



A TRANSACTIONAL GUIDE TO FEDERAL TAX ASPECTS OF RESTRUCTURING TROUBLED CORPORATION DEBT

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In this article, Levin and Rocap analyze the tax consequences of restructuring the debt of financially troubled corporations, both to the corporations and their creditors. They discuss how to measure debt cancellation, the circumstances in which debt cancellation results in taxable income, attribute reduction, or neither and the impact of the restructuring transaction on the corporation's future interest and OID deductions and future use of its NOLs. With respect to the corporation's creditors, they discuss the factors that affect whether, and in what amount, the creditors will recognize gain or loss in the restructuring transaction and the impact of the transaction on their future interest and OID income. Numerous examples illustrate how economically similar transactions can produce widely disparate tax results.

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A. Consequences to Obligor

1. Key Issues

A debt restructuring raises four key issues for the obligor:

- a. Will the restructuring result in debt cancellation ("DC") and, if so, how much DC?
- b. If there is DC, will the DC produce cancellation of debt income ("CODI")?
- c. Will any DC that does not produce CODI result in attribute reduction ("AR"), i.e., a reduction in the obligor's NOLs, asset tax basis, or other tax attributes?
- d. Will the restructuring transaction result in a change in the obligor's ownership that may limit future use of the obligor's NOLs or other tax attributes?

A debt instrument's adjusted issue price is generally its face plus any accrued unpaid interest.

2. Amount of Debt Cancellation

In general, DC occurs if old debt is discharged for an amount of consideration less than the old debt's adjusted issue price ("AIP").

a. A debt instrument's AIP is generally its face plus any accrued unpaid interest. However, in the case of a debt instrument which was initially issued with original issue discount ("OID") or original issue premium, AIP is the original issue price, *plus* any OID accrued since issuance, *plus* any accrued unpaid interest, *minus* any premium amortized since issuance, *minus* any payment of principal or OID since issuance.

b. For this purpose, the consideration given by the obligor for the old debt instrument is the sum of the following items:

- i. the amount of any cash,
- ii. the "issue price" of any new debt instrument of the obligor, and
- iii. the FMV of any other property (including issuer stock).

c. The "issue price" of a new debt instrument is determined as follows:

i. *Where neither the old nor the new debt is "traded on an established securities market" ("market-traded") and the interest rate on the new debt is at least equal to the AFRR, the issue price of the new debt equals its face amount.* Code section 1273(b)(4).

- Hence, if the new debt's face (plus any cash, stock or other property issued) is at least equal to the old debt's AIP, the obligor has no DC.

ii. *Where either the old or the new debt is market-traded, the issue price of the new debt equals the FMV of the market-traded debt instrument at the time of the exchange.* Code section 1273(b)(3).

- Hence, where the new debt's FMV (plus any cash, stock or other property issued) is less

than the old debt's AIP, DC equals the excess of the old debt's AIP *over* the new debt's FMV (plus any cash, stock or other property issued).

The debt of a troubled obligor typically trades at a substantial discount to face because of the high credit risk.

iii. Under the rather complex wording of the regulatory language, a debt instrument is market-traded if it is traded on (A) a national securities exchange registered under section 6 of the 1934 Act, (B) an exchange which is exempted from registration under section 5 of the 1934 Act because of its limited volume of transactions, or (C) any over-the-counter market . . . reflected by the existence of an interdealer quotation system . . . of general circulation to brokers and dealers which *regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of business and containing only quotations of such broker or dealer.*" Reg. section 15A.453-1(e)(4)(iv).

iv. Under this definition, most junk bonds not listed on an exchange should *not* be treated as market-traded.

Most junk bonds not listed on an exchange should not be treated as traded on an established securities market.

- National Daily Quotation Service "yellow sheets" do not provide current bid and asked prices.
- Quotation sheet published by a single dealer (e.g., Salomon) containing bid and asked prices of only that one dealer does not fit the definition.
- The Treasury Department is reviewing this issue and may issue revised regulations or other guidance in an effort to broaden the definition.

d. An obligor who discharges old debt for an amount of consideration less than the old debt's AIP may be treated as not having any DC (or as having DC but no CODI) under one of several exceptions, including the AR-instead-of-CODI bankruptcy and insolvency exceptions (discussed below in A.4. and A.5.), the stock-for-debt super exception (discussed below in A.6. and A.7.), the purchase price adjustment exception (discussed below in A.9.d.), and the shareholder contribution to capital exception (discussed below in A.9.e.).

3. Cancellation of Debt Income ("CODI")

Subject to the exceptions described below, if there is any DC (calculated pursuant to A.2.), the obligor recognizes taxable CODI.

a. For regular income tax purposes, the obligor can generally offset such CODI by any available NOL, subject to section 382 and other NOL limitations (discussed below in E.).

b. For purposes of the 20-percent corporate alternative minimum tax ("AMT"), the obligor can generally offset such CODI by current year losses but can offset only 90 percent of its current year AMT income (including CODI) by NOL carryovers (subject to section 382 and other NOL limitations). Hence, CODI recognized by an obligor with adequate available NOLs generally incurs a two percent tax (20% AMT rate x the 10% of CODI not offset by NOL carryforwards for AMT purposes).

4. Bankruptcy AR-Instead-of-CODI Exception

If the obligor is *in bankruptcy*:

a. DC causes no CODI, but rather invokes attribute reduction ("AR"), i.e., reduces the obligor's NOLs, asset basis, and other tax attributes. Code sections 108(a)(1)(A); 108(b)(1).

i. Tax attributes are reduced *after* the obligor's tax liability for the year of the discharge is calculated. Thus, NOLs can first be used to shelter any taxable income (including CODI) for the year of the discharge. Code section 108(b)(4).

ii. Tax attributes are reduced in the following order: (1) NOL carryovers, (2) tax credit carryovers, (3) capital loss carryovers, (4) asset tax basis, and (5) foreign tax credit carryovers. Code section 108(b)(2).

iii. Asset tax basis is reduced in the following order:

- First, any property (other than inventory or accounts receivable) which the discharged debt was incurred to purchase.
- Second, all depreciable or amortizable property secured by the discharged debt.
- Third, all other property (other than inventory or accounts receivable) secured by the discharged debt.
- Fourth, all depreciable or amortizable property not secured by the discharged debt.
- Fifth, all other property (other than inventory or accounts receivable) not secured by the discharged debt.
- Sixth, inventory and accounts receivable. Reg. section 1.1017-1(a).

Attribute reduction generally occurs on a company-by-company basis, even if a consolidated income tax return is filed.

iv. Query whether the obligor can avoid the impact of the basis reduction requirement by contributing assets to a partnership prior to the end of the taxable year in which the debt cancellation occurs.

- If the asset transfer is respected, the obligor's basis in the partnership interest would be reduced, but not the partnership's basis in the assets.

v. Asset basis is not reduced below the aggregate liabilities of the obligor immediately *after* the discharge. Code section 1017(b)(2). See A.5.e.ii. regarding probable inclusion of contingent liabilities at estimated ultimate amount.

vi. In lieu of the general ordering rules described in A.3.a.ii. and iii., the obligor may elect to reduce the basis of depreciable property first. Code section 108(b)(5).

- If the obligor makes this election, the floor rule described in A.3.a.v. does not apply. Code section 1017(b)(2).

b. Attribute reduction generally occurs on a company-by-company basis, even if a consolidated income tax return is filed. *LTR 9121017, LTR 9122067*. Cf. Code section 1017(b)(3)(D).

- Separate company attribute reduction may produce favorable tax results if most of the canceled debt is in the holding company and most of the consolidated group's NOLs are attributable to (and most depreciable assets are held by) operating subsidiaries. If holding company debt is canceled, it appears that current law permits the consolidated group to preserve the NOLs attributable to (and the asset basis of) the operating subsidiaries, while reducing only the NOLs of the holding company and the holding company's basis in subsidiary stock.

c. If debt cancellation exceeds the obligor's tax attributes available for reduction, still no CODI.

5. Insolvency AR-Instead-of-CODI Exception

If obligor is *not* in bankruptcy, but is *insolvent*:

a. Debt cancellation (up to the amount of obligor's insolvency) is not CODI, but rather invokes the AR rules (as described in A.4.). Code sections 108(a)(1)(B) and 108(b)(1).

b. DC in excess of the obligor's pre-cancellation insolvency is CODI. Code section 108(a)(3).

i. Obligor can generally offset such CODI by any available NOLs, subject to NOL limitations (as described in A.3.a. and b.).

c. "Insolvency" for this purpose means the excess of the obligor's liabilities over the FMV of its assets, determined immediately *before* the debt discharge. Code section 108(d)(3).

i. Assets include goodwill and other intangible assets, whether or not reflected on the balance sheet, thus creating significant asset valuation issues.

ii. Liabilities should include contingent liabilities (probably at estimated ultimate amount), although the law is unclear, thus creating significant liability valuation issues. Compare *Conestoga Transportation Co. v. Commissioner*, 17 T.C. 506 (1951), and *LTR 8348001*.

iii. If the obligor receives an equity capital infusion as part of the debt restructuring, the new equity infusion should be ignored in calculating the extent of insolvency (since insolvency is determined "immediately before" the debt discharge).

- In analogous contexts (e.g., section 351), "immediately after" has been interpreted to refer to the state of affairs after all steps of a plan have been completed. Similarly, "immediately before" should refer to the state of affairs before any of the steps of the restructuring plan have been implemented.

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- Nonetheless, it is prudent to avoid closing on a new equity infusion prior to closing on the debt exchange.

6. Common-Stock-for-Debt Super Exception

If a *bankrupt or insolvent* obligor issues common stock (or common stock together with other consideration) in exchange for old debt, no DC is deemed to exist (and hence the obligor *neither recognizes CODI nor AR*), subject to the following limitations and requirements:

a. If the obligor is insolvent (but not in bankruptcy), the exception applies only to the extent of insolvency, determined immediately *before* the exchange (as described in A.5.c.). Code section 108(e)(10)(B)(i).

b. The amount of common stock issued to the creditor must be more than "nominal or token." Code section 108(e)(8)(A).

i. Proposed regulations state that whether common stock is nominal or token is a factual test, based on the following (nonexclusive factors):

a. *Stock-to-debt ratio*: Ratio of FMV of stock transferred to the particular creditor to the amount of debt discharged in exchange for that stock. (IRS calls this the most important factor.)

- Note that the denominator of this ratio is the amount of the old debt less any new consideration issued other than obligor common stock.

b. *Stock-to-total-consideration ratio*: Ratio of FMV of stock transferred to the particular creditor to FMV of total consideration transferred to such creditor.

It appears that warrants to acquire common stock will not be treated as stock for purposes of the stock-for-debt super exception.

c. *Stock-to-total-stock ratio*: Ratio of FMV of stock transferred to all creditors as a group to total FMV of all outstanding stock after workout. Prop. Reg. section 108-1(b).

- Note that the first two ratios focus on only the exchange with the particular creditor, while this ratio focuses on all creditors as a group.
- The denominator of this ratio is probably the obligor's actual outstanding stock, ignoring warrants, convertible debt, and the like, because the proposed regulation refers to the obligor's "outstanding stock" without referring to any attribution rules. However, if the obligor has a substantial amount of outstanding warrants and the like, the IRS or a court may (because of the overall facts-and-circumstances nature of the nominality determination) make the calculation both ways or may require a higher than normal ratio, especially when the warrants and the like are in the money at the time of the debt restructuring.
- ii. The preamble to the proposed regulations suggests possible "safe harbors," under which stock would not be nominal or token if:

a. With respect to the particular creditor, the stock-to-debt ratio is at least 10 percent *and* the stock-to-total-consideration ratio is at least 25 percent, *or*

b. With respect to the particular creditor, the stock-to-total-consideration ratio is at least 25 percent *and* the stock-to-total-stock ratio is at least 25 percent (i.e., the particular creditor acquires at least 25 percent of the obligor's stock), *or*

c. With respect to unsecured creditors as a group, the stock-to-total-consideration ratio is 100 percent and the stock-to-total-stock ratio is at least 90 percent.

iii. In practice, issuances of significantly lesser amounts of common stock than suggested in the IRS' proposed safe harbors should qualify as more than nominal or token, and many experienced tax practitioners believe that one or more ratios at or above 10 percent should suffice.

There is a substantial risk that the IRS will interpret the common-stock-for-debt super exception as applying on a separate company basis.

c. It appears that warrants to acquire common stock will not be treated as stock for purposes of the stock-for-debt super exception.

i. It is arguable, however, that warrants should be treated as stock for this purpose if the exercise price of the warrants is so low that it is substantially certain at the time of the warrant issuance that they will be exercised. See, e.g., *Rev. Rul. 82-150*, 1982-2 C.B.110.

d. In the case of an unsecured creditor, a "proportionality test" must also be satisfied in order for the common-stock-for-debt super exception to apply:

i. The ratio of the FMV of common stock received by the unsecured creditor to the amount of debt canceled in exchange for the common stock must be at least 50 percent of the same ratio for all unsecured creditors as a group. Code section 108(e)(8)(B).

a. It may be difficult to satisfy the proportionality test when there are different classes of unsecured debt. For example, a subordinated creditor may receive a materially different mix of stock and nonstock consideration than a senior unsecured creditor.

b. Secured debt is treated as unsecured debt for this purpose to the extent the debt exceeds the FMV of the security. S. Rep. No. 1035, 96th Cong. 2d Sess. 17, n. 19 (1980).

c. Unsecured creditors who receive no stock at all (i.e., who receive only nonstock consideration in the workout) should be included in the proportionality calculation. Inclusion of such creditors in the calculation will make it easier to satisfy the proportionality test with respect to unsecured creditors who do receive some stock.

e. There is a substantial risk that the IRS will interpret the common-stock-for-debt super exception as applying on a separate company basis, even if the obligor is a member of a consolidated group. Cf. Code section 108(e)(7)(C). Under this interpretation, issuance of new parent stock in satisfaction of old subsidiary debt would not qualify.

i. The IRS has issued two taxpayer-favorable private rulings recharacterizing an issuance of new parent stock in satisfaction of a consolidated subsidiary's old debt as first a deemed issuance of subsidiary stock for subsidiary debt (qualifying for the common-stock-for-debt exception) followed by a deemed exchange of parent stock for subsidiary stock. The IRS indicated that it was willing to issue such rulings only because:

a. both the parent and the subsidiary were in bankruptcy *and*

b. the deemed exchange of parent stock for subsidiary stock would have qualified as a tax-free reorganization. *LTR 8933001* (August 22, 1988); *LTR 8914080* (January 11, 1990).

ii. The IRS now refuses to issue similar private rulings, even in the circumstances described above.

f. If the common-stock-for-debt super exception applies (i.e., an obligor which is in bankruptcy or is insolvent [to extent of insolvency] issues more than nominal or token common stock in exchange for old debt), the exception is not adversely affected where the obligor also issues other consideration (e.g., preferred stock, new debt, or cash).

i. In this situation, the common stock (regardless of its FMV) is treated as paying in full any excess of the old debt's AIP over the sum of the issue price of the new debt, the cash, and the FMV of any other property. S. Rep. No. 1035, 96th Cong. 2d Sess. 17 (1980).

The stock-for-debt super exception . . . is not by its terms limited to common stock.

7. Preferred-Stock-for-Debt Super Exception

a. The stock-for-debt super exception described above in A.6. is not by its terms limited to common stock. Hence, it can apply to preferred stock. However, the exception does not apply to the issuance of "disqualified stock" for old debt. Code section 108(e)(10)(B).

i. Stock is "disqualified" if it *both*:

a. has a stated redemption price *and*

b. *either* (X) has a fixed redemption date, or (Y) is callable by the issuer, or (Z) is puttable by the holder. Code section 108(e)(10)(B)(ii).

Indeed even stock called "common" is "disqualified" if it has both of the characteristics described above.

- Query whether stock has a stated redemption price if it has the right to receive the *greater* of \$1 million plus a stated yield thereon or an amount equal to 30 percent of the issuer's FMV.

ii. Mandatorily redeemable, callable, or puttable stock with a stated redemption price is dis-

qualified even if it is convertible into common stock and even if it is participating.

iii. Hence, stock (whether called common or preferred) counts as qualifying only if it is (A) typical common stock (i.e., no stated redemption price) or (B) "evergreen" preferred stock (i.e., neither mandatorily redeemable, nor callable, nor puttable).

iv. There appears to be a risk that stock will be treated as mandatorily redeemable if it must be redeemed in connection with a sale of the obligor.

- It should be possible to reduce this risk by omitting any provision requiring mandatory redemption and instead obtaining (A) a covenant that the issuer will promptly liquidate upon a sale of substantially all of its assets and (B) a covenant (from the obligor and its principal shareholders) that any person or group which purchases more than a specified percentage of the obligor's common stock also must offer to purchase the preferred stock at a price equal to its liquidation preference.

The issuance of some disqualified stock does not alter the availability of the common-stock-for-debt super exception.

v. Stock that must be repurchased by an *affiliate* of the issuer (as opposed to the issuer itself) is not literally treated as disqualified stock, because code section 108(e)(10)(B)(ii) applies to stock with a "redemption date" and an obligation by an affiliate to purchase the stock should not be a "redemption." Cf. code section 304. The IRS may, however, seek to treat such stock as disqualified stock.

b. As discussed in A.6., where the amount of common stock issued by the obligor in exchange for old debt is sufficiently substantial as to be more than nominal or token, the issuance of some disqualified stock in addition does not alter the availability of the common-stock-for-debt super exception.

c. If the amount of common stock issued by the obligor in exchange for old debt is *not* by itself sufficiently substantial as to be more than nominal or token, the obligor apparently is permitted to take into account any evergreen preferred stock issued in exchange for the old debt for purposes of applying certain of the "nominal or token" tests discussed at A.6.b. (i.e., these tests are applied by reference to both the common stock and the evergreen preferred stock).

i. If both common and evergreen preferred stock are issued in exchange for old debt, the evergreen preferred apparently can be counted along with the common in applying the stock-to-total-consideration ratio and the stock-to-total-stock ratio. Prop. Reg. section 1.108-1(b)(2)(i).

ii. However, according to the proposed regulations, the more important stock-to-debt ratio is applied separately with respect to common stock and evergreen preferred stock. The separate ratios are determined as follows:

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a. The FMV of the evergreen preferred is compared to an amount of old debt equal to the liquidation preference of the evergreen preferred.

b. The FMV of the common is compared to an amount of old debt equal to the excess of the old debt's AIP over the sum of (X) the liquidation preference of the evergreen preferred, (Y) the issue price of any new debt, and (Z) the FMV of any other property issued in exchange for the old debt. Prop. Reg. section 1.108-1(b)(2)(ii).

d. If the common stock plus the evergreen preferred stock are not in the aggregate sufficiently substantial to cause the common to be treated as more than nominal or token, the obligor can nevertheless use a variation of the common-stock-for-debt super exception described in A.6. (if it is in bankruptcy or to the extent of insolvency):

i. The evergreen preferred stock is deemed to offset an amount of old debt equal to such preferred's liquidation preference (rather than its FMV). Hence, DC is deemed to exist only to the extent the old debt's AIP exceeds the sum of (A) the evergreen preferred stock's liquidation preference, (B) the issue price of any new debt, and (C) the FMV of the other consideration (including the nominal or token common stock). Prop. Reg. section 1.108-1(b)(2)(i); *Rev. Rul. 90-87*, 1990-2 C.B. 32.

ii. Thus, if the obligor issues evergreen preferred with a liquidation preference equal to the old debt's AIP, the obligor has no DC, even if the evergreen preferred's FMV is less than the old debt's AIP.

iii. The special rule described in this A.7.d. does not, however, apply if the evergreen preferred's FMV is nominal in comparison to its liquidation preference. Code section 108(e)(8)(A).

If the obligor issues evergreen preferred with a liquidation preference equal to the old debt's AIP, the obligor has no DC.

e. Where the stock-for-debt super exception does not apply but some stock is being issued to creditors in the debt restructuring (whether disqualified stock or not), the stock is valued (for purposes of calculating the amount of the obligor's DC) at its FMV (whether or not the stock is market-traded).

8. Exception Where New Debt Not Materially Different

a. If the terms of the new debt instrument are not "materially different" from the terms of the old debt instrument, the new debt will be treated as a continuation of the old, resulting in no debt cancellation. Reg. section 1.1001-1(a).

i. A change in maturity or interest payment dates or covenants or collateral is generally not treated by the IRS as a material change.

ii. A change in interest rate is generally treated by the IRS as a material change. *Rev. Rul. 87-19*, 1987-1 C.B. 249.

a. IRS has permitted *de minimis* changes in interest rate (e.g., 10 basis points). *LTR 8932067* (May 19, 1989); *LTR 8835050* (June 8, 1988).

b. Query the result when old debt has OID and the maturity is extended: this reduces the debt's yield unless the stated principal amount is increased commensurate with the maturity extension.

iii. Proposed regulations state that a payment to (or from) the lender not set forth in the old debt instrument is a material change in the old debt instrument. Prop. Reg. section 1.1274-1(c).

a. A prohibited payment to the lender includes cash, property, stock, or an increase in the principal amount of the debt. If these items were not prohibited, the rule in A.8.a.ii. prohibiting an increase in interest rate could easily be circumvented.

A change in maturity of interest payment dates or covenants or collateral is generally not treated by the IRS as a material change.

b. Although the law is unclear, it appears that a payment to reimburse the lender for additional out-of-pocket costs incurred because of the default and/or the restructuring should not be treated as a modification. Cf. Prop. Reg. section 1.1273-2(f)(2) (borrower's reimbursement of lender's loan processing costs does not reduce issue price of debt instrument).

b. Where the new debt is not materially different from the old debt except that the new debt's AIP is less than the old debt's AIP, the new debt should be treated as a continuation of the old debt, with DC equal to the reduction in AIP.

c. Where (A) the new debt is not materially different from the old debt except that the new debt's AIP is less than the old debt's AIP, (B) the obligor also issues other consideration (e.g., cash, stock or warrants) to the holder of the old debt, and (C) the other consideration does not exceed the AIP reduction, then the new debt should be treated as a continuation of the old debt, with DC equal to the AIP reduction less the cash and FMV of property issued to the old debt holder.

i. The other consideration should be treated as first satisfying any accrued interest or OID, and then reducing principal. Prop. Reg. sections 1.446-2(d) and 1.1272-1(c)(ii).

ii. If the old debt's AIP exceeds the sum of the new debt's AIP plus the amount of cash or FMV of other property issued by the obligor, the obligor will have DC equal to such excess.

iii. The IRS may, however, attempt to treat any reduction in the old debt's AIP as a material change resulting in the deemed issuance of a new debt instrument. *Rev. Rul. 89-122*, 1989-2 C.B. 200.

9. Other Exceptions and Special Rules

a. *Exception for lost deduction.*

i. The obligor does not have CODI or AR if payment of the canceled debt would have generated a tax deduction. Code section 108(e)(2).

a. This exception does *not* apply where the obligor was previously entitled to a deduction upon accrual of the canceled obligation (e.g., in the case of an obligation to pay interest by an accrual method taxpayer, the deduction matures at the time the interest accrued).

b. *Exception for deductible item which produced no tax benefit.*

i. The obligor does not have CODI or AR if the debt relates to an item previously deducted by the obligor, but which produced no tax benefit (e.g., where a deduction for accrued interest produced an NOL that expired unused). Code section 111, *Rev. Rul. 67-200*, 1967-1 C.B. 15.

c. *Exception for debt to the extent obligor received no consideration.*

i. Under several cases, the obligor does not have CODI or AR to the extent the obligor did not receive consideration for the discharged debt. *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) (discharged debt was issued by the obligor as a dividend to its shareholders); *Fashion Park v. Commissioner*, 21 T.C. 600 (1954) (discharged debt was issued in exchange for preferred stock originally issued for an amount less than paid by the obligor in discharge of the debt).

The law is quite vague on when a shareholder/creditor will be treated as having made a 'contribution to capital.'

ii. The continuing validity of these cases following the 1984 and subsequent legislative amendments is uncertain.

d. *Exception for purchase price adjustment.*

i. If the purchaser of property has a debt to the seller of the property which arose in connection with the sale, and such debt is reduced (while the debt is still held by the seller), the reduction is treated as a reduction in the purchase price of the property (i.e., purchaser reduces its tax basis for the purchased property and does not have CODI or AR). Code section 108(e)(5).

ii. The statute states that the exception does *not* apply if the purchaser/obligor is in bankruptcy or insolvent.

- This statutory rule does not, however, displace the preexisting nonstatutory rule, which may be more favorable in certain respects. Cf. Code section 108(e)(1).

e. *Exception for shareholder contribution to capital.*

i. If the creditor is a shareholder of the obligor and forgives or otherwise contributes the debt to the capital of the obligor, the obligor is treated as satisfying the debt with an amount of money equal to the shareholder's adjusted basis in the old debt. Code section 108(e)(6).

a. Hence, the obligor does not have DC (and does not have CODI) if the shareholder's adjusted basis for the debt is at least equal to the old debt's AIP.

b. If the shareholder's adjusted basis for the old debt is less than the old debt's AIP, the excess is CODI (unless another exception applies).

ii. The law is quite vague on when a shareholder/creditor will be treated as having made a "contribution to capital." Several factors which appear to militate in favor of the exception:

a. The shareholder receives no compensation at all from the obligor in exchange for the canceled old debt, *or* receives property (new debt, stock, cash or other property) from the obligor with an FMV substantially less than the FMV of the canceled old debt.

b. The shareholder (or group of shareholders) transferring the old debt to the obligor owns a substantial portion of the obligor's stock.

c. No holder of debt who is not a shareholder of the obligor is participating in the exchange on the same terms.

iii. The following examples illustrate the two polar extremes of the exception:

a. The exception would apply if the obligor had one or several shareholders (owning in the aggregate 100 percent of its stock) who transferred old debt to the obligor in exactly the same proportions as they owned the stock and received back no consideration at all.

b. It is doubtful whether the exception would apply if a shareholder owning 10 percent of the obligor's stock transferred old debt to the obligor, receiving consideration (cash, new debt, etc.) with an FMV equal to the full FMV of the old debt transferred, especially where other holders of the same old debt (who own no obligor stock) participate in the same transaction on the same terms.

f. *Exception for foreclosure on nonrecourse debt.*

i. If an obligor transfers property which is subject to a nonrecourse debt to the creditor in satisfaction of the nonrecourse debt, the transaction is treated as a sale of the property for an amount equal to the nonrecourse debt (even if the nonrecourse debt exceeds the property's FMV), rather than as DC. *Commissioner v. Tufts*, 461 U.S. 300 (1983).

- Thus, a bankrupt or insolvent obligor cannot use the bankruptcy or insolvency AR exception or the stock-for-debt super exception to exclude such gain on sale of the property from taxable income.

If an obligor transfers property . . . in satisfaction of the nonrecourse debt, the transaction is treated as a sale of the property.

10. Acquisition of Debt by Related Party

a. Code section 108(e)(4) states that, "to the extent provided in regulations," the acquisition of old debt by certain persons related to the obligor is to be treated as an acquisition of the old debt by the obligor (and hence acquisition of the old debt for less than its AIP would produce DC).

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i. Persons treated as related to an obligor corporation for this purpose include:

a. an individual who owns more than 50 percent of the obligor's stock. Stock owned by persons related to the individual (e.g., family members and entities in which the individual and family members own an interest) is treated as owned by the individual in making this determination. Code sections 108(e)(4)(A) and 267(b)(2);

b. a partnership if the same persons own (including ownership by attribution from related persons) more than 50 percent of the capital or profits interests of the partnership and more than 50 percent of the value of the obligor corporation's stock. Code sections 108(e)(4)(A) and 267(b)(10); and

c. a corporation which is a member of a group of corporations (in which the obligor is also a member) connected by more than 50 percent stock ownership (measured by vote or value).¹ Code sections 108(e)(4)(A) and 267(b)(3).

b. IRS recently issued proposed regulations implementing section 108(e)(4). The proposed regulations contain surprisingly harsh anti-taxpayer rules.

i. DC occurs where a person related to the obligor (or a person who becomes related to the obligor on the date the debt is acquired) acquires the debt from a person unrelated to the obligor. Prop. Reg. section 1.108-2(b)(1).

ii. DC also occurs where a holder of debt subsequently becomes related to the obligor, if the debt holder acquired the debt "in anticipation" of becoming related to the obligor. A debt holder would be treated as acquiring debt in anticipation of becoming related to the obligor where:

a. the holder acquired the debt less than six months before becoming related to the obligor, or

b. under a rebuttable presumption, the holder acquired the debt between six and 24 months before becoming related to the obligor; the parties may rebut the presumption by establishing that the debt was not acquired in anticipation of becoming related, or

The proposed regulations [implementing section 108(e)(4)] contain surprisingly harsh anti-taxpayer rules.

c. debt of the obligor constitutes more than 25 percent of the holder's gross assets (excluding certain short-term investment assets) on the date the holder becomes related to the obligor, apparently without regard to (X) the length of the temporal

¹ The obligor corporation and the corporation which acquires the obligor's debt can apparently avoid being treated as related for this purpose if (a) the link of more-than-50-percent-stock-ownership is broken by interposing a partnership and (b) the obligor corporation and the purchasing corporation are not linked by an 80-percent-or-more-stock-or-partnership-interest-ownership chain. See code sections 108(e)(4)(C) and 414(b) and (c).

separation between the time the holder acquired the debt and the subsequent transaction which creates the relationship between the debt holder and the obligor and (Y) whether the parties anticipated (at the time the holder acquired the debt) that a future relationship would develop. Prop. Reg. section 1.108-2(b)(2).

iii. The amount of DC equals the excess of the old debt's AIP over the FMV of the old debt on the date the old debt was acquired by the related person or (where the holder and the obligor were not related on that date) the date the debt holder and obligor became related. Prop. Reg. section 1.108-2(a).

The holder of the old debt apparently would be treated as receiving an amount equal to the issue price of the new debt.

a. This formula is used even where the old debt is nonmarket-traded and the related person acquires the old debt in exchange for new nonmarket-traded debt (bearing interest at least equal to the AFR) so that, under sections 1273 and 1274, the new debt has an issue price equal to face rather than FMV.

b. Under this rule, an acquisition of old debt by a related party in exchange for new nonmarket-traded debt issued by the related party may result in a substantially greater amount of DC (i.e., DC measured by reference to the old debt's FMV rather than the new debt's face) than if the old debt had been acquired by the obligor in exchange for a new debt instrument *issued by the obligor*.

c. The holder of the old debt apparently would be treated as receiving an amount equal to the issue price of the new debt (as opposed to the FMV of the old debt), as determined under the section 1274 rules. Prop. Reg. section 1.1274-2(a); *Rev. Rul. 89-121*, 1989-2 C.B. 203. Thus, the proposed regulations appear to treat the purchaser of the old debt as paying an amount equal to only the old debt's FMV, but treat the holder of the old debt as receiving an amount equal to the new debt's full issue price (generally face when neither the old nor new debt is market-traded and the new debt bears interest of at least the AFR).

d. OID deductions (if any) for the related party issuer of the new debt apparently would be calculated by reference to the issue price of the new debt (as opposed to the FMV of the old debt), as determined under the section 1274 rules. Using issue price to calculate future OID deductions but FMV to determine CODI results in over-taxation of the obligor and the related party.

e. In light of the above, it is questionable whether the proposed regulation section 1.108-2(a) is valid.

iv. If a holder of old debt subsequently becomes related to the obligor and the transaction is treated as resulting in DC under the rules described above, the holder would be treated as if it had sold the old debt to an unrelated person for an amount

equal to the old debt's FMV on the date the holder became related to the obligor and would recognize gain or loss on such sale. Prop. Reg. section 1.108-2(b)(3). The related person would also be treated as acquiring a new debt instrument as described in the next paragraph.

v. If an obligor has DC because a related person acquires its old debt or because the obligor becomes related to a holder of its old debt (even if the DC is covered by an exception), the old debt held by the related person is treated as a new debt instrument with an issue price equal to the old debt's FMV on the acquisition date (or if later, the date the holder and the obligor became related). Prop. Reg. section 1.108-2(e)(1).

- This deemed new debt instrument may have substantial OID because the obligor's low credit rating may cause the old debt to have an FMV on such date substantially less than face.

c. The regulations are proposed to apply to transactions on or after March 21, 1991, except that section 108(e)(4) "is effective for any transaction after December 31, 1980."

i. Apparently, the IRS will take the position that section 108(e)(4) applied, at least to certain related-party debt acquisitions, prior to the promulgation of implementing regulations. See, e.g., Rev. Rul. 91-17

- A recent court decision construing similar statutory language in an unrelated code section makes this IRS position doubtful. *Alexander v. Commissioner*, 95 T.C. 467 (1990).

11. Deduction of Unamortized Issuance Expenses

a. In general, expenses incurred by the obligor in connection with the issuance of the old debt are amortized over the term of the old debt. Upon retirement of the old debt, any remaining unamortized issuance expenses are immediately deductible.

b. However, if the obligor issues new debt or stock in exchange for the old debt, unamortized issuance expenses with respect to the old debt are treated as capital expenditures incurred in connection with the issuance of the new debt or stock. *Great Western Power Co. v. U.S.*, 297 U.S. 543 (1936); *Chicago, Rock Island & Pacific Railway Co. v. Commissioner*, 356 F.2d 990 (7th Cir. 1931).

Unamortized issuance expenses with respect to the old debt are treated as capital expenditures incurred in connection with the issuance of the new debt or stock.

c. If the old debt is retired in exchange for a mixture of new debt and/or new stock and/or cash and/or other property, the obligor should be permitted to deduct unamortized issuance expenses with respect to the portion of the old debt that is retired in exchange for cash or for property other than new debt or stock of the obligor.

i. For this purpose, the old debt generally should be allocated among the different types of

consideration given by the obligor in the exchange in proportion to the relative amount of the cash, issue price of new debt and FMV of new stock or other property given in the exchange.

- The IRS may take the position (particularly if the stock-for-debt exception to CODI applies to the exchange) that, if new common stock of the obligor is issued in the exchange, the old debt should be allocated entirely to the new common stock to the extent of any excess of the adjusted issue price of the old debt over the sum of the issue price of any new debt, any cash and the FMV of any other property given in the exchange. See A.6.e.i., above.

Where the exchange is treated as a recapitalization . . . [the holder's] loss on the exchange . . . cannot be recognized.

B. Consequences to Holder

1. Treatment as Recapitalization

a. If the old debt instrument is treated as a "security" for tax purposes *and* it is exchanged:

- for stock of the issuer *or*
- for a new debt instrument of the issuer which is also treated as a "security" for tax purposes *or*
- for a package of consideration consisting in part of issuer stock and/or a new debt "security" and in part of cash or other property,

the exchange will be treated as recapitalization under code section 368(a)(1)(E).

i. Whether a debt instrument will be treated as a "security" depends on a number of factors, the most important of which is the original term of the debt instrument.

- An instrument with a term of 10 years or more is normally treated as a "security."
- An instrument with a term of more than five years is often treated as a security.
- An instrument with a term of three years or less is normally not treated as a "security."
- The treatment of an instrument with a term between three and five years is unclear.

b. Where the exchange is treated as a recapitalization, then (except as discussed below in B.1.c., with respect to accrued interest and accrued OID):

i. If the holder has a loss on the exchange (i.e., the holder's tax basis in the old debt exceeds the sum of the cash, issue price of any new debt, and FMV of any stock or other property received in the exchange), the *loss cannot be recognized*. Code section 354(a)(1).

ii. If the holder has a gain on the exchange, the holder must recognize the gain, but only to the extent of the sum of the cash plus the FMV of property (other than stock or debt securities of the

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obligor) received by the holder in the exchange. Code section 356(a)(1).²

iii. The holder's tax basis in the obligor's stock and debt securities received in the exchange will equal:

- the holder's basis in the old debt (less any portion of such basis which is attributable to previously unpaid accrued interest and accrued OID),
- plus the amount of any gain recognized by the holder on the exchange,
- minus the cash and the FMV of any property other than obligor stock or debt securities received in the exchange (which portion of the holder's basis is allocated to the cash and other property). Code section 358(a).

iv. The holder's aggregate tax basis in stock and debt securities received in the exchange is allocated between the stock and debt securities in proportion to the relative FMV of the stock and issue price of the debt securities immediately after the exchange. Reg. section 1.358-2(a)(3).

c. Previously unpaid accrued interest and accrued OID—The recapitalization rules described above do not apply to the holder's exchange of that portion of the old debt which is attributable to previously unpaid interest and accrued OID that accrued during the period the holder owned the old debt. Code section 354(a)(2)(B).

[T]he question is . . . whether the exchange should be treated as a single aggregated exchange or . . . can or must be segregated.

i. A holder who has previously included the accrued interest/OID in income is allowed to recognize a loss to the extent the amount previously included in income exceeds the issue price of new debt securities and FMV of stock and other property deemed received in payment of the accrued interest/OID.

ii. A holder who has not previously included all accrued interest/OID in income (e.g., because of the risk of noncollectibility) must recognize interest income to the extent the issue price of new debt securities and FMV of stock and other property deemed received in payment of the accrued interest/OID exceeds the amount previously included in income.

iii. The legislative history indicates that if the exchange offer explicitly allocates the stock, debt

securities and other property received by the holder between the principal amount of the old debt and the accrued interest/OID on the old debt, both the obligor and the holder should follow this allocation. H.R. Rep. No. 833, 96th Cong., 2d Sess. 33 (1980). Thus, where the consideration provided by the obligor is less than the adjusted issue price of the old debt, the exchange offer may explicitly:

- allocate the consideration first to principal, with any excess over principal allocated to accrued interest/OID, or
- allocate the consideration first to accrued interest/OID, with any excess allocated to principal, or
- allocate the consideration pro rata between principal and accrued interest/OID.

iv. If the exchange offer does not explicitly allocate between principal and accrued interest/OID, the result is probably a pro rata allocation.

2. Treatment If Not Recapitalization

a. The exchange will not qualify as a recapitalization, and the holder of the old debt will recognize gain or loss, if:

- i. the old debt is not treated as a "security" (e.g., short-term debt held by trade creditors) or
- ii. the consideration issued in the exchange does not consist in whole or in part of obligor stock or debt securities (e.g., old debt is canceled in exchange for a partial cash payment).

3. Treatment of Different Blocks or Classes of Instruments or Different Exchange Consideration

a. Where a holder either exchanges multiple old debt instruments which have different characteristics or receives different forms of consideration in the exchange, the question is presented whether the exchange should be treated as a single aggregated exchange or whether the holder's transfer of different debt instruments or receipt of different forms of consideration can or must be segregated.

b. If the holder acquired the old debt at different times or at different prices (i.e., in separate lots), the holder is required to determine his gain or loss separately with respect to each block, and, in a recapitalization exchange, cannot offset gains on certain lots with losses on other lots. *Rev. Rul. 68-23*, 1968-1 C.B. 144.

c. If the holder exchanges only one class of old debt instruments (even if acquired in separate lots) and receives different forms of consideration in the exchange, the holder is generally required to allocate the different forms of exchange consideration proportionately among the old debt instruments transferred in the exchange. Reg. section 1.358-2(a)(3); Cf. *Rev. Rul. 68-55*, 1968-1 C.B. 140.

i. Under this rule, the holder cannot avoid recapitalization treatment with respect to some of his old debt instruments transferred in the exchange by allocating only nonstock and nonsecurity consideration to such instruments.

d. If the holder exchanges different classes of debt instruments and receives different forms of exchange consideration, a factual determination must be made regarding the amount and form of consideration received with respect to the different

² The holder also would be required to recognize gain to the extent the "principal amount" of any new debt securities received by the holder in the exchange exceeds the "principal amount" of old debt securities given up by the holder in the exchange. Code section 354(a)(2)(A). "Principal amount" for this purpose should be interpreted to mean the "issue" price of the new debt and "adjusted issue price" of the new debt security, as opposed to the respective stated principal amounts of the securities. Cf. *Rev. Rul. 89-122*. The Tax Simplification Bill of 1991 would clarify that this is the result.

classes of debt instruments. Reg. section 1.358-2(a)(4); *Rev. Rul. 74-515*, 1974-2 C.B. 118.

i. The IRS takes the position that, even if only nonstock and nonsecurity consideration is allocated to one class of debt (i.e., all stock and security consideration is allocated to another class), the exchange of the former class by a holder who exchanges both classes constitutes a recapitalization in which loss cannot be recognized. *Rev. Rul. 74-515*. The validity of this position is questionable.

4. OID On New Debt Instrument

a. The new debt received in the exchange has OID to the extent:

- the new debt's issue price *is less than* the new debt's "stated redemption price at maturity." Code section 1273(a).

b. Rules for determining the issue price of the new debt are described in A.2.

i. If neither the old debt nor the new debt is market-traded and the stated yield is at least equal to AFR, the issue price of the new debt is its face amount.

ii. If either the old debt or the new debt is market-traded, the issue price of the new debt is based on the trading price of the publicly traded instrument at the time of the exchange.

- Because of the high credit risk, the debt of a troubled obligor will typically trade at a substantial discount to face.

c. The stated redemption price at maturity of a debt instrument equals the stated amount payable at maturity *plus* all amounts payable before maturity other than "qualified periodic interest payments" ("QPIP"). Code section 1273(a)(2).

i. Interest is QPIP only if it is a fixed amount unconditionally payable at fixed periodic intervals of one year or less. Code section 1273(a)(2); Prop. Reg. section 1.1273-1(b)(1).

- Interest payable only if certain earnings or cash flow tests are met is not QPIP because it is not unconditional.
- Under proposed regulations, interest is unconditionally payable "if the failure to pay interest timely results in an acceleration of all amounts due under the debt instrument or if the unpaid interest compounds at a penalty interest rate that is significantly higher than the interest rate otherwise payable under the terms of the debt instrument." Prop. Reg. section 1.1273-1(b)(1)(iii).

Interest is QPIP only if it is a fixed amount unconditionally payable at fixed periodic intervals of one year or less.

- If the debt instrument has an interest "holiday" at the front end (i.e., a short period of perhaps a year or two following issuance during which the obligor can defer interest payments) none of the interest payments will qualify as QPIP. In this case, all stated interest payments

would be included in "stated redemption price at maturity" and hence treated as OID.

- "Baby bonds" issued in payment of interest on a payment-in-kind ("PIK") debt instrument do not qualify as QPIP. Thus, stated yield on a PIK debt instrument is treated as OID.

d. As described above in B.4.b. and c., debt instruments have two sources of OID:

i. OID attributable to stated interest which does not qualify as QPIP.

ii. OID attributable to the issue price of the debt instrument being less than its face amount.

- This type of OID has the effect of increasing the annual amount the holder must include in income above the stated yield on the debt instrument.
- This type of OID will arise on new debt issued in exchange for old debt only if (A) the old debt or the new debt is traded on an established securities market *or* (B) neither is market-traded but the stated yield on the new debt is less than the AFR.

If the holder's basis in the new debenture exceeds [its] issue price . . . the excess reduces proportionately the holder's OID income accruals.

e. If the amount of OID on the new debt exceeds a *de minimis* amount (0.25 percent times the number of complete years to maturity), the holder must include OID in income (and the issuer generally may deduct OID) as it accrues (even though no cash is received at such time) under the constant-interest-rate method. Code sections 1273(a)(3) and 1272(a).

i. The amount of OID accrual is determined for each "accrual period" (i.e., the interval between regular interest payment or compounding dates, provided that this interval does not exceed one year).

ii. The amount of OID accruing in each accrual period is the "adjusted issue price" of the debt instrument at the start of the accrual period multiplied by the yield-to-maturity on the debt (minus any QPIP paid during the accrual period).

- The adjusted issue price of a debt instrument is its original issue price, *plus* prior OID accruals, *minus* prior payments of principal or accrued OID.
- The amount of OID accruing during any accrual period is allocated ratably to each day in the accrual period.

f. The general OID rules would reach an erroneous result in those cases where (A) the holder pays face or near face for the old debt, (B) the old debt thereafter declines in value, and (C) at a time when the old debt is market-traded, the holder swaps it for a new long-term debt security.

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i. For example:

- Mr. A buys a Bigco \$100 face debenture for \$100.
- Because Bigco thereafter has financial problems, the old debenture drops in value to \$50.
- The old debenture is traded on an established market.
- In an exchange offer, Mr. A swaps the old \$100 debenture for a new \$100 debenture (paying nine percent QPIP interest) with an FMV of \$55.
- Mr. A's \$45 loss (\$100 basis in old debenture less \$55 FMV of new market-traded debenture) is disallowed by the recapitalization rules and hence Mr. A takes a \$100 basis for the new debenture.
- The new debenture has \$45 of OID (\$100 stated redemption price at maturity less \$55 issue price).
- Under the general OID rules, Mr. A would recognize \$45 of OID income over the life of the new debenture, even though the \$45 is merely a recovery of his original principal. (In this case, Mr. A's basis for the new debenture would increase from \$100 to \$145, so that he would recognize a \$45 capital loss on redemption of the debenture for its \$100 face amount.)

g. The proposed OID regulations (dealing with acquisition premium) generally grant relief in this situation. Prop. Reg. section 1.1272-1(g)(1).

- If the holder's tax basis in the new debenture exceeds the new debenture's issue price (i.e., because of the holder's high carryover basis from the old debenture), the excess reduces proportionately the holder's OID income accruals on the new debenture (but not the obligor's OID deduction accruals).
- Thus, if the holder's carryover tax basis in the new debenture is equal to the new debenture's stated redemption price at maturity, the holder is not treated as having any OID income.

Unlike OID, the holder does not have to include market discount in income until the debt instrument matures or is disposed of.

h. Amortization of issuance premium.

i. In certain cases, the holder's tax basis in the new debt may not only exceed the new debt's issue price (as described immediately above), but may also exceed the new debt's stated redemption price at maturity. Such excess is referred to as "bond premium."

- For example, Mr. A purchased the old debt for \$100. He exchanges the old debt for new debt which matures in 10 years, has a stated principal amount of \$90, an issue price of \$50, and bears adequate QPIP interest.

ii. In this situation, Mr. A does not have to include in income any OID on the new debt and

may also elect to amortize the \$10 bond premium (i.e., his \$100 basis less the \$90 redemption price) over the term of the new debt. Code sections 1272(c)(1) and 171(a)(1).

- The annual amortization amount is determined on a constant-yield-to-maturity method. Code section 171(b)(3).
- The amortized bond premium is treated as an offset to the holder's interest income on the new debt instrument. Code section 171(e).
- The election is irrevocable and applies to all debt instruments (other than tax-exempt bonds) held or thereafter acquired by the taxpayer. Code section 171(c).

i. Treatment of market discount.

i. The holder of old debt may have acquired the old debt in a secondary purchase (i.e., a purchase from another holder rather than a primary issuance from the obligor) at a "market discount."

- In general, market discount is the excess of a bond's adjusted issue price (i.e., original issue price, plus all OID accrued to date, minus all payments of principal or OID to date) over the holder's tax basis in the bond. Code section 1278(b)(2), (4).

ii. Unlike OID, the holder does not have to include market discount in income until the debt instrument matures or is disposed of. Code section 1276(a).

- On disposition of a market discount bond in a transaction in which gain is recognized, the holder's gain is treated as ordinary income (rather than capital gain) to the extent of the market discount that has accrued while the holder owned the debt instrument.
- Unless the holder makes an irrevocable election to the contrary, market discount is treated as accruing on a straight-line basis, rather than a constant-yield-to-maturity basis. Code section 1276(b)(1).
- The holder may elect to include market discount in income as it accrues, under rules similar to the OID rules. Code section 1276(b)(2).

iii. If an old market discount debt instrument is exchanged in a recapitalization, then:

- If the holder receives no boot in the recapitalization (i.e., he receives only the obligor's stock and/or a new debt security), the holder should recognize no gain, despite the accrued market discount on the old debt. Code section 1276(d)(1).
- If the holder receives some boot (i.e., cash or property other than the obligor's stock or debt security) and if he has a gain on the transaction (i.e., all the consideration received exceeds his basis in the old debt), he recognizes gain to the extent of the boot. The gain so recognized is ordinary income to the extent of the accrued market discount and any excess is capital gain. Code section 1276(a).
- Any accrued market discount on the old debt not recognized in the recapitalization will be treated as ordinary income if and when the new debt security or stock is disposed of at a

gain in a taxable transaction. Code section 1276(c).

iv. If either the old debt or the new debt is market-traded, an exchange of old debt which was acquired at a market discount for new debt will have the effect of converting at least part of the as-yet-unaccrued market discount into OID on the new debt.

- For example, if Mr. A purchased a \$100 face old debenture (with no OID) for \$60 (thus creating \$40 of market discount) and later exchanged it in a recapitalization for a \$100 face market-traded new debenture with an FMV of \$65, the new debenture in his hands would have \$35 of OID.
- This would accelerate Mr. A's income recognition since OID is included in income as it accrues, while recognition of market discount can be deferred.

[A]n exchange of old debt . . . acquired at a market discount for new debt [may] . . . convert at least part of the as-yet-unaccrued market discount into OID.

C. Obligor's Interest and OID Deductions

1. Code section 163(e)(5) defers, and in certain cases partially disallows, a corporation's interest deductions on an "applicable high yield discount obligation" (an "AHYDO"), i.e., an instrument which meets all of the following requirements:

- a. the maturity date is more than five years from the date of issuance, and
- b. the yield-to-maturity is equal to or greater than AFR plus five percentage points ("AFR + 5"), and
- c. the debt instrument has "significant" OID.

- i. A debt instrument has significant OID if (according to its terms) the *excess of* aggregate interest accruals (including amortized OID and PIK issuances of baby debt and stock) *over* the aggregate required interest payments at any time after the instrument has been outstanding more than five years *may be greater than* the first year's interest.

2. Deductions for interest (including amortized OID and PIK issuances of baby debt and stock) on an AHYDO are deferred until paid in cash. Code section 163(e)(5)(A)(ii).

3. To the extent the yield to maturity on an AHYDO exceeds AFR + 6, interest deductions (other than QPIP) are disallowed entirely. Code section 163(e)(5)(A)(i).

- a. Corporate holders of an AHYDO are allowed a dividends received deduction for the nondeductible portion (provided that the issuer has adequate E&P). Code section 163(e)(5)(B).

4. If the stated yield on a debt instrument issued in a restructuring is less than AFR + 5, the section 163(e)(5) rules will apply only if the new instrument is treated as issued at a discount, and the OID, together with the stated yield, increases the yield-to-maturity to AFR + 5 or greater.

5. Rules for determining the issue price of a new debt instrument issued in exchange for an old debt instrument are described above in A.2.

- a. If *neither* the old debt nor the new debt is market-traded, section 163(e)(5) will apply *only if the stated yield is at least AFR + 5* (since such instruments are deemed to have OID only to the extent necessary to raise their yield-to-maturity to the AFR).

- b. If *either* the old debt *or* the new debt is market-traded, section 163(e)(5) will in most cases apply to the new debt.

- i. Because of the high credit risk, the trading price of the market-traded new debt typically will reflect a yield-to-maturity of at least AFR + 5.

- c. It may be very tax advantageous for the obligor to avoid public trading in new or old debt (e.g., by delisting old debt prior to the restructuring), in order to avoid:

- CODI income equal to the *excess of* the old debt's adjusted issue price *over* the new debt's FMV (because if not market-traded, the new debt is treated as a payment equal to face so long as it bears interest at least equal to AFR), and
- creation of OID for the new debt which would push the yield over AFR + 5 and AFR + 6 and hence invoke the AHYDO deferral and disallowance rules.

D. Debt Restructuring—Examples

Example 1: Debenture Canceled in Exchange for Cash

Troubled Corp. ("T") has outstanding a 10-year debenture with a face amount and adjusted issue price of \$100 and a yield, paid currently, of 12 percent. The holder of the debenture ("H") has a \$90 basis in the debenture. Because of T's poor financial condition, the FMV of the debenture has declined to \$60. T pays H \$60 cash in cancellation of the debenture.

In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV	60
• H's basis	90
• Cash paid in cancellation	60

It may be very tax advantageous for the obligor to avoid public trading in new or old debt

Treatment of T

1. Amount of DC. Assuming that none of the exceptions to DC (e.g., purchase price adjustment, shareholder contribution to capital) apply, T has DC of \$40 (\$100 adjusted issue price less \$60 cash paid in cancellation).

2. Amount of CODI.

- a. If T is *neither in bankruptcy nor insolvent*—T has CODI of \$40 (which may be offset by T's NOLs, subject to section 382 and other NOL limitations). For AMT purposes, NOL carryforwards can offset only 90 percent of AMT income (including CODI) and hence T's AMT may be 2 percent of the CODI

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(20% AMT rate x 10% of CODI not sheltered by NOL carryforwards).

b. *If T is in bankruptcy*—T has no CODI (and hence no AMT exposure on the CODI), but its NOLs and other tax attributes must be reduced by \$40, subject to the floor on reduction of asset tax basis; if there are not \$40 of T tax attributes to reduce, still no CODI.

c. *If T is not in bankruptcy, but is insolvent by \$40 or more immediately before discharge*—T has no CODI (and hence no AMT exposure on the CODI), but its NOLs and other tax attributes must be reduced by \$40.

d. *If T is insolvent by, e.g., \$30 immediately before discharge*—T has \$10 CODI (\$40 DC less \$30 pre-discharge insolvency) which may be offset by T NOLs, subject to section 382 and other limitations, and \$30 of attribute reduction.

Treatment of H

1. **Recognition of gain or loss.** H recognizes a \$30 loss (\$90 tax basis less \$60 cash received).

Example 2: Nonmarket-Traded Debenture Canceled in Exchange for New Nonmarket-Traded Debenture With Reduced Yield

Same facts as Example 1, except that, in cancellation of the old nonmarket traded debenture, T issues to H a new 10-year nonmarket-traded debenture with a face amount of \$100 and stated interest of 10 percent (rather than the old debenture's 12 percent) per annum (payable currently).

In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV (nonmarket-traded)	60
• H's basis	90
• New debenture face (nonmarket-traded)	100

Treatment of T

Because neither the old debenture nor the new debenture is traded on an established securities market, and the new debenture has a stated yield at least equal to AFR, the issue price of the new debenture will be its face amount (\$100). T has no DC and hence no CODI and no attribute reduction.

Because . . . the new [nonmarket-traded] debenture has a stated yield at least equal to AFR, the issue price of the new debenture will be its face amount.

Treatment of H

1. **Recognition of gain or loss.** Since the old debenture and the new debenture are long-term "securities," H's exchange is a recapitalization. H realizes (but does not recognize) a \$10 gain on the exchange (\$100 issue price of new debenture less \$90 adjusted basis).

2. **Basis in new debenture.** H's basis in the new debenture is \$90 (carryover of \$90 basis in old debenture).

Example 3: Market-Traded Debenture Canceled in Exchange for New Debenture With Reduced Yield

The facts are the same as Example 2, except that the old debenture is market-traded and had a trading price of \$60 immediately before the exchange.

In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV (market-traded)	60
• H's basis	90
• New debenture face	100

Treatment of T

1. **Amount of DC.** Because the old debenture is market-traded, the issue price of the new debenture is \$60 (the FMV of the old debenture immediately before the exchange). (This is in sharp contrast to Example 2, where neither the old nor the new debenture was market-traded and hence the issue price of the new debenture was its face amount.) Assuming that none of the exceptions to DC (e.g., purchase price adjustment, shareholder contribution to capital) apply, T has DC of \$40 (\$100 adjusted issue price of old debenture less \$60 issue price of new debenture).

2. **Amount of CODI.** Same as Example 1, i.e., \$40 of CODI unless T is in bankruptcy or insolvent.

3. **Interest and OID accruals on new debenture.** The yield to maturity on the new debenture is approximately 19 percent (taking into account OID of \$40, annual interest payments of \$10 and 10-year term). Assuming that the AFR is 8 percent, the new debenture will be subject to section 163(e)(5), since it (a) has a yield to maturity in excess of AFR + 5, (b) has a term of more than five years, and (c) has significant OID.

Accordingly, T's deductions for OID (including any stated interest which does not qualify as QPIP) on the new debenture will be deferred until actual payment is made in cash. Moreover, such deductions will be disallowed entirely to the extent the yield on the new debenture exceeds AFR + 6%. Under this rule, approximately 26 percent of the payments (but not in excess of the non-QPIP payments) would be nondeductible (AFR + 6% = 14%; [(19% - 14%) ÷ 19%] = 26%).

Treatment of H

1. **Recognition of gain or loss.** Since the old debenture and the new debenture are long-term "securities," H's exchange is a recapitalization. H realizes (but does not recognize) a \$30 loss on the exchange (\$90 adjusted basis less \$60 amount realized).

2. **Basis in new debenture.** H's basis in the new debenture is \$90 (\$90 carryover basis from old debenture).

3. Interest and OID accruals on new debenture.

As discussed above in connection with T, the new debenture will have significant OID, producing a yield to maturity on the new debenture of approximately 19 percent. This would require H to include approximately \$11.50 interest and OID in income in the first year H holds the new debenture (and to include increased amounts in future years as the OID builds up).

Because H's \$90 tax basis in the new debenture will exceed the \$60 issue price of the new debenture, H should be permitted to offset OID accruals by the \$30 acquisition premium. The acquisition premium offset will

reduce H's income by \$30 over the term of the new debenture.

Example 4: Market-Traded Debenture Canceled in Exchange for New Debenture with Same Yield

Same facts as Example 3, except that, in cancellation of the old debenture, T issues to H a new debenture which has the same terms (including the same yield-to-maturity) as the old debenture, except for an extension of the maturity date, a delay in certain interest payment dates and looser covenants.

The new debenture should be treated as a continuation of the old debenture for tax purposes. Accordingly, its issuance should have no tax consequences to T or H.

Since the old debenture and the new debenture are long-term 'securities,' H's exchange is a recapitalization.

Example 5: Old Debenture (Whether or not Market-Traded) Canceled in Exchange for T Common Stock

The facts are the same as Example 1, except that the old debenture is canceled in exchange for T common stock with a \$60 FMV.

In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV	60
• H's basis	90
• T stock FMV	60

Treatment of T

1. Amount of DC. Assuming that none of the exceptions to DC (e.g., purchase price adjustment, shareholder contribution to capital) apply, T has DC of \$40 (\$100 adjusted issue price of old debenture less \$60 FMV of new debenture).

2. Amount of CODI.

a. *If T is neither in bankruptcy nor insolvent*—T has CODI of \$40 (which may be offset by T's NOLs, subject to section 382 and other NOL limitations). For AMT purposes, NOL carryforwards can offset only 90 percent of AMT income (including CODI) and hence T's AMT may be 2 percent of the CODI (20% AMT rate x 10% of CODI not sheltered by NOL carryforwards).

b. *If T is in bankruptcy*—Exchange should qualify for stock-for-debt exception to CODI. Accordingly, T has no CODI (and hence no AMT exposure) and no attribute reduction.

c. *If T is insolvent by \$40 or more immediately before discharge*—Exchange should qualify for stock-for-debt exception to CODI, resulting in no CODI (and hence no AMT exposure) and no attribute reduction.

d. *If T is insolvent by, e.g., \$30 immediately before discharge*—T has \$10 CODI (\$40 DC less pre-discharge insolvency) which may be offset by T NOLs, subject to section 382 and other limitations and no additional CODI or attribute reduction.

Treatment of H

1. Recognition of gain or loss. Since the old debenture is a long-term "security," H's exchange is a recapitalization. H realizes (but does not recognize) a \$30 loss on the exchange.

2. Basis in stock. H's basis in the stock is \$90 (\$90 carryover basis from the old debenture).

Example 6: Nonmarket-Traded Debenture Canceled in Exchange for Cash, New Nonmarket-Traded Debenture and T Common Stock

The facts are the same as Example 1, except that the old debenture is canceled in exchange for T common stock with an FMV of \$10, a new debenture with a face of \$50 and stated interest of 10 percent per annum (payable currently), and \$20 cash.

In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV (nonmarket-traded)	60
• H's basis	90
• T stock FMV	10
• New debenture face (nonmarket-traded)	50
• Cash	20

Treatment of T

1. Amount of DC.

a. *If T is neither in bankruptcy nor insolvent*—Assuming that none of the exceptions to DC (e.g., purchase price adjustment, shareholder contribution to capital) apply, T has DC of \$20 (\$100 adjusted issue price of old debenture less sum of \$10 FMV of stock, \$50 issue price of new debenture³ and \$20 cash).

b. *If T is in bankruptcy*—Exchange should qualify for stock-for-debt exception to DC.

IRS may argue that the T stock issued in the exchange is nominal or token. If the T stock is treated as nominal or token, T would have DC of \$20.

[P]roposed regulations describe three ratios . . . as relevant in testing whether stock is nominal or token.

As discussed in A.6., proposed regulations describe three ratios (the stock-to-debt ratio, the stock-to-total-consideration ratio, and the stock-to-total-stock ratio) as relevant in testing whether stock is nominal or token.

- In this example, the stock-to-debt ratio would be 33 percent: \$10 FMV of stock ÷ \$30 (\$100 adjusted issue price of old debenture minus sum of (i) \$20 cash plus (ii) \$50 adjusted issue price of new debenture).
- The stock-to-total-consideration ratio would be 13 percent: \$10 FMV of stock ÷ \$80 (sum of (i) \$10 FMV of stock plus (ii) \$50 adjusted

³ The issue price of the new debenture equals its face amount as neither the new debenture nor the old debenture is market-traded and the stated interest on the new debenture is not less than the AFR.

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issue price of new debenture *plus* (iii) \$20 cash).

- The exchange would not meet any of the IRS' suggested stock-for-debt-exception safe harbors, as all of the safe harbors require a stock-to-total-consideration ratio of 25 percent or more.
- Nonetheless, it is likely that the amount of common stock issued in the exchange would be viewed as more than nominal or token, particularly if all of T's creditors, as a group, obtain a significant portion (e.g., 10 percent or more) of T's aggregate stock.

c. *If T is insolvent by \$20 or more immediately before discharge*—Exchange should qualify for stock-for-debt exception to DC. If the T stock is treated as nominal or token, T would have DC of \$20.

d. *If T is insolvent by, e.g., \$15 immediately before discharge*—If stock-for-debt exception applies, T has \$5 DC (\$20 DC less \$15 pre-discharge insolvency). If T stock is treated as nominal or token, T has \$20 of DC.

2. Amount of CODI.

a. *If T is neither in bankruptcy nor insolvent*—T has CODI of \$20 (which may be offset by T's NOLs, subject to section 382 and other NOL limitations). For AMT purposes, NOL carryforwards can offset only 90 percent of AMT income (including CODI) and hence T's AMT may be 2 percent of the CODI (20% AMT rate x 10% of CODI not sheltered by NOL carryforwards).

b. *If T is in bankruptcy*—As discussed above, if the exchange qualifies for the stock-for-debt exception to DC, T will have no CODI (and hence no AMT exposure) and no attribute reduction. If the T stock is treated as nominal or token, T would have no CODI, but would have \$20 of attribute reduction.

c. *If T is insolvent by \$20 or more immediately before discharge*—As discussed above, if the exchange qualifies for the stock-for-debt exception to DC, T will have no CODI (and hence no AMT exposure) and no attribute reduction. If the T stock is treated as nominal or token, T would have no CODI, but would have \$20 of attribute reduction.

d. *If T is insolvent by, e.g., \$15 immediately before discharge*—As discussed above, if the stock-for-debt exception applies, T will have \$5 of DC, all of which would be treated as CODI, but no additional attribute reduction. If T stock is treated as nominal or token, T would have \$15 of attribute reduction, in addition to the \$5 of CODI.

Treatment of H

1. **Recognition of gain or loss.** Since the old debenture and new debenture are long-term "securities," H's exchange is a recapitalization. H realizes (but does not recognize) a \$10 loss on the exchange.

2. **Basis in cash, stock and new debenture.** H's basis in cash is \$20. H's aggregate basis in the stock and new debenture is \$70 (\$90 adjusted basis in old debenture, less \$20 basis allocated to cash). This aggregate basis is allocated between the stock and new debenture in proportion to the respective FMV of the stock and issue price of the new debenture. Accordingly,

\$11.67 (\$70 x \$10/\$60) is allocated to the stock and \$58.33 (\$70 x \$50/\$60) is allocated to the new debenture.

3. **Interest and OID accruals on new debenture.** As the new debenture has an issue price equal to its face amount, the new debenture will not have any OID. Since the new debenture has a basis to H of \$58.33 and a stated redemption price at maturity of \$50, H would be treated as having \$8.33 of amortizable bond premium with respect to the new debenture. If H so elects, the amortizable bond premium may be amortized as an offset to the stated interest on the new debenture.⁴

As the new debenture has an issue price equal to its face amount, the new debenture will not have any OID.

Example 7: Market-Traded Debenture Canceled in Exchange for Cash, New Nonmarket-Traded Debenture and T Common Stock

The facts are the same as Example 6, except that the old debenture is traded on an established securities market and had a trading price of \$60 immediately before the exchange. In summary:

• Old debenture face	\$100
• Old debenture adjusted issue price	100
• Old debenture FMV (market-traded)	60
• H's basis	90
• T stock FMV	10
• New debenture face (nonmarket-traded)	50
• Cash	20

Treatment of T

1. Amount of DC.

a. *If T is neither in bankruptcy nor insolvent*—The amount of DC depends on the issue price of the new debenture, the determination of which involves several steps. *First*, determine the aggregate issue price for the new "investment unit" consisting of the stock and new debenture. The aggregate issue price of the new investment unit is the trading price of the old debenture immediately before the exchange (\$60), less the amount of cash issued in the exchange (\$20). *Second*, the \$40 issue price of the new investment unit is then allocated between the new debenture and the stock. If the stock is market-traded, an amount equal to the trading price of the stock (\$10) will be allocated to the stock, and the new debenture will thus have an issue price of \$30.⁵

⁴ This assumes that all stated interest on the new debenture is QPIP. If the stated interest on the new debenture did not qualify as QPIP, the amortizable bond premium rules would not apply. Rather, the stated interest on the new debenture would be treated as OID and the acquisition premium rules would apply.

⁵ If neither the stock nor the new debenture is market-traded, the issue price of the new debenture would be the FMV of the new debenture, determined using a reasonable discount rate, not less than AFR (and if T and H agree upon such a reasonable rate, using the rate they selected). The issue price of the new debenture under this rule cannot exceed the issue price of the new investment unit. Prop. Reg. section 1.1273-2(d)(2)(iv).

Assuming that none of the exceptions to DC (e.g., purchase price adjustment, shareholder contribution to capital) apply, T has DC of \$40 (\$100 adjusted issue price of old debenture less sum of \$10 FMV of stock, \$30 issue price of new debenture and \$20 cash).

b. *If T is in bankruptcy*—Exchange should qualify for stock-for-debt exception to DC. The IRS may argue that the T stock issued in the exchange is nominal or token. If the T stock is treated as nominal or token, T would have \$40 of DC.

As discussed in A.6, proposed regulations describe three ratios (the stock-to-debt ratio, the stock-to-total-consideration ratio, and the stock-to-total-stock ratio) as relevant in testing whether stock is nominal or token.

- In this example, the stock-to-debt ratio would be 20 percent: \$10 FMV of stock ÷ \$50 (\$100 adjusted issue price of old debenture minus sum of (i) \$20 cash and (ii) \$30 adjusted issue price of new debenture).
- The stock-to-total-consideration ratio would be 17 percent: \$10 FMV of stock ÷ \$60 (sum of (i) \$10 FMV of stock plus (ii) \$30 adjusted issue price of new debenture plus (iii) \$20 cash).
- The exchange would not meet any of the IRS' suggested stock-for-debt-exception safe harbors, as all of the safe harbors require a stock-to-total-consideration ratio of 25 percent or more.
- Nonetheless, it is likely that the amount of common stock issued in the exchange would be viewed as more than nominal or token, particularly if T's creditors, as a group, obtain a significant portion (e.g., 10 percent or more) of T's aggregate stock.

c. *If T is insolvent by \$40 or more immediately before discharge*—Exchange should qualify for stock-for-debt exception to DC, resulting in no DC. If the T stock is treated as nominal or token, T would have \$40 of DC.

d. *If T is insolvent by, e.g., \$30 immediately before discharge*—If stock-for-debt exception applies, T has \$10 of DC (\$40 DC less \$30 pre-discharge insolvency). If T stock is treated as nominal or token, T has \$40 of DC.

2. Amount of CODI.

a. *If T is neither in bankruptcy nor insolvent*—T has CODI of \$40 (which may be offset by T's NOLs, subject to section 382 and other limits, including the two-percent AMT exposure).

b. *If T is in bankruptcy*—As discussed above, if the exchange qualifies for the stock-for-debt exception to DC, T will have no CODI (and hence no AMT exposure) and no attribute reduction. If the T stock is treated as nominal or token, T would have no CODI, but would have \$40 of attribute reduction.

c. *If T is insolvent by \$40 or more immediately before discharge*—As discussed above, if the exchange qualifies for the stock-for-debt exception to DC, T will have no CODI (and hence no AMT exposure) and no attribute reduction. If the T stock is treated as nominal or token, T would have no CODI, but would have \$20 of attribute reduction.

d. *If T is insolvent by, e.g., \$30 immediately before discharge*—As discussed above, if the stock-for-debt exception applies, T will have \$10 DC, all of which would be treated as CODI, but no additional attribute reduction. If T stock is treated as nominal or token, T would have \$30 of attribute reduction, in addition to the \$10 CODI.

3. **Interest and OID accruals on new debenture.** The yield to maturity on the new debenture is approximately 19 percent (taking into account \$20 of OID, annual interest payments of \$5 and 10-year term). Assuming that the AFR is 8 percent, the new debenture will be subject to section 163(e)(5), since it (a) has a yield-to-maturity in excess of AFR + 5, (b) has a term of more than five years and (c) has significant OID.

[D]eductions for any stated interest which does not qualify as QPIP on the high-yield discount obligation will be deferred until payment is made in cash.

Accordingly, T's OID deductions (and deductions for any stated interest which does not qualify as QPIP) on the high-yield discount obligation will be deferred until payment is made in cash. Moreover, the OID payments (and any stated interest payments which do not qualify as QPIP) will be disallowed entirely to the extent the yield exceeds AFR + 6%. Under this rule, approximately 26 percent of the payments (but not in excess of the non-QPIP payments) would be nondeductible (AFR + 6% = 14%; [(19% - 14%) ÷ 19%] = 26%).

Treatment of H

1. **Recognition of gain or loss.** Since the old debenture and new debenture are long-term "securities," H's exchange is a recapitalization. H realizes (but does not recognize) a \$30 loss on the exchange (\$90 adjusted basis less \$60 amount realized).

2. **Basis in cash, stock and new debenture.** H's basis in the cash is \$20. H's aggregate basis in the stock and new debenture received in the exchange is \$70 (\$90 adjusted basis in old debenture, less \$20 basis allocated to the cash). The aggregate basis is allocated between the stock and new debenture in proportion to the respective FMV of the stock and issue price of the debenture. Accordingly, \$17.50 (\$70 × \$10/\$40) is allocated to the stock and \$52.50 (\$70 × \$30/\$40) is allocated to the new debenture.

3. **Interest and OID accruals on new debenture.** As discussed above in connection with T, the new debenture will have significant OID, producing a yield to maturity on the new debenture of approximately 19 percent. In general, this would require H to include approximately \$5.75 interest and OID in income in the first year H holds the new debenture (and to include increased amounts in future years as the OID builds up).

However, because H's \$52.50 tax basis in the new debenture will exceed both the \$30 issue price and (assuming that all of the stated interest on the new debenture is QPIP) the \$50 stated redemption price at maturity of the new debenture, H would not be required to accrue

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any OID and would have a \$2.50 amortizable bond premium.

Example 8: Nonmarket-Traded Debenture with Accrued OID Canceled in Exchange for Cash, New Nonmarket-Traded Debenture and T Common Stock

T has outstanding a 10-year, nonmarket-traded debenture which has an adjusted issue price of \$100 (\$90 attributable to principal and \$10 attributable to OID accrued since the start of H's holding period), a face amount of \$110 and a yield to maturity of 12 percent. H has a \$95 basis in the debenture (\$86 attributable to principal and \$9 attributable to OID accrued since the start of H's holding period). Because of T's poor financial condition, the FMV of the debenture has declined to \$60. The old debenture is canceled in exchange for T common stock with an FMV of \$10, a new nonmarket-traded debenture with a face amount of \$50 and \$20 cash.

In summary:

• Old debenture face	\$110
• Old debenture adjusted issue price	100
• Original principal	90
• OID accrued during H's ownership	10
• Old debenture FMV	60
• H's basis	95
• H's original purchase price	86
• OID previously recognized by H	9
• T stock FMV	10
• New debenture face	50
• Cash	20

Treatment of T

Same as Example 6.

[T]he \$10 FMV stock, \$50 issue price new debenture and \$20 cash should be allocated pro rata between the \$90 principal and \$10 accrued OID of the old debenture.

Treatment of H

1. Recognition of gain or loss. Since the old debenture and new debenture are long-term "securities," H's exchange is a recapitalization. Unless the exchange offer provides otherwise, the \$10 FMV stock, \$50 issue price new debenture⁶ and \$20 cash should be allocated pro rata between the \$90 principal and \$10 accrued OID of the old debenture. Thus, \$9 FMV of the stock, \$45 issue price of the new debenture and \$18 of the cash (totalling \$72) should be allocated to the principal of the old debenture and \$1 of the stock, \$5 of the issue price of the new debenture, and \$2 of the cash (totalling \$8) should be allocated to the OID on the old debenture.

H realizes (but does not recognize) a \$14 loss on the exchange of the principal element of the old debenture

⁶ The issue price of the new debenture equals its face amount as neither the new debenture nor the old debenture is traded on an established securities market and the stated interest on the new debenture is not less than the AFR.

((\$86 adjusted basis less \$72 amount realized).⁷ H realizes (and does recognize) a \$1 loss on the exchange of the OID element of the old debenture (\$9 adjusted basis less \$8 amount realized).

If the exchange offer had provided that exchange consideration was to be allocated entirely to the original principal of the old debenture (and not to accrued OID), H would be treated as realizing (but not recognizing) a \$6 loss on the exchange of the principal element of the old debenture (\$86 adjusted basis less \$80 amount realized) and as realizing (and recognizing) a \$9 loss on the OID element of the old debenture (\$9 adjusted basis and \$0 amount realized).

[A]mortizable bond premium may be amortized as an offset to the stated interest on the new debenture.

2. Basis in cash, stock and new debenture. H's basis in the cash is \$20. H's basis in the portion of the stock and new debenture received in exchange for the accrued OID is \$1 and \$5, respectively. H's aggregate basis in the stock and new debenture received in exchange for the principal of the old debenture is \$68 (\$86 adjusted basis in principal element of old debenture, minus \$18 basis allocated to the cash paid for a portion of the principal of the old debenture). This aggregate basis is allocated between the stock and new debenture in proportion to the respective FMV of the stock and issue price of the debenture. Accordingly, \$11.33 (\$68 x \$9/\$54) is allocated to the stock and \$56.67 (\$68 x \$45/\$54) is allocated to the new debenture. Thus, the new stock has a total basis of \$12.33 and the new debenture a total basis of \$61.67.

3. Interest and OID accruals on new debenture. Since the new debenture has an issue price equal to its face amount, the new debenture will not have any OID. Since the new debenture has a basis to H of \$61.67 and a stated redemption price at maturity of \$50, H would be treated as having \$11.67 of amortizable bond premium with respect to the new debenture. If H so elects, the amortizable bond premium may be amortized as an offset to the stated interest on the new debenture.⁸

Example 9: Market-Traded Debenture with Accrued OID Canceled in Exchange for Cash, New Nonmarket-Traded Debenture and T Common Stock

The facts are the same as Example 8, except that the old debenture is traded on an established securities market and had a trading price of \$60 immediately before the exchange.

⁷ If H had purchased the old debenture after it had declined in value and had, e.g., a \$60 basis in the principal of the debenture, H would realize a \$12 gain on the exchange, which would be recognized to the extent of the portion of the cash received in exchange for the principal of the old debenture (\$18). Thus, H would recognize a gain of \$12.

⁸ This assumes that all stated interest on the new debenture is QPIP. If the stated interest on the debenture did not qualify as QPIP, the amortizable bond premium rules would not apply. Rather, the stated interest on the new debenture would be treated as OID and the acquisition premium rules would apply.

Treatment of T

Same as Example 7.

Treatment of H

1. Recognition of gain or loss. Since the old debenture and new debenture are long-term "securities," H's exchange is a recapitalization. Unless the exchange offer provides otherwise, the \$10 FMV stock, \$30 issue price new debenture⁹ and \$20 cash should be allocated pro rata between the \$90 principal and \$10 accrued interest in the old debenture. Thus, \$9 FMV of the stock, \$27 issue price of the new debenture and \$18 of the cash (totalling \$54) should be allocated to the principal of the old debenture and \$1 FMV of the stock, \$3 of the issue price of the new debenture and \$2 of the cash (totalling \$6) should be allocated to the OID on the old debenture.

H realizes (but does not recognize) a \$32 loss on the exchange of the principal element of the old debenture (\$86 adjusted basis less \$54 amount realized). H realizes (and does recognize) a \$3 loss on the exchange of the OID element of the old debenture (\$9 adjusted basis less \$6 amount realized).

If the exchange offer had provided that exchange consideration was to be allocated entirely to the original principal of the old debenture (and not to accrued OID), H would be treated as realizing (but not recognizing) a \$26 loss on the exchange of the principal element of the old debenture (\$86 adjusted basis less \$60 amount realized) and as realizing (and recognizing) a \$9 loss on the OID element of the old debenture (\$9 adjusted basis and \$0 amount realized).

2. Basis in cash, stock and new debenture. H's basis in the cash is \$20. H's basis in the portion of the stock and new debenture received in exchange for the accrued OID is \$1 and \$3, respectively. H's aggregate basis in the stock and new debenture received in exchange for the principal of the old debenture is \$68 (\$86 adjusted basis in principal element of old debenture, minus \$18 basis allocated to the cash paid for a portion of the principal of the old debenture). This aggregate basis is allocated between the stock and new debenture in proportion to the respective FMV of the stock and issue price of the debenture. Accordingly, \$17 (\$68 x \$9/\$36) is allocated to the stock and \$51 (\$68 x \$27/\$36) is allocated to the new debenture. Thus, the new stock has a total basis of \$18 and the new debenture a total basis of \$54.

3. Interest and OID accruals on new debenture. As discussed in Example 7, the new debenture will have significant OID, producing a yield to maturity on the new debenture of approximately 19 percent. This would require H to include approximately \$5.75 interest and OID in income in the first year H holds the new debenture (and to include increased amounts in future years as the OID builds up). Because H's \$54 tax basis in the new debenture will exceed the \$30 issue price and (assuming that all stated interest is QPIP) the \$50 stated redemption price at maturity of the new debenture, H would not be required to accrue any OID and would have a \$4 amortizable bond premium.

⁹ See Example 7.

E. Impact of Restructuring on Obligor's NOLs**1. DC Reduces NOLs**

a. In general, as described above, unless the stock-for-debt exception applies, DC typically has the effect of reducing the obligor's NOLs by the amount of the DC.

i. For an obligor which is solvent and not in bankruptcy, DC creates CODI, which uses up the obligor's NOLs (unless prevented by section 382 or other NOL limitations).

ii. For an obligor which is bankrupt or insolvent (to extent of insolvency), DC does not create CODI, but does reduce NOLs and then other tax attributes.

- As discussed in A.4.a.vi., the obligor can elect to reduce depreciable asset basis prior to reducing NOLs.
- As discussed in A.4.a.vii., consolidated group NOLs which are attributable to members of the consolidated group other than the obligor apparently escape the reach of the attribute reduction rule.

[C]onsolidated group NOLs which are attributable to members of the consolidated group other than the obligor apparently escape the reach of the attribute reduction rule.

2. Survival of Obligor's NOLs

a. Whether the obligor's NOLs and other favorable tax attributes (which remain after reduction for DC as described in E.1.) survive a restructuring depends on the form of restructuring transaction.

i. If L (a loss corporation) survives as a free-standing corporation (or as a member of an old consolidated group), its NOLs survive and may be used to offset future income of L (and other members of L's old group), subject to section 382 and other NOL limitations.

ii. If L's stock is acquired by P (a purchasing corporation) in a tax-free acquisition or a taxable acquisition (with no section 338 election), L's NOLs survive and may be used to offset future income of L (and other members of the P group), subject to section 382 and other NOL limitations.

iii. If L's assets are acquired by P in a tax-free acquisition, L's NOLs survive and may be used to offset future income of P (and other members of the P group), subject to section 382 and other NOL limitations. Code section 381(c)(1).

iv. If L's assets are acquired by P in a taxable acquisition and L is liquidated (or L's stock is acquired by P in a taxable acquisition with a section 338 election), its NOLs do *not* survive.¹⁰

¹⁰ If L was a member of the Bigco consolidated group before the transaction and L's assets are acquired by P in a taxable transaction (or its stock is acquired in a taxable transaction with Bigco and P making a section 338(h)(10) election), L's NOLs survive in the hands of the Bigco group (not the P group).

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b. The tax-free reorganization rules are relaxed somewhat for asset acquisitions from a bankrupt corporation. Code section 368(a)(1)(G).

3. Section 382 Limits on Utilization of L's Remaining NOLs in a One Company Restructuring

a. Issuance of L stock in connection with a debt restructuring may (by itself or taken in conjunction with prior and subsequent changes in the ownership of L stock) result in an "ownership change" of L for purposes of section 382.

The tax-free reorganization rules are relaxed somewhat for asset acquisitions from a bankrupt corporation.

i. An ownership change occurs if the percentage of L's stock (by value) held by certain persons (including creditors who exchange old debt for new stock) increases by more than 50 percentage points over a moving three-year period. Code section 382(g); Reg. section 382-2T(j)(2)(iii)(B)(1).

b. If L undergoes an ownership change, L may use NOLs from pre-change periods only in modulated amounts—use of NOLs in each post-change year is limited to approximately 7 percent of the total value of L's stock immediately before the ownership change. Code section 382(b).

i. If (and only if) L is in bankruptcy, the value of L's stock is adjusted upward to reflect any increase in value resulting from the surrender or cancellation of creditor claims in the restructuring. Code section 382(l)(6).

- Treasury officials have indicated that, at least in certain circumstances, section 382(l)(6) will be interpreted to permit an upward adjustment in the value of L's stock for an issuance of stock for cash, where the cash is used to cancel creditor claims in the restructuring.

ii. If L's net built-in losses at the time of the ownership change exceed a threshold level (lesser of \$10 million or 15 percent of FMV of L's gross assets, not reduced by L's liabilities), any recognition of such losses during a taxable year that begins or ends within five years after the ownership change is treated like a pre-change NOL and hence is subject to the section 382 limitation. Code section 382(h).

- L's post-change depreciation and amortization deductions attributable to built-in loss are treated as recognized built-in losses, and hence such deductions claimed during the five-year post-change period are subject to the section 382 limitation. Code section 382(h)(2)(B).

iii. L's taxable income or loss for the year in which the ownership change occurs is generally allocated pro rata between the pre- and post-ownership change periods. L's taxable income for the pre-change portion of the year can be fully offset by the NOL carryforwards. L's taxable income for the post-change portion of the year can be offset

only by the modulated amount of NOLs. Code section 382(b)(3).

iv. Taxpayers must seek specific permission from the IRS to allocate income or loss for the ownership-change year based on a closing of the books. Notice 87-79, 1987-2 C.B. 387.

- If there is a risk of substantial CODI, it may be advantageous to allocate income based on a closing of the books so that the CODI is allocated to the pre-change period and can be offset by NOLs without limitation. Otherwise, the CODI is allocated on a daily pro rata basis between the pre- and post-change partial years.
- Where the IRS permits taxpayers to use the closing-of-the-books method, it takes the position that the amount of income or loss allocated to either the pre-change period or the post-change period cannot exceed the taxable income or loss for the entire taxable year. As a relief measure, however, the IRS permits the section 382 limitation for the ownership-change year to be increased to the extent that net pre-change income is offset by net post-change losses. See, e.g., LTR 9119032 (February 8, 1991).

Taxpayers must seek specific permission from the IRS to allocate income or loss for the ownership-change year based on a closing of the books.

v. Huge trap: If L makes an exchange offer, the ownership change may occur at the time the offer is made (rather than at the time the exchange is actually closed). Reg. section 1.382-2T(h)(4).

- If the exchange closes within 120 days after the exchange offer is treated as made, L can treat the ownership change as occurring at the time the exchange closes. Reg. section 1.382-2T(h)(4)(vi)(B).
- If the exchange closes more than 120 days after treated as made, L must treat the ownership change as occurring when the exchange offer is made. Hence, the full amount of CODI is in the post-change partial year and is subject to the section 382 limitation. (Although the CODI may qualify as a recognized built-in gain as described below in E.3.c.)
- The IRS has interpreted an offer as made for purposes of section 382 when it "cannot be withdrawn as a legal or practical matter." See, e.g., LTR 8929018 (April 19, 1989); LTR 8903043 (October 14, 1988); LTR 9101008 (October 3, 1990).
- Under proposed regulations, an option to acquire stock pursuant to a bankruptcy plan of reorganization will not be taken into account for purposes of section 382 until the plan becomes effective. Prop. Reg. section 1.382-2T(h)(4)(x)(J).

- If an ownership change occurs *before* L realizes CODI (e.g., because an exchange offer results in an ownership change or because L issues sufficient new stock to cause an ownership change for cash, which it then uses to retire debt at a discount), it will generally be in L's interest to allocate income or loss for the ownership-change year under the general daily proration rule, rather than seeking permission to close its books.

[T]he ownership change may occur at the time the offer is made rather than at the time the exchange is actually closed.

vi. If L does not continue to conduct a significant portion of its historic business for at least two years following the ownership change, its annual section 382 limitation is *retroactively* reduced to zero (i.e., pre-change NOLs are generally lost). Code section 382(c).

c. If L's net built-in *gains* at the time of the ownership change exceed the threshold level (lesser of \$10 million or 15 percent of FMV of L's *gross* assets), the section 382 limitation is increased by the amount of any built-in gains recognized during a taxable year that begins or ends within five years after the ownership change. Code section 382(h)(1)(A).

i. Income items attributable to periods before the change date are treated as recognized built-in gains. Code section 382(h)(6)(A). CODI from a debt restructuring occurring after, but in connection with, the ownership change may qualify as a recognized built-in gain under this rule. *LTR 8923021* (March 10, 1989).

d. Elective rule for bankruptcy reorganizations.

i. Unless L "elects out", a special set of rules applies if L is in bankruptcy *and* L's shareholders and creditors (determined immediately before the ownership change) end up owning (immediately after the ownership change) 50 percent or more, by vote and value, of L's stock. Code section 382(l)(5).

- Creditors are counted for this purpose only if they acquire stock in exchange for debt that was *either* held for 18 months before bankruptcy filing *or* arose in the ordinary course of business and has been held at all times by the particular creditor. Code section 382(l)(5)(E).
- Stockholders apparently are counted for this purpose even if they acquired their stock shortly before the ownership change, i.e., within three years before the ownership change. Code section 382(l)(5)(A)(ii).
- ii. Benefits of special elective rule:
 - L's pre-change NOLs are *not* subject to section 382 limitation. Code section 382(l)(5)(A).
 - L's pre-change NOLs are *not* lost if corporation fails to continue a significant portion of its historic business for at least two years. Code section 382(l)(5)(A). (Failure to continue business may, however, result in loss of

NOLs under section 269, discussed below in E.5.)

iii. Detriments of special elective rule:

- L's pre-change NOLs are reduced by an amount equal to the interest which accrued on debt exchanged for stock in the bankruptcy reorganization during the year of the reorganization and three prior taxable years. Code section 382(l)(5)(B).
- NOLs (and other tax attributes) are reduced by an amount equal to 50 percent of the attribute reduction that would have occurred had the stock-for-debt exception to debt cancellation not applied. (This reduction does not apply to debt representing accrued interest to which the preceding paragraph applies.) Code section 382(l)(5)(C).
- If a second ownership change occurs within two years, the special elective rule is *retroactively* made inapplicable and the section 382 limitation after the second ownership change is zero. Code section 382(l)(5)(D).

4. Section 382 Limits on Utilization of L's Remaining NOLs in a Two Company Restructuring

a. A section 382 ownership change also may be triggered if L stock is acquired by new investors (either through a primary issuance from L or a secondary sale from old L stockholders).

i. Purchases from old L stockholders who own less than 5 percent of L's stock by new investors who also own less than 5 percent of L's stock are generally ignored. Code section 382(g)(2)(B).

A section 382 ownership change also may be triggered if stock is acquired by new investors.

b. A section 382 ownership change triggered by new investor purchases will result in application of the rules described above in E.3.

c. If a new investor ("A") makes a leveraged acquisition of the L stock, the section 382 limitation on use of pre-change losses may be reduced by a special set of rules. Code section 382(e)(2).

i. The value of L's stock for purposes of determining the annual section 382 limitation is reduced by the amount of any *redemptions* of L stock which occur in connection with the ownership change.

- If the assets of L are used to fund A's purchase of stock from L stockholders (e.g., acquisition debt is assumed by L), the stock purchase is treated as a redemption for tax purposes, thereby reducing the section 382 limitation.
- This rule also applies in a one-company restructuring where L redeems stock of shareholders.
 - ii. The value of L's stock is also reduced by any "*corporate contraction*" occurring in connection with the ownership change.
 - The IRS has not yet issued regulations indicating in what circumstances it will treat a

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leveraged acquisition as a "corporate contraction."

- The rule may well apply whenever a new parent corporation borrows to buy L stock and L becomes a subsidiary of the new parent.

5. Section 269 Limits on NOL Utilization

a. L's NOLs (and other favorable tax attributes) may be lost if persons acquire "control" of L and the "principal purpose" of the acquisition is tax avoidance. Code section 269(a).

i. Acquisition of "control" occurs if a person or persons who did not previously own as much as 50 percent (by vote *or* value) of L become the owner(s) of 50 percent or more (by vote *or* value) of L.

ii. IRS takes the position that "absent strong evidence to the contrary," an acquisition of control in a bankruptcy reorganization will be treated as having the principal purpose of tax avoidance "unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to" the bankruptcy reorganization. Prop. Reg. section 1.269-3(d).

- This section 269 continuity of business requirement applies even if the section 382 continuity of business requirement is waived under the special elective rule for a bankruptcy reorganization.

6. Reduction of AMT Asset Basis Upon Ownership Change

a. If a corporation undergoes a section 382 ownership change and its net built-in losses at the time of the ownership change exceed a threshold level (the lesser of \$10 million or 15 percent of the corporation's gross assets), the basis of each of its assets is written down (or up) to FMV for purposes of calculating adjusted current earnings ("ACE") under the AMT rules. Code section 56(g)(4)(G).

- This write down may trigger additional tax as the assets are depreciated or sold at a 15 percent rate (20% AMT rate x 75% inclusion of ACE adjustment in AMT income).

b. This rule would be repealed by the Tax Simplification Bill of 1991.

7. Special Consolidated Group Considerations

a. Under proposed regulations, the section 382 rules are generally applied by treating the consolidated group as a single entity. Prop. Reg. section 1.1502-91(a).

Under proposed regulations, the section 382 rules are generally applied by treating the consolidated group as a single entity.

i. Whether ownership change has occurred is generally determined solely by reference to the parent's stock. Prop. Reg. section 1.1502-92(b).

ii. The annual section 382 limit is calculated by reference to the value of the parent's stock plus the value of any stock of the subsidiaries held by nonmembers. Prop. Reg. section 1.1502-93(b).

iii. The section 382 limitation is a single group-wide number. Prop. Reg. section 1.1502-93(a).

b. If a consolidated group (the Bigco group) with an NOL sells the stock of a loss subsidiary (with no section 338(h)(10) election):

i. The portion of the Bigco group's consolidated NOL which was attributable to the loss subsidiary leaves the group with the loss subsidiary. Reg. section 1.1502-79(a).

ii. If the Bigco consolidated group previously suffered an ownership change to which section 382 applied, the parent of the Bigco group may elect to allocate a portion of the Bigco group's consolidated annual section 382 limitation to the loss subsidiary. Prop. Reg. section 1.1502-95(c).

- If Bigco does not elect to allocate a portion of the Bigco group's consolidated NOL limitation to the subsidiary, the subsidiary's NOL limitation is zero. Prop. Reg. section 1.1502-95(b)(2)(ii).

c. If a consolidated group (the P group) acquires stock of a corporation (or a group of corporations which had been members of another consolidated group), i.e., P acquires L's stock from Bigco, and L (or L and its subsidiaries) has an NOL, then:

i. The "SRLY" rule provides that NOLs of L and each of its subsidiaries generally can be used only against the portion of the P group's positive consolidated taxable income which is attributable to the particular corporation (i.e., L or an L subsidiary) to which the NOL was attributable and not against income of other members of the P group. Reg. section 1502-21(c).

Recently proposed regulations would liberalize the SRLY rule.

ii. Recently proposed regulations would liberalize the SRLY rule.

- The SRLY limitation would be calculated on a cumulative basis, so that positive income of L in a year in which the P group had a consolidated loss would increase the SRLY limitation, thereby permitting use of L's NOL carryovers in a subsequent year in which the P group had positive consolidated taxable income. Prop. Reg. section 1.1502-21(c)(1).
- The SRLY limitation would be calculated on a subgroup basis, so that the NOL carryovers of L and its subsidiaries could be used against the aggregate cumulative income of the subgroup consisting of L and its subsidiaries. Thus, L and each of its subsidiaries would *not* have a separate, fractionated SRLY limitation. Prop. Reg. section 1.1502-21(c)(2).
- For purposes of calculating the SRLY limitation with respect to built-in losses (as opposed to NOLs), corporations would be treated as being members of a SRLY subgroup only if they were affiliated for at least 60 consecutive months before joining the new consolidated group. Prop. Reg. section 1.1502-21(c)(2)(iii).