# Taxation of High-Yield Debt — Beware the End of the Reprieve

**By Viva Hammer**

Viva Hammer is a leading practitioner in the taxation of financial products and alternative energy strategies. As a partner in the New York and Washington offices of Crowell & Moring, she advises hedge funds and other alternative investment vehicles, banks, mutual funds, energy companies, and large corporations.

Before joining the firm, Hammer was associate tax legislative counsel in the Office of Tax Policy at the Treasury Department. While there, she was instrumental in the publication of landmark regulations governing swaps, hedging transactions, and book-tax conformity for dealers in securities. She also oversaw the release of guidance relating to contingent convertibles, FELINE PRIDES, credit card fees, credit derivatives, foreign currency transactions, and the treatment of nonperforming loans by banks.

At Treasury, Hammer participated in the President's Working Group on Derivatives Oversight and Implementation. Since 1999 she has been on the editorial board of *Derivatives and Financial Instruments Journal* of the International Bureau of Fiscal Documentation. In 1997 she served as chair of the U.S. Council for International Business' Committee on the Tax Implications of the European Monetary Union. Currently, she is chair of the legislative matters subcommittee of the Banking and Savings Institutions Committee, Section of Taxation of the American Bar Association.

A punishing regime for the taxation of high-yield OID debt was introduced in 1989, which we call the "AHYDO rules." The rules were one of Congress's chief responses to the leveraged buyout frenzy of the 1980s. For 20 years, the absurdly complex rules rested in hibernation, but reared their heads in 2008, during the financial crisis. Recognizing that the application of the AHYDO regime to a large swath of American corporate debt was not what Congress intended in enacting the rules, Congress abrogated them in 2009 — but only for a brief period. In this article, I: (1) explain the history of the AHYDO rules, (2) walk readers through the maze of their application, (3) explain attempts by Treasury and Congress to mitigate their barb during the financial crisis, and (4) offer some long-term solutions to the problem of what to do when the rules rear their heads once again in a few months.

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This report is dedicated to the memory of Patricia — Pesha Laya, who was taken suddenly in the Season of our Freedom.

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## I. Introduction

### A. Prelude

At the end of the 1980s, the United States faced a collapsing investment bubble involving exotic debt securities, looming corporate bankruptcies, and failing financial institutions. The bubble was fueled by leveraged buyouts (LBOs), the exotic securities were the junk bonds that funded them, and savings and loan associations were collapsing under the weight of investment portfolios overwhelmed with junk bonds.

Congress's principal response to the financial crisis of the 1980s was the enactment of rules that limit interest

deductions on applicable high-yield discount obligations (AHYDO) — the AHYDO rules. After the wave of LBOs ebbed, these provisions spent much of the following 20 years in hibernation. Then, in 2008, amid the collapse of another investment bubble involving even more exotic securities and more spectacular failures of financial institutions, the AHYDO rules emerged from their slumber. Many corporations were denied interest deductions on market-rate debt they issued or modified because of the anomalous interaction of the LBO-era tax provision with the credit markets in crisis. This decade, Congress has responded by suspending the law it devised to combat the earlier crisis until the current crisis has passed. The broad legislative change came several months after Treasury published guidance to provide more limited relief to taxpayers.[1]

This report discusses the AHYDO rules, including the recent efforts by both Congress and Treasury to relieve taxpayers from their harsh effect. I illustrate the rules by way of an example: a debt instrument issued under a binding financing commitment that is later amended, triggering a deemed exchange.[2]

### B. History of AHYDO Rules

The AHYDO rules were enacted in 1989 in response to a great wave of LBOs that occurred during the 1980s. In an LBO, investors wishing to buy a company fund the purchase mostly with nonrecourse debt secured by the target company's assets, contributing only a small amount of their own funds as equity. The investors intend to pay off the debt with money generated either by the target company's operations or by selling the target's assets.

Over the course of the decade, LBOs were financed increasingly by instruments with deferred interest payments that created large amounts of original issue discount. These instruments were treated as debt under the tax law, and issuers were able to deduct the OID as it accrued, while maintaining control over cash that would otherwise have been consumed in making periodic interest payments. Investors in the instruments were entities that did not require current cash flow to make tax payments on the accruing OID such as tax-exempts.

Debt used to finance LBOs was often below investment grade because of the high degree of leverage and low quality of loan security. The instruments earned the title of "junk bonds" and their popularization pushed deal volume and takeover premiums to unsustainable heights. *The Wall Street Journal* reported in 1989 that junk bonds were being used in virtually every LBO by then and typically made up 15 percent to 20 percent of the financing.[3] One expert estimated that at the peak of the mania, "we [were] flipping the ownership of whole businesses at a roughly 10 percent annual rate."[4]

As the decade drew to a close, many high-profile LBOs were collapsing and junk bonds were reportedly defaulting at a rate of 34 percent.[5] A pioneer of the LBO strategy stated publicly that junk bonds had overinflated buyout premiums, were endangering otherwise healthy target companies, and needed to be reined in.[6]

It was widely believed that junks bonds had become popular because they took advantage of a tax arbitrage opportunity. As then-Treasury Secretary Nicholas Brady expressed it: "The substitution of [deductible] interest charges for [taxable] income is the mill in which the grist of takeover premiums is ground."[7] Both popular and expert opinions warned that the massive increase in leverage in the economy was dangerous, but there was no agreement on either the cause of or solution to the problem.[8]

Treasury believed that the root of the evil was the unequal tax treatment of debt and equity. Because interest payments were generally deductible, and dividends were not, taxpayers preferred debt over equity financing. In January 1989, Brady repeatedly discussed bringing closer the treatment of debt and equity, both by limiting the deductibility of interest and reducing the taxation of dividends.[9] However, Treasury concluded that it could not devise a regulatory solution, and by May 1989, Treasury informed Congress that it opposed any general limitation on interest deductions.[10]

Congress was concerned about the LBO bubble, but was hesitant about taking strong action to halt it. It had attempted to limit interest deductions on debt used for hostile takeovers in a bill approved by the House Ways and Means Committee in October 1987. The following week opened with the infamous Black Monday, when the Dow Jones Industrial Average plunged 22.6 percent. Popular commentators blamed the bill limiting interest

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[1]Rev. Proc. 2008-51, 2008-35 IRB 562, *Doc 2008-17402, 2008 TNT 155-10*.

[2]For an excellent discussion of issues that arise in the context of bridge loans, see generally Charles Morgan, "Bridge Loans — Confronting Tax Issues Triggered by the Recent Economic Downturn," *The Tax Club*, Sept. 22, 2008.

[3]Kevin G. Salwen, "Two Legislative Proposals Would Raise Cost of Leveraged Buy-Outs up to 10%," *The Wall Street Journal*, Oct. 19, 1989 (quoting Robert Willens, former senior vice president in charge of tax issues at Shearson Lehman Hutton Inc. in New York).

**(Footnote continued in next column.)**

[4]Louis Lowenstein, "LBOs, Enough Already!: How Wall Street's Dealmakers Divide Up The Spoils — And Leave Us the Scraps," *The Washington Post*, Oct. 22, 1989, at C1.

[5]Matthew Winkler, David B. Hilder, and James A. White, "The Party's Over: Mounting Losses Are Watershed Event for Era of Junk Bonds — Excesses of the Eighties Are Likely to Fall Victim to New Caution in Market — Assessing the Milken Factor," *The Wall Street Journal*, Sept. 18, 1989.

[6]*See, e.g.*, Theodore J. Forstmann and John A. Sprague, "LBOs Can Keep America Competitive — But Not Without 'Junk' Financing Curbs," *The Washington Post*, Apr. 21, 1989, at F3.

[7]Max Holland, "How to Kill a Company; Anatomy of a Leveraged Buyout," *The Washington Post*, Apr. 23, 1989, at C1.

[8]Predictably, those who disagreed as to whether junk bonds were a problem opposed any fix. *See, e.g.*, Thomas M. Humbert and John M. Olin Fellow, "Ten Myths About Leveraged Buyouts," *The Heritage Foundation*, Feb. 16, 1989.

[9]*See* Alan Murray, "Treasury Agency Backs Away From Plan for Use of Tax Code to Discourage LBOs," *The Wall Street Journal*, May 17, 1989.

[10]*Id.*

deductions for the crash, although more thoughtful studies pointed to other causes.[11] Two years later, so much evidence about the cause of the LBO bubble had accumulated that even another steep stock market decline (termed the ''Friday the 13th mini-crash'') did not deter legislative action.

In early 1989, Congress waded into the LBO waters, beginning with hearings hosted by both the Senate Finance and Ways and Means Committees.[12] In anticipation of the hearings, the Joint Committee on Taxation prepared a treatise on the tax aspects of corporate financial structures (the JCT report).[13] The JCT report surveys the buildup of leverage in the American economy in the 1980s and searches for its sources. First on the list are federal taxes: an LBO results in ''reduction in future corporate taxes arising from the increased amount of deductible interest'' in the target corporation. The JCT report quotes studies that provide mathematical evidence that the LBO buyout premiums are mostly the present value of future corporate tax savings. It also expresses grave concern about the fact that increased leverage also leads to increased instability in the corporate sector.

The JCT report offers a sumptuous menu of options to solve the LBO/leverage problem. These are worth reciting, just to be mystified at the narrowness of the approach Congress eventually took: (A) integrating the corporate and individual tax systems; (B) limiting the debt-equity distinction by limiting interest deductions: (1) generally, (2) specifically, where the corporate equity base is threatened, (3) specifically, for corporate acquisitions; (C) a combination of interest disallowance and dividend relief; and (D) other options, including (1) excise tax on acquisition indebtedness, (2) objective standards to distinguish debt and equity.[14]

Dumbstruck by the dazzling array of reform possibilities offered it, Congress's response to the 1980s economic crisis was to enact four narrowly targeted laws: (1) AHYDO[15]; (2) corporate equity reduction transactions (CERTs)[16]; (3) earnings-stripping[17]; and (4) Treasury authority under section 385(a) allowing designation of an instrument as part debt and part equity.[18]

One sub-sub-policy option offered in the JCT report was to ''disallow interest deductions in excess of a specified rate of return to investors.''[19] The report suggested the policy could be implemented by disallowing interest deductions on a debt instrument in excess of the rate of return on a risk-free investment, based on the theory that any interest payment above the risk-free rate of return is akin to a dividend distribution and should not be deductible. Presciently, the JCT report identifies two problems with this idea: First, finding the appropriate risk-free rate above which returns would be denied deductibility; second, a blanket rule for the deductibility of interest over a flat rate would penalize riskier business ventures as compared to their more stable brethren.[20]

Congress seized on this idea and applied it narrowly to the securities considered to be at the eye of the LBO storm — OID debt. But the House and Senate envisaged different solutions to the problem. The House bill treated high-yield OID securities as preferred stock, permanently disallowing all deductions on the instruments whether for OID or cash payments. The Senate bill preserved all interest deductions, but deferred them until paid out in cash.

The conference report describes an awkward detente. The AHYDO provision that came out of conference ''bifurcates the yield on applicable instruments, creating an interest element that is deductible when paid and a return on equity element for which no deduction is granted and for which the dividends received deduction may be allowed.''[21] The yield is bifurcated by reference to the applicable federal rate (AFR), a set of interest rates published by the IRS and reflecting the federal government's borrowing costs.

In the conference report, the conferees contrast the treatment of OID debt and equity in the tax law at that time. Discount on debt was deductible as interest even if no actual interest was paid until maturity. Distributions on stock, even if paid in cash on a regular basis, were not deductible (although a dividends received deduction was available in some circumstances). The conferees recognize that the determination of whether an instrument fits within the deductible debt or nondeductible equity camps is a ''facts and circumstances'' determination and that ''characteristics of debt include the following: a preference over, or lack of subordination to, other interests in the corporation, insulation from risk of the corporation's business; and an expectation of repayment.''[22] The conferees then announce, without further analysis, ''that a portion of the return on certain high-yield OID obligations is similar to a distribution of corporate earnings with respect to equity.''[23]

The AHYDO rules that resulted from the compromise between the House and Senate bills generally apply to debt instruments issued by corporations[24] with durations

[11]Jeffrey H. Birnbaum, ''Congressional Action on LBOs Slows to a Dragging Feat,'' *The Wall Street Journal*, Mar. 9, 1989. *See also* Humbert and Fellow, *supra* note 8 (explicitly blaming Congress for Black Monday and warning that similar legislation in 1989 risked the same result).

[12]The House Ways and Means Committee held hearings on ''Tax Policy Aspects of Mergers and Acquisitions,'' Jan. 31; Feb. 1, 2; and Mar. 14, 15, 1989. A second round of hearings on this topic occurred on May 16 and 17, 1989.

[13]JCT, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS-1-89), Jan. 19, 1989.

[14]*See* p. IV-VI of the JCT report, *id*.

[15]P.L. 101-239, section 7202.

[16]Now section 172(b)(1)(E), P.L. 101-239, section 7211.

[17]Now section 163(j), P.L. 101-239, section 7210.

[18]P.L. 101-239, section 7208.

[19]*See* the JCT report, *supra* note 13, at 104.

[20]*See id.* at 104-105.

[21]H.R. Conf. Rep. No. 101-386 at 553 (1989).

[22]*Id.* at 552.

[23]*Id.*

[24]The AHYDO rules can also apply to debt issued by a partnership to the extent attributable to corporate partners. *See* reg. section 1.701-2(f), Example 1.

greater than five years, that bear interest at a rate greater than or equal to the AFR plus 5 percent, and that have significant amounts of OID. If a taxpayer has issued an AHYDO, the total return on the instrument exceeding the AFR plus 6 percent is treated as a nondeductible dividend, and any remaining return is deferred until paid in cash.

How did Congress arrive at the 5 percent and 6 percent rates enshrined in the AHYDO rules? In 1989, borrowing rates for credit-worthy corporations had never diverged from Treasury rates by even as much as 4 percent,[25] so a rate greater than 5 percent over federal borrowing costs apparently looked to Congress to be an equity-type return.[26] From 1989 until late 2008, Congress' choice of AHYDO-triggering rates was appropriate, as the difference between borrowing rates for highly rated corporations and the federal government only exceeded 4 percent during the 2002-2003 period and in 2008, and, until September 2008, the difference always remained safely below 5 percent. However, in late 2008, the difference between the rates diverged dramatically. While Treasury rates continued a decline that had begun in mid-2007, corporate borrowing rates surged in September 2008, peaking two months later at a spread over Treasury yields just below 7 percent.[27] This spread remained above 6 percent into the second quarter of 2009 as Treasury rates remained unusually low.[28]

When the spread between corporate and federal government borrowing costs widened dramatically at the end of 2008, large numbers of debt securities came within the ambit of the AHYDO rules, even though they lacked the significant equity flavor that Congress intended to target. Because the rules are triggered by a crude and inflexible measure of equity-return — a yield that is a fixed percentage above the AFR — they were punishing a wide swath of all public debt issued during the financial crisis, rather than being limited to deterring the kinds of abuses that plagued the country in 1989.

### C. Future of AHYDO Rules

The AHYDO rules were enacted to respond to an economic crisis that had resulted partly from two tax arbitrages: between debt and equity, and between taxable and nontaxable entities. Instead of addressing the sources of the arbitrages, Congress developed a targeted rule to solve what it believed was the immediate cause of the problem, namely, the favorable treatment of certain high-yield debt. In the 20 years since the rules were enacted, changes in tax regulations and in the market for debt instruments have made it more likely for the AHYDO rules to apply to debt that Congress never intended to target. Congress moved commendably fast to temporarily abrogate the AHYDO rules during the 2008-2009 crisis. But the moratorium did nothing to solve the anomalies in the rule itself, and these anomalies will rear their heads when the rules come into operation again at the end of 2009.

Congress has given Treasury wide powers to prevent the AHYDO rules from applying in inappropriate circumstances. Before the legislative moratorium ends, Treasury should use those powers to do one or more of the following: (1) continue abrogation of the rules until the credit markets have normalized; (2) change the *formula* for determining when the AHYDO rules begin to be applicable, from a simple interest rate trigger to something more nuanced; and (3) reconsider when and how the AHYDO rules should be applied if an issuer amends its debt.

If Treasury fails to exercise its regulatory powers to relieve taxpayers from inappropriate application of the AHYDO rules, Congress should provide relief at least for the problem that causes the greatest trouble, namely debt that is amended but is treated by the law as if it were issued anew in exchange for the originally issued debt.

### D. Illustrative Example

A corporation (Borrower) enters into a binding financing commitment (Commitment) with an unrelated financial institution (Lender) in 2007. Under the terms of the Commitment, Lender agrees to provide $1 billion to Borrower in early 2008, and in exchange, Borrower agrees to issue debt instruments at an interest rate and terms agreed to in the Commitment. Lender intends to resell the debt instruments to investors either before or soon after they are issued.

The parties close the transaction on January 15, 2008. Lender provides $1 billion net cash to Borrower, and Borrower issues debt instruments to Lender with the following features:

*Maturity Date*: January 15, 2015;

*Principal Amount*: $1.05 billion, reflecting the cash proceeds of $1 billion and fees to Lender of $50 million. Of the $50 million in fees, $23 million reflects commitment fees, $1 million is for loan processing costs reimbursed to Lender, and there are $26 million of other fees;

*Interest Rate*: 6 percent per year, payable semiannually.

Lender placed Borrower's debt instruments with investors unrelated to Borrower (Investors) soon after issuance for $1.02 billion.

On December 15, 2008, Borrower and the subsequent holders amend the terms of the debt instrument. Investors agree to relax certain covenants in exchange for: (1) an increase in the stated interest rate to 7 percent per year; (2) Borrower's prepayment of $100 million in principal; and (3) an additional cash payment from Borrower of $10 million. On the date of the amendment, the debt

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[25]Based on a comparison of Moody's Seasoned BAA Corporate Bond Yield (series BAA, monthly) to Five-Year Treasury Constant Maturity Rate (series GS5, monthly) from the Federal Reserve Bank of St. Louis, Economic Research Division, *available at* http://research.stlouisfed.org/fred2.

[26]*See* H.R. Rep. 101-247 (1989) (explaining treatment of an instrument with a return greater than AFR + 5 percent like preferred stock because "the presence of a high return suggests that payment on the instrument depends on the profitability of the issuer's underlying business"). From 1989 until late 2008, the difference between these rates generally widened, but always remained safely below 5 percent.

[27]The Five-Year Treasury Constant Maturity Rate (series GS5, monthly) declined from 5.03 percent in June 2007 to 2.29 percent in November 2008. The Moody's Seasoned BAA Corporate Bond Yield (series BAA, monthly) rose over the same period from 6.7 percent in June 2007 to 9.21 percent in November 2008. *See* note 25 *supra*.

[28]Based on comparison of same data series. *See* note 25 *supra*.

instruments appear on a computerized quotation medium available to subscribing brokers at an average quote of 80 percent of outstanding principal.

## II. Operation of AHYDO Rules

### A. Original Issue Discount

The AHYDO rules deny an issuer deductions for some or all of the OID on applicable debt obligations. OID is the difference between a debt instrument's stated redemption price at maturity (SRPM) and issue price.[29] The SRPM is the sum of all payments that are not payments of qualified stated interest (QSI).[30] The issue price is determined in different ways, depending on various circumstances under which the loan was made, such as: (1) whether the obligation was issued for money or property, (2) whether the property it was issued for was publicly traded, or (3) whether the obligation itself was publicly traded.[31] While the issuer can control the payment schedule and SRPM of a debt instrument, the issue price may never be under the issuer's control, or can slip beyond the issuer's control after issuance, as will be discussed below.

**1. Issue price.** Of the many possible routes a taxpayer may have to travel to determine the issue price of its debt, three are of particular interest for us here:

1. The issue price of debt instruments that are part of an issuance *issued for money* is the first price at which a substantial amount of the instruments in the same issue is sold for money,[32] disregarding sales to certain persons acting as underwriters, placement agents, or wholesalers.[33]

2. The issue price of debt instruments that are part of an issuance *not issued for money but issued for property* in which a *substantial amount of the issuance is traded on an established market* is the fair market value of the instruments on the issue date.[34]

3. If a debt instrument issuance does not fall within (1) or (2), and a *substantial amount of the issuance is for property that is traded on an established market*, then the issue price of the instruments equals the FMV of that property on the issue date.[35]

If the issue price of a debt instrument cannot be found under the above rules, other rules govern, which are not directly relevant here.[36]

**a. Established market and fair market value.** Property (including a debt instrument) is considered traded on an established market (as the term is used in (2) and (3) above) in several circumstances, but most importantly, if at any time during the 60-day period ending 30 days after the issue date, the property:

- appears on a "quotation medium"; or
- is a debt instrument for which price quotes are readily available from dealers, brokers, or traders (subject to certain safe harbor exceptions).[37]

Property appears on a "quotation medium" if it appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine FMV by disseminating either (a) recent price quotations of one or more identified brokers, dealers, or traders; or (b) actual prices of recent sales transactions.[38]

The regulations require taxpayers to find the FMV of a debt instrument to determine its issue price in at least two circumstances, but no definition of FMV is provided. The two circumstances (discussed above) are when either the debt is traded on an established market, or it is issued in exchange for property that is traded on an established market. Instinctively, a tax adviser would assume that the information that helps conclude that debt is traded on an established market should also be used to determine the FMV of the debt. But nowhere in the regulations is this connection drawn. For example, if a price quotation for recently issued debt is found on a computer listing widely disseminated to subscribers, the debt could be considered traded on an established market. Then, one might assume, the price quotation found on the computer listing could (or should) be used to determine the issue price of the debt. Although the regulatory definition of "quotation medium" does hint to the connection, nothing more is suggested by the rules as to how taxpayers are to determine the fair market values of their debt issuances.

I would argue that the absence of a definition of FMV in the OID regulations is not a mere oversight. In the original rules that governed this area, reg. section 1.1232-3, FMV was indeed defined, by reference to the estate and gift valuation rules. When the regulations under section 1273 were finalized (replacing the section 1232 regulations), the cross reference was eliminated. Had Treasury or the IRS felt it necessary to define FMV, they would have either used the original cross reference or devised something new. Perhaps the government wished to leave the concept undefined, so as to allow it to adapt to changing marketplace practices and technologies for valuing securities. Alternatively, the government may have been looking for assistance from practitioners before issuing guidance in this fast-developing area.

In the absence of guidance, taxpayers searching for the issue price of their debt generally use the values found on "established markets" defined in the regulations. However, when trading in an asset is thin, the kinds of market data the regulations refer to are an unreliable gauge of value. During 2008, trading in corporate debt securities collapsed, as did market prices. Nevertheless, various electronic services listed bid prices for debt securities,

[29]Section 1273(a)(1).

[30]Section 1273(a)(2) and reg. section 1.1273-1(b).

[31]*See generally* reg. section 1.1273(b)(1)-(5); section 1273(c); and reg. section 1.1273-2(a)-(f).

[32]Reg. section 1.1273-2(a)(1).

[33]Reg. section 1.1273-2(e). *See also* the section on the underwriting rule, *infra*.

[34]Reg. section 1.1273-2(b)(1).

[35]Reg. section 1.1273-2(c)(1).

[36]*See* section 1274(a) and (c), reg. sections 1.1274-1 and 1.1273-2(d)(1).

[37]For these and the other circumstances, see reg. section 1.1273-2(f)(1)-(5).

[38]Reg. section 1.1273-2(f)(4).

even though few (if any) actual trades were being consummated. Taxpayers using this unreliable market data to value debt instruments was a second reason (along with the divergence between corporate and federal borrowing rates) why a large proportion of debt instruments began triggering the AHYDO rules last year.

However, even under noncrisis conditions, the breadth of the definition of ''traded on an established market'' causes issuers practical problems. For example, because a debt instrument can meet the ''traded on an established market'' test any time within 30 days of its issue date, its issue price could remain uncertain for up to a month after it is issued. Further, issuers do not necessarily have any control over whether their debt instruments become publicly traded if initial holders seek to resell them, or third parties seek to buy them, after the instruments are out of the issuer's control. If the potential for resale or purchase activity leads a broker to post a price quote on a ''quotation medium'' too soon after the issue date, the securities are treated as traded on an established market. Moreover, issuers will not always know whether or when those quotes appear on a quotation medium or become available from brokers, which could make the rules virtually impossible to comply with.

Given the many difficulties in finding a market-based issue price for many debt instruments, one wonders why the government did not encourage greater use of an alternative system, for example, that found in section 1274. Section 1274 generally applies to debt instruments with a duration greater than six months that are issued in consideration for the sale or exchange of property unless the instrument provides for adequate stated interest and no OID, or if certain exceptions apply.[39] If section 1274 governs an instrument, the issue price generally equals either the stated principal amount or an imputed principal amount depending on whether the instrument calls for adequate stated interest.[40] If neither section 1274 nor any of the other rules fit the facts of the debt issuance, the issue price equals the instrument's SRPM.[41] Anecdotally, the government has expressed nervousness that these catchall rules governing issue price are susceptible to manipulation by issuers, and because values found on established markets are less open to abuse, the law forces taxpayers to use market values in most circumstances.

Recognizing that the government may not be comfortable with the definitions of issue price found in section 1274 or reg. section 1.1273-2(d)(1), we are still left with the problem of defining issue price in cases involving publicly traded property. Inspiration can be found elsewhere in the tax law. For example, reg. section 1.1275-1(h) defines a debt instrument as ''publicly offered'' if it is part of an issue of debt instruments the initial offering of which was either registered with the SEC, or would have been required to be registered but for certain exemptions from registration.[42] Issuers know whether they registered a debt offering with the SEC, or whether they qualified for a specific exemption from registration. Further, because the definition of ''publicly offered'' debt instruments looks to the initial issuance, whether an instrument meets that definition is fixed on its issue date. Unlike the definition of ''publicly traded'' property, this definition looks only to an instrument's issue date and relies on criteria that the issuer controls and has full knowledge of.

In conclusion, the rules governing the issue price of a debt instrument not issued for money often turn on whether the instrument, or the property for which it is issued, is traded on an established market. If such trading exists, the issue price is the FMV of the instrument. This term is not defined but is assumed to equal the values found on the established market on which the debt, or the property, is traded. This leads to anomalous results, and so Treasury and the IRS might consider providing guidance on the meaning of FMV, to ensure that a taxpayer has access to the necessary information, within a reasonable time frame around the issuance of its debt.

**b. Underwriting rule.** The issue price of a debt instrument issued for money is generally the first price at which a substantial amount of the instrument is sold.[43] However, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesales are ignored.[44] When these intermediaries are involved in the distribution of the debt instrument, the issue price depends on the first price at which they resold the instrument (the underwriting rule).

In this context, underwriters generally act either as principals in ''firm-commitment'' underwritings, or as agents in ''best efforts'' underwritings.

When an underwriter acts as principal, it buys securities from an issuer and resells them in the open market, earning a profit (or risking a loss) equal to the difference between the prices at which it bought the securities from the issuer and resold them to investors (''firm commitment'' underwriting). In contrast, when an underwriter acts as agent for the issuer, it earns a fee for securities that it sells, but is not obligated to pay for any securities that are not sold (''best efforts'' underwriting).

Regulations in other contexts reflect this understanding of the underwriting function. For example, reg. section 1.351-1(a)(3) defines a ''qualified underwriting transaction'' for purposes of section 351 as ''a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.'' This definition reflects both types of underwriting functions. Reg. section 1.721-1(c) provides a rule similar to reg. section 1.351-1(a)(3) in the context of partnership interests. The preamble to the notice of proposed rulemaking that introduced the partnership rules states that the treatment of underwriters for those purposes is intended to be similar to their treatment

[39] *See* section 1274(c) and reg. section 1.1274-1.
[40] Section 1274(a).
[41] Reg. section 1.1273-2(d)(1).
[42] Reg. section 1.1275-1(h).
[43] Reg. section 1.1273-2(a)(1).
[44] Reg. section 1.1273-2(e).

under the underwriting rule of reg. section 1.1273-2(e).[45] It therefore appears that Treasury understands the underwriting rule to encompass both principal and agent types of underwriting.

The underwriting rule appears to have been written so that the issue price of a debt instrument is calculated irrespective of the commissions charged by an underwriter for its services in placing the instrument; the tax law is trying to find the ''retail'' rather than the ''wholesale'' price for an instrument. The government may also have been concerned that, without the underwriting rule, an issuer could collude with its underwriters to manipulate the issue price of an instrument.

In the case of a borrowing under a financing commitment, it is unclear how, and whether, the underwriting rule would apply. Such a transaction resembles a bank loan, in which the lender advances money to the borrower, and the borrower agrees to repay the lender. However, parties often enter into transactions under financing commitments expecting the lender to quickly resell the newly issued debt securities rather than keep the instruments on its own books, or they may structure the terms to include a ''discount'' or other fee intended to serve as the lender's compensation (rather than expecting the interest payable on the debt to serve as the lender's main compensation). Some commentators have argued that these facts are consistent with viewing the lender's role in such a transaction as that of an underwriter, placement agent, or wholesaler.[46] The analysis can be further complicated if the lender enters into the transaction with the intention to immediately resell the debt, but has difficulty doing so.[47] Neither the underwriting rule itself nor the policies that appear to justify it provide guidance in this case.

Even when the underwriting rule applies in theory, it can be difficult or impossible to apply it in practice. This is particularly true when, in a firm-commitment underwriting, the underwriter refuses to tell the issuer what price the debt instruments ultimately sold for. Without access to this information, an issuer simply cannot know what the issue price for its instrument is.

If the underwriting rule does not (or, for practical reasons, cannot) apply, the parties are left with the daunting task of characterizing the various fees and charges that constitute what may otherwise have been the lender's underwriting discount. For a debt instrument that is issued for money and that is not publicly offered, a cash payment from the borrower to the lender will generally reduce the issue price.[48] However, payments for property or for services provided by the lender, such as commitment fees or loan processing costs, do not reduce the issue price, but are generally deductible as debt issuance costs.[49]

**2. Applying issue price rules to example.** Borrower issued the original debt instruments (Original DI) in January for cash. Therefore, the issue price of Original DI is the first price at which a substantial amount of the issue was sold. However, because it is not clear when the underwriting rule should apply, it is not clear which sale determines Original DI's issue price.

Lender bought Original DI with the intention of immediately placing the instruments with investors, and quickly did so. Therefore, it can be argued that Lender acted in the capacity of an underwriter in a firm-commitment underwriting and Borrower's sale to Lender should therefore be disregarded under the underwriting rule of reg. section 1.1273-2(e). Instead, applying the underwriting rule, the issue price of Original DI should be determined with reference to the price at which Lender sold the instrument to investors, or $1.02 billion. Original DI would therefore have OID equal to the difference between its SRPM of $1.05 billion and its issue price of $1.02 billion, or $30 million.

However, the transaction could also be viewed as a private lending transaction to which the underwriting rule does not apply. The first price at which a substantial amount of Original DI was sold would be $1.05 billion — the price for which Borrower issued Original DI to Lender at closing. If Original DI is treated as issued in a private lending transaction, then the cash payments Borrower made to Lender incident to that transaction must be accounted for according to reg. section 1.1273-2(g)(2). Under that rule, such payments generally reduce the issue price of Original DI, unless they are payments for property or services provided by the lender.

In our example, Borrower paid Lender $23 million as a commitment fee, reimbursed Lender for $1 million in loan processing costs, and paid $26 million in other fees. Commitment fees and loan processing costs are payments for property or services provided by Lender, so they do not reduce the issue price. Therefore, the issue price of Original DI equals $1.05 billion less the remaining $26 million in other fees, or $1.024 billion. Original DI has OID equal to the difference between its SRPM of $1.05 billion and its issue price of $1.024 billion, or $26 million.

Whether or not the underwriting rule is applied leads to a difference in issue price of $4 million in our example. However, if Lender had resold Original DI for a lower price, the difference would be much greater. Therefore, it would be useful for Treasury to clarify the scope of the underwriting rule. For purposes of this example, we

[45]CO-24-95.

[46]*See, e.g.*, Morgan, *supra* note 2.

[47]To address this complication, David Garlock argues for a rule treating debt instruments retained by a bond house, broker, etc., for 30 days or more as having been purchased to hold, regardless of the original intention. Such a rule, however, does not exist. David Garlock, *Federal Income Taxation of Debt Instruments*, para. 203.01, n. 40 (5th ed. 2005).

[48]*See* reg. section 1.1273-2(g).

[49]Reg. section 1.1273-2(g)(2)(i). Payments from borrower to lender for property or for services provided by the lender, such as commitment fees or loan processing costs, are exempted from the general rule that cash payments from the borrower to the lender in a transaction to which section 1273(b)(2) applies reduce the issue price of the debt instrument evidencing the loan.

assume that the underwriting rule does apply when Lender acted as an underwriter in a firm commitment underwriting.

In December, Borrower and Investors agreed to amend Original DI to (among other changes) increase the stated interest rate by 1 percent per year and force a $100 million prepayment. Together, the amendments amounted to a significant modification within the meaning of reg. section 1.1001-3.[50] Original DI is therefore treated as if it were exchanged for newly issued debt instruments (Amended DI) together with any additional compensation exchanged in the transaction.[51]

Amended DI is deemed to be issued for property, namely Original DI. Because the debt instruments appeared on a quotation medium at the time of the amendment, Amended DI was publicly traded. Therefore, the issue price of Amended DI is its fair market value as of the issue date.

The average price quote for the debt instruments as of the issue date was 80 percent of outstanding principal. Borrower repaid $100 million in principal in connection with the Amendment, and so the outstanding principal amount of Amended DI was $950 million ($1.05 billion - $100 million), and its FMV was $760 million (80 percent of $950 million). Therefore, the issue price of Amended DI is $760 million. Amended DI has OID equal to the difference between its SRPM of $950 million and its issue price of $760 million, or $190 million.

### B. Cancellation of Indebtedness Income

**1. Discussion.** An issuer recognizes cancellation of indebtedness (COD) income on the repurchase of a debt instrument for an amount less than its adjusted issue price.[52] A significant modification of a debt instrument is treated as an exchange of the original debt instrument for a new debt instrument.[53] If a debtor satisfies a debt obligation by issuing a new debt instrument, then the debtor is treated as satisfying the old debt with a payment equal to the issue price of the new debt.[54]

If an issuer and holder modify a debt instrument in a manner considered ''significant,'' then the issuer is treated as repurchasing the original debt instrument for consideration in the amount of the issue price of the amended debt instrument (plus any other consideration exchanged in the transaction). As discussed above, the issue price of the original debt may vary widely from the issue price of the amended debt based on market conditions, and both may differ significantly from the face amount of the instrument. Also, reg. section 1.1001-3 has a low threshold for determining significance and does not distinguish between an increase or decrease in the borrower's burden.[55]

**2. Applying COD rules to example.** Borrower and Lender agreed to amend Original DI. This amendment was a significant modification within the meaning of reg. section 1.1001-3(e) and therefore is treated as an exchange of Original DI for a new instrument, Amended DI, under reg. section 1.1001-3(b). Under section 108(e)(10), Borrower is deemed to have satisfied Original DI for an amount of money equal to the issue price of Amended DI plus additional consideration of $10 million in cash. Under reg. section 1.61-12(c)(2)(ii), Borrower must recognize COD income equal to the difference between the adjusted issue price of Original DI and the sum of the issue price of Amended DI and $10 million.

The issue price of Original DI is adjusted for OID accruals and Borrower's $100 million principal payment to calculate Original DI's adjusted issue price of $923.5 million. Because Amended DI's issue price is $760 million, Borrower recognizes COD income on the Amendment Date in an amount equal to:

$$\$923.5 \text{ million} - (\$760 \text{ million} + \$10 \text{ million}) = \$153.5 \text{ million}.$$

Borrower recognizes $153.5 million in income from its amendment of Original DI even though, by most measures, its debt burden increased: the interest rate increased, while none of the principal was forgiven, the term of the debt was not extended, and Borrower remains obligated to pay interest semiannually. This counterintuitive result is due to (1) the difference in how the tax law determines the issue prices of Original DI and Amended DI, and (2) the change in market conditions between the issue dates of the two instruments.

In the absence of the AHYDO rules, Borrower's $153.5 million in COD income would be offset by an increase in OID deductions in the same amount. In that scenario, although Borrower might be faced with an unfavorable timing difference, it ultimately would recapture the entire amount of COD. However, to the extent that the AHYDO rules prevent Borrower from deducting OID (as will be discussed below), Borrower can never recapture the COD income it must recognize from amending its debt.

### C. AHYDO Defined

**1. Discussion.** A debt obligation is subject to the AHYDO rules if it (1) was issued by a corporation, and has (2) a term greater than five years, (3) a yield equal to or greater than the AFR plus 5 percent, and (4) ''significant original issue discount.''[56] An obligation has significant original discount if:

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[50]Reg. section 1.1001-3 has been given substantial airing by esteemed lawyers. I refer you to their accounts rather than recite the rules again here. *See, e.g.*, Ginny Y. Chung, ''Taxing Times Ahead: The Impact of the Cottage Savings Regulations on Debtors and Creditors in Workouts,'' 12 *Bank. Dev. J.* 245 (1995); Lorence L. Bravenec and David N. Hurtt, ''Modifications of Debt Instruments as Taxable Exchanges,'' 75 *Taxes* 369 (July 1997); Richard M. Lipton, ''The Section 1001 Debt Modification Regulations: Problems and Opportunities,'' 85 *Journal of Taxation* 216, 216-229 (Oct. 1996).

[51]Reg. section 1.1001-3(b).

[52]Reg. section 1.61-12(c)(2)(ii).

[53]Reg. section 1.1001-3(b).

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

[55]*See* reg. section 1.1001-3(e) (describing test for identifying a ''significant'' modification of a debt instrument).

[56]Section 163(i)(1) (defining applicable high-yield discount obligation).

A. the aggregate amount which would be includable in gross income with respect to such instrument for periods before the close of any accrual period . . . ending after the date five years after the date of issue, exceeds —

B. the sum of —

i. the aggregate amount of interest to be paid under the instrument before the close of such accrual period; and

ii. the product of the issue price of such instrument . . . and its yield to maturity.[57]

**Part (A):** Part (A) of the definition of significant OID requires that a test be performed with regard to any accrual period ending after the fifth anniversary of the issue date of the obligation (the test period). A debt obligation has significant OID if the ''aggregate amount'' includable in the gross income of the holder of the obligation from the time that the obligation was issued through the end of the test period is greater than the amount calculated in Part (B). The aggregate amount includable in the gross income of a holder of a debt generally consists of (x) payments of QSI, and (y) OID. The aggregate amount can thus be expressed as the sum of all payments of QSI made, and all amounts of OID accrued, through the end of the test period.[58]

**Part (B):** Part (B) of the test for significant OID calls for adding (i) the amounts of all of the interest payments due under the terms of the obligation from the issue date through the end of the test period, to (ii) the product of the obligation's issue price and yield to maturity.

If the Part (A) amount exceeds the Part (B) amount, then the debt instrument has significant OID. If the other three tests are also satisfied, then the instrument is an AHYDO.

**2. Applying AHYDO definition to example.** A debt instrument is an AHYDO if it:

- is issued by a corporation;
- has a term greater than five years;
- has a yield at least 5 percent greater than the AFR; and
- has significant OID.

Both Original DI and Amended DI meet the first two criteria because Borrower is a corporation and both debt instruments have terms exceeding five years.

The yield of each instrument is a calculated value based on its issue price and scheduled payments, and equals 6.51 percent for Original DI and 11.74 percent for Amended DI. The AFR applicable to Original DI is 3.55 percent, and for Amended DI is 2.83 percent.[59] Because the yield on Original DI does not exceed its threshold amount (AFR of 3.55 percent + 5 percent spread = 8.55 percent), Original DI is not an AHYDO. However, because of its depressed issue price, Amended DI carries a yield far above its threshold amount of 7.83 percent (AFR of 2.83 percent + 5 percent spread = 7.83 percent).

Amended DI breaches the threshold yield solely because its market value, as measured by the issue price rules, was depressed on its issue date. This market value, however, reflected a dramatic drop in the demand for corporate debt instruments generally at that time. To avoid breaching this threshold, Amended DI's issue price would have had to reflect a market value of more than 96 percent of its outstanding principal amount. This would have been implausible at the time the debt was amended; many bonds of solvent companies were trading at much lower values in the third and fourth quarters of 2008, including Macy's 7 percent bonds which traded at 74 cents on the dollar, Home Depot 5.875 percent bonds at 54 cents, and Clear Channel Communications 7.25 percent bonds at 27 cents.[60] Also, although plummeting demand for corporate debt had driven corporate yields *higher*, the threshold yield used for the AHYDO test *fell* because federal borrowing rates dropped over the same period.

Amended DI's low issue price not only causes it to breach the threshold yield, but also creates ''significant OID.'' Amended DI will have significant OID if the sum of all interest payments made and OID accrued from its issue date through the close of any accrual period ending more than five years later (the Part (A) Amount) exceeds the amount of interest paid over that same period plus Amended DI's issue price multiplied by its yield to maturity (the Part (B) Amount). Because Amended DI has a term of six years and accrues interest semiannually, it has 12 accrual periods. Of those, periods 11 and 12 each end after the fifth anniversary of Amended DI's issue date. The Part (A) Amount and Part (B) Amount for each of these periods is:

| Accrual Period | Part (A) Amount | Part (B) Amount |
|---|---|---|
| 11 | $482.8 million | $394.0 million |
| 12 | $532.0 million | $422.5 million |

[57]Section 163(i)(2) (defining significant original issue discount).

[58]Although the statutory language is unclear on the point, commentators generally agree that the calculations should include amounts paid or accrued as of the close of the test period. *See, e.g.*, Garlock, *supra* note 47, at para. 601.08; Jack S. Levin and Patrick C. Gallagher, ''New Code Section 163(e)(5) Limiting Deductibility of Interest on OID and PIK Debentures,'' *Tax Notes*, Jan. 29, 1990, p. 555, at 567.

[59]These values represent the midterm, semiannual rate in effect in January 2008 as published in Rev. Rul. 2008-4, 2008-3 IRB 272, *Doc 2007-27737, 2007 TNT 245-15*, in the case of Original DI and December 2008 as published in Rev. Rul. 2008-53, 2008-49 IRB 1231, *Doc 2008-24432, 2008 TNT 224-7*, in the case of Amended DI.

[60]Todd F. Maynes, *Distressed Debt in Disorderly and Dysfunctional Markets*, Presentation at the 61st Annual University of Chicago Tax Conference (Nov. 7, 2008); *see also* Todd F. Maynes and Thad Davis, ''Distressed Debt in Disorderly and Dysfunctional Markets,'' 87 *Taxes* 55, 55-74 (Mar. 2009).

The Part (A) Amount exceeds the Part (B) Amount in each of these accrual periods. Because this test is satisfied for at least one accrual period, Amended DI has significant OID.

Thus, Amended DI fits the definition of an AHYDO, while Original DI does not. This is true even though Borrower decreased the amount of its borrowing by prepaying $100 million in principal, increased the amount of current interest payments from 6 percent to 7 percent of outstanding principal, and left the duration of the borrowing unchanged. Examining Amended DI in the light of the policy enunciated in the legislative history to the AHYDO rules, Amended DI's terms did not acquire any more equity flavor than those of Original DI. As between Original DI and Amended DI in the facts we have described, there is no change in preference over, or lack of subordination to, other interests in the corporation, reduced insulation from risk of the corporation's business, or reduced expectation of repayment. As for the yield test, the major determining factor in the significant OID test is Amended DI's depressed issue price.

### D. Implementation of AHDYO Rules

**1. Discussion.** The AHYDO rules state that, with respect to an AHYDO issued by a corporation:

- no deduction shall be allowed . . . for the disqualified portion of the OID; and
- the remainder of such OID shall not be allowable as a deduction until paid.[61]

This rule, therefore, disallows a portion (the "disqualified portion") of the total OID on an AHYDO, and defer any remaining deductible portion (the "remainder") until paid. In the absence of this rule, OID is deductible as it accrues according to specific allocation rules, regardless of when cash payments are made. Therefore, the above rule affects both the amount of OID a borrower may deduct, as well as the timing of the deduction.

The disqualified portion of the OID is defined as the lesser of:

I. the amount of such OID; and

II. the portion of the "total return" on such obligation which bears the same ratio to such total return as the "disqualified yield" on such obligation bears to the yield to maturity (YTM) on such obligation.[62]

The calculation in subpart (II) (the Part (II) Calculation) can be expressed mathematically as:

**Part (II) amount = total return x (disqualified yield / YTM)**

Total return is defined as the amount which would have been the OID on the obligation if QSI were included in the SRPM,[63] and disqualified yield means the excess of the YTM on the obligation over the sum of the AFR + 6 percent.[64] Therefore, these amounts can be expressed as:

**Total return = OID + QSI**

**Disqualified yield = YTM - (AFR + 6 percent)**

The disqualified portion is an amount calculated with respect to the total return on an AHYDO, subject to a maximum amount of disallowance equal to the total OID on the obligation. Because the amount of disallowance is calculated by disallowing a portion of *total return* proportionate to the amount of yield that is deemed to be excessive (that is, the disqualified yield), it is possible for this calculation (the Part (II) Calculation) to result (the Part (II) Amount) in an amount that is *greater than the total OID on the obligation*, even when the amount of yield that is disqualified is less than 100 percent of the total yield on the obligation. However, the ceiling on the amount of the disallowance provided by Part (I) ensures that the AHYDO rules will never disallow deductions for payments of QSI.

The portion of OID on an AHYDO that remains deductible is only deductible when paid.[65] Therefore, to calculate the OID deduction allowed to the borrower in any year, the borrower must determine (1) the amount of deductible OID that has accrued up to that point, and (2) how much of that deductible OID it has paid. If the borrower makes payments over the life of the instrument other than payments of QSI, it becomes necessary to allocate the deductible amount among the various payment periods of the instrument.

In general, payments under debt instruments (other than payments of QSI, which are respected as such) are attributed first to accrued and as-yet undeducted OID, and next to principal.[66] Therefore, in general, a borrower pays OID when and to the extent that the borrower makes any payments under the instrument that are not attributable to QSI, as long as some amount of OID has accrued and remains undeducted at the time of the payment.

The precise interaction among the general OID accrual, payment ordering, and AHYDO rules is unclear, but some guidance is available from the legislative history. In particular, the relevant conference agreement[67] contains examples illustrating the apportionment of paid OID into the nondeductible disqualified portion and deductible remainder. That conference agreement also states that if the YTM on an AHYDO exceeds the AFR plus 6 percentage points, then the disqualified portion is the entire amount of the OID.[68]

In general, the portion of a payment of OID attributable to the deductible remainder equals:

**Amount of OID payment x 100 percent - (Disqualified Yield / Yield)**

However, this is true only until the total amount of the remainder for the instrument has been deducted. After that, no more deduction is allowed for OID.

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[61]Section 163(e)(5)(A).
[62]Section 163(e)(5)(C)(i).
[63]Section 163(e)(5)(C)(ii).
[64]*Id.* Note that this is similar but not identical to the sum used in Part (2) of the definition of an AHYDO, the AFR + 5 percent.
[65]Section 163(e)(5)(A)(ii).
[66]Reg. section 1.1275-2(a) (the payment ordering rule).
[67]House Conf. Rep. No. 101-386 at p. 554-555.
[68]*Id.* at p. 554.

**2. Applying AHYDO rules to example.** In our example, Amended DI has total OID of $190 million (the difference between its SRPM of $950 million and its issue price of $760 million), a stated interest rate of 7 percent payable semiannually, and a yield (calculated from its issue price and payment schedule) of 11.74 percent. The AFR that applies to Amended DI is 2.83 percent.

The ''disqualified portion'' (the nondeductible portion of the OID on Amended DI) is equal to the lesser of (I) the total OID, and (II) the total return multiplied by the disqualified yield. The total return on the instrument is equal to:

Total OID + QSI

$190 million + $399 million = $589 million

Amended DI has disqualified yield equal to:

Yield - (AFR + 6 percent)

11.74 percent - (3.83 percent + 6 percent) = 2.91 percent

The disqualified yield represents 24.77 percent of the total yield:

Disqualified Yield / Total Yield

2.91 percent / 11.74 percent = 24.77 percent

Therefore, the disqualified portion is the lesser of (I) $190 million, and (II) $589 million x 24.77 percent. $589 million x 24.77 percent = $145.9 million. Because this amount is less than the total amount of OID on the instrument, the disqualified portion for Amended DI is $145.9 million.

The remainder (the portion of OID on Amended DI that is deductible when paid) is equal to:

Total OID - Disqualified Portion

$190 million - $145.9 million = $44.1 million

Because Amended DI does not call for any payments before maturity other than payments of QSI, all of the deductible remainder is paid at maturity. Therefore, it is not necessary to allocate the remainder among the various payment periods.

The application of the AHYDO rules to Amended DI yields surprising results. One of the surprises is that the portion of OID that is made permanently nondeductible by the AHYDO rules is 77 percent of the total $190 million, even though the disqualified yield represents less than a quarter of the total yield. This is because the AHYDO rules work by disallowing a portion of the *total return* on the obligation (rather than a portion of the OID) subject to a cap equal to the amount of OID.

A second surprise is how the AHYDO rules alter the expected relationship between the COD income Borrower recognized on the exchange and Borrower's OID deductions. Borrower recognized $153.5 million in COD income on its deemed exchange of Original DI for Amended DI and $10 million cash, and total OID on Amended DI increased over the amount of OID on Original DI by the same amount ($153.5 million). If all the OID on Amended DI were ultimately deductible, Borrower would eventually recapture the full $153.5 million of COD income it realized on the exchange through a total increase in OID deductions over the remaining term of the borrowing of $153.5 million. However, because of the AHYDO rules, Borrower is prevented from deducting $145.9 million of the OID on Amended DI. Therefore, in this example, *Borrower is prevented from recapturing 95 percent of the COD income it must recognize on the exchange*.

## III. Emergency Relief

### A. Rev. Proc. 2008-51

**1. History of revenue procedure.** In early 2008, representatives of private equity funds (PE Funds) approached Treasury with a problem raised by changing credit conditions at that time. In the fall of 2007, PE Funds had negotiated financing commitments with banks that would allow them to complete contemplated leveraged buyouts. Historically, these commitments were extended but not called on by the PE Funds, because when funds were needed, cheaper financing could be found elsewhere. But in 2008, PE Funds were in fact calling on their commitments because credit was scarce, and negotiations over the terms of the financing resulting from the financing commitments became fraught. Lenders who had made the commitments in 2007 did not seriously consider that they would be called on to extend credit and, in 2008, were having much greater trouble selling the loans resulting from the commitments than they would normally have. To the extent that their contracts allowed them to, lenders were demanding that borrowers agree to change the terms of their loans so that the lenders could sell the loans in the secondary markets. These circumstances raised the specter of COD and AHYDO for borrowers.

Treasury and the IRS were sympathetic with the scenarios described by the taxpayer representatives and published Rev. Proc. 2008-51 in response to their problems.[69]

Consistent with its provenance, the revenue procedure focuses on debt issued under financing commitments,[70] agreements that ''ensure that [a] corporation will have sufficient debt financing at a future date, within certain parameters (for example, the total amount to be borrowed, an interest rate not to exceed a certain level, and the term of the loan).'' The revenue procedure then describes two possible outcomes of a financing commitment: (1) the borrower obtains funds on a long-term basis (permanent funding) under the terms of the financing commitment, or (2) the borrower obtains funds for a short period (''temporary'' funding) after which the loan is extended on a long-term basis (permanent funding).

The revenue procedure notes that when economic conditions deteriorate between the time a financing commitment is negotiated and when funds are extended, tax problems may arise. Two specific problems are described. In the first, if a lender is only able to sell the loan made under the financing commitment for an amount much less than the money provided to the borrower, the issue

[69]Rev. Proc. 2008-51, 2008-15 IRB 562, *Doc 2008-17402, 2008 TNT 155-10*.

[70]This part of the discussion is based on Section 2. Background of the revenue procedure.

price of the loan may be significantly less than the cash received. In the second, parties that renegotiate the terms of the permanent financing during the temporary financing period to make the permanent loan more salable by the lender, may find that changes in the loan terms trigger a sale of the old loan for the new.

The revenue procedure addresses a possible problem raised by the facts it describes, namely, that the interest deductions on the renegotiated debt may be substantially denied under the AHYDO rules.

**2. Operation of revenue procedure.** The substantive part of the revenue procedure permanently turns off the AHYDO rules for certain debt instruments.[71] This relief generally applies to corporate debt instruments issued for money under the terms of a binding financing commitment, and debt instruments issued in up to two exchanges of those instruments (including exchanges deemed to occur because of a modification).

**a. Original instrument.** The first type of instrument to which the revenue procedure applies is a debt instrument issued in an original issuance (Original Instrument) that is:

1. issued by a corporation;

2. for money;

3. the terms of which are generally consistent with the terms of a financing commitment where:

   a. the terms of such financing commitment are binding on the parties;

   b. the financing commitment was obtained from a party unrelated to the issuer;

   c. the financing commitment was obtained before January 1, 2009; and

4. the debt instrument would not be an AHYDO if its issue price were the net cash proceeds actually received by the corporation for the debt instrument (instead of any market-based issue price that otherwise applies to the instrument).[72]

**b. Secondary instrument.** The second type of instrument to which the revenue procedure (Secondary Instrument) applies is issued:

1. in exchange for an instrument —

   a. issued by the same corporation; and

   b. meets the definition of an Original Instrument;

2. within 15 months following the issuance of the Original Instrument; and

3. such that the Secondary Instrument would not be an AHYDO if the AHYDO test were applied to it using an issue price equal to the net cash proceeds actually received by the corporation for the Original Instrument.

**c. Tertiary instrument.** The third type of instrument to which the revenue procedure (Tertiary Instrument) applies is issued:

1. in exchange for an instrument —

   a. issued by the same corporation; and

   b. meets the definition of a Secondary Instrument;

2. within 15 months following the issuance of an Original Instrument; and

3. such that the Tertiary Instrument would not be an AHYDO if the AHYDO test were applied to it using an issue price equal to the net cash proceeds actually received by the corporation for the Original Instrument.

For example, if a corporation issued a debt instrument for money under a financing commitment and then performed two modifications that are treated as debt-for-debt exchanges, the first modification would be a direct exchange eligible for relief as a Secondary Instrument, and the second modification would be an indirect exchange eligible for relief as a Tertiary Instrument (if, in each case, the other requirements are met). However, if the corporation issued a further instrument in a third debt-for-debt exchange, that instrument would not be eligible for relief.

Finally, additional requirements apply to debt instruments issued in exchanges taking place after August 8, 2008. For this relief to apply, there must not be an increase in maturity date greater than one year over that of the Original Instrument, and no increase at all in the SRPM.

**3. Unanswered questions in revenue procedure.** The revenue procedure is as interesting for the questions it does not address as for those it does. In each case of debt modification described by the revenue procedure, there would likely be COD income generated. No doubt Treasury felt it did not have authority to relieve taxpayers of that burden, and so the guidance is silent on COD. By abrogating the operation of the AHYDO rules, the revenue procedure does eliminate, for most taxpayers, the permanent ill effects of the interaction between the COD and AHYDO rules. As long as a taxpayer can deduct OID throughout the life of its debt, COD income recognition can be reversed over time.

A second question raised by the facts in the revenue procedure is the treatment of the difference in cash received by the borrower and the amount the lender is able to sell the debt for in the secondary markets. For example, if a borrower received $100 cash under a commitment made earlier by a lender, but because of economic conditions, the lender can only sell the loan to third parties for $60, the question is how the borrower should treat the $40.

If, in the above example, the borrower concludes that the FMV of its debt is $60, then it has OID deductions of $40. If, in addition, the conditions of the borrowing are such that the revenue procedure ensures the AHYDO rules do not limit the OID deductions, it appears that a large tax benefit has been conferred on the borrower with no corresponding cost.

The New York State Bar Association report on Rev. Proc. 2008-51 claims that it is not clear that a borrower

[71]This part of the discussion is based on Section 4. Scope and Section 5. Application of the revenue procedure.

[72]The author has enumerated the requirements of the revenue procedure to clarify them.

should treat the difference between the cash it received and the issue price of the debt as income,[73] but Treasury officials have rejected this conclusion orally in public forums. Under one theory, the difference between cash received by the borrower and the ultimate issue price on the debt instrument (determined by the market) is current, unencumbered accretion to wealth and must be recognized immediately. Under another theory, the difference is attributable to an anticipatory hedging transaction — the financing commitment — and the benefit of the hedge must be taken into account over the life of the loan.

The hedge timing theory is novel. One of the types of transactions defined as a hedging transaction in section 1221(b)(2)(A) and reg. section 1.1221-2(b) is a transaction that a taxpayer enters into in the normal course of its trade or business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Under reg. section 1.446-4, hedges of debt instruments that meet the above definition must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates.[74] The example provided in the regulation is of a transaction that hedges the whole term of an anticipated fixed rate borrowing; gain or loss generated by the hedge is treated as if it decreased or increased the issue price of the debt instrument.

Although hedging transactions are required to be identified by taxpayers for both character[75] and timing[76] purposes, a recent revenue ruling interprets the statute and regulations to mean that a transaction that meets the statutory definition must be accounted for as a hedging transaction even without proper identification.[77]

Treating the difference between what the borrower received from the lender under the financing commitment and what the lender sold the debt for as a hedging gain, as Treasury officials have suggested, is interesting, but not entirely persuasive. Even if no hedge identification of the initial commitment is necessary, it is not clear that such commitments are entered into *primarily* to manage risk of interest rate or price changes or currency fluctuations of the anticipated loan. The primary purpose of a financing commitment is to ensure access to cash when the borrower needs it. In 2008, the promise embodied in a financing commitment was not equivalent to an interest rate hedge.

Irrespective of the persuasiveness of the oral opinions expressed by Treasury officials on this matter, if the government has a view on the appropriate treatment of the difference between issue price and cash received in a debt entered into under a financing commitment, it should publish guidance and give taxpayers an opportunity to comment.

**4. Application of revenue procedure to example.** Amended DI is issued in direct exchange for Original DI. Therefore, Amended DI must be issued in exchange for an Original Instrument under Rev. Proc. 2008-51.

1. Amended DI was deemed to be issued in exchange for Original DI by operation of reg. section 1.1001-3:

a. Original DI was issued by the same issuer as Amended DI;

b. Original DI is described as an Original Instrument in Rev. Proc. 2008-51:

i. Original DI was issued by Borrower, a corporation;

ii. Original DI was issued for money;

iii. the terms of Original DI were generally consistent with the terms of a financing commitment that was:

1) binding on the parties;

2) obtained from Lender, who is not related to Borrower; and

3) obtained in 2007, before the cutoff date of January 1, 2009;

iv. Original DI would not be an AHYDO if its issue price were the net cash proceeds actually received by Borrower for Original DI since:

1) Borrower received net cash proceeds for Original DI of $1 billion;

2) at an issue price of $1 billion, Original DI would yield 6.87 percent; and

3) 6.87 percent does not exceed the AFR applicable to Original DI of 3.55 percent plus 5 percent (6.87 percent < 3.55 percent + 5 percent, or 8.55 percent).

2. Amended DI was issued within 15 months of Original DI since Original DI was issued in January 2008 and Amended DI was issued in December 2008.

3. Amended DI would not be an AHYDO if its issue price were equal to the net cash proceeds Borrower received for Original:

a. *Net Cash Proceeds*: Borrower received net cash proceeds of $1 billion for Original DI in January 2008. However, Borrower also made two payments to Lender in connection with the debt modification transaction in December 2008, as well as an interest payment between those two dates. Rev. Proc. 2008-51 does not specify whether any of these later payments should be taken into account in determining the net cash proceeds that Borrower received for Original DI.

A reasonable interpretation would be to adjust the net cash proceeds that Borrower received in January for the unscheduled

[73]New York State Bar Association Tax Section report on Rev. Proc. 2008-51, Jan. 20, 2009, at p. 21, *Doc 2009-1196*, *2009 TNT 12-26*.

[74]Reg. section 1.446-4(e)(4).

[75]Section 1221(a)(7).

[76]Reg. section 1.446-4(d).

[77]Rev. Rul. 2003-127, 2003-2 C.B. 1245, *Doc 2003-27070, 2003 TNT 248-9*.

payments that Borrower made to Lender in connection with the December transaction — a payment of $100 million in principal plus an additional payment of $10 million — because those payments in substance reduce the net proceeds Borrower received in exchange for the borrowing, but not to adjust for Borrower's interest payment, because that payment in substance compensates Lender for Borrower's use of the borrowed funds.

Following this interpretation, the cash proceeds to Borrower for purposes of performing an evaluation under Rev. Proc. 2008-51 equals the $1 billion net cash proceeds to Borrower in January less the $100 million principal payment and $10 million additional payment Borrower made to Lender in December, or $890 million.

b. *AHYDO Test*: Amended DI would satisfy the definition of an AHYDO if it (i) is issued by a corporation, (ii) has a term greater than five years, (iii) has a yield at least 5 percent over the AFR, and (iv) has significant OID:

i. Amended DI is issued by Borrower, which is a corporation.

ii. Amended DI has a duration of six years.

iii. *Yield Test*: At an issue price of $890 million, the yield on Amended DI would be 8.36 percent. Because the AFR that applies to Amended DI is 2.83 percent, Amended DI does have a yield that exceeds the AFR plus 5 percent (8.36 percent > 2.83 percent + 5 percent, or 7.83 percent).

iv. *Significant OID Test*: Amended DI would have significant OID for purpose of this test if the sum of all interest payments made and OID accrued from its issue date through the close of any accrual period ending more than five years later (the Part (A) Amount) exceeds the amount of interest paid over the same period plus Amended DI's issue price multiplied by its yield to maturity (the Part (B) Amount). Amended DI has two accrual periods that end after the fifth anniversary of Amended DI's issue date, accrual periods 11 and 12. The Part (A) Amount and Part (B) Amount for each period is:

| Accrual Period | Part (A) Amount | Part (B) Amount |
|---|---|---|
| 11 | $419.5 million | $440.2 million |
| 12 | $459.0 million | $473.4 million |

Because the Part (A) Amount would not exceed the Part (B) Amount for either accrual period, Amended DI would *not* have significant OID.

Because Amended DI would not have significant OID, it would not be an AHYDO, and therefore is a debt instrument described as a Secondary Instrument under Rev. Proc. 2008-51.

Amended DI was issued in an exchange after August 8, 2008; therefore it must satisfy two additional requirements to qualify for relief under Rev. Proc. 2008-51. Those requirements are that (1) the maturity date of Amended DI must not be more than one year later than the maturity date of Original DI, and (2) the SRPM of Amended DI must not exceed the SRPM of Original DI. Because the maturity date of Amended DI is identical to that of Original DI, and the SRPM of Amended DI is lower than that of Original DI, Amended DI satisfies these additional requirements as well. Therefore, Rev. Proc. 2008-51 does apply to Amended DI, and the Service will therefore not treat it as an AHYDO for purposes of section 163(e)(5) and (i).[78]

### B. Legislative Relief

**1. Discussion.** Congress recently enacted further relief, albeit temporary, in the American Recovery and Reinvestment Act of 2009.[79] The act added language under both sections 163(e)(5) (the AHYDO rules) and 163(i)(1) (the AHYDO definition). The act also provided certain temporary relief from recognition of COD income from the reacquisition (including in a debt-for-debt exchange) of business indebtedness.[80]

First, Congress added a new subparagraph to section 163(e)(5)(F) generally suspending application of the AHYDO rules for debt instruments issued in exchange for non-AHYDO debt instruments between September 1, 2008, and the end of 2009 (although Congress also granted authority to Treasury to extend the relief to instruments issued beyond that time). This suspension is available as long as there is no change in issuer or obligor in the exchange, the instrument is not issued to a related person within the meaning of section 108(e)(4), and the interest on the obligation is not contingent interest described in section 871(h)(4)(A) through (C). If an instrument qualifying for this new relief is later exchanged for a new debt instrument, then the older instrument will not be treated as an AHYDO for purposes of determining whether the newer instrument also qualifies for the relief.

Congress also added language to section 163(i)(1) granting authority to Treasury to temporarily allow the use of an interest rate higher than the AFR for purposes of applying the AHYDO definition to an instrument. Previously, Treasury could only substitute a different rate if it were ''based on the same principles'' as the AFR and was appropriate for the term of the instrument. It is not clear what it means for a rate to be ''based on the same principles'' as the AFR. However, because the AFR is tied to the borrowing costs of the federal government, it is doubtful that Treasury previously had authority to substitute a rate that would reflect corporate, rather than

[78]Rev. Proc. 2008-51, section 5.

[79]P.L. 111-5, section 1232. This act is also commonly known as Stimulus.

[80]*Id.*, section 1231. A discussion of that provision is beyond the scope of this report.

government, borrowing costs. The new authority granted Treasury, in contrast, is broadly worded, and clearly grants it the power to address the unusually wide spread that developed over the last year between corporate and government borrowing rates.

**2. Applying legislative relief to example.** Amended DI is eligible for the legislative relief if:

- Amended DI was issued in exchange for a debt instrument that was not an AHYDO;
- Amended DI was issued between September 1, 2008, and the end of 2009;
- there is no change in issuer or obligor between Amended DI and Original DI;
- Amended DI was not issued to a related person; and
- interest on Amended DI is not contingent interest described in section 871(h)(4)(A) through (C).

As discussed above, Amended DI was deemed issued in exchange for Original DI by operation of reg. section 1.1001-3, and Original DI was not an AHYDO. Also, Amended DI was issued in December 2008, which falls within the scope of this relief. The issuer and obligor of Original DI and Amended DI are identical (Borrower in both cases), Amended DI was not issued to a related person (because Investors are not related to Borrower), and the interest payable under the instrument is not contingent interest described in section 871(h)(4)(A) through (C).

Therefore, under section 163(e)(5)(F)(i), the AHYDO rules do not apply to Amended DI.

## IV. Suggestions for Permanent Relief

Neither the regulatory nor legislative relief from the AHYDO rules is sufficiently retroactive or long-lasting to cover the likely span of the economic crisis. Also, because these efforts were intended as temporary emergency responses to the crisis, neither was designed to prevent the rules from applying inappropriately in the future. However, the current relief does provide time to develop a more systematic solution to ensure that the rules function as intended in the future.

Both the regulatory and legislative relief provisions are designed to apply to a narrow period of time. Both sources of relief were made effective from dates during the third quarter of 2008: the revenue procedure from August 8, 2008, and the legislative relief from September 1, 2008. However, while the spread between corporate and federal borrowing rates diverged most dramatically after those dates, the spread had been widening throughout the year. Issuers caught by the AHYDO rules earlier in that year are not eligible for relief. Particularly vulnerable were less creditworthy borrowers who generally faced even higher interest rates and lower market values for their debt instruments — the companies least able to absorb extra costs from the inappropriate operation of the rules.

Also, both sources of relief are designed to expire soon: the legislative provision through an explicit expiration date at the end of 2009, and the revenue procedure through the natural operation of its terms. These tight expirations put pressure on corporate debtors to renegotiate their debt in 2009, although they may not know whether an amendment would ultimately be necessary for them. Any such negotiations impose additional costs on issuers and holders, and could alter the parties' bargaining positions.

### A. Suggested Treasury Guidance

**1. Further suspension of AHYDO rules.** Congress extends to Treasury broad powers to further suspend the AHYDO rules. In the newly created section 163(a)(5)(F)(iii), Treasury is permitted to suspend the AHYDO rules after the end of the congressional suspension (December 31, 2009) if ''the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets.'' This provides Treasury the opportunity to suspend the rules not only in connection with the current crisis, but into the future as well. Neither the statute nor the legislative history limit Treasury's ability to determine when ''distressed conditions'' exist.

With debt capital markets still fragile, the simplest intervention Treasury could make is to suspend the AHYDO rules for another year. This would not require complex drafting or resolution of authority questions. Moreover, it is highly unlikely that any 1980s-style mischief could be engineered in such a short time period.

**2. Adjusting interest rate triggers.** Congress also grants authority to use a rate higher than the AFR for purposes of determining the application of the AHYDO rules — but only on a temporary basis — if that rate is appropriate in light of distressed conditions in the debt capital markets.[81] Treasury had authority under the original statute to permit a rate higher than the AFR to be used for debt instruments, but only if the rate were based on the same principles as the AFR. The new law permits Treasury to depart from the principles underlying government lending rates, but only on a temporary basis.

This new power granted Treasury is more difficult to exercise than the broader suspension power. It requires Treasury to monitor corporate borrowing rates relative to the federal government borrowing rates, and to issue guidance periodically advising taxpayers on some appropriate rate for the application of the AHYDO rules. The benefit of this power is that it allows Treasury to develop a formula, rather than a simple arithmetical relationship, to determine the AHYDO rate. But it does involve more complicated policy decisions and timeliness in decisionmaking. The experience from 2008 shows that neither of those resources may be available in an economic crisis.

**3. Definition of issue price.** The most egregious, and unexpected, source of distress from operation of the AHYDO rules results from the amendment of existing debt instruments. The ''issue price'' of the amended instrument is determined under rules that were written before the tremendous increase in electronic services providing information for the debt markets. Treasury needs to modernize the rules in reg. section 1.1273-2 setting the issue price of debt instruments. Those rules define market price in the broadest possible way. Issuers must consider even exploratory activity of holders who offer to sell, or third-party dealers who seek to buy, debt

[81]New language in section 163(i)(1).

instruments, whether or not trades subject to the bid or offer terms actually take place. The current rules assume that markets for corporate debt securities are efficient in that market prices can be relied on to reflect the fundamental value of instruments. However, market prices reflect more than just the fundamentals of a particular security, and can be dramatically affected by swings in the demand for entire classes of assets.

One permanent solution would be for Treasury to update the issue price rules to narrow the definition of publicly traded property in reg. section 1.1273-2(f). Currently, an instrument is publicly traded if it merely appears on a quotation medium. Instead, the definition could be confined to relatively large, more liquid markets like the market for SEC-registered securities. The new definition could be modeled on the definition of publicly offered debt instruments in reg. section 1.1275-1(h): instruments that are registered with the SEC or would be required to be registered but for certain exemptions from registration. This approach has the advantage of requiring participation by the issuer for an instrument to meet the definition, creating more predictability for issuers.

### B. Suggested Congressional Rulemaking

**1. In general.** For those who have arrived this far in the discussion, it should be clear that the AHYDO rules are diabolically complex. Congress did not have the time to revisit the rules in their entirety as the stimulus act developed in 2009. In calmer times, there may be some value in developing less obtuse rules. Knowing that small wishes are more likely to be granted than grand ones, we suggest below a humble change in the code that would avoid many of the problems encountered in 2008.

**2. Definition of issue price.** Congress could add a special rule to provide that the issue price of a debt security could not be less than the adjusted issue price of the debt security for which it is exchanged. Such a rule once was contained in section 1275(a)(4) before that section was repealed in 1990. Conventional wisdom is that section 1275(a)(4) was drafted too narrowly, providing taxpayers inappropriate flexibility in the timing of income recognition.

Section 1275(a)(4) generally provided that the issue price of a new debt instrument issued by a corporation in a reorganization was equal to the adjusted issue price of the original debt if its issue price otherwise would be less than the adjusted issue price of the original debt. When section 1275(a)(4) was repealed, it was replaced by section 108(e)(11) (now section 108(e)(10)) which provides that (A) a debtor that issues a new debt instrument in satisfaction of an old debt instrument is treated as having satisfied the old debt with an amount of money equal to the issue price of the new instrument, and (B) the issue price of the new instrument is generally to be determined under sections 1273 and 1274.

The effect of these changes on the taxation of debt-for-debt exchanges was to substitute a ''theoretical value'' approach for a ''substitution of obligation'' approach. The theoretical value approach taken by current law deems the debtor to have issued a new instrument for cash proceeds equal to its issue price and to have used those proceeds to redeem the old debt instrument. In contrast, under the substitution of obligation approach, a debt-for-debt exchange is viewed as a substitution of the new debt for the old one, with the issue price of the new instrument equal to the adjusted issue price of the old instrument.

In 1993 the American Bar Association Section of Taxation adopted resolutions supporting the reinstatement of a version of section 1275(a)(4) expanded to address the concerns that led to its repeal.[82] The report that accompanied the resolutions described the current law (post repeal of section 1275(a)(4)) as ''primarily a trap for the unwary'' citing anecdotal evidence that a number of debtors had, even then, inadvertently triggered COD income by failing to either plan a debt workout to take advantage of exceptions for bankruptcy or insolvency or take steps to ensure that the new debt does not have an issue price lower than the adjusted issue price of the old debt.[83] Also, the ABA report described the law after repeal of section 1275(a)(4) as (1) poorly reflecting the economic reality of debt workouts (by ignoring the continuity of the debtor's obligation to the creditor), (2) increasing the complexity and cost of workouts (because recognition of COD income can generally be avoided by taking advantage of exceptions for bankruptcy or insolvency, or in some cases by carefully managing the issue price of the new instrument), and (3) creating new opportunities for taxpayer selectivity (by providing taxpayers a way to refresh net operating losses though creating COD income in debt-for-debt exchanges).

Before its repeal, it was felt that taxpayers were selectively applying various interpretations of section 1275(a)(4) to minimize federal income tax. For example, the rule did not expressly require reducing the issue price of the new instrument when the principal amount of the borrowing was reduced. Also, a debtor could elect to avoid section 1275(a)(4) by arranging for an affiliate to issue its debt in exchange for the debtor's existing debt securities, structuring the new debt so that it did not constitute a security for purposes of section 354, or issuing properly structured investment units in exchange for existing debt securities.[84]

The ABA report recommended that old section 1275(a)(4) be expanded to apply to all types of debtors and debt instruments and account for reductions in principal amount to address these concerns.[85] A new rule modeled after the tax section's recommendations would prevent inappropriate triggering of both COD income

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[82]ABA Section of Taxation, ''The Case for Reinstatement and Expansion of Section 1275(a)(4),'' *Tax Notes*, Jan. 10, 1994, p. 217, *94 TNT 9-60*. This report contains an excellent discussion of section 1275(a)(4) and the tax section's recommended expansions of that rule.

[83]*Id.* at p. 223.

[84]*Id.*

[85]*Id.* at p. 226. The report also recommended a corresponding amendment to section 1001 to defer recognition of any losses that otherwise would be recognized by debt holders in exchanges that are subject to section 1275(a)(4). This would be advisable because section 354 (generally providing for nonrecognition of gain or loss by holders of corporate debt securities in a reorganization) is generally avoidable by structuring a transaction to fall outside of the definition of a reorganization.

and the AHYDO rules regardless of market conditions. Such a fix would provide taxpayers increased predictability in the law because it would more reliably function as intended in a wide variety of economic environments, and require fewer (if any) temporary fixes in the future.