The Tax Lawyer

VOL. 64, NO. 1 • FALL 2010

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Deborah L. Paul

70 YEARS OF PUBLIC SERVICE

Published by the American Bar Association Section of Taxation
in Collaboration with the Georgetown University Law Center
www.abanet.org/tax/pubs/ttl

TAXATION
A Section of the American Bar Association

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DEBORAH L. PAUL*

I. Introduction

In the most recent economic downturn, mergers and acquisitions deal-making became a story about debt. While conventional strategic and private equity acquisitions subsided, debt of potential acquisition targets traded well below its face amount, tempting buyers seeking an equity-type return to invest in debt. Private equity firms and other investors bought debt in their own portfolio companies or in other companies, in each case believing the debt was undervalued and would recover along with the issuer's fortunes. The emergence of a vibrant market in distressed debt puts pressure on many concepts relating to debt in the tax law, and highlights the contrasts between the way the tax law addresses debt and the way financial actors in the real world think about debt.

Tax law is premised on conventional views about the nature of debt and equity. Under those views, debt is a stable investment with a steady predictable cash flow, while common stock is volatile and reflects the fortunes of the issuer and the residual value of the company. Distressed debt undercuts these conventional views. The value of distressed debt is much lower than its face amount, and the economics of the instrument behave like equity. If the company's fortunes improve, the debt holders will benefit; if the company's fortunes decline, the debt will plunge further in value. Indeed, an instrument can start off behaving like traditional debt and then, as the condition of the issuer, its industry, or markets as a whole deteriorates, the instrument may slide in value and behave in an increasingly equity-like fashion.

The sharp distinction in tax law between debt and equity—including its "all or nothing" aspect and relatively immutable fixing of states at the time of

*Partner, Wachtell, Lipton, Rosen & Katz; Harvard University, A.B., 1986; J.D., 1989; New York University School of Law, LL.M., 1994. The author thanks Tijana Dvornic for superb research assistance, Peter Canellos and Joshua MacLeod for helpful comments, and Vincent Kalafat and Rachel Carlton for excellent work on selected sections. All errors are the author's own.

issuance—does not reflect reality, as has long been recognized;[1] but distressed debt challenges the conceptual basis of the debt–equity distinction in a new way. Most debt–equity hybrids are "structured" in the sense that the terms of the debt are designed to incorporate debt- and equity-like features,[2] while the typical terms of distressed debt are "plain vanilla," *i.e.*, purely debt-like.[3] The equity nature of distressed debt arises through market forces. Distressed debt thus highlights that the difficulties with the debt–equity distinction are basic and inherent.

Financial actors recognize that there is a debt–equity gradient rather than a debt–equity distinction. For example, rating agencies rate debt along a spectrum according to risk; the most secure debt instruments receive the highest rating and the most speculative receive the lowest. Moreover, not only does tax law reject the idea of a debt–equity gradient,[4] insisting on classifying the instrument as debt or equity,[5] but tax law classifies instruments as debt or

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[1] *See* Notice 1994-47, 1994-1 C.B. 357 (providing that the Service will scrutinize instruments intended to be treated as debt for tax purposes but equity for other purposes); William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971) (the classic work on the debt–equity distinction); *see also* Peter C. Canellos & Deborah L. Paul, *Contingency and the Debt/Equity Continuum*, 3 J. Tax'n Fin. Products 29 (2002) (explaining that specific tax rules address debt that resembles stock and stock that resembles debt); Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981–1997*, 52 Tax L. Rev. 119, 132 (1997) (finding that taxpayers exploit inconsistencies and discontinuities in the tax law and that "monthly income preferred shares" are debt for tax purposes but equity for other purposes); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 Cornell L. Rev. 1627, 1638 (1999) ("The distinction between debt and equity possibly could be an even worse morass than the definition of a realization event . . . . The two extremes are clear . . . . However, there are vast numbers of financing devices that fall between these two simple cases . . . .").

[2] *See* Rev. Rul. 2002-31, 2002-1 C.B. 1023 (regarding convertible debt with interest based on debt issuer's dividends); Rev. Rul. 1983-98, 1983-2 C.B. 40 (ruling that a purported debt instrument with payout at maturity in stock or cash should be recharacterized as stock because of the high probability that it would be converted to stock); *see also* Notice 1994-47, *supra* note 1; Notice 1994-48, 1994-1 C.B. 357 (providing notice that the Service will challenge a transaction structured to provide interest deductions to a corporation issuing preferred stock). For example, the debt instrument might have included interest based on the issuer's dividends, or featured contingent principal.

[3] Such debt often bears fixed or conventional types of floating interest rates and is issued for its face amount, which is also the amount due at maturity.

[4] In some cases, acknowledging that financial instruments do not always readily fall into one category or the other, tax law applies special rules to debt that resembles equity (or equity that resembles debt). *See, e.g.*, I.R.C. § 163(i) (applicable high yield discount obligations (AHYDO)); I.R.C. § 163(j) ("earnings stripping"); I.R.C. § 305(b)(4) ("stock distributions on preferred stock"); *see also* Canellos & Paul, *supra* note 1, at 33 (arguing that tax law has developed subcategories that recognize hybrid elements).

[5] Some instruments are neither debt nor equity, such as options, forward contracts, and notional principal contracts.

equity based on the facts at the time the instrument is issued.[6] This classification is generally not reevaluated after issuance[7]—investors in the financial world, by contrast, continually reevaluate whether the assets they hold are consistent with the investor's risk profile.

Furthermore, tax law generally aims for conformity between the treatment of a creditor and debtor. The tax treatment of debt is considered to be an integrated regime that applies to holders and issuers; likewise, the tax treatment of stock is considered to be an integrated regime that applies to shareholders and issuers.[8] But this insistence on conformity between holder and issuer has its pitfalls. What is appropriate for the issuer is not always appropriate for the holder and vice versa. Integrating issuer and holder rules sometimes means that, in the name of conformity, the most appropriate rule is not adopted for one group or the other.

This Article focuses primarily on creditor issues. For example, a significant focus of the Article is the "market discount" rules—the regime relating to a purchase of debt from a holder (as distinguished from the issuer) at a discount.[9] The market discount rules relate to the timing and character of a holder's income, but do not affect the issuer at all. The Article also discusses issues relating to whether an exchange of debt for new debt or equity is a recapitalization, also purely a creditor issue. Other rules discussed affect both issuers and holders, such as rules relating to reissuances of debt instruments and the creation of original issue discount. Different sets of pressures exist when both issuer and holder consequences are at stake.

All of these themes raise the question: Would broader changes in the tax law be appropriate to address distressed debt and other problem areas in

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[6]Lease v. Commissioner, 66 T.C.M. (CCH) 1121, 1126, 1993 T.C.M. (RIA) ¶ 93,493, at 2,626 ("Generally, the time for applying the tests required to classify a transaction as debt or equity is at its inception."); *see also* 1 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.02[5] (7th ed. 2006).

[7]*See Lease*, 66 T.C.M. (CCH) at 1126, 1993 T.C.M. (RIA) ¶ 93,493 at 2,626 (finding that the initial characterization of an instrument as debt or equity is "for the most part . . . a one-way street."). A few courts have, however, recharacterized a debt instrument as equity where necessary to prevent abusive transactions. *See* Tampa & Gulf Coast R.R. Co. v. Commissioner, 469 F.2d 263, 264 (5th Cir. 1972) (per curiam) (reclassifying parent's loan to a subsidiary as a contribution to capital where the subsidiary had not paid interest for over 30 years but continued to take interest deductions while parent failed to recognize interest income); Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695, 699 (4th Cir. 1963) (finding the acquisition of insolvent target corporation's stock and debt is occasion to reevaluate debt–equity classification); Cuyuna Realty Co. v. United States, 382 F.2d 298, 301–02 (Ct. Cl. 1967) (finding that a parent's loan to subsidiary "may start out as bona fide indebtedness . . . but the character of indebtedness may vanish when the parent and the subsidiary cease acting like debtors and creditors"). *See generally* BITTKER & EUSTICE, *supra* note 6, at ¶ 4.02[5].

[8]The most evident example is that an issuer of a debt instrument generally is entitled to deduct interest, while a holder must include interest. By the same token, an issuer of stock reduces its earnings and profits when it pays a distribution to shareholders, and a holder includes the distribution as a dividend up to the amount of earnings and profits so reduced.

[9]I.R.C. §§ 1276–78.

debt–equity characterization and treatment? For example, one could retain the debt–equity distinction and reclassify distressed debt as equity when the debt trades below a certain level[10]—but that approach exacerbates the cliff effect of a regime that pigeonholes instruments as either debt or equity.[11] Another approach would be to do away with the debt–equity distinction and adopt a uniform approach for both. For example, holders could be required to accrue a fixed percentage of their basis into income each year, regardless

[10] Under such an approach, from the time of reclassification forward, all rules applicable to debt would be turned off and all rules applicable to equity would be turned on. Among other things, the issuer would no longer be entitled to deduct stated interest. The reclassification might constitute an "ownership change" under section 382 of the issuer and could cause a subsidiary to cease to be a member of its parent's affiliated group under section 1504. The portfolio interest exception of sections 871(h) and 881(c) would no longer apply. Further, a holder could no longer rely on the instrument failing to be a "United States real property interest" under section 897 on the basis that it is an "interest solely as a creditor." I.R.C. § 897(c)(1)(A)(ii); Reg. § 1.897-1(d)(1), -1(d)(3). Stated "interest" would have to be evaluated under section 301(c) to determine whether it would be includible by holders, as includibility would turn on whether the issuer had earnings and profits. The treatment of the reclassification itself would either be an exchange, potentially triggering cancellation of debt income to the issuer, or a nonrecognition event.

[11] The approach could lead to a great deal of uncertainty. Identifying the magic moment of when debt becomes equity would likely not be straightforward. It is one thing to work with a rudimentary distinction—debt or equity—once, when an instrument is issued. It is another to have the possibility that an instrument might shift midstream from one category to the other.

A modification of this approach would be to reclassify the distressed debt as equity for purposes of holder consequences, but not those of the issuer. From an issuer's perspective, distressed debt is still a claim for 100% of the principal amount of the debt. The debt must be reflected on the issuer's books as such. Failure to pay can lead to bankruptcy of the issuer. Thus, the equity-like nature of distressed debt may be experienced more acutely by a holder than an issuer. Furthermore, the anomalies discussed in this Article apply to holders, not issuers. Thus, one could argue that issuers and holders should be treated differently. Under this approach, an instrument would be treated as equity in the hands of a holder and debt of the issuer. Disparate treatment of holders and issuers is not unprecedented. For instance, the AHYDO rules of section 163(e)(5) disallow or defer an issuer's deduction for accrued original interest discount (OID) but generally have no effect on the treatment of holders, who must continue to report the OID as it accrues. Corporate holders are entitled to a dividends received deduction on the portion of OID that is disallowed.

Similarly, section 163(l) prevents issuers from deducting any interest paid or accrued on certain disqualified debt instruments that "more closely resemble equity transactions for which an interest deduction is not appropriate," while leaving the tax treatment of the payments to the holder unchanged. H.R. Rep. No. 105-148, at 457–58 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 851–52.

of whether the holder holds debt or equity,[12] or holders could be required to mark-to-market (*i.e.*, to recognize gain or loss annually based on changes in value of the debt or equity that they hold).[13] A third paradigm would be a system in which quintessential debt and equity instruments are taxed according to different rules, and instruments that lie between the poles are taxed according to a graduated system. For example, an instrument could be given a rating based on where it falls along the debt–equity spectrum[14] and taxed according to such rating.[15]

This Article uses a "life cycle" paradigm to illustrate the pressures that distressed debt places on the debt–equity distinction in tax law. The life cycle of a distressed debt investment typically involves an investment in troubled debt, followed by an exchange for new debt or a modification of the terms of the debt, and finally, an exchange of the debt for equity. Frequently, a restructuring is on the horizon when a firm makes an investment in distressed debt because the issuer is unable to meet its payment obligations or satisfy finan-

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[12]This approach has been proposed by Edward Kleinbard. Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (The Hamilton Project at the Brookings Inst., Discussion Paper 2007-09, 2007), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2007/06corporatetaxes_kleinbard/200706kleinbard.pdf. For example, if the holder has a basis of $100 in debt *or* equity, the holder would be required to include 10% of $100, or $10 in income annually. *Id.* at 12. This regime would be part of a comprehensive income tax reform proposal under which issuers would deduct a fixed percent of their total invested capital (as represented by their asset basis) each year, while investors would include the same percent of the value of their entire financial investment portfolio (including debt, equity, and financial derivatives) in their yearly income. *Id.* at 11–13.

A concern about this type of uniform approach would be that it would not readily match an individual's increase or decrease in wealth with the individual's taxable income. A holder of a share of stock that declined in value over the year would pay the same amount of tax as a holder of a share of stock that increased in value over the year. Moreover, a holder would be subject to tax irrespective of whether the issuer actually makes any cash distributions. Thus, this approach seems in tension with notions of equity and concerns regarding ability to pay.

[13]Such a regime has appeal in theory but raises concerns about scope, valuation, and liquidity. As to scope, the regime would be most fair if it covered the widest range of assets, but many assets are not readily valued. As to liquidity, the regime could force holders to sell in order to raise funds to pay taxes, which is generally considered an undesirable result.

[14]The rating could take into account creditworthiness of the issuer and the features of the instrument. Indeed, ratings provided by rating agencies could serve this function. *See* Canellos & Paul, *supra* note 1, at 35. Secured debt of a creditworthy issuer would be at one end of the spectrum and common stock would be at the other.

[15]For example, for an instrument that was rated five on a scale of ten (with ten being the strongest form of debt), half the interest or original issue discount would be deductible, half the market discount would be accruable, and half the amount of cancellation of indebtedness income would be recognized if the instrument were cancelled. This graduated approach would be difficult to administer, as it would involve many more categories than under current law. Additionally, tax law should be cautious about relying on nontax conceptual frameworks such as those involved in credit ratings. On the one hand, an advantage of relying on nontax frameworks, such as credit ratings, is that tax planning is not involved in their implementation; thus these frameworks may be more objective from a tax policy perspective. The disadvantage is that they may involve principles and goals that are inconsistent with tax policy goals.

cial covenants contained in the debt. An exchange for equity, for example, is an acknowledgment that the holders have been taking equity-like risks.

Rules that work comfortably in the context of regular debt often appear anomalous in the case of distressed debt. Working within the confines of the current-law debt–equity distinction, there are two principal remedies to many of the issues discussed in this Article. First, the market discount rules that generally apply to debt instruments should not apply to distressed debt. Such rules are designed to address timing issues and presuppose a relatively steady and secure flow of income from an instrument, an unwarranted assumption in the case of distressed debt. Moreover, turning off the market discount rules does not create a disparity between issuer and holder treatment because the issuer does not deduct the market discount. Second, the concept of "recapitalization" in section 368(a)(1)(E) should be understood broadly in the context of a distressed debt exchange. In a recapitalization, a holder exchanges one instrument of an issuer for another without recognizing gain or loss. A broad understanding of "recapitalization" avoids anomalies that would otherwise apply in the case of exchanges of debt for debt or debt for equity. These exchanges do not seem like the appropriate time to tax holders, or worse, disallow losses, as can be the case under current law.

As discussed in Part II, during the investment phase of the life cycle of a distressed debt investment, a holder confronts the market discount accrual rules.[16] Those rules emulate, for the holder, the original issue discount (OID) rules, which in turn emulate rules relating to interest—none of which are a proper paradigm for an instrument that behaves like equity, such as distressed debt. Just as the OID rules apply when a debt instrument is issued for a price less than its principal amount, the market discount rules apply when a debt instrument is purchased from an existing holder for a price less than its principal amount. The OID rules treat such excess as being akin to interest and require holders to accrue it into income over the term of the note. The market discount rules take a similar tack but allow a holder to refrain from including the market discount in income as long as gain on a disposition is treated as ordinary. The theory behind the market discount rules is that the market discount is generally caused by a rise in prevailing interest rates and thus that the market discount relates to the time value of money, like interest. However, under circumstances of distress, where the note trades at a significant discount to its issue price, the spread no longer bears any resemblance to interest. Hence, as argued in Part II.A, neither the theory nor the policy goals underlying the market discount rules have relevance in the context of distressed debt.

Moreover, the application of an interest paradigm to distressed debt, which behaves like equity, leads to anomalous results, as illustrated in Parts II.B and C. Part II.B argues that, assuming the market discount rules apply in the first place, a holder of a bridge loan in circumstances of distress should be entitled

[16]I.R.C. §§ 1276–78.

to accrue market discount over the entire term of the bridge loan, rather than a shorter period that might be suggested by the OID rules.[17]

Part II.C addresses a scenario in which a taxpayer contributes a market discount bond to a partnership at a time when market discount has accrued but no gain is built into the bond (*i.e.*, value is less than or equal to basis). For example, a private equity fund holding a market discount bond may wish to move the bond around within the fund structure, including by contributing the bond to a partnership. This Article argues that if the market discount bond is subsequently sold by the partnership at a gain, the gain should be ordinary to the extent of the accrued market discount. The contributing partner should not be treated in any special way because the appreciation occurs after the contribution. The gain, and the ordinary income taint, should be allocated according to the partnership's usual sharing ratios.

As in the first phase, in the second phase of the life cycle of distressed debt—a modification or exchange of the debt for new debt (sometimes referred to as an "amend and extend" transaction)—the market discount rules lead to unintuitive and harsh results for holders, as discussed in Parts III.A and B. For example, if the transaction is a recognition event, a holder that owns a significant stake in the issuer might realize and recognize a loss that is permanently disallowed. Other holders might recognize a capital loss. In either case, a holder might face ordinary income OID inclusions going forward, despite there being little prospect of recovering the full principal amount of the loan. Further, capital losses cannot be used against ordinary income, thus whipsawing a holder who has recognized a capital loss (or worse, who has recognized a loss that was disallowed).

Recapitalization treatment of the exchange avoids some of those undesirable consequences. Whether the transaction qualifies as a recapitalization depends, among other things, on whether the old debt and the new debt qualify as "securities," which is largely a function of the debt instruments' term to maturity. Part III.C argues that bank debt should not be precluded from being viewed as a security by reason of the issuer's right to repay the debt at any time. Part III.D describes another possibility for ameliorating the harsh results—qualification as a transaction that is not a realization event under Regulation section 1.1001-3. This Article argues that, under certain circumstances, bank debt might qualify for a relatively liberal measure as to whether the yield on the debt has changed sufficiently to trigger a realization event.

Part IV discusses the last phase of the life cycle, an exchange of distressed debt for equity (sometimes called a "loan to own" transaction). In these transactions, the economic similarity of distressed debt to equity is formalized by transferring equity interests to the debt holders in exchange for their debt. Part IV.A challenges the commonly received view that if debt is recapitalized into stock, the accrued market discount should carry over to the stock. Instead, the accrued market discount should carry over—but not in excess of

[17] *See* Reg. § 1.1272-1(c)(5).

the amount of gain built into the debt at the time of the exchange. Appreciation that occurs while the holder holds stock should never be characterized as ordinary under the market discount rules because it is plainly not interest-like, even if market discount on the debt had accrued prior to the exchange of debt for stock.

Part IV.B focuses on another common debt-for-equity scenario, a scenario where debt has been issued by an operating subsidiary and, in the exchange, debt holders receive parent company stock for the operating subsidiary's debt. There are at least three models for characterizing such a transaction. Moreover, if steps are taken to liquidate the subsidiary for tax purposes, additional characterizations are possible. This Part argues that taxpayers should be able to choose among these alternative characterizations by formally structuring the transaction in the desired manner.

In another vein, Part IV.C argues that the similarity of distressed debt to equity means that restructurings of distressed debt should not give rise to a trade or business on the part of non-U.S. holders of the debt. If a fund acquires distressed debt and leads a workout where the distressed debt is exchanged for equity, or for a combination of equity and debt, such activities should not give rise to a trade or business because the transaction formalizes the equity-like nature of the debt and no new cash is introduced into the system.

Ultimately, the tax problems and anomalies discussed in this Article arise from applying tax rules designed for quintessential debt instruments to distressed debt, which behaves like equity. Tax law should be flexible enough to adapt to this economic reality notwithstanding the long-standing conceptual view of debt and equity as sharply distinguishable types of investments. The contrast between the way financial actors think about debt and the way tax law addresses debt has long been recognized, but this Article's analysis of distressed debt further illustrates the pervasiveness of the issue.

II. Owning Distressed Debt: Market Discount Accruals

A. *Market Discount and Distressed Debt*

During the first phase in the life cycle of distressed debt—where the investor acquires from a holder[18] a note with a fair market value that is considerably lower than its issue price—the investor must consider the market discount rules. These rules generally require either current accrual of ordinary income or ordinary income treatment of gain upon the later disposition or repayment of the debt.

The market discount regime was inspired by two goals, neither of which is generally relevant in the distressed debt context because of the equity-like nature of distressed debt. Accordingly, the market discount rules should not apply to distressed debt. First, the market discount rules were enacted to counter a tax shelter in which taxpayers borrowed funds in order to buy debt

[18]As distinguished from the issuer.

that was trading at a discount. Taxpayers sought to deduct the interest on the borrowed funds without including the corresponding income accruing on the purchased debt. But this concern is inapposite in the case of distressed debt whose volatility makes it ill-suited to be used for that tax shelter. Investments in distressed debt are typically unleveraged and are not generally structured for avoidance purposes. Second, the rules stem from a view that market discount should be treated in a similar fashion to OID (*i.e.*, as a type of interest).[19] This goal also does not make sense in the case of distressed debt. The OID rules presuppose that the holder will be repaid the principal amount of the debt, but that is far from certain in the case of distressed debt.

Because the policy goals of the market discount regime do not generally relate to distressed debt, it is not surprising that applying the rules to distressed debt leads to anomalous results.[20] While it is open to interpretation as to whether the rules do apply to distressed debt under current law,[21] the Service or Congress should provide that they do not.[22]

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[19] *See generally* Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 Tax L. Rev. 565, 570, 574–76 (1983) (arguing that universal rules based on uniform theory of compound interest should govern accrual of interest and market discount).

[20] For example, assume a taxpayer purchases a debt instrument at a steep discount two years before maturity. Assume that two years later the debt is repaid, whether in a bankruptcy or otherwise, for some amount in excess of the taxpayer's basis but far less than the principal amount of the debt. Under the market discount rules, discussed *infra*, either the taxpayer must include market discount in income currently over the taxpayer's holding period or treat any gain recognized on the repayment as ordinary up to the amount of accrued market discount. In the former case, the taxpayer would include far more in income than the taxpayer's actual gain; the market discount inclusions would increase the taxpayer's basis in the debt resulting in a loss on the repayment. But, the market discount inclusions are ordinary and the loss is capital, resulting in a mismatch. If the taxpayer chooses not to include market discount in income currently, much if not all of the taxpayer's gain would be ordinary, an inappropriate result given that the taxpayer's return is speculative and is more akin to an equity-like return than interest.

[21] *See, e.g.*, Andrew W. Needham, *Do the Market Discount Rules Apply to Distressed Debt? Probably Not*, 8 J. Tax'n Fin. Products 1, 25 (2009) (arguing that the doubtful collectibility doctrine supports the inapplicability of market discount rules to distressed debt); John Kaufmann, *The Treatment of Payments on Distressed Debt Instruments*, 26 J. Tax'n Investments 13, at 32–33 (2008) (stating that preemption doctrine supports the view that common law rules regarding tax treatment of distressed debt survived the enactment of statutory market discount rates).

[22] *See* David C. Garlock, *How to Account for Distressed Debt*, 14 Tax Notes (TA) 999, 1010 (May 31, 2010) (arguing that market discount rules are a "serious obstacle" to sensible treatment of severely distressed debt); Richard M. Weber, *Applying Market Discount Rules to Notes in Default*, 129 Tax Notes (TA) 1349, 1353 (Dec. 20, 2010) (arguing that Congress did not intend to apply the market discount rules to notes purchased after default); David H. Schnabel, *Great Expectations: The Basic Tax Problem with Distressed Debt*, 89 Taxes 173, 188–89 (2011) (arguing that market discount rules create different results for economically equivalent transactions).

The market discount rules were enacted as an anti-abuse measure targeting leveraged investments in debt.[23] The rules are similar to the straddle rules of section 1092 in that they preclude a taxpayer from taking a deduction prior to the inclusion of the corresponding income.[24] To illustrate, prior to the enactment of the market discount rules, a taxpayer would borrow say, $90 (borrowed debt) and use the $90 to buy debt on the secondary market (purchased debt) that had a principal amount of $100. The $10 excess of the principal amount of the purchased debt over the taxpayer's basis in the purchased debt is referred to as "market discount."[25] The taxpayer would deduct the interest on the borrowed debt but would not include any portion of the $10 market discount in income until the purchased debt was repaid or sold. At that time, the taxpayer would claim capital gain on the $10. Thus, the tax shelter provided the taxpayer with ordinary deductions immediately while deferring the corresponding capital gain, both a timing and a character benefit.[26]

The Deficit Reduction Act of 1984 aimed to end that tax shelter.[27] According to the legislative history, market discount ideally would have been subject to the same rules as original issue discount.[28] But the original issue discount rules apply to holders and issuers, while market discount relates exclusively to holders. Further, the original issue discount rules were considered to be too complex.[29] Instead, Congress enacted a more manageable regime for market discount under which taxpayers had a choice. Under the general rule, a taxpayer is required to defer the deduction of interest on debt incurred to "purchase or carry" the market discount bond[30] and is required to include accrued

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[23] *See* H.R. Rep. No. 98-432, at 1170 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 844–45.

[24] Under the straddle rules of section 1092, recognition of loss realized on a position in actively traded personal property is deferred until gain is recognized on an economically offsetting position.

[25] I.R.C. § 1278(a)(2).

[26] *See* H.R. Rep. No. 98-432.

[27] Congress had already prevented this type of gambit in the case of debt purchased at original issue, because discount arising from "original issue discount" (generally, an excess of principal amount of the debt over the issue price of the debt) was required to be included in income over the term of the debt on a constant yield basis. *See generally* I.R.C. §§ 1272–75. *See also* Canellos & Kleinbard, *supra* note 19, at 565–71 (arguing that the Tax Equity and Fiscal Responsibility Act of 1982 rationalized treatment of OID by requiring economic accrual).

[28] H.R. Rep. No. 98-432 ("the theoretically correct treatment of market discount . . . would require current inclusion in the income of the holder over the life of the obligation"); *see also* Canellos & Kleinbard, *supra* note 19, at 574 ("From a non-tax perspective, there is no difference to a prospective holder between market and original issue discount.").

[29] *See* H.R. Rep. No. 98-432.

[30] I.R.C. § 1277. A market discount bond is a debt instrument that has "market discount" (*i.e.*, a more than *de minimis* excess of stated redemption price at maturity over the taxpayer's basis in the bond immediately after its acquisition by the taxpayer). I.R.C. § 1278(a)(2)(A). In the case of a bond issued with original issue discount, market discount means a more than *de minimis* excess of the "revised issue price" (generally, the issue price plus accrued original issue discount) over the taxpayer's basis. I.R.C. § 1278(a)(2)(B).

market discount in income on disposition as ordinary interest income.[31] This approach eliminated the timing and character benefit by matching the timing and character of the interest deductions with the timing and character of the gain on sale of the market discount bond.

Alternatively, a taxpayer may elect out of the general rule. If the taxpayer does so, the taxpayer is entitled to deduct interest on debt incurred to purchase or carry the market discount bond but is required to include accrued market discount in income over the period that the taxpayer owns the debt.[32] This approach eliminates the timing and character benefit by matching the timing and character of the interest deductions to the timing and character of income inclusions over the taxpayer's holding period of the market discount bond.

The original issue discount analogy that forms the basis for the market discount rules has force as a general matter. The original issue discount rules put all taxpayers on an accrual basis on the theory that the value of the debt instrument appreciates over time as the holder gets closer to receiving the principal amount at maturity.[33] From this perspective, market discount is similar to original issue discount; the debt instrument should become increasingly valuable as maturity draws nearer.

But neither the anti-abuse purpose nor the original issue discount analogy apply in the case of distressed debt because of the uncertainty of payment. The anti-abuse purpose relates to leveraged investments and is thus inapplicable to unleveraged purchases. The market discount rules should arguably not apply even in the case of a leveraged investment in distressed debt. Interest is deductible in the case of a leveraged investment in stock.[34] A leveraged investment in distressed debt is similar. Section 263(g) further reinforces the theme that it is appropriate to deny interest deductions on a leveraged investment where the asset is secure and stable in value but not where the asset is

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[31] I.R.C. § 1276(a)(1). Under the general rule, gain on the disposition of a "market discount bond" is ordinary interest income to the extent that the gain does not exceed the "accrued market discount" on the bond. Accrued market discount on a bond means the market discount that has accrued on the bond from the time that the taxpayer acquired it through the date of the disposition. Market discount generally accrues ratably, but the taxpayer may instead elect to have the market discount accrue on a constant yield method. I.R.C. § 1276(b). In the case of ratable accrual, the accrued market discount is the market discount multiplied by a fraction; the numerator is the number of days that the taxpayer has held the bond, and the denominator is the number of days after the date the taxpayer acquired the bond (up to and including the date of its maturity). I.R.C. § 1276(b). In the case of accrual under the constant yield election, the accrued market discount is calculated under the original issue discount rules as if the bond was issued on the date the taxpayer acquired it. I.R.C. § 1276(b).

[32] I.R.C. § 1278(b).

[33] *See* Canellos & Kleinbard, *supra* note 19, at 568 (arguing that the original issue discount rules require inclusion and deduction of "economic accruals").

[34] Section 246A reduces the dividends received deduction for corporate holders of debt-financed portfolio stock.

volatile, such as equity or distressed debt.[35]

The original issue discount analogy and its focus on interest breaks down because distressed debt behaves economically like equity. The value of distressed debt, rather than steadily increasing toward maturity, fluctuates dramatically. In fact, oftentimes there is no prospect that the principal will be repaid in full.[36] In the case of distressed debt, the market discount arises because of deteriorating conditions in the issuer's business or industry, not merely from changes in prevailing interest rates. The premise of an accreting return on a discount instrument is inapposite here.

One might be tempted to argue that if distressed debt is equity-like, it is similar to preferred equity, thereby implicating the rules of section 305(b)(4) and 305(c); these rules require accrual of discount on preferred stock.[37] But the analogy with preferred equity is illusory. While preferred stock and distressed debt both carry the formal indicia of seniority to common stock,[38] the economics of distressed debt distinguish it from traditional debt and from preferred stock. Distressed debt is volatile, like common stock. Common stock is an unaugmented participation in the corporate venture. Similarly, in the case of distressed debt, the creditor has little prospect of full recovery, and what recovery the creditor does receive will depend almost entirely on the debtor's fortunes. The economic facts make distressed debt analogous to common, rather than preferred, equity.

If the market discount rules should not apply to distressed debt, the question becomes how to distinguish distressed debt from other debt.[39] One approach would be to use the applicable high yield discount obligation (AHYDO) rules of section 163(e)(5) and (i) as a yardstick.[40] These rules provide, among other things, that certain types of high yield debt are sufficiently similar to equity so that a portion of the yield is nondeductible.[41] Under this approach, if the yield on a debt instrument (measured by reference to the purchaser's purchase price) is greater than the AHYDO rate that governs interest disallowance (*i.e.*,

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[35] Under section 263(g), interest deductions are not allowed in the case of a leveraged investment in a section 1092 "straddle," a hedged investment that is generally expected to hold its value; section 263(g), however, does not apply to an unhedged investment.

[36] High-yield debt also resembles equity and some of the same considerations may apply.

[37] I.R.C. § 305(b)(4), (c).

[38] Preferred stock carries a dividend preference, seniority in the event of liquidation, and other favorable terms. Distressed debt is senior to preferred and common stock as a formal matter.

[39] *See* Am. Bar Ass'n Section of Taxation, Comments Regarding Application of Market Discount Rules to Speculative Bonds, *reprinted in* 1991 Tax Notes Today 113-28 (May 15, 1991) (suggesting exclusion of speculative bonds from definition of market discount bonds and/or modification of market discount rules to take into account special considerations presented by speculative bonds).

[40] *See* Kaufmann, *supra* note 21, at 48–49 (defining distressed debt by reference to whether yield exceeds AHYDO threshold).

[41] I.R.C. § 163(e)(5), (i).

the applicable federal rate plus six percent) at the time the buyer buys the debt, the market discount rules should not apply to the buyer at all.

A variant of this approach was proposed as part of the Clinton Administration's 2000 budget.[42] Under that proposal, accrual basis taxpayers would be required to include market discount in income as it accrued, rather than be entitled to deferral as under current law. The Administration recognized, however, that

> [i]n cases where the credit of the issuer is severely impaired, it may be inappropriate to treat the entire difference between the holder's basis and the principal amount as market discount. A significant portion of this difference, if realized, is more in the nature of a gain on an equity investment in the issuer than income from a lending transaction.[43]

Thus, under the Clinton Administration's proposal, the holder's yield for purposes of calculating market discount was limited to the greater of the original yield on the instrument, plus five percent, and the applicable federal rate at the time the holder purchased the instrument, plus five percent.[44] Although the proposal, which was never enacted, failed to recognize that a severely distressed debt instrument behaves entirely like equity, it did take a step in the right direction by acknowledging that at least in some circumstances market discount rules should not apply to distressed debt.

In sum, because the market discount rules were intended to counteract a specific tax shelter involving leveraged investments in debt trading at a discount, and were more broadly based on analogies to OID rules and theories related to interest that do not translate to equity-like distressed debt, they should not be applicable in that context. Moreover, because of this theoretical disconnect, application of the market discount rules to distressed debt is fraught with difficulties and raises manifold technical issues that frequently appear in workouts of distressed debt. These issues are best illustrated through specific examples considered in the following sections.

B. *Accrual of Market Discount on a Bridge Loan*

The difficulties of applying the market discount rules to distressed debt are highlighted by an examination of their application to bridge loans. The salient features of bridge loans from a tax perspective are that the interest rate generally increases over time up to a stated maximum rate and that the issuer

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[42] DEP'T OF THE TREASURY, GEN. EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 121 (1999), *available at* http://www.treas.gov/press/releases/docs/grnbk99.pdf [hereinafter GENERAL EXPLANATIONS 1999].

[43] *Id.*; *see also* STAFF OF J. COMM. ON TAX'N, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 207 (Comm. Print 1999), *available at* http://www.jct.gov/publications.html?func=startdown&id=1225 (finding a portion of the holder's return on high-yield discount debt more properly viewed as gain on equity investment).

[44] GENERAL EXPLANATIONS 1999, *supra* note 42, at 121.

is generally entitled to repay the bridge loan at any time during its term.[45] These features imply, by analogy to OID rules, that an investor should accrue market discount over a very short time. OID must generally be accrued with the assumption that an issuer will exercise an option in a manner that will reduce the yield on an instrument.[46] Thus, when faced with OID, one would assume that a debt instrument with an increasing interest rate that an issuer is entitled to retire at any time would be retired at, or perhaps even prior to, the next interest payment date. One might then conclude that market discount attributable to a bridge loan acquired under circumstances of distress should be accrued over the same period. This is not the better interpretation, however, for the reasons discussed below.

The period for accrual of market discount on a bridge loan may depend, in part, on whether a taxpayer elects to use a "constant interest rate" method under section 1276(b)(2). Under this election, the "accrued market discount on [a] bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a)."[47] The constant interest rate method in section 1276(b)(2) thus seems to incorporate the OID rules. Under the OID option rule in Regulation section 1.1272-1(c)(5), an issuer is deemed to exercise or not exercise an option in

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[45]A bridge loan is taken out until permanent financing can be arranged. Bridge loans are sometimes referred to as swing loans, interim financing, or gap financing. The interest rate for a bridge loan is a variable rate (such as LIBOR plus a fixed spread) or a fixed rate, each of which typically increase (subject to a cap) at specified intervals (such as quarterly) after a specified number of months (*e.g.*, six months) following issuance. In the case of a bridge loan based on a variable rate, it is the fixed spread that increases; the overall rate could go up or down depending on the value of LIBOR from time to time.

A bridge loan typically has three potential phases: an "initial" term of one year; the "extended loan" phase; and the "exchange note" phase. During the initial term, the borrower may repay the loan at any time. At the one year anniversary, the bridge loan automatically converts into an "extended loan" with a longer maturity (*e.g.*, an additional seven years), provided that certain conditions are met, such as that the borrower pays a specified fee and is solvent. The extended loan also has an interest rate that continues to increase at specified intervals (subject to a cap) and may similarly be repaid by the borrower at any time. The extended loan differs from the initial term in that the financial covenants of the borrower tend to be weaker under the extended loan. Furthermore, a holder of an extended loan has the option to exchange such loan for an "exchange note." The exchange note generally has an interest rate fixed at the rate of the extended loan at the time that the holder exchanges the extended loan for the exchange note, the same maturity as the extended loan, and even less restrictive covenants. Unlike the initial term and the extended loan, the exchange note may not be repaid prior to maturity, or a year or two preceding maturity, without a penalty.

If a bridge loan is not repaid within a year and the issuer does not repay the extended loan by the time that the interest rate equals the cap, the holder will often convert the extended loan to an exchange note in order to fix the interest rate at its maximum possible amount. During the second half of the initial term, lenders typically have the right to require the issuer to issue permanent debt to replace the bridge loan. *See* Charles Morgan, *Bridge Loans—Confronting Tax Issues Triggered by the Recent Economic Downturn,* 7 J. TAX'N FIN. PRODUCTS 4, 35 (2009).

[46]Reg. § 1.1272-1(c)(5).

[47]I.R.C. § 1276(b)(2).

a manner that minimizes the yield on the debt instrument for purposes of determining its yield and maturity.[48] Applying that rule for purposes of section 1276(b)(2) arguably means that market discount would accrue over the period until the next interest payment date (or perhaps over an even shorter period, such as a day or an instant). On this view, because the interest rate increases at each interest payment date (typically beginning at the six month anniversary of issuance), the issuer would minimize its yield by redeeming the loan as soon as possible. However, the OID option rule should not be so interpreted for purposes of determining market discount accruals.

A more appropriate way to apply the OID option rule for purposes of section 1276(b)(2) is to calculate yield to maturity by reference to the market discount purchase price of the bridge loan, rather than the issue price (or adjusted issue price). This approach is supported by section 1276(b)(2)(A), which provides that market discount accrues under the OID rules as if the bond had been "originally issued on the date on which such bond was acquired by the taxpayer, for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition."[49] Under this interpretation, the issuer would generally not be deemed to exercise its option to redeem the bridge loan early for purposes of accruing market discount because redeeming early typically would not minimize the yield, as calculated by reference to the market discount purchase price. This approach also reflects economic reality. Although the issuer does not in fact have the right to repay the loan for the price paid by the purchaser, that price does provide the best benchmark for the price at which the issuer could refinance in the then current market.[50]

Absent an election to apply the constant interest rate method of section 1276(b)(2), a taxpayer generally would use the "ratable accrual" method in section 1276(b)(1). Under this method, the taxpayer accrues market discount pro rata based on the number of days until the date of the bond's "maturity."[51] Unlike the constant interest rate method, the ratable accrual method does not expressly refer to the OID rules. Consequently, it appears that under this method the OID rules should not be incorporated for purposes of determining a bridge loan's date of maturity. Since section 1276(b)(1) was intended to be simple to apply and administer, incorporation of the OID rules would be a more complicated approach than was intended. Indeed, section

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[48] That rule applies if the timing and amounts of payments under all possible payment schedules are known as of the issue date. *See* Reg. § 1.1272-1(c)(1), -1(c)(5). Arguably, the rule would not apply to a bridge loan (or any loan) with interest based on LIBOR or another floating rate, because the amount of the floating interest payments is not known as of the issue date. Many taxpayers apply the option rule to floating rate notes nonetheless.

[49] *See* I.R.C. § 1276(b)(2)(A).

[50] *See* David C. Garlock, Federal Income Taxation of Debt Instruments ¶ 1103.02 n.40 (5th ed. 2006) (arguing that yields in the secondary market provide a "more sound basis for adopting a presumption of exercise").

[51] *See* I.R.C. § 1276(b)(1)(B).

1278(a)(5) implies that the concept of "maturity" inherent in the OID rules is not intended to apply for purposes of the market discount rules because that provision enumerates those definitions (such as the "stated redemption price at maturity") from the OID rules that are to apply for purposes of the market discount rules.[52]

Assuming then that the OID rules do not apply to a taxpayer under section 1276(b)(1), there remains a question over what period market discount should accrue. Arguably, the maturity date of the loan is the maturity date of the extended loan,[53] since that is the date on which the principal amount of the debt is due and payable. If so, the loan would be subject to the market discount rules, and market discount would accrue over the period until the maturity date of the extended loan. Such interpretation would be consistent with the intent that the ratable accrual method be simple to apply and administer. However, some might argue that the initial term, ending on the one year anniversary of issuance,[54] is the maturity date. If that approach were adopted, the loan would arguably be outside the market discount rules because it would be a short-term obligation with a "fixed maturity date" of one year or less under section 1278(a)(1)(B)(i).[55]

While the better approach would seem to be to accrue market discount (if at all) over the extended loan period under either accrual method in section 1276, this conclusion could be viewed as permitting taxpayers to have their cake and eat it too. On the one hand, taxpayers would accrue market discount on bridge loans over the longer period of the extended loan. On the other hand, for OID on bridge loans, as discussed, the OID regulations provide that the issuer is deemed to retire the bridge loan either daily or at the end of the accrual period (before the next interest rate increase) because repayment on such date generally would minimize the yield (calculated by reference to the issue price).[56] Thus, for OID purposes, taxpayers would defer the inclusion of the back-end stepped-up interest on the bridge loan on the basis that the OID option rule would treat the loan as being redeemed prior to the increases in the interest rate provided in the bridge loan. But, the apparent inconsistency (*i.e.*, the assumption of early retirement for OID purposes and no early retirement for market discount purposes) is superficial. The holder is not likely to receive either the market discount or the original issue discount,

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[52] *See* I.R.C. § 1278(a)(5).

[53] *See supra* note 45 regarding the phases of a bridge loan.

[54] *Id.*

[55] Query whether the reference to a "fixed" maturity date in section 1278(a)(1)(B)(i) is meant to capture something different from the reference to the date of "maturity" in section 1276(b)(1)(B). Assuming that the OID rules do not apply to a taxpayer under section 1276(b)(1), Regulation section 1.1272-1(f)(2) would not apply. That Regulation provides that, for certain enumerated sections, the maturity date of a debt instrument is the last possible date that the instrument could be outstanding under its terms, without regard to remote or incidental contingencies.

[56] *See* Reg. § 1.1272-1(c)(5).

and thus it is appropriate that neither the market discount nor the original issue discount accrues for tax purposes.

As this example illustrates, the application of the market discount rules to distressed debt is not only exceedingly difficult and uncertain, but potentially leads to anomalous and undesirable results. Moreover, these issues are not confined to computational matters, but, as illustrated below, may also appear across a variety of transactions.

C. *Contributions of Market Discount Debt to Partnerships*

The market discount rules also present interpretive issues when a bond purchased under circumstances of distress is transferred in nonrecognition transactions. For example, a private equity fund structured as a group of partnerships might wish to contribute a market discount bond to a partnership. In such a case, a question arises about the treatment of pre-contribution accrued market discount that exceeds the amount of gain built into the bond at the time of contribution. The built-in gain is the fair market value[57] of the bond less the holder's basis at the time of the contribution. Some might argue that the market discount accrued at the time of the contribution should, when eventually recognized upon a sale of the market discount bond by the partnership, taint the contributing partner by causing the contributing partner's gain to be ordinary, regardless of the amount of gain built into the bond at the time of the contribution. But, that argument should not prevail. Under the market discount regime, the contributing partner's share of the gain on a subsequent sale of the market discount bond should be ordinary in an amount equal to the *lesser* of the market discount accrued at the time of the contribution and the gain built into the bond at the time of contribution. In addition, the accrued market discount in excess of the built-in gain should, if eventually recognized, be treated as ordinary (assuming the market discount rules apply to distressed debt); that ordinary income should be allocated according to the usual sharing ratios of the partnership and not tagged in any special way to the contributing partner.

Assume that, at the time of contribution of a market discount bond to a 50–50 partnership, the built-in gain is zero and there is accrued market discount of say, $10. Suppose that sometime after the contribution to the partnership, the partnership disposes of the bond and recognizes $20 of gain. Under section 1276(c)(1), the partnership steps into the shoes of the transferor.[58] Ten dollars of the $20 gain will be ordinary because $10 of market discount has accrued (for simplicity, the example disregards post-contribution market discount accruals). Section 704(c) does not apply, however, because

[57] Under section 704(b), the fair market value of the bond is also the amount by which the holder's capital account in the partnership increases as a result of the contribution.

[58] I.R.C. § 1276(c)(1).

there was no pre-contribution appreciation.[59] Therefore, the $20 of gain should be allocated according to the usual allocation rules in the partnership agreement ($10 to each partner) without any special regard to the pre-contribution accrued market discount. Furthermore, the contributing partner's gain should be treated as ordinary in the same manner as the other partner's gain. Thus, $5 of the contributing partner's gain and $5 of the other partner's gain should be treated as ordinary.

A principle inherent in the section 1245 regulations that preserves the character of pre-contribution recapture items arguably suggests otherwise. Under those regulations, a partner's share of recapture income recognized by a partnership on a sale of section 1245 property equals the partner's share of depreciation or amortization with respect to the property (or, if less, the partner's share of total gain from the disposition).[60] Furthermore, in the case of section 1245 property contributed to a partnership, the contributing partner's share of depreciation or amortization with respect to the property includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property was contributed.[61] Thus, if contributed section 1245 property is sold by the partnership and recapture income is recognized, the contributing partner's share of gain will be ordinary in an amount that is at least equal to the depreciation or amortization deductions taken by that partner prior to contribution without regard to the amount of gain built in at the time of the contribution.[62] Some would argue that, by analogy, pre-contribution accrued market discount should taint the contributing partner differently from the other partners. The fact that market discount and section 1245 recapture income are section 751 "hot" assets arguably supports this view.[63] As well, section 1276(d) contemplates market discount regulations similar to the section 1245(b) rules regarding nonrecognition treatment.[64]

The better view, however, is the former view, namely that the $10 of ordinary income taint in the example is shared among the partners without any special regard for the fact that the contributing partner held the bond while

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[59] Section 704(c)(1) applies in the case of a "variation between the basis of the property to the partnership and its fair market value at the time of contribution." In the example in the text, the built-in gain is zero; thus section 704(c) does not apply.

[60] Reg. § 1.1245-1(e)(2)(i).

[61] Reg. § 1.1245-1(e)(2)(ii)(C).

[62] Reg. § 1.1245-1(e)(2)(iii), Ex. (3).

[63] I.R.C. § 751(c)(2).

[64] *See, e.g.*, Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts ¶ 54.4.2 (RIA 2010) (finding that, as with section 1245 recapture, where recognition of market discount is excused on a transfer of the bond in a nonrecognition transaction, the transferee ultimately recognizes market discount accruing during holding periods of both transferor and transferee); 2 William S. McKee et al., Federal Taxation of Partnership and Partners ¶ 20.03 & n.20, 21.05[3] (4th ed. 2007) (noting that market discount bonds are subject to similar rules as "true" recapture items); P.L.R. 1987-50-045 (Sept. 15, 1987) (finding that recapture provisions of the Code and similar rules of law include sections 1245 and 1276).

the pre-contribution market discount accrued. The contribution of the market discount bond without any built-in gain but with accrued market discount is akin to a partner contributing inventory to a partnership where the inventory has no built-in gain. If the inventory goes up in value after contribution, gain on disposition of the inventory will be ordinary, but, because the appreciation occurred after contribution, the partnership is not required to account for that gain in any special way. Pre-contribution accrued market discount that is not matched by pre-contribution built-in gain (as could well be the case where a distressed debt instrument is involved) is similar. The accrued market discount measures how much of the gain on eventual disposition will be ordinary, but it is not appropriately tagged to the contributing partner because of the absence of built-in gain at the time of contribution. The partner is contributing property that will produce ordinary income *if* the property appreciates in the future. Since the future increase in value benefits the partners according to their sharing ratio, the partners, in accordance with their sharing ratio, should recognize that gain as ordinary income.

Moreover, the section 1245 analogy is not apt. In the case of section 1245 property, the contributing partner received a benefit prior to contribution in the form of depreciation deductions. It is thus appropriate to cause an equal amount of gain that is allocated to the contributing partner to be characterized as ordinary. In the case of the market discount bond that has no built-in gain at the time of contribution, there is no analogy to the pre-contribution depreciation deductions on section 1245 property. Indeed, section 751 treats section 1245 property and market discount bonds as hot assets, but only insofar as there is gain inherent in the property at the time of the section 751 transaction.[65] Thus, if there is no pre-contribution built-in gain, there should be no ordinary income chargeback to the contributing partner.

III. The First Restructuring: Exchanging Distressed Debt for New Debt or Modifying Distressed Debt

The discussion thus far has centered on the market discount rules that pertain solely to holders. In the second phase of the life cycle, economic pressures push the debtor and creditors to amend the terms of the debt or exchange old debt for new,[66] a major event for issuers and holders as an economic and tax matter. The tax law attempts to synchronize the treatment of issuers and holders in many ways. For example, a single set of rules determines whether there

[65]The flush language to section 751(c) defines "unrealized receivables" to include section 1245 property and market discount bonds but only to the extent, in the case of section 1245 property, of the amount that would be treated as gain to which the ordinary income recapture rule of section 1245(a) would apply if, at the time of the transaction giving rise to the application of section 751, "such property had been sold by the partnership at its fair market value," and, in the case of market discount bonds, the amount which would be treated as ordinary income if such property had been sold at such time by the partnership.

[66]Often, the changes involve an extension of the maturity or a liberalization of financial covenants in exchange for an increase in interest rate or a consent fee.

has been a realization event on such a transaction. Further, if there has been a realization event, the adjusted issue price of the new debt serves as the reference point for measuring both the issuer's cancellation of debt income and the holder's gain or loss. Additionally, one set of rules measures and accounts for original issue discount on the new debt for issuers and holders.

Seeking conformity between issuers and holders brings to bear pressures that might not otherwise apply. Indeed, the core rules relating to realization, adjusted issue price, and OID are supplemented by additional rules that apply only to holders or only to issuers, an acknowledgment that symmetry sometimes must be sacrificed in favor of other tax policy goals. For example, as discussed below, for holders, the transaction might qualify for nonrecognition as a "recapitalization" under section 368(a)(1)(E).[67] There is no analogue to recapitalization treatment on the issuer side.[68] This Part focuses on holder consequences, especially the concept of "recapitalization," while bearing in mind that issuer consequences are also at stake. Transactions that fail to qualify for tax-free treatment can have drastic consequences often without any strong policy justifications therefor.

A. *Exchanges That Are Not Recapitalizations: Loss Disallowance and Gain Recognition*

If a debt-for-debt exchange or debt modification is a section 1001 event and fails to qualify as a recapitalization, unintuitive consequences may follow, including a harsh result of loss disallowance for a holder of the debt who also owns a large equity stake in the issuer. The chart below summarizes the consequences of a debt-for-debt exchange or debt modification assuming, as is frequently the case, that the principal amount of the new debt is the same as the principal amount of the old debt. The chart assumes that no nonrecognition rule applies to the exchange, and thus, that it is taxable. The key variables are the taxpayer's basis in the old debt and the "issue price" of the new

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[67] I.R.C. § 368(a)(1)(E).

[68] Congress recognized the severity of taxing an issuer on cancellation of debt income in the case of a debt-for-debt exchange or debt modification where the principal is not reduced and enacted section 108(i) for transactions effected between December 31, 2008 and January 1, 2011. Under section 108(i), an issuer is entitled to defer inclusion of the cancellation of debt income for several years (with a corresponding deferral of original issue discount deductions on the new debt).

Another example of asymmetry is the AHYDO regime that generally applies only to issuers. *See supra* note 11. Holders are required to accrue OID notwithstanding that the debt instrument might be an AHYDO. The AHYDO regime can be particularly harsh to issuers engaging in a debt-for-debt exchange or debt modification because the AHYDO regime defers some original issue discount deductions until paid in cash and denies other original issue discount deductions altogether. Recognizing this, Congress suspended the AHYDO regime for certain transactions occurring between September 1, 2008, and December 31, 2009. I.R.C. § 163(e)(5)(F)(i). The Service, acting on its authority under section 163(e)(5)(F)(iii), extended this suspension "in light of distressed conditions in the debt capital markets" to certain debt instruments issued on or before December 31, 2010. Notice 2010-11, 2010-4 I.R.B. 326.

debt, because a holder realizes gain or loss equal to the difference between the holder's basis in the old debt and the issue price of the new debt.[69] The issue price of the new debt is generally fair market value if the debt is "publicly traded" and the principal amount if it is not publicly traded.[70] The rules defining publicly traded in this context[71] are widely recognized to be outdated and difficult to apply.[72] For purposes of illustration, the chart assumes two possibilities for tax basis (principal amount and distressed fair market value) and two possibilities for issue price (also principal amount and distressed fair market value).

Taxable Exchange Scenarios

	Issue Price Equals Principal Amount	**Issue Price Equals Distressed Value**
Basis Equals Principal Amount	A No gain or loss realized or recognized. No OID.	B Capital loss recognized (but possible section 267 disallowance). OID inclusions.
Basis Equals Distressed Value	C Gain recognized; ordinary to the extent of accrued market discount; otherwise capital. No OID.	D No gain or loss realized or recognized. OID inclusions.

[69] *See* Reg. § 1.1001-1(g). Some holders might be able to claim a deduction under section 166(a)(2) for partially worthless debt. But, section 166(a)(2) is narrow. For example, under section 166(e), it does not apply to bonds, debentures, notes, or other evidences of indebtedness issued by a corporation. Moreover, under section 166(d), no deduction is allowed for partially worthless "nonbusiness" debt held by a holder that is not a corporation.

[70] Issue price is determined under section 1273 if the debt is publicly traded or section 1274 if it is not publicly traded. Under section 1274, generally, issue price equals the principal amount if the debt has an interest rate at least equal to the applicable federal rate.

[71] Reg. § 1.1273-2(f).

[72] JIYEON LEE-LIM ET AL., N.Y. STATE BAR ASSOC. TAX SECTION, REPORT NO. 1209, REPORT ON DEFINITION OF "TRADED ON AN ESTABLISHED MARKET" WITHIN THE MEANING OF SECTION 1273 AND RELATED ISSUES 32 (2010), *available at* www.nysba.org/Content/ContentFolders20/TaxLawsection/TaxReports/1209Rpt.pdf (arguing that the definition of public trading should be amended in light of "confusion and ambiguities" in its application); Daniel M. Dunn, *Publicly Traded Debt–How Something So Simple Is Not So Easy*, at 2–3 (Jan. 20, 2010) (unpublished Tax Club paper, on file with author) ("substantial ambiguity in many cases"); JIYEON LEE-LIM ET AL., N.Y. STATE BAR ASSOC. TAX SECTION, REPORT NO. 1066, REPORT ON DEFINITION OF "TRADED ON AN ESTABLISHED MARKET" WITHIN THE MEANING OF SECTION 1273 2 (2004), *available at* www.nysba.org/Content/ContentFolders20/TaxLawsection/TaxReports/1066Report.pdf (claiming that the definition of public trading does not "properly reflect the current market conditions," is "unclear," and is "subject to varying interpretations"). Indeed, the Service recently proposed new rules defining public trading intended to update and simplify their application. Prop. Reg. § 1.1273-2(f), 76 Fed. Reg. 1101 (2011).

This Part III.A. focuses on Scenarios B and C. Scenario A above is benign, as no gain or loss is realized or recognized when a holder with a basis equal to the principal amount exchanges for a new debt instrument with an issue price equal to the principal amount. Scenarios B and C are harsh, and the results have no particular policy justification. Part III.B focuses on Scenario D.

In Scenario B, a holder with a high basis exchanges old debt for new debt with a low issue price. The holder thus recognizes capital loss on the exchange. Capital losses may not be used against ordinary income. But going forward, the holder will have ordinary income OID inclusions. There does not appear to be any policy reason to whipsaw the holder in this fashion.

The situation in Scenario B is even worse for a debt holder that also owns a significant stake in the equity of the issuer—the holder's loss on the exchange could be disallowed under section 267(a). For a private equity fund that owns debt in its own portfolio company, for example, a recognized loss may be disallowed if the fund and the corporation are "related" under a 50% ownership test. The first sentence of section 267(a) could be read to suggest that section 267(a) would not apply to a debt-for-debt exchange with the issuer.[73] Arguably, there is no "exchange of property . . . between persons,"[74] because the debt disappears when it is given to the issuer. However, section 267(a) arguably does apply based on authorities in the analogous area of exchanges of stock with the issuer. First, the second sentence of section 267(a) says that section 267(a) does not apply to a shareholder who exchanges stock in a complete liquidation.[75] The implication is that, absent such sentence, section 267(a) would apply to a shareholder who gives up stock of the issuer in a complete liquidation. Further, Revenue Ruling 1957-387 holds that a loss recognized by a shareholder in a section 302(a) redemption, where the shareholder bears a section 267 relationship with the issuer, is disallowed under section 267.[76] By analogy, a loss recognized by a debtholder on an exchange with the issuer would likely be disallowed under section 267 if the debtholder and the issuer are related under section 267. That permanent disallowance seems punitive, however, as the investor in the distressed debt has incurred a real economic loss and, unlike many section 267 scenarios, the loss property (*i.e.*, the distressed debt) disappears in the transaction.

Scenario C is similarly harsh without any apparent policy justification. This scenario involves a holder with low basis that receives debt with an issue price equal to the principal amount. The issue price would equal the principal amount if the debt is not publicly traded, even though the debt's value may be much less than the principal amount. The holder will realize gain equal to the excess of the new debt's issue price (*i.e.*, its principal amount) over the

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[73] "No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in [§ 267(b)]." I.R.C. § 267(a)(1).

[74] I.R.C. § 267(a)(1).

[75] I.R.C. § 267(a)(1).

[76] Rev. Rul. 1957-387, 1957-2 C.B. 225.

holder's basis. If the transaction is not a recapitalization, then that gain will be recognized. Moreover, a portion of this gain will be ordinary up to the amount of accrued market discount. The balance of the gain would generally be capital. Recognition of the gain does not reflect economic reality, however, where the debt is in fact worth less than its principal amount.

Scenarios B and C are both mitigated if the transaction is a recapitalization. In a recapitalization, neither the loss in Scenario B nor the gain in Scenario C is recognized. Both roll over into the new debt. In the case of Scenario B, although OID is created on the new debt, the inclusions of OID by the holder with the high basis are offset by the holder's acquisition premium resulting from basis in excess of issue price of the new debt.[77] In the case of Scenario C, the gain inherent in the debt becomes market discount, as illustrated in the table below:

Recapitalization Scenarios

	Issue Price Equals Principal Amount	**Issue Price Equals Distressed Value**
Basis Equals Principal Amount	A No gain or loss realized or recognized. No OID.	B Loss realized, but not recognized. No OID inclusions, because of acquisition premium.
Basis Equals Distressed Value	C Gain realized, but not recognized. Market discount.	D No gain or loss realized or recognized. OID inclusions.

B. *Conversion of Market Discount to Original Issue Discount*

One of the well-recognized consequences of the repeal of former section 1275(a)(4) is a conversion of market discount to OID in the case of an exchange of debt for debt that is trading at a discount (*i.e.*, Scenario D).[78] The repeal of section 1275(a)(4) seems to have been an attempt to trigger

[77] I.R.C. § 1272(a)(7).

[78] Former section 1275(a)(4) provided that in a debt-for-debt exchange that was part of a reorganization, the issue price of the new debt instrument would be no less than the adjusted issue price of the old debt instrument. I.R.C. § 1275(a)(4), *repealed by* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(2), 104 Stat. 1388, 1466 (1990).

cancellation of debt income to the issuer,[79] but had implications to the holder as well.

Specifically, if debt is exchanged for new debt with the same principal amount (*e.g.*, $100), and either the old or new debt is publicly traded, then the issue price of the new debt is fair market value (*e.g.*, $60). Assume that the holder purchased the old debt for the same fair market value ($60). On these facts, the holder has no gain or loss on the exchange because basis equals issue price of the new debt. However, the holder is worse off from a tax perspective as a result of the exchange. The holder held the old debt with a market discount of $40, equal to the principal amount less the holder's basis. The market discount need not have been included in income on a current basis. The new debt has OID of $40. The holder must include a portion of the $40 of OID in income each year.

Scenario D is a softened version of the taxable version of Scenario C. Recall that Scenario C involved a low-basis holder receiving new debt with an issue price equal to principal amount and thus, in a taxable exchange, recognizing gain all at once on the exchange. Scenario D spreads this gain over the term of the new debt. If that term is only a few years, Scenario D starts to look like Scenario C in a taxable exchange. Furthermore, scenario D is worse than Scenario C in the sense that all of the original issue discount inclusions will be ordinary—where in Scenario C, a portion of the gain is likely capital.

Thus, in Scenario D, a holder could have significant phantom income inclusions even though, in some transactions, the issuer likely will not repay the full $100 of principal amount. A holder could argue that the doubtful collectibility doctrine applies such that the holder need not include the OID in income on a current basis.[80] The Service took the contrary position, however, in the controversial Technical Advice Memorandum 1995-38-007, arguing against the doubtful collectibility doctrine in the context of OID on three grounds.[81] First, the Service argued that under the statute, an issuer of an OID instrument is viewed as paying cash equal to the amount of the accrued OID for the period, which the holder then relends to the issuer.[82] Second, the Service argued that allowing holders to cease to accrue OID on the grounds of doubtful collectibility would create a mismatch between hold-

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[79] *See* H.R. Rep. No. 101-881, at 354 (1990), *reprinted in* 1990 U.S.C.C.A.N. 2017, 2356 (finding that the repeal of section 1275(a)(4) may result in cancellation of debt income upon a debt-for-debt exchange).

[80] *See* Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766 (6th Cir. 1968) (finding that "reasonable doubt" as to collectibility would prevent accrual); Corn Exch. Bank v. United States, 37 F.2d 34, 35 (2d. Cir. 1930) (finding that the government should not tax income that "in all probability will not be paid within a reasonable time"); Rev. Rul. 1980-361, 1980-2 C.B. 164 (ruling that post-insolvency interest does not "properly accrue"); *see also* Rev. Rul. 2007-32, 2007-21 I.R.B. 1278 (ruling that a bank lender is required to include accrued interest on defaulted debt because lender reasonably expects borrower to make some payments on the loan).

[81] T.A.M. 1995-38-007 (Sept. 22, 1995).

[82] *Id.*

ers and issuers, who would continue to deduct OID.[83] Third, the Service argued that specific rules regarding accrual of income, such as the OID rules, trump general rules, such as the doubtful collectibility doctrine (applicable to accrual basis taxpayers in respect of accruals of non-OID interest).[84]

The Service's position is difficult to accept. The OID rules plainly stem from a recognition that OID is similar to interest, compensation for the use of money. The Code is replete with provisions that treat OID the same as interest.[85] In normal circumstances, current reflection of income requires that both interest and OID be included currently. The doubtful collectibility doctrine recognizes, however, that in circumstances where the holder is not likely to be paid, it would be inconsistent with clear reflection of income to require the holder to accrue interest income. It is not apparent how interest and OID differ in this regard. Thus, it seems reasonable to apply the doubtful collectibility doctrine to OID.

The Service's specific arguments against the doctrine's applicability to OID are not compelling. First, the construct of section 1272(a)(1) need not be viewed as a deemed payment followed by a reinvestment. Rather, it is a statutory accrual system requiring inclusions and basis increases despite income not actually having been paid (yet). Since it is an accrual system, accrual doctrines, such as the doubtful collectibility doctrine, can apply. Second, the mismatch between issuer and holder treatment already may exist in the case of stated interest, as the rules governing the issuer's ability to deduct unpaid stated interest do not clearly match with the doubtful collectibility doctrine applicable to holders.[86] Finally, the argument that the specific prevails over the general seems to beg the question. If the OID rules are viewed as an accrual system, then the argument in favor of applying the doubtful collectibility doctrine to OID is not that the general rule trumps the specific, but rather that the general rule should be considered to be part of the specific OID accrual rules.

The Service's position leads to a further whipsaw in the event that the debt is sold or retired for a price less than the adjusted issue price. Suppose that, as in Scenario D, the new debt's issue price is its distressed value, the holder's basis also equals the distressed value, and the holder includes OID going forward for a period of time. Suppose the debt is then sold or retired for an amount equal to the same distressed value. The holder will recognize a capital loss equal to the amount of OID that the holder accrued. Since capital losses cannot generally be used against ordinary income, the holder will suffer a mismatch—ordinary OID accruals and an economically offsetting capital

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[83] *Id.*

[84] *Id.*

[85] For example, OID is treated as interest for treaty purposes and the portfolio interest exemption. I.R.C. § 871(h)(2); Reg. § 1.871-12(b). OID is deductible under section 163(e)(1), while interest is deductible under section 163(a). *See* Reg. § 1.163-7 (deductibility of OID); *cf.* I.R.C. § 1276(a)(4) (market discount generally treated as interest).

[86] *See* GARLOCK, *supra* note 50, at ¶ 1602.01.

loss. There does not appear to be any policy justification for this result. While the result is inherent in the OID rules, as a general matter, it should not apply where the investment is similar to equity. OID accruals are intended to be a proxy for increases in value of an OID debt instrument, but, in the case of distressed debt, this relationship breaks down.[87]

C. *Recapitalization Treatment: Bank Debt As a Security*

One approach for avoiding the punitive effects of section 267 or unanticipated recognition of phantom gain in these scenarios is the adoption of an expansive interpretation of the concept of recapitalization. As mentioned above, section 267 disallows *recognized* losses. In a recapitalization, losses and gains are realized but not recognized, and a holder's basis is preserved in the new debt. An exchange of debt for debt, or a significant modification, qualifies as a recapitalization generally if the old debt and the new debt are "securities" and the new debt does not have a principal amount greater than the old debt. The concept of "security" means a debt instrument that provides the holder with a long-term proprietary interest in the issuer.[88] The receipt of a short-term debt instrument is thought to be akin to receiving cash and is therefore treated as boot.[89] A recipient of a short-term instrument is "too close" to the cash to merit nonrecognition treatment. Although courts state that the term of the debt instrument is not the only factor relevant to the determination of whether the debt is a security, debt with a term of more than ten years is generally considered a security, while debt with a term of less than five years is generally not considered a security.[90]

Debt with a term within the five to ten-year range is conventionally thought to be in a gray area, but such debt should generally be considered a security because it provides a long-term proprietary interest in the issuer. Much can

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[87] Indeed, the contingent payment debt instrument rules of Regulation section 1.1275-4 are instructive, as they address instruments with uncertain payments. Those rules provide that losses are ordinary to the extent of previous income inclusions on the instrument. Reg. § 1.1275-4(b)(6)(iii)(B).

[88] *See, e.g.*, Camp Wolters Enters., Inc. v. Commissioner, 22 T.C. 737, 751 (1954) (finding that the term "securities" "denotes an obligation of a character giving the creditor some assured participation in the business of the debtor, or, in other words, an investment in the business, and . . . does not include evidences of indebtedness for short term loans representing temporary advances for current corporate needs").

[89] *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468–69 (1933) (notes with a term of less than six months were not "securities" as they were "mere evidence" of an obligation to pay the purchase price and were the "equivalent of cash"); Reg. §1.368-1(b) (stating that "a short-term purchase money note is not a security").

[90] *See* Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599, 602 (3d Cir. 1945) (finding that three, four, and five-year notes evidencing advances are not securities); Burnham v. Commissioner, 86 F.2d 776, 778 (7th Cir. 1936) (finding that ten-year notes are securities). *See generally* BITTKER & EUSTICE, *supra* note 6, at ¶ 12.41[3] ("Notwithstanding [the] difficulties in determining whether an instrument is a security, the courts have ordinarily focused on the instrument's maturity date: A term of five years or less seems to be too short to qualify a note as a security, while a term of ten years or more is apparently sufficient . . . .").

occur over five years. A debt instrument with a five-year term should not be considered akin to cash boot. Thus, an exchange of an old debt instrument with a term of five or more years for a new instrument with a term of five or more years should be considered a recapitalization.

Indeed, an exchange of an old debt instrument with a term of five or more years for a new debt instrument that matures no earlier than the old debt instrument matured should also generally be considered a recapitalization under Revenue Ruling 2004-78.[91] That Revenue Ruling held, in the acquisitive context, that an exchange of target debt securities for acquiror debt was governed by section 354.[92] The acquiror debt had the same terms and the same maturity date as the target debt, except that the interest rate of the acquiror debt was greater than that of the target debt. Commentators have questioned the scope of Revenue Ruling 2004-78—specifically what types of changes, other than interest rate, are permitted in order for Revenue Ruling 2004-78 to apply.[93] Given that the Ruling approves of changes in interest rate,[94] and interest rate is a very important economic feature of a debt instrument, it seems appropriate that the Ruling would apply if other types of changes are made, except possibly a shortening of the maturity.[95] There is no reason to believe that the Ruling would not apply in a single company context, as compared with an acquisitive context.

An option on the part of the issuer to repay debt without penalty, as is common in bank debt, should not prevent the debt from being considered a "security." To be a security, debt must represent a long-term proprietary interest in the issuer. A right of a holder to put the debt to the issuer would undermine a debt instrument's status as a security, but an issuer prepayment right should not undermine its security status. In the case of an issuer prepayment right, the holder is not "too close" to the cash because the holder does not have the right to convert its investment to cash. The holder is committed and therefore the holder's interest should be measured by reference to the stated term without regard to the prepayment right.

Revolver bank debt raises additional issues. First, it is debatable whether the term of revolver debt should be measured relative to when the creditors agree to the credit agreement, and thereby commit themselves to lend, versus when the issuer draws down under the revolver. As of the date of the commit-

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[91] Rev. Rul. 2004-78, 2004-2 C.B. 108.

[92] *Id.*

[93] *See, e.g.*, Simon Friedman, *Debt Exchanges After Rev. Rul. 2004-78*, 105 Tax Notes (TA) 979, 982–83 (Nov. 15, 2004); Letter from Yaron Z. Reich, Cleary, Gottlieb, Steen & Hamilton to Donald Lee Korb, Chief Counsel, Internal Revenue Serv. & Eric Solomon, Deputy Assistant Sec'y for Regulatory Affairs, Dep't of the Treasury (July 16, 2004), *available at* http://services.taxanalysts.com/taxbase/eps_pdf2004.nsf/DocNoLookup/14966/$FILE/2004-14966-1.pdf.

[94] Rev. Rul. 2004-78, 2004-2 C.B. 108.

[95] Reich, *supra* note 93, at 2.

ment, the creditors care about the prospects of the issuer.[96] But until the time that funds are drawn, the creditors have not yet invested anything. Moreover, one might view a revolver as a shorter-term investment as revolver balances often go up and down over the term. Yet, the creditor has no control over these fluctuations and must stand ready to lend when drawn upon. Thus, it seems arguable that a revolver with an appropriate maturity, like a term loan, could be a security.

A bridge loan raises yet additional issues in relation to security status because the issuer has an incentive to exercise its right to redeem the bridge loan sooner rather than later. As discussed above, the interest rate on a bridge loan increases over time. In the context of OID, Regulation section 1.1272-1(c)(5) treats an issuer as exercising an option that reduces yield, measured by reference to principal amount.[97] Thus, if these rules were applied to determine the debt instrument's term, the bridge loan would likely not qualify as a security. But, as in the context of market discount as discussed in Part II.B, principal amount is not the appropriate benchmark for determining yield, and hence maturity, in the context of analyzing a bridge loan's status as a security.

Consider a bridge loan that is worth far less than its principal amount. The value of the bridge loan provides a measure of the yield that the issuer would be required to pay if the issuer were to seek to refinance the bridge loan. Thus, a reasonable approach to determine whether a bridge loan is a security is to apply the mechanics of Regulation section 1.1272-1(c)(5), but determine yield by reference to the value of the bridge loan instead of its principal amount.[98] In most cases, despite the increasing stated interest, the issuer would vastly increase yield if the issuer repaid the bridge loan currently as compared with leaving the loan outstanding. Payment of principal currently would represent a huge yield (because principal far exceeds value), whereas payment of principal at the end of the extended loan period represents a far smaller yield. Alternatively, one could determine security status without such a formal mechanic, recognizing instead that the bridge loan is a long-term interest in the company—despite the increasing interest rate—because the issuer economically has little choice but to leave the bridge loan outstanding.

D. *Yield Test for Significant Modification*

While the above discussion has grappled with the consequences of a debt exchange or modification that is a realization event, some modifications are not "significant" within the meaning of Regulation section 1.1001-3 and are, therefore, not realization events. For example, small changes in yield do not

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[96] *Cf.* Reg. § 1.368-1T(e)(2) (indicating that continuity of proprietary interest is measured at date of signing acquisition agreement).

[97] *See* Reg. § 1.1272-1(b)(1)(i) (describing determination of yield).

[98] Reg. §1.1271-1(c)(5).

result in a significant modification. The application of the yield test in Regulation section 1.1001-3(e)(2)[99] is less straightforward than one might expect in the context of bank debt because bank debt routinely contains a complicated formula for determining interest rate.[100] The application of the yield test hinges on whether the interest rate is a "qualified floating rate" (QFR) or an "objective rate." [101] Depending on one's view regarding whether the contingencies inherent in the interest rate formula for bank debt are remote (and therefore should be disregarded), bank debt might be considered to bear an "objective rate" of interest, rather than a "qualified floating rate" of inter-

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[99] In the case of a modification of fixed rate debt or "variable rate debt," a change in yield constitutes a significant modification if the yield of the modified debt differs from the yield on the unmodified debt (determined as of the date of the modification) by more than the greater of (a) one-quarter of one percent (25 basis points), and (b) five percent of the annual yield of the unmodified debt. Reg. § 1.1001-3(e)(2)(ii).

For this purpose, the yield on the modified debt takes into account, as a reduction in issue price, any payment to the holders as consideration for the modification. For example, assume that notes are issued in 2007 for face value of $100 with an interest rate of 12.5%, and that in 2010, the issuer pays the holders $1 as consideration for a modification pursuant to which the interest rate is increased to 14.5%. The yield on the unmodified notes is 12.5%. The yield on the modified notes is determined by reference to an issue price of $99 and payments of $14.5 per year and a payment of $100 at maturity.

[100] Typical bank debt provides that a loan may be a "Base Rate Loan" or a "Eurodollar Rate Loan" at the issuer's option, and that the issuer may switch between the two during the term of the loan. The difference between the two primarily relates to the interest rate.

A Base Rate Loan will bear interest at a rate equal to the sum of the Base Rate and an Applicable Margin. The Base Rate is generally the greater of the prime rate and a fixed amount (*e.g.*, one-half of one percent) above the Federal Funds Rate. The Applicable Margin is a fixed amount (*e.g.*, 1.25%), or it may be an amount that varies according to the issuer's credit rating. Interest payments are typically quarterly or semiannual.

Eurodollar Rate Loans bear interest at a rate equal to the sum of the Eurodollar Rate plus the Applicable Margin. The Eurodollar Rate is the London interbank offered rate (LIBOR) divided by a percentage equal to 100% minus the Eurodollar Rate Reserve Percentage. This latter concept, the Eurodollar Rate Reserve Percentage, is zero currently, and is apparently a vestige of old law. The Eurodollar Rate Reserve Percentage is the reserve percentage imposed by the Federal Reserve System on a member bank with respect to Eurocurrency Liabilities, as defined in Regulation D of the Board of Governors of the Federal Reserve System. Thus, since the Eurodollar Rate Reserve Percentage is zero, the denominator of the fraction is always 100%, and the Eurodollar Rate is LIBOR. The Applicable Margin for Eurodollar Rate Loans is, like Base Rate Loans, a fixed percentage or a percentage that varies according to the issuer's credit rating. These will be different fixed percentages from the Applicable Margin for Base Rate Loans. Within prescribed limits, the issuer chooses the period between interest payments in the case of a Eurodollar Rate Loan.

[101] In the case of variable rate debt instruments, the yield calculations are made based on an "equivalent fixed rate debt instrument" that is constructed as of the date of the modification by assuming that the variable rate equals a fixed rate. Reg. § 1.1001-3(e)(2)(iv). If the stated interest rate is a "qualified floating rate," yield is calculated based on an assumed fixed rate equal to the value, as of the date of modification, of the variable rate. Reg. § 1.1275-5(e)(2)(ii)(A), -5(e)(3)(i)(A). If the stated interest on the variable rate debt is instead an "objective rate," then the yield calculations assume a fixed rate that reflects the yield that is "reasonably expected" for the debt instrument. Reg. § 1.1275-5(e)(2)(ii)(B), -5(e)(3)(i)(C).

est.[102] If so, the baseline for the yield test is the "reasonably expected" yield under the unmodified bank debt, not the yield using the current value of the floating rate. In an environment where interest rates are expected to rise, this means that bank debt could be modified, without triggering a realization event, by replacing the interest rate formula with a fixed rate that is much higher than the rate that the debt instrument is paying.

For example, assuming that the interest rate in a bank loan is an objective rate, then if the debt is modified, and it is paying the London interbank offered rate (LIBOR) plus a fixed spread, which today totals, say, 3%, but the expectation is that the yield over the remaining term is going to be 5%, then the debt could be modified by replacing the formula with fixed interest of 5.25% (assuming no fee is paid). Similarly, one could replace the interest rate formula with a formula that contains a floor and a cap as long as the reasonably expected yield on the new instrument is no greater than 5.25% in the example. This is a much greater increase in yield than would be permitted if the rate were a QFR. In the latter case, the yield (using current LIBOR) could only be increased to 3.25% in the above example.

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[102] Most loans in the current environment are Eurodollar Rate Loans because LIBOR is very low. If one believes that the likelihood that an issuer would choose to convert the loan to a Base Rate Loan is remote, then the Base Rate part of the formula should be disregarded. In that event, the rate is LIBOR plus the Applicable Margin. In the case where the Applicable Margin is a fixed amount (as distinguished from an amount that varies according to credit rating), the rate is a straightforward qualified floating rate, as "variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds." Reg. § 1.1275-5(b)(1), -5(d), Ex. (2). If the Applicable Margin depends on the issuer's credit rating, it is less clear whether the rate is a qualified floating rate (QFR) or an objective rate. An objective rate includes a rate "that is based on one or more qualified floating rates." Reg. § 1.1275-5(c)(1)(i). Moreover, a rate does not fail to be objective "merely because it is based on the credit quality of the issuer." Reg. § 1.1275-5(c)(1)(ii). Those rules appear to capture a rate based on LIBOR plus a fixed amount that depends on the issuer's credit quality. On the other hand, one could argue that, notwithstanding that the rate depends on the issuer's credit quality, variations in the formulary rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds, and thus that the rate is a QFR. Reg. § 1.1275-5(b)(1).

If one believes that the likelihood that the issuer would convert the loan to a Base Rate Loan is not remote, then the interest rate must be judged based on the entire formula, including the optional conversion. An objective rate is a rate, other than a QFR, determined "using a single fixed formula" and based on "objective financial or economic information." The issuer's right to choose should not prevent the rate from being considered a single fixed formula because the rate could be rewritten as the lesser of the Base Rate and the Eurodollar Rate. An issuer can be expected to choose the lower rate. Thus, it would appear that, on this view, the rate is an objective rate, although the argument could once again be made that, all things considered, variations in the rate measure contemporaneous variations in the cost of newly borrowed funds, and thus that the rate is a QFR.

As a result of the contingencies inherent in the interest rate formula, one could even question whether bank debt is contingent payment debt, but this discussion assumes that it is not.

IV. The Final Workout: Exchanging Debt for Equity

In the last phase in the life cycle of distressed debt, the debt is exchanged for equity. In such a workout, a tranche of distressed debt, the "fulcrum" security, is often exchanged for the lion's share of the equity in the issuer. Frequently, this exchange is coupled with a "rights offering" in which holders of the fulcrum security are offered the right to invest additional funds in order to get more equity than they otherwise would. A large holder of the fulcrum security often agrees to buy whatever equity the other holders do not choose to buy, up to a specified maximum.

An exchange of debt for equity raises myriad tax issues for both the issuer and the holder. From the issuer's perspective, cancellation of debt income[103] (with corresponding attribute reduction)[104] and the application of the loss limitation rules of section 382 are primary concerns. From a holder's perspective, the exchange transaction could take a variety of forms, discussed *infra*.[105] In the simplest case, a single issuer issues its own stock for the issuer's outstanding debt. A holder would generally not recognize gain or loss on that transaction if the debt qualifies as a security because the exchange would generally be a recapitalization under section 368(a)(1)(E).[106] However, the market discount rules can be interpreted to produce anomalous results in this situation if the amount of gain built into the market discount bond is less than the amount of accrued market discount at the time of the recapitalization. Part IV.A argues that the accrued market discount should carry over to the stock only up to the amount of the built-in gain, in contrast to the received wisdom that there is no built-in gain limitation. Absent such a limitation, appreciation that occurs while the holder holds stock would be treated as ordinary when the shares are eventually sold, an anomalous result since the market discount rules are intended to capture income that is akin to interest.

Part IV.B considers transactions where debt of one company is exchanged for stock of a parent company, as distinguished from a single company transaction where debt of a company is exchanged for stock of the same company.

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[103] I.R.C. § 108(e)(8) (issuer is treated as repaying debt for an amount equal to the value of the stock so exchanged).

[104] I.R.C. § 108(b) (issuer must reduce tax attributes in the amount of excluded cancellation of debt income).

[105] A threshold structuring question is whether the transaction will take the form of a "Bruno's" transaction, a sale of all the assets of the issuer to another company in a taxable transaction. C.C.A. 2003-50-016 (Aug. 28, 2003) (finding that a transfer of a bankrupt company's assets to a new corporation failed to qualify as a reorganization under section 368(a)(1)(G) because the creditors who received stock in the new corporation were not "security" holders in the bankrupt corporation). That structure is typically efficient only if the issuer is in bankruptcy and then only if tax attributes are sufficient to absorb the gain on the asset sale (or, in some circumstances if there is a loss on the asset sale). A Bruno's transaction is taxable to the fulcrum debt holder because it does not qualify as a reorganization or section 351 transaction.

[106] *See* I.R.C. §§ 354(a)(1), 368(a)(1)(E).

Frequently, the debt that is the subject of a workout has been issued by an operating subsidiary. In the workout, the debt is meant to be exchanged for stock of the subsidiary's ultimate parent. Several models exist for characterizing such an exchange, each supported by different authorities. Further, if steps are taken to liquidate the operating subsidiary for tax purposes (and any intermediate corporations between the operating subsidiary and the parent), additional characterizations are possible. This Part argues that taxpayers should be able to choose among the characterizations by formally structuring the transaction in the desired manner.

Part IV.C considers workouts in which distressed debt is exchanged either for equity, debt, or a combination of equity and debt and argues that such workouts should not generally result in foreign investors being viewed as engaged in a trade or business in the United States. When distressed debt is exchanged for equity, it merely formalizes the pre-existing equity-like nature of the distressed debt. Changes in the investment along the way, where no new funds are injected into the company, should not be viewed as a trade or business.

A. *Market Discount and Exchanges of Debt for Stock*

Recapitalizations of market discount bonds into stock occur frequently, as such debt is often the "fulcrum" security in a workout. Under some interpretations, however, a recapitalization can lead to the anomalous result that post-recapitalization appreciation in the shares received in the exchange is ultimately taxed at ordinary income rates.

Suppose debt is recapitalized into stock at a time when market discount has accrued on the debt but there is no gain realized on the exchange. Suppose a taxpayer purchased a market discount bond with a principal amount of $100 for $40. When the bond is worth $35 (*i.e.*, the holder holds the bond with a built-in loss), and $10 of market discount has accrued on the bond, the taxpayer exchanges the bond for stock in a recapitalization under section 368(a)(1)(E).[107] The taxpayer realizes, but does not recognize, $5 of loss on the recapitalization exchange, and the taxpayer's basis remains at $40.

The received wisdom is that the accrued market discount of $10 carries over to the stock that the taxpayer received, thus tainting the first $10 of gain that the taxpayer recognizes on a later sale of the stock as ordinary, without regard to the fact that there was a built-in loss at the time of the exchange of debt for stock.[108] That is, if the taxpayer eventually sells the stock for $50 or more, the view is that $10 of the taxpayer's gain is ordinary, even though all $10 of appreciation arose while the taxpayer held *stock*. The legislative his-

[107] Assume the taxpayer has not elected to include market discount in income currently.

[108] Under section 1276(d)(1)(B), the recapitalization is a nonrecognition transaction; thus section 1276(c)(2) applies.

tory arguably provides support for that reading[109] but the statute is far from clear.[110]

The received wisdom is not the correct answer as a tax policy matter. If appreciation occurs during the period that the holder holds the *stock,* none of that gain should be converted into ordinary income because none of that gain is akin to interest. It is one thing to say that a sale of a market discount bond at a gain should give rise to ordinary income up to the amount of accrued market discount. Consistent with that principle, if a market discount bond is exchanged for stock in a nonrecognition transaction, it is appropriate to treat gain on a subsequent sale of the stock as ordinary to the extent that the appreciation occurred during the period the taxpayer held the market discount bond. But, it is quite another thing to treat appreciation that occurs during the period *after* the taxpayer disposed of the market discount bond as ordinary. In the above example, the market discount bond lost value while the taxpayer held the bond, and then the stock gained value while the taxpayer held the stock. The taxpayer did not experience any interest-like return in respect of the market discount. To the contrary, the taxpayer experienced a loss on the bond and a gain on the stock.

The rule should be that accrued market discount carries over to the stock to the extent of the *lesser* of accrued market discount on the debt and gain

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[109] The Senate Explanation to the Tax Reform Act of 1984 states as follows:

> The amount of accrued market discount with respect to "exchanged basis property" (property received in a nonrecognition transaction the basis of which is determined in whole or in part by reference to the basis of property that was transferred in the transaction) includes any accrued market discount to the extent such amount was not previously treated as interest income under the provisions of the bill. For example, on the disposition of stock received upon the conversion of a convertible bond or in a recapitalization gain is treated as interest income to the extent of the amount of accrued market discount as of the date of conversion.

S. Rep. No. 98-169, at 157 (1984).

[110] In the case of a nonrecognition disposition involving "exchanged basis property," section 1276(c)(2) states as follows:

> [A]ny accrued market discount determined with respect to the property disposed of to the extent not theretofore treated as ordinary income . . . (A) shall be treated as accrued market discount with respect to the exchanged basis property received by the taxpayer in such transaction if such property is a market discount bond, and (B) shall be treated as ordinary income on the disposition of the exchanged basis property received by the taxpayer in such exchange if such property is a market discount bond.

I.R.C. § 1276(c)(2).

Thus, the statutory language says that accrued market discount is treated as ordinary income on a subsequent sale of the stock without reference to the amount of gain recognized, or even the amount realized, on the sale of the stock. Accordingly, it is unclear under the statute what portion of the accrued market discount is treated as ordinary.

realized on the recapitalization exchange.[111] In the above example, because there was loss, not gain, realized on the exchange, no accrued market discount should carry over to the stock.

Another curiosity arises if, after the recapitalization of the market discount debt into stock, the stock is then disposed of in another nonrecognition transaction. Suppose that stock received in a debt-for-equity recapitalization is then itself recapitalized into another type of stock. Section 1276(c)(2) should apply, but that provision says it applies to a disposition of "any market discount bond."[112] It does not say it applies to a disposition of property received in exchange for a market discount bond, another glitch in the drafting of section 1276(c).[113]

Contributions of market discount bonds to corporations in section 351 transactions raise further peculiarities. It is evident that such a contribution causes gain to be recognized up to the amount of accrued market discount.[114] It is not clear what policy justifies this result, but it can help with planning in a situation where a taxpayer wants to prevent the stock received from being tainted with accrued market discount.[115]

Another nuance associated with section 351 transactions arises in the event that a market discount bond is exchanged for stock of the issuer in a transaction that is both a recapitalization under section 368(a)(1)(E) and part of a

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[111]Thus, in the example, if, at the time of the recapitalization, the market discount bond had a value of $47, $7 of accrued market discount should carry over to the stock, equal to the lesser of the $10 of accrued market discount on the bond and the $7 of gain realized on the exchange.

[112]I.R.C. § 1276(c)(2).

[113]I.R.C. § 1276(c)(2).

[114]I.R.C. § 1276(d)(1)(C).

[115]As discussed above, accrued market discount may carry over to the equity received in exchange for market discount debt if the exchange is a recapitalization under section 368(a)(1)(E), without regard to the amount of gain realized on the exchange. If instead of engaging in a recapitalization, the taxpayer contributes the market discount bond to a corporation in a section 351 transaction, the taxpayer will recognize gain up to the amount of accrued market discount on the bond. Thus, if there is little or no gain realized, the taxpayer will recognize little or no market discount.

The stock in the transferee corporation received by the taxpayer should not be considered exchanged basis property subject to section 1276(c)(2), and therefore any further gain in the stock should not be tainted as ordinary under the market discount rules. In order to be subject to section 1276(c)(2), the taxpayer must dispose of the market discount bond in a "nonrecognition transaction" to which section 1276(c)(1) does not apply. Section 1276(c)(1) applies where a market discount bond is transferred in a "nonrecognition transaction" and the transferee takes a basis based in whole or in part on the transferor's basis. In a section 351 transaction, the transferee corporation takes a basis equal to the transferor's basis (adjusted by the amount of gain recognized to the transferor). Thus, the contribution of the market discount bond to the corporation in the section 351 transaction is subject to section 1276(c)(1), not (c)(2), and the stock received is not tainted.

section 351 transaction.[116] One would expect that because recapitalizations are entitled to nonrecognition treatment for purposes of market discount under section 1276(d)(1)(B) that such a transaction would be entitled to nonrecognition treatment. The fact that the transaction is also a section 351 transaction should not disrupt that nonrecognition treatment.

B. *Exchanging Debt of a Subsidiary for Stock in the Parent*

While Part IV.A primarily addressed exchanges of debt of the issuer for stock of the same company, oftentimes, the issuer of the distressed debt is one or more tiers below the top-tier parent company. In such a case, the debt of the subsidiary is exchanged for stock of the parent. While a seemingly minor variation on the theme, the analysis of this type of transaction is significantly more complex than a single company transaction. In the end, taxpayers have a number of characterizations to choose from. This Part argues that taxpayers should be able so to choose as long as they structure the transaction in a form consistent with their chosen characterization.

Tax law has grappled with how to characterize an exchange of debt in "Opco" for stock in "Holdco" for decades. Suppose that Holdco, a corporation, owns the stock of Opco, also a corporation and the issuer of the debt. In a workout, the holders of Opco's distressed debt will exchange their debt for stock in Holdco. Conceptually, there are at least three ways to characterize this transaction. First, it could be viewed as if Opco exchanged its own stock for the Opco debt, and then Holdco acquired the Opco stock from the holder in exchange for Holdco stock (the "Opco Stock Issuance Construct"). Under this approach, the first step would be a recapitalization (assuming that the Opco debt is a security) and the second step might qualify as a B reorganization or a section 351 transaction. If so, the transaction would be a nonrecognition event to holders.

Second, it could be viewed as if Holdco contributed Holdco stock to Opco, and then Opco delivered the Holdco stock to the holder in exchange for the Opco debt (the "Down the Chain Construct"). Under this approach, the transaction would generally be taxable to holders. Third, it could be viewed as if Holdco issued Holdco stock to the holder in exchange for the Opco debt, and then Holdco contributed the Opco debt to Opco (the "Over the Top Construct"). This transaction could potentially qualify as a section 351 nonrecognition transaction to holders, notably, without regard to whether the Opco debt is a security.

The Opco Stock Issuance Construct, developed decades ago, enabled the Service to conclude in Revenue Ruling 1959-222 that an acquisition by one corporation of an unrelated bankrupt target corporation, in which creditors

[116]This can occur if the market discount bond is a "security." Section 351(d)(2) states that debt of the transferee "corporation which is not evidenced by a security" is not considered property for section 351 purposes. The implication is that debt of the transferee corporation that is evidenced by a security is considered property for section 351 purposes.

of the target received acquiror stock, qualified as a section 368(a)(1)(B) reorganization.[117] The Service also concluded in that Ruling that the target did not experience cancellation of debt income under a prestatutory version of the stock-for-debt exception.[118] The Service stated that, because the target was insolvent, the transaction should be viewed as if the debtholders "surrendered their claims, received the new issue of [target] common stock and then exchanged such stock for the stock of [the acquirer]."[119]

The scope of the Opco Stock Issuance Construct remains to be seen. While the Service has applied the Opco Stock Issuance Construct in private rulings in the parent–subsidiary context addressing the "stock-for-debt exception" under former section 108(e)(10),[120] certain statements made in those rulings[121] would lead one to believe that the Opco Stock Issuance Construct cannot be relied upon outside of bankruptcy.[122] Furthermore, the Opco Stock Issuance Construct is in some tension with the Supreme Court's decision in

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[117] Rev. Rul. 1959-222, 1959-1 C.B. 80.

[118] *Id.*

[119] *Id.*

[120] Section 108(e)(10) was enacted in the Deficit Reduction Act of 1984. *See* Pub. L. No. 98-369, § 59(a), 98 Stat. 494, 576, *repealed by* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a)(1)(A), 107 Stat. 312, 487–88. Prior to its repeal, section 108(e)(10) provided, in general, that for purposes of determining cancellation of debt income, if a debtor corporation transferred stock in satisfaction of its debt, the stock would be measured at its fair market value. An exception, the so-called "stock-for-debt exception" existed, however, for a bankrupt or insolvent corporation. A question thus arose as to whether an exchange of one company's debt for another company's stock qualified for the exception since holders did not receive stock of the issuer of the debt.

[121] P.L.R. 1989-33-001 (Aug. 22, 1989) (characterizing an exchange of bankrupt subsidiary debt for bankrupt parent stock as an exchange of subsidiary debt for subsidiary stock, followed by an exchange of subsidiary stock for parent stock; thus stock-for-debt exception and section 368(a)(1)(B) applied), *revoked in part by* P.L.R. 1993-33-048 (May 28, 1993) (finding the second step was not a B reorganization as to one subsidiary because of failure to satisfy continuity of business enterprise; application of the stock-for-debt exception reaffirmed); P.L.R. 1989-14-080 (Jan. 11, 1989) (deeming acquisition of target that was in receivership for unrelated acquirer stock an exchange of creditors' claims for stock in target, followed by an exchange of target stock for acquirer stock, and thus stock-for-debt exception and section 368(a)(1)(G) applied); P.L.R. 1988-52-039 (Oct. 4, 1988) (holding that the stock-for-debt exception and section 368(a)(1)(B) applied in an exchange of bankrupt subsidiary debt for subsidiary stock followed immediately by an exchange of subsidiary stock for bankrupt parent's stock).

The Service eventually applied the stock-for-debt exception in the case of an exchange of subsidiary debt for parent stock without reference to Revenue Ruling 1959-222 or a deemed recapitalization. P.L.R. 1995-16-025 (Jan. 18, 1995) (finding that the issuance of stock of the common parent of an affiliated group satisfies the stock-for-debt exception with respect to subsidiary debt); *see also* GORDON D. HENDERSON & STUART J. GOLDRING, TAX PLANNING FOR TROUBLED CORPORATIONS § 504A.3.2 (2009 ed. 2008).

[122] The Service has indicated that Holdco and Opco must be bankrupt in order for Revenue Ruling 1959-222 to apply. P.L.R. 1989-33-001 n.12 (Aug. 22, 1989) (indicating that the Service would not apply Revenue Ruling 1959-222 recast if not all parties are in bankruptcy). The private rulings applying Revenue Ruling 1959-222 in the parent–subsidiary context all involve bankruptcy or receivership. *See* authorities cited *supra* note 121.

Helvering v. Southwest Consolidated Corp.[123] On the other hand, some have argued that the proposed "no net value" regulations implicitly would apply the Opco Stock Issuance Construct outside the bankruptcy context.[124]

Some have argued that Regulation section 1.1032-3 overrules Revenue Ruling 1959-222 in any event, or, alternatively, that the Down the Chain Construct applies outside bankruptcy.[125] In the event that Holdco's stock is issued in exchange for Opco's debt, that regulation treats Holdco as contributing cash to Opco, Opco as purchasing the Holdco stock using the contributed cash, and Opco as then delivering the Holdco stock for the Opco debt.[126] Under that construct, the exchange is taxable to holders because it is neither a reorganization nor a section 351 transaction.

If taxpayers formally structure the exchange consistent with the Over the Top Construct, however, that construct ought to be respected. The Over the

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[123]315 U.S. 194 (1941). In *Southwest Consolidated*, a corporation in receivership transferred all of its assets to a newly formed corporation in exchange for voting common stock of the new company and warrants. Most of the common stock was distributed to the bondholders, while a small portion of the common stock, as well as the warrants, went to certain other creditors and common and preferred shareholders of the old corporation.

The Court ruled that the transaction was not a reorganization under the predecessor statutes of sections 368(a)(1)(C), (D), (E), and (F). In so doing, the Court arguably rejected the construct of a preliminary exchange of target debt for target stock. Had the Court deemed the bondholders first to exchange their bonds in the old corporation for stock in that corporation, the transaction could potentially have qualified as a first-step recapitalization under the predecessor of section 368(a)(1)(E) followed by an acquisition of assets qualifying as a reorganization under the predecessor of section 368(a)(1)(D) or (F).

The Court declined to treat the bondholders as stockholders of the old corporation. The Court interpreted the statutory reference to "stockholders" of the target to mean "an existing, specified class of security holders" who could not be treated "as something other than 'stockholders' of the old company merely because they acquired a minority interest in the new one." *Sw. Consol.*, 315 U.S. at 202. The Court distinguished its holding in *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), on the grounds that the latter case involved the continuity of proprietary interest test for reorganizations as distinguished from the statutory references to "stockholders" that were at issue in *Southwest Consolidated.*

The Court further noted that the predecessor to section 368(a)(1)(D) intended that the transferor corporation or its stockholders "rather than its creditors" own control of the new corporation. *Id.* Thus, *Southwest Consolidated* casts some doubt on the reach of Revenue Ruling 1959-222 and the Opco Stock Issuance Construct.

[124]In an example, those proposed regulations conclude that an exchange of acquiror voting stock for target debt securities satisfies certain reorganization requirements set forth in the proposed regulations. Prop. Reg. § 1.368-1(f)(5), Ex. (9), 70 Fed. Reg. 11903 (2005). No consideration is given to the target stockholders because the target's liabilities exceed the value of its assets. *Id.* The example implies that the transaction could qualify as a section 368(a)(1)(B) reorganization. But, section 368(a)(1)(B) requires an acquisition of "stock" of the target corporation. Thus, it appears that the example implicitly deems the target debt securities to be exchanged for target stock in advance of the acquisition. It makes no mention of the target being bankrupt, although clearly the target is insolvent. Thus, the example could be read to apply Revenue Ruling 1959-222 outside the bankruptcy context. *See* HENDERSON & GOLDRING, *supra* note 121, at § 602.

[125]Reg. § 1.1032-3; Rev. Rul. 1959-222, 1959-1 C.B. 80.

[126]Reg. § 1.1032-3 (aimed to eliminate a "zero basis" problem).

Top Construct will often qualify as a section 351 transaction, which is generally tax-free to holders[127] regardless of whether the debt exchanged is a security. If parties to the transaction structure the transaction in a form consistent with the Over the Top Construct, the transaction should not be deemed to involve either the Opco Stock Issuance Construct or the Down the Chain Construct. The Over the Top Construct does not involve any greater number of steps than the other two constructs.[128]

All three of the above structures leave the two corporate entities, Holdco and Opco, in place. The most permissive—the Over the Top Construct—creates potential corporate level gain that could be undesirable, however. While the issuer would expect to recognize cancellation of debt income equal to the difference between the value of the Holdco stock and the adjusted issue price of the Opco debt, the Over the Top Structure creates potential corporate level built-in gain above and beyond the cancellation of debt income. In the Over the Top Construct, if treated as a section 351 transaction, Holdco will take a basis in the Opco debt of no greater than the holder's basis in that debt.[129] If that basis is less than the value of the Holdco stock, then that increment (the value of the Holdco stock less Holdco's basis in the Opco debt) will be recognized at some point, either when Holdco contributes the debt to Opco's capital,[130] when Opco repays the debt, or possibly on the exchange of Opco

[127]As discussed in Part IV.A above, gain is recognized to the extent of accrued market discount in a section 351 transaction. *See* I.R.C. § 1276(d)(1)(C).

[128]*See* Esmark, Inc. v. Commissioner, 90 T.C. 171, 196 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989) (rejecting the Service's recast of the transaction because "[n]o route was more 'direct' than the others," each requiring the same number of steps); Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) (finding that a taxpayer "is not bound to choose that pattern which will best pay the Treasury"); F.S.A. 1994 WL 1725525 (Sept. 1, 1994) (finding that the Service would have a "difficult burden" because the Service's recharacterization "involves the same number of steps" as the actual transaction).

[129]Under both I.R.C. § 108(e)(4) and the regulations governing consolidated returns, the acquisition of Opco's debt by Holdco will result in cancellation of indebtedness. *See* Reg. §§ 1.108-2(a), 1.1502-13(g)(5)(ii). Both sets of rules point to Regulation section 1.108-2(f) to determine the amount of cancellation of indebtedness income realized. Generally, the amount of cancellation of indebtedness income is determined by reference to the fair market value of the note on the date of Holdco's acquisition. Reg. § 1.108-2(f)(2). Further, upon Holdco's acquisition, the note is deemed satisfied and reissued at an issue price equal to such fair market value. *See* Reg. §§ 1.108-(2)(g)(1), 1.1502-13(g)(5)(ii). Holdco's basis in the reissued note could well be less than such issue price, since in a section 351 transaction, Holdco's basis would be determined by the basis of the creditors who transferred the debt to Holdco in exchange for Holdco stock. I.R.C. §§ 351(h)(2), 358(a).

[130]I.R.C. § 108(e)(6).

debt for Holdco stock.[131]

An alternative structure would aim to avoid that corporate level taxable income by converting Opco to a limited liability company treated as a disregarded entity for tax purposes. If the transaction is not a section 332 liquidation because of insolvency, it should qualify as a C reorganization.[132] The transaction would pass muster under the "no net value" regulations.[133] Since the transaction is intended to qualify as a C reorganization, though, boot is a sensitive matter. Boot going to other Opco debt holders (*e.g.*, debt going to other Opco debt holders) could disqualify the transaction. From the holder's perspective, the transaction is likely to be viewed either as a candidate for a section 368(a)(1)(C) reorganization or a liquidation of Opco followed by an exchange of Holdco debt for Holdco stock. In either case, the debt would

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[131] Some have argued that the deemed satisfaction under Regulation section 1.1502-13(g)(5)(ii) itself generally triggers the gain at Holdco. Furthermore, even apart from that Regulation, in special circumstances the gain would be triggered on the exchange of Opco debt for Holdco stock. Although the amount of cancellation of debt income is generally measured by reference to the value at the time of the exchange of the Opco debt (which should equal the value of the Holdco stock), in certain circumstances, cancellation of debt income is measured by reference to Holdco's basis in the debt. *See supra* note 101. Specifically, if the creditor acquired Opco's note by purchase on or less than six months before Holdco's acquisition of the note from the creditor in a section 351 transaction, then cancellation of indebtedness income is determined by reference to Holdco's basis in the note. Reg. § 1.108-2(f)(1) (last sentence). In that event, the excess of the value of the Opco note and Holdco stock over Holdco's basis would be recognized at the time of the debt-for-stock exchange as cancellation of debt income.

[132] *See, e.g.*, Resorts Int'l, Inc. v. Commissioner, 60 T.C. 778 (1973), *aff'd*, 511 F.2d 107 (5th Cir. 1975) (finding that the acquisition of target stock followed by liquidation of target is a section 368(a)(1)(C) reorganization).

One could question whether dissolving a wholly-owned subsidiary into its parent corporation can qualify as a section 368(a)(1)(C) reorganization in light of the requirement that the target assets be transferred to the acquiror "in exchange solely for all or a part of [the acquiror's] voting stock." I.R.C. § 368(a)(1)(C). Here, no acquiror voting stock is issued to the target shareholder because the target shareholder is the acquiror. But, the Service has ruled that a conversion of a wholly owned subsidiary to a limited liability company can qualify as a section 368(a)(1)(C) reorganization. P.L.R. 2009-52-032 (Sept. 24, 2009).

Regulation section 1.368-2(d)(4)(i), rejecting *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), also supports treatment as a section 368(a)(1)(C) reorganization, as it says that "prior ownership of stock of the target corporation by an acquiring corporation" does not prevent the "solely for voting stock" requirement from being satisfied. Reg. § 1.368-2(d)(4)(i). The proposed regulations, by contrast, stated that "prior ownership of a *portion* of . . . the stock" of the target would not prevent the requirement from being met. Prop. Reg. § 1.368-2, 64 Fed. Reg. 31770 (June 14, 1999) (emphasis added). The omission of "a portion" in the final regulation implies that prior ownership of all or a portion of the target stock by the acquirer is permissible. Furthermore, where Holdco voting stock is issued to the Opco debt holders, such issuance could be viewed as the requisite issuance of voting stock.

[133] Prop. Reg. § 1.368-1(f)(2)(i), 70 Fed. Reg. 11903 (Mar. 10, 2005). Those regulations state that the target (here, Opco) debt that is eliminated in the transaction in exchange for the issuance of acquirer (here, Holdco) stock is disregarded in determining whether target is insolvent, thus bolstering net value.

likely need to be viewed as a "security" in order for nonrecognition treatment to apply.

C. *"Engaged in a Trade or Business"*

One of the most discussed issues in the international arena relating to debt workouts is the question of what activities result in the creditor being treated as engaged in a trade or business. A non-U.S. person is taxable on income that is effectively connected with a U.S. trade or business. While the safe harbor in section 864(b)(2) protects trading,[134] origination of debt might not be covered by the safe harbor and could under some circumstances be viewed as akin to the lending done by banks in an active business.[135] Further, some have questioned whether negotiating a workout is consistent with the passivity expected of a mere investor. The acknowledgment that distressed debt is similar to equity facilitates the analysis of at least some scenarios as it is widely accepted that originating equity is not a trade or business, but rather an investment.[136]

Much of the concern about whether a creditor is engaged in a trade or business derives from an analogy with banks. Banks provide funds in exchange for debt of an issuer, not equity. Thus, when a hedge fund or private equity fund invests in equity, one would not expect a trade or business to arise. By the same token, if a fund invests in distressed debt, a trade or business should not arise because the distressed debt is economically similar to equity. Consider the case of a fund that acquires positions in debt at a steep discount and then leads the workout of that debt when the debt goes into default. The fund may exchange the debt for a significant equity stake in the company. Exchanging the distressed debt for equity, and leading the workout relating to such exchange, should not give rise to a trade or business at the fund—economically, the transaction merely formalizes the equity-like nature of the debt.

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[134] I.R.C. § 864(b)(2).

[135] *See, e.g.*, Andrea L. Mullin, *The Impact of the '97 Tax Act on Private Investment Funds*, 15 J. Tax'n Investments 91, 102–03 (1998); Andrew W. Needham, *Private Equity Funds*, 735-2nd Tax Mgmt. Port. (BNA) VII.G (2010); Andrew W. Needham, *Hedge Funds*, 736-1st Tax Mgmt. Port. (BNA) VII.F (2010); David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 Tax Law. 719, 761 (2003).

[136] *See* Whipple v. Commissioner, 373 U.S. 193 (1962) (disallowing a bad debt deduction because provision of services and cash advances to one or more corporations in exchange only for normal investor's return does not constitute a trade or business); Higgins v. Commissioner, 312 U.S. 212 (1940) (finding that investment activities do not constitute "carrying on a business" no matter how continuous or extended the work required); Sicular & Sobol, *supra* note 135, at 772–73 (finding that, in light of the *Whipple* and *Higgins* lines of cases, "virtually all practitioners and commentators seem to agree [that] the tax law appears to treat equity financing as a presumptively passive activity"); *see also* Stuart Leblang & Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 Tax Mgm't Int'l J. 131, 149 (2002) ("There is essentially no risk under current law that a foreign person that enters into private equity transactions will be treated as engaged in a trade or business by virtue of such activities.").

Likewise, if the fund leads a workout in which the debt is exchanged for new debt and a significant equity stake, or if the debt is exchanged solely for new debt, the workout should not give rise to a trade or business at the fund, despite new debt being issued. Changes in the investment along the way should not give rise to a trade or business. The active business of lending involves lending new funds, not restructuring existing debt instruments. Moveover, the acquisition of the original debt on the market should be treated the same, from a trade or business perspective, as the acquisition of an equity instrument. If a fund purchased equity in a company (whether a primary or a secondary purchase), one would not expect the purchase or a restructuring thereof to give rise to a trade or business and the same result should apply if the fund acquires distressed debt and restructures it.

V. Conclusion

The prevalence of distressed debt investments in the recent economic downturn has highlighted anomalies that result from the indiscriminate application of tax rules designed for traditional debt instruments to distressed debt that behaves like equity. Those problems are yet another manifestation of the limitations of tax law's long-standing conceptual view of debt and equity as sharply distinguishable types of investments. This Article illustrates the pervasiveness of this issue and makes recommendations to alleviate those problems in the distressed debt context.

Tax law should be flexible enough to recognize the economic similarity of distressed debt to equity and produce appropriate tax results. One solution would be comprehensive reform of tax law's classification of instruments as debt or equity. Alternatively, more targeted solutions are also available. Two principal remedies would address many of the issues discussed in this Article. First, rendering market discount rules inapplicable to distressed debt would prevent inappropriate recognition of interest-like ordinary income in the context of distressed debt investments. Second, a broad understanding of "recapitalization" would avoid a number of anomalies in the context of debt-for-debt, or debt-for-equity, exchanges. Those two remedies focus on distressed debt without attempting to solve the larger debt–equity classification problem and allow for easier implementation, while still alleviating many of the tax problems that arise.