taxpayer").

a related person the deduction for which is deferred under Section 267(a)(2)[109] until such payment is included in the income of the related person does not decrease E&P until the deduction is allowed,[110] and (iii) under Treas. Reg. § 1.1502-33(c)(2), intercompany items and corresponding items under Treas. Reg. § 1.1502-13 are not reflected in E&P before they are taken into account under Treas. Reg. § 1.1502-13.

Deviations from Accounting Method Consistency. In other cases, the IRS has determined that a particular method of accounting applicable for tax purposes will not be applied for E&P purposes, even when there was no specific statutory authority for doing so. For example, E&P is reduced on a current basis by (i) interest expense that is deferred under Section 163(j)[111] and (ii) excess charitable contributions that are deferred under Section 170(b)(2).[112] Notably, in both examples deviating from the accounting treatment used in calculating taxable income allowed E&P to better reflect economic income and the power of the corporation to distribute earnings to its shareholders.[113]

In other cases, Congress has amended the E&P rules to ensure that certain tax preferences are not taken into account in computing E&P. For example, Section 312(n)(5)[114] provides that E&P is computed without regard to the application of the

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[109] Although not an E&P case, the court in Tate & Lyle, Inc. v. Comm'r, 103 T.C. 656 (1994) noted that Section 267(a)(2) is directed to preventing "the use of differing methods of reporting income for Federal tax purposes in order to obtain artificial deductions . . . ."

[110] Treas. Reg. § 1.267(f)-1(g) provides a similar rule for a loss or deduction from a transaction between members of a controlled group that is deferred under Section 267(f).

[111] Prop. Treas. Reg. § 1.163(j)-1(e). Unlike Section 163(j), the AHDYO rules include a specific statutory directive that reaches the same result, so that OID deductions that are deferred or disallowed under the AHYDO rules will reduce E&P on a current basis (other than for purposes of calculating the dividend equivalent portion of any payment). Section 163(e)(5)(E).

[112] Rev. Rul. 75-515, 1975-2 C.B. 117. In G.C.M. 37546 (May 23, 1978), the IRS noted that "we believe it correct to say that departures from normal tax accounting principles as applied in computing earnings and profits should be sanctioned only when it is observed that adherence to such principles does not reflect the real economic consequence of the particular item on income available for dividend distribution."

[113] S. Rep. No. 98-169, at 198 (1984).

[114] This Section overturned the provision in Treas. Reg. § 1-312-6(a) which provided that gain deferred under the installment method was similarly deferred for E&P purposes.

installment sale rules and Section 312(k) provides that E&P is generally computed without regard to accelerated depreciation deductions.

In providing that the special rules for intangible drilling costs and the installment sale rules would not be taken into account in computing E&P, Congress noted that:

> The committee is aware that, under present law, a corporation's earnings and profits may not reflect its economic income. For example, an oil and gas corporation reduces its earnings and profits each year by the amount which it deducts from taxable income as intangible drilling costs even though the expenditure may lead to the creation of an asset which will last many years. Such a corporation may, as a result, have economic earnings available for distribution to its shareholders but no earnings and profits available for tax purposes. Another corporation might sell an appreciated asset, realizing substantial amounts of gain. If the corporation reports the gain on the installment method, it will increase its earnings and profits in the year of sale and in subsequent years by an amount equal only to the portion of the realized gain that is recognized in such year. In either case, a distribution by the corporation to its shareholders that is treated as a dividend under State law might constitute a return of capital for tax purposes. When this occurs, a corporate tax preference or other benefit is, in effect, being passed through to shareholders with an unintended tax benefit.[115]

In providing that E&P would be computed without regard to accelerated depreciation deductions, the Ways and Means Committee noted that:

> The phenomenon of 'tax-free dividends' (in effect, resulting in current exemption from tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates) is increasing in a number of industries. This matter was brought to your committee's attention regarding the treatment of accelerated depreciation by regulatory agencies . . . and the use of accelerated depreciation in the real estate industry. . . . Your committee believes these tax-free distributions constitute an improper tax benefit to shareholders which is generally unrelated to the purposes for which accelerated depreciation deductions are made available to corporations. Accordingly, your committee has determined that economically profitable corporations should not be permitted to use this device to create improper tax benefits.[116]

[115] S. Rep. No. 98-169, at 198 (1984).

[116] Ways and Means Committee Report, Tax Reform Act of 1969, 134.

COD Income. Under Section 312(l)(1), E&P does not include COD income to the extent the COD income is (i) excluded from gross income under Section 108(a) and (ii) applied to reduce the tax basis of assets under Section 1017.[117] In contrast, COD income increases E&P on a current basis to the extent it is excluded from gross income under Section 108(a) but is not applied to reduce the basis of property under Section 108(b).[118] E&P is also generally increased on a current basis to the extent the COD income is not excluded under Section 108(a).

b. Arguments Related to When Items Deferred Under Section 108(i) Should Impact E&P

A number of factors support having the E&P rules mirror the rules for computing taxable income in the case of COD income and OID deductions deferred under Section 108(i). These include: (i) the fact that taxable income is generally the starting point for calculating E&P; (ii) the fact that E&P is typically computed using the same accounting methods used by the taxpayer in computing taxable income and Section 108(i) would seem to be a method of accounting under Treas. Reg. § 1.446-1(a)(1); (iii) the fact that when COD income is deferred through a reduction in asset tax basis, Section 312 defers the E&P impact; and (iv) the fact that Congress did not include a rule requiring that Section 108(i) deferred items be taken into account on a current basis in computing E&P, similar to the one in Section 312(n)(5) for income deferred under the installment sale rules and the one in Section 163(e)(5)(E) for items deferred under the AHYDO rules.

Other factors, however, support having the deferred items impact E&P on a current basis. These include: (i) the fact that a reacquisition of debt will generally increase the ability of the corporation to make a distribution in the year of the reacquisition, at least where (as discussed below) the stated principal amount of the corporation's debt is reduced as a result of the reacquisition; (ii) the fact that accounting methods used in computing taxable income are not always used in computing E&P,

[117] See Bangor & Aroostook R.R. Co. Comm'r, 16 T.C. 578 (1951) (applying this rule before the promulgation of Section 312(l)(1)).

[118] Section 312(l)(1) establishes only the treatment of COD income that is applied to reduce basis. However, the legislative history of this provision makes it clear that Congress intended the general rule to be that COD income increases E&P. The Senate Finance Committee report states that "[t]he Committee believes that income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income." S. Rep. No. 96-1035, at 44 (1980). This was also the holding of the Tax Court in Meyer v. Comm'r, 46 T.C. 65 (1966). The Eight Circuit's opinion reversing Meyer was specifically rejected in the legislative history of Section 312(l).

especially when the item has a real effect on the corporation's economic income;[119] (iii) the fact that the Section 108(i) deferral is analogous to the deferral of gain from an installment sale (which increases E&P on a current basis) and the fact that the policies underlying the E&P rule for installment sales seem applicable to COD income deferred under Section 108(i);[120] (iv) the fact that COD income deferred under section 108(i) will in all cases be included in taxable income in the future (which is unlike the case for COD income deferred for E&P purposes under Section 312(l)(1)); and (v) that the deferral can extend for a long time (up to ten years).

Regardless of what the IRS and Treasury decide should be the general rule for when deferred COD income should be taken into account in computing E&P, we recommend that the IRS and Treasury consider how the term E&P is used in each Code Section to determine whether an exception is appropriate.

c. Recommendation for a General Rule

We believe that the impact of a Section 108(i) election on E&P is best considered by distinguishing between the two basic types of transactions to which Section 108(i) was directed. The first is where a corporation truly reduces its outstanding debt. The second is where a corporation modifies its outstanding debt at a time when the debt is Publicly Traded, or otherwise exchanges its Publicly-Traded debt, but does not reduce its total outstanding debt (or where the COD income exceeds the reduction in its debt).

Reduction of Principal Amount of Indebtedness. Where a corporation realizes COD income as a result of a reacquisition that reduces the stated principal amount of the corporation's debt, it seems reasonably clear that the underlying transaction increases the ability of the corporation to pay dividends at that time. As a result, it seems appropriate to require an increase in the corporation's E&P at that time. Increasing E&P by deferred COD income in such a case would be consistent with the treatment of gain deferred under the installment sale rules. As noted above, there is no suggestion in Section 108(i) or its legislative history that, in enacting Section 108(i), Congress intended to create two benefits—one for the corporation and another for its shareholders. Moreover, the case for increasing E&P in the Section 108(i) case is in some respects even stronger than in the Section 453 case since in the Section 108(i) case the taxpayer has already received the cash associated with the deferred income.

[119] To this extent, like Section 163(j), the AHYDO rules, and Section 170(b)(2), Section 108(i) defers the effect of an item on taxable income even though the item currently affects the corporation's economic income.

[120] We note that nothing in Section 108(i) or its legislative history suggests that Congress intended to pass on a second Section 108(i) benefit to shareholders of a regular C corporation.

However, if this recommendation is adopted, it may be appropriate to apply a different rule for purposes of applying special tax regimes where the inclusion of the deferred COD income in E&P in the year of the reacquisition could impact a separate tax imposed upon the corporate taxpayer (or a consolidated group that includes the corporate taxpayer) that deferred the COD income. This could occur, for example, under Sections 531-535 (relating to the accumulated earnings tax), Section 884 (relating to the branch profits tax) and Section 1375 (tax on passive investment income of S corporation). Part IV.F.3 discusses our recommendation that, in the case of a RIC or a REIT, the deferred COD income increase E&P only as it is recognized.

Significant Modification of Indebtedness, Principal Amount Unchanged. Where the COD income results from a significant modification of a corporation's debt but the stated principal amount of the corporation's debt is unchanged (or where the corporation engages in an actual debt exchange but the COD income exceeds the reduction in the stated principal amount of the corporation's debt), the transaction does not increase the economic earnings of the corporation by the full amount of the COD income. Rather, the transaction may create offsetting items of COD income and OID deduction, which over time may not have any net impact on E&P or the corporation's economic ability to make distributions. If the COD income increases E&P in the year of the reacquisition, but the OID deductions are taken into account as they accrue, it would distort E&P as of any given time. We believe that the E&P rules should generally align the inclusion of the COD income with the deduction for the related OID deductions. Accordingly, we recommend that a corporation be required to take deferred COD income into account for E&P purposes but only to the extent the COD income exceeds the amount of related OID that is subject to deferral under the OID Deferral Rule and has not been recognized.[121] For the avoidance of doubt, if an acceleration event occurs before all of the OID has been deducted, all of the remaining deferred items would be taken into account in computing E&P at that time.[122]

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[121] For this limited purpose, it may be appropriate to calculate the deferred OID without regard to the rule in Section 108(i)(2)(A)(i)(I) that provides that the OID Deferral Rule applies only to OID that accrues prior to the Recognition Period. This would allow for better alignment for E&P purposes of the deferred COD income and the deferred OID deductions.

[122] If this recommendation is adopted it would be helpful for guidance to explain how it will apply in cases where the COD income arises under Section 108(e)(4) and whether it matters whether the related party purchaser and the issuer of the ADI are members of the same consolidated group.

2. Treatment of Deferred Items under Sections 382 and 384

If a corporation undergoes an "ownership change," Section 382 generally imposes an annual limitation on the amount of pre-change net operating losses and other tax attributes that such corporation may utilize to offset taxable income in post-change periods. To the extent the corporation has a "net unrealized built-in gain" in its assets that exceeds certain thresholds (a "NUBIG"), its Section 382 limitation may be increased by "recognized built-in gains" ("RBIGs") that are triggered within five years following the ownership change (the "382 Recognition Period").[123] RBIGs include items of "built-in" income that are recognized during the 382 Recognition Period but are attributable to pre-change periods.[124] However, the cumulative increase of the Section 382 limitation on account of such RBIGs may not exceed the NUBIG.

Similarly, Section 384 provides that if a corporation acquires control of another corporation (or the assets of another corporation in an A, C or D reorganization) and either corporation is a "gain corporation," then income recognized during the five years following the acquisition (to the extent attributable to RBIGs) may not be offset by any preacquisition loss (other than a preacquisition loss of the gain corporation). Thus, if a loss corporation acquires another corporation with a built-in gain, the loss may not be used to offset the gain during the five-year period following the acquisition.

Notice 90-27[125] addresses the application of Sections 382 and 384 in cases where (i) a corporation sells a built-in gain asset either prior to its acquisition (or ownership change) or during the relevant five-year period and (ii) some or all of the gain will be recognized under the installment method following the relevant five-year period. The ruling holds that (i) Section 384 will apply to the gain even if it is recognized beyond the five-year period contemplated by Section 384 and (ii) the gain will be treated as an RBIG for purposes of Section 382, and thus available to increase the Section 382 limitation, even if it is recognized following the 382 Recognition Period. Similar issues could arise if a Section 108(i) election caused "built-in" COD income to be recognized beyond the relevant five-year period.

Notice 87-79[126] addressed "built-in" COD income and stated that regulations would be issued that would permit COD income "which is determined to be integrally related to a transaction resulting in an ownership change to be allocated to the pre-change

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[123] Section 382(h).

[124] Section 382(h)(6)(A).

[125] 1990-1 C.B. 336 (April 9, 1990).

[126] 1987-2 C.B. 387 (Dec. 15, 1987).

period." This approach would have effectively permitted such income to escape any Section 382 limitation by being treated as pre-change income that can be offset with pre-change losses without any restrictions. However, no such regulations were ultimately issued.

Notice 2003-65[127] provided further guidance on the application of the Section 382 built-in gain and loss rules and adopted a rule that treats "built-in" COD income as a RBIG (which is somewhat different from the approach suggested in Notice 87-79). Notice 2003-65 explicitly supersedes Notice 87-79, and allows taxpayers to elect to apply the Section 382 built-in gain and loss rules using one of two approaches. If the taxpayer elects to use the "Section 1374 approach," the taxpayer's RBIG will include any COD income included in gross income pursuant to Section 61(a)(12) during the first 12 months of the 382 Recognition Period that is attributable to pre-change debt. If the taxpayer elects to use the "Section 338 approach," the taxpayer's RBIG will include any COD income included in gross income pursuant to Section 61(a)(12) that is attributable to pre-change debt but only to the extent that the issue price of the debt exceeds the fair market value of the debt on the change date.[128]

We believe that guidance under Section 108(i) should extend the principles of Notice 90-27 and Notice 2003-65 to COD income that is deferred under Section 108(i). Accordingly, if the taxpayer adopts the Section 1374 approach, it seems appropriate to treat COD as an RBIG under Sections 382 and 384 even if it is recognized after the relevant five-year period but only if the underlying reacquisition occurs prior to the end of the first 12 months of the 382 Recognition Period. If the taxpayer adopts the Section 338 approach, it seems appropriate to treat COD as an RBIG under Section 382 even if it is recognized after the 382 Recognition Period but only to the extent that (i) the reacquisition occurs prior to the ownership change or (ii) (if the reacquisition occurs after the ownership change) the issue price of the underlying ADI exceeds the fair market value of the ADI on the ownership change date.

Similarly, any deferred OID should be considered a "recognized built-in loss" to the extent the OID would have been considered a "built-in deduction" had a Section 108(i) election not been made. OID deductions accruing before the ownership change but recognized after the ownership change would presumably be treated as built-in deductions under Notice 2003-65, but OID deductions accruing after the ownership change presumably would not be treated as built-in deductions.

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[127] 2003-2 C.B. 747 (Sept. 12, 2003).

[128] The discussion of the treatment of COD income under the Section 338 approach in Notice 2003-65 is silent as to whether the "built-in" COD income must be recognized during the 382 Recognition Period.

Notice 2003-65 generally does not provide that "built-in" income or deductions are included in the computation of NUBIG, even though Section 382(h)(6)(C) is arguably predicated upon such inclusion. Rather, the NUBIG computation methodology in Notice 2003-65 is based on Treas. Reg. § 1.1374-3(a), which generally does not take into account such deferred items (aside from Section 481 adjustments and certain "deductible liabilities"). Thus, a corporation whose COD income is triggered before an ownership change and deferred under a Section 108(i) election may be unable to offset such income with pre-change losses when it is subsequently recognized, even if such income is treated as an RBIG, if it is not included in the computation of NUBIG for purposes of Section 382. Similar issues arise under Section 384 in determining whether the corporation is a "gain corporation." We believe it is important for guidance to clarify that items deferred under Section 108(i) are taken into account in computing the NUBIG and the "net unrealized built-in loss" for purposes of Section 382, and in determining whether the taxpayer is a "gain corporation" for purposes of Section 384.[129]

C. <u>Deferral of OID Deductions</u>

If a Section 108(i) election is made with respect to the reacquisition of an ADI and the reacquisition is effected by issuing a new DI with OID, Section 108(i)(2) defers the issuer's deduction for any OID on the new DI (up to the amount of deferred COD) that is allowable during the period prior to the Recognition Period. To the extent Section 108(i)(2) applies, the deferred OID is allowed as a deduction ratably over the Recognition Period.

1. <u>Interaction with Other Interest Deferral Rules</u>

It would be appropriate and helpful for guidance to explain how the OID Deferral Rule interacts with other rules that may defer the deduction for OID, such as Sections 163(e)(3), 163(e)(5)(A)(ii), 163(j) and 267. The OID Deferral Rule is somewhat different than the other deferral rules since (in general) it applies only to OID deductions otherwise allowable prior to a specific period (generally prior to 2014) and then spreads the deduction for the deferred OID over a later period. As a result, a taxpayer could do better under the OID Deferral Rule if one of the other OID deferral rules essentially preempted the OID Deferral Rule by deferring the OID deduction beyond 2013.

> <u>Example 5</u> In 2009, US Corp (a calendar-year taxpayer) borrows $80 under a 10-year term loan from its non-US parent and uses the $80 of proceeds to redeem for $80 third-party debt with an issue price of $100. Assume that (i) interest on the intercompany debt is allowed to accrue and

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[129] Alternatively, with respect to Section 382, it may be appropriate to revert to some version of the approach suggested in Notice 87-79 and treat built-in COD income as pre-change income that is simply not subject to Section 382 limitations.

compound until paid and (ii) on January 1, 2014, US Corp makes a payment of $8 of accrued and unpaid interest.

Section 163(e)(3) generally provides that no deduction for OID owed to a related foreign person is allowed until paid. Accordingly, no deduction for any of the OID in the example above is allowed prior to 2014. However, the OID Deferral Rule only defers OID deductions that are "otherwise allowable" prior to 2014 (or, more specifically, prior to the Recognition Period). If the application of Section 163(e)(3) caused the OID to not be "otherwise allowable," the OID Deferral Rule would not apply to the $8 of OID deductions and the US Corp could claim an $8 OID deduction in 2014.[130] This would be peculiar since, if the new debt had been owed to a third party, Section 108(i)(2) (rather than Section 163(e)(3)) would have applied and the $8 OID would have been deductible ratably over the Recognition Period (that is, ratably during years 2014-2018). Similar issues could arise under the related party rules of Section 267.

The AHYDO deferral rule of Section 163(e)(5)(A)(ii) presents the same theoretical issue where the issuer does not pay OID prior to the Recognition Period but then pays that OID at a rate faster than the rate at which Section 108(i)(2) would have allowed the OID deduction. Similar issues can arise under Section 163(j).

In order to avoid these results, it may be appropriate (at least in the context of the related party situations) to clarify how the OID Deferral Rule interacts with the other deferral and disallowance rules[131] and provide that OID will be considered "otherwise allowable" for purposes of the OID Deferral Rule even if it is deferred or disallowed under a different rule.

2. Directly or Indirectly

Under Section 108(i)(2)(B), if a DI is issued by an issuer and the proceeds of such DI are used "directly or indirectly" by the issuer to reacquire an ADI of the issuer, the new DI is treated as having been issued in exchange for the ADI for purposes of applying the OID Deferral Rule. If only a portion of the proceeds from a DI are so used, the OID Deferral Rule applies to the portion of OID on the newly issued DI which equals the portion of the proceeds from such DI used to reacquire the ADI.

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[130] See Section 108(i)(2)(A)(i). On the other hand, a deduction may be treated as allowable even though it is not currently allowed. See, e.g., Flood v. United States, 845 F. Supp. 1367 (D. Alaska 1993).

[131] The proposed regulations under Section 163(j) provide that Section 163(j) applies after any other rules. Prop. Treas. Reg. § 1.163(j)-7.

We recommend that guidance be issued as to when the proceeds of a DI will be treated as having been used “directly or indirectly” to reacquire an ADI. More specifically, we recommend that such guidance reflect the principles in Treas. Reg. § 1.279-3(b), which provides that:

> Obligations are issued to provide direct consideration for an acquisition within the meaning of section 279(b)(1) where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions of this subsection relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section 279(b)(1) where (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

Accordingly, the proceeds of a new DI would be treated as being used directly or indirectly by the issuer to reacquire an ADI if (i) at the time of the issuance of the new DI, the issuer anticipated the reacquisition of the ADI and the new debt would not have been issued if the issuer had not so anticipated such reacquisition, or where (ii) at the time of the reacquisition of the ADI, the issuer foresaw or reasonably should have foreseen that it would be required to issue the new DI, which it would not have otherwise been required to issue if the reacquisition had not occurred, in order to meet its future economic needs.

It may also be appropriate for guidance to confirm that the OID Deferral Rule will also apply to (i) any DI issued in exchange for a DI which was subject to the OID Deferral Rule (or which would have been subject to the OID Deferral Rule if it were issued with OID) and (ii) any other DI where the proceeds from the issuance of such DI were used directly or indirectly to refinance a DI described in clause (i). A somewhat similar provision is found in Section 163(e)(5)(F)(ii).

It would also be helpful if guidance included certain presumptions or safe harbors regarding when proceeds will be considered to have been used directly or indirectly to reacquire an ADI.

3. Application of the OID Deferral Rule in the Case of Consolidated Group and Partnerships

It is not clear whether or how the OID Deferral Rule applies in cases where an affiliate of the issuer issues new debt and the proceeds are used to reacquire an ADI issued by a different member.

> Example 6 Parent owns 100% of Subsidiary and the two corporations are members of a consolidated group. Parent issues a DI to a non-member (*e.g.*, a bank) with an \$80 issue price and a \$100 face amount (\$20 of OID), Parent contributes the \$80 to the Subsidiary, the Subsidiary uses the proceeds to reacquire for \$80 an ADI issued by the Subsidiary that had an issue price of \$100 and an election is made under Section 108(i) to defer the \$20 of COD income.
>
> Example 7 Same as Example 6 except Subsidiary is a partnership and Parent is a direct or indirect partner in that partnership.

As noted above, Section 108(i)(2)(B) provides that if a DI is issued by an issuer and the proceeds of such DI are used directly or indirectly by the issuer to reacquire an ADI of the issuer, the DI so issued is treated as issued for the ADI being reacquired for purposes of applying the OID Deferral Rule.

Read literally, Section 108(i)(2)(B) seems to apply only if the issuer of the new DI is the same as the issuer of the ADI being reacquired. Under this reading, the OID Deferral Rule would appear not to apply where the issuers are different, even if they are members of the same affiliated group or otherwise related within the meaning of Section 108(e)(4). Under this reading, the deduction for the OID on the new debt in Example 6 would not be deferred under the OID Deferral Rule.[132]

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[132] By contrast, Section 246A (which governs debt financed stock eligible for the 70% or 80% dividends received deductions) specifically provides that the regulations to be issued under that Section shall include regulations providing for the disallowance of interest deductions or other appropriate treatment (in lieu of reducing the dividend received deduction) where the obligor of the indebtedness is a person other than the person receiving the dividend. Although regulations under Section 246A have yet to be issued, the Tax Court examined the issue of debt-financed portfolio stock and the dividend received deduction under Section 246A in the context of two members of a consolidated group where one member engaged in borrowing and the other member acquired stock. See H. Enterprises Int'l v. Comm'r, 105 T.C. 71 (1995) (regarding both the dividend received deduction with respect to debt-financed portfolio stock under Section 246A and interest relating to tax-exempt securities under Section 265(a)(2)). In H. Enterprises Int'l v. Comm'r, the Tax Court determined that despite the absence of regulations Sections

a. Application to Consolidated Groups

Since a Section 108(i) election by a member results in a deferral of the COD income by the group, we believe that the OID Deferral Rule should similarly apply to defer OID deductions on a DI issued by one member of the group if the proceeds of the DI are used directly or indirectly to reacquire an ADI of another member as to which a Section 108(i) election is made.[133] Accordingly, in Example 6, the OID on the DI issued by Parent to a third party would be subject to the OID Deferral Rule even though the proceeds of the DI were used by Subsidiary to reacquire an ADI issued by Subsidiary. Various provisions of the Code are applied at the consolidated group level and essentially treat all of the members of the group as a single entity.[134] Moreover, Section 1502 includes the following very broad grant of authority in this regard:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 of the Code that would apply if such corporations filed separate returns.

246A and 265(a)(2) may nevertheless be applied in situations where one member of a group borrows for the purpose of enabling another member to purchase portfolio stock and tax-exempt securities. However, in making this determination, the Tax Court noted that "[n]either section 246A or section 265(a)(2) by its terms requires the borrower to be the same entity as the purchaser of the portfolio stock or the tax exempt securities."

[133] To the extent Treasury is concerned with its authority in this area, it could require the taxpayer to agree to this treatment as a condition to making a Section 108(i) election or provide that any failure by the relevant parties to agree to this approach will be treated as an acceleration event. Alternatively, Treasury could seek a technical correction.

[134] <u>See, e.g.,</u> Sections 163(j)(6)(C) (treating all members of an affiliated group as one taxpayer for purposes of determining limitations of deduction for interest on certain indebtedness), 172(h)(9)(c) (treating all members of consolidated group as one taxpayer for purposes of determining certain NOL carryback limitations with respect to corporate equity reduction transactions), 469(j)(11) (treating all members of a consolidated group as one entity for purposes of the passive activity loss and passive activity credit limitations) and 472(g) (treating all members of the same group of financially related corporations as one taxpayer for purposes of applying LIFO conformity rules).

However, we believe it makes sense for the OID Deferral Rule not to apply to intercompany debt used (directly or indirectly) to reacquire an ADI held by a non-member.[135] Thus, the OID Deferral Rule would not apply in the following examples:

> Example 8 P and S are members of a consolidated group. P uses $80 of cash on hand to repurchase a $100 ADI issued by S. Under Section 108(e)(4) and Treas. Reg. § 1.1502-13(g), S is treated as satisfying the debt with $80 and (absent a Section 108(i) election) recognizes $20 of COD income. S is also deemed to issue new debt to P, with an $80 issue price and $20 of OID.

> Example 9 P and S are members of a consolidated group. P lends $80 to S in exchange for a $100 note and S uses the $80 to repurchase a $100 ADI.

However, if guidance provides that the OID Deferral Rule does apply in Examples 8 and 9, it would be helpful for the guidance to confirm how the consolidated return regulations apply. Although Section 108(i) defers the deduction for the OID to the issuer and does not defer the inclusion of the OID to the holder, in the consolidated return context it seems reasonably clear that, under the matching rule and Treas. Reg. § 1.1502-13(g), the holder of DI would recognize the OID income only as the issuer deducts the OID.

Similar issues may arise if the parent of a consolidated group issues a new DI with OID and uses the proceeds to reacquire an ADI of a subsidiary.

> Example 10 P and S are members of a consolidated group. P issues a $100 DI to a bank in exchange for $80 and uses the proceeds to purchase a $100 ADI issued by S. Alternatively, P reacquires the $100 ADI by issuing its own $100 note to the holder of the ADI.

In this case, Section 108(e)(4) and Treas. Reg. § 1.1502-13(g) would deem the ADI to have been satisfied with new debt issued to the Parent. Consistent with our recommendations above, we believe that the intercompany debt should effectively be ignored in applying the OID Deferral Rule but the OID Deferral Rule should apply to the new DI issued by P.

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[135] See Treas. Reg. § 1502-80 ("Section 163(e)(5) does not apply to any intercompany obligation (within the meaning of § 1.1502-13(g)) issued in a consolidated return year beginning on or after July 12, 1995.").

b. Application to Partnerships

Similarly, since a Section 108(i) election by a partnership results in a deferral of the COD income by the partners, good arguments can be made that the OID Deferral Rule should operate at the partner level. Under this view, the OID Deferral Rule would apply to defer OID deductions on a DI issued by one partnership even if the proceeds of the DI are used directly or indirectly to reacquire an ADI issued by a another partnership in cases where the two partnerships are related.[136] Accordingly, in Example 7 above, the OID on the DI issued by the Parent (upper-tier) partnership would be subject to the OID Deferral Rule even though the proceeds of the DI were used by the Subsidiary (lower-tier) partnership to reacquire an ADI issued by the Subsidiary. Many provisions of the Code are applied to partnerships on an aggregate basis at the partner level, including the provisions under Section 108 relating to the insolvency and bankruptcy exceptions for COD income and reductions in tax attributes. Moreover, Treas. Reg. § 1.701-2(e) provides that the Commissioner of the IRS can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the Treasury Regulations except to the extent that (i) a provision of the Code or the Treasury Regulations prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) the treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

If the determination of whether a DI is subject to the OID Deferral Rule is made at the partner level, it seems appropriate that the extent to which any partner is subject to the OID Deferral Rule also be made at the partner level. Under this view, the OID deductions required to be deferred by a partner in respect of a particular reacquisition would not exceed the COD income deferred by such partner in respect of such reacquisition. As discussed in Part IV.E.3 and 4, in both the tiered context and the single partnership context, the direct and indirect partners may benefit from the COD income differently than they bear the related OID deductions and, as a result, the allocation of the deferred OID may differ from the allocation of the deferred COD income.

> Example 11 A and B each hold a 50% interest in a Partnership with an ADI outstanding. C contributes cash to the partnership in exchange for a one-third partnership interest. The partnership uses C's cash plus the proceeds of a new DI to reacquire the ADI. Although the COD income will be shared as an economic and tax matter by A and B, the OID

[136] We note that the case for applying the OID Deferral Rule at the partner level is less strong than the case for applying the OID Deferral Rule at the consolidated group level. In the consolidated return context, there is one consolidated taxpayer and one consolidated tax return. In the partnership context, there are often numerous partners and numerous tax returns.

deductions on the new debt may be shared economically (and for tax purposes) equally by A, B and C.

The question arises as to whether any portion of the OID deductions allocable to C should be deferred under Section 108(i) since C did not benefit from the deferral of the COD income. More fundamentally, the question is whether the OID Deferral Rule should operate at the partnership level or at the partner level. Applying the rule at the partner level could result in a reduction in aggregate tax since it would allow one taxpayer to claim a current deduction for the OID even though another taxpayer was permitted to defer the associated COD income. This could be viewed as inconsistent with Congressional intent in enacting the OID Deferral Rule. Moreover, the decision to have the Section 108(i) election made at the partnership level (rather than the partner level) was presumably done to make Section 108(i) easier to administer and applying the OID Deferral Rule at the partner level will entail complexity.

However, arguments can be made that the OID Deferral Rule should apply to the OID deductions allocated to a partner only to the extent (if any) that the partner will be allocated the deferred COD income (under the Allocation Rule). First, it is arguably inappropriate in Example 11 to defer C's share of the OID deductions since C did not benefit from the deferral of the COD income. Second, the OID Deferral Rule can be analogized to other provisions in the Code which are designed to prevent a taxpayer from claiming a current deduction for interest on debt incurred to acquire property that is producing tax-deferred income. For example, Section 163(d) allows a deduction for investment interest only to the extent that the taxpayer has investment income. Notably, Section 163(d) is applied at the partner level—meaning that the deductibility of investment interest allocated to a particular partner is based on that partner's investment income (rather than the partnership's investment income). Third, as discussed in Parts III.A.6.b. and c., while the OID Deferral Rule seems designed to mitigate the extent to which a taxpayer could actually do better by triggering COD income upon a reacquisition, it will be the exception rather than the rule where the OID Deferral Rule operates to perfectly align the timing of the COD income and the OID deduction. Thus, even where the allocation of the deferred OID deductions mirrors the allocation of the deferred COD income, the timing of the OID deductions generally will not match up with the timing of the COD income. Moreover, where the new DI is modified to provide for the payment of qualified stated interest (rather than OID), the OID Deferral Rule will not apply at all. Conversely, if the reacquired ADI was an AHYDO (or if the reacquisition occurs after 2009), all or a portion of the offsetting OID may be disallowed under Section 163(e)(5). Thus, while having the OID match the COD income may have been a desirable goal, it is often not the result under Section 108(i) even where a single taxpayer is involved. Fourth, if the OID Deferral Rule is not applied at the partner level in cases like Example 11, it seems inappropriate to apply the OID Deferral Rule at the partner level for purposes of applying the OID Deferral Rule to DI issued by related persons. Finally, if the OID Deferral Rule is not applied at partner level and therefore the OID deductions allocable to C are deferred, additional guidance will be needed to explain what portion of C's deferred OID deductions are accelerated upon a sale of a partnership interest held by a partner that is allocated deferred COD income (that is, in Example 11, how much of C's OID deferred deductions get accelerated when either A or B sells its partnership interest).

It is not clear, however, that the statutory direction that that deferred COD income be allocated to the partners in the partnership immediately before the discharge of indebtedness – which is what gives rise to the potential mismatch between the allocation of deferred COD income and deferred OID deductions – was intended to override the connection that Section 108(i) otherwise draws between those two deferred items. If one believes that the linkage of deferred income and deferred deductions is a central, albeit somewhat imprecisely executed, aspect of the Section 108(i) election, then the partnership rules should be applied in a manner that retains that linkage.

Approximately half of the members of the Executive Committee believe that the OID Deferral Rule should be applied at the partner level both in determining which DIs are potentially subject to the OID Deferral Rule and in determining the extent to which OID must be deferred. Thus, those members of the Executive Committee believe that in Example 11 the OID allocated to A and B should be subject to the OID Deferral Rule (up to the amount of COD income deferred by each such partner) but the OID allocated to C should not be subject to the OID Deferral Rule. Approximately half of the members of the Executive Committee believe that the OID Deferral Rule was intended to be applied at the partnership level so that in Example 11 C's share of the OID deduction would generally be subject the OID Deferral Rule even though C was not allocated any of the deferred COD income.[137]

However, the Executive Committee as a whole believes that, if guidance provides that the OID Deferral Rule is generally applied at the partnership level, it is important for guidance to include a rule (similar to the remedial method under Section 704(c)) that would allow a partnership to elect to accelerate each year a portion of the deferred COD income of the partners who were allocated deferred COD income (A and B in Example 11) in an amount corresponding to the OID deductions allocated to those partners who were not allocated any of the deferred COD income (C in example 11).[138] This election

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[137] If this alternative is adopted, guidance should explain what portion of C's OID deductions will be accelerated upon a transfer by A or B.

[138] Various rules under Subchapter K of the Code (such as the remedial method under Section 704(c) and Sections 743 and 754) allow a new partner to receive roughly the same tax treatment regardless of whether the new partner acquires its interest from an existing partner or directly from the partnership. Moreover, in the case of a publicly traded partnership, it is generally important for all interests in the partnership to be fungible from a tax perspective, and this is generally achieved by having the partnership

would also be available to the extent that a partner's share of the deferred OID exceeds the partner's share of the deferred COD. However, if this approach is adopted, we believe that either (i) the OID Deferral Rule should similarly be applied at the partnership level for purposes of determining which DIs are subject to the OID Deferral Rule (meaning that a DI issued by an upper-tier partnership to fund the reacquisition of an ADI issued by a lower-tier partnership would not be subject to the OID Deferral Rule) or (ii) guidance should extend this alternative to tiered arrangements.

c. S Corporations

We recommend that guidance also clarify how the OID Deferral Rule will apply in cases where a shareholder of an S corporation is allocated OID that is potentially subject to the OID Deferral Rule but is not allocated any of the deferred COD income.

D. Acceleration of Deferred Items in General

Section 108(i)(5)(D)(i) provides that, in the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under new Section 108(i) (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed). Section 108(i)(5)(D)(ii) provides that the acceleration rule also applies in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity. Section 108(i)(7) provides that the Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying Section 108(i), including extending the application of the acceleration rules to other circumstances where appropriate.

Under Section 367, a taxpayer is permitted non-recognition treatment for certain reorganizations under Section 368 and certain liquidations under Section 332 only if the taxpayer enters into a so-called gain recognition agreement (a "GRA") with respect to the

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elect the remedial method and always have a Section 754 election in place. In order to maintain that fungibility in the case of partnerships that make an election under Section 108(i), it is important for guidance to provide some mechanism to allow a new partner to receive essentially the same treatment regardless of whether the partner acquires its interest from an existing partner (where the OID would not be deferred as a result of the application of the acceleration rule to the transfer) or directly from the partnership (where the OID would not be deferred under this recommendation or our recommendation that the OID Deferral Rule apply to a partner only to the extent it is allocated deferred COD income).

transaction. A GRA requires the taxpayer, upon the happening of certain events, to treat gain arising from the transaction as having been recognized at the time of the original transaction (and to file an amended return reporting that gain) or to treat the gain as having been recognized in the year such event occurs (but to pay interest from the date of the original transaction). Upon the happening of certain such events, the GRA rules allow the taxpayer to continue to treat the gain arising from the original transaction as not having been recognized, so long as the taxpayer (or a transferee of the taxpayer) enters into a new GRA with respect to the original transaction.

By contrast, very few transactions accelerate income deferred under the installment sale rules. Although we believe that the installment sale rules also provide a useful guide as to how the Section 108(i) acceleration rules should be applied, it is worth noting that the installment method is often not used to defer large payments in light of the interest charge imposed by Section 453A(c) on installment sales where the aggregate face amount of the installment obligations exceeds five million dollars.

We believe that guidance under Section 108(i) should address the extent to which various types of transactions will be treated as acceleration events.

1. Stock Transfers of Corporations (other than Pass-Thru Entities)

a. Transfer of stock in a corporation (other than a pass-thru entity) which does not result in the corporation joining or leaving a consolidated group

The first type of transaction is the transfer of stock in a corporation (other than a pass-thru entity) which does not result in the corporation joining or leaving a consolidated group.[139] This could occur, for example, where such stock is sold to a third party for cash or such stock is acquired by a third party in a tax-free transaction (such as a B or (a)(2)(E) reorganization or a Section 351 or 721 exchange).

Although Section 108(i)(5)(D)(ii) provides that a transfer of an interest in a pass-thru entity is treated as an acceleration event, it does not include a similar rule for transfers of an interest in a C corporation that is not a pass-thru entity. Moreover, in the case of a corporate taxpayer that is not a pass-thru entity, Section 108(i) operates at the corporate level rather than the shareholder level. Accordingly, we believe that guidance should confirm that the transfer of stock in a corporation (other than a pass-thru entity) which does not result in the corporation joining or leaving a consolidated group is not treated as an acceleration event. The entity that made the election to defer COD income remains responsible for recognizing that income and is visible to the taxing authority.

[139] Intragroup transfers of stock of a member are discussed in Part IV.D.1.e below.

b. Transfer of stock in a corporation (other than a pass-thru entity) which results in the corporation leaving a consolidated group

The second type of transaction is the transfer of stock in a corporation which results in the corporation leaving a consolidated group (other than where an entire consolidated group is acquired by another group). This could occur, for example, where the stock of a subsidiary member of a consolidated group is transferred to a non-member (either in a taxable sale or tax-free transaction, including a corporate reorganization or corporate spin-off).

As noted above, while Section 108(i) provides that a transfer of an interest in a pass-thru entity is treated as an acceleration event, it does not include a similar rule for transfers of stock in C corporations that are not pass-thru entities. While we are not aware of any Code provision that treats a member of a consolidated group specifically as a "pass-thru entity," the consolidated return regulations effectively treat members of a consolidated group in an analogous way for a variety of purposes. For example, the parent of a consolidated group files a consolidated tax return reporting the consolidated taxable income of all of the members and it is on that tax return that a Section 108(i) election would presumably be made.[140] Also, income of a subsidiary member increases the tax basis in the stock of the member held by the consolidated group.[141] Accordingly, by analogy to the acceleration rule applicable upon a transfer of an interest in a pass-thru entity, a case can be made that the transfer of a subsidiary member of a consolidated group to a non-member should be treated as an acceleration event.

Accelerating the COD income of a subsidiary member upon a taxable sale of the stock of the member to a non-member will, in certain cases, reduce the aggregate tax burden of the selling group and the member. Such an acceleration would cause the COD income to be taxable to the selling group on the transfer date (rather than to the member during the Recognition Period). Any such COD income would increase the selling group's tax basis in the stock being sold and reduce any gain recognized in the sale. Thus, accelerating the COD income will relieve the member of the burden to include the

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[140] The application of Section 108(i) at the group level is consistent with the general treatment of the consolidated group as a single entity for various tax purposes. Generally, the income of a subsidiary member is taxed once at the group level when reported on the return of the common parent of the group. This system of a single layer of tax effectively treats the members of the consolidated group (other than the parent) as pass-thru entities with the common parent acting as the agent for the entire group.

[141] Moreover, as described elsewhere in this Report, other aspects of Section 108(i) may be applied at the consolidated group level rather than at the member level such as the OID Deferral Rules.

COD in income after the sale but may not increase the tax burden to the selling group. However, in other cases, accelerating the COD income could accelerate (or increase) the aggregate tax burden, such as where the disposition is effected as a tax-free transaction (including a tax-free spin-off or corporate reorganization), the selling group has excess capital losses or the recognition of the COD income causes the loss disallowance rule to apply to the sale of the member.[142]

The deconsolidation of a member generally does not trigger income or gain deferred by the member under Section 453. In the Section 367 context, if a member of a consolidated group engages in a transaction in which gain went unrecognized pursuant to a GRA, the gain is generally required to be recognized if the member leaves the group.[143] However, Section 367 allows for continued non-recognition if a new GRA is entered into by the member (or, where the member joins a new consolidated group, by the new group with respect to such member).[144]

We believe that guidance should provide that the transfer of stock in a member which results in the corporation leaving a consolidated group will not be treated as an acceleration event. However, it may be appropriate for guidance to require the member (or the new consolidated group) to include a copy of the Section 108(i) election on its tax

[142] Accelerating the subsidiary member's deferred income in cases where it would trigger (or increase) the application of the loss disallowance rules seems particularly harsh, since COD income is not the type of income that should generally trigger (or increase) the application of the loss disallowance rules (unless the debt pre-dates the group's acquisition of the member and the ADI was trading below par on the original acquisition date). Of course, the application of those rules would be attributable to the realization of the COD income in the first place (rather than its acceleration).

[143] We note that the installment sale rules may provide a better analogy than the GRA rules for evaluating when items deferred under Section 108(i) should be triggered since the deferral and recognition under Section 108(i) and Section 453 are both mandated by the Code. As noted above, the deconsolidation of a member generally does not trigger income or gain deferred by that member under Section 453.

[144] If a member joins a new consolidated group, the common parent of the new consolidated group, acting as agent for the member, may enter into the new GRA on behalf of such member. See Treas. Reg. § 1.367(a)-8(d)(3). If such a new GRA is entered into and the gain that is the subject of the GRA is later triggered under the GRA, the gain is treated as recognized in the year it is triggered, rather than on an amended tax return of the prior group.

returns going forward.[145] Also, if our recommendation in Part IV.C.3.a is adopted and the OID Deferral Rule applies where one member of a consolidated group issues a DI and the proceeds are used directly or indirectly to reacquire an ADI of another member, it may be appropriate to include special rules for cases where one (but not both) of the members leaves the group.

c. Transfer of stock in a corporation which results in the acquisition of one consolidated group by another consolidated group

The third type of transaction is the transfer of stock in a corporation which is the parent of a consolidated group where the corporation's group terminates but the members join another consolidated group. This could arise, for example, where a publicly traded corporation is acquired by another publicly traded corporation in a B reorganization, (a)(2)(E) reorganization or taxable stock purchase. It could be argued that the acquisition of one consolidated group by another consolidated group should accelerate the acquired group's deferred items since the acquired group was in some sense the taxpayer for purposes of Section 108(i) and that group will terminate upon the acquisition by the other group.[146] However, we believe that a more appropriate approach would be to view the acquired group as becoming a part of a new group with the new group succeeding to the attributes of the acquired group (including any items deferred under Section 108(i)).[147] Therefore, we believe that guidance should provide that the acquisition of one consolidated group by another consolidated group will not accelerate the acquired group's deferred Section 108(i) items. Again, it may be appropriate for guidance to require the new consolidated group to include copies of any Section 108(i) elections made by the acquired group on the new group's consolidated tax return going forward.

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[145] We believe that a failure to include a copy of the Section 108(i) election should not accelerate the income. Otherwise, the requirement to include a copy of the election would effectively give the taxpayer the option to accelerate the deferred COD income.

[146] This assumes that the transaction is not a reverse acquisition under Treas. Reg. § 1.1502-75(d)(3).

[147] We note that such a transaction similarly does not trigger intercompany items deferred under the consolidated return regulations. See Treas. Reg. § 1.1502-13(j)(5).

d. <u>Transfer of stock in a corporation (other than a pass-thru entity and other than a member of a consolidated group) which results in the corporation joining a consolidated group</u>

The fourth type of transaction is the transfer of stock in a corporation (other than a pass-thru entity and other than the parent or a member of a consolidated group) which results in the corporation joining a consolidated group. This could occur, for example, where a stand-alone C corporation is acquired by a consolidated group. We believe that guidance should provide that such a transfer will not accelerate amounts deferred by the corporation under Section 108(i). However, since the eventual recognition of those items would (after the transfer) be reportable by the acquiring consolidated group, it may be appropriate to require the acquiring consolidated group to include a copy of any Section 108(i) elections made by the acquired corporation on the acquiring group's consolidated tax returns going forward.[148]

e. <u>Transfer of stock in a corporation (other than a pass-thru entity) that is a member of a consolidated group to another member of the same consolidated group</u>

The fifth type of transaction is the transfer of stock in a corporation that is a member of a consolidated group to another member of the same consolidated group. This could occur, for example, where stock of a member of a consolidated group is sold to another member of the group or stock of a member of a consolidated group is acquired by another member of the group in a tax-free transaction.

Under the consolidated return regulations, tax items arising from intercompany transactions are generally deferred until one of the members that was a party to the transaction leaves the group or the underlying property leaves the group.[149] The reasons underlying the deferral afforded to intercompany transactions similarly support continued deferral under Section 108(i). Accordingly, we believe that guidance should provide that

[148] If a corporation engages in a transaction as to which the gain went unrecognized pursuant to a GRA and that corporation subsequently joins a consolidated group, the gain is generally required to be recognized at that time. However, the gain is not required to be recognized if the common parent of the consolidated group, acting as agent for the new member, enters into a new GRA on behalf of such member. By contrast, no such agreement is required to continue deferral under Section 453.

[149] <u>See</u> Treas. Reg. § 1.1502-13(a)(1) ("The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).").

such a transfer does not accelerate amounts deferred by the corporation under Section 108(i).

2. Asset Transfers that Involve the Liquidation of the Taxpayer

We believe that the disposition of substantially all of the assets of a corporate taxpayer (other than a pass-thru entity) in a transaction to which Section 381 applies (such as an A, C, or D reorganization or a Section 337 liquidation) generally should not be considered an acceleration event. Under Section 381, the transferee in such a reorganization or liquidation is treated as the successor to the target corporation for tax purposes and we think it is appropriate to extend that successor treatment for purposes of Section 108. Similar principles apply to gain deferred under Section 453 and (in certain circumstances) under the GRA rules.[150] Asset reorganizations, like corporate reorganizations in general, serve an important function by allowing business combinations to take place without triggering current tax at the corporate or shareholder level. Because the business is simply reorganized, to the extent the shareholders receive an ownership interest in the acquiring corporation, tax is deferred and the attributes of the target corporation carry over. We believe that these policies indicate that it is not an appropriate time to accelerate the COD income. Moreover, if asset reorganizations were not exempted, it would effectively force companies to use stock reorganizations instead. This would not serve the purposes underlying the acceleration rules, would needlessly limit (or put a cost on) the use of the asset reorganizations, and would create a material trap for the unwary or ill-advised.[151]

Again, where the corporate taxpayer was a member (or the parent) of a consolidated group or the assets are acquired by a consolidated group, it may be appropriate for guidance to require that the member (or the new consolidated group) agree to include a copy of the Section 108(i) election on its tax returns going forward. Also, if our recommendation in Part IV.C.3.a is adopted and the OID Deferral Rule applies where one member of a consolidated group issues a DI and the proceeds are used directly or indirectly to reacquire an ADI of another member, it may be appropriate to include special rules for cases where one (but not both) of the members leaves the group.

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[150] See Treas. Reg. § 1.367(a)-8(k)(2) (providing that the complete liquidation of a US transferor under Sections 332 and 337 will not trigger gain recognition under an existing GRA if the corporate distributee (i) is a domestic corporation and (ii) enters into a new GRA).

[151] We note that an F reorganization presents a particularly strong case for continued deferral.

3. Asset Transfers that Do Not Involve a Liquidation of the Taxpayer

As noted above, Section 108(i)(5)(D)(i) generally requires acceleration of items deferred under Section 108(i) in the case of the liquidation or sale of substantially all the assets of the taxpayer, the cessation of business by the taxpayer, or similar circumstances.

We believe that the substantially all analysis should be applied by looking at both the taxpayer, any corporate subsidiaries held by the taxpayer and the taxpayer's interest in any lower-tier partnerships.[152] Thus, if the taxpayer holds only stock of a subsidiary and the subsidiary sells substantially all of its assets, we believe that such a sale should accelerate any Section 108(i) items deferred by the taxpayer.

However, if a taxpayer transfers assets in a tax-free transaction (such as a Section 351, 354, 721 or 1031 transaction) in exchange for other property and the taxpayer does not liquidate (or distribute the other property received in exchange), we believe that the transfer should essentially be ignored for purposes of determining whether there has been a transfer of substantially all of the taxpayer's assets and that this determination should thereafter be made by reference to the property received in the tax-free transaction. Moreover, we believe that such a transfer should not be treated as an acceleration event even if it causes the taxpayer ceases to be directly engaged in business (other than by reason of holding an interest in the transferee), at least where the taxpayer continues to hold a sufficient interest in the transferee.

4. Bankruptcy Proceedings

As noted above, if an acceleration event occurs during a title 11 or similar case, the items of deferred income and deduction are triggered the day before the petition is filed. The legislative history to Section 108(i) does not explain the reason for retroactively taking the accelerated COD income into account the day before the petition in the title 11 or similar case is filed. Several potential rationales are possible. For example, the purpose may have been to ensure that the tax liability would be recognized in an individual debtor's pre-bankruptcy taxable year, so as to have access to the assets of the individual debtor's bankruptcy estate for payment.[153] It was also speculated that there might have initially been some fear that the bankruptcy exception might otherwise have applied to exclude such income.[154] However viewed, it appears that the purpose was to enhance the

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[152] We note that this does not appear to be the result under the GRA rules.

[153] See Section 1398(d).

[154] As a technical matter, the application of the bankruptcy exception is precluded by Section 108(b)(5)(C), which preempts the bankruptcy exception with respect to any deferred COD income for the taxable year of the election and "any subsequent taxable

likelihood that any tax resulting from the income inclusion would be paid. Accordingly, although the retroactive inclusion of the income should operate to preserve any tax payable, it seems to us that the taxpayer should not be charged with interest for the "late" payment of the tax caused by the retroactive inclusion.[155] In this regard, we observe that, although interest might not be payable in bankruptcy where the debtor's taxable year in fact terminates as of the day before the bankruptcy case thereby making the tax a prepetition claim,[156] in those cases where the taxable year straddles the bankruptcy filing (as is generally the case in corporate bankruptcies) the tax payable probably would be regarded as an administrative expense of the bankruptcy estate that is required to be timely paid.[157]

A bankruptcy proceeding can continue for a long period and therefore it is possible that the statute of limitations for the year that includes the date the petition is filed could be closed by the time the acceleration event occurs.[158] In order to protect

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year." This provision may not always have been included in the legislation during its drafting, however.

[155] Interestingly, the retroactive inclusion of the COD income could have the effect of causing such income to be taxable in a year prior to the actual COD event where the election is made with respect to a COD event occurring during the course of the title 11 or similar case (such as with respect to an interim settlement of a creditor's claim, or a related party purchase of debt during the case).

[156] See 11 U.S.C. §§ 502(b)(2) and 506(b) (in general, postpetition interest on a prepetition unsecured claim is not an allowable claim in bankruptcy).

[157] See 11 U.S.C. §§ 503(b)(1)(B), (D) and 507(a)(8)(A) (carving out income taxes for taxable years ending before the petition date from administrative expense treatment, and authorizing payment of any administrative expense tax liability without any prior request from the taxing authority); and 28 U.S.C. § 960 (generally requiring current payment of any tax unless excused under a specific provision of the Bankruptcy Code).

[158] Section 6503(h) provides that the running of the period of limitations provided in Section 6501 or 6502 on the making of assessments or collection shall, in a case under title 11 of the United States Code, be suspended for the period during which the Secretary is prohibited by reason of such case from making the assessment or from collecting and sixty days thereafter (for assessment) or six months thereafter (for collection). Upon the filing of a Chapter 7 or 11 petition, there is generally an automatic stay of (i) any litigation against the debtor with respect to a prepetition claim, (ii) any act to obtain possession of property of the bankruptcy estate, and (iii) any effort to create or enforce a lien against the property of the bankruptcy estate. 11 U.S.C. 362(a). The stay remains in effect until the bankruptcy case is either closed or dismissed or, in a case under Chapter 11, a discharge is granted or denied. The automatic stay bars any government action to

against this outcome, Treasury may wish to treat the filing of a petition as an acceleration event unless the taxpayer agrees to extend the statute of limitations during the pendency of the proceeding.

5. Changes in Status

It may also be appropriate for guidance under Section 108(i) to explain whether various changes in status are considered acceleration events, such as (i) when an S corporation becomes a C corporation (or vice versa) or (ii) when a consolidated group terminates but is not acquired by another group.

6. Transfer of an Interest in a CFC by a 10% U.S. Shareholder

In Private Letter Ruling 9729011, the IRS ruled that the COD income recognized by a controlled foreign corporation generally would not be considered subpart F income. However, the IRS provided in the ruling that the corporation may be treated as earning subpart F income in the year of the discharge in an amount equal to any subpart F income previously reduced by accrued but unpaid interest. If a foreign corporation makes a Section 108(i) election, it may be appropriate to treat the transfer of an interest in the corporation by a 10% U.S. shareholder as an acceleration event with respect to any COD income which would be treated as subpart F income. Depending upon whether deferred COD income increases E&P on a current basis, such an acceleration rule may also be appropriate to preserve the portion of any gain treated as a dividend under Section 1248. We note, however, that the accelerated COD income should apply only with respect to the transferring 10% U.S. shareholder.

7. Transfer of an Interest in a PFIC by a Shareholder that made a QEF Election

Similarly, depending upon whether COD income deferred under Section 108(i) increases E&P for purposes of the QEF inclusion rules, it may be appropriate to treat a transfer of an interest by a shareholder of a PFIC that has a QEF election in place as an acceleration event.[159] Again, the acceleration rule should apply only with respect to the transferred interest.

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collect or recover any prepetition tax deficiency. 11 U.S.C. 362(a)(6). However, for bankruptcy cases commenced after October 21, 1994, the government may initiate audits, assess taxes and issue notices of deficiency in spite of the automatic stay. 11 U.S.C. 362(b)(9).

[159] If a taxpayer makes a QEF election for a PFIC, the taxpayer is required to include in gross income the shareholder's pro rata share of (i) the "ordinary earnings" of the PFIC for the year and (ii) the net gain of the PFIC for the year. Section 1293(a). For this

8. Cessation of Business

As noted above, Section 108(i)(5)(D)(i) provides that the cessation of business by the taxpayer is treated as an acceleration event. A DI issued by a C corporation is treated as an ADI without regard to whether the corporation is engaged in business. Accordingly, it would be helpful if guidance confirmed that a C corporation will not be treated as having ceased business for purposes of the acceleration rules unless and until the C corporation finally liquidates for purposes of Section 331.

If a person other than a C corporation (such as an upper-tier partnership that is not directly engaged in business) issues a DI to acquire an interest in a partnership that is conducting a trade or business (the lower-tier partnership) and the DI is treated as an ADI solely by reason of the trade or business being conducted by the lower-tier partnership, it seems appropriate to treat a complete termination of the interest in the lower-tier partnership as an acceleration event.

Revenue Procedure 97-27[160] generally provides that Section 481 adjustments must be taken into account when the taxpayer ceases to be engaged in a trade or business or terminates its existence. Revenue Procedure 97-27 also includes detailed rules for when a taxpayer will be considered to cease to be engaged in a trade or business. The acceleration rules set forth in Revenue Procedure 97-27 trigger Section 481 adjustments in a number of cases where we think it would be inappropriate to accelerate items deferred under Section 108(i), including, for example, where a partnership terminates under Section 708(b). It would be helpful for guidance to confirm the extent (if any) to which the principles set forth in Revenue Procedure 97-27 will apply for purposes of Section 108(i).

E. Special Rules for Partnerships and Other Pass-Thru Entities

Section 108(i)(6) includes a number of special rules that apply to partnerships. In addition, Section 108(i)(5)(D)(ii) provides that the acceleration rule applies in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.

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purpose, ordinary earnings are defined as the excess of the E&P of the PFIC for the year over its net capital gain for the year. Section 1293(e)(1). However, notwithstanding Section 312(n)(5), E&P is generally computed for this purpose by excluding any gain that has not been recognized under the installment sale rules, suggesting that Congress believes different E&P standards may apply more generally in this situation. Section 1293(e)(3).

[160] 1997-1 C.B. 680.

1. Special Rules Applicable to Partnerships

Section 108(i)(6) provides that:

> In the case of a partnership, any income deferred under new Section 108(i) is required to be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge is not taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under Section 731. Any decrease in partnership liabilities deferred under the preceding sentence is required to be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.

We refer to the first rule as the Allocation Rule and the second two rules collectively as the "Section 731 Gain Deferral Rule."[161]

a. The Allocation Rule

It would be appropriate and helpful for guidance to elaborate on various aspects of the Allocation Rule and how the deferred COD income should be treated under Subchapter K of the Code.

i. Closing of the Books

As an initial matter, we note that nothing in Section 108(i) either expressly requires or permits a partnership to close its books (or its taxable year) in determining how the deferred COD income would have been allocated under Section 704(b) if a Section 108(i) election had not been made. Absent such a closing of the books (or the taxable year), the allocation of deferred COD income resulting from a reacquisition may depend in certain cases on the results of the partnership for the portion of the taxable year following the reacquisition. It would be helpful for guidance to explain whether the allocation of the COD will be based on the normal application of Section 704 and not

[161] We note that these rules refer to the "discharge" and "such discharge." These references seem intended to refer to either the "reacquisition" as to which the Section 108(i) election is made or the cancellation of the liability that gives rise to the COD income as to which the Section 108(i) election is made.

require any sort of closing of the books (at least where there are no changes in the interests of the partners during the taxable year of the reacquisition).[162]

> Example 12 A and B are partners. Under the partnership arrangement, the first $10 of net income is allocated to A and thereafter all net income is allocated equally between A and B. On August 1, the partnership reacquires an ADI and elects under Section 108(i) to defer the resulting $10 of COD income. For the portion of the taxable year ending on August 1, the partnership has no items of income or deduction. For the remainder of the taxable year, the partnership has $110 of gross income (excluding the COD income) and $100 of gross deductions. Assuming the partnership has a bottom line allocation, absent a Section 108(i) election $15 of net income (presumably comprised of 75% of each item of income and deduction) would have been allocated to A and $5 of net income (presumably consisting of 25% of each item of income and deduction) would have been allocated to B. As a result A would have been allocated $7.50 of COD income and B would have been allocated $2.50 of COD income.
>
> Alternatively, assume that the partnership generates $120 of gross income (excluding the COD income) following the reacquisition. Assuming the partnership has a bottom line allocation, $20 of net income (presumably comprised of 66.67% of each item of income and deduction) would have been allocated to A and $10 of net income (presumably consisting of 33.33% of each item of income and deduction) would have been allocated to B. As a result, A would have been allocated $6.67 of COD income and B would have been allocated $3.33 of COD income.

ii. Treatment of Deferred Items for 704(b) Book Purposes

It would also be helpful for guidance to confirm that items deferred under Section 108(i) will be treated as current items for book purposes under Section 704(b) and the Treasury Regulations thereunder. Thus, in Example 12, the capital accounts of A and B would be credited with the amount of COD income they would have been allocated if a Section 108(i) election had not been made. Similarly, a partner's share of any deferred OID deductions would reduce the partner's Section 704(b) book capital account as the deductions accrue.

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[162] See Prop. Treas. Reg. § 1.706-4(d)(3)(vi) (COD income is treated as an extraordinary item that must be allocated to the partners in proportion to their interest on the day of the discharge).

b. Section 731 Gain Deferral Rule

The Section 731 Gain Deferral Rule seems designed to prevent a partner from recognizing gain under Section 731 as a result of the reacquisition of an ADI which the partner would not have recognized if a Section 108(i) election had not been made with respect to the reacquisition. Although the purpose of this rule is relatively straightforward, its application is both complicated and limited. We recommend that guidance provide that the deemed distribution to a partner under Section 752 resulting from a reacquisition will be reduced (but not below zero) to the extent necessary to cause the partner to recognize the same amount of gain under Section 731 for the taxable year[163] of the reacquisition that the partner would have recognized in the absence of the Section 108(i) election. In general, this would reduce (but not below zero) the deemed distribution to a partner resulting from the reacquisition by the lesser of (i) the partner's share of the deferred COD income realized in such reacquisition (applying the Allocation Rule) and (ii) the total amount of gain that the partner would have recognized under Section 731 in the taxable year of the reacquisition in the absence of the Section 731 Gain Deferral Rule.

i. Background

Section 752(a) provides that an increase in a partner's share of the liabilities of a partnership is treated as a contribution of money by the partner to the partnership. Accordingly, when a partnership issues an ADI, the partners are deemed to contribute money to the partnership in an aggregate amount equal to the ADI. Each partner's share of the liability is determined under a detailed set of Treasury Regulations under Section 752. Similarly, Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership is treated as a distribution of money to the partner from the partnership. Accordingly, when a partnership reacquires an ADI, each partner is

[163] We would also support a rule that extends this principle to Section 731 gain that would otherwise be recognized in a later taxable year but that would not have been recognized in such later year if a Section 108(i) election had not been made. For example, it might be possible to interpret the Section 731 Gain Deferral Rule to effectively increase the partner's basis in the partnership solely for purposes of computing gain under Section 731 by the lesser of (i) the partner's share of the COD income and (ii) the partner's share of the debt. Alternatively, it might be possible to provide that a partner's cumulative gain under Section 731 for all years will never exceed the amount of cumulative gain the partner would have recognized if a Section 108(i) election had not been made.

ordinarily deemed to receive a distribution of money from the partnership equal to the partner's share of the liability immediately before the reacquisition.[164]

Section 731(a)(1) generally provides that a partner does not recognize gain upon the receipt of a distribution of money by a partnership except to the extent the distribution of money exceeds the partner's tax basis in the partnership immediately before the distribution. Section 705(a) generally provides that a partner's tax basis is increased or decreased, as the case may be, by his distributive share of net income or net loss for the taxable year. Since the amount of that net income or net loss cannot be determined until the end of the taxable year, Section 705 is generally interpreted to mean that the associated increase or decrease in the partner's tax basis does not occur until the end of the taxable year. By contrast, distributions by or to a partner generally reduce the partner's tax basis when made.

In order to address the potential timing disconnect between Sections 731 and 705, Treas. Reg. § 1.731-1(a)(1)(ii) provides that, for purposes of Sections 731 and 705, "advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner." Thus, if a partnership makes a distribution of earnings for the year prior to the end of the taxable year, the distribution generally will not be taken into account under Section 731 until after those earnings have increased the tax bases of the partners under Section 705.[165]

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[164] If the reacquisition results from an actual or deemed debt exchange, each partner will (absent the application of the Section 731 Gain Deferral Rule) be deemed to receive a distribution equal to the net reduction in the partner's share of liabilities. Treas. Reg. § 1.752-1(f). It would be helpful if guidance (i) confirmed that when new debt is issued in such an exchange, the amount of the "liability" for purposes of Section 752 associated with the net debt will equal the issue price of the new debt and (ii) explained whether there will be a deemed contribution to the partnership in respect of any OID that has accrued but is deferred under the OID Deferral Rule. Treas. Reg. § 1.752-1(a)(4)(i) provides that an obligation is a liability for purposes of Section 752 only if and to the extent that incurring the obligation (A) creates or increases the basis of any of the obligor's assets (including cash), (B) gives rise to an immediate deduction to the obligor, or (C) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

[165] Although a partner's distributive share of net income for the taxable year will generally reduce the extent to which distributions received by the partner during the year result in gain under Section 731, a partner's distributive share of net loss for the taxable year generally will not increase the extent to which distributions received by the partner during the year result in gain under Section 731. See Rev. Rul. 66-94, 1966-1 C.B. 166.

Revenue Ruling 92-97[166] discusses the application of these rules in two situations involving the allocation of COD income. In the first situation, A contributes $10x and B contributes $90x to a partnership, the partnership borrows $900x and buys $1000x of depreciable property. For Section 752 purposes, A is allocated $90x (10%) of the debt and B is allocated $810x (90%) of the debt. Similarly, A is allocated 10% of the losses and B is allocated 90% of the losses. During the first five years, A is allocated $100x of depreciation deductions and B is allocated $900x of depreciation deductions. At the end of year 5, A and B each has a $0 tax basis in the partnership. At the beginning of year 6, the debt is forgiven and the partnership recognizes $900x of COD income, which is allocated $90x to A and $810x to B. In discussing the application of Section 731, the ruling notes that:

> Under section 705(a)(2), the outside bases of *A* and *B* are decreased by $90*x* and $810*x*, respectively, for their distributions of money under section 752(b) resulting from the cancellation of the debt. *A* and *B* recognize no gain under section 731 in year 6 because the distributive shares of COD income provide an outside basis increase for each partner sufficient to cover the distribution of money to that partner. Because of the integral relationship between the COD income and the section 752(b) distribution of money from the cancelled debt, section 1.731-1(a)(1)(ii) of the regulations treats the distribution of money to each partner from the cancellation of the debt as occurring at the end of *AB's* taxable year as an advance or drawing against that partner's distributive share of COD income.

The second situation addressed in Revenue Ruling 92-97 is the same as the first, except that A and B are each allocated $450x of the COD income. According to the ruling:

> This allocation, which is not in proportion to the partners' shares of the cancelled debt under section 752(b), causes *B* to recognize a $360*x* capital gain under sections 752(b) and 731(a). Although *B*'s outside basis is increased under section 705(a)(1)(A) for *B*'s $450*x* distributive share of COD income, the $810*x* distribution of money resulting from the decrease in *B*'s share of the partnership liability exceeds *B*'s outside basis by $360*x.*
>
> *B* recognizes gain even though the distribution of money from the cancellation of the debt is treated under section 1.731-1(a)(1)(ii) of the regulations as occurring at the end of *AB*'s taxable year. Because of the application of section 1.731-1(a)(1)(ii), however, *A* does not recognize gain in *Situation 2. A*'s outside basis is increased by the allocation to *A* of

[166] 1992-2 C.B. 124.

$450*x* of the partnership's COD income, so the $90*x* distribution of money resulting from the decrease in *A*'s share of the partnership liability does not exceed *A*'s outside basis. After adjustment for the $90*x* distribution, *A* has an outside basis of $360*x*.

In Revenue Ruling 94-4,[167] the IRS held more generally that:

A deemed distribution of money under section 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under section 1.731-1(a)(l)(ii) to the extent of the partner's distributive share of income for the partnership taxable year. An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year. A deemed distribution of money resulting from a cancellation of debt may qualify for advance or drawing treatment under this revenue ruling and under Rev. Rul. 92-97.

ii. <u>Need for the Section 731 Gain Deferral Rule</u>

The need for a provision like the Section 731 Gain Deferral Rule arises from the fact that COD income deferred under Section 108(i) does not increase a partner's tax basis in its partnership interest until the COD income is actually recognized (either during the Recognition Period or upon an acceleration event).

<u>Example 13</u> A and B each contribute $50 to a partnership, the partnership borrows $100 and buys depreciable property for $180 (and retains $20 in cash). Over time the property is fully depreciated and A and B each claim $90 of depreciation deductions on the property (bringing each partner's tax basis down to $10, computed as $50 actual contribution, plus $50 share of the liability, less $90 of depreciation). Midway through the year, the partnership reacquires the $100 DI in exchange for $20. Assume the partnership has no other items of income, gain, loss, or deduction during the taxable year and that no other actual (or deemed) contributions or distributions are made during the year.

In the absence of a Section 108(i) election, the partnership would recognize $80 of COD income upon the acquisition. Each of A and B would be allocated $40 of COD income, increasing each of A's and B's tax basis in its partnership interest from $10 to $50. The elimination of the $100 of partnership debt would give rise to a $50 deemed distribution

[167] 1994-1 C.B. 196.

> to each of A and B but would not trigger gain under Section 731 to A or B since A and B each has $50 of tax basis in its partnership interest.
>
> However, if a Section 108(i) election were made, the $80 of realized COD income would not be recognized in the year of the reacquisition and therefore it would not increase the partners' tax bases in their partnership interests. As a result, A and B would each have a $10 tax basis in its partnership interest. In the absence of the Section 731 Gain Deferral Rule, A and B would each recognize $40 of gain under Section 731 since the $50 deemed to distributed to each partner would exceed the partner's $10 tax basis.

The basic purpose of Section 108(i) is to facilitate reacquisitions of ADIs by allowing taxpayers to defer the resulting COD income and to recognize that COD income ratably over the Recognition Period (or, if sooner, upon an acceleration event). As illustrated by Example 13, that purpose would be undermined in the partnership context if the deferral of the COD income merely caused the partner to recognize a corresponding amount of gain under Section 731. The Section 731 Gain Deferral Rule prevents such a result in the example above by reducing the deemed distribution to each partner from $50 to $10 and thereby restores each partner's Section 731 gain for the year to the amount of Section 731 gain the partner would have recognized during the taxable year of the reacquisition if the partnership had not made a Section 108(i) election (here $0).

iii. Deferred COD Income Cap

It seems reasonably clear that the reduction in the deemed distribution to a partner under the Section 731 Gain Deferral Rule cannot exceed the partner's share of the COD income realized upon the underlying reacquisition (applying the Allocation Rule).

> Example 14 Same as Example 13, except that the COD income is allocated $50 to A and $30 to B.
>
> In the absence of a Section 108(i) election, A's tax basis would have been increased from $10 to $60 and B's tax basis would have been increased from $10 to $40. The elimination of the $100 of partnership debt would give rise to a $50 deemed distribution to each of A and B. The $50 deemed distribution to A would not have given rise to any Section 731 gain since A's $60 tax basis would exceed the deemed distribution to A. By contrast the $50 deemed distribution to B would have given rise to $10 of Section 731 gain to B since the deemed distribution would have exceeded B's $40 tax basis. Thus, in the absence of a Section 108(i) election, B's total income and gain from the transaction would be $40 ($30 of COD income and $10 of Section 731 gain).

Since B would have recognized $10 of Section 731 gain even if the COD income had not been deferred under Section 108(i), requiring current recognition of that gain would not undermine the basic purpose behind Section 108(i) (that is, to defer COD income). Accordingly, it seems reasonable to cap the reduction in the deemed distribution under the Section 731 Gain Deferral Rule at the partner's share of the deferred COD income. We note, in this regard, that such an interpretation is consistent with the use of the word "such discharge" in Section 108(i)(6) (which seems intended to limit the application of the rule to the portion of the liability that gives rise to discharge of indebtedness income). This interpretation is also consistent with the framework of Section 108(i), which requires that the reduction in the deemed distribution be taken into account as a current deemed distribution "by such partner at the same time, and to the extent remaining in the same amount, as" the COD income deferred under Section 108(i) is recognized.

iv. Section 731 Gain Cap

The reduction in the deemed distribution to a partner under the Section 731 Gain Deferral Rule also appears to be capped at the amount of the Section 731 gain that the partner would have recognized in the absence of the Section 731 Gain Deferral Rule.

> Example 15 At the beginning of the year, A has a $100 tax basis in its partnership interest. The partnership reacquires an ADI and makes a Section 108(i) election for the resulting $40 of COD income. A was allocated 50% of the ADI under Section 752 and, absent the Section 108(i) election, A would have been allocated $20 of the COD income. Assume that the partnership did not have any other items of income or loss for the year and that no other distributions were made during the year.

Under the Section 731 Gain Deferral Rule, a decrease in a partner's share of partnership liabilities as a result of the discharge is not taken into account for purposes of section 752 to the extent it would cause the partner to recognize gain under Section 731. Here, the deemed distribution resulting from the reacquisition would not cause A to recognize any gain since A's $100 tax basis immediately before the discharge exceeded the amount of the $20 deemed distribution. Accordingly, on these facts, the Section 731 Gain Deferral Rule would not reduce any portion of the deemed distribution to A. Accordingly, A would be treated as receiving a $20 distribution and A's tax basis at the end of the taxable year would be $80. Notably, the $20 reduction in A's tax basis may impact A in later years if, for example, the total distributions and losses allocated to A in the future exceed $80.

While it seems clear that the Section 731 Gain Deferral Rule only applies if the deemed distribution in some sense causes the partner to have gain under Section 731, it is less clear how the application of the rule should take into account other items that impact the existence, timing and amount of such gain.

(A) Partner is Allocated a Net Loss

If a partner is allocated net loss for the year of the reacquisition, the net loss itself generally will not impact the amount of Section 731 gain that is recognized by the partner by reason of the deemed distribution resulting from the reacquisition, apart from the application of the Section 731 Gain Deferral Rule.[168]

It is not entirely clear how the Section 731 Gain Deferral Rule should apply in cases where a partner (i) is allocated a net loss for the year (or is otherwise not allocated any net income for the year) and (ii) receives an actual (or deemed) distribution from the partnership (in addition to the deemed distribution resulting from the reacquisition).

> Example 16 A is a partner in partnership. At the beginning of the taxable year, A has a $10 tax basis in its partnership interest. Partnership reacquires a $100 ADI for $0. A's share of the liability was $50, and A is allocated $50 of the COD income realized upon the reacquisition. A receives an actual $10 distribution from the partnership during the taxable year. Assume that A is not allocated any net taxable income for the year.
>
> If the actual $10 distribution precedes the reacquisition, then the actual $10 distribution would not cause any Section 731 gain and would reduce A's basis from $10 to $0. As a result, A's tax basis at the time of the reacquisition would be $0 and (but for the Section 731 Gain Deferral Rule) A would be deemed to receive a $50 distribution as a result of the reacquisition and that deemed distribution would cause $50 of gain under Section 731. As a result, it appears that the deemed distribution resulting from the reacquisition would be reduced by $50 so that A would recognize no gain under Section 731 for the taxable year.
>
> By contrast, if the actual $10 distribution occurs after the reacquisition, then A's tax basis at the time of the reacquisition would be $10 at the time of the reacquisition and (but for the Section 731 Gain Deferral Rule) the $50 deemed distribution as a result of the reacquisition would cause $40 of gain under Section 731. When A thereafter receives the $10 actual distribution, A would recognize an additional $10 of gain under Section 731.

Where the reacquisition precedes the actual distribution, the deemed distribution resulting from the reacquisition directly causes $40 of gain under Section 731 at the time of the reacquisition. However, even where the actual distribution precedes the reacquisition it could be fairly said the $10 of gain subsequently recognized under Section 731 upon the actual distribution was also caused by the reacquisition since, but for the reacquisition, A would have had $10 of tax basis at the time of the actual $10

[168] See Rev. Rul. 66-94.

distribution and therefore A would not have recognized any gain under Section 731 as a result of that distribution. Moreover, if the partnership had not made a Section 108(i) election, A would have had $50 of COD income but no gain under Section 731 on either the actual distribution or the deemed distribution (regardless of how they were ordered). Accordingly, it seems reasonable to interpret the Section 731 Gain Deferral Rule to reduce the deemed distribution by $50 (the lesser of (i) the amount of COD income allocated to A under the Allocation Rule and (ii) the total amount of Section 731 gain that would have been recognized for the year in the absence of the Section 731 Gain Deferral Rule).[169]

(B) Partner is Allocated Net Income

The analysis is somewhat more complicated if the partner is allocated net income for the year of the reacquisition.

> Example 17 A is a partner in partnership. At the beginning of the taxable year, A has a $10 tax basis in its partnership interest. Partnership reacquires a $100 ADI for $0. A's share of the liability was $50, and A is allocated $50 of the COD income realized upon the reacquisition. A receives no distributions from the partnership (other than the deemed distribution resulting from the reacquisition). A is allocated $40 of unrelated net income during the year.

Without regard to the Section 731 Gain Deferral Rule, (i) A would be deemed to receive a $50 distribution during the year, (ii) of that $50 distribution, $40 would be treated as an advance (and not be taken into account as a deemed distribution until the end of the year) and $10 would be taken into account at the time of the reacquisition, (iii) the $10 distribution taken into account at the time of the reacquisition would not result in any gain under Section 731 because A would have $10 of outside tax basis at that time, and (iv) the $40 distribution taken into account at the end of the taxable year would not result in any gain under Section 731 because the $40 of net income allocated to A would have increased A's tax basis from $0 to $40. Since A would not recognize any gain under Section 731 in the absence of the Section 731 Gain Deferral Rule, it appears that the Section 731 Gain Deferral Rule does not reduce any portion of the $50 deemed distribution. Put differently, no reduction in the deemed distribution to A is necessary because A would not have recognized any gain under Section 731 even if a Section 108(i) election had not been made.

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169 Put differently, the application of the Section 731 Gain Deferral Rule would restore each partner's Section 731 gain for the year to the amount of Section 731 gain the partner would have recognized during the taxable year if the partnership had not made a Section 108(i) election (again, here $0).

However, the analysis becomes more complicated where a partner receives both a distributive share of net income and a distribution from the partnership (other than the deemed distribution resulting from the reacquisition).

> Example 18 A is a partner in partnership. At the beginning of the taxable year, A has a $0 tax basis in its partnership interest. Partnership reacquires a $100 ADI for $0. A's share of the liability was $50, and A is allocated $50 of the COD income realized upon the reacquisition. A is allocated $40 of unrelated net income for the year and receives a $40 distribution during the year.

Ignoring the Section 731 Gain Deferral Rule, (i) it seems clear that of the $90 in total distributions, $40 would be treated as an advance and taken into account at the end of the year and $50 would be treated as occurring during the year and (ii) A would recognize $50 of gain under Section 731. It is not entirely clear which distribution would be treated as having caused the Section 731 gain since it is not clear whether the $40 advance should be treated as reducing the $40 actual distribution or the $50 deemed distribution that resulted from the reacquisition, depending upon which came first, or reducing some combination of the two distributions. However, since the COD income associated with the deemed distribution was deferred, it seems sensible to treat the "other" distribution (that is, the distribution not associated with the COD income) as an advance against the partner's net income. Under this approach, in determining the application of the Section 731 Gain Deferral Rule, the $50 deemed distribution would be treated as having been made at the time of the reacquisition and therefore causing the $50 Section 731 gain. As a result, the Section 731 gain would reduce the deemed distribution by $50 and A would not recognize any Section 731 gain. We note that A would not have recognized any Section 731 gain if the partnership had not made a Section 108(i) election.

v. Triggering the Deferred Section 752 Distributions Upon the Recognition of the Deferred COD

As noted above, any decrease in the deemed distribution to a partner under the Section 731 Gain Deferral Rule is taken into account by the partner at the same time, and to the extent remaining in the same amount, as deferred COD income is recognized. The application of this rule is straightforward where the reduction in the deemed distribution equals the deferred COD income. However, the application is less clear where a partner's deferred COD income exceeds the reduction in the partner's deemed distribution (because the partner's share of the deferred COD income exceeds either the partner's share of the underlying liability under Section 752 or the amount of Section 731 gain that would otherwise have been recognized). In such a case, it seems sensible to trigger the deemed distribution based on the last portion of the COD income that is recognized.

vi. Application of Section 751(b)

In Revenue Ruling 84-102,[170] the IRS indicated that a deemed distribution under Section 752 could trigger the application of Section 751(b). As noted in our prior report on the proposal in Notice 2006-14 to change the manner in which Section 751(b) is applied, Revenue Ruling 84-102 has been widely criticized.[171] It would be helpful for guidance under Section 108(i) to confirm that a deemed distribution resulting from a reacquisition (including a reacquisition effected as an exchange of debt for equity) will not trigger the application of Section 751(b).

c. Transfer of Interests in a Partnership

Section 108(i)(5)(D)(ii) provides that the acceleration rule also applies in the case of the sale or exchange or redemption[172] of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity. Although not entirely clear from the words of the statute, it seems reasonably clear that the transfer of an interest in a partnership by a partner does not trigger all of the deferred items but rather triggers only the portion associated with the transferred interest. Moreover, in light of the Allocation Rule, it seems reasonably clear that the portion associated with the transferred interest is the amount of COD income that would have been allocated with respect to such portion in the year of the discharge if no Section 108(i) election had been made. However, since the statute could be read literally to mean that a transfer of even a small portion of the partnership interests accelerates all

[170] 1984-2 C.B. 119.

[171] See N.Y. State Bar Ass’n, Tax Section, “Report Responding to Notice 2006-14 Relating to the Treatment of Partnership Distributions under Section 751(b)” (Nov. 28, 2006) (noting that (i) Rev. Rul. 84-102 does not take into account Section 751(b)(2)(A) (which provides that Section 751(b) shall not apply to a distribution of property that the distributee partner contributed to the partnership, as would seem to be the case with any deemed distribution under Section 752), (ii) the shift in hot asset gain in the ruling had nothing to do with the liability shift that occurred in the ruling, (iii) since the liability shift did not give rise to an economic exchange it is hard to understand how Section 751(b) could be implicated, and (iv) the application of reverse Section 704(c) principles would now seem to prevent the shift in hot-asset gain present in the ruling).

[172] The concept of a partnership redemption generally does not exist under Subchapter K of the Code, other than perhaps in Section 751(b). Although we assume that this term will be limited to cases where a partner’s interest in a partnership is completely liquidated and to corporate pass-thru entities, we note that this would allow a partner to receive a distribution from the partnership that reduces the partner’s interest substantially but does not accelerate any of the COD income.

of the partnership's deferred items, we believe it is important for guidance to be issued confirming that such a transfer accelerates only the deferred items associated with the transferred interest.[173] Further, we believe it is important for guidance to confirm that in the tiered-partnership context, a transfer of an interest in an upper-tier partnership accelerates the transferring partner's allocable share of any COD income deferred by a lower-tier partnership but no more.

It would also be appropriate and helpful to provide that certain transactions involving a transfer of an interest in a partnership will not be treated as an acceleration event. For example, if a corporate partner's interest in a pass-thru entity is acquired in an asset reorganization or Section 332 liquidation, it seems appropriate to extend the deferral. Similarly, if an interest in a partnership is transferred to a lower-tier partnership or distributed from an upper-tier partnership to a partner, it seems appropriate to continue deferral to the extent that each partner's share of the deferred items remains the same. Similarly, it would be helpful to confirm that a Section 708(b) termination of a partnership (and the deemed transfers of any lower-tier partnerships resulting from such a termination) will not be considered an acceleration event.

2. Special Rules Applicable to S Corporations

It is not clear how deferred COD income should be allocated in the case of an S corporation where there are changes in the ownership of the S corporation after the reacquisition.

We note in this regard that the Allocation Rule is limited to partnerships and does not by its terms apply to S corporations or other pass-thru entities. By contrast, Section 108(i)(5)(D)(ii) provides that the acceleration rule applies upon a transfer of an interest in a partnership, S corporation or other pass-thru entity. As with a transfer of an interest in a partnership, we believe that in the S corporation context this acceleration rule was intended to trigger only the deferred items associated with the transferred interest. However, since the Allocation Rule does not expressly extend to S corporations, it is not

[173] In some cases accelerating a partner's share of the deferred COD income upon a transfer will work to the partners' advantage. For example, assume that a partner owns a partnership interest that has a fair market value of $100, a tax basis of $40 and as to which there is $20 of deferred COD income. Upon a sale of the interest, the selling partner will have $60 of net income whether or not the acceleration rule applies (either $20 of COD income and $40 of Section 741 gain or $0 of COD income and $60 of Section 741 gain). By contrast, the buying taxpayer is likely to prefer that the COD income be accelerated upon the transfer so that it is taxable to the seller rather than to the buyer. Of course, the acceleration rule generally will impact the character of the income and the application of the acceleration rule could put the selling taxpayer in a position where it has ordinary income and a capital loss.

entirely clear how much COD income is triggered upon a transfer of an interest in an S corporation, how the accelerated COD income is allocated among the then owners of the S corporation, or how the remainder of the COD income is allocated. It is also unclear how the deferred COD income should be allocated when interests in an S corporation change by reason of the issuance of additional stock in the S corporation.

> Example 19 S corporation elects to defer $90 of COD income at a time when A owns 50 shares and B owns 50 shares. The next year, S corporation issues 50 shares of stock to C. Absent an acceleration event, $18 of COD income will be recognized in each of years 2014-2019.

This simple example raises a number of questions. First, assuming that the issuance of stock to C is not an acceleration event, which S corporation shareholders are required to include the $18 of COD income recognized in 2014? If the normal S corporation rules are followed, it appears that A, B and C would each be allocated and recognize $6 of the COD income. However, the principles underlying the acceleration rules applicable to S corporations (and other pass-thru entities) suggest that A and B should be allocated all of the deferred COD income since they were the owners at the time of the reacquisition. One approach would be to treat the issuance of the stock to C as an indirect transfer by A and B to C of one-third of their interests and therefore trigger one-third of the COD income at the time of the issuance. However, it is not clear whether or how this would address the basic issue. First, it would presumably accelerate only $30 of the COD income, meaning the remaining $60 of COD income would still be allocated one-third to each of A, B and C if the normal rules applied. Moreover, if the accelerated COD income is recognized at the S corporation level, it seems that C would pick up $10 of that income in the year of the acceleration if the normal rules applied. Finally, it appears that a later transfer by C would trigger COD income, and this makes little sense at all since C really should not be recognizing any of the COD income in the first place.

In order to address these issues, it seems sensible to treat the deferred COD income as deferred at the shareholder level rather than at the S corporation level, similar to the deferral of losses under Section 1366(d). This would ensure that the S corporation shareholders at the time of the reacquisition ultimately include the deferred COD income in cases where there are changes to the ownership of the S corporation, whether by reason of a new issuance of S corporation stock that does not trigger the acceleration or by reason of a transfer of S corporation stock that does trigger the acceleration rule. It would also identify how much COD income gets accelerated upon a transfer of an interest in an S corporation and ensure that the accelerated income is recognized by the transferring shareholder.

We recommend that guidance also clarify how the OID Deferral Rule will apply in cases where a shareholder of an S corporation is allocated OID that is potentially subject to the OID Deferral Rule but is not allocated any of the deferred COD income.

3. Allocation and Deferral of the OID Deductions

a. In General

Section 108(i) does not provide how OID deferred under the OID Deferral Rule will be allocated when it is recognized during the Recognition Period or upon an acceleration event. The OID deduction may well be borne economically by partners (or S corporation shareholders) in a manner different from the manner in which the COD income was shared.

> Example 20 A and B each holds a 50% interest in a Partnership (or S corporation) with an ADI outstanding. C contributes cash to the entity in exchange for a one-third interest in the entity. The entity uses C's cash plus the proceeds of a new debt offering to reacquire the ADI. Although the COD income will be shared as an economic and tax matter by A and B, the OID deductions on the new debt will be shared economically by A, B and C.

Since the OID deductions on the new debt will be shared economically by A, B and C, we believe those OID deductions should be allocated among A, B and C in the same manner.

As discussed in Part IV.C.3.b, good arguments can be made that since C did not benefit from the COD income deferral, it is inappropriate to defer C's share of the OID deductions, although there are equally persuasive arguments to the contrary.

We recommend that guidance provide that (i) OID will be allocated based on each partner's share of the OID as it accrues based on normal Section 704(b) principles, (ii) such OID will reduce such partner's Section 704(b) capital account as it accrues, and (iii) each partner will recognize its share of the deferred OID during the Recognition Period (or upon an acceleration event).

b. Following a Transfer

If the OID Deferral Rule is applied at the partner level, it seems relatively clear that, following a transfer of an interest in a pass-thru entity which triggers the acceleration rule, the transferee's share of any OID accruing after the date of the transfer generally would not be subject to the OID Deferral Rule. However, if guidance provides that the OID Deferral Rule is applied at the partnership level, it would be helpful for guidance to explain in the case of a transfer that triggers the acceleration rule (i) what portion of the OID that has accrued as of the transfer date but was deferred under the OID Deferral Rule is accelerated (and whether the acceleration rule will operate to accelerate both the transferor's share of the accrued OID and the other partners' share of the accrued OID), (ii) what portion of any unaccrued OID will be exempt from the application of the

OID Deferral Rule (either to the transferee or the other partners) and (iii) whether the special acceleration rule referred to in Part IV.C.3.b. is available.

4. Tiered Arrangements

It would also be appropriate and helpful for guidance to explain how Section 108(i) operates in the context of tiered arrangements, such as where a partnership makes a Section 108(i) election and interests in the partnership are held by an upper-tier partnership or an S corporation.

F. RICs and REITs

We recommend that guidance confirm how Section 108(i) applies in the context of RICs and REITs.

1. Background

The term "regulated investment company" ("RIC") is generally defined as any domestic corporation that meets the requirements set forth in Sections 851(a) and (b). Section 852(b) imposes a tax upon a RIC's "investment company taxable income" for the taxable year and a tax upon a RIC's "net capital gain" for the year. However, in computing the tax bases upon which such taxes are applied, a RIC is allowed a deduction for dividends paid by the RIC (as defined in Section 561). The tax imposed by Section 852(b) (and the dividends paid deduction) apply only if the RIC satisfies the distribution requirement set forth in Section 852(a). Thus, a RIC that satisfies Section 852(a) may distribute its income and gains to its shareholders free of tax at the RIC level.[174]

A RIC that satisfies the distribution requirements of 852(a) may, under certain circumstances, designate the distributions made by the RIC in a manner that allows the shareholders receiving such distributions to be taxed on the distribution by reference to the character or type of income recognized by the RIC. Thus, for example, a distribution can be designated as a long-term capital gain distribution (up to the long-term capital gain recognized by the RIC), in which case the recipient of the distribution will be taxed on the distribution as long-term capital gain.

The term "real estate investment trust" ("REIT") is defined as a corporation, trust or association which (but for the application of the REIT rules) would be taxable as a domestic corporation and which meets the requirements set forth in Section 856. Section

[174] As a general rule, only dividends described in Section 316 (relating to the definition of dividends for purposes of corporate distributions) qualify for the dividends paid deduction. Thus, only distributions by a RIC out of current earnings and profits or accumulated earnings and profits will qualify for the dividends paid deduction.

857(b) imposes a tax upon a REIT's "real estate investment trust taxable income" for the taxable year and a tax upon a REIT's "net capital gain" for the year. However, in computing the tax bases upon which such taxes are applied, a REIT is allowed a deduction for dividends paid by the REIT (as defined in Section 561). The tax imposed by Section 857(b) (and the dividends paid deduction) apply only if the REIT satisfies the distribution requirement set forth in Section 857(a). Thus, a REIT that satisfies Section 857(a) may distribute its income and gains to its shareholders free of tax at the REIT level.[175]

A REIT that satisfies the distribution requirements of 857(b) may, under certain circumstances, designate the distributions made by the REIT in a manner that allows the shareholders receiving such distributions to be taxed on the distribution by reference to the character or type of income recognized by the REIT. Thus, for example, a distribution can be designated as a long-term capital gain distribution (up to the long-term capital gain recognized by the REIT), in which case the recipient of the distribution will be taxed on the distribution as long-term capital gain.[176]

2. Basic Application of Section 108(i) to RICs and REITs

Although the basic application of Section 108(i) in the context of a RIC or a REIT seems relatively straightforward, it would be helpful if guidance confirmed that (i) COD income deferred under Section 108(i) is not taken into account in computing "investment company taxable income" or "real estate investment trust taxable income" until such income is includible in income under Section 108(i), (ii) when the income is includible under Section 108(i), Section 108(e)(9) will prevent the recognition of the COD income from contributing to or causing a disqualification of a REIT for failure to satisfy the REIT income test, and (iii) because the COD income will treated as "excess noncash income under Section 857(e)(2)(D) when it is recognized under Section 108(i), a REIT will not be required to distribute the COD income when it is recognized (but will be subject to tax on such income under Section 857(b) if it fails to distribute the income).

3. Special E&P Rule for RICs and REITs

In order to eliminate any corporate level tax when the deferred COD income is includible in income under Section 108(i), the RIC or a REIT will need to pay a distribution out of current or accumulated E&P so that it can claim an offsetting dividends paid deduction. If the deferred COD income increases the E&P of the RIC or

175 However, a REIT may be subject to several other taxes, including a tax on net income from foreclosure property and a 100% tax on income from prohibited transactions. Section 857(b)(4); Section 857(b)(6).

176 Section 857(b)(3)(C).

the REIT in the year of the reacquisition (as per our recommendation above), the RIC or REIT may not have sufficient E&P in the year the COD income is recognized under Section 108(i) in order to create an offsetting dividends paid deduction. This could occur, for example, if prior to the time the deferred COD income is recognized, the RIC or the REIT recognizes a loss that reduces accumulated E&P or the RIC or the REIT makes a distribution in excess of its current E&P (disregarding the E&P associated with the deferred COD income). We recommend that, in order to ensure that a RIC and REIT always has sufficient E&P to claim a dividends paid deduction in the year the COD income is recognized, the E&P of a RIC or a REIT be increased only when the deferred COD income is recognized.[177]

4. RICs and REITs are Not Pass-Thru Entities

Section 108(i)(5)(D)(ii) provides that the acceleration rule shall apply in the case of the sale or exchange or redemption of an "interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity."[178] It seems clear that RICs and REITs should not be treated as pass-thru entities for purposes of Section 108(i). However, since Section 108(i) does not include a specific definition of pass-thru entity for purposes of Section 108(i), it would be helpful if guidance confirmed that RICs and REITs are not pass-thru entities for purposes of Section 108(i).

We note that RICs and REITs are not pass-thru entities in the conventional sense of the word since the income and losses of a RIC or REIT do not flow through to the shareholders. Rather, a shareholder of a RIC or a REIT does not realize any income from the RIC or REIT except to the extent the RIC or REIT elects to pay a dividend to its shareholders (or deem a dividend to be paid). By contrast, the income and loss of a partnership or S corporation flows through automatically to the owners, the subpart F income of a CFC flows through automatically to the 10% United States shareholders, and

[177] We note that this is essentially an extension of our recommendation in Part IV.B.1.C that E&P not be increased in the year of the reacquisition for purposes of applying any special tax regimes where the inclusion of the deferred COD income in E&P in the year of the reacquisition could result in the imposition of a corporate level tax.

[178] In addition, (i) Section 108(i)(5)(B)(iii) provides that in the case of a partnership, S corporation, or other pass-thru entity, a Section 108(i) election is made by the partnership, the S corporation, or other entity involved and Section 108(i)(7) provides that the Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying Section 108(i), including (among other things): "rules for the application of Section 108(i) to partnerships, S corporations, and other pass-thru entities, including for the allocation of deferred deductions."

the ordinary income and gain of a PFIC flows through automatically to the shareholders who have made QEF elections with respect to the PFIC. Thus, in the case of a partnership, S corporation, CFC or PFIC as to which there is a QEF election is place, the income of the entity flows through to the owner, the income increases the owner's tax basis (or the equivalent) in the entity, and the owner is allowed to receive a corresponding distribution without further tax. The opposite is true in the case of a RIC or REIT as no income flows through to owners and the owners are taxed upon the receipt of distributions received from the RIC or the REIT. Although a RIC or REIT may to a certain extent designate distributions in a manner that allows the recipient to be taxed on the distribution by reference to the type or character of the income or gain recognized by the RIC or REIT, the fact remains that the shareholder is taxed on the receipt of the distribution, not the income or gain realized by the RIC or the REIT.[179]

Moreover, as discussed in Part IV.E.1.C, the acceleration rule applicable upon a transfer of an interest in a partnership, S corporation or other pass-thru entity is clearly intended to accelerate only the transferor's share of the deferred items. Because the deferred COD income is income of the RIC or the REIT (rather than income of the shareholders), the acceleration rule can trigger income only at the RIC or REIT level. Nothing in Section 108(i) allows the IRS or Treasury to deem a RIC or a REIT to have paid a dividend to its shareholders. Thus, even if the acceleration rule were applied to require a RIC or a REIT to recognized a portion of the deferred COD income upon a transfer of an interest in the RIC or a REIT, the practical impact of such an acceleration rule would be to require either the RIC or the REIT to pay the tax on that income or to force the RIC or the REIT to pay a taxable dividend to all of its shareholders. We note, moreover, that it is not possible to use the consent dividend mechanism to focus the dividend on the transferring shareholders since the consent dividend may not be preferential and, in any case, the consent dividend is taxable to the owner of the transferred stock on the last day of the taxable year of the RIC or the REIT.

Accordingly, it seems clear that RICs and REITs are not pass-thru entities for purposes of Section 108(i) and, in any case, that it is not possible to apply the acceleration rule in a manner that deems a transferring shareholder to have received an ordinary dividend equal to its share of the deferred COD income.

However, in light of this, it bears noting that a Section 108(i) election made by a RIC or REIT can facilitate the ability of the shareholders to in some sense convert

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[179] Moreover, a RIC or REIT is a taxable corporation that must pay tax on its net income (as computed under the RIC and REIT rules). Although the dividends paid deduction available to RICs and REITs allows them to eliminate corporate level tax on all (or most) of their income, the fact remains that RICs and REITs are taxable at the corporate level to the extent they do not eliminate their net income by paying deductible dividends.

ordinary income into capital gain. Although this is inherent in the statutory scheme applicable to RICs and REITs, the long-term deferral afforded by Section 108(i) affords shareholders some additional latitude.

For example, suppose that a REIT (that at no relevant time is insolvent or in bankruptcy) realizes $100 of COD income on July 1, 2009, the REIT does not elect Section 108(i), and the REIT pays a $100 dividend to its shareholders on December 27, 2009. A owns 10% of the stock of the REIT at the time the COD income is realized. If A retains his stock through the end of the year, A will have $10 of ordinary dividend income. By contrast, if A sells his stock before the record date for the dividend, A can recognize capital gain on the sale. Suppose instead that the REIT makes a Section 108(i) election. Now, A can retain his interest in the REIT beyond 2009 and still avoid dividend income in respect of the COD income so long as A sells his shares in the REIT before the REIT pays a dividend in 2014.

Similarly, suppose that (i) a private REIT (that at no relevant time is insolvent or in bankruptcy) has purchased a series of properties (each secured by nonrecourse debt), (ii) some (but not all) of the properties are not valued below the amount of the related debt, (iii) in 2009, the lenders agree to forgive a portion of the debt on the troubled properties, and (iv) the REIT makes a Section 108(i) election with respect to the resulting COD income. In 2013, the REIT sells or distributes its profitable properties (and distributes the cash from the sales), and the shareholder sells or donates its stock in the REIT to a tax-exempt, which agrees to a consent dividend for the deferred COD for 2014-2018.[180] In such a case, the shareholder of the private REIT will have avoided being taxed on the ordinary dividend income associated with the deferred COD income.

V. Comments on Section 163(e)(5)(F) and Related Provisions

A. Related Party Exception

Section 163(e)(5)(F) provides that Section 163(e)(5) does not apply to any AHYDO issued during the period beginning on September 1, 2008, and ending on December 31, 2009, in exchange (including an exchange resulting from a modification of a DI) for an obligation which is not an AHYDO and which has an issuer (or obligor) which is the same as the issuer (or obligor) of such AHYDO. However, the exception set out in new Section 163(e)(5)(F) does not apply to (i) any obligation the interest on which is interest described in Section 871(h)(4) (without regard to subparagraph (D) thereof) or (ii) any obligation issued to a related person (within the meaning of section 108(e)(4)) (the "Related Party Exception"). Section 163(e)(5)(F) is referred to below as the AHYDO Turnoff Rule.

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180 Alternatively, the shareholder could sell the shares to a trader that has made an election under Section 475(f).

Although the Related Party Exception seems to say that the AHYDO Turnoff Rule does not apply to debt issued to a related person, it cross references the entire related party rules of Section 108(e)(4). As a result, it is not entirely clear from reading the Related Party Exception whether it was intended to mean that the AHYDO Turnoff Rule will not apply (i) only if the AHYDO is issued pursuant to a transaction governed by Section 108(e)(4) or (ii) whenever the AYHDO is issued to a related party (as that term is used in Section 108(e)(4)) even if the debt is not issued in a transaction to which Section 108(e)(4) applies (such as where a DI is held by a person related to the issuer and that DI is exchanged for another DI issued by the same issuer). It would be helpful if guidance explained the scope of the Related Party Exception.

B. Over Inclusiveness and Under Inclusiveness

We note that the AHYDO Turnoff Rule seems to be both over inclusive and under inclusive. For example, while the AHYDO Turnoff Rule applies only to an AHYDO that is issued in exchange for debt meeting certain requirements, nothing limits the AHYDO Turnoff Rule to exchanges which result in the realization of COD income. Thus, a taxpayer can effectively avoid the application of the AHYDO deferral and disallowance rules by structuring the issuance of new debt as an exchange of any existing debt (as opposed to an issuance for cash). For example, a taxpayer that was planning to issue a new AHYDO for cash could arrange for the underwriter to acquire existing short-term debt of the taxpayer and exchange that short-term debt for a longer-term AHYDO of the taxpayer. This seems inappropriate if the purpose behind the AHYDO Turnoff Rule is limited to preventing taxpayers from essentially being whipsawed in a debt exchange by having to include the COD income in gross income but not being permitted to claim a deduction for the offsetting OID. However, if the AHYDO Turnoff Rule was intended to have the broader purpose of curtailing the application of the AHYDO deferral and disallowance rules more generally, one would think it should apply with equal force to AHYDOs issued in exchange for cash.

Moreover, the scope of the AHYDO Turnoff Rule is more limited than the scope of the OID Deferral Rule. While the OID Deferral Rule can apply to OID that accrues on a DI issued for cash if the proceeds are used directly or indirectly to reacquire an ADI, the AHYDO Turnoff Rule does not apply to such a DI even if the OID accruing on the DI is subject to the OID Deferral Rule.

Depending upon how guidance interprets the OID Deferral Rule in cases where the new DI is issued by a related person, the disconnect between the OID Deferral Rule and the AHYDO Turnoff Rule could increase. For example, suppose that the parent of a consolidated group acquires an ADI issued by a subsidiary of that group in exchange for a DI of the parent. Under a strict reading of the statute, neither the OID Deferral Rule nor the AHDYO Turnoff Rule seem to apply to the parent’s DI because both Sections arguably require that the issuer of the new DI be the same as the issuer of acquired DI. We recommend that, if guidance interprets the OID Deferral Rule to apply in such a case,[181] guidance should similarly extend the application of the AHYDO Turnoff Rule in the same manner.

VI. Additional Suggestions Relating to the Rules Applicable to Debt Exchanges

A. In General

As described in Part II, the existing rules relating to the taxation of debt exchanges and debt modifications are in many cases difficult to apply and can lead to tax consequences that are both severe and counterintuitive. Although Section 108(i), Section 163(e)(5)(F) and the other related provisions are very helpful, they do not address the fundamental technical tax issues leading to those tax consequences.

Accordingly, we recommend that the IRS and Treasury consider whether the existing rules relating to debt modifications and exchanges should be revised. More specifically, we recommend that the IRS and Treasury consider seeking a legislative change (or using the regulatory authority granted by Section 1275(d)) either to revise the existing issue price rules applicable to debt exchanges or otherwise change the rules relating to debt exchanges to better align the timing of the resulting COD income and OID deductions. In addition, we recommend that the IRS and Treasury consider revising (i) the Publicly Traded Rules to allow taxpayers greater certainty in determining whether those rules apply to a debt exchange[182] and (ii) the potentially abusive situation rules to clarify whether and to what extent those rules apply to a debt exchange that is not governed by the Publicly Traded Rules.[183] If requested, we are happy to prepare one or more additional reports covering these areas.

B. Issue Price of New DIs Issued in Exchange for Existing DIs

Former section 1275(a)(4), which was repealed by the Revenue Reconciliation Act of 1990, contained a special rule for determining the issue price in the case of a debt-for-debt exchange by a corporate issuer pursuant to a plan of reorganization. Under former section 1275(a)(4), the issue price of the new DI was equal to the adjusted issue price of the old DI if the issue price, as determined under Sections 1273 and 1274, would otherwise have been less than such adjusted issue price. Thus, former section 1275(a)(4) generally prevented the creation of OID upon a debt-for-debt exchange that qualified as a

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[181] See our recommendation above in Part IV.C.3.

[182] See also N.Y. State Bar Ass'n, Tax Section, "Report on Definition of 'Traded on an Established Market' Within the Meaning of Section 1273" (Aug. 12, 2004).

[183] See also Todd F. Maynes and Thad Davis, Distressed Debt in Disorderly and Dysfunctional Markets, 87 Taxes 55 (Mar. 2009).

reorganization, regardless of the fair-market value of the DI or the adequacy of the interest rate of the new DI, so long as the principal amount of the new DI was not greater than the principal amount of the old DI (or, more precisely, the stated redemption price at maturity of the new DI was not greater than the adjusted issue price of the old DI).

In 1991, we issued a report (the "1991 Report") recommending that former section 1275(a)(4) be reenacted with certain modifications.[184] The reasons underlying the recommendation in the 1991 Report remain applicable today. Moreover, we note that if former section 1275(a)(4) were reenacted, (i) the application of Section 108(i) to debt modification and other debt exchanges would generally not be necessary, (ii) the OID Deferral Rule would generally not be necessary, (iii) the AHYDO Turnoff Rule would generally not be necessary, and (iv) a taxpayer whose debt is valued substantially below its issue price would not risk incurring a substantial tax liability that could render it insolvent merely by agreeing to a modification that does not reduce the amount owed by the taxpayer.

Although a reenactment of former section 1275(a)(4) in its prior form would reduce (or eliminate) the need for various aspects of Sections 108(i) and 163(e)(5)(F), it could allow taxpayers to engage in other transactions that are inappropriate. For example, as described in the 1991 Report, when former section 1275(a)(4) was effective, some taxpayers took the position that they could (with the help of a friendly investment bank) create artificial bond premium by structuring a debt issuance as a debt-for-debt exchange. In other cases, taxpayers may have used former section 1275(a)(4) essentially to convert OID into market discount.

We recommend that the IRS and Treasury consider seeking a legislative change (or using the regulatory authority under Section 1275(d)) to revise the issue price rules applicable to debt exchanges in a manner that would avoid the creation of COD income and offsetting OID deductions upon a debt exchange (except to the extent there is an actual reduction in the issuer's indebtedness). Moreover, we believe that consideration should be given to reinstating the principles of former section 1275(a)(4) but with various modifications.

Those modifications could include, for example, one or more of the following:[185] (A) providing that the issue price of the new debt be equal to the lesser of (i) the adjusted issue price of the old DI and (ii) the stated principal amount of the new DI, (B) providing that the issue price of the new DI initially be determined under the current rules but then

[184] N.Y. State Bar Ass'n, Tax Section, "Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges," 51 Tax Notes 79 (Apr. 8, 1992).

[185] The modifications described in (A) and (B) are alternatives.

increased (but not above the stated principal amount of the new DI) by the lesser of (i) the COD that would otherwise result in the exchange and (ii) the OID that would otherwise exist on the new DI, (C) expanding the scope of former section 1275(a)(4) so that it applies to all debt exchanges rather than only those debt exchanges which qualify as recapitalizations under Section 368(a)(1)(E), and (D) reinstating the principles of former section 1275(a)(4) (as modified) solely for purposes of determining the issuer's tax consequences.

We note that even if former section 1275(a)(4) were reenacted with the modifications described in (A) or (B), it would still be possible to structure a debt issuance that would allow for the conversion of OID into market discount.[186] For example, an investment bank could acquire pre-existing DIs with a fair market value of $80 and a stated principal amount (and adjusted issue price) of $100 and exchange the pre-existing DIs for a new DI with the same principal amount. Moreover, while such a rule would prevent the issuer from recognizing COD income, it would still permit an issuer to claim a deduction for redemption premium in an exchange where the pre-existing DIs are trading above at a price that exceeds the adjusted issue price.[187]

As an alternative, we believe consideration should be given to revising the existing rules to create a permanent rule that would, in the case of a debt modification or other debt exchange, (i) allow the issuer to recognize the resulting COD income as the related OID deductions accrue and (ii) turn off the AHYDO deferral and disallowance rules with respect to the OID deductions corresponding to the COD income. We note, in this regard, that we believe that the IRS and Treasury have the authority to enact such a rule under the general rules for methods of accounting, similar to the rules for prepaid forwards.[188] Although Sections 108(i) and 163(e)(5)(F) have a similar effect and apply only for a limited period, nothing in Section 108(i) or Section 163(e)(5)(F) or the

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[186] However, the proposed modifications in (A) and (B) above would reduce (as compared to former section 1275(a)(4)) the ability of taxpayers to convert OID into market discount. Moreover, if the choice is between a rule that creates COD income to the issuer (but allows for some conversion of OID into market discount by the holder) or a rule that prevents the creation of COD income to the issuer (but allows for some conversion of OID into market discount), it is not clear to us that the law should favor the prevention of market discount. We note, in this regard, that many holders of debt are either not subject to U.S. tax on interest or OID (*e.g.*, non-U.S. and tax exempt investors) or otherwise indifferent as to whether the yield on a DI is subject to the OID rules or the market discount rules (*e.g.*, dealers and traders who mark-to-market their investments).

[187] Moreover, even if that were addressed, issuers would have the option of retiring the debt held by one holder and issuing similar debt to another holder.

[188] See Treas. Reg. § 1.446; see also Notice 89-21, 1989-1 C.B. 651.

legislative history suggests that the IRS and the Treasury lack the authority to enact similar rules under the provisions governing methods of accounting.