

# Bridge Loans—Confronting Tax Issues Triggered by the Recent Economic Downturn

*By Charles Morgan*

Charles Morgan describes the tax issues commonly confronted by the parties involved in bridge loan financings, the underlying tax policy issues and approaches for the Treasury to consider in addressing these issues.

- I. Factual Background
- II. Courses of Action
- III. Current U.S. Federal Income Tax Analysis
  - A. If Lenders Sell Bridge Loan
    1. Issue Price
    2. Application of AHYDO Rules
  - B. Sale of Permanent Securities
    1. Follow the Form
    2. Debt-for-Debt Exchange Not Involving a “Modification” (Reg. §1.1001-3)
    3. Debt-for-Debt Exchange Involving a “Significant Modification” (Reg. §1.1001-3)
  - C. If Lenders Elect and Then Sell Exchange Notes
- IV. Tax Policy Considerations
  - A. Overview and AHYDO
  - B. COD Income
    1. Restatement of Key Underlying Facts
    2. Economic Substance
    3. Legislative History Underlying Enactment of Code Sec. 108(e)(10) and Repeal of Code Sec. 1275(a)(4)
    4. Suggested Approaches for the Treasury to Consider

Bridge loans have been around for decades. During previous economic downturns, certain financial institutions that had extended bridge loans reportedly experienced substantial losses related to being unable to refinance such temporary loans with more permanent sources of financing, as the values of the underlying businesses declined. Over the last 12 months, as credit conditions have deteriorated globally, references to the phenomenon of “hung bridges” have resurfaced. As the high-yield market has tightened, resulting in a dramatic reduction in the number of notes/bonds being issued to refinance the much more substantial level of outstanding bridge loans, the financial institutions that are left holding such loans and the borrowers that have used the proceeds to consummate the underlying corporate transactions have been focused on any number of alternative financing approaches.

This article will present a fact pattern that, although fictional, contains many features actually present in bridge loan financings consummated in the recent past. The purpose is to describe some of the more common features of such financings, to highlight some of the more important U.S. Federal income tax issues commonly confronted by the parties considering alternative financing approaches, to discuss some of the underlying tax policy issues, and finally, on the assumption that the Treasury Department (“the Treasury”) is favorably inclined, to offer approaches for the Treasury to consider in addressing the particular issues discussed herein.

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Several bridge loan-related topics will not be addressed herein, including (i) issues as to whether participation in refinancing activities raises Code Sec. 864<sup>1</sup> “engaged in trade or business” issues for certain non-U.S. investors purchasing portions of bridge loans in the “secondary” market; (ii) structures used to facilitate purchases of “underwater” bridge loans by parties related to the borrowing entities, but not related enough to be subject to the special rules of Code Sec. 108(e) (4) (involving cancellation of indebtedness (COD) income); (iii) an analysis of whether typical bridge loan interest rate provisions and related borrower/lender options cause bridge loans to be governed by the original issue discount rules of Reg. §1.1272-1(c), the variable rate debt instrument rules (VRDI), or the contingent payment debt instrument rules (CPDI);<sup>2</sup> and (iv) issues uniquely presented by borrowers that are or are close to being (a) involved in Title 11 cases or (b) insolvent.

In addition, although this article primarily is intended as a vehicle for discussing some of the important U.S. Federal income tax issues presented by bridge loan fact patterns, it is important to emphasize that due to the unique current market conditions, the actual negotiations between the many bridge loan borrowers and lenders present in the marketplace may not proceed in the particular manner described herein—though the described alternative financing choices and related U.S. Federal income tax consequences are believed to be representative of those confronted by a number of existing bridge loan financing fact patterns. Further, there will be obvious similarities between certain of the issues discussed in this article and those arising in debt-for-debt exchange transactions involving workouts in the broader distressed debt environment not involving bridge loans, but no particular effort will be undertaken to discuss the particular U.S. Federal income tax issues arising in that broader marketplace.

## **I. Hypothetical Factual Situation (the “Base Case”)**

In 2007, an entity characterized as a corporation for U.S. Federal income tax purposes (“Borrower”) entered into a binding commitment with a group of financial institutions (“Lenders”), pursuant to which Lenders committed to lend Borrower \$1 billion under the terms of a bridge loan agreement (“the Bridge Loan”). Pursuant to the terms of the binding commitment, to the extent Lenders were unable to place \$1 billion of notes or bonds of Borrower with investors

earlier, Lenders would be required on December 31, 2007, to lend Borrower the \$1 billion under the Bridge Loan, to facilitate Borrower’s acquisition on that date of the stock of a target corporation.

Due to a general deterioration in the credit markets and an increase in Borrower’s credit spread to Treasuries, Lenders were not able to place \$1 billion of notes or bonds of Borrower by the December 31, 2007, date. Consequently, and pursuant to the terms of the binding commitment, Lenders extended a \$1 billion Bridge Loan to Borrower as of December 31, 2007, to enable Borrower to complete the stock purchase transaction.

Some of the essential features of the Bridge Loan are as follows:

- (i) **Maturity Date**—Although the initial term of the Bridge Loan is 12 months, the loan agreement provides that unless Lenders elect to convert the Bridge Loan into “Exchange Notes” (described below), the Bridge Loan automatically will convert into an “Extended Loan” with a maturity date of December 31, 2015 (but otherwise with terms identical to the Bridge Loan).
- (ii) **Principal Amount**—\$1 billion
- (iii) **Interest Rate**—(a) for the first 12 months, interest is payable quarterly at a rate equal to LIBOR plus 400 basis points, subject to a 15-percent cap—with the rate increasing by 75 basis points every quarter (but subject to the overall 15-percent cap); (b) at the end of the first 12 months, the interest rate automatically converts to a fixed rate quarterly payment equal to whatever the LIBOR plus 400 basis point rate (subject to the respective 75 basis point increases) would be as of such date.
- (iv) **Prepayment Right**—Until the end of the first 12 months, Borrower is able to prepay the Bridge Loan at any quarterly payment date by paying the outstanding Principal Amount plus accrued interest; thereafter, prepayment generally would require a “make-whole” prepayment penalty; Permanent Securities or Exchange Notes will have a three-year no-call period, with a call subject to a declining prepayment penalty thereafter.
- (v) **Transfer Rights**—Lenders have the right to transfer all or a portion of their rights and obligations under the Bridge Loan, subject to customary conditions.
- (vi) **Fees**—Borrower paid a two-percent commitment fee at the time the commitment letter was executed in 2007; if neither of the two options

described below are exercised, Borrower will be obligated to pay another two-percent fee as of the 12-month date, at the time the Bridge Loan will convert into an Extended Loan; if Permanent Securities (described below) are issued, Borrower will pay a two-percent fee.

- (vii) Options—(a) During the period from the 183rd day through the 365th day after issuance of the Bridge Loan, broker-dealer affiliates (“Brokers”) of Lenders can require Borrower to issue Permanent Securities with “market terms” for high yield debt at such time, with the interest rate subject to a 15-percent cap; or (b) at any time after the 12-month anniversary of the issuance of Bridge Loan, Lenders can force a conversion of the Extended Loan into “Exchange Notes,” with the interest rate being whatever the fixed rate would be on the Extended Loan at that time, with the same maturity date as the Extended Loan and with all other terms, including covenant provisions, being the same as those contained in the Exchange Note document that was attached as an exhibit to the Bridge Loan agreement when it was originally executed.

The provision of the Bridge Loan that permits Brokers to force the issuance of Permanent Securities, sometimes referred to as the “go to market” or “securities demand” provision, requires as a condition of its exercise that Brokers express their opinion that market conditions at such time would permit the issuance of the Permanent Securities containing “economic terms, including ranking, guarantees, interest rate, yields and redemption prices that are customary for recently issued high yield debt securities of issuers of a similar type and are no less favorable to Borrower than those generally available in the high yield debt capital markets to issuers of securities having creditworthiness comparable to Borrower, and all other arrangements with respect to such Permanent Securities will be customary taking into account prevailing market conditions.”<sup>3</sup> It also is a condition of the issuance of the Permanent Securities that they be issued at par, with the proceeds used to redeem the Bridge Loan. The Permanent Securities provisions typically are added to bridge loans so as to give liquidity to the Lenders/Brokers.

Assume for purposes of the analysis herein that if the Bridge Loan were to be sold anytime from December 31, 2007, onward or if the Permanent Securities or the Exchange Notes were to be publicly traded (in the manner to be described below) immediately upon their issuance or thereafter, the Bridge Loan would be

sold for and the fair market value of the Permanent Securities or Exchange Notes on the relevant dates would be \$700 million, reflecting a loss in value of \$300 million since the date in 2007 when the commitment was executed.

## II. Courses of Action

In the current economic environment, many borrowers and lenders are parties to bridge loan transactions with provisions similar to those of the Base Case. In some situations, however, due to a significant decline in LIBOR rates over the last year, prior to a recent spike in such rates, borrowers may have preferred the rates on the bridge loans as compared to the likely higher rates associated with the issuance of permanent securities. Moreover, it is known that many borrowers and lenders have debated the meaning of the permanent securities’ provisions, with some borrowers asserting that such securities may not be issued absent brokers confirming that such securities will be contemporaneously sold to investors and some brokers asserting that they are permitted to force the issuance of such securities in exchange for the bridge loans, whether or not such securities are able to be sold currently to investors. In reality, due to the depressed state of the high-yield markets, with reference to refinancing large bridge loan transactions, the widely divergent financial conditions of the many borrowers under bridge loan agreements, the uncertainty as to the appropriate credit spreads for senior credit facilities in the current marketplace, and various other factors, it is difficult to generalize about the optimal pathways to be followed for refinancing many of the “hung bridge loans.” As the parties to these transactions have considered alternatives, however, they have been very focused on seeking ways to avoid the triggering of COD income, particularly as the refinancing alternatives discussed below do not generate any additional cash proceeds for the borrowers. The potential economic impact to the borrowers of having to pay tax on significant amounts of COD income has been and will continue to be a very significant consideration in the evaluation of the available alternatives.

This article will analyze a few of the most obvious pathways available to the parties under the Bridge Loan documents described above, either to permit Lenders to dispose of all or a portion of their financial exposure under the Bridge Loans or to refinance the Bridge Loans through the issuance of Permanent Securities or the conversion to and sale of Exchange Notes. First, in

circumstances where the effort to sell notes or bonds prior to the closing date of the underlying corporate transaction has been unsuccessful, with the result that Lenders were obligated to and did fund the Bridge Loan, Lenders would often be interested in disposing of as much of the Bridge Loan as possible to other institutional investors (“Investors”). Second, this article will explore the consequences associated with Brokers exercising the option to have Permanent Securities issued and sold to institutional investors. Finally, on the assumption that the Permanent Securities are not issued, this article will explore the consequences associated with Lenders exercising their rights to convert the Extended Loans to Exchange Notes and disposing of them to institutional investors.

### III. Current U.S. Federal Income Tax Analysis<sup>4</sup>

For each of the three pathways to be considered, the discussion below will focus on some of the U.S. Federal income tax issues that raise significant questions concerning the appropriate tax treatment to Borrower, Lenders/Brokers and Investors.

#### A. If Lenders Sell Bridge Loan

As indicated above, Lenders were unsuccessful in their efforts to sell notes or bonds of Borrower prior to December 31, 2007. As a result, Lenders executed the Bridge Loan on December 31, 2007, and advanced \$1 billion to Borrower, permitting Borrower to close on the underlying stock purchase transaction. Although Lenders almost certainly will have attempted to sell portions of the Bridge Loan to Investors, it is not at all clear in the current economic environment that any such portions will have been sold. For purposes of the following analysis, it will be assumed that either none of the Bridge Loan was sold to Investors or that as much as 50 percent of the Bridge Loan was sold to Investors; and, moreover, it will be assumed that such sales, if they occurred at all, will have occurred very shortly after December 31, 2007, but in all cases at a 30-percent discount from par, caused by a general deterioration in the credit markets and an increase in Borrower’s credit spread to Treasuries occurring between the date the Borrower and Lenders signed the binding commitment in 2007 and the date the Bridge Loan was funded on December 31, 2007.

##### 1. Issue Price

Is the issue price of the Bridge Loan \$1 billion or \$700 million? From the perspective of Borrower, an issue

price of \$1 billion is consistent with the fundamentals of its economic bargain—it received \$1 billion of proceeds<sup>5</sup> and has an obligation to repay \$1 billion plus interest, pursuant to the formulation described above. From the perspective of Lenders, an issue price of \$1 billion is consistent with the fundamentals of their economic bargain—they advanced \$1 billion to Borrower at the time the Bridge Loan was funded and they have a contractual right to receive repayment of \$1 billion at maturity or earlier redemption, plus interest, pursuant to the formulation described above. From the perspective of Investors, as an economic matter their \$700 million purchase price reflects a 30-percent discount to par, irrespective of whether for U.S. Federal income tax purposes that discount is treated as market discount (within the meaning of Code Sec. 1278) or original issue discount (OID), by reason of the application of the principles of Code Secs. 1273(b) and 1274 and the related Regulations.<sup>6</sup>

Reg. §1.1273-2(a)(1) provides that in connection with debt instruments issued for money, “the issue price of each debt instrument ... is the first price at which a substantial amount of the debt instruments is sold for money.” Reg. §1.1273-2(e) provides that “[f]or purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.” In this case, the Bridge Loan was “sold” to Lenders, in the first instance, for \$1 billion. That price would determine the issue price of the Bridge Loan to be \$1 billion, absent the application of Reg. §1.1273-2(e). The critical factual question to be answered is whether the Lenders were or were not acting in the “capacity of underwriters, placement agents or wholesalers” (referred to hereafter as the “Underwriter Rule”). If it is determined that the Lenders were so acting, then the price paid by Lenders would be ignored, resulting in an issue price of \$700 million for Bridge Loan, reflective of the discounted price paid by Investors—provided at least a “substantial amount” of Bridge Loan was sold to Investors.<sup>7</sup>

The Regulations do not define what it means to be acting in the capacity of underwriters, placement agents or wholesalers, and there is very little other indication of how the rule should be implemented in fact patterns such as the Base Case. The Underwriter Rule was first added as Section 1232(b) of the 1954 Code and was relevant to the determination of “issue price” in connection with bond issues registered

with the Securities and Exchange Commission, as opposed to bonds privately placed. The legislative history indicates that in such cases, where the “issue price” equaled the “initial offering price to the public, ... the public is not deemed to include bond houses and brokers.”<sup>8</sup>

Without further guidance from the Treasury, it would be very difficult to conclude that Lenders were not “acting in the capacity of underwriters, placement agents, or wholesalers” with respect to Bridge Loan. It would not have been uncommon for Lenders prior to the funding of Bridge Loan, knowing that they were experiencing great difficulty in the sale of bonds and notes of Borrower prior to the closing date of the underlying stock purchase transaction, to have undertaken significant efforts to sell all or a portion of the Bridge Loan required to be funded on December 31, 2007—so that they would not be left holding the entire Bridge Loan. There likely are many parties in the position of Lenders here who would not be pleased with a fact pattern where Bridge Loan ended up on their books for any significant period of time. Many parties in the position of Lenders would much prefer to sell notes or bonds, earn their underwriting fees, and move on to the next transaction. Bridge Loans often arise as a last resort and are almost always structured so that they either will be sold, refinanced with Permanent Securities or exchanged for Exchange Notes, both of the latter of which are then sold into the marketplace. The likely Lender behavior in this fact pattern would be consistent with what many would think of as underwriter, placement agent or wholesaler functions—and would tend to be confirmed as such to the extent Lenders actually sell say 50 percent of the Bridge Loan to Investors.

It is suggested, however, that the Treasury could amend Reg. §1.1273-2(e) to clarify the meaning of the terms “acting in the capacity of underwriters, placement agents, or wholesalers” so that it would be clear that the provision would not apply in a fact pattern, such as the Base Case, containing certain specific features. As support for such a position, the following points should be relevant: First, there would not appear to be any intuitively logical reason for the price paid by underwriters always to be ignored in the determination of issue price. For example, in a firm commitment underwriting, where the lenders are contractually committed to loan a specific sum of money to the borrower, as an economic matter the sale of such a loan into the market at a discount is more reflective of a loss to the lender than it is evidence of a discount

issue price to the borrower, particularly in the situation where the borrower received the par amount of loan proceeds and separately compensated the underwriters for their services. Second, although no explanations for the carve-out appear ever to have been articulated by the Treasury, in fact, there probably is a rather simple explanation for why the “(excluding bond houses and brokers)” language was first included in 1954.

At its most elementary level, the carve-out likely was included for no more complicated a reason than to clear up confusion that otherwise would arise if no rules were provided for how to address customary sales commissions, underwriting spreads and wholesale/retail price differentials earned by intermediaries involved in the sale or placement of debt securities. For example, if the way an intermediary lender was to be compensated by a borrower for the services of selling debt instruments to investors was for the borrower to agree to sell the debt to the intermediary at a two-percent discount to the price obtained on the sale to investors, it would be quite reasonable to apply the Underwriter Rule to ignore the price between the borrower and the lender, and instead determine the issue price of the debt instrument by reference to the price paid by the investors. The reason it would be appropriate to ignore this price between the borrower and lender is that, fundamentally, the two-percent discount is compensation paid to the lenders for selling the debt instruments and therefore should not be taken account of in determining the issue price of the debt instrument that impacts the calculation of original issue discount for all holders. In other words, this carve-out likely was created merely to ensure that, regardless of the form of the transaction, the compensatory element would be excluded from the determination of the issue price.

Absent a more compelling set of reasons for including the carve-out in 1954, the existing record would seem to permit the Treasury to clarify that in a fact pattern where (i) it is clear from the documentation that the lenders have been compensated separately for the underwriting or similar functions of undertaking the transaction (*i.e.*, Lenders received a separate two-percent commitment fee at the time in 2007 when the binding commitment to enter into Bridge Loan was executed) and (ii) the lenders have entered into a firm commitment underwriting and have extended the par amount of the loan proceeds to the borrower in satisfaction of their commitment (as in the case of Lenders entering into such a commitment to extend \$1 billion to Borrower), then the cash price paid by the lenders would be respected as the issue price of the debt instrument, as it would not contain a

compensatory element.<sup>9</sup> This rule could be combined with an anti-abuse provision to ensure the exception to the otherwise application of the carve-out was not applicable in unsuitable transactions.<sup>10</sup>

As will be illustrated in the next section of this article, to the extent the Treasury does not clarify the application of Reg. §1.1273-2(e) in the manner suggested for a fact pattern like the Base Case, not only will the transaction implicate the applicable high yield discount obligation (AHYDO) rules for borrowers, but it also could create an unjustified potential tax benefit for borrowers with respect to the excess of the loan proceeds over the lower issue price.

## 2. Application of AHYDO Rules

If the issue price of the Bridge Loan is determined to be \$700 million rather than \$1 billion for purposes of applying Code Sec. 163(e)(5) and (i), Borrower could be subject to the interest deferral and disallowance rules of the AHYDO provisions. From a purely tax policy perspective, and taking account of the 1989 legislative history relating to the enactment of those provisions it would be inappropriate to apply the AHYDO provisions in this case. In 1989, Congress was concerned with the frequent use of long-dated, high-yield, deferred interest payment transactions, partly on the basis that Congress believed some of such transactions were more properly characterized as equity rather than debt for U.S. Federal income tax purposes.<sup>11</sup> The Base Case raises none of those concerns: Borrower receives \$1 billion in exchange for issuing Bridge Loan; Borrower obligates itself to repay the principal amount of \$1 billion at the end of eight years (*i.e.*, December 31, 2015); Borrower further obligates itself to make quarterly interest payments at a market rate throughout the term of the Bridge Loan. The palpable inappropriateness of applying the AHYDO rules to these facts tends to underscore the appropriateness of determining the issue price of Bridge Loan for purposes of Code Secs. 163 and 1273 to be \$1 billion rather than \$700 million, as suggested in the above discussion.

The IRS released Rev. Proc. 2008-51 on August 8, 2008.<sup>12</sup> Rev. Proc. 2008-51 described fact patterns in which the IRS will not treat the particular debt instruments as AHYDOs for purposes of Code Secs. 163(e)(5) and (i). The essential features (set forth immediately below) of two of the fact patterns described in Rev. Proc. 2008-51 are the same as the Base Case described in this article:

**Fact Pattern 1 (§4.01 of Rev. Proc. 2008-51).** (i) Borrower obtains a binding financing commitment from an unrelated party prior to January 1, 2009;

(ii) Borrower issues a debt instrument (“Old Debt Instrument”) for net cash proceeds and the terms of the debt instrument are consistent with the terms of the binding financing commitment; and (iii) The debt instrument issued by Borrower would not be an AHYDO if the issue price is equal to the net cash proceeds received by Borrower in exchange for issuance of the debt instrument.

**Fact Pattern 2 (§4.02 of Rev. Proc. 2008-51).** (i) Assume the presence of all the facts present in Fact Pattern 1; (ii) Borrower issues a new debt instrument (“New Debt Instrument”) in exchange for Old Debt Instrument (including by reason of a deemed exchange under section 1.1001-3); (iii) New Debt Instrument is issued within 15 months of Old Debt Instrument and the maturity dates and principal amounts of the Old Debt Instrument and the New Debt Instrument are the same;<sup>13</sup> and (iv) The New Debt Instrument would not be an AHYDO if the issue price is equal to the net cash proceeds received by Borrower upon issuance of Old Debt Instrument.

On the basis of the above facts, Borrower will not be subject to the AHYDO rules with respect to Bridge Loan. Rev. Proc. 2008-51, however, does not contain any analysis indicating whether as a substantive legal matter the IRS would agree that in determining the issue price and yield to maturity for purposes of Code Sec. 163(e)(5) and (i) it is appropriate in the fact patterns described therein to calculate the issue price in the manner suggested herein—resulting in an issue price of \$1 billion rather than \$700 million. The limited relief from the application of the AHYDO rules clearly is welcomed, because otherwise it is unlikely that taxpayers could reach a similar conclusion under current law. Section IV of this article will discuss in more detail the policy aspects of applying the AHYDO provisions to the Base Case fact pattern and will analyze the legal authority aspects underlying the issuance of Rev. Proc. 2008-51.

In addition to the COD income issue to be discussed in detail later in this article, the facts presented by the Base Case and in Rev. Proc. 2008-51 present an additional important tax issue that was not addressed in Rev. Proc. 2008-51. If the issue price of Bridge Loan is determined to be \$700 million, rather than \$1 billion, in a circumstance where Borrower received \$1 billion of net proceeds, what rule of current tax law determines whether Borrower is required to include in income currently or at least amortize over time the \$300 million differential between the \$1 billion net proceeds and the

\$700 million issue price? Recall that Borrower originally receives net proceeds of \$1 billion and remains contractually obligated to repay the \$1 billion, in addition to current payments of interest. Absent such a rule, Borrower would be able to take advantage of the Revenue Procedure and fully deduct the \$300 million of OID and yet not include any of the excess \$300 million of net proceeds received over the issue price in income. In this regard, note that Reg. §1.163-13 is not applicable to require Borrower to offset its OID deductions by this excess, because the issue price of Bridge Loan is not in excess of its principal amount and, therefore, the excess of the net proceeds received over the issue price does not qualify as bond issuance premium.<sup>14</sup> It would be difficult to identify a stronger set of facts tending to confirm that determining the issue price of Bridge Loan to be \$700 million would be inappropriate on these facts.<sup>15</sup> Absent further guidance from the Treasury establishing as a matter of substantive tax law that the issue price of Bridge loan is \$1 billion or making clear that the Treasury would make use of its broad powers under Code Sec. 446(b) to require Borrower to apply principles like those contained in the bond issuance premium rules in order to clearly reflect its income, the publication of Rev. Proc. 2008-51 ironically might encourage inappropriate tax arbitrage.<sup>16</sup>

## B. Sale of Permanent Securities

As indicated above in the description of the Base Case, the Bridge Loan agreement contains a provision that affords Brokers an option during the period from the 183rd day to the 365th day subsequent to the issue date of the Bridge Loan to cause Borrower to issue Permanent Securities, the proceeds of which are required to be used to redeem the Bridge Loan. The essential feature of the option available to Brokers with respect to the Permanent Securities is that once they express an opinion in writing that the particular conditions set forth in the Bridge Loan relating to the issuance of Permanent Securities can be satisfied, Borrower is required to execute an offering of Permanent Securities in a Rule144A/Regulation S offering or other private placement upon the terms set forth in the written notice issued by Brokers. In this regard, the Bridge Loan contains further language, quoted above, setting forth the understanding of the parties that all the features of the Permanent Securities would be customary, when compared to recent issues of private placement high-yield debt securities of issuers of a similar type.

Before setting forth below an analysis of the different ways to characterize the events related to Borrower's

issuance of Permanent Securities, it is important to identify what is at stake here from an economic and tax perspective. From an economic perspective, Borrower, which originally received \$1 billion of proceeds, receives no net amount of new proceeds as a result of the issuance of the Permanent Securities, remains obligated to repay the \$1 billion over the same timeframe and as a result of issuing the Permanent Securities will become liable for additional interest payments, all of which continue to be paid quarterly over the remaining term. All of these events occur pursuant to the terms of the originally executed Bridge Loan.

From a U.S. Federal income tax perspective, although Lenders and Investors likely will recognize no gain or loss in respect of the issuance of Permanent Securities, in that the Bridge Loan and the Permanent Securities are both likely eligible to be treated as "securities" within the meaning of Code Secs. 368(a)(1)(E) and 354, there could be a triggering of \$300 million of COD income and significant AHYDO limitations to Borrower and the creation of OID to Investors, among other impacts.

At this point in the discussion, the reader is encouraged to begin thinking about whether and for what reasons an exchange of new debt for old debt is an appropriate occasion for deeming a realization event to have occurred in a fact pattern where Borrower receives no net amount of new proceeds, remains obligated to make the same level of principal payments, and undertakes an increased level of interest payments. The final section of this article will contain a discussion of some of the relevant tax policy considerations and some suggested approaches for Treasury to consider should it be sympathetic to publishing guidance to enable taxpayers to avoid some of the uneconomic outcomes otherwise potentially applicable.

### 1. Follow the Form

One approach to analyzing the issuance of the Permanent Securities for U.S. Federal income tax purposes is to respect the form of the transaction and analyze the components accordingly. Pursuant to the form of the transaction, the Permanent Securities would be issued for \$1 billion provided by Brokers. Borrower would make use of the \$1 billion in proceeds to repay Bridge Loan principal amount in full. Further, Brokers would sell the Permanent Securities for \$700 million to Investors. In the event the form of the transaction is respected for U.S. Federal income tax purposes: (i) Borrower would not recognize any COD income on the repayment of Bridge Loan, as it will be repaid at

par; (ii) the Permanent Securities would be issued for \$1 billion and sold for \$700 million, raising the same tax issues as those described in the previous section of this article, with the only difference being that the issues would be analyzed with respect to the issuance of the Permanent Securities rather than Bridge Loan.<sup>17</sup>

On the basis that if Permanent Securities are to be issued at all, the Bridge Loan documentation requires Brokers to purchase the Permanent Securities for \$1 billion, with Borrower obligated to use the proceeds to repay Bridge Loan at par, the conclusion that Borrower would not recognize any COD income on the repayment of Bridge Loan would appear consistent with the underlying economics of the transaction. From the perspective of Borrower, it received \$1 billion originally upon issuance of Bridge Loan and, net of the steps described above with respect to the issuance of the Permanent Securities, it would continue to be obligated to repay \$1 billion of principal amount of indebtedness and to make quarterly interest payments throughout the remaining term of the Permanent Securities. In no sense has Borrower experienced an economic event that resembles “accretion to wealth.” Lenders/Brokers would recognize a true economic loss of \$300 million on the sale of the Permanent Securities to Investors, which loss would be totally a function of the fact that Lenders/Brokers were legally obligated by the terms of Bridge Loan to advance \$1 billion to Borrower (and elected application of the Permanent Securities provision out of self interest as possibly the best pathway available to exit the “hung” Bridge Loan and to obtain the desired liquidity).

Admittedly, it is not uncommon when witnessing cash moving around in a circle between the same counterparties (e.g., Borrower and Lenders/Brokers), to question whether the form of a transaction in which such “circling” occurs should be respected or whether, perhaps, the transaction should be analyzed, in substance, as if the cash had not circled at all and the characterization of events should be analyzed on the basis of what else actually occurred. In this fact pattern, however, there are strong arguments to support respecting the form of the transaction, in part because such a characterization would be consistent with the economic rights and obligations of the respective parties.

## ***2. Debt-for-Debt Exchange not Involving a “Modification” (Reg. §1.1001-3)***

On the alternative assumption that the issuance of the Permanent Securities would be analyzed, in substance, as an exchange of Bridge Loan for Permanent Securities, rather than as an issuance for \$1 billion, the question

arises as to whether such a debt-for-debt exchange could be characterized for U.S. Federal income tax purposes as one that would not constitute a “modification” of Bridge Loan within the meaning of Reg. §1.1001-3 (the “Debt Modification Regulations”). Pursuant to the Debt Modification Regulations, a “modification” of a debt obligation that is determined to be “significant” results in the debt instrument being treated for U.S. Federal income tax purposes as if it were exchanged for a new debt instrument in a realization transaction for purposes of Reg. §1.1001-1. Reg. §1.1001-3 applies to any form of modification, including an actual or deemed exchange of an old debt instrument for a new debt instrument. Reg. §1.1001-3(c)(1)(ii) provides that an alteration that occurs by operation of the terms of the old debt instrument will not be considered a “modification” within the meaning of the Debt Modification Regulations and therefore will not constitute a realization event within the meaning of Reg. §1.1001-1.

For this purpose, a change occurring by operation of the terms of a debt instrument includes a change occurring “as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument” (the “Unilateral Option Rule”).<sup>18</sup> In order for an option to be considered “unilateral,” it must satisfy certain conditions, including the following: (i) there may “not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument ... ;”<sup>19</sup> and (ii) “the exercise of the option does not require the consent or approval of ... the other party.”<sup>20</sup> In addition, the Unilateral Option Rule is subject to the limitation that in the case of an option exercisable by a holder, the exercise of the option may not result in a “deferral of, or a reduction in, any scheduled payment of interest or principal.”<sup>21</sup>

The Brokers’ exercise of their option to require the issuance of the Permanent Securities might be eligible for treatment as a change occurring by operation of the terms of the debt instrument within the meaning of the Debt Modification Regulations described above.<sup>22</sup> There will not be any deferral or reduction of payments of principal or interest.<sup>23</sup> At the time Lenders exercise their option or as a result of the exercise of the option, there would not appear to be any obvious right in Borrower to alter or terminate the debt instruments.<sup>24</sup> As to whether the “consent or approval of the ... other party” exception is implicated in a situation where Brokers exercise their right to require issuance of Permanent Securities, it is conceded that an argument can be advanced that since the specific terms of the Permanent Securities are not explicitly provided for

in the original Bridge Loan documentation, and since Brokers must make various demonstrations that the terms to be incorporated into the Permanent Securities are “customary” for recently issued debt instruments, there must be some type of “approval” required of Borrower in order to issue the Permanent Securities.

The “change occurring by operation of the terms of the debt instrument” rule (including the Unilateral Option Rule) was included in the Debt Modification Regulations to permit explicit modifications to debt instruments to be made without triggering a “modification” of the old debt instrument in circumstances where it was reasonably clear the modifications were the result of provisions provided for in the original debt instrument or would result from a unilateral exercise of powers possessed by the exercising party, not the result of renewed bilateral negotiations between the parties at the future date when the option was being exercised; modifications resulting from actual bilateral negotiations were intended to be treated as “modifications” to be tested under the “significance” standards of the Debt Modification Regulations. Further, however, it is important to note that many advisors have concluded that there is quite a bit of leeway provided within the application of the “change occurring by operation of the terms of the debt instrument” exception to the “modification” triggers; there appears to be no requirement that any of the actual terms of the “new debt instrument” be specified at the date of issuance of the “old debt instrument,” and this fact has afforded taxpayers flexibility in drafting the terms of original debt instruments in an effort to avoid the subsequent modifications constituting “modifications” within the meaning of the Debt Modification Regulations.

On balance, a reasonable, but not compelling, case can be advanced for the position that the exercise by Brokers of the option to require issuance of Permanent Securities should be eligible for application of the “change occurring by operation of the terms of the debt instrument” rule, with the result that the issuance of the Permanent Securities would not be treated as a “modification” of Bridge Loan for purposes of the Debt Modification Regulations and not a realization event for purposes of Reg. §1.1001-1. The balance of this section of the discussion proceeds on the basis of such a conclusion.<sup>25</sup>

The U.S. Federal income tax consequences to Borrower, Lenders/Brokers and Investors would be a function of whether the issue price of Bridge Loan would have been established for tax purposes prior to the sale of the Permanent Securities. Based on

the discussion in section III A 1 above, there would seem to be a few possibilities: (i) If Lenders were determined to have acted as principals, then the issue price will have been established as the \$1 billion price they paid, the sale of the Permanent Securities would produce a loss of \$300 million to Lenders/Sellers, the Investors would be treated as acquiring the Permanent Securities at a market discount of \$300 million, and the issuer would have no COD income and would not be subject to AHYDO limitations—because the Permanent Securities would be treated for tax purposes as the same debt instrument as Bridge Loan, there having been no realization event for purposes of Code Sec. 1001; (ii) If Lenders were determined to have acted as “underwriters” in connection with the sale of a substantial portion of Bridge Loan to investors, then the issue price will have been established as the \$700 million price paid by Investors, with the consequences described in section III A above; and (iii) If Lenders had not sold any of Bridge Loan prior to the sale of the Permanent Securities and they were determined to be acting as underwriters in the sale of the Permanent Securities, then the issue price would be determined in the same manner as the issue price would have been determined had Lenders, as underwriters, sold Bridge Loan to Investors, also as discussed in section III A above.

### ***3. Debt-for-Debt Exchange Involving a “Significant Modification” (Reg. §1.1001-3)<sup>26</sup>***

If the issuance of the Permanent Securities is not characterized for U.S. Federal income tax purposes on the basis of either of the two approaches outlined above, but is rather characterized as a debt-for-debt exchange of Bridge Loan for Permanent Securities treated as a significant modification within the meaning of the Debt Modification Regulations and a tax realization event for purposes of Reg. §1.1001-1, then the tax consequences to Borrower could be dramatically different from those outlined above.

**a. Tax Consequences to Borrower.** From the perspective of Borrower, the “issue price”—for Bridge Loan and the Permanent Securities—is the critical term impacting whether for U.S. Federal income tax purposes the transaction will result in COD income and whether the AHYDO rules will apply. Some simplifying assumptions will be made for purposes of the discussion that follows. As to the issuance of Bridge Loan, it will be assumed either that Lenders did not sell any of Bridge Loan to Investors or that, in an underwriting capacity, they sold 50 percent to Investors for cash. As to the issuance of

the Permanent Securities, it will be assumed either that Lenders/Brokers acquired the Permanent Securities as principals or that Lenders/Brokers, in an underwriting capacity, sold 100 percent of the Permanent Securities to Investors for cash.<sup>27</sup> In addition, statements regarding AHYDO consequences for Borrower do not take into account the potential application of Rev. Proc. 2008-51 except as noted.

**i. Lenders Did Not Sell Bridge Loan.** In the situation where Lenders did not sell any of Bridge Loan to Investors, resulting in an issue price of Bridge Loan of \$1 billion, and Lenders/Brokers, in an underwriting capacity, sold 100 percent of the Permanent Securities to Investors for cash, resulting in an issue price for the Permanent Securities of \$700 million, the deemed exchange of Bridge Loan for Permanent Securities would cause Borrower to recognize \$300 million of COD income and the application of the AHYDO rules would be triggered, resulting in both deferral and disallowance of deductions with respect to interest payments.

In the situation where Lenders did not sell any of Bridge Loan to Investors, but Lenders/Brokers acquired the Permanent Securities in the deemed exchange, as principals, the issue price of such securities would be determined by reference to the rules of Code Secs. 1273 and 1274. In general, if either Bridge Loan or the Permanent Securities are “traded on an established market” (hereafter “publicly traded”) within the meaning of Reg. §1.1273-2(f), then the issue price of the Permanent Securities will equal the fair market value of the respective debt instruments on the issue date (*i.e.*, \$700 million, as determined from prices for the publicly traded security)—triggering the COD income and AHYDO consequences to Borrower. In an effort to simplify the analysis, it will be assumed that Bridge Loan is not publicly traded for this purpose.<sup>28</sup> If neither Bridge Loan nor Permanent Securities are publicly traded, and on the assumption that for purposes of Code Sec. 1274 the Permanent Securities bear “adequate stated interest,”<sup>29</sup> then pursuant to Code Sec. 1274 the issue price will equal the stated principal amount of \$1 billion, subject to the exception described immediately below, resulting in no triggering of COD income nor AHYDO consequences to Borrower.

If a “potentially abusive situation” (within the meaning of Code Sec. 1274(b)(3)) were determined to be present, the issue price of the Permanent Securities would be equal to the fair market value of the Permanent Securities (*i.e.*, \$700 million) rather than the principal amount of \$1 billion. Code Sec. 1274(b)(3)(B) provides that the term “potentially abusive situation”

means, among other things, “any other situation which, by reason of ... recent sales transactions, or other circumstances, is of a type which the Secretary specifies by regulations as having potential for tax avoidance.” This rule was added in [1984] as part of an effort to combat what were then considered abusive tax shelter transactions making use of property purchases with nonrecourse notes having stated principal amounts significantly in excess of the true fair market values of the underlying properties—with the objective of claiming excessive depreciation/amortization deductions and other benefits. The IRS has never provided any helpful guidance as to how the above quoted language would be utilized or in what types of transactions it would be appropriate to apply this rule. In general, pursuant to Code Sec. 7805(b), the Treasury is permitted to promulgate regulations with retroactive effective dates to the extent issued to address “abuses.”<sup>30</sup> In a circumstance where neither Bridge Loan nor Permanent Securities are publicly traded, with the result that the issue price rules of Code Sec. 1273 are not applicable, query would it be appropriate for the Treasury to apply Code Sec. 1274(b)(3), in light of any recent sales transactions, such as the sale of the Permanent Securities themselves for \$700 million, to assert that it would be abusive not to make use of that value in establishing the issue price of the Permanent Securities? Although many would assert that such an argument is inappropriate and not within the scope of what Congress intended, with the very large amounts at stake in the fact pattern described herein, it could take rather courageous counsel to dismiss the possibility out of hand.<sup>31</sup>

In returning to Code Sec. 1273 and the Regulations thereunder to assess whether the Permanent Securities would be considered publicly traded, Reg. §1.1273-2(f)(1) provides that “... a debt instrument ... is traded on an established market ... if, at any time during the 60-day period ending 30 days after the issue date, the [debt instrument] is described in paragraph (f)(2), (f)(3), (f)(4), or (f)(5) of this section.” Today, for debt instruments offered in the high-yield marketplace, generally only “(f)(4)” (the “quotation medium” test) and/or “(f)(5)” (the “readily quotable” test) are potentially available. The New York State Bar Association Tax Section submitted a report to the Treasury in 2004 (“NYSBA 2004 Report”) addressing the many open questions relating to the application of the rules in Reg. §1.1273-2(f).<sup>32</sup> As the issues are well developed in the NYSBA 2004 Report, this article will not examine the question in detail. Suffice it to say that in today’s marketplace, although there might be a strong factual argument that the Permanent Securities would

not be publicly traded within the meaning of the tests set forth in the Regulations, due to the lack of more specific guidance and due to the enormous impact of answering this question incorrectly, it often can be very difficult when there has been a successful offering of debt instruments, such as the Permanent Securities, to express a highly confident view that the conditions for satisfying the quotation medium or regularly quoted test have not been met within the timeframes provided for in the Regulations. For those with the courage to structure debt-for-debt exchanges on a basis that it would be more than 30 days following the exchange before it would be possible to satisfy the conditions of Reg. §1.1273-2(f), Reg. §1.1273-2(f)(6) exists to inject a note of caution. That section provides: "If there is any temporary restriction on trading a purpose of which is to avoid the characterization of the property as one that is traded on an established market for Federal income tax purposes, then the property is treated as traded on an established market." In the face of such language, many advisors are appropriately concerned that any efforts to take advantage of the "30-day rule" in Reg. §1.1273-2, in a situation where there is a very large disparity between the principal amount-determined issue price and a fair market value-determined price, could be met with an adverse outcome, by reason of an application of the somewhat ambiguous language in Reg. §1.1273-2(f)(6).

In either of the two circumstances described above in which COD income and AHYDO consequences would be triggered for Borrower, Rev. Proc. 2008-51 (described and discussed above) would appear to apply so as to prevent application of the AHYDO rules.<sup>33</sup> Although the publication of Rev. Proc. 2008-51 would be welcomed by Borrower, the failure of the Revenue Procedure to relieve the burden of the COD income, also a function of the same issue price determination that triggers application of the AHYDO rules, will dominate the thinking of Borrower and make it reluctant to embrace this type of transaction. Section IV of this article will discuss the tax policy issues and the legal authority issues relating to the question of whether it would be appropriate and permissible for the Treasury to promulgate rules to address the COD income issue as well.

**ii. Lenders Sold Bridge Loan in Underwriting Capacity.** In a situation where Lenders, in an underwriting capacity, sold 50 percent of Bridge Loan to Investors for cash and Lenders/Brokers, in an underwriting capacity, sold 100 percent of the Permanent Securities to Investors for cash, since the issue price of both Bridge Loan and the Permanent Securities would be \$700 million,

this fact pattern should not trigger COD income or AHYDO consequences to Borrower.

**b. Tax Consequences to Lenders/Investors.** If Bridge Loan and the Permanent Securities are both characterized as "securities" for purposes of Code Sec. 354, the deemed exchange of Bridge Loan for Permanent Securities should be characterized as a recapitalization under Code Sec. 368(a)(1)(E). On that basis, Lenders and Investors would not recognize any gain or loss on the exchange.<sup>34</sup> Much has been written about the relevance of term or duration of a debt instrument in assessing whether such debt instrument is properly characterized as a security for purposes of the reorganization provisions.<sup>35</sup> In this particular fact pattern, the Bridge Loan has a term of eight years and the Permanent Securities will have a term of no less than seven years (assuming issuance just prior to the 365th day after issuance of Bridge Loan).<sup>36</sup> Both Bridge Loan and the Permanent Securities rank junior in right of repayment to Borrower's senior credit instruments and are unsecured indebtedness. On these facts, Bridge Loan and Permanent Securities should be characterized as "securities," and since the principal amount of the Permanent Securities is the same as the principal amount of Bridge Loan, there should be no gain or loss to Lenders or Investors on the deemed exchange.

Depending upon what the issue price of the Permanent Securities is determined to be, even though the deemed exchange should be a nonrecognition transaction for Lenders/Investors, if Lenders retain Permanent Securities they could be unable currently to recognize the inherent economic loss, could be required to accrue OID, but should be able to apply the acquisition premium rules.<sup>37</sup> For example, if it is determined that the Permanent Securities are publicly traded, within the meaning of Reg. §1.1273-2(f), as discussed above, or are issued for cash in a transaction where Lenders/Brokers are acting in an underwriting capacity, the issue price of the Permanent Securities will be \$700 million and they will be determined to have been issued with \$300 million of OID. For Investors that purchase the Permanent Securities reflecting the 30-percent discount from par, there will be no economic surprise in being required to accrue OID reflecting that discount on such securities. But for Lenders, with respect to the portion of the Permanent Securities that are unable to be sold and are retained, and for which Lenders generally will have a par amount adjusted tax basis, a \$700 million issue price will mean that, even though they will not be able to claim a current loss related to the underlying economic discount, they will be required to accrue OID related to that economic

discount but should be permitted to apply the “acquisition premium” rules to amortize the difference between their adjusted tax basis and the lower issue price as an offset over time to the accruing OID.<sup>38</sup>

### **C. If Lenders Elect and Then Sell Exchange Notes**

As summarized above in the description of the Base Case, pursuant to the terms of Bridge Loan, at any time after the 12-month anniversary of the issuance of Bridge Loan, Lenders can force a conversion of the Extended Loan into “Exchange Notes,” with the interest rate on the Exchange Notes being whatever the fixed rate would be on the Extended Loan at that time, with the same maturity date as the Extended Loan and with all other terms, including covenant provisions, being the same as those contained in the Exchange Note document that was attached as an exhibit to the Bridge Loan agreement when it was originally executed.<sup>39</sup>

On the basis of these facts, and assuming that Lenders had not sold any of Bridge Loan to Investors and that an issue price of \$1 billion had been established for Bridge Loan, it should be possible to conclude that the issuance of Exchange Notes would not constitute a “modification” of Bridge Loan for purposes of the Debt Modification Regulations, with the result that there would not be a deemed exchange for U.S. Federal income tax purposes of Bridge Loan for Exchange Notes. Rather, Exchange Notes would be treated for tax purposes as a continuation of Bridge Loan.<sup>40</sup> As such, Borrower would not recognize COD income and would not be subject to the AHYDO rules; no OID would be created; Lenders would recognize a loss on sale of the Exchange Notes to investors; and Investors that purchase the Exchange Notes at a discount (*i.e.*, the 30 percent to par) would be treated as purchasing the Exchange Notes with market discount.<sup>41</sup>

If, rather than merely exercising the option to convert Bridge Loan to Exchange Notes, however, Lenders decided, due to deteriorating conditions in the credit markets or a weakening in Borrower’s credit spread to Treasuries, that it would be prudent to negotiate with Borrower some modifications to the terms of the Exchange Notes in an effort to make them more marketable, and if those modifications were determined to be “significant” within the meaning of the Debt Modification Regulations, then for U.S. Federal income tax purposes there would be a deemed exchange of Bridge Loan for Exchange Notes (as modified) that would constitute a realization event under Reg. §1.1001-1. In such a case, the tax consequences to the parties

generally would be the same as those described above in section III B 3 of this article (substituting Exchange Notes for the various references to Permanent Securities in such section), with a couple of potential differences discussed immediately below.

First, unlike in the situation relating to the sale of Permanent Securities, where it may more often be the case that if such securities are to be issued at all they will be issued in circumstances where Investors are willing and ready to purchase them and will be issued at the moment in time when Investors step forward to purchase them, the conversion of Extended Loans to Exchange Notes may more frequently occur some significant period of time prior to any later sale of such securities to Investors. This could have significant relevance to the determination of the issue price of the Exchange Notes under Reg. §1.1273-2(f), due to the fact that generally only securities that are publicly traded within 30 days after issuance will be treated as publicly traded for purposes of those rules. To the extent the Exchange Notes are not publicly traded, and to the extent that Lenders are not acting in an underwriter capacity in the sale of such Exchange Notes, it is likely their issue price will be determined under Code Sec. 1274 to be the principal amount (*i.e.*, \$1 billion), resulting in no COD income to Borrower and no OID.

Second, in situations where the parties intend to effect a more substantial restructuring of Extended Loans or Exchange Notes, such as entering into a recapitalization debt-for-debt exchange, creating senior classes of debt and more junior classes, it also may be possible to trigger a realization exchange for some of the recapitalized debt, but by reason of the modifications, permit such senior debt to be sold into the marketplace at par, thereby avoiding COD income and OID as to that portion, with the intention of not selling the more subordinated portions until a much later date, thereby permitting the issue price of even such subordinated portions of debt to be determined under Code Sec. 1274 based on the principal amount, thereby avoiding COD income and OID for those portions as well. The degree to which it is appropriate to “force” parties to engage in such efforts to avoid the application of the COD and AHYDO rules in the types of fact patterns described in this article is another topic to be discussed in the next section addressing tax policy considerations.

## **IV. Tax Policy Considerations**

### **A. Overview and AHYDO**

This article has made use of a fictional bridge loan agreement, the terms of which are representative of

other such agreements in effect in the marketplace today, to highlight some of the more important U.S. Federal income tax consequences arising when the parties to such agreement seek to implement some common provisions—in a setting where the financial credit markets and the credit spreads of many borrowers have deteriorated between the time the parties committed to the terms of the bridge loan and the time when such bridge loans were funded. From the perspective of many borrowers, the attempts to implement standard refinancing techniques have raised significant risks of substantial COD income and the application of the AHYDO rules, all in a context where no net new proceeds are being raised, no reductions in principal amounts due are being proposed and where interest payments under the new debt instruments are being paid at the same or higher rates of interest.

Rev. Proc. 2008-51 directly addresses the AHYDO issues confronted by Borrower. The suspension of the application of the AHYDO rules, though on a temporary basis and subject to some rather restrictive conditions, clearly eliminates an otherwise potentially significant tax exposure for Borrower. From a U.S. Federal income tax policy perspective, the holding of Rev. Proc. 2008-51 is appropriate, in that Borrower has not engaged in the type of transaction that was troubling to Congress when it enacted Code Sec. 163(e)(5) and (i) in 1989. In a circumstance where Borrower originally received \$1 billion, remains obligated to repay \$1 billion at maturity, continues to owe interest at a market rate currently throughout the term of the debt instrument, and where, from a seniority perspective, the indebtedness is not highly subordinated and the term is only eight years, none of the signal conditions for application of the AHYDO rules appears to be present.

With respect to the Treasury's authority to issue Rev. Proc. 2008-51, Code Sec. 163(i)(5) provides: "The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection and subsection (e)(5), including ... regulations providing for modifications to the provisions of this subsection and subsection (e)(5) in the case of ... or other circumstances where such modifications are appropriate to carry out the purposes of this subsection and subsection (e)(5)." This authority granted to the Treasury to make modifications to Code Sec. 163(e)(5) and (i) to carry out the purposes of the AHYDO rules would appear more than adequate to justify the holdings of Rev. Proc. 2008-51.<sup>42</sup> As a related matter, however, and as discussed earlier in this article, it would appear to be

completely inconsistent with the principles of clear reflection of income embodied in Code Sec. 446(b) to permit Borrower in Fact Patterns 1–2 both (i) to deduct, without restriction, the OID created in the event the issue price of such debt instrument is determined to be the fair market value of the debt at the time of issuance; and (ii) at the same time, not to amortize into income on some basis the excess of the net proceeds received over the much lower deemed issue price (e.g., the \$300 million differential in the fact pattern discussed in this article). As suggested above, this excess amount would not be characterized as "bond issuance premium" pursuant to Reg. §1.166-13(c), since the issue price in this fact pattern would be substantially lower than the stated redemption price at maturity. In order to prevent an obviously inappropriate result, the Treasury should give serious thought to following up promptly with further guidance on this issue to require borrowers to amortize this excess amount into income in a manner similar to that required for bond issuance premium.

As indicated earlier in this discussion, although the publication of Rev. Proc. 2008-51 certainly will have been welcomed by those borrowers with fact patterns described therein, it is very likely that, due to the potential application of the COD income rules to the same fact patterns, only those borrowers covered by the first of the three fact patterns described in the Revenue procedure (e.g., Fact Pattern 1, described in section III A 2 above) will find the holdings of the Revenue procedure to be meaningfully helpful to them. The principal reason for this is that the dollar magnitude of the exposure to COD income is very significant for a number of borrowers, due to the significant discounts in value that have developed over the last year or so in the values of many funded bridge loans. Hence, for many borrowers considering alternative approaches to refinancing their bridge loans, the COD income issue tends to assume a significant level of importance and will influence their behavior as to the courses of action to be taken.

## B. COD Income

Code Sec. 61(a)(12) provides that gross income includes "income from discharge of indebtedness."<sup>43</sup> Reg. §1.61-12(c)(2)(ii) provides that "an issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price ... ." Code Sec. 108(e)(10) provides that for purposes of determining the amount of COD income in a situation where an issuer issues a new debt instrument in satisfaction of an existing

debt instrument, the issuer “shall be treated as having satisfied the [existing] indebtedness with an amount of money equal to the issue price of such [new] debt instrument.” And for that purpose, “the issue price of any debt instrument shall be determined under sections 1273 and 1274.”<sup>44</sup>

Code Sec. 108(e)(10) was added to the Code as part of the Revenue Reconciliation Act of 1990 (the “1990 Act”).<sup>45</sup> As part of the 1990 Act, Congress also repealed Code Sec. 1275(a)(4), a provision that prior to its repeal generally provided that the issue price of new debt issued in an exchange for old debt would not be less than the issue price of the old debt. The legislative history relating to the enactment of Code Sec. 108(e)(10) and the repeal of Code Sec. 1275(a)(4) provided, as the reasons for the changes, that “[t]he rules for determining the amount of COD created on a debt-for-debt exchange need to be clarified in order to provide guidance to taxpayers, to ensure similar treatment for taxpayers undertaking similar transactions, and to prevent taxpayers from selectively choosing the tax treatment for a transaction.”<sup>46</sup> In explaining the proposed changes, the legislative history provided:

The provision provides explicit rules for determining the amount of COD created in a debt-for-debt exchange and how the OID rules apply in such a situation . . . . Under the provision, for purposes of determining the amount of COD of a debtor that issues a new debt instrument in satisfaction of an old debt, such debtor will be treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt. In any case in which an old debt instrument is exchanged by the holder for a new debt instrument, or in which the terms of an old debt instrument are modified so as to constitute an exchange by the holder, the debtor is treated as having issued a new debt instrument in satisfaction of an old debt instrument. For this purpose, the issue price of the new obligation will be determined under the general rules applicable to debt instruments issued for property (*i.e.*, secs 1273(b) and 1274).

Rev. Proc. 2008-51 did not address the COD income issue. On the assumption that the Treasury, motivated by the same thinking that led it to publish the Revenue procedure to address the AHYDO issues, may be sympathetic to the view that triggering COD income would be inappropriate in the fact patterns

described therein, but on the basis of the statutory, regulatory and legislative history language set forth above, possibly may be less certain of its authority to promulgate rules similar to those contained in the AHYDO Revenue Procedure, this section of the article will undertake a brief review of the COD income topic as it relates to the Borrower/Lender/Investor fact pattern described herein and offer some suggested approaches for the Treasury to consider should it decide to take steps to address the issue in future guidance.

The discussion below presents the following: (i) a brief restatement of the key underlying facts; (ii) an economic substance analysis relating to such underlying facts; (iii) a survey of the Congressional legislative history process relating to COD income in connection with debt-for-debt exchanges; and (iv) suggested approaches for the Treasury to consider in crafting guidance that would accomplish the objective of relieving Borrower from the risk of COD income recognition.

### **1. Restatement of Key Underlying Facts**

Although described in detail in prior sections of this article, the key underlying facts associated with the Borrower/Lender/Investor fact pattern that are most relevant to the COD income tax analysis are as follows (“Base Case Facts”): (i) Borrower received proceeds of \$1 billion at the time Bridge Loan was entered into; (ii) the principal amount of all the relevant debt instruments (*e.g.*, Bridge Loan, the Permanent Securities and the Exchange Notes) is \$1 billion; (iii) the maturity date of all the relevant debt instruments is December 31, 2015; (iv) the interest payments on all of the debt instruments are payable quarterly; and (v) the interest rates on the Permanent Securities and the Exchange Notes will be higher than on Bridge Loan, but assume for simplicity that they will be higher by the minimum amount necessary to constitute a “significant” modification under the Debt Modification Regulations.<sup>47</sup>

### **2. Economic Substance**

The three examples set forth immediately below are designed to highlight the most important facts that will be considered in the following discussion of economic substance principles.

**Example 1 (Three-Party Transaction).** On January 1, 2008, Borrower issues “publicly traded” bonds (“A Bonds”) for \$1 billion, with the \$1 billion

principal amount due December 31, 2015. The Bonds carry a five-percent interest rate, payable annually (for simplicity of analysis). On January 1, 2009, one year after issuance, the A Bonds are trading in the secondary marketplace for \$700 million and are owned by Investor Group A. On that day, Borrower borrows \$700 million from unrelated lenders (“Investor Group B”) under a loan (“Loan”) that requires six annual interest payments of \$50 million (same amounts as due on the A Bonds) and a payment at maturity on December 31, 2015 of \$1.05 billion (same amount as due on the A Bonds). The Loan reflects a yield of 11.5 percent. Also on January 1, 2009, Borrower uses the \$700 million Loan proceeds to purchase 100 percent of the A Bonds, trading for that price in the marketplace. As of the end of the day on January 1, 2009, Borrower has a \$700 million, rather than a \$1 billion, balance of outstanding indebtedness. If Borrower were to default on the Loan on January 2, 2009, Investor Group B’s claim for repayment would be \$700 million. If Borrower had not entered into the Loan and were to default on the A Bonds on January 2, 2009, Investor Group A’s claim for repayment would be \$1 billion. The deterioration in the credit profile of Borrower between January 1, 2008 and 2009 explains why it is required to issue new indebtedness with an 11.5-percent yield on the Loan, a substantial increase over the five-percent interest rate on the A Bonds.

**Example 2 (Two-Party Transaction “Equivalent” to Three-Party Transaction).** Assume the same steps occur in this example as occur in Example 1 above, with the only difference being that instead of there being three parties involved (*i.e.*, Borrower, Investor Group A and Investor Group B), there are only two (Borrower and Investor Group A). Borrower issues the same A Bonds to Investor Group A for \$1 billion; one year after issuance, the A Bonds are trading in the secondary marketplace for \$700 million but are still owned by Investor Group A; Investor Group A, rather than Investor Group B, makes the Loan to Borrower on January 1, 2009 for \$700 million and Borrower uses the proceeds to purchase 100 percent of the A Bonds from Investor Group A. In this example as well, at the end of the day on January 1, 2009, Borrower has reduced its total obligations outstanding from \$1 billion to \$700 million.

**Example 3 (Two-Party “Deemed Exchange” Transaction).** Assume that Borrower issues the A Bonds with the same terms as in the prior two examples. On January 1, 2009, when the A Bonds are trading in the marketplace at \$700 million, rather than Borrower entering into the Loan with Investor Group B (as in Example 1) or with Investor Group A (as in Example 2), it instead negotiates with Investor Group A and enters into a modification of the terms of the A Bonds. Assume the modifications involve nothing more than a change in certain covenants and an increase in the annual interest rate to be paid of approximately 26 basis points per annum, just enough to constitute a “significant” modification within the meaning of Reg. §1.1001-3(e)(2)(ii). All other terms remain the same as in the originally issued A Bonds.

As a matter of economic substance, Borrower should recognize COD income in Examples 1 and 2. Borrower originally received \$1 billion when the A Bonds were issued, yet is able to extinguish that \$1 billion obligation by paying only \$700 million on January 1, 2009. From the perspective of Borrower’s contractual and legal obligations, the facts in Example 3 are not equivalent to those in Examples 1 and 2, even though the economic values of the instruments may be the same or approximately the same at the time the described events occur in January 1, 2009.<sup>48</sup> In Example 3, Borrower remains obligated to repay the same \$1 billion it originally received and has an increased obligation to pay interest. There has been no accretion to wealth or freeing up of assets of the type traditionally considered by the courts to justify triggering COD income to Borrowers.<sup>49</sup>

Absent more compelling factors being present, a third-party cash paradigm should not be imposed on a debt modification fact pattern where the borrower receives no new cash, where there is no reduction in the borrower’s legal and contractual obligations to repay principal and interest, and hence no net increase in the borrower’s net asset values as a result of the modification, and where the tax consequences to be triggered are largely uncorrelated with and potentially significantly disproportionate to any actual economic impacts of the modifications themselves. To treat such a transaction in a manner equivalent to one in which a new debt instrument is issued for cash and the cash is used to retire the old debt instrument at a discount, triggering COD income, represents an elevation of form over economic substance, permits

transactions that ordinarily would be considered inappropriate and lacking in substance, and penalizes bona fide efforts to restructure existing debt instruments.<sup>50</sup> This point of view should be seen as compelling even without consideration of the further facts: (i) that at the time of the modification, borrowers in these situations may find themselves in sufficient economic difficulties that, while short of a Title 11 case or insolvency, it would be impractical to assume they actually could consummate cash borrowings from third parties to permit the cash to be used to fully retire the existing indebtedness; (ii) that investors in the modified debt instruments will possess par amount creditor claims against borrowers, not discounted claims reflective of the fair market value of the modified debt—and these par amount creditor claims could represent a significant economic difference in bankruptcy or other default situations; and (iii) that even in situations where new debt could be issued for cash to third parties, it is far from clear that borrowers in the fact patterns considered herein would be able to redeem the existing indebtedness at the discounted amount—since contractually they do not possess the right to redeem such instruments at less than par.<sup>51</sup>

Perhaps another way to express this point of view more simply is that absent more compelling reasons, the tax law should be very reluctant to deem an outcome that could have very significant tax consequences in connection with transactions where there is no significant change in the underlying economics, even though the change may rise to a level of constituting a “significant” modification within the meaning of the Debt Modification Regulations. When a borrower engages in a debt-for-debt exchange, in order to test whether the borrower genuinely has experienced something that is equivalent, economically, to accretion to wealth, the facts should be compared to a situation where most all would agree that such accretion has occurred—a situation where third-party lenders loan new cash to borrower in an amount equal to the discounted current fair market value of borrower’s other existing indebtedness and borrower takes the cash from the third-party lenders and uses it to purchase in the marketplace, at a discount from the principal amount due, the entire amount of the other existing indebtedness. If the economic circumstances relating to a proposed debt-for-debt exchange are determined to be similar enough to the above paradigm debt forgiveness fact pattern (a fact pattern also consistent with applicable

case law<sup>52</sup>), then suitable conditions might exist to trigger application of the rules. But, on the other hand, if the economic comparability conditions are not compelling enough, then the rules should not be triggered. The goal should be to look for evidence as to whether there has been a net increase in assets, as a result of the alleged discharge event. Where the borrower remains obligated on the same amount of principal indebtedness, where the maturity date of the new indebtedness is the same as the old indebtedness, and where the interest obligations even though different are still broadly similar to those contained in the old indebtedness, it should be concluded that there is not sufficient evidence present to trigger application of the discharge of indebtedness rules. More compelling circumstances should be present before a deemed exchange treatment is selected as the proper tax characterization, particularly where, in fact, there is little underlying economic substance and where the approach can be used in ways the IRS should view or often would view in other settings to be abusive.<sup>53</sup> For at least a select group of fact patterns, the process leading to a conclusion of deemed exchange treatment should require more of a comprehensive qualitative analysis or be controlled by the use of safe harbors with related anti-abuse rules.

In this regard, it is acknowledged that the foregoing discussion takes the most deserving type of fact pattern as its base case, and that many other fact patterns in the marketplace today involving potential debt-for-debt exchanges are not as compelling. But the principal point of this analysis is to emphasize that in order to assess whether there has been an event that properly should be characterized as creating discharge of indebtedness, it is important that more of a qualitative analysis of the particular fact patterns be undertaken—the all or nothing, and at times somewhat hair-trigger approach of the Reg. §1.1001-3 regulations appears at odds with the underlying economic substance of many transactions impacted by those rules.

### ***3. Legislative History Underlying Enactment of Code Sec. 108(e)(10) and Repeal of Code Sec. 1275(a)(4)***

In analyzing the statutory language and legislative history relating to the enactment of Code Sec. 108(e)(10) and the repeal of Code Sec. 1275(a)(4), some portions of which were quoted in detail above, it is important to understand that these legislative actions do not ap-

pear to have had the luxury of careful consideration by Congress. Less than three weeks elapsed between the time the provision that became Code Sec. 108(e)(10) was proposed and the date of its enactment.<sup>54</sup> The record of contemporaneous events suggests that the legislation was initiated directly in response to what were described as three different approaches then being followed by taxpayers in applying Code Sec. 1275(a)(4) concerning debt-for-debt exchanges.<sup>55</sup> In particular, Congress may have been concerned with the degree of flexibility available to taxpayers in making use of those approaches to manipulate the face amount and interest rates of new debt instruments in proposed debt-for-debt exchanges.<sup>56</sup> This was, however, a legislative review at a very high level.<sup>57</sup> There was no critical review and examination of detailed and particular fact patterns; rather, all the attention in the rather limited time available focused on some selected fact patterns that had recently become the topic of informal discussions among tax practitioners and Treasury officials involving debt-for-debt exchanges and the impact of differing face amounts, issue prices, principal amounts and fair market values on the application of how then Code Sec. 1275(a)(4) was being applied in practice. It does not appear that any consideration was given to whether it would be appropriate to apply the new rules to more unique fact patterns involving debt-for-debt exchanges where alternative outcomes might be more appropriate from a substantive tax and policy perspective. It also appears as if no consideration was given to whether, and to what extent, existing case law precedents<sup>58</sup> would properly impact the application of Code Sec. 108(e)(10) in particular factual circumstances, such as the fact patterns described in this article.

There also is substantial evidence that in the years leading up to the enactment of Code Sec. 108(e)(10) and the repeal of Code Sec. 1275(a)(4), Congress addressed this specific topic of COD income in connection with debt-for-debt exchanges only indirectly, as a consequence of more specific legislative efforts to address the appropriate manner of determining OID in debt-for-debt exchanges.<sup>59</sup> From 1969, when Congress added language preventing the creation of OID in debt-for-debt exchanges qualifying as reorganizations,<sup>60</sup> to 1982 when further changes again were made to address specific OID and bond premium questions concerning consistency and selectivity behavior issues presented by Code Sec. 1232, which then addressed those issues in connection with debt-for-debt exchanges,<sup>61</sup> through 1984,

when some further clarifying changes were made, primarily to address the application of the related OID rules,<sup>62</sup> it does not appear that Congress had ever closely examined the underlying details of particular debt-for-debt exchanges to assess the appropriate operation of the COD income rules. It was noted, in this regard, in an article focusing on the tax treatment of borrowers in debt-for-debt exchanges, with reference to the law as it existed prior to the enactment of Code Sec. 108(e)(10), that “nothing in the legislative history of either the Technical Corrections Act of 1982 or the Tax Reform Act of 1984 suggests that Congress intended to choose the [fair market value issue price treatment] over the [principal amount treatment] ... ,”<sup>63</sup> relating to the issue price determination of the new indebtedness in such an exchange.

The potential relevance of the above information is that in attempting to ascertain what, if any, limits there may be on the Treasury’s authority to act to address what it might consider an inappropriate application of the COD income rules in certain types of debt-for-debt exchanges, it might be useful to know that Congress apparently has never examined this particular topic in any detail and that when it has considered it the review has taken place at a very high level in an effort to promote the appropriate goals of achieving consistency of application among taxpayers involved in similar transactions and eliminating or minimizing taxpayer selectivity with respect to interpretations of the same statutory language. The fact that Congress may have taken steps to accomplish those goals, largely in response to an apparent lack of consistency of treatment and the presence of what was thought to be excessive flexibility in the application of then existing law in 1990, does not suggest that the Treasury should not be free to implement more specific rules today in ways it finds to be appropriate in suitably deserving fact patterns.

#### ***4. Suggested Approaches for the Treasury to Consider***

On the assumption that the Treasury is favorably inclined to address the COD income issue, there are several approaches for it to consider: (i) promulgate regulations under Code Sec. 446(b), the so-called clear reflection of income authority, to require that COD income otherwise recognized in connection with a specified category of debt-for-debt exchanges instead be amortized into income as an offset to OID over the duration of the new debt instrument; (ii) modify Reg. §1.1001-3 to carve out from the category

of events constituting a “significant modification” a specified category of debt-for-debt exchange transactions; (iii) promulgate regulations to implement Code Sec. 108(e)(10), with the objective of defining a specified category of debt-for-debt exchanges that would not be subject to the rules triggering COD income; and (iv) promulgate regulations that would modify the Code Sec. 1273/1274 “issue price” rules for determining when certain debt instruments will be treated as publicly traded.<sup>64</sup>

**a. “Clear Reflection of Income” Regulations.** With respect to the proper methods to be used by taxpayers in reporting income, deductions, gains and losses, the Code contains an extremely broad delegation of authority to the Treasury: “... , or if the method [of accounting] used [by the taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”<sup>65</sup> Further, the related Regulations provide “...no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.”<sup>66</sup> On a number of occasions, the courts have confirmed the existence of this broad authority. The Supreme Court has indicated: “In construing §446 and its predecessors, the Court has held that ‘[t]he Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income’ ... . Since the Commissioner has ‘[m]uch latitude for discretion,’ his interpretation of the statute’s clear-reflection standard ‘should not be interfered with unless clearly unlawful.’”<sup>67</sup> Further, Code Sec. 7805(a) provides: “... the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.” In combination, these provisions should be seen as providing the Treasury with ample authority to promulgate regulations that would require any amount of COD income realized in connection with a specified category of debt-for-debt exchange transactions containing the Base Case Facts to be amortized over the remaining term of the new debt instrument in a manner similar to bond issuance premium, as an offset to OID determined to have been created as a result of the debt-for-debt exchange. There are comparable precedents in which the Treasury has relied on these statutory provisions to promulgate regulations to establish

rules that depart from the otherwise application of the realization/recognition rules of the Code.

For example, in 1993 the Treasury proposed regulations to promote the clear reflection of income in the case of hedging transactions.<sup>68</sup> These regulations, finalized in the form of Reg. §1.446-4 and Reg. §1.1221-2,<sup>69</sup> created rules that both defined categories of assets that would not be treated as capital assets and defined categories of hedging transactions, the income, deduction, gain or loss from which was required to be reported on a basis that matched the timing of the income, deduction, gain or loss from the item being hedged. In the preamble to those proposed regulations, the Treasury provided a few statements that are quite relevant in the present setting: “Taking gain or loss on the hedging transaction into account when it is realized often does not reflect the economics of the hedging transaction ... . When property is part of a hedging transaction, taking income, deduction, gain or loss on the property into account when it is realized often provides significant opportunities for abuse ... . Accordingly, the proposed regulations invoke the Commissioner’s authority under sections 446(b), 451, and 461 to require that a taxpayer’s method of accounting for hedging transactions clearly reflect income.” As finalized, the rules in Reg. §1.446-4 require amortization of amounts that otherwise would be governed by the traditional current realization and recognition rules of the Code (e.g., Code Secs. 61 and 1001).<sup>70</sup>

Another example of the Treasury exercising its broad authority under Code Sec. 446(b) was in the promulgation of regulations to prescribe the manner by which income, deductions, gains and losses relating to “notional principal contracts” were to be reported for tax purposes. As finalized, Reg. §1.446-3 set forth specific rules governing the timing of when income, deductions, gains and losses related to notional principal contracts were to be reported for tax purposes—requiring in many cases that income associated with “nonperiodic” payments be taken into account over the duration of the notional principal contract, rather than at the time of payment/receipt.<sup>71</sup>

The promulgation of regulations that would require any amount of COD income realized in connection with a specified category of debt-for-debt exchange transactions containing the Base Case Facts to be amortized over the remaining term of the new debt instrument in a manner similar to bond issuance pre-

mium would accomplish a result for Borrower that clearly reflects its economic income. In the Base Case Facts, Borrower has not experienced an accretion to wealth, has not derived any net additional proceeds and will not experience any increase in its actual net borrowing costs other than the incremental increase in the interest rate associated with the interest to be paid in cash. In such a circumstance, not only should it not be required to recognize income for tax purposes that it has not experienced as an economic matter, but in addition, it should not benefit from an increased OID interest expense in a circumstance where it does not bear the economic cost of such deductions. This result would be accomplished for Borrower to the extent the COD income is amortized over the duration of the new debt instrument as an offset to the accruing OID.<sup>72</sup>

From the perspective of Investors, the Treasury may prefer the above approach, in that those Investors which purchase the Permanent Securities or Exchange Notes likely will do so in a transaction that, from the perspective of the Investors, looks and feels like an original issuance. As a result, the purchase by Investors at a discount would be subject to the OID rather than the market discount rules. Since Investors are required to recognize OID income as it accrues, whereas they would not recognize market discount income currently, absent their making a formal election to do so,<sup>73</sup> the Treasury may prefer that result from a tax policy perspective.

**b. Modify Reg. §1.1001-3.** The Debt Modification Regulations (*i.e.*, Reg. §1.1001-3) originally were proposed in December of 1992 and were “intended to address the uncertainty concerning when the modification of a debt instrument results in a deemed exchange of the old debt instrument for a new instrument. Some of this uncertainty resulted from the possible impact of the decision of the Supreme Court in *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991).”<sup>74</sup> The fact pattern in *Cottage Savings* was quite different from the fact patterns arising in the types of debt-for-debt exchanges described herein, primarily on the basis that the exchanges at issue in *Cottage Savings* related to two different taxpayers entering into exchanges of separate property each owned. The question before the court was whether the properties each received in the exchanges were “differing materially either in kind or in extent” within the meaning of Reg. §1.1001-1. Real estate loans

secured by single-family homes were the subject of the exchanges, with the taxpayer exchanging a portfolio of such loans for a separate portfolio of similar loans owned by a counterparty. There was no overlap among the individual borrowers on the underlying real estate loans, meaning that the obligors on the loans transferred by the taxpayer were completely different from the obligors on the loans received by the taxpayer from the counterparty. Moreover, the properties securing the loans transferred by the taxpayer were all located in different states from the properties securing the loans received by the taxpayer. On the basis of those facts, the Supreme Court had little difficulty in concluding that the “differing materially” standard of Reg. §1.1001-1 was satisfied—and concluded its analysis on the basis that “the exchanged interests embodied legally distinct entitlements.”<sup>75</sup>

Following the decision in *Cottage Savings* and the publication of the proposed Debt Modification Regulations, several published articles debated the extent to which the court in *Cottage Savings* had established a “hair-trigger” test for use in interpreting the “materially different” standard in Reg. §1.1001-1.<sup>76</sup> One perspective was that the Supreme Court had, in fact, interpreted the law to be that any change in the legal rights of the parties to a debt instrument would trigger a realization event under Code Sec. 1001, irrespective of the economic significance of such change—the so-called hair-trigger test. Another perspective was that the court’s references to legal entitlements were merely *dicta* and completely unnecessary to reaching what many thought was an unsurprising holding that real estate loans of different individuals secured by properties located in different states qualified as property “differing materially either in kind or in extent” within the meaning of Reg. §1.1001-1.

The Treasury’s promulgation of the Debt Modification Regulations would appear to confirm that it did not believe the decision in *Cottage Savings* had established a hair-trigger test; for had it been of such a view, it would not have chosen to adopt regulations using a “significant modification” standard, generally looking to the “economic significance” of proposed modifications rather than mere changes in legal entitlements, to determine whether a Code Sec. 1001 realization event had occurred.<sup>77</sup> On this basis, the Treasury should have the authority to amend Reg. §1.1001-1 to make clear that a specified category of debt-for-debt ex-

change transactions containing the Base Case Facts would not be treated as satisfying the “materially different” standard of Reg. §1.1001-1 and therefore would not be treated as realization events for U.S. Federal income tax purposes.<sup>78</sup> For example, such an amendment to the Debt Modification Regulations could relieve the otherwise application of the change in yield test in a narrowly circumscribed set of facts, such as the Base Case Facts, to prevent what otherwise would be a triggering of adverse tax consequences to Borrower significantly disproportionate to the change in its economic position resulting from the proposed debt modifications. One of the issues for the Treasury to consider in analyzing this approach, as opposed to the “clear reflection of income” approach discussed above, is that it would cause the Investors to be subject to the market discount rather than the OID rules in respect of their purchase of the Permanent Securities or Exchange Notes—and the Treasury properly may view this to be a less desirable outcome, from a tax policy perspective.

**c. Promulgate Regulations to Implement Code Secs. 61(a)(12) and 108(e)(10).** In defining what it means to repurchase a debt instrument, relevant to the determination of whether COD income will be realized, Reg. §1.61-12(c)(2) provides that the term “repurchase” includes “... the exchange (*including an exchange under Code Sec. 1001*) of a newly issued debt instrument for an existing debt instrument.” The legislative history underlying the enactment of Code Sec. 108(e)(10), portions of which have been excerpted above, contained the following statements: (i) “In any case in which an old debt instrument is exchanged by the holder for a new debt instrument, *or in which the terms of an old debt instrument are modified so as to constitute an exchange by the holder*, the debtor is treated as having issued a new debt instrument in satisfaction of an old debt instrument”; and (ii) “Thus, either or both COD or OID may be created in a debt-for-debt exchange that qualifies as a reorganization, *so long as the exchange qualifies as a realization event under Code Sec. 1001* for the holder.”<sup>79</sup> The above excerpts from Reg. §1.61-12 and the 1990 legislative history relating to the enactment of Code Sec. 108(e)(10) confirm that Code Sec. 108(e)(10) is not applicable in a debt-for-debt exchange unless such exchange represents a realization event within the meaning of Code Sec. 1001. This fact, combined with the lack of detailed attention given

by Congress to the COD income consequences in the types of fact patterns involving the Base Case Facts (as discussed above in section IV B 3) provide ample basis for the Treasury to amend the Debt Modification Regulations to address fact patterns involving Base Case Facts, as suggested in the prior section above. Those same references, however, tend also to suggest that in circumstances where a realization event within the meaning of Code Sec. 1001 is determined to have occurred in a debt-for-debt exchange transaction involving Base Case Facts, and where the issue price of the new debt instrument in such exchange is determined to be the fair market value of such instrument, there would be little support for a regulation to exempt such transactions from the application of Code Sec. 108(e)(10).<sup>80</sup> In such a circumstance, it is suggested that the more appropriate course of action would be to promulgate a regulation under Code Sec. 446(b), as suggested above, to require any realized COD income to be amortized over the duration of the new debt instrument.

**d. Modify “Issue Price” Regulations Under Code Secs. 1273 and 1274.** As discussed earlier in this article, Reg. §1.1273-2(f) establishes rules for the determination of the issue price of debt instruments issued in exchange for property, such as in debt-for-debt exchanges. In general, subject to some exceptions in Code Sec. 1274 and the corresponding regulations, to the extent the debt instruments are not treated as publicly traded within the meaning of the Regulations, the issue price of the new debt instrument deemed issued in a debt-for-debt exchange will be its principal amount, provided it bears interest at a rate equal to or greater than the applicable federal rate. In circumstances where the issue price of the new debt instrument is determined to be equal to its principal amount (which in the Base Case Facts described in this paper is also equal to the principal amount of the old debt instrument), the deemed issuance of the new debt instrument will not result in the recognition of COD income to Borrower and will not produce OID deductions to Borrower or OID income to Lenders/Investors.

To the extent the Treasury is sympathetic to such an outcome in factual settings like those described in this article, amending the regulations to provide for the issue price of the new debt instruments to be equal to their principal amount may appear to be an alternative solution.

On closer reflection, however, such an approach may be viewed as addressing only indirectly the core issue of concern to Borrower (*i.e.*, the realization of COD income) and as raising collateral consequences that are undesirable from a tax policy perspective. To begin with, this approach would only operate successfully in those situations where Lenders are operating as “principals” and not as “underwriters,” for in the latter case the cash price paid by Investors would determine the issue price.<sup>81</sup> In addition, in a manner similar to that discussed above in relation to amending the Debt Modification Regulations, this approach would not cause the Investors to be subject to the OID rules; instead, the market discount rules would apply, raising the same tax policy issues for the Treasury to consider. Moreover, use of a “principal amount” issue price for this purpose could be seen as producing undesirable collateral consequences. For example, any relief that a “principal amount” issue price rule would offer to borrowers could be offset by the detriment to investors that had purchased the old debt instruments at a discount and then had participated in a debt-for-debt exchange not qualifying as a tax-free reorganization—causing such investors to recognize taxable income equal to the amount of the COD income not recognized by Borrower.<sup>82</sup> Finally, this approach could be seen as somewhat

artificial and impractical to implement. Even with a modification of the Regulations, an approach that deems the issue price of certain debt instruments to be the principal amount arguably could only be justified to the extent such debt instruments are fairly characterized as “not publicly traded,” since this would appear to be the only circumstance under Code Secs. 1273 and 1274 that a principal amount issue price is permissible in a property exchange transaction. Recognizing that whatever rules would be crafted to implement this approach would require significant factual inquiries to establish whether or not the debt instruments would be “publicly traded,” it is very likely that the uncertainty over the application of the rules would reduce the likelihood that such an approach would, in practice, have a significant beneficial impact. Even the existing rules defining when property is publicly traded have created uncertainties in application that have impeded market transactions.<sup>83</sup> In summary, this approach would seem to raise a number of tax policy objections and seems ill-suited to accomplishing the primary goal. On balance, the suggestion that the Treasury promulgate “clear reflection of income” regulations under the authority of Code Secs. 446(b) and 7805 would appear to be the most defensible proposal, both from a tax policy and economic substance perspective.

#### ENDNOTES

<sup>1</sup> Section references are to the Internal Revenue Code of 1986, as amended (“the Code”), and regulations promulgated thereunder (“Reg. §”).

<sup>2</sup> To simplify the tax analysis and focus attention on only a select number of issues, the discussion assumes that none of the debt instruments under consideration are properly characterized as CPDIs and all of the interest payments are characterized as qualified stated interest (within the meaning of Reg. §1.1273-1(c)(1)).

<sup>3</sup> The quoted language is taken from the relevant provision of a representative Bridge Loan.

<sup>4</sup> A June 21, 2008, draft of a paper authored by Jeff Maddrey and Rebecca Lee, *COD and AHYDO Considerations for Issuers in “Underwriter Loss” Transactions* (“Maddrey & Lee”) addresses many of the key U.S. Federal income tax issues discussed herein—and, among other things, proposes an innovative alternative approach under current law to mitigate the impact of COD, by amortizing such income over the life of

the debt instruments, relying on the rules in Reg. §1.446-4.

<sup>5</sup> The fact that Borrower incurred \$20 million of commitment fees and will be required, pursuant to Reg. §1.446-5, to amortize this amount in a manner as if it were original issue discount, will not impact the determination of the issue price of the Bridge Loan for any other purpose.

<sup>6</sup> Under current law, because Investors would be required to include OID in income currently as it accrues but would only include accrued market discount in income currently if they make an election under Code Sec. 1278(b) to do so, most taxpaying investors would prefer the market discount characterization.

<sup>7</sup> Even if the appropriate issue price was determined to be \$700 million, Lenders would be determined to have purchased with “acquisition premium,” within the meaning of Reg. §1.1272-2(b)(3), with the result that they would not be required to accrue any OID (assuming away for purposes of this discussion any issues about how the “quali-

fied stated interest” rules are applied in this context). In such a case, however, Investors would be determined to have purchased with OID.

<sup>8</sup> See H.R. REP. NO. 1337 (83rd Cong., 2nd Sess. 1954).

<sup>9</sup> In this regard, the use of the “firm commitment” versus “best efforts” commitment distinction would not alone be a suitable distinction for differentiating those instances where the price paid by “underwriters” should be ignored, since even in a firm commitment underwriting, the transaction could be structured in form in such a way that the compensatory aspect as between the borrower and the lenders would be effected *via* the pricing of the debt instrument.

<sup>10</sup> There are unrelated fact patterns tending to support the conclusion that the carve-out language should not be taken too literally. What does one do in a situation where underwriters extend a loan to borrower on June 30 of a tax year and are unable to sell any of the loan to investors until November of the following year? Would it be reasonable

ENDNOTES

- to conclude that the debt instrument does not have an issue price at all, because it is held by lenders acting in the capacity of underwriters? Tax returns must be filed for the year of issuance and life must go on. The Treasury should take comfort in the fact that certain clarifications are quite appropriate.
- <sup>11</sup> See H.R. REP. NO. 101-247 (101st Cong., 1st Sess. 1989).
- <sup>12</sup> Rev. Proc. 2008-51, IRB 2008-35, 562.
- <sup>13</sup> Although certain simplifying assumptions have been made in presenting Fact Pattern 2, none of them has impacted the appropriate U.S. Federal income tax analysis.
- <sup>14</sup> Reg. §1.163-13(c).
- <sup>15</sup> Suspicions also would be raised if a provision of current law required Borrower to include such differential in income at the same time that the AHYDO provisions applied to limit or disallow Borrower's interest deductions on Bridge Loan.
- <sup>16</sup> Maddrey & Lee recommended that the Treasury amend the debt reopening regulations in Reg. §1.163-7(e) to address this issue.
- <sup>17</sup> If Brokers were unrelated to and not affiliates of Lenders, which is not the situation encountered in the bridge loan transactions described in this article, Brokers would never exercise the option to purchase Permanent Securities from Borrower for \$1 billion only to sell such securities to Investors for \$700 million. That would be a stiff price to pay in order to earn a two-percent commission. The fact that Brokers are affiliates of Lenders best explains why the option might be exercised—as it is one of the approaches to be considered to enable the Lenders and their affiliates to obtain liquidity with respect to the “hung” Bridge Loan.
- <sup>18</sup> Reg. §1.1001-3(c)(1)(ii).
- <sup>19</sup> Reg. §1.1001-3(c)(3)(i).
- <sup>20</sup> Reg. §1.1001-3(c)(3)(ii).
- <sup>21</sup> Reg. §1.1001-3(c)(2)(iii)(B).
- <sup>22</sup> Brokers are different legal entities from Lenders, and not parties to the Bridge Loan. Technically, therefore, the Unilateral Option Rule would not be available. Because the Brokers in this fact pattern are wholly owned affiliates of Lenders and because the definitions in the bridge loan documentation can be read to treat the Brokers as Lenders for some purposes, the discussion in the text proceeds solely for purposes of analysis as if the Unilateral Option Rule is potentially available.
- <sup>23</sup> There likely will be a number of fact patterns, unlike the Base Case, where the terms of the “new debt instrument” to be issued pursuant to the exercise of a unilateral option by one of the parties may provide for the deferral or reduction of payments of principal or interest, when compared to the terms of the “old debt instrument,” causing the unilateral option rule to be inapplicable.
- <sup>24</sup> As indicated in the description of the Base Case, a three-year no-call period is applicable upon issuance of the Permanent Securities. Various other bridge loan transactions afford borrowers a prepayment right upon issuance of the “permanent securities,” but subject to a make-whole or other penalty provision. As to whether a borrower's right to call or prepay a debt instrument subject to such a make-whole provision is the type of “right to terminate” contemplated in the described exception to the application of the Unilateral Option Rule, it is noted that the preamble to Reg. §1.1001-3 contains the following statement suggesting that any prepayment right could be such a right to terminate: “[I]n the case of a prepayable debt instrument, the holder's waiver of rights may be an inducement to the obligor not to terminate the debt instrument.” In addition, proposed Reg. §1.1001-3 had provided that a “right to terminate” possessed by one of the parties would deny availability of the Unilateral Option Rule only if the unilateral option “created” in the other party the right to terminate, unlike the language in the final regulations that denies availability of the rule merely if such right to terminate exists in the other party.
- <sup>25</sup> In practice, Borrower and Brokers often enter into significant negotiations with respect to the terms of the Permanent Securities, making the “change occurring by operation of the terms of the debt instrument” rule unavailable. The discussion in this section of the article has been included primarily for analytical purposes to highlight some of the issues that would be encountered should the facts be different from those normally encountered.
- <sup>26</sup> A number of excellent papers describe the U.S. Federal income tax consequences to the relevant parties of debt-for-debt exchanges, a few of which are cited here: Berg, *Selected Federal Income Tax Issues Arising in Corporate Debt Restructurings*, 789 PLI/TAX 151 (2007); Friedman, *Debt Exchanges After Rev. Rul. 2004-78*, 105 TAX NOTES 979 (2004); Goldring, *Modifying Debt and its Consequences*, 789 PLI/TAX 361 (2007); Rosen, *Practical Guide to the Tax Considerations and Consequences of Acquiring Stock and Debt Securities of Financially Troubled Corporations*, 789 PLI/TAX 431 (2007); Swartz, *Debt Exchanges*, 789 PLI/TAX 261 (2007).
- <sup>27</sup> Actually, there are several potential permutations and combinations related to the assumed facts. The discussion herein is limited to those thought to present the more interesting tax characterizations.
- <sup>28</sup> Even though it is assumed that Bridge Loan was not sold, it is possible that it could be considered “publicly traded” under the rules discussed in the text below.
- <sup>29</sup> In general, adequate stated interest will be determined to exist if the interest rate on the Permanent Securities is at least equal to the “applicable federal rate,” currently set at approximately 3.5 percent for September 2008. See Code Sec. 1274(b)(c).
- <sup>30</sup> Code Sec. 7805(b)(3).
- <sup>31</sup> If either or both of the debt instruments in a debt-for-debt exchange are contingent payment debt instruments (CPDIs), the issue price determinations under Code Sec. 1274 require application of special rules that should be consulted. See Reg. §1.1274-2(g).
- <sup>32</sup> New York State Bar Association, Tax Section, *Report No. 1066 on Definition of ‘Traded on an Established Market’ Within the Meaning of Section 1273* (Aug. 12, 2004).
- <sup>33</sup> For a discussion of the application of the AHYDO rules resulting from modifications of debt instruments, see Garlock & Urbina, *Modifications of Debt Instruments and the High-Yield Discount Obligation Rules*, 4 J. TAX'N FINANCIAL PRODUCTS 3 (2003), at 9.
- <sup>34</sup> Code Sec. 354(a)(1).
- <sup>35</sup> See Friedman, *Debt Exchanges After Rev. Rul. 2004-78*, 105 TAX NOTES 979 (2004).
- <sup>36</sup> Although the documentation relating to Bridge Loan contains language describing Bridge Loan as having a 12-month term (e.g., an “Initial Maturity Date” at the end of 12 months), the documents also provide that the term automatically extends to the eight-year date, absent an election by Lenders to exercise rights to force conversion of Bridge Loan into Exchange Notes. The Exchange Notes, if issued, would also have a maturity date that is the same as the original eight year date provided for in Bridge Loan. Moreover, Lenders are not able to demand repayment of Bridge Loan at the 12-month date, absent a default by Borrower, and similarly are unable to demand repayment of Exchange Notes prior to their maturity date, absent a default by Borrower.
- <sup>37</sup> To the extent Bridge Loan was not eligible to be characterized as a “security” within the meaning of Code Sec. 354, with the result that the deemed exchange would be a taxable transaction, the U.S. Federal income tax consequences to Lenders/Investors could be quite different than described herein. This article does not address the tax consequences to the parties in such circumstances.
- <sup>38</sup> Pursuant to Reg. §1.1272-2(a),(b)(3), Lenders generally would be permitted to reduce the amount of OID to be accrued by a fraction set forth in Reg. §1.1272-2(b)(4)—reflecting the premium of Lender's adjusted tax basis over the issue price of the Permanent Securities.
- <sup>39</sup> It is important again to emphasize that although the bridge loan agreement described in this article is representative of a number of actual bridge loan agreements in the

## ENDNOTES

marketplace, there are many others with terms that are different, and those differences could significantly impact the applicable U.S. Federal income tax consequences.

<sup>40</sup> As described above in Section III B 2 of this article, there are a few exceptions to the application of the unilateral option rule of the Debt Modification Regulations, none of which should be applicable in this particular fact pattern: (i) there will not be any deferral or reduction of payments of principal or interest under the terms of the Exchange Notes (though it is conceded that it would not take much to run afoul of this rule in other fact patterns); (ii) the exercise of the option by Lenders to convert Bridge Loan into Exchange Notes does not require the consent or approval of Borrower; and (iii) as to the test requiring that there “not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument . . .,” the Borrower will not possess any such proscribed rights at the time of the exchange.

<sup>41</sup> To the extent Lenders, in the capacity as underwriters, had sold a substantial portion of Bridge Loan to Investors for cash, then the same OID/AHYDO issues discussed in section III A of this article would have been confronted, and Lenders would have recognized their loss at the time of such earlier sale, not as indicated above in the text at the time of the sale of the Exchange Notes.

<sup>42</sup> In a 1991 NYSBA report on this topic, it was noted that the application of the AHDO rules in a fact pattern similar to that discussed herein would be “particularly inappropriate (and, apparently unintended).” See New York State Bar Association, Tax Section, *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges* (Mar. 25, 1991).

<sup>43</sup> Added to the Code in 1954, Code Sec. 61(a) (12)’s predecessor was the Supreme Court’s decision in *Kirby Lumber Co.*, SCT, 2 USTC ¶ 814, 284 US 1 (1931). Also see *Coastwise Transp. Corp.*, CA-1, 4 USTC ¶ 1288, 71 F2d 104 (1934); *D. Jelle*, 116 TC 63, Dec. 54,227 (2001); *Zappo*, 81 TC 77, Dec. 40,325 (1983); Rev. Rul. 77-437, 1977-2 CB 28; GCM 36602 (Mar. 1, 1976); LTR 7752002 (Sept. 2, 1977); Garlock, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS (¶ 1501.01, *Discounted Debt Discharge as Income*) (5th ed. 2006); American Bar Association, Tax Section, *Report of the Section 108 Real Estate and Partnership Task Force* (July 20, 1992). Both Garlock and the ABA Report reference *Centennial Savings Bank*, SCT, 91-1 USTC ¶ 50,188, 499 US 573 (1991), and *Hillsboro National Bank*, SCT, 83-1 USTC 9229, 460 US 370 (1983), as articulating a “tax benefit” approach to defining COD

income.

<sup>44</sup> Code Sec. 108 provides a number of exceptions to the application of the COD income rules, such as when the issuer of the indebtedness is subject to a Title 11 case or is insolvent, but those exceptions are not discussed herein, primarily because the borrowers described in this article typically are not experiencing sufficient financial distress to make consideration of such alternatives appropriate or necessary.

<sup>45</sup> Act Sec. 11325(a) of the Revenue Reconciliation Act of 1990, Title XI of the Omnibus Reconciliation Act of 1990, P.L. 101-508, 104 Stat. 1388 (Nov. 5, 1990), originally enacted as Code Sec. 108(e)(11).

<sup>46</sup> See H.R. 101-881 (101st Cong., 2d Sess. 1990).

<sup>47</sup> The discussion that follows in the text is designed to address the most sympathetic set of facts; hence a description of the facts that would just barely trigger application of the “significant modification” rules in the Debt Modification Regulations. There are many other fact patterns that, while not quite as deserving, are nonetheless worthy of serious consideration, from the perspective that the present value impact of the proposed modifications on the fair market value of the debt instrument in the hands of the investors is but a tiny fraction of the amount of COD income that would be triggered if a deemed exchange under the Debt Modification Regulations were determined to have occurred.

<sup>48</sup> The facts provided in Examples 1–3 are overly simplistic and it is acknowledged that there should be more of a pricing differential between the Loan and the trading value of the A Bonds on January 1, 2009, reflective of the differing legal obligations of Borrower. Notwithstanding the oversimplification, the essential points of comparison among the three alternatives remain as indicated.

<sup>49</sup> See Garlock, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS (¶ 1501.01, *Discounted Debt Discharge as Income*) (5th ed. 2006) for an excellent discussion of the relevant COD income case law. That discussion also references the Supreme Court’s decisions in *Centennial Savings Bank*, *supra* note 43, and *Hillsboro Nat’l Bank*, *supra* note 43, involving a “tax benefit” perspective, but involving “debt forgiveness” fact patterns where it was clear the taxpayer had been able to extinguish a liability with a lesser amount of assets than originally received when the liability first arose.

<sup>50</sup> This viewpoint has been expressed by others with eloquence almost 20 years ago. See Wilcox & Rievman, *Restructuring Troubled Debt Under the New Debt Exchange Rules*, 10 VA. TAX REV. 665, at 680 (1991); Cohen & Henningsen, *The Repeal of Section 1275(a)*

(4), 44 TAX LAW. 697, 734 (1990).

<sup>51</sup> It is conceded that Borrower’s facts are not representative of all such debt instruments, but they are representative of a significant number of transactions and those tend to support the need for this issue to be addressed.

<sup>52</sup> See *Kirby Lumber*, *Coastwise*, *supra* note 43.

<sup>53</sup> Various articles and letters have been written highlighting how corporations with expiring net operating losses or about to experience ownership changes triggering Code Sec. 382 limitations are able to mitigate or eliminate the adverse tax consequences by triggering COD income in transactions otherwise lacking in economic substance. See Adrion & Blasi, *Renegotiated Debt: The Search For Standards*, 44 TAX LAW. 967 (1991); ABA Tax Section, *Comments Regarding Repeal of Section 1275(a)(4) and Enactment of New Section 108(e)(11)*, 90 TNT 225-27 (Oct. 23, 1990).

<sup>54</sup> Wilcox & Rievman, *supra* note 50, at 670; various letters were submitted to Congress during this three-week period requesting that the proposed repeal of Code Sec. 1275(a)(4) not be adopted: ABA Tax Section, *Comments on Pending Legislation as to Debt-for-debt Exchanges*, 90 TNT 220-66 (Oct. 18, 1990); ABA Tax Section, *Comments Regarding Repeal of Section 1275(a)(4) and Enactment of New Section 108(e)(11)*, 90 TNT 225-27 (Oct. 23, 1990); New York State Bar Association, Tax Section, *Letter to Messrs. Bentsen and Rostenkowski*, 90 TNT 216-19 (Oct. 17, 1990).

<sup>55</sup> Wilcox & Rievman, *supra* note 50; Sheppard, *Is There Cancellation of Indebtedness Income in Debt-For-Debt Exchanges*, 47 TAX NOTES 900 (May 21, 1990); Sheppard, *Debt-For-Debt Exchanges: Issue Price in Reorganizations*, 48 TAX NOTES 954 (Aug. 20, 1990). It also had been demonstrated that Code Sec. 1275(a)(4) produced erroneous results that appropriately were in need of correction. Hariton, *Recapitalizations: The Issuer’s Treatment*, 40 TAX LAW. 873 (1987).

<sup>56</sup> Wilcox & Rievman, *supra* note 50, at 674.

<sup>57</sup> New York State Bar Association, Tax Section, *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges* (Mar. 25, 1991); Dahlberg, *Reasons for Reenacting Code Section 1275(a)(4), Analysis and Recommendations on H.R. 5655*, 56 TAX NOTES 1461 (Sept 14, 1992); Cohen & Henningsen, *The Repeal of Section 1275(a)(4)*, 44 TAX LAW. 697 (1990); Adrion & Blasi, *Renegotiated Debt: The Search For Standards*, 44 TAX LAW. 967 (1991).

<sup>58</sup> *Kirby Lumber Co.*, *supra* note 43; *American Chicle Co.*, SCT, 4 USTC ¶ 1240, 291 US 426 (1934); *Coastwise Transp. Corp.*, *supra* note 43; *National Alfalfa Dehydrating & Milling Co.*, SCT, 74-1 USTC ¶ 9456, 417 US 134

ENDNOTES

- (1974).
- <sup>59</sup> Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructurings*, 10 VA. TAX REV. 357 (1990).
- <sup>60</sup> H.R. 13270 (91st Cong., 1st Sess. 1969); S. REP. NO. 91-552 (91st Cong., 1st Sess. 293 (1969)).
- <sup>61</sup> Act Sec. 306(a)(9)(C)(i) of P.L. 97-448, 96 Stat. 2365, 2404 (1982); Cohen & Reinhold, *Debt-For-Debt Exchanges and Section 1275(a)(4)*, 90 TNT 112-18 (May 20, 1990); see Walter, *Tax Aspects of Recent Innovative Financings—Strategies for Existing Discount Debt And for New Securities*, 60 TAXES 995 (1982), for an explanation of the particular type of financing transaction responsible for the change made in the Technical Corrections Act of 1982.
- <sup>62</sup> P.L. 98-369, 98 Stat. 494 (1984).
- <sup>63</sup> Hariton, *supra* note 55.
- <sup>64</sup> Maddrey & Lee recommended that the Treasury promulgate regulations to, among other things, require otherwise COD income to be capitalized when arising in fact patterns of the type described herein.
- <sup>65</sup> Code Sec. 446(b).
- <sup>66</sup> Reg. §1.446-1(a)(2).
- <sup>67</sup> *Thor Power Tool Co.*, SCT, 79-1 USTC ¶9339, 439 US 522 (1979); *Hughes Properties, Inc.*, SCT, 86-1 USTC ¶9440, 476 US 593 (1986); *Ford Motor Company and Affiliated Companies*, 102 TC 87, Dec. 49,642 (1994).
- <sup>68</sup> Proposed Reg. §1.446-4, 58 FR 54077, Oct. 20, 1993.
- <sup>69</sup> Reg. §1.446-4, T.D. 8554 (July 18, 1994).
- <sup>70</sup> See Garlock & Munro, *The Timing of Interest Rate Hedging Gains and Losses*, 20 J. TAX'N INVESTMENTS 195 (2003) for a discussion and analysis of the application of Reg. §1.446-4 to a number of interest rate hedging transactions.
- <sup>71</sup> Reg. §1.446-3, T.D. 8491 (Oct. 8, 1993).
- <sup>72</sup> See Reg. §1.163-13. To the extent the Treasury elects to promulgate such regulations, it also should consider contemporaneously amending the regulations relating to bond redemption premiums, so as to provide that the deemed redemption premium arising in connection with a debt-for-debt exchange of the type described herein would be required to be amortized over the duration of the new debt instruments, rather than as currently provided, immediately in circumstances where the new debt instruments are publicly traded. See Reg. §1.163-7(c).
- <sup>73</sup> Code Sec. 1278(b).
- <sup>74</sup> Reg. §1.1001-3, T.D. 8675, 1996-2 CB 60; American Bar Association, Tax Section, *Comments on Proposed Treasury Regulation—Reg. §1.1001-3 Relating to Modifications of Debt Instruments* (Apr. 26, 1994).
- <sup>75</sup> The particular language used by the Supreme Court that attracted so much attention was the following: “Under our interpretation of §1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are ‘materially different’—that is, so long as they embody legally distinct entitlements.”
- <sup>76</sup> See Bacon & Adrion, *Taxable Events: The Aftermath of Cottage Savings (Part I)*, 59 TAX NOTES 1227 (May 31, 1993); *(Part II)*, 59 TAX NOTES 1385 (June 7, 1993); Sheppard, *Why Vultures Should Not Be Nice Guys*, 90 TAX NOTES 1132 (Feb. 26, 2001), for a discussion of the controversy surrounding the proposed Reg. §1.1001-1 regulations; Lipton, *IRS Issues Proposed Regulations on Debt Modifications*, 71 TAXES 67 (1993), for a discussion of why the Treasury should not have finalized Reg. §1.1001-1; Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (Apr. 29, 2002).
- <sup>77</sup> The fact that certain of the tests adopted in the Debt Modification Regulations contain a hair-trigger-like feature (e.g., the change in yield rule in Reg. §1.1001-3(e)(2)) does not detract from this overall point.
- <sup>78</sup> Reg. §1.61-12(c)(2) defines the term “repurchase” to include “the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.” It should be clear that only an exchange that constitutes a realization event within the meaning of Code Sec. 1001 and the Regulations thereunder is the type of exchange that could produce discharge of indebtedness income for purposes of Code Sec. 61.
- <sup>79</sup> See H.R. 101-881 (101st Cong., 2d Sess. 1990).
- <sup>80</sup> Even if a rule having the effect of exempting certain debt-for-debt exchanges from the application of Code Sec. 108(e)(10) were to be adopted, unless such a rule also were to establish that the exchanges would not create OID, borrowers would benefit from an inappropriate series of OID deductions with no offsetting income.
- <sup>81</sup> As discussed in section III B 3 above, Lenders may be acting either as “principals” or in an “underwriting capacity” in connection with the sale of Bridge Loan, the Permanent Securities and/or the Exchange Notes. Hence, the Treasury’s clarification of the rules in Reg. §1.1273-2(e) would be welcomed by taxpayers, whether or not the approach described above in the text is adopted.
- <sup>82</sup> Reg. §1.1001-1(g) provides that the amount realized by Investor in a taxable debt-for-debt exchange would be equal to the issue price of the new debt instrument. So, for an investor that had purchased the debt instrument at a steep discount, the taxable debt-for-debt exchange would produce a significant taxable gain measured by the difference between the principal amount of the new debt instrument and the much lower discounted purchase price of the old debt instrument. The extent to which it would be desirable to consider amending Reg. §1.1001-1(g) to produce an outcome more appropriate from a tax policy perspective in fact patterns of the type described herein, but that happen to be taxable, is a topic beyond the scope of this article.
- <sup>83</sup> In 2004, the New York State Bar Association, Tax Section, submitted a report to the Treasury containing several recommendations relating to the need for further guidance as to the application of Reg. §1.1273-2(f). Absent further guidance in this area, which has not yet been provided, taxpayers are often unable to determine with confidence whether the tests set forth in the existing regulations are satisfied in particular transactions. The uncertainties surrounding the application of the regulations makes it difficult to assess with confidence the tax consequences associated with particular exchange scenarios. See Report 1066, *Report on Definition of ‘Traded on an Established Market’ Within the Meaning of Code Sec. 1273* (Aug. 12, 2004). An August 19, 2008, NYSBA Tax Section letter to the Treasury entitled *Guidance on Economic Downturn Issues* reiterated the request for guidance on this topic.

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