UNIVERSITY OF HOUSTON LAW CENTER

BANKRUPTCY TAX

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Modification of Debt Instruments

Class 6 – September 26, 2017 5:30 PM

Assignment

Assigned Reading—All

1. FOREWORD TO CLASS 6
2. *Cottage Savings Ass'n v. Commissioner*, 449 U.S. 554 (1991)
3. Internal Revenue Code §§ 1001(c), 1273, 1274
4, Treas. Reg. § 1.1001-1(a)(first sentence), -1(g)(1), -3(all)

Optional Reading:

1. Goldring and Neubort, Modifying Debt and its Consequences

Problems. As part of the assignment, please come prepared with your answers to each of these problems:

Q - D Corporation has outstanding $300 million principal amount of $1,000 denominated 8% notes (the "8% Notes"), which are publicly traded. Interest on the 8% Notes is payable semiannually. The 8% Notes were issued on February 1, 2013 and mature on February 1, 2023. The 8% Notes are convertible into common stock of D. D has significant cash flow problems during 2017.

Would there be a significant modification of the notes if D failed to make scheduled payments during 2017 in respect of the 8% Notes? Would it matter if the debt instrument gave the right to the holder to call a default and accelerate the notes? What if during the period of nonpayment the parties are negotiating over how to proceed?

Q – What if on February 1, 2018, D pays all past due amounts and the holders waive any default rights?

Q – What if the parties agree to change the terms of the 8% Notes as of February 1, 2018 to provide that, each year, 4% interest will continue to be paid semiannually, but the remaining 4% will be paid at maturity at the same rate and terms as the principal obligation (*i.e.*, the unpaid portion will compound and itself bear interest).

Q – What if the indenture governing the 8% Notes currently provides that the notes are accelerated if D's debt/equity ratio exceeds a given level, and the parties amend the indenture to permit an increased debt/equity ratio, and as an inducement for the amendment, D agrees to increase the interest rate on the notes to 8.35%?

Q – What if D files for bankruptcy, and upon emergence from bankruptcy 50% of the principal amount of each outstanding 8% Note is cancelled and the terms of the other 50% remain the same?

Q – What if the maturity date is accelerated to February 1, 2022?

Q – What if the maturity date is extended to January 1, 2025?

Q – What if two years later, the maturity date is again extended to January 1, 2029?

Q – What tax consequences would result to the obligor if a significant modification resulted from any of these changes?

Q – What tax consequences would result to the holders if a significant modification resulted from any of these changes?

Q - Corporation D has a $300 million principal amount bank loan (the "Bank Debt") outstanding. In addition to interest payments, D must make semi-annual principal payments of $20 million. The Bank Debt was issued on July 1, 2005 and matures on January 1, 2012. The bank has a first lien (subject to the mortgage described below) on all of the properties owned by D. D may prepay the bank debt at any time.

D has also granted a mortgage on a parcel of real estate securing a non-recourse debt owed by D in an amount of $5 million. The terms of the debt provide that D may obtain a release of the mortgage if D agrees to convert the debt to a recourse obligation and D is sufficiently creditworthy.

What if D converts the real estate debt to a recourse obligation, obtains a release of the mortgage and sells the parcel of real estate? Is there a significant modification of the real estate debt?

Q – Is there a significant modification of the Bank Debt?

Q – What if D sells all of its assets to another corporation and the buyer assumes all of D's liabilities, including the Bank Debt and the real estate debt.

Q – What if the terms of the Bank Debt are modified such that the $20 million semi-annual prepayments will only be due if D's excess working capital exceeds $10 million on the prepayment date. Is there a significant modification?

Q – What if he terms of the real estate debt provide that D may substitute certain other types of collateral in place of the parcel of real estate if the other collateral is appraised at 1-1/2 times the value of the real estate, and D obtains the consent of the bank to substitute other collateral to secure the real estate debt's first lien in exchange for a portion of the proceeds of the sale of the parcel of real estate as a partial prepayment of the Bank Debt.

Q – In these times of economic distress, what should you be telling the banking and transactional attorneys in your law firm?

FOREWORD – DEBT MODIFICATION

When there is a sale of other disposition of property, then "except as otherwise provided [elsewhere in the Internal Revenue Code]," gain or loss will be recognized. IRC §1001(c). Thus, when we find a sale or other disposition, we look to see whether there is some reason why the gain or loss should not be recognized, such as a like kind exchange or a tax free reorganization. Whether there is a sale or other disposition is usually obvious.

The regulations, § 1.1001-1(a), caution us, however, that when property is exchanged for other property, there is a sale or other disposition only if the property received "differs materially in kind or in extent." For example, early in the life of the income tax, many corporations were migrating from their state of incorporation to Delaware to take advantage of Delaware's more modern corporation law. In these transactions, the capital and debt structure of the Delaware corporation mirrored the equity and debt structure of the old corporation and the relative stock and debt interests were identical. The investors received new pieces of paper with identical terms. The Supreme Court held that the whole transaction was taxable because the rights of stockholders and creditors were different under the laws of the two states. In one case, where the corporation reincorporated in the same state, the Court held that no taxable event had taken place. The particular issue has now been resolved by statute, as IRC § 368(a)(1)(F) provides that a mere reincorporation is a reorganization, and effectively the transaction is ignored for tax purposes. But the learning of these cases may still be relevant.

What if a debtor and creditor change the terms of a debt, for example change the interest rate, extend the maturity date, substitute security or some combination thereof? The regulation requires us to determine whether or not there is a material difference, and the IRS has long taken the position that the same analysis will apply whether there is an actual exchange of debt instruments or merely some oral or written modification of the existing documentation. For many years, these rules were followed intensely by the tax-exempt bond community, since a "reissuance" of a tax exempt bond could in some cases lead to the loss of tax exempt status for the bond, yet it produced some authority on what changes in a debt instrument were substantial enough to result in a deemed exchange for tax purposes.

It is probably true that there have historically been many cases in which changes to the terms of a debt instrument have been made, but neither the parties nor their tax advisors considered whether some sort of taxable event had occurred. The along came the *Cottage Savings* case, assigned reading for this class, in which two banks exchanged portfolios of mortgages that had substantially identical components (except for the identities of the obligors and the properties securing the debt) and substantially identical aggregate values. The sole purpose of the transaction was to realize a tax loss, as the economy had given rise to severe declines in the value of these mortgages. Interestingly enough, the IRS took the view that there was no transaction of economic significance and disallowed the loss. The Supreme Court sided with the banks, and allowed the losses. We will discuss the reasoning of the case in class.

Although *Cottage Savings* involved an actual swap of assets between two banks and did not deal with modifications of existing debt instruments, it gave rise to concern in the tax community, because the principles underling exchanges of debt instruments and modification of debt instruments were the same. Could it be that small changes in the terms of a debt could give rise to a taxable event?

The Service's answer was to issue Reg. § 1.1001-3 (sometimes called the *Cottage Savings* regs), assigned as reading for this class. The form of the regs is unusual, in that instead of setting out principles and giving examples, they promulgate bright line rules and safe harbors for the vast majority of changes that might be made to a debt instrument. They did a great job. The rules are straightforward and easily understandable, just what tax lawyers like. In more than twenty years since they became final, very few significant issues of construction that have arisen.

The regs are detailed but not lengthy. Read them carefully and then work through the problems assigned.

Supreme Court of the United States
COTTAGE SAVINGS ASSOCIATION
v.
COMMISSIONER OF INTERNAL REVENUE.
No. 89-1965.

Argued Jan. 15, 1991.
Decided April 17, 1991.

MARSHALL, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and STEVENS, O'CONNOR, SCALIA, KENNEDY, and SOUTER, JJ., joined. BLACKMUN, J., filed a dissenting opinion, in which WHITE, J., joined, *post*, p. 1519.
Dennis L. Manes argued the cause for petitioner. With him on the briefs was *Scott M. Slovin.*

Acting Solicitor General Roberts argued the cause for respondent. With him on the brief were *Assistant Attorney General Peterson, Deputy Solicitor General Wallace, Clifford M. Sloan, Richard Farber,* and *Bruce R. Ellisen.*

****1506** Justice MARSHALL delivered the opinion of the Court.

The issue in this case is whether a financial institution realizes tax-deductible losses when it exchanges its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. We hold that such a transaction does give rise to realized losses.

Petitioner Cottage Savings Association (Cottage Savings) is a savings and loan association (S & L) formerly regulated by the Federal Home Loan Bank Board (FHLBB).[FN1] Like many S & L's, Cottage Savings held numerous long-term, low-interest mortgages that declined in value when interest rates surged in the late 1970's. These institutions would have benefited from selling their devalued mortgages in order to realize tax-deductible losses. However, they were deterred from doing so by FHLBB accounting regulations, which required them to record the losses on their books. *557 Reporting these losses consistent with the then-effective FHLBB accounting regulations would have placed many S & L's at risk of closure by the FHLBB.

FN1. Congress abolished the FHLBB in 1989. See § 401 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub.L. 101-73, 103 Stat. 354.

The FHLBB responded to this situation by relaxing its requirements for the reporting of losses. In a regulatory directive known as "Memorandum R-49," dated June 27, 1980, the FHLBB determined that S & L's need not report losses associated with mortgages that are exchanged for "substantially identical" mortgages held by other lenders.[FN2] The FHLBB's acknowledged purpose for Memorandum R-49 was to facilitate transactions that would generate tax losses but that would not substantially affect the economic position of the transacting S & L's.

FN2. Memorandum R-49 listed 10 criteria for classifying mortgages as substantially identical.

"The loans involved must:

"1. involve single-family residential mortgages,

"2. be of similar type (e.g., conventionals for conventionals),

"3. have the same stated terms to maturity (e.g., 30 years),

"4. have identical stated interest rates, "5. have similar seasoning (i.e., remaining terms to maturity),

"6. have aggregate principal amounts within the lesser of 2 1/2 % or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,

"7. be sold without recourse,

"8. have similar fair market values,

"9. have similar loan-to-value ratios at the time of the reciprocal sale, and

"10. have all security properties for both sides of the transaction in the same state." Record, Exh. 72-BT.

This case involves a typical Memorandum R-49 transaction. On December 31, 1980, Cottage Savings sold "90% participation" in 252 mortgages to four S & L's. It simultaneously purchased "90% participation interests" in 305 mortgages held by these S & L's.[FN3] All of the loans involved*558 in the transaction were secured by single-family homes, most in the Cincinnati area. The fair market value of the package of participation interests exchanged by each side was approximately $4.5 million. The face value of the participation interests Cottage Savings relinquished in the transaction was approximately $6.9 million. See 90 T.C. 372, 378-382 (1988).

FN3. By exchanging merely participation interests rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S & L continued to service the loans on which it had transferred the participation interests and made monthly payments to the participation-interest holders. See 90 T.C. 372, 381 (1988).

On its 1980 federal income tax return, Cottage Savings claimed a deduction for $2,447,091, which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation interests that it received. As permitted by Memorandum**1507 R-49, Cottage Savings did not report these losses to the FHLBB. After the Commissioner of Internal Revenue disallowed Cottage Savings' claimed deduction, Cottage Savings sought a redetermination in the Tax Court. The Tax Court held that the deduction was permissible. See 90 T.C. 372 (1988).

On appeal by the Commissioner, the Court of Appeals reversed. 890 F.2d 848 (CA6 1989). The Court of Appeals agreed with the Tax Court's determination that Cottage Savings had realized its losses through the transaction. See *id.*, at 852. However, the court held that Cottage Savings was not entitled to a deduction because its losses were not "actually" sustained during the 1980 tax year for purposes of 26 U.S.C. § 165(a). See 890 F.2d, at 855.

Because of the importance of this issue to the S & L industry and the conflict among the Circuits over whether Memorandum R-49 exchanges produce deductible tax losses,[FN4] we granted certiorari. 498 U.S. 808, 111 S.Ct. 40, 112 L.Ed.2d 17 (1990). We now reverse.

FN4. The two other Courts of Appeals that have considered the tax treatment of Memorandum R-49 transactions have found that these transactions do give rise to deductible losses. See *Federal Nat. Mortgage Assn. v. Commissioner*, 283 U.S.App.D.C. 53, 56-58, 896 F.2d 580, 583-584 (1990); *San Antonio Savings Assn. v. Commissioner*, 887 F.2d 577 (CA5 1989).

*559 II

Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. The realization requirement is implicit in § 1001(a) of the Code, 26 U.S.C. § 1001(a), which defines "[t]he gain [or loss] from the sale or other disposition of property" as the difference between "the amount realized" from the sale or disposition of the property and its "adjusted basis." As this Court has recognized, the concept of realization is "founded on administrative convenience." *Helvering v. Horst*, 311 U.S. 112, 116, 61 S.Ct. 144, 147, 85 L.Ed. 75 (1940). Under an appreciation-based system of taxation, taxpayers and the

Commissioner would have to undertake the "cumbersome, abrasive, and unpredictable administrative task" of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value. See 1 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶ 5.2, p. 5-16 (2d ed. 1989). In contrast, "[a] change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer." R. Magill, Taxable Income 79 (rev. ed. 1945).

Section 1001(a)'s language provides a straightforward test for realization: to realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property." The parties agree that the exchange of participation interests in this case cannot be characterized as a "sale" under § 1001(a); the issue before us is whether the transaction constitutes a "disposition of property." The Commissioner argues that an exchange of property can be treated as a "disposition" under § 1001(a) only if the properties exchanged are materially different. The Commissioner further submits that, because the underlying mortgages *560 were essentially economic substitutes, the participation interests exchanged by Cottage Savings were not materially different from those received from the other S & L's. Cottage Savings, on the other hand, maintains that *any* exchange of property is a "disposition of property" under § 1001(a), regardless of whether the property exchanged is materially different. Alternatively, Cottage Savings contends that the participation interests exchanged were materially different because the underlying loans were secured by different properties.

We must therefore determine whether the realization principle in § 1001(a) incorporates a "material difference" requirement. If it **1508 does, we must further decide what that requirement amounts to and how it applies in this case. We consider these questions in turn.

A

[1][2][3] Neither the language nor the history of the Code indicates whether and to what extent property exchanged must differ to count as a "disposition of property" under § 1001(a). Nonetheless, we readily agree with the Commissioner that an exchange of property gives rise to a realization event under § 1001(a) only if the properties exchanged are "materially different." The Commissioner himself has by regulation construed § 1001(a) to embody a material difference requirement:

> "Except as otherwise provided ... the gain or loss realized from the conversion of property into cash, *or from the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained." Treas.Reg. § 1.1001-1, 26 CFR § 1.1001-1 (1990) (emphasis added).

Because Congress has delegated to the Commissioner the power to promulgate "all needful rules and regulations for the enforcement of [the Internal Revenue Code],"26 U.S.C. § 7805(a), we must defer to his regulatory interpretations*561 of the Code so long as they are reasonable, see *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472, 476-477, 99 S.Ct. 1304, 1306-1307, 59 L.Ed.2d 519 (1979).

[4] We conclude that Treasury Regulation § 1.1001-1*is* a reasonable interpretation of § 1001(a). Congress first employed the language that now comprises § 1001(a) of the Code in § 202(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 253; that language has remained essentially unchanged through various reenactments.FN5 And since 1934, the Commissioner has construed the statutory term "disposition of property" to include a "material difference" requirement.FN6 As we have recognized, " 'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reënacted statutes, are deemed to have received congressional approval and have the effect of law.' " *United States v. Correll*, 389 U.S. 299, 305-306, 88 S.Ct. 445, 449, 19 L.Ed.2d 537 (1967), quoting *Helvering v. Winmill*, 305 U.S. 79, 83, 59 S.Ct. 45, 46, 83 L.Ed. 52 (1938).

FN5. Section 202(a) of the 1924 Act provided:

> "Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized."

The essence of this provision was reenacted in § 111(a) of Revenue Act of 1934, ch. 277, 48 Stat. 703; and then in § 111(a) of the Internal Revenue Code of 1939, ch. 1, 53 Stat. 37; and finally in § 1001(a) of the Internal Revenue Code of 1954, Pub.L. 591, 68A Stat. 295.

FN6. What is now Treas.Reg. § 1.1001-1 originated as Treas.Reg. 86, Art. 111-1, which was promulgated pursuant to the Revenue Act of 1934. That regulation provided:

"Except as otherwise provided, the Act regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, *or from the exchange of property for other property differing materially either in kind or in extent*" (emphasis added).

[5] Treasury Regulation § 1.1001-1 is also consistent with our landmark precedents on realization. In a series of early decisions involving the tax effects of property exchanges, this Court made clear that a taxpayer realizes taxable income ***562** only if the properties exchanged are "materially" or "essentially" different. See *United States v. Phellis,* 257 U.S. 156, 173, 42 S.Ct. 63, 67, 66 L.Ed. 180 (1921); *Weiss v. Stearn,* 265 U.S. 242, 253-254, 44 S.Ct. 490, 491-492, 68 L.Ed. 1001 (1924); *Marr v. United States,* 268 U.S. 536, 540-542, 45 S.Ct. 575, 576-577, 69 L.Ed. 1079 (1925); see also *Eisner v. Macomber,* 252 U.S. 189, 207-212, 40 S.Ct. 189, 193-195, 64 L.Ed. 521 (1920) (recognizing realization requirement). Because these decisions were part of the "contemporary legal context" in which Congress enacted § 202(a) of the 1924 Act, see ****1509***Cannon v. University of Chicago,* 441 U.S. 677, 698-699, 99 S.Ct. 1946, 1958-1959, 60 L.Ed.2d 560 (1979), and because Congress has left undisturbed through subsequent reenactments of the Code the principles of realization established in these cases, we may presume that Congress intended to codify these principles in § 1001(a), see *Pierce v. Underwood,* 487 U.S. 552, 567, 108 S.Ct. 2541, 2551, 101 L.Ed.2d 490 (1988); *Lorillard v. Pons,* 434 U.S. 575, 580-581, 98 S.Ct. 866, 869-870, 55 L.Ed.2d 40 (1978). The Commissioner's construction of the statutory language to incorporate these principles certainly was reasonable.

B

[6][7] Precisely what constitutes a "material difference" for purposes of § 1001(a) of the Code is a more complicated question. The Commissioner argues that properties are "materially different" only if they differ in economic substance. To determine whether the participation interests exchanged in this case were "materially different" in this sense, the Commissioner argues, we should look to the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB. We conclude that § 1001(a) embodies a much less demanding and less complex test.

Unlike the question *whether* § 1001(a) contains a material difference requirement, the question of *what constitutes* a material difference is not one on which we can defer to the Commissioner. For the Commissioner has not issued an authoritative, prelitigation interpretation of what property ***563** exchanges satisfy this requirement.[FN7] Thus, to give meaning to the material difference test, we must look to the case law from which the test derives and which we believe Congress intended to codify in enacting and reenacting the language that now comprises § 1001(a). See *Lorillard v. Pons, supra,* at 580-581, 98 S.Ct., at 869-870.

FN7. In its brief in *United States v. Centennial Savings Bank FSB,* No. 89-1926, the United States cites two Revenue Rulings that support the position that mortgages exchanged through reciprocal mortgage sales are not materially different. See Brief for United States 25, n. 21 (citing Rev.Rul. 85-125, 1985-2 Cum.Bull. 180; Rev.Rul. 81-204, 1981-2 Cum.Bull. 157). Perhaps because the two Revenue Rulings postdate the reciprocal mortgage exchange transaction at issue here and do not purport to define the "differ materially" language in Treasury Regulation § 1.1001-1, the Commissioner has not argued that the position taken in these rulings is entitled to deference. Compare, *e.g., National Muffler Dealers Assn., Inc. v. United States,* 440 U.S. 472, 483-484, and nn. 16-19, 99 S.Ct. 1304, 1310-1311, and nn. 16-19, 59 L.Ed.2d 519 (1979) (deferring to position reflected in longstanding series of Revenue Rulings consistently adhering to same position in a variety of fact patterns). See generally Udall v. Tallman, 380 U.S. 1, 16-17, 85 S.Ct. 792, 801-802, 13 L.Ed.2d 616 (1965) (agency's reasonable interpretation of its own regulations is entitled to deference).

We start with the classic treatment of realization in *Eisner v. Macomber, supra,* 252 U.S. 189, 40 S.Ct. 189. In *Macomber,* a taxpayer who owned 2,200 shares of stock in a company received another 1,100 shares from the company as part of a pro rata stock dividend meant to reflect the company's growth in value. At issue was whether the stock dividend constituted taxable income. We held that it did not, because no gain was realized. See id., 252 U.S., at 207-212, 40 S.Ct., at 193-195. We reasoned that the stock dividend merely reflected the increased worth of the taxpayer's stock, see id., at 211-212, 40 S.Ct., at 194-195, and that a taxpayer realizes increased worth of property only by receiving "something of exchangeable value *proceeding from* the property," see id., at 207, 40 S.Ct., at 193.

In three subsequent decisions- United States v. Phellis, supra, 252 U.S. 189, 40 S.Ct. 189; Weiss v. Stearn, supra, 265 U.S. 242, 44 S.Ct. 490 and Marr v. United States, supra, 268 U.S. 536, 45 S.Ct. 575- we refined *Macomber*'s conception of realization in the context of property exchanges. In each case, the taxpayer owned stock that had appreciated in value since its acquisition.*564 And in each case, the corporation in which the taxpayer held stock had reorganized into a new corporation, with the new corporation assuming the business of the old **1510 corporation. While the corporations in *Phellis* and *Marr* both changed from New Jersey to Delaware corporations, the original and successor corporations in *Weiss* both were incorporated in Ohio. In each case, following the reorganization, the stockholders of the old corporation received shares in the new corporation equal to their proportional interest in the old corporation.

The question in these cases was whether the taxpayers realized the accumulated gain in their shares in the old corporation when they received in return for those shares stock representing an equivalent proportional interest in the new corporations. In *Phellis* and *Marr,* we held that the transactions were realization events. We reasoned that because a company incorporated in one State has "different rights and powers" from one incorporated in a different State, the taxpayers in *Phellis* and *Marr* acquired through the transactions property that was "materially different" from what they previously had. United States v. Phellis, 257 U.S., at 169-173, 42 S.Ct., at 65-67; see Marr v. United States, supra, 268 U.S., at 540-542, 45 S.Ct., at 576-577 (using phrase "essentially different"). In contrast, we held that no realization occurred in *Weiss.* By exchanging stock in the predecessor corporation for stock in the newly reorganized corporation, the taxpayer did not receive "a thing really different from what he theretofore had." Weiss v. Stearn, supra, 265 U.S., at 254, 44 S.Ct., at 492. As we explained in *Marr,* our determination that the reorganized company in *Weiss* was not "really different" from its predecessor turned on the fact that both companies were incorporated in the same State. See Marr v. United States, supra, 268 U.S., at 540-542, 45 S.Ct., at 576-577 (outlining distinction between these cases).

Obviously, the distinction in *Phellis* and *Marr* that made the stock in the successor corporations materially different from the stock in the predecessors was minimal. Taken together,*565 *Phellis, Marr,* and *Weiss* stand for the principle that properties are "different" in the sense that is "material" to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Thus, separate groups of stock are not materially different if they confer "the same proportional interest of the same character in the same corporation." Marr v. United States, 268 U.S., at 540, 45 S.Ct., at 577. However, they *are* materially different if they are issued by different corporations, id., at 541, 45 S.Ct., at 597; United States v. Phellis, supra, 257 U.S., at 173, 42 S.Ct., at 67, or if they confer "differen[t] rights and powers" in the same corporation, Marr v. United States, supra, 268 U.S., at 541. No more demanding a standard than this is necessary in order to satisfy the administrative purposes underlying the realization requirement in § 1001(a). See Helvering v. Horst, 311 U.S., at 116, 61 S.Ct., at 146-47. For, as long as the property entitlements are not identical, their exchange will allow both the Commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases.

In contrast, we find no support for the Commissioner's "economic substitute" conception of material difference. According to the Commissioner, differences between properties are material for purposes of the Code only when it can be said that the parties, the relevant market (in this case the secondary mortgage market), and the relevant regulatory body (in this case the FHLBB) would consider them material. Nothing in *Phellis, Weiss,* and *Marr* suggests that exchanges of properties must satisfy such a subjective test to trigger realization of a gain or loss.

Moreover, the complexity of the Commissioner's approach ill serves the goal of administrative convenience that underlies the realization requirement. In order to apply the Commissioner's test in a principled fashion, the Commissioner and the taxpayer must identify the relevant market, establish ****1511** whether there is a regulatory agency whose views should be taken into account, and then assess how the relevant market ***566** participants and the agency would view the transaction. The Commissioner's failure to explain how these inquiries should be conducted further calls into question the workability of his test.

Finally, the Commissioner's test is incompatible with the structure of the Code. Section 1001(c) of Title 26 provides that a gain or loss realized under § 1001(a) "shall be recognized" unless one of the Code's nonrecognition provisions applies. One such nonrecognition provision withholds recognition of a gain or loss realized from an exchange of properties that would appear to be economic substitutes under the Commissioner's material difference test. This provision, commonly known as the "like kind" exception, withholds recognition of a gain or loss realized "on the exchange of property held for productive use in a trade or business or for investment ... for property of like kind which is to be held either for productive use in a trade or business or for investment." 26 U.S.C. § 1031(a)(1). If Congress had expected that exchanges of similar properties would *not* count as realization events under § 1001(a), it would have had no reason to bar recognition of a gain or loss realized from these transactions.

C

[8] Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are "materially different"-that is, so long as they embody legally distinct entitlements. Cottage Savings' transactions at issue here easily satisfy this test. Because the participation interests exchanged by Cottage Savings and the other S & L's derived from loans that were made to different obligors and secured by different homes, the exchanged interests did embody legally distinct entitlements. Consequently, we conclude that Cottage Savings realized its losses at the point of the exchange.

[9] The Commissioner contends that it is anomalous to treat mortgages deemed to be "substantially identical" by the ***567** FHLBB as "materially different." The anomaly, however, is merely semantic; mortgages can be substantially identical for Memorandum R-49 purposes and still exhibit "differences" that are "material" for purposes of the Internal Revenue Code. Because Cottage Savings received entitlements different from those it gave up, the exchange put both Cottage Savings and the Commissioner in a position to determine the change in the value of Cottage Savings' mortgages relative to their tax bases. Thus, there is no reason not to treat the exchange of these interests as a realization event, regardless of the status of the mortgages under the criteria of Memorandum R-49.

III

[10] Although the Court of Appeals found that Cottage Savings' losses were realized, it disallowed them on the ground that they were not sustained under § 165(a) of the Code, 26 U.S.C. § 165(a). Section 165(a) states that a deduction shall be allowed for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Under the Commissioner's interpretation of § 165(a),

> "To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and § 1.165-11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." Treas.Reg. § 1.165-1(b), 26 CFR § 1.165-1(b) (1990).

The Commissioner offers a minimal defense of the Court of Appeals' conclusion. The Commissioner contends that the losses were not sustained because they lacked "economic**1512 substance," by which the Commissioner seems to mean that the losses were not bona fide. We say "seems" because the Commissioner states the position in one sentence in a footnote*568 in his brief without offering further explanation. See Brief for Respondent 34-35, n. 39. The only authority the Commissioner cites for this argument is *Higgins v. Smith,* 308 U.S. 473, 60 S.Ct. 355, 84 L.Ed. 406 (1939). See Brief for United States in No. 89-1926, p. 16, n. 11.

In *Higgins,* we held that a taxpayer did not sustain a loss by selling securities below cost to a corporation in which he was the sole shareholder. We found that the losses were not bona fide because the transaction was not conducted at arm's length and because the taxpayer retained the benefit of the securities through his wholly owned corporation. See *Higgins v. Smith, supra,* at 475-476, 60 S.Ct. at 356-357. Because there is no contention that the transactions in this case were not conducted at arm's length, or that Cottage Savings retained *de facto* ownership of the participation interests it traded to the four reciprocating S & L's, *Higgins* is inapposite. In view of the Commissioner's failure to advance any other arguments in support of the Court of Appeals' ruling with respect to § 165(a), we conclude that, for purposes of this case, Cottage Savings sustained its losses within the meaning of § 165(a).

IV

For the reasons set forth above, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

So ordered.

U.S.Ohio,1991.
Cottage Sav. Ass'n v. C.I.R.
499 U.S. 554, 111 S.Ct. 1503, 113 L.Ed.2d 589, 67 A.F.T.R.2d 91-808, 1991-2 C.B. 34

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MODIFYING DEBT AND ITS CONSEQUENCES

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Modifying Debt and Its Consequences

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What some may view as "tinkering" with the terms of a debt instrument — such as dropping a covenant here, increasing the interest rate there, granting an interest moratorium, deferring payments of principal, canceling a bit of the debt — may sometimes be viewed as "material changes" in the debt for federal income tax purposes. The various types of changes that may be considered material are discussed in the first part of this outline. Where a debt instrument is changed in a material way, the modification or amendment will be treated for federal income tax purposes as an "exchange" of the original debt for a new debt, with the ancillary tax consequences. Conversely, a physical exchange of a purportedly new debt instrument for an old debt instrument will not be treated as a true "exchange" for federal income tax purposes if the terms of the debts do not "materially" differ.

The federal income tax consequences of an exchange of "old" debt for "new" debt can be significant. As discussed in the second part of this outline, these may include gain or loss to the holder, cancellation of debt ("COD") income to the issuer, the creation of original issue discount ("OID"), the retesting of the debt instrument as debt or equity, and the loss of potentially favorable "grandfathered" status with respect to recent legislative or regulatory changes.

Accordingly, it is important that the individuals who negotiate changes in the terms of debt instruments be aware of the potential consequences of their seemingly innocent acts — both from the issuer's and holder's perspective. In addition, certain advance planning may be possible. In particular, changes that may be unilaterally effected pursuant to the terms of the original debt instrument may be of no consequence, whereas the same changes, if made in an amendment, may be considered "material" and, thus, result in a deemed exchange of the debt.

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§ 1.01 WHAT CONSTITUTES A "MATERIAL" MODIFICATION

Under Treasury Regulation § 1.1001-1(a), changes in the terms of a debt instrument will be treated as an "exchange" of the original debt for the modified debt if the terms of the modified instrument differ "materially either in kind or in extent" from the original terms. Thus, the substance, not the form, of the changes will govern; whether the changes are embodied in an amendment or in a new debt instrument is irrelevant to whether an "exchange" has occurred for federal income tax purposes. See, e.g., Treas. Reg. § 1.1001-3(a)(1); Rev. Rul. 81-169, 1981-1 C.B. 429.

[1] The Changing Law

[a] Development

Since the Depression Era of the 1930s, case law and administrative guidance describing what constitutes a material modification or what otherwise would be respected as an exchange developed gradually. In 1991, the Supreme Court's decision in the Cottage Savings case appeared to change the course of this development. This Supreme Court opinion, which contains several broad statements of dicta (discussed below), created a wave of speculation over whether, and the extent to which, the prior law as it had developed would continue to be respected. The IRS and Treasury addressed these concerns in the 1992 proposed regulation under Section 1001 and invited comments (i) with respect to whether it was desirable to provide debt modification rules, and (ii) with respect to the actual rules of the proposed regulation. See former Prop. Treas. Reg. § 1.1001-3, FI-31-92, 1992-2 C.B. 683. The proposed regulation received a deluge of commentary. Although a few commentators argued against the promulgation of debt modification rules in general, most supported the regulation and commented on the specific rules. The IRS and Treasury incorporated many of these comments in the final regulation, which was issued on June 26, 1996. The final regulation changed prior law in many respects. Query, whether the IRS exceeded its authority to issue interpretative regulations to the extent the final regulation provides standards that are inconsistent with prior case law given that Section 1001 contains no special authorization for legislative regulations. But see Mayo Foundation for Medical Education & Research v. United States, 131 S. Ct. 704 (2011) (giving great deference to Treasury regulations that "fill gaps" explicitly or implicitly left by Congress, and that adapt to changing conditions and new problems).

[b] Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991)

[i] Factual Issue

Cottage Savings was not a debt modification case. Rather, at issue was whether the exchange by two savings and loan institutions ("S&Ls") of 90% participation interests in different mortgage pools was an event which gave rise to the realization of loss. The S&Ls claimed a loss on the exchange. The IRS disallowed the loss, arguing that the two mortgage pools were not "materially" different.

These types of exchanges were prompted by the promulgation by the Federal Home Loan Bank Board of Memorandum R-49, which permitted the beleaguered S&Ls to exchange "substantially identical" pools of mortgages without recording losses for regulatory accounting purposes. In order to qualify as "substantially identical," among other things, the pools of mortgage loans had to consist of single family residential mortgages in the same state, with the same stated terms to maturity, identical interest rates, and similar loan-to-value ratios, seasoning and fair market values.

[ii] Holding

In analyzing the case, the Court first established conclusively that, in determining whether a realization event had occurred, the "material difference" test set forth in Treasury Regulation § 1.1001-1(a) was the proper test to apply. The Court then faced the question of defining a material difference.

In rejecting the IRS's position, the Court relied on precedents dating back to the 1920s. In a number of early cases, the Court had ruled that the exchange of stock in a corporation organized in one state for stock in a corporation organized in another state was a realization event where the only difference between the two corporations was the state of incorporation. This result followed from the Court's view that a corporation incorporated in one state has different rights and powers from one incorporated in another state. The Court in the Cottage Savings case recognized that these differences could be truly minimal, stating that these old cases stood for the proposition that properties are materially different "so long as their respective possessors enjoy legal entitlements that are different in kind or extent." Applying this standard to mortgage pools, the Supreme Court concluded that, because the underlying loans were made to different obligors and were secured by different homes, they embodied legally distinct entitlements.

However, not content to leave well enough alone, the Court added that "[f]or, as long as the property entitlements are not identical, their exchange will allow both the Commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases." It is this language which added most of the fuel to the fire over whether the Court had adopted a "hair trigger" standard for realization.

[iii] Implications

The obvious question flowing from Cottage Savings is its meaning for debt modification transactions, where in most cases the obligor remains the same and a change in the collateral may or may not be involved. Can the Cottage Savings decision be read narrowly? Does it mean merely that if the obligor and the security are different, there is an exchange? Or does it create a so-called "hair trigger" test for realization, under which any properties that are not identical in all respects are considered materially different? The 1996 final regulation represents the IRS's and Treasury's response to these questions.

[2] Final Regulation on Debt Modifications

On June 26, 1996, the IRS and Treasury issued final Treasury Regulation § 1.1001-3, T.D. 8675, which sets forth certain standards for determining whether given changes are sufficiently "material" to be deemed an exchange. The final regulation applies only to debt modifications, and not to modifications of nondebt financial instruments such as warrants, options and notional principal contracts. Whether an instrument is considered debt for tax purposes is determined based on all of the surrounding circumstances and not merely by the labels attached to the instrument by the parties. See generally Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and Proposal, 26 Tax L. Rev. 369 (1971). For a detailed discussion of the federal income tax consequences of modifying nondebt financial instruments, see Peaslee, Modification of Nondebt Financial Instruments as Deemed Exchanges, 95 Tax Notes 737 (April 29, 2002); see also IRS Legal Memorandum 200515019 (December 3, 2004) (involving changes to the terms of trading rights in a securities company, and discussing case law involving changes in the terms of a license).

[a] Effective Date

The final regulation applies to alterations in debt instruments made on or after September 24, 1996. However, taxpayers may rely on the final regulation for alterations occurring after December 2, 1992 and before September 24, 1996. During this intervening period, taxpayers may choose to apply either prior law or the final regulation, depending upon which rule produces the most favorable result. See, e.g., Field Service Advice 199928007 (July 16, 1999) (allowing a taxpayer to apply the final regulation to a modification that occurred before March 31, 1996 so the taxpayer could claim a currency loss).

Although the final regulation generally applies only to changes on or after September 24, 1996, it is unclear whether the cumulative effect of pre-effective date changes must be taken into account in applying the final regulation to later date changes. In general, Treasury Regulation § 1.1001-3(f)(3) provides that "two or more modifications of a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification . . . ." Similarly, the 5-year-or-

50% safe harbor for payment deferrals and maturity extensions (discussed later) incorporates a cumulative concept. Thus, if the cumulative effect of pre-effective date changes must be taken into account, it is possible that even a very modest change in terms post-effective date could result in a material (significant) modification.

In 2011, several minor amendments were made to Treasury Regulation § 1.1001-3 through the issuance of temporary regulations in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires the removal of references to, or requirements of reliance on, "credit ratings." The temporary regulations, which were made final on September 6, 2013, removed the proscribed terms from several subsections and examples in Treasury Regulation § 1.1001-3 and replaced them with terms that reflect credit quality, such as "creditworthy." These changes apply to modifications to debt instruments made on or after July 6, 2011. See Preamble to Treas. Reg. § 1.1001-3, T.D. 9637.

[b] General Approach of the Regulation; Standards

The final regulation requires a two-step analysis. The first step is to determine whether there has been a "modification" of a debt instrument. The second step is to determine whether the "modification" is "significant." A "modification" of a debt that is "significant" results in a new debt instrument for federal income tax purposes and a deemed exchange of the old debt instrument for the new debt instrument.

The final regulation thus retains the basic structure of the 1992 proposed regulation. As the result of addressing specific issues that were raised by commentators, certain of the proposed rules were modified or deleted, and new rules were added. Where relevant throughout this outline, the differences between the final and proposed regulation are highlighted.

[c] Broad Definition of "Modification"

The final regulation defines a modification to mean "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." Treas. Reg. § 1.1001-3(c)(1)(i). For example, adding, deleting, or changing a covenant would be considered a modification (although such a change ultimately may not be "significant").

A modification need not be in writing: mere conduct of the parties evidencing a change from the original terms is enough. The regulation can also apply to a modification accomplished indirectly through one or more transactions with third parties.

Example — "Non-Binding" Third Party Subsidy Not a Modification: In Letter Ruling 201139003 (September 30, 2011), members of a consolidated group involved in the mortgage lending business gratuitously committed to subsidize interest payments to holders of "covered mortgages" (some of whom may have been unrelated to the group) incurred by service members of the U.S. Armed Forces. Because the service members had no legal means to require the group to pay the subsidy and the service members remained legally obligated to the mortgage holders if the group were unable to pay the subsidy, the IRS found that the legal rights or obligations of the service members and mortgage holders had not been altered. Thus, the interest subsidy did not constitute a "modification" of the covered mortgages.

Like the proposed regulation, the final regulation generally excludes from the definition of a modification alterations that occur by operation of the terms of the instrument and failures to perform. However, it creates additional exceptions to these exceptions.

[i] Exception: Changes Pursuant to Original Terms (or the "Unilateral Option" Exception)

In general, alterations that occur by operation of the original debt instrument (whether automatically or at the option of one party) are not considered a modification. Treas. Reg. § 1.1001-3(c)(1)(ii). Thus, if the drafter has the foresight at the time the loan is made to include the prospect of a particular change, effectuation of the change will not (except as described below) be a modification. The final regulation provides examples of such changes, such as the periodic resetting of the interest rate under a formula contained in the original instrument or a specified increase in the interest rate if the value of the collateral declines from a specified level.

There are three limitations to this general rule:

a. Change in Obligor or in Nature of the Instrument. The substitution, addition or deletion of an obligor or a change (in whole or in part) in the recourse or nonrecourse nature of the instrument, even if provided for in the original terms of the debt instrument, is a modification. Treas. Reg. § 1.1001-3(c)(2)(i).

The IRS and Treasury believed that these changes are so fundamental that they should be considered modifications even if they occur by operation of the original terms. See Preamble to Final Regulation, T.D. 8675. This rule is a departure from the proposed regulation. See former Prop. Treas. Reg. § 1.1001-3(d) (Example 6) (stating that the assumption of a mortgage by a buyer of a residence would not be a modification where the holder cannot unreasonably withhold consent).

b. Changes that Turn Debt into Non-Debt. An alteration that results in an instrument or property right that is not debt for federal income tax purposes will be a modification, unless the alteration occurs by the exercise of an option by the holder of the debt to convert the debt into equity of the issuer. Treas. Reg. § 1.1001-3(c)(2)(ii). See § 1.01[3][m][ii] below for a more detailed discussion. Thus, the long-standing "convertible bond" rule, as it relates to a holder initiated conversion, remains unchanged. It is unclear whether an issuer initiated conversion is similarly treated.

c. Certain Changes Resulting from the Exercise of an Option. Two categories of embedded options, if and when exercised, are considered modifications:

(1) options that are not "unilateral" (as defined below); and

(2) options that are exercisable by a holder where such exercise results in (or, in the case of a variable or contingent payment, is reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

Treas. Reg. § 1.1001-3(c)(2)(iii). In contrast, a similar deferral option exercised by the issuer is not a modification. See Treas. Reg. § 1.1001-3(d) (Examples 10 and 11). The failure to exercise an option is not a modification. By excluding the above types of options from the "original terms" exception, the IRS and Treasury have attempted to treat as modifications changes which typically result from negotiations or a workout between the issuer and the holder.

A "unilateral" option is one which under the terms of the instrument or under applicable law meets the following three requirements:

- there does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is "related" (within the meaning of Section 267(b) or Section 707(b)(1)) to the issuer. It is unclear whether this means that the right to alter or terminate must be currently exercisable as of the time the option is exercised, such that a right to terminate that continues to be contingent on future unrelated events or the material passage of time would not prevent the option from being a unilateral option;

- the option's exercise does not require the consent or approval of (i) the other party, (ii) a person who is "related" to the other party, or (iii) a court or arbitrator; and

- the option's exercise does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is (i) a de minimis amount (which amount is not defined in the regulation), (ii) a specified amount, or (iii) an amount based on a formula that uses "objective financial information," defined in Treasury Regulation § 1.446-3(c)(4)(ii) as meaning "any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances." Treas. Reg. § 1.1001-3(i)(3).

  These requirements serve to differentiate between those changes that truly have been agreed to from the time of issuance and those that have not. If the lender may call the loan, withhold consent at its discretion or require a significant amount of consideration, a "right" of the borrower which may be exercised cannot be said to have been a part of the original bargain between the parties. Cf. Ltr. Rul. 201149017 (December 9, 2011) (concluding that bonds with terms requiring tender by holders if the issuer exercised an option did not involve the "right of the *holders* to alter or terminate the instrument," and thus the issuer's option was unilateral; emphasis added). For a discussion of these issues, see, e.g., Lee-Lim & Bozkurt, Significant Modification of Debt Instruments: A Case Study, 154 Tax Notes 1647 (March 27, 2017)

Note that an option need not be expressly provided for in the instrument so long as the party has the option pursuant to applicable law. In Letter Ruling 200321015 (February 14, 2003), the IRS ruled that no modification occurred where a borrower substituted treasury securities for real estate as security for the borrower's obligation. The IRS relied on dicta in an opinion of the highest court in the controlling state, which stated that a mortgagee that provides the mortgagor with the benefit of its bargain by providing substitute security may obtain a release of the mortgage on the land.

[ii] Exception: Temporary Failure to Perform (or the "Temporary Forbearance" Rule)

The final regulation expressly provides that nonperformance by the issuer is not, in and of itself, a modification. Moreover, a lender's forbearance for up to two years, and possibly longer, generally will not be considered a modification, at least for the duration of such forbearance. See Treas. Reg. § 1.1001-3(c)(4).

Specifically, such regulation provides that, absent a written or oral agreement to alter other terms of the debt, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including after already having demanded payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds:

(1) two years following the issuer's initial failure to perform; and

(2) any additional period during which (a) the parties conduct good faith negotiations or (b) the issuer is in a bankruptcy, receivership, foreclosure, or similar proceeding in a federal or state court.

Once the parties agree to new terms, there is a modification.

a. Effect of Expiration of Forbearance Period. Although the forbearance itself will not be a modification so long as it is within the permitted forbearance period under the regulation, what happens when the issuer cures the default and is again in compliance? Can the cure be a modification? Although one would hope not, the answer is unclear, at least in the case of a payment default.

By curing a nonpayment default such as a covenant default, the parties should be placed in roughly the same position as they were before. However, there is little difference between a two-party agreement to defer a payment for two years and a forbearance by the lender. Accordingly, although the forbearance is not a modification, it is unclear whether the make-up payment must be treated as a deferred payment and tested to determine whether or not it is a "significant" modification. Presumably, such treatment would run counter to the apparent purpose of the Temporary Forbearance Rule, which is to allow a debtor to "pick up the pieces" and to resume paying its obligations in accordance with their terms but for the effect of the temporary forbearance.

b. Example — Acceleration Clause: Under the terms of a bond, if the issuer fails to make a scheduled payment, the full principal amount of the bond is immediately due and payable. Following the issuer's failure to make a scheduled payment, the holder waives its right to receive full payment for a period ending one year from the date of the issuer's default to allow the issuer to obtain additional financial resources. The holder's temporary waiver is not a modification. Moreover, Treasury Regulation § 1.1001-3(d) (Example 13) provides that this result would not change if the holder in fact accelerated and then waived the acceleration for one year.

Although this example in the regulation clearly illustrates the basic application of the Temporary Forbearance Rule, it does not address the treatment of the payment itself in the event the payment default is cured and the debt remains outstanding.

c. Example — Late Payments: X makes a late payment under his loan, then does so again. Ultimately, there develops a pattern of late payments. Has there been a modification?

Assuming such payments are not within a permitted late period already provided for in the loan, a single late payment should be viewed as a temporary failure to perform, and the issuer's waiver of such late payment would be protected by the Temporary Forbearance Rule. In addition, however, the late payment arguably may be viewed as a deferred payment, depending on the treatment of cure payments under the regulation following a temporary forbearance. If X is continuously late, however, the parties may have effectively modified the terms of the debt by their conduct.

Alternatively, if the late payments are within a permitted late period under the loan, the borrower generally should be treated as having exercised a "unilateral" option to make the late payments and the late payments should not be treated as a "modification."

[iii] Beware Section 1275 OID Deferral Rule

a. Deemed Reissuance for OID Purposes Only. It is important to note that regardless of whether a deferral is a significant modification under Treasury Regulation § 1.1001-3, Treasury Regulation § 1.1275-2(j) requires the holder of an instrument to recompute OID and issue price if "the terms of a debt instrument are modified to defer one or more payments and the modification does not cause an exchange under Section 1001" (emphasis added). If there is such a modification, "then, solely for purposes of Sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date."

This regulation applies to debt instruments issued on or after August 13, 1996. Although not clearly stated, the term "modified" under Treasury Regulation § 1.1275-2(j) is probably intended to mean a "modification" under Treasury Regulation § 1.1001-3. Cf. Preamble to Treas. Reg. § 1.1275, T.D. 8674, 96 TNT 123-75 (stating "[i]f the payment is not made (other than because of insolvency, default, or similar circumstances), the final regulations require a deemed reissuance for OID purposes . . . .").

The proposed 1001 regulation would have treated any deferral payment made with a principal purpose of avoiding the time value of money rule as a significant modification. No similar rule is provided in the final 1001 regulation in light of the adoption of the rule under Treasury Regulation § 1.1275-2(j).

b. Elective Deemed Exchange under Section 1001. Treasury Regulation § 1.1275-2(j) created a fungibility problem for issuers who wanted to refinance and consolidate two or more outstanding issues of debt instruments into debt instruments of a single, new issue. This problem arose because the OID on the portion of the new debt attributable to each issue of old debt would be determined independently under Treasury Regulation § 1.1275-2(c). To eliminate this problem, the IRS issued Revenue Procedure 99-18, 1999-1 C.B. 736, modified by Revenue Procedure 2000-29, 2000-2 C.B. 113, and since modified and superseded by Revenue Procedure 2001-21, 2001-1 C.B. 742 (effective March 13, 2001), which allows taxpayers to elect to treat certain debt substitutions occurring on or after March 1, 1999, as deemed exchanges under Section 1001 even though they do not trigger a significant modification under the final regulation. By treating the substitution as a Section 1001 exchange, the issue price of the new debt will be determined under Section 1273 and will result in a uniform issue price (and a de minimis amount of OID, if any) for the entire issue of new debt.

c. Conditions for Election: To make this election under Revenue Procedure 2001-21, the debt must satisfy the following conditions:

(1) debt instruments from a single issue, including (effective March 13, 2001) debt instruments issued in a "qualified reopening" as defined in Treasury Regulation § 1.1275-2(k)(3), are being substituted for debt from two or more issues;

(2) the substitution is not a significant modification under Treasury Regulation § 1.1001-3 and, thus, not otherwise a realization event;

(3) both the new debt and old debt are publicly traded within the meaning of Treasury Regulation § 1.1273-2(f);

(4) the old debt was issued at par, at a premium (effective March 13, 2001, even if not de minimis) or with a de minimis amount of OID;

(5) the new debt is issued at par or with a de minimis amount of OID or premium;

(6) neither the new debt nor the old debt is:

  (a) a contingent payment debt instrument under Treasury Regulation § 1.1275-4;

  (b) a tax-exempt obligation under Section 1275(a)(3); or

  (c) a convertible debt instrument under Treasury Regulation § 1.1272-1(e); and

(7) all payments on the old and new debt are denominated in, or determined solely by, U.S. dollars, and the U.S. dollar is the functional currency of the new issue.

In addition, for an election to qualify, the issuer and at least one or more of the holders of the old debt must agree in writing to the treatment provided in the revenue procedure by the last day of the month in which the substitution occurs (and the issuer must make a timely filing with its tax return). This election only binds the issuer and any electing holder. Nevertheless, an issuer may structure a public offering document so as to bind all holders of old debt by providing in that document that:

(a) the issuer, by distributing the documents, elects under the revenue procedure to treat the substitution as a realization event for federal income tax purposes;

(b) any holder of old debt that tenders its old debt for new debt as part of the substitution thereby makes the election under the revenue procedure; and

(c) the issuer and the holders who have tendered their old debt for the new debt ("electing holders") will comply with the provisions of the revenue procedure.

d. Consequences of Election. In general, the effect of an election under Revenue Procedure 2001-21 is to treat the new debt as having been "exchanged" for the various series of old debt in a nonrecognition transaction to the parties. In brief, the parties are treated as follows:

(1) The issuer is treated as having an issue price in the new debt equal to the aggregate adjusted issue prices of the old debt, with OID or bond premium on the new debt computed accordingly. (Technically, the revenue procedure starts with the issue price of the new debt determined under Section 1273; however, it then requires that the issue price be adjusted for any differences between it and the aggregate issue prices of the old debt.)

(2) An electing holder is treated as having the same tax basis and holding period in the new debt as the holder had in its old debt. The holder recognizes no gain or loss as a result of the deemed exchange. In general, any market discount or bond premium on the old debt will carry over to the new debt (with the possible exception of a de minimis amount of market discount). See § 1.02[4][b] below.

(3) A non-electing holder will determine its tax consequences without regard to the revenue procedure. Accordingly, assuming the substitution results in a deferral of payments with respect to the debt held by the non-electing holder, the holder would recompute the issue price and OID of the debt under Treasury Regulation § 1.1275-2(j).

(4) Presumably, the issue price of the new debt applicable to a subsequent holder who purchases the new debt in the market from an electing holder will be the same as the new issue price that was applicable to the electing holder, which was determined under Section 1273. The general market discount and bond premium rules should apply to any difference between the subsequent holder's tax basis and principal amount of the new debt.

[iv] Time of Modification

Generally, the modification occurs at the time that the issuer and holder enter into the agreement, even if the change of the term is not immediately effective. However, if the parties condition a change in the terms on reasonable closing conditions, the change occurs on the closing date. Furthermore, if the change occurs pursuant to a bankruptcy proceeding, the modification occurs on the effective date of the plan.

[d] "Significant" Modifications

In general, the final regulation treats a "modification" as "significant" if it meets any one of several separate tests depending on the type of change. For those types of modifications not covered by any of the separate rules, the regulation tests such modifications on a collective basis under the general "economic significance" standard, based on all facts and circumstances.

There are five general types of changes covered by separate rules:

(1) changes in yield (but only for certain debt instruments);

(2) changes in timing of payments;

(3) additions or deletions of co-obligors, changes in security or credit enhancement, and changes in priority;

(4) changes in the nature of a debt (such as changes in the recourse nature or debt equity status of a debt); and

(5) changes in customary accounting or financial covenants.

In some of these cases, the regulation provides a bright-line rule or safe harbor and, in others, a specially crafted, yet general, standard for determining whether the modification is "significant."

Notwithstanding that a change in terms would fall within one of the separate rules of the final regulation, a change must be tested under the general "economic significance" standard if it is (i) effective only upon the occurrence of a substantial contingency or (ii) in the case of a change in obligor, security, or recourse/nonrecourse status, effective on a substantially deferred (although not contingent) basis.

[i] <u>General "Economic Significance" Standard</u>

The general "economic significance" standard tests whether, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. Treas. Reg. § 1.1001-3(e)(1). This general standard only applies to modifications not covered by one of the separate rules in the final regulation. All modifications subject to the general "economic significance" standard are tested collectively. Accordingly, a modification which in and of itself may not be significant may be significant when considered together with other modifications.

<u>Example — Ltr. Rul. 9819043 (February 11, 1998)</u>: In this ruling, the IRS examined three proposed changes to two installment obligations: (1) the addition of a right of the obligors to make payments in property with a fair market value equal to the otherwise required cash payment; (2) the addition of a right of the obligors to split the note into one or more separate notes with identical terms to the note surrendered, except the principal amount and security under the surrendered note would be

reasonably apportioned among the new separate notes; and (3) the extension of maturity by five years.

The IRS stated that neither of the first two proposed modifications fell under any of the separate rules enunciated in the final regulation and, accordingly, tested both under the general "economic significance" standard. In both cases, the IRS found the legal rights of the parties were not altered to an economically significant degree. Although a literal reading of the ruling suggests that the IRS tested these two modifications separately, Treasury Regulation § 1.1001-3(e)(1) is clear that all modifications subject to the general "economic significance" standard must be tested collectively. (<u>See</u> § 1.01[3][b][iii] for a discussion of the proposed extension of maturity.)

[ii] <u>Examples of Significant Modifications</u>

The following modifications are among those identified in the final regulation as "significant" under certain bright-line tests:

- A change in the yield of a fixed rate or variable rate instrument by more than 1/4 of 1% (25 basis points) or, if greater, 5% of the annual yield of the unmodified instrument;

- A substitution of a new obligor on a recourse debt instrument (other than in connection with certain specific transactions); and

- A change in the nature of a debt instrument from substantially all recourse to substantially all nonrecourse or vice versa (with minor exceptions).

[iii] <u>Examples of Safe Harbors</u>

The following modifications are considered <u>insignificant</u> under what amounts to a safe-harbor:

- A deferral of one or more scheduled payments for a period not to exceed, in the aggregate, the lesser of five years or 50% of the original term of the instrument;

- The substitution of a new obligor on a nonrecourse debt instrument; and

- A modification that adds, deletes, or alters customary accounting or financial covenants (presumably, on the same basis, mere ministerial changes in the terms of an instrument, such as a change in the mechanics of making a payment, would not be "significant").

The next section of this outline details the final regulation's rules regarding what modifications are significant.

[3] Types of Modifications and their Materiality

The following section discusses the treatment accorded debt modifications in the final regulation and compares such treatment with the "prior law." In this regard, one should bear in mind that the prior law authorities may still be relied on for changes in the terms of a debt prior to September 24, 1996. For a more detailed discussion of modifying debt and its consequences under prior law, and a further discussion of the final regulation, see G. Henderson and S. Goldring, Tax Planning for Troubled Corporations: Bankruptcy and Nonbankruptcy Restructurings, Chapter 4 (CCH 2017 ed.) (hereinafter, Henderson & Goldring).

Traditionally, the determination of whether changes in the terms of a debt are material has depended on the facts of each particular case, although, through the development of case law and IRS rulings, certain general benchmarks have emerged. The final regulation, which by its terms supplants existing law, adopts certain of these benchmarks and rejects others. As discussed above, the final regulation employs a series of separate rules for different types of modifications, and includes certain bright-line tests and safe harbors. Modifications not covered by any of these separate rules (or made only on a contingent basis or, in certain cases, on a substantially deferred basis) are tested under a general "economic significance" standard (see prior section).

Each general type of modification for which a separate rule is provided in the regulation is tested on its own and not in combination with other types of changes. However, modifications of the same type that are made at the same time or at different times would be aggregated (subject to a five-year historic cutoff for certain changes in yield). See Treas. Reg. § 1.1001-3(f)(3), (4). All changes covered by the general "economic significance" standard are tested on a cumulative basis.

Example: A 24 basis point change in yield in a fixed rate debt instrument with a 15-year maturity combined with a first-time extension (or deferral of payments) of less than five years would not result in a significant modification.

[a] Reduction in Principal Amount

[i] Prior Law: Revenue Ruling 89-122 — Cancellation Material

In Revenue Ruling 89-122, 1989-2 C.B. 200 (Situation 2), the IRS held that the cancellation of $350,000 of a $1 million debt was a material modification that resulted in a taxable exchange of the original debt for "new" debt.

The IRS's position in Revenue Ruling 89-122 was surprising and, arguably, wrong (although the final regulation reaches the same result). More appropriately, the cancellation should merely be viewed as the recognition of the worthlessness of the portion of the debt canceled.

Further, the IRS's position arguably places a premium on evidencing what traditionally would be a single loan with multiple notes of smaller denominations, rather than a single note. Query, whether a holder could then cancel one of the notes without causing an exchange of the others. Given the IRS's regulations regarding the aggregation of debt instruments in the original issue discount and imputed interest areas, it would be surprising if the IRS did not assert that the cancellation of one of an issue of multiple notes should be treated the same as the cancellation of a portion of a single note. See Treas. Reg. § 1.1275-2(c) (providing, for purposes of the original issue discount rules, that in certain circumstances debt instruments issued in connection with the same or related transactions may be aggregated and treated as a single debt instrument); Treas. Reg. § 1.446-2(f) (to similar effect).

[ii] Final Regulation Consistent

Treasury Regulation § 1.1001-3(g) (Example 3) effectively reaches the same result as Revenue Ruling 89-122 by treating the cancellation of a portion of a debt as an effective reduction in the overall yield of the original debt. As discussed below at § 1.01[3][f][ii], a change in the yield of a fixed rate or variable rate debt instrument by more than 1/4 of 1% (25 basis points) or, if greater, 5% of the annual yield of an unmodified instrument, is "significant."

Example: A debt instrument issued at face has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10% payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the parties agree to reduce the principal by $20,000. Interest continues to be payable on the reduced principal of $80,000 at 10%. Under the final regulation, the yield on the debt after the cancellation is measured based on the holder's return (i.e., four annual payments of $8,000 and a payment at maturity of $88,000) as measured against the adjusted issue price immediately before the cancellation (i.e., $100,000). Under this analysis, the new yield is 4.332%, a reduction of more than 25 basis points and more than 5% of the original 10% yield. Thus, the final regulation concludes that the reduction is a "significant" modification.

[iii] Partial Prepayments

Certain types of prepayments that constitute "pro rata prepayments" should not be treated as a modification of the portion of the debt instrument that remains unpaid. A pro rata prepayment is defined in Treasury Regulation § 1.1275-2(f)(2) as a payment on a debt instrument (i) made prior to maturity, (ii) that is not made pursuant to the instrument's payment schedule (including certain deemed payment schedules determined under Treasury Regulation §1.1272-1(c)), and (iii) results in a substantially pro rata reduction of each payment remaining to be paid on the instrument. Treasury Regulation § 1.1275-2(f)(1) generally treats a pro rata prepayment as causing a retirement of the portion of the debt instrument that is prepaid by bifurcating the debt instrument into two different instruments – the portion that is repaid and the portion that remains outstanding. The regulation allocates a pro rata portion of the tax items attributable to the debt instrument to each such portion, including basis, adjusted issue price and OID. Gain or loss is realized by the holder of the debt instrument with respect to the portion of the debt instrument that is treated as retired. Treas. Reg. § 1.1275-2(f)(1). Similarly, the issuer may realize COD income or repurchase premium with respect to such portion. It would appear, therefore, that a pro rata prepayment should not be treated as a potential modification of the portion of the debt instrument that remains outstanding.

If a partial prepayment is pursuant to the original terms of the instrument or pursuant to applicable law, then, even if the prepayment does not constitute a pro rata prepayment, the prepayment right should, in most cases, constitute a "unilateral" option such that the actual prepayment would not be considered a modification. This generally requires that (i) the prepayment right not be contingent upon another's consent, (ii) the holder does not have the right to alter the terms of, or terminate the debt or put it to a related party of the issuer, and (iii) the holder receives no consideration other than a "specified" amount, a "de minimis" amount or an amount based on a formula that uses "objective financial information." See § 1.01[2][c][i] above (defining a unilateral option).

Thus, in most cases, the only issue will be whether the prepayment premium falls within any of these categories of permitted consideration. Because the regulation does not define the terms "specified" or "de minimis," the answer may not always be clear. By way of an example, however, the Regulations indicate that a prepayment premium based on a percentage of the outstanding principal amount is a "specified" amount. See Treas. Reg. § 1.1001-3(d) (Example 8).

If the prepayment constitutes a modification, the standard for determining whether the modification is significant will depend upon the particular terms of the prepayment. For example, if the prepayment is effective upon the occurrence of a substantial contingency (such as an optional prepayment right), the modification would appear to be tested under the general "economic significance" standard. On the other hand, if the modification provides for one or more prepayments at dates certain (such as a change from a lump-sum payment at maturity to a fixed amortization schedule), the prepayment should be subject to the separate "change in timing" rule. As discussed below at § 1.01[3][c][ii], the "change in timing" rule provides that a change in the timing of payments is significant only if it materially defers scheduled payments. Accordingly, a fixed acceleration in the timing of any payments should not, in and of itself, result in a significant modification (because it does not result in a deferral). One should beware, however, of prepayment penalties. In general, where a prepayment gives rise to a modification, any additional amounts received must be tested to determine whether they cause a change in the yield. See § 1.01[3][f][ii]. The only exception is a commercially reasonable prepayment penalty for a pro rata payment (as defined in Treasury Regulation § 1.1275-2(f)) which is not taken into account in determining a change in yield. See Treas. Reg. § 1.1001-3(e)(2)(iii)(B).

[iv] Allocation of Payments: Beware Deemed Payments of Interest

Traditionally, the general rule has been that the parties' allocation of a payment between principal and interest governs. In the absence of any agreement, payments occurring before retirement of the debt normally are applied first to accrued unpaid interest, and payments at maturity generally have been assumed to apply proportionately to unpaid interest and principal. However, support exists for the position that, in certain cases (particularly involving foreclosures), amounts paid at retirement could be applied first to principal. See Henderson & Goldring, at § 402.15. The time-value-of-money regulations released in final form on February 2, 1994, and generally effective for debt issued on or after April 4, 1994, purport to change this result.

Under Treasury Regulation § 1.446-2, all payments are to be treated first as interest to the extent of accrued unpaid interest, and the remainder as principal. Similarly, Treasury Regulation § 1.1275-2 generally provides that each payment (other than a payment of stated interest) on an installment note having OID is allocated first to the payment of the accrued unpaid OID, and then to the payment of principal. There is no suggestion in either regulation that the parties can change these results by agreement (except possibly in the case of a partial pro rata prepayment prior to maturity). Accordingly, where the characterization of a payment as principal would have economic effect, such as where unpaid interest does not compound, one wonders whether the parties' designation as principal of a payment that the regulations would treat as interest might be viewed as an amendment of the debt (particularly where the debt is in default) that would have to be tested to see whether it was significant enough to result in a deemed exchange of the debt.

[b] Change in Final Maturity Date

[i] Extension - Prior Law

Under prior law, the IRS had consistently held that merely extending the maturity of debt did not in and of itself create an exchange. Rev. Rul. 73-160, 1973-1 C.B. 365; see West Missouri Power Co. v. Comm'r, 18

T.C. 105 (1952), acq. 1952-2 C.B. 3; Motor Products Corp. v. Comm'r, 47 B.T.A. 983 (1942), acq. 1946-1 C.B. 3, aff'd per curiam, 142 F.2d 449 (6th Cir. 1944); Ltr. Rul. 8722064 (March 2, 1987).

But see Gen. Couns. Mem. 37884 (March 19, 1979) (expressing "serious doubts" that a change in maturity date can "never" be material); Ltr. Rul. 8346104 (August 18, 1983) (same).

[ii] Extension - Final Regulation

The final regulation changes prior law and provides that an extension of any payment is a significant modification if it extends beyond the safe-harbor period (discussed below) and results in a "material" deferral of scheduled payments. The same standard applies to interim payments. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments. Treas. Reg. § 1.1001-3(e)(3)(i).

[iii] 5-Year-or-50% Safe-Harbor

Under the final regulation, if the duration of the deferral is within the safe-harbor period and the deferred payments are "unconditionally" payable no later than the end of such period, the deferral is not a material modification. The safe-harbor period begins "on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument." Treas. Reg. § 1.1001-3(e)(3)(ii). The safe-harbor period is applied cumulatively and is shortened for each prior deferral. Deferrals of de minimis payments are ignored.

Example 1: Corporation holds a 10-year instrument that provides for the payment of $1,000 at maturity with interest payments at the rate of 10% payable at the end of each year. Assume at the end of year 2, the corporation agrees to defer the year 2 annual interest payment of $100 for 4 years. All remaining payments until maturity are timely made. The issuer would like to defer its final maturity payment for 2 years. Under the safe harbor, the 4-year deferral of the interim payment is included in the 5-year count. Consequently, the issuer may only defer the final maturity payment for one year.

Example 2 — Ltr. Rul. 9819043 (February 11, 1998): In this ruling, the joint obligors under two installment obligations wanted to extend their final maturity by a period of five years. The notes previously had been modified to accelerate the payment schedule. (It is unclear whether this included a shortening of the final maturity date). It was represented that all payments under the notes had been made in accordance with this modification or the notes' original terms. The IRS ruled that the proposed extension fell within the 5-year-or-50% safe harbor.

Example 3 — Field Service Advice 199928007 (July 16, 1999): The IRS applied the "material deferral" rule of Treasury Regulation § 1.1001-3(e)(3) to determine whether the taxpayer could claim a nonfunctional currency loss under Treasury Regulation § 1.988-2(b)(6). Here, the taxpayer borrowed fixed rate, currency funds from related corporations to refinance existing loans from those same corporations. The existing loans had an original maturity of 5 years. The terms of the new loans were identical to those of the existing loans, including a new 5-year maturity. The IRS found that the economic effect of paying the existing loans with proceeds from new loans was to extend the maturity date by 5 years. Accordingly, the IRS ruled that such extensions were outside the safe harbor (as they exceeded 50% of the terms of the existing loans) and, under the circumstances, constituted significant modifications to the old loans.

a. Beware: Safe Harbor is Arbitrary. The safe harbor does not distinguish between small and large payments (although there is an exception for de minimis payments). Thus, an interim payment of a more minor nature may deprive a debtor of the benefit of the safe harbor with respect to more major deferrals, such as an extension of final maturity. In addition, an inadvertent late payment arguably reduces the safe-harbor period just as would an intentional deferral.

b. Need to Adjust Interest Rate. Under the final regulation, if an extension of maturity involves a change in yield, it also must be tested for significance under the change in yield rules (discussed below at § 1.01[3][f]). In many cases, this may simply mean that the stated interest must continue to compound. However, where the debt was issued with OID, this provision would require that the original yield to maturity on the debt be preserved by increasing the stated interest rate on the bonds. See Treas. Reg. § 1.1001-3(g) (Example 2) (involving a zero coupon bond). However, to increase the interest rate in the context of an extension of maturity which was probably brought about by the failing condition of the issuer may make little commercial sense.

c. Change to Avoid OID. Under the proposed regulation, any change in the timing and/or amount of payment the principal purpose of which was to avoid the application of the OID rules (Sections 1271 through 1275) was a significant modification. The final regulation does not retain this rule. However, in its place, Treasury adopted Treasury Regulation § 1.1275-2(j), which provides that if the terms of an instrument are modified to defer one or more payments without causing an exchange under Section 1001, then, solely for purposes of the OID provisions, the debt instrument is treated as retired and then reissued on the date of the modification. See § 1.01[2][c][iii] above.

d. Pre-Effective Date Changes. Given that the final regulation generally applies only to modifications occurring on or after September 24, 1996, it is unclear whether pre-effective date deferrals must be accumulated with later deferrals for purposes of applying the safe-harbor.

e. Payment Deferral Under the Temporary Forbearance Rule. Under the Temporary Forbearance Rule discussed at § 1.01[2][c][ii], a lender's temporary waiver of an acceleration clause or similar default right is not treated as a modification for at least two years following a debtor's initial failure to perform. However, it is unclear whether a payment default that is subsequently cured and the default waived should be (i) tested as a "deferred" payment at the time of payment (although such treatment seems inconsistent with the apparent purpose of the Temporary Forbearance Rule) or (ii) otherwise taken into account in applying the safe harbor to subsequent deferrals.

[iv] Shortening of Maturity

For purposes of prior law, the IRS had indicated that shortening the maturity (like a prepayment) of the debt would not produce a deemed exchange. See Gen. Couns. Mem. 22901 (September 16, 1941); Gen. Couns. Mem. 37002 (February 10, 1977); Gen. Couns. Mem. 23148 (February 15, 1942); see also cases cited at § 1.01[3][b][i]. Similarly, it was believed that the mere addition of a sinking fund provision or the substitution of a serial obligation for a term bond should not be material. See Gen. Couns. Mem. 37884 (March 19, 1979).

Final Treasury Regulation § 1.1001-3(e)(3)(i) (entitled "change in timing of payments") provides:

> A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments.

By its terms, such section applies to any change in timing of payments, but only treats such change as significant if it results in a material deferral. Accordingly, the shortening of a debt's maturity or the addition of a sinking fund provision – which, by its nature, involves an acceleration rather than a deferral of payment – should not result in a significant modification.

As discussed above in § 1.01[3][a][iii], the right to prepay will, in many cases, be built into the original terms of the instrument and should not be considered a modification. Additionally, a commercially reasonable prepayment penalty for a pro rata payment (as defined in Treasury Regulation § 1.1275-2(f)) is not taken into account in determining a change in yield.

[v] Put/Call Provisions

Under prior law, because a call (redemption) provision is merely a method of shortening the maturity of debt, changes in, or the addition of, a call provision generally should not, alone or in combination with a change in maturity date, have been material. See West Missouri Power Co. v. Comm'r, 18 T.C. 105 (1952), acq. 1952-2 C.B. 3. However, it would seem that the addition of a call permitting the repurchase of the debt at a price significantly less than its adjusted issue price could, under Revenue Ruling 89-122 – discussed above at § 1.01[3][a][i] – have been considered material.

Under Treasury Regulation § 1.1001-3(f), a change in terms that is effective upon the occurrence of a substantial contingency is tested under the general "economic significance" standard (regardless of whether such change would otherwise be governed by one of the more specific rules). As a result, the addition, deletion or alteration of a put or call right – which, although affecting the timing of payment or the yield on the debt, is dependent upon the discretionary action of the holder – should be tested under the general "economic significance" standard.

[c] Deferral of Interim Payments

[i] Prior Law

Similar to an extension of maturity, a change in the amortization schedule of debt (or in a sinking fund provision) resulting in a deferral of principal payments did not, under prior law, trigger a deemed exchange. See, e.g., Ltr. Rul. 9037009 (June 12, 1990); Ltr. Rul. 8928049 (April 18, 1989); Ltr. Rul. 8920047 (February 17, 1989); Ltr. Rul. 8907049 (November 23, 1988); Ltr. Rul. 8753014 (October 2, 1987); Ltr. Rul. 8731011 (May 1, 1987); Ltr. Rul. 8722064 (March 2, 1987); Ltr. Rul. 8708017 (November 21, 1986); Ltr. Rul. 8534064 (May 28, 1985).

Under prior law, it appeared that the deferral of interest was also not a material change. See cases cited at § 1.01[3][b][i]. For example, in West Missouri Power Co. v. Commissioner, 18 T.C. 105 (1952), the Tax Court permitted the interest rate on bonds issued in partial payment of interest to be lower than the stated interest rate on the bonds themselves without causing a deemed exchange. In Letter Ruling 8920047 (February 17, 1989), the IRS held that the addition of interest on late payments of interest, at the same interest rate as the interest originally accrued, was not a material change. Accordingly, it appears that a "current pay" bond could have been converted into a "pay-in-kind" bond without causing a deemed exchange and without invoking the OID provisions of the Code.

[ii] Final Regulation Changes Prior Law

In contrast, Treasury Regulation § 1.1001-3(e)(3)(i) provides that a change in timing of payments – whether principal or interest – is a significant modification if it "materially" defers scheduled payments. As stated above, if the deferral of payments is within the safe harbor period, it is not material. See § 1.01[3][b][iii] above, discussing the application of the safe harbor. As discussed above, the materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amount of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

Example: A 20-year debt instrument provides for $100,000, due at maturity, and for annual interest payments at the rate of 10%. At the beginning of the 11th year, the issuer and holder agree to defer all remaining interest payments until maturity, with compounding. The yield of the modified instrument remains at 10%. The safe-harbor period begins at the end of the 11th year, when the interest payment for that year is deferred, and ends at the end of the 16th year. However, the deferred interest payments during this period are not unconditionally payable until maturity (at the end of the 20th year). Thus, the deferral of interest payments is not within the safe harbor. The final regulation indicates that such deferral would be considered material and is a significant modification. See Treas. Reg. § 1.1001-3(g) (Example 4).

[d] Change in Priority/Subordination

Under prior law, the IRS had ruled that a change in maturity date did not create an exchange even when it was coupled with the addition of a subordination provision. Rev. Rul. 73-160, 1973-1 C.B. 365; Ltr. Rul. 9043060 (August 1, 1990).

Under the final regulation, a change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a "change in payment expectations." Treas. Reg. § 1.1001-3(e)(4)(v).

Change in Payment Expectations Test: A "change in payment expectations" occurs if there is either:

- a "substantial enhancement" of the obligor's capacity (including guarantees, third party collateral and any other sources of payment or credit enhancement) to meet the payment obligations and that capacity was "primarily speculative" before the modification and is "adequate" after the modification; or

- a "substantial impairment" of the obligor's capacity to meet the payment obligations and that capacity was "adequate" before the modification and is "primarily speculative" after the modification.

Treas. Reg. § 1.1001-3(e)(4)(vi). Consequently, if a change in priority of a debt instrument makes the payment of the debt more or less likely to occur than it originally was, such change in priority may give rise to a significant modification.

[e] Change in Collateral, Guarantee and Other Credit Enhancements

[i] Prior Law

Under prior law, a change in collateral had been held not to be a material modification, even when coupled with a change in maturity date, at least in the case of recourse debt. See Ltr. Rul. 8346104 (August 18, 1983); cf. West Missouri Power Co. v. Comm'r, 18 T.C. 105 (1952), acq. 1952-2 C.B. 3; Ltr. Rul. 8753014 (October 2, 1987) (deferral of sinking fund installments and reduction in reserve fund held not material). To similar effect, see Ltr. Rul. 8907049 (November 23, 1988); Ltr. Rul. 8920047 (February 17, 1989); Ltr. Rul. 8928049 (April 18, 1989).

[ii] Final Regulation: Recourse v. Nonrecourse Debt

The final regulation distinguishes between changes in the collateral or other credit enhancements (including guarantees) of recourse and nonrecourse debt. A change in the nature of an instrument from nonrecourse to recourse (or vice versa) generally is governed by a separate rule. See § 1.01[3][e][iv] discussion below. However, if a change in status is effective upon a substantially deferred basis, such change is tested under the general "economic significance" standard discussed at § 1.01[2][d] above.

a. Recourse Debt. Treasury Regulation § 1.1001-3(e)(4)(iv)(a) provides that a change in collateral or other credit enhancement is a significant modification if it results in a change in payment expectations. (See definition of "change in payment expectations" above at § 1.01[3][d].)

Example: An issuer's obligations under a recourse instrument are secured by a letter of credit from Bank A. The instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. Bank A experiences financial difficulty.

The issuer and the holder agree to substitute a letter of credit from Bank B. The substitution of Bank B's letter of credit is not a significant modification, unless the substitution results in a change in payment expectations – such as where the issuer's ability to meet its payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate. Treas. Reg. § 1.1001-3(g) (Example 8).

b. Nonrecourse Debt. In the case of nonrecourse debt, a change in the collateral by a substantial amount or any form of credit enhancement generally is a significant modification except in two limited circumstances relating to the substitution of collateral. A substitution of collateral is not a significant modification if (i) the collateral is fungible in nature (such as government bonds or securities of a particular type and credit quality) or (ii) the substitution is of a similar commercially available credit enhancement contract. Improvements to the collateral would not result in a significant modification. Treas. Reg. § 1.1001-3(e)(4)(iv)(B).

Example 1 — Ltr. Rul. 9801047 (January 5, 1998): In this ruling, the IRS considered the effect of a proposed amendment to a nonrecourse mortgage loan that permitted the borrower to deliver, in substitution for certain mortgages and related liens, U.S. government obligations with a principal amount equal to 100% of the loan's principal, rather than 125% as required by the original terms of the loan. The borrower had already obtained a release of mortgage liens for properties to which approximately four-fifths of the principal amount of the loan was allocable, by substituting U.S. government obligations equal to 125% of such principal amount. Accordingly, the amendment effectively only related to the final one-fifth.

The IRS ruled that the amendment was not a significant modification under Treasury Regulation § 1.1001-3(e)(4)(iv)(B) because it did not release a substantial amount of the collateral. The IRS reasoned that a substantial amount was not released "under the specific circumstances in which the entire mortgage lien is released because, whether collateralized at 125% or at 100%, the obligation to repay the entire mortgage loan is fully and identically secured."

Example 2: A parcel of land and its improvements, a shopping center, secure a nonrecourse debt. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt and its inclusion in the collateral securing the debt is not a significant modification. Treas. Reg. § 1.1001-3(g) (Example 9).

Example 3 — Ltr. Rul. 9833015 (August 14, 1998): A REMIC requested a ruling that a release of a portion of the collateral (a shopping center) securing a borrower's nonrecourse mortgage would not disqualify the mortgage under Section 860G(a)(3). One of the shopping center's anchor tenants wanted to purchase its space. Under the terms of the mortgage, the borrower had a limited period in which it could have exercised a release option to sell a portion of the shopping center in exchange for the payment of a release price and a release prepayment premium. The release price (but not the prepayment premium) was to be applied to the balance of the loan. Because the date by which the prepayment option had to be exercised had passed, the borrower wanted to modify the terms of the mortgage to allow it to apply the prepayment option to the proposed sale. No other changes were suggested. If this change were a significant modification under Section 1001, the mortgage would need to be retested as a "qualified mortgage" for REMIC purposes.

The IRS ruled that, although the note was modified, it was not a significant modification because the release of the portion of the shopping center did not release a "substantial amount" of collateral within the meaning of Treasury Regulation § 1.1001-3(e)(4)(iv)(B). The IRS reasoned that (i) the amount paid for the release (other than the prepayment premium) was applied entirely to the balance of the loan and the loan continued to be secured by the remaining collateral and (ii) based on loan-to-value ratios, the extent to which the remaining collateral secured the remaining debt did not differ to a significant degree from the total collateral securing the total debt.

In addition, the taxpayer represented that all the fees payable in connection with the lease, together with the prepayment premium, would not change the yield on the unmodified debt by more than the greater of 25 basis points or 5% of the annual yield. See discussion of change in yield at § 1.01[3][f][ii][b] below.

Example 4 — Ltr. Rul. 200648023 (August 17, 2006): A borrower under a nonrecourse loan that was secured by commercial real estate sought to obtain a release of the mortgage on the real estate. Under the terms of the loan, the borrower had a defeasance option pursuant to which the borrower could obtain a release of the mortgage if the borrower substituted as collateral government securities that provide for payments that were payable on or prior, but as close as possible, to future payments due on the loan. The borrower sought to amend the terms of the loan to permit the substitution of government securities with payment dates no more than 12 months prior to the corresponding payment dates under the loan. The IRS ruled that the modification would not be significant under Treasury Regulation § 1.1001-3(e)(4)(iv)(B) because the amendment "would only permit Borrower to substitute government securities for other government securities to be used as collateral in a defeasance of the loan."

[iii] Distinguishing Between Recourse and Nonrecourse

The regulation does not define, or elaborate upon, the terms "recourse" and "nonrecourse." Such terms should therefore, in most (if not all) cases, be considered to have their normal commercial meanings, with the legal rights and obligations of the debt determined under applicable state law. Accordingly, labels cannot always be relied upon.

For example, in Field Service Advice 200135002 (April 10, 2001), the IRS Chief Counsel's office considered, for purposes of determining gain or loss with respect to the disposition of property securing a loan, whether a "limited recourse" loan should be considered to be "recourse" or "nonrecourse." A limited recourse loan is a loan that, by its terms, limits the creditor's recourse to specifically encumbered assets. In this instance, the encumbered assets represented almost everything that the debtor owned at the time the loan was entered into, and appears to have comprised virtually all of the debtor's assets at the time of disposition. Nevertheless, looking to state law, as well as other federal cases that considered similar type loans, the Chief Counsel recommended that the loan be treated as a nonrecourse debt.

A more difficult issue is presented by the issuance or assumption of debt by a limited liability company (LLC) that is disregarded for federal tax purposes under Treasury Regulation § 301.7701-3(b)(1)(ii). What governs – commercial realities or tax fictions? In Letter Ruling 200315001 (September 19, 2002), the IRS considered whether unsecured debt of a corporation that converts into a single member, disregarded LLC is treated as undergoing a deemed exchange under Section 1001 where a portion of the assets of the LLC are distributed in connection with the conversion. Looking to state law, the IRS observed that the conversion preserved the debt holders' legal rights and obligations vis-à-vis the legal entity (the LLC). The IRS therefore concluded that the restructuring (including the distribution of assets) "[would] not effect an alteration that results in either a change in obligor or a change in the recourse nature of the Debt" for Section 1001 purposes (emphasis added). Although the IRS has employed a different approach in subsequent letter rulings relating to whether a conversion results in a change-in-obligor, such rulings still conclude (implicitly or, in the case of a 2006 ruling, explicitly) that a conversion does not result in a change in the recourse nature of the debt. See Ltr. Rul. 201010015 (November 5, 2009), Ltr. Rul. 200709013 (November 22, 2006) and Ltr. Rul. 200630002 (April 24, 2006) discussed below at § 1.01[3][h][ii]. The ruling thus provides some insight into the treatment of debt of LLCs, but still leaves the most difficult issues unresolved. For a discussion of these and other issues involving the treatment of recourse debt of a disregarded entity as potentially nonrecourse, see American Bar Association, ABA Tax Section Recommendations for 2016-2017 Treasury-IRS Guidance Priority List, March 18, 2016; Peaslee, Disregarded Entities and Debt Modifications, 150 Tax Notes 1145 (March 7, 2016); Hoffer, Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities, 107 Tax Notes 327 (April 18, 2005); Cummings, The Disregarded Entity Is and Isn't Disregarded, 99 Tax Notes 743 (May 5, 2003); Cuff, Indebtedness of a Disregarded Entity, 81 Taxes 303 (March 1, 2003). In some contexts, the IRS has already indicated that it favors nonrecourse treatment. See Ltr. Rul. 201644018 (July 28, 2016) (holding that debt of an LLC that is disregarded for tax purposes is nonrecourse debt for federal income tax purposes because, under state law, the regarded owner — i.e., the borrower for tax purposes — was not liable for any portion of the debt); Preamble to Treas. Reg. § 1.108-9, T.D. 9771 (June 10, 2016) (expressing the view that recourse debt of a disregarded entity or grantor trust generally should be treated as nonrecourse debt of the owner-taxpayer for purposes of the insolvency exception to COD income).

[iv] Change in the Nature of the Instrument

In general, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), or vice versa, is a significant modification. Thus, for example, the regulation provides that a "legal defeasance" of a debt in which the issuer is released from all liability to make payment (or contribute additional assets to a trust to meet scheduled payments) is a significant modification, except possibly in the case of a tax-exempt bond (as discussed below). If a debt instrument is not substantially all recourse or not substantially all nonrecourse, either before or after the modification, the modification is tested under the general "economic significance" standard. Treas. Reg. § 1.1001-3(e)(5)(ii)(A).

Notwithstanding the above, the regulation provides the following two exceptions:

a. Defeasance of Tax Exempt Bonds. A defeasance of a tax-exempt bond (whether or not constituting a "legal defeasance") is not a significant modification if (i) it occurs by operations of the original terms and (ii) the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to satisfy the payment obligations under the terms of the original bond. Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1).

b. No Effective Change in Collateral. A modification that changes the debt from recourse to nonrecourse debt is not a significant modification if (i) the debt continues to be secured by the original collateral and (ii) the modification does not create a "change in payment expectations" (defined above under change in priority). Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (such as government securities or financial instruments of a particular type or credit quality), the replacement of some or all of the collateral with other collateral of the same or similar type and the same aggregate value is not considered a change in the original collateral.

[f] Change in Interest Rate and Other Changes in Yield

[i] Prior Law

The IRS had held that a significant change in interest rate was, in and of itself, a material change in terms. See, e.g., Rev. Rul. 87-19, 1987-1 C.B. 249 (bank waived automatic increase in interest rate from 7% to 8.56%); Rev. Rul. 89-122, 1989-2 C.B. 200 (Situation 1) (decreased interest rate by one percentage point).

Conversely, the IRS had, on several occasions, ruled that a de minimis change in rate would not result in a deemed exchange. See Ltr. Rul. 8835050 (June 8, 1988) (1-year waiver effecting less than a 3 basis point (3/100 of 1%) change not material); Ltr. Rul. 8932067 (May 17, 1989) (12.5 basis point (1/8 of 1%) change in yield not material); cf. Ltr. Rul. 8834090 (June 3, 1988) (IRS declined to rule on the materiality of a 1/5th of 1% change in the fixed interest component of a floating interest rate). See also Ltr. Rul. 8920047 (February 17, 1989) (the addition of interest on late payments of interest was not a material change).

Traditionally, the courts had not focused on change in "yield" as distinguished from changes in the stated interest rate as evidenced by the cases cited at § 1.01[3][b][i]. This similarly was true of the IRS until the concept of "yield" began creeping into its private rulings, as reflected in the foregoing letter rulings. Moreover, as discussed at § 1.01[3][j], below, changes in value historically were disregarded.

[ii] Final Regulation

Treasury Regulation § 1.1001-3(e)(2) confirms the IRS ruling position on changes in interest rate, but goes beyond prior law by adopting a bright-line "change in yield" rule for certain debt obligations. For all other debt obligations, such as a contingent payment debt instruments ("CPDIs"), a change in yield is tested under the general "economic significance" standard.

a. Bright-Line Test for Certain Obligations. The final regulation provides that a change in yield is significant if the change exceeds the greater of 1/4 of 1% (25 basis points) or 5% of the original yield on the unmodified instrument (.05 x annual yield). This rule applies to the following types of debt:

- debt with only fixed payments;
- debt with alternative payment schedules subject to Treasury Regulation § 1.1272-1(c) (which only have known payments and meet certain other requirements);
- debt that provides for a fixed yield subject to Treasury Regulation § 1.1272-1(d) (which applies to debt issued on or after August 13, 1996 that provides for one or more contingent payments but all possible payment schedules result in the same fixed yield); and
- certain variable rate debt instruments.

All changes in yield falling within this rule are tested on a cumulative basis, including any change in yield occurring not more than five years before the date of the modification being tested. Treas. Reg. § 1.1001-3(f)(3). However, any prior modification occurring more than five years before the date of the modification being tested is disregarded.

Example — Offsetting Yield Changes: The interest rate on a debt instrument (issued without OID) is decreased by one percentage point. At the same time, the issuer pays to the holder a restructuring fee reflecting an increase in the yield by 3/4 of 1%, such that the net change is 1/4 of 1%. No significant modification should be deemed to occur. See Treas. Reg. § 1.1001-3(f)(4) (in testing each modification, it is assumed that all other simultaneous modifications have already occurred).

b. Applying Bright-Line Test by Analogy

As discussed above, whether a change in yield of a CPDI is a significant modification is determined under the general "economic significance" standard, rather than under the bright-line test. However, the IRS did apply a rule similar to the bright-line test when considering whether a consent fee caused a significant modification of a CPDI under the general "economic significance" rule. See Ltr. Rul. 201431003 (August 1, 2014). The IRS reasoned that it was appropriate to apply a test similar to the bright-line test because (i) the notes were CPDIs to which the noncontingent bond method of accounting under Treasury Regulation § 1.1275-4(b) applied, and (ii) the consent payment would result in a one-time payment to the noteholders and would not otherwise alter the amounts they would receive under the notes. Id.; see also Ltr. Rul. 201546009 (November 13, 2015) (applying an approach similar to the change in yield rule to a consent payment paid in connection with amending a debt instrument treated as a CPDI); Field Service Advice 20151704F (November 21, 2014) (discussing the treatment of consent fees for debt modifications).

c. Computation of Yield for Bright-Line Test, Generally. The computation of the annual yield of the modified debt instrument (other than a variable rate debt instrument) is based on:

(1) the ongoing payments under the modified debt; and

(2) an assumed issue price equal to the adjusted issue price of the unmodified instrument, (i) increased by any accrued but unpaid interest, (ii) decreased by any accrued bond issue premium not yet taken into account, and (iii) increased or decreased (as appropriate) "to reflect payments made to the issuer or to the holder as consideration for a modification."

For this purpose, a commercially reasonable prepayment penalty for a "pro rata prepayment" is not treated as consideration for the modification. A pro rata prepayment is defined as a payment prior to maturity that is not pursuant to the instrument's payment schedule and results in a substantially pro rata reduction of each payment remaining to be paid on the instrument. See Treas. Reg. § 1.1275-2(f).

Example 1 — Reduction in Principal Amount: See § 1.01[3][a][ii] above for an example of a reduction in principal as a change in yield and the yield computation.

Example 2 — Ltr. Rul. 9833015 (August 14, 1998): In this ruling, the IRS considered whether a qualified mortgage of a REMIC had been significantly modified. In addition to releasing a portion of the collateral securing the original loan (see § 1.01[3][e][ii][b]), the borrower modified the yield on the loan. The borrower represented that the yield on the modified debt would not vary from the yield on the unmodified debt by more than the greater of 25 basis points or 5% of the annual yield. All fees payable in connection with the release, including a prepayment penalty, were taken into account for purposes of determining the yield on the modified instrument. Because the prepayment penalty had been included in the yield calculation, it was not necessary to determine whether it was commercially reasonable.

Example 3 — Chief Counsel Advice 199943037 (July 30, 1999): As a side point to the main issues raised in this Chief Counsel Advice, the IRS analyzed certain changes in the terms of loans issued by the City of Grand Forks as part of a financial assistance program to businesses that were damaged by a recent flood. The original loans (the "Loans") had a three year term and were issued for cash equal to their stated principal amount. Under certain conditions, which were likely to occur (the "Contingency"), the Loans would be deemed satisfied in full upon payment of 75% of their stated principal ("Reduced Payment"), without payment of accrued interest. If the businesses failed to satisfy the Contingency, the full amount of the respective Loan, including accrued interest, would be payable. Subsequently, prior to the satisfaction of the Contingency (and regardless of whether the Contingency was ultimately satisfied), the City forgave all the interest on the Loans.

In analyzing whether a significant modification occurred as a result of the forgiveness of the interest, the IRS observed that the OID regulations presume that a holder with alternative payment options will choose the option that achieves the lowest yield. Treas. Reg. § 1.1272-1(c)(5). As such, under the OID regulations, the Loans were initially regarded as having a stated redemption price at maturity equal to the Reduced Payment, which was lower than the issue price, and thus had a zero yield. (Under the OID regulations, if the Contingency was ultimately not satisfied and the full amount of the Loan became payable, the original loans as characterized for OID purposes would be treated as exchanged for new loans).

Accordingly, the forgiveness of the interest prior to the date by which the Contingency had to be satisfied did not change the yield of the loan (i.e., it was zero before and remained zero after), and hence there was no significant modification of the loan.

d. Yield of Variable Rate Instruments. For purposes of the bright-line test, the annual yield of a variable rate debt instrument is the annual yield of an equivalent fixed rate debt instrument (as defined in Treasury Regulation § 1.1275-5(e)) which is constructed based on the terms of the debt as of the date of the modification.

e. General Example — Conversion From Fixed to Variable Rate: A debt instrument with a fixed interest rate of 9% is converted to a variable rate of prime plus 2% (where prime equals 7% at the time of the conversion and 9% is the annual yield of an equivalent fixed rate debt instrument). Under the bright-line test, if applicable, this would not be a significant modification. However, the preamble to the final regulation states that a conversion from a fixed rate instrument to a variable rate instrument will be tested under the general "economic significance" standard, in which event the change would be evaluated based on all facts and circumstances. See T.D. 8675. It is therefore unclear which rule applies to test the conversion. One possible way to reconcile the preamble with the specific change in yield rule is to recognize that a change from a fixed rate to a variable rate involves two distinct modifications. The first modification, governed by the specific change in yield rule, involves the amount of the yield on the debt instrument and the manner in which the amount of the yield is calculated for purposes of these rules. The second modification, referred to in the preamble, involves a change in the "method under which" (i.e., fixed or variable) actual future payments on the debt instrument will be determined. See id.

f. Changes in Yield of Debt Issued with De Minimis OID. The adjusted issue price of a debt instrument that is issued with de minimis OID generally does not reflect the economic accrual over time of the de minimis OID amount – rather, de minimis OID is generally only taken into account upon retirement of the debt. As a result, the stated yield to maturity for tax purposes of a debt with de minimis OID differs from its "real" yield to maturity. Because of this difference, strict adherence to the formula for calculating a change in yield can lead to a modification of a debt instrument issued with de minimis OID being treated as a significant modification due to even the slightest change in the amount and timing of payments due under the debt – a result that surely was not intended. Significantly, in comparing the yield of the modified and unmodified debt, the issue price of the modified debt is treated as equal to the adjusted issue price of the unmodified debt, which (as indicated) does not reflect the portion of the de minimis OID that has economically accrued prior to the modification. Yet, the yield computed on this issue price for the modified debt will take into account all future payments that remain to be paid, including the full amount of the de minimis OID. The yield on the modified debt is therefore artificially inflated, which becomes more pronounced if the terms of the instrument are altered later in the life of the debt when much of the de minimis OID has already accrued from an economic standpoint, with the result that even a slight change in the instrument may be regarded as creating a change in yield beyond the protected amount. For a discussion of this issue and potential solutions, see New York State Bar Association, "Effect of De Minimis OID Under Reg. § 1.1001-3(e)(2)," December 22, 2010, reprinted at 2010 TNT 246-22 (December 23, 2010).

[iii] Automatic Changes (Floating Rates, Etc.)

An automatic change in the yield pursuant to the original terms of the instrument (e.g., an interest rate that floats with prime, or even a multiple index) is not a "change" in the terms of the debt under both prior law and the final regulation. See Treas. Reg. § 1.1001-3(c)(1)(ii); Rev. Rul. 87-19, 1987-1 C.B. 249; see also Treas. Reg. § 1.1275-5(e) (providing principles for accrual of OID throughout the term of a floating rate debt instrument); Prop. Treas. Reg. § 1.7872-3(e)(1)(i) (determination of whether a floating rate loan bears sufficient stated interest is based on index on the date the loan is made). As discussed above at § 1.01[2][c][i], an alteration that occurs by operation of the terms of the debt instrument is not a modification unless it falls within one of the three exceptions to the "original terms" rule (such as changes that turn the debt into non-debt).

Example: A bond provides for the interest rate to be reset each 49 days through an option by a remarketing agent. The reset of the interest rate occurs by operation of the terms of the bond and is not a modification under the "original terms" exception. Treas. Reg. § 1.1001-3(d) (Example 1).

[g] Change in Interest Rate and Maturity Date

[i] Prior Law

The IRS generally had considered a change in interest rate coupled with a change in maturity to result in a deemed exchange, even in circumstances in which the change in interest rate alone might not have triggered a deemed exchange. See, e.g., Rev. Rul. 81-169, 1981-1 C.B. 429 (involving 0.5% change in rate). See generally Henderson & Goldring, at § 402.4 n. 29.

However, the courts did not always reach the same conclusion. See, e.g., Newberry v. Comm'r, 4 T.C.M. (CCH) 576 (1945); Thomas Watson v.

Comm'r, 8 T.C. 569 (1947), acq. 1947-2 C.B. 5. For additional cases, see Henderson & Goldring, at § 402.4 n. 30.

[ii] Final Regulation

As previously discussed, the final regulation tests certain changes separately and only those of a type not covered by one of the specific tests in the regulation are tested on a collective basis under the general "economic significance" standard to determine whether there is a significant modification. See § 1.01[3] and Treas. Reg. § 1.1001-3(f)(4). For example, a change in yield in a fixed rate or variable rate debt instrument that is not a significant modification under the bright-line test for changes-in-yield when combined with an extension of maturity date that is not a significant modification do not together result in a significant modification.

[h] Change in Obligor

The consequences of a change in obligor differ depending on whether there is a "novation" (i.e., a release of the old obligor) or an assumption that simply adds another obligor.

[i] Prior Law

A change in obligor could have been sufficiently material to constitute an exchange. Except possibly in connection with the acquisition of property (see below), the IRS probably would have viewed a complete change in obligor – even where a parent corporation was substituted for its subsidiary – as a material change in terms. See Gen. Couns. Mem. 39225 (April 27, 1984) (substitution of parent company as obligor on a debt, including substitution of parent's stock as the stock into which the debt could be converted, considered material). As discussed above, the Supreme Court in Cottage Savings held that a swap of mortgage pools was a taxable exchange because the loans exchanged had different obligors and different security.

In contrast, the IRS had, on several occasions, ruled that no exchange occurs where a newly organized parent holding company assumed joint and several liability for its subsidiary's debt, even where such assumption was coupled with the parent's assumption of the subsidiary's conversion obligation to issue stock. See Ltr. Rul. 8504049 (October 30, 1984); Ltr. Rul. 8223044 (March 9, 1982); Ltr. Rul. 8117091 (January 28, 1981); compare Gen. Couns. Mem. 37844 (March 19, 1979) (suggests combination not material, absent other changes) with Gen. Couns. Mem. 37583 (June 22, 1978) (IRS original position, combination material); see also Ltr. Rul. 8509066 (December 3, 1984) (assumption of conversion obligation alone, not material).

[ii] Final Regulation Consistent

a. New Obligor of Recourse Debt. Under Treasury Regulation § 1.1001-3(e)(4), the substitution of a new obligor of recourse debt is a significant modification, except in the case of (i) a Section 381(a) transaction, (ii) an acquisition of substantially all of the assets of the original obligor, (iii) tax exempt bonds where the new obligor is a related entity to the original obligor (as defined in Section 168(h)(4)(A)), or (iv) a new deemed obligor upon the making of a Section 338 election with respect to the original obligor.

A substitution pursuant to a Section 381(a) transaction or in connection with an acquisition of substantially all of the original obligor's assets will be a significant modification only if it results in (i) a "change in payment expectations" (see change in priority discussion above) or (ii) other than in the case of an "F" reorganization, a "significant alteration" (defined as an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument). Treas. Reg. § 1.1001-3(e)(4)(i)(E). See, e.g., Ltr. Rul. 201418039 (May 2, 2014), and related Ltr. Rul. 201418046 (May 2, 2014) (parent corporation's assumption of subsidiary corporation's liabilities in connection with an upstream C reorganization into parent held not to be a significant modification where taxpayer represented that the proposed transaction would not result in a change in payment expectations).

Example 1 — LLC Conversion Rulings: Each of these rulings involved a change in an entity's tax classification either by means of (i) a conversion to LLC status through the filing of a certificate of conversion under state law or (ii) a check-the-box election under Treasury Regulation § 301.7701-3.

In Letter Ruling 200315001 (September 19, 2002), the earliest of the rulings, the IRS ruled that the conversion of a corporate obligor into a single member LLC that was disregarded for federal tax purposes under Treasury Regulation § 301.7701-3(b)(1)(ii) was not a substitution of a new obligor for the purposes of determining a deemed exchange. The IRS observed that the conversion did not change the legal rights and obligations that the debt holders had against the corporation, since the LLC, as a matter of state law, steps into the shoes of the corporation and in effect "remain[s] the same legal entity."

Subsequently, however, the IRS issued three letter rulings retreating from its prior position. In Letter Ruling 200630002

(April 24, 2006), while the IRS did not explicitly mention whether the conversion effected a change in obligor, the IRS hinted at this conclusion by ruling that the conversion of a corporation into a disregarded LLC did not result in a "significant" modification of the debt issued by that entity for purposes of Treasury Regulation § 1.1001-3(e). Had the IRS believed that there was no change in obligor, there would have been no "modification" in the first instance, and thus no need to analyze its "significance" under Treasury Regulation § 1.1001-3(e).

In Letter Ruling 200709013 (November 22, 2006), a corporation that converted into an LLC initially elected to be treated as a corporation for tax purposes, but later elected to be treated as a disregarded entity. Thereafter, an affiliate invested cash in exchange for units in the LLC as a result of which the LLC was treated as a partnership for tax purposes. The IRS, in its analysis of the effect of this restructuring on the debt issued by the entity, noted that several steps in the restructuring involved a change in obligor under Treasury Regulation § 1.1001-3(c)(2)(i), but ruled that such changes were not significant. <u>See also</u> Ltr. Rul. 201010015 (November 5, 2009) (change in obligor resulting from conversion of a subsidiary corporation into an LLC as part of Section 381 transaction held not to be a significant modification).

<u>Example 2 — Ltr. Rul. 9711024 (March 14, 1997)</u>: The first IRS pronouncement to apply the final regulation addressed the issue of whether, in connection with a Section 355 spin-off, the substitution of a controlled corporation ("Controlled") as the obligor on the distributing corporation's ("Distributing") notes was a significant modification and thus a deemed exchange. As part of the spin-off, Distributing transferred substantially all of its assets to Controlled. Both before and after (at least on a preliminary basis) the spin-off, the notes received the highest possible investment rating from a rating agency. In consideration for permitting the change in obligor, the noteholders required that the prepayment premium payable to them be increased in the event of a subsequent decrease in the notes' investment rating. The IRS ruled that the change in obligor was not a significant modification and that an exchange did not occur, as the transaction involved the transfer of substantially all of Distributing's assets without a change in payment expectations under the notes. (Although not expressly stated, the IRS's ruling also implicitly entailed a finding that the increase in the prepayment premium was not a significant modification.)

<u>Example 3 — Ltr. Rul. 201119002 (October 14, 2010), supplemented by Ltr. Rul. 201120015 (February 14, 2011)</u>: The obligations of a parent corporation (Oldco) under its outstanding

bonds (Bonds) and under a guarantee of the bonds of one of its subsidiaries (Sub 1 Bonds) were successively assumed by different entities in a complex series of transactions without a significant modification being held to occur. First, a new holding company (New Holdco) was created to own the stock of Oldco through an inversion transaction treated as a tax-free exchange under Section 351. Following the inversion transaction, New Holdco owned all of the stock of Oldco through a limited partnership (LP) that was treated as a disregarded entity. New Holdco then contributed its interests in LP to a newly formed corporation (New Holdco 2). Oldco then distributed all of its assets to LP and LP assumed all of Oldco's liabilities (other than certain guarantees). The IRS ruled that the contribution of LP to New Holdco 2 followed by the LP assumption of Oldco's liabilities was an "F" reorganization of Oldco into New Holdco 2. LP then distributed to New Holdco 2 all of the stock of Oldco and of Sub 2. New Holdco 2 then distributed LP to New Holdco, which was treated for tax purposes as a tax-free spinoff under Section 355 of the stock of Sub 1 and an assumption by New Holdco of the liabilities of Oldco that had previously been assumed by LP (Internal Spinoff). New Holdco then distributed all of the stock of New Holdco 2 pro rata to its shareholders in a tax-free spinoff under Section 355. Finally, LP dissolved and New Holdco directly assumed Oldco's liabilities that had previously been assumed by LP (Dissolution). The taxpayer made separate representations that there was no change in payment expectations and no significant alteration in connection with each of the "F" reorganization, the Internal Spinoff and the Dissolution and made a separate representation with respect to the overall transaction. Based on these representations, the IRS ruled that there was no significant modification of the Bonds or the Sub 1 Bonds. It is unclear why the representation that there was no significant alteration was necessary with respect to the "F" reorganization since a change in obligor pursuant to an "F" reorganization is not a significant modification even if a significant alteration occurs.

<u>Example 4 — Ltr. Rul. 200742016 (June 21, 2007)</u>: During the term of a debt issued by a sister corporation, a corporation became a guarantor on the debt. Subsequently, the guarantor made a tender offer to holders of the debt (with a cash inducement payment) to exchange its own newly issued debt for the old debt issued by its sister corporation. The new debt had the same yield and maturity as the original debt (exclusive of the cash inducement). Following the tender offer, the original issuer made a cash payment to the guarantor to retire the old debt in an amount equal to the value of the newly-issued debt. The IRS tested the exchange of the old debt for the new debt as an indirect

modification under Treasury Regulation § 1.1001-3 to determine if a significant modification had actually occurred. The IRS ruled that, as the old debt was a recourse debt, the change in obligor was a significant modification.

Example 5 — Ltr. Rul. 199904017 (January 29, 1999): In this ruling, the common parent of an affiliated group of corporations assumed two notes of one of its subsidiaries that it had previously guaranteed. Instead of treating the parent's assumption of the subsidiary's debt as the substitution of a new obligor, the IRS treated the parent as "essentially . . . a co-obligor" and, in turn, analyzed the parent's assumption as the deletion of a co-obligor. The subsidiary was a special finance subsidiary whose primary purpose was to issue debt for the parent and its affiliates. The parent had guaranteed all of the subsidiary's debt. Major rating companies rated the subsidiary's debt based upon the parent's credit rating, and all of the financial information provided in SEC prospectuses filed by the subsidiary related solely to its parent. Also, the assets of the subsidiary consisted almost entirely of intercompany obligations.

Treating the parent as a co-obligor, the IRS ruled that the parent's assumption was not a significant modification because there was no "change in payment expectations" (as discussed below). It reasoned that there was no change because the common parent was liable on the notes before and after the modification. (Note that, had the IRS adhered strictly to the form of the parent's assumption and treated the assumption as a substitution of obligors, the substitution would have constituted a significant modification.)

Example 6 — Generic Legal Advice Memorandum 2011-003 (August 26, 2011): Here, a foreign insolvent subsidiary, Z, which was owned 80% by a domestic corporation, X, and 20% by a foreign corporation, Y (a wholly-owned subsidiary of X), elected under applicable Treasury Regulations to change its tax classification from a corporation to a partnership. Under the facts of Situation 1, Z's liabilities were all owed to X, while in Situation 2, Z's liabilities were all owed to an unrelated third-party. Under both situations, the IRS concluded that the substitution of the obligor from the former corporation to the new partnership was not a significant modification. The IRS reasoned that, "under local law, Z's . . . liability to X . . . survives the deemed liquidation and continues in identical form as an obligation of Z," and therefore, Z continued to hold substantially all of the assets after the deemed liquidation and there was no change in payment expectations. (The memorandum also indicated that there was no significant alteration.) However, as noted by some commentators, the IRS's analysis failed to account for the fact that, in Situation 1, the debt should technically be deemed merged out of existence as a result of the deemed liquidation to the extent the creditor and debtor positions were both momentarily held by X. See, e.g., Treas. Reg. § 301.7701-3(g)(1)(ii); Sutton, Check-the-Box Elections of Insolvent Entities, 135 Tax Notes 483 (April 23, 2012). By the same accord, the IRS's analysis failed to follow the technical tax construct (i.e., the deemed liquidation and contribution) in determining whose assets one must look to in order to determine whether the "substantially all" requirement is met. Because the assets are momentarily treated as acquired by X prior to the deemed contribution, Z would seemingly need to have acquired all of X's assets in addition to its own historic assets to satisfy the "substantially all" requirement. Thus, although it did not purport to do so, the IRS appears to have relied on some notion of the step transaction doctrine in reaching its conclusion, effectively looking at the debt immediately before and after the deemed transactions and ignoring the interim steps.

b. New Obligor of Nonrecourse Debt. The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification. See Treas. Reg. § 1.1001-3(e)(4)(ii).

c. Change in Co-Obligor. The addition or deletion of a co-obligor is significant if it results in a "change in payment expectations" (see change in priority discussion above). See Treas. Reg. § 1.1001-3(e)(4)(iii); see also Ltr. Rul. 199904017, discussed in Example 2 above; Ltr. Rul. 200047046 (November 22, 2000) (no change in payment expectations where parent holding company continued to be liable after release of subsidiary). If the addition or deletion is part of a transaction or series of related transactions that results in the substitution of a new obligor, the transaction will be treated as a substitution of an obligor and not as the addition or deletion of an obligor. Query, what happens where you add an obligor as step one and where you delete the original obligor as an independent subsequent step? Under the general operating rules, an alteration of a lesser degree than specified as significant in the final regulation is not a significant modification. Arguably, the deletion of the original obligor is a modification of lesser degree and should not be collapsed. If the above two steps are tested under the cumulative effect rule and not the lesser degree rule, there probably has been a significant modification. Will the steps be collapsed and viewed as a substitution of the second obligor for the first?

d. Bankruptcy Irrelevant. The final regulation makes clear that the filing of a petition in a bankruptcy case, or the commencement of receivership, foreclosure, or similar proceeding in a federal or state court, does not by itself result in the substitution of a new obligor. Treas. Reg. § 1.1001-3(e)(4)(i)(G). Thus, the bankruptcy estate is not considered a new obligor for this purpose.

[iii] Change in Obligor In Connection With Acquisition of a Portion of the Obligor's Assets

a. Prior Law. Under prior law, the IRS had issued at least two private letter rulings dealing with assumptions of debt between parent and subsidiary in connection with the acquisition of property. In Letter Ruling 8047021 (August 26, 1980), a corporation assumed the debt of its newly acquired subsidiary when it acquired the subsidiary. The assumption was held not to result in a taxable event. In Letter Ruling 7925065 (March 22, 1979), on the other hand, the IRS ruled that where a corporation divided its assets and liabilities into two new corporations in a "split-up" transaction, a taxable event resulted with respect to the debt. Because of the split-up, this transaction had more of the flavor of a novation. These rulings appear consistent with the subsequent authorities issued after the above rulings but before the final regulation, including the Cottage Savings case.

Upon the enactment of Section 1274(c)(4) (discussed below), it was unclear to what extent, if at all, such provision supplanted these authorities. As discussed below, Treasury and the IRS in the final regulation apply Section 1274(c)(4) only for purposes of the OID rules and not for Section 1001 exchange purposes.

b. Final Regulation. Under the final regulation, there are no special rules for a change in obligor with respect to a transfer of less than substantially all of the obligor's assets in a non-Section 381(a) transaction. Thus, the basic rules discussed in the prior section would apply. Accordingly, if there is a novation which releases the original obligor and the debt is recourse debt, the substitution would be a significant modification (except where the debt is a tax exempt bond and the new obligor is related). In contrast, if the original obligor is not released, the addition of a co-obligor would be tested under the "change in payment expectations" test. If the debt was nonrecourse debt, the substitution would not be a significant modification.

c. Section 1274(c)(4) Exception For OID Purposes. Section 1274(c)(4) provides that if a transferee of property assumes (or acquires the property subject to) an existing debt instrument, the assumption (or acquisition) shall not be taken into account in determining whether Section 483 or 1274 applies to such debt instrument, unless "the terms and conditions of such debt instrument are modified (or the nature of the transaction is changed) in connection with the assumption (or acquisition)."

In effect, Section 1274(c)(4) appears to permit the substitution of obligors in connection with the transfer of property. However, commentators have questioned whether the broad application of Section 1274(c)(4) was intended where there was a novation or substitution of collateral in connection with the transfer of a portion of the obligor's assets. See Henderson & Goldring, at § 402.5.

Example 6 of Treasury Regulation § 1.1001-3(g) makes clear that Section 1274(c)(4) is applied independently of the debt modification rules of the regulation and only applies to prevent a reissuance for OID purposes.

d. Example — Assignment Clause: Pursuant to an assignment clause in the original recourse debt, the mortgagor can assign the debt instrument (together with the underlying mortgage) with the consent of the lender, which cannot be unreasonably withheld. Is the substitution of obligor a significant modification?

Under the final regulation, the assignment would be a modification even though pursuant to the original terms of the instrument because it requires the consent of the lender. See § 1.01[2][c][i][c]. Whether the assignment is a significant modification depends on whether the original obligor is released. If he is, then it is. And, if he is not, then the substitution would be tested under the "change in payment expectations" test.

This represents one of the significant changes from the proposed regulation for residential mortgage lenders. Under the proposed regulation, a substitution under an original assignment clause would not have been a "modification." See former Prop. Treas. Reg. § 1.1001-3(d) (Example 6).

[i] Relevance of Voluntary or Involuntary Exchange

Historically, several courts had mentioned the voluntariness of a modification in determining whether a taxable event occurred. See, e.g., Mutual Loan and Savings Co. v. Comm'r, 8 T.C.M. (CCH) 203 (1949), rev'd, 184 F.2d 161 (5th Cir. 1950); West Missouri Power Co. v. Comm'r, 18 T.C. 105 (1952), acq. 1952-2 C.B. 3; C.M. Hall Lamp Co. v. United States, 97 F. Supp. 481 (E.D. Mich. 1951), rev'd on other grounds, 201 F.2d 465 (6th Cir. 1953); Newberry v. Comm'r, 4 T.C.M. (CCH) 576 (1945). Voluntariness for this purpose appeared to relate to the borrower's financial health rather than to the consensual nature of the arrangement. See, e.g., Gen. Couns. Mem. 37002 (February 10, 1977) (changes in terms not likely to be considered involuntary unless debt is in default). Although the IRS appeared not to give much weight to the voluntariness of a change in terms, it had stated that, as a policy matter, it would not litigate an involuntary change in terms, except where "the bonds were acquired after [a] default in contemplation of realizing a gain from the change in terms." Id. at n.10.

The final regulation makes no distinction between voluntary and involuntary changes. However, they do make clear that (i) the filing of a bankruptcy case, or the commencement of a receivership, foreclosure or similar proceeding in a federal or state court, does not result in the substitution of a new obligor, (ii) the duration of the bankruptcy case or similar proceeding is a permitted forbearance under the Temporary Forbearance Rule, and (iii) any changes made pursuant to a confirmed plan of reorganization in such case or proceeding is not a modification until the plan is effective. See Treas. Reg. § 1.1001-3(c)(4)(ii), (c)(6)(iii), (e)(4)(i)(E).

[j] Irrelevance of Differing Market Value

In the past, the IRS had stated that the mere fact that the new debt had a different market value than the old debt was not a material factor in determining whether there had been an exchange; rather, one should focus on the changes in terms alone. See Rev. Rul. 81-169, 1981-1 C.B. 429; Gen. Couns. Mem. 37884 (March 19, 1979); Gen. Couns. Mem. 37002 (February 10, 1977). This makes sense as the debt's value will reflect not only the debt's terms but also the financial condition of the company before and after the change. Thus, changes in market value would not be a reliable guide to the materiality of the modifications.

The final regulation represents a dramatic change in this regard in that changes in value emanating from the modification would appear to be a significant fact or circumstance that would be taken into account under the general "economic significance" standard.

[k] Timing of Changes

[i] Prior Law

Under prior law, an agreed change became effective at the time the issuer and the holder entered into the agreement even if the change had a delayed effective date. Thus, in Revenue Ruling 87-19, 1987-1 C.B. 249, the waiver of a future increase in interest rate resulted in a deemed exchange at the time of the waiver.

[ii] Final Regulation

Treasury Regulation § 1.1001-3(c)(6) is consistent with prior law and provides, in general, that the date of the modification will be the date that the issuer and the holder enter into the agreement to modify the terms of the debt.

a. Closing Condition Exception. If the parties condition a change in the term of a debt instrument on reasonable closing conditions (such as shareholder, regulatory, or senior creditor approval, or additional financing), the modification occurs on the closing date of the agreement. If the agreement does not close, no modification occurs. Treas. Reg. § 1.1001-3(c)(6)(ii).

b. Bankruptcy Exception. Any change to a debt instrument pursuant to a confirmed plan of reorganization in a bankruptcy case or similar proceeding is not a modification until the plan is effective. Treas. Reg. § 1.1001-3(c)(6)(iii).

[l] Change Pursuant to Original Terms

As discussed above at § 1.01[3][f][iii], a change that automatically occurs pursuant to the original terms of an instrument is not considered a modification either under existing law or under the final regulation, with certain limited exceptions under the final regulation discussed above at § 1.01[2][c][i].

For examples of prior law, see Rev. Rul. 57-535, 1957-2 C.B. 513 (no "exchange" occurred upon conversion of nonmarketable treasury bonds into marketable treasury notes pursuant to a right contained in the original treasury bonds); Rev. Rul. 72-265, 1972-1 C.B. 222 (no gain or loss "realized" upon a holder's exercise of its right to convert convertible debentures into stock of the same corporation).

[m] Other Changes Under Final Regulation

[i] Change in Accounting or Financial Covenants

A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification. Treas. Reg. § 1.1001-3(e)(6).

[ii] Turning Debt into Equity

Under the final regulation, any change in the terms of an instrument that causes the instrument not to be debt for federal income tax purposes is automatically a significant modification, even if it occurs under the original terms of the instrument (other than a conversion under the original terms of the instrument into stock of the issuer, at least where the conversion occurs upon the exercise of a holder option). Treas. Reg. § 1.1001-3(e)(5)(i), -3(c)(2)(ii).

Many commentators questioned when the modification of a debt instrument would require a determination of whether the modified instrument was debt or equity. They also were concerned that a deterioration in the financial condition of the issuer between the original issue and modification date would trigger equity treatment. In response to these concerns, the final regulation originally provided that:

> For purposes of this paragraph (e)(5)(i) [which provides that a change that turns debt into non-debt is a significant modification], any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

This is referred to below as the "deterioration" exception.

a. Interpreting the Deterioration Exception. Literally read, the "deterioration" exception quoted above only applied for purposes of whether a change was a significant modification; it did not, by its terms, address the age old question of whether the deemed reissuance of a debt that has undergone a significant modification should be treated as equity for federal income tax purposes due to the obligor's deteriorated financial condition.

However, at the ABA annual meeting in August 1996, Thomas J. Kelly, the principal drafter of the final regulation, stated that the IRS intended to apply the language broadly to encompass the post-reissuance debt/equity analysis as well. See, e.g., 96 Tax Notes Today 164-2 (August 21, 1996); Daily Tax Report No. 156, at G-1 (August 13, 1996). Cf. Field Service Advice 199910009 (December 2, 1998) (involved characterization of debt as "stock" under Section 382; IRS held that, when debt was modified to make it more likely it could be collected, the mere fact that the debtor did not have enough assets to pay the debt in full at that time did not mean that the debt should be treated as "stock"). Nevertheless, practitioners had been cautious in relying on such statements and in advising clients.

Clarifying Regulations. In response to this uncertainty, on June 3, 2010, Treasury and the IRS released proposed modifications to the regulation, REG-106750-10, 75 Fed. Reg. 31736, which were finalized on January 6, 2011 in substantially the same form. T.D. 9513, 2011 TNT 5-7. The modifications added a new Treasury Regulation § 1.1001-3(f)(7). Under the new regulation, the determination of whether a modified debt instrument is recharacterized as an instrument or property right that is not debt generally takes into account all of the factors relevant to such a determination. Importantly though, the new regulation provides a safe harbor "clarifying" that, except if there is a substitution of a new obligor or the addition or deletion of a co-obligor:

> in making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account. For example, any decrease in the fair market value of a debt instrument (whether or not the debt instrument is publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument.

Unlike the original regulation, this safe harbor is not limited to determinations of whether there is a significant modification; it applies even to the determination of the tax classification of a significantly modified instrument.

According to the preamble to the proposed regulation, if a publicly traded debt instrument is significantly modified and there is an increase in the yield in the new debt instrument as a result of a lower issue price (determined by reference to the lower fair market value of the debt instrument), the increased yield attributable to the deterioration of the financial condition of the issuer will be ignored in determining whether the instrument is not debt. However, any increase in yield resulting from general increases in interest rates is taken into account. Thus, taxpayers may be placed in the awkward position of having to substantiate the portion of the yield increase attributable to general increases in interest rates and the portion attributable to the deterioration in the issuer's financial condition.

As indicated above, the safe harbor does not apply if there is a substitution of a new obligor or if there is an addition or deletion of a co-obligor. The scope of this exception is not entirely clear. For example, would a reduction in the fair market value of the property securing a nonrecourse loan be taken into account in determining whether the debt continues to be respected as debt if there is a change in the obligor of the nonrecourse debt? Cf. Treas. Reg. § 1.1001-3(e)(4)(ii) (change in obligor on a nonrecourse debt instrument is not a significant modification). Further, as discussed in § 1.01[2][h][ii][a], recent letter rulings treat a conversion of a corporation into an LLC or a change in the tax classification of an entity as a change in obligor. Would the deterioration exception apply in such cases? Literally read, it does not.

What if there is a change in obligor that is not treated as a significant modification, and thereafter the financial condition of the new obligor deteriorates – could any subsequent change in the terms of such instrument, no matter how inconsequential, potentially convert the debt instrument into equity? In the latter regard, note that all modifications are generally aggregated for purposes of considering whether collectively they are significant.

Taxpayers are permitted to rely on the new regulation even for debt modifications occurring prior to the date that the regulation was finalized.

See American Bar Association, ABA Tax Section Recommendations for 2013-2014 Treasury-IRS Guidance Priority List, July 8, 2013, reprinted at 2013 TNT 131-15 (July 9, 2013) (requesting guidance on application of Treasury Regulation § 1.1001-3(f)(7)(ii), relating to deterioration in financial condition of the obligor in the case of Section 368(a)(1)(F) reorganizations, check-the-box elections, and other circumstances where there is a change in either the legal form of the obligor or the tax classification of the obligor).

[iii] Modifications Through Indirect Transactions

The final regulation "also applies to modifications of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties." Treas. Reg. § 1.1001-3(a)(1). Thus, one must be careful in entering into any arrangement affecting the debt with a related party of the issuer as such arrangement may be considered to be a modification of the debt. See also 96 Tax Notes Today 164-2 (August 21, 1996) (reporting remarks of Thomas J. Kelly, the principal drafter of the final regulation).

Example: Subsidiary is a wholly-owned subsidiary of Parent. The holder of Subsidiary's principal debt enters into an arrangement with Parent pursuant to which Parent acquires an option to purchase the debt at a significant discount. Under prior law, the entering into the option agreement with Parent would likely be respected as an independent transaction separate and apart from the debt instrument, and thus not a modification of Subsidiary's debt (despite the fact that, upon exercise of the option, Section 108(e)(4) would treat Parent's acquisition as a deemed acquisition of the debt by Subsidiary for cancellation of debt purposes). However, under the final regulation, the entering into the option agreement likely would be an indirect modification of the debt and, given the discounted option price, probably considered a "significant" modification. See earlier discussion of put/call provisions.

[n] Tax-Exempt Obligations

In general, deemed reissuances of tax-exempt obligations under Sections 103 and 140-150 have been governed by the same criteria as taxable obligations. The notable exception is so-called "tender bonds," the rules for which are set forth in Notice 88-130, 1988-2 C.B. 543 and Notice 2008-88, 2008-42 I.R.B. 933 (October 1, 2008), amending and supplementing Notice 2008-41, 2008-15 I.R.B. 742 (March 25, 2008), superseding Notice 2008-27, 2008-10 I.R.B. 543 (February 19, 2008), amended by Notice 2010-7, 2919-3 I.R.B. 296 (December 22, 2009). See Henry, Reissuance Revisited, 42 Tax Notes 91 (January 2, 1989). Under the final regulation, the IRS has continued to exclude "tender bonds" from the debt modification rules and will determine whether "tender bonds" have been reissued based on the rules set forth in Notice 88-130, Notice 2008-41 and Notice 2008-88. However, the final regulation will be relevant to the extent that Notice 88-130, Notice 2008-41 and Notice 2008-88 defer to the general debt modification rules under Section 1001.

The IRS rejected commentators' pleas to exclude tax-exempt bonds from the application of the final regulation altogether. However, the final regulation contains a number of special rules for tax-exempt bonds. See, e.g., Treas. Reg. § 1.1001-3(e)(4)(i)(D) (substitution of obligor is not a significant modification if the new obligor is a related entity to the original obligor and the collateral securing the instrument continues to include the original collateral); Treas. Reg. § 1.1001-3(e)(5)(ii)(B) (defeasance of tax-exempt bond is not a significant modification provided certain conditions are met); Treas. Reg. § 1.1001-3(f)(6) (prescribing special rules for conduit loans and clarifying that the obligor is the issuing entity, although transactions with the borrower of a conduit loan may be an indirect modification).

In a Chief Counsel Advice Memorandum, the IRS considered whether a taxable direct pay Build America Bond issued by a state or local government is a "tax-exempt bond" for purposes of the debt modification rules, since it satisfied the criteria of Section 103 – see Treas. Reg. § 1.1001-3(f)(5)(iii) (defining a "tax exempt bond" in reference to section 103(a) – but was rendered taxable by reason of Section 54AA(f)(1)). The IRS concluded that it's not. AM 2014-009 (December 8, 2014), *reprinted at* 2014 TNT 245-29. As a result, a legal defeasance of the bonds resulted in a significant modification and deemed reissuance, with the effect that the bond could no longer qualify as a Build America Bond since the authority to issue such bonds had expired.

[o] Irrelevance of Installment Sale Authorities

Section 453B provides that where an installment obligation for which the holder has elected the installment method of taxation is "satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of," gain or loss shall result to the extent of the difference between the basis of the obligation and the amount realized. The IRS has been liberal, given the policy considerations, in ruling that a disposition by a holder does not occur under this provision when: the interest rate is increased and the maturity date deferred; the principal amount is reduced; a single note is split in two; a new obligor is added or substituted; or the security of the note is changed. See Henderson & Goldring, at § 402.14. Accordingly, it is not surprising that the IRS has said that the installment sale disposition authorities should not be considered precedent for purposes of applying Section 1001. See Preamble to Treas. Reg. § 1.1001-3, T.D. 8675; Gen. Couns. Mem. 39225 (April 27, 1984); see also Gen. Couns. Mem. 37889 (March 20, 1979).

Thus, modifications that result in a deemed issuance of a new debt under Treasury Regulation § 1.1001-3 generally do not result in a "disposition" of the original debt under Section 453B for installment reporting purposes. Accordingly, no gain or loss generally will be recognized as a result of the deemed issuance, even though the new debt has an issue price in excess of the basis of the old debt. However, the deemed issuance of a new debt may have other consequences under Section 453, as well as other provisions of the Code. For example, the deemed issuance may result in a redetermination of original issue discount and issue price under the imputed interest/OID provisions of the Code. In the event that the issue price of the new debt is less than the adjusted issue price of the old debt, the holder would have to recompute its gross profit and contract price under Treasury Regulation § 15A.453-1(b)(2). See also Rev. Rul. 72-570, 1972-2 C.B. 241. In addition, the deemed issuance of a new debt may result in a loss of grandfathering protection under other provisions of the Code and Treasury Regulations.

To date, installment sale disposition cases have dealt only with the tax treatment of the holder of the note, leaving many issuers to wonder to what extent (if any) such disposition authorities are relevant to their side of the transaction. Given that Section 453B focuses solely on the holder, it would be logical to expect that such authorities would have no effect on the issuer's consequences. Nevertheless, in absence of authority, issuers may be able to take the position on this issue that proves most advantageous to them in a particular case.

§ 1.02 CONSEQUENCES OF A DEEMED EXCHANGE

As discussed below, the potential federal income tax consequences of a deemed exchange of an existing debt for "new" debt are, in general, the same as arise in connection with the issuance of any new debt and in any debt-for-debt exchange. In the context of a restructuring, however, certain problems may be exacerbated. For example, the addition of a "pay-in-kind" option to the payment of interest, or making all or part of the interest contingent, may raise concerns about the new debt's status as debt or equity.

For other consequences of a deemed exchange, see, e.g., Bacon and Adrion, Taxable Events: The Aftermath of Cottage Savings (Part I), 93 TNT 118-39 (June 4, 1993).

[1] Creditor Recognition of Gain or Loss

One obvious consequence of a deemed exchange to a creditor is the potential for gain or loss. This risk is reduced in the corporate context, where the possibility for "tax-free" recapitalization treatment exists. In addition, where a deemed exchange occurs by election under Revenue Procedure 2001-21, modifying and superseding Revenue Procedure 99-18, a creditor is accorded "tax-free" treatment regardless of whether the issuer of the debt was a corporation. The provisions of the Revenue Procedure are discussed above at § 1.01[2][c][iii][b].

[a] Qualification as a Corporate Recapitalization: Status of Debt as a "Security"

An exchange of new debt for old debt constitutes a tax-free recapitalization exchange — with gain recognition to the extent of any boot received, and no loss recognition — where each of the old and the new debt constitute a corporate "security" for purposes of Sections 368 and 354. This rule applies to deemed as well as actual exchanges.

When a debt is exchanged either actually or constructively, the new debt must be analyzed to determine whether it constitutes a security. The old debt's security status does not automatically carry over to the new debt.

In general, the most important, though not sole, factor in determining whether a debt is a security is its original maturity. Instruments with original weighted average maturities of 10 years or more usually will be considered securities while instruments with original weighted average maturities of 5 years or less usually will not. The status of instruments which have an original maturity of between 5 and 10 years is unclear. The "original" maturity of a new debt resulting from a deemed exchange will be the weighted average of its remaining term beginning on the day after the date of the exchange.

In Revenue Ruling 2004-78, 2004-2 C.B. 108, the IRS ruled that, based on the policies that underlie Section 354 and the reorganization provisions generally, if "debt instruments of [an] Acquiring Corporation . . . bear the same terms (other than interest rate) as the securities of the Target Corporation, the debt instruments of the Acquiring Corporation represent a continuation of the security holder's investment in the Target Corporation in substantially the same form" and "are securities within the meaning of § 354." In the ruling, a corporation issued notes with a twelve-year term, which were treated as securities. The corporation was merged into another corporation in a qualifying "A" reorganization when there were only two years remaining to maturity of the notes. In the merger, the notes were exchanged for new notes of the acquiring corporation with substantially the same terms as the old notes (including the maturity date), except that the interest rate on the notes was modified to an extent that caused an exchange under Treasury Regulation § 1.1001-3. The IRS held that the exchange of the new notes for the old notes qualified as a tax-free exchange of securities. Presumably, the same would hold true had the transaction been a recapitalization exchange, rather an "A" reorganization. Query, however, whether the old note would be considered "substantially in the same form," and thus automatically still securities, if instead of a change in interest rate the two notes differed in some other respect. What if the term of the new notes were less than two years? Also, would the same rational preclude a modified debt instrument from being treated as a security if the old debt instrument was not a security? For a discussion of these and other questions, see Friedman, Debt Exchanges After Rev. Rul. 2004-78, 105 Tax Notes 979 (November 15, 2004); Sweet, Debt-Exchange Ruling Leaves Questions Unanswered, 104 Tax Notes 623 (August 9, 2004).

[b] Treatment of Other Debt Exchanges

[i] Potential for "Exchange" Gain

Even if the adjusted principal amount of the debt remains constant for tax purposes, a creditor still may recognize gain where it has previously written down the debt for tax purposes or acquired the debt at a discount, so that it has a low tax basis in the debt. Where the debt is not publicly traded such that, under Section 1274, the fair market value of the new debt may continue to be substantially less than the issue price of the debt, the potential for "phantom" income is great.

The installment method of accounting may provide some relief in particular cases. In addition, in appropriate circumstances, the "doctrine of uncollectability" may arguably provide some relief. Under case law, income is not accruable where the debtor is insolvent and real doubt exists as to the collectability of the related obligation. Accordingly, in the case of an insolvent debtor, a creditor may be able to compute gain or loss on an exchange by reducing the new debt's principal amount by the amount likely to be uncollectible (rather than by using the new debt's adjusted principal amount). As a practical matter, however, uncollectability may be difficult to establish where an underlying premise of the restructuring is the expectation or hope that the restructured obligation would ultimately be paid in full. See Henderson & Goldring, at § 403.2.1; Pollack, Goldring and Gelbfish, Uncollectible OID: To Accrue or Not to Accrue? 84 J. Tax'n 157 (1996).

Moreover, regulations under Section 166 provide additional relief. See T.D. 8763, 98 TNT 19-7 (January 7, 2011). Section 166 permits a partial bad debt deduction – other than with respect to corporate debt that is subject to the wholly-worthless security rule of Section 165(g) – only in the year, and only to the extent, that the taxpayer makes a partial charge-off for book accounting purposes. This left taxpayers in the situation where, because the book charge-off is not reversed upon the occurrence of a deemed exchange, the taxpayer could not offset any resulting income with a further partial bad debt deduction. Treasury Regulation § 1.166-3 rectifies this situation by generally deeming a book charge-off to occur upon a deemed exchange of the previously charged-off debt, not to exceed the lesser of (i) any gain recognized or (ii) the amount by which the tax basis of the debt exceeds the higher of the debt's fair market value or its remaining book value (reduced for any specific allowance for loan losses).

[ii] Potential for "Exchange" Loss

Conversely, a creditor may recognize a loss where, for example, the "issue price" of the new debt is determined based on its fair market value and the creditor has a historically high tax basis. In addition, where there is unpaid interest, the allocation rules mentioned above at § 1.01[3][a][iv] may allocate a portion of the "new" debt to the accrued interest, creating ordinary income and exacerbating any loss (which loss may be a capital loss). This similarly would be of concern in the gain context where the interest would be taxed at ordinary income rates but the gain potentially would be taxed at capital gain rates.

[c] Disposition of "Old" Installment Note

Aside from "exchange" gain, a holder of an installment note may be deemed to have made a "disposition" of such note for purposes of Section 453B, thereby triggering a current recognition of all or part of the deferred gain. As discussed at § 1.01[3][o], above, however, it generally takes more to trigger a Section 453B "disposition" than a Section 1001 exchange.

[2] Compensation Income

An exchange of an obligation issued by an employee or other service provider for the purchase of property (e.g., employer stock) in connection with the performance of services can result in compensation income to the service provider.

The regulations under Section 83 provide that, if an employee or other service provider pays for property with a note and the obligation is subsequently cancelled, forgiven or satisfied for an amount less than the amount of such obligation, the amount that is not, in fact, paid shall be includible in the gross income of the service provider. Treas. Reg. § 1.83-4(c). In Revenue Ruling 2004-37, 2004-11 I.R.B. 583, the IRS considered whether a reduction in the stated principal amount of a recourse note issued by an employee to his employer in exercise of a stock option was compensation income or, instead, a purchase price adjustment under the COD rules of Section 108(e)(5) in circumstances where the value of the stock had declined. Observing that not every debt that is cancelled results in a debtor realizing "discharge of indebtedness" income to which the provisions of Section 108 can apply, the IRS concluded that the reduction in the stated principal amount generally results in compensation income. Moreover, the IRS stated that, "[w]hether the reduction of the stated principal amount of the Note is a cancellation, forgiveness, or satisfaction for an amount less than the amount of the Note, and, thus, whether an amount is includible in income under § 1.83-4(c), is determined in accordance with § 1.1001-3." Interestingly, this would suggest that a reduction in principal amount that is insufficient to result in a deemed exchange under Section 1001 does not result in current compensation income under Section 83.

[3] Creation of OID or Imputed Interest

As indicated above, the new debt that results from a material modification will have a new "issue price" for federal income tax purposes, potentially resulting in OID under Section 1272 et seq. or imputed interest under Section 483, which apply where the OID rules of Section 1273 (governing old or new debt that is publicly traded) and 1274 (governing debt that is not publicly traded) do not. See also Section 1281 et seq. (for short-term obligations); Rev. Proc. 2001-21, 2001-1 C.B. 742, modifying and superseding Rev. Proc. 99-18, 1999-1 C.B. 736, discussed at § 1.01[2][c][iii][b] above (permitting, under certain conditions, a deemed exchange election where a single class of new debt is substituted for multiple classes of old debt with only minor modification of the old debt, and addressing the OID treatment of the new debt).

[a] Section 1274 vs. Section 483

Section 1274(c)(3)(C) provides that Section 1274 does not apply – and thus Section 483 does apply – to sales or exchanges of property (including all sales and exchanges which are part of the same transaction or a series of related transactions) if the total payments do not exceed $250,000. The aggregation rule applicable in determining the $250,000 limit should be applied at the debtor rather than at the creditor level. The main difference between the imputed interest and OID rules is that imputed interest under Section 483 is not taxed (or deducted) until payments are due (for accrual basis taxpayers) or paid (for cash basis taxpayers), whereas OID is taxed (and generally deducted) each year as it accrues regardless of the taxpayer's method of accounting. See Section 1272; Treas. Reg. §§ 1.483-1(a)(2)(i) and (ii).

[b] Effect of the "High Yield Discount" Rules

In certain cases, the "high yield discount" rules of the Code may defer or disallow an issuer's OID deduction and, in the case of a corporate holder, cause a portion of its accrued OID to be treated as a dividend, rather than as interest income. See Sections 163(e)(5), (i). Upon a deemed exchange, the status of the debt as a "high yield discount obligation" must be retested, subject to a narrow refinancing exception described below.

[i] High Yield OID or PIK Debt

"High yield discount obligations" to which these rules apply are corporate obligations (other than S corporations) generally having a maturity of more than five years, a yield more than five percentage points above the applicable federal rate, and more than one year's worth of unpaid OID following the end of the fifth year.

If the yield is more than six percentage points above the applicable federal rate, the issuer's interest deduction for the excess portion of the interest is disallowed (rather than merely deferred); and, "solely" for purposes of the dividends received deduction, an equivalent portion of a corporate holder's interest would be treated as a dividend by the issuing company to the extent of available earnings and profits.

[ii] Transitional Refinancing Rule

The "high yield discount" rules will not apply to the deemed exchange of a pre-July 11, 1989 debt for new debt, where the terms of the new debt fit a narrow refinancing exception: namely, the maturity of the new debt cannot be later than the maturity of the old debt; the issue price of the new debt may not exceed that of the old debt; the stated redemption price at maturity of the new debt may not be greater than that of the old debt; and the interest payments required under the new debt before maturity must not be less than (or paid later than) the interest payments required by the old debt. Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7202(c)(2)(C).

[iii] Limited Administrative Relief

On August 8, 2009, in response to the worsening economy and the difficulties facing borrowers attempting to refinance short-term bridge loans, the IRS issued Revenue Procedure 2008-51, 2008-35 I.R.B. 562, to provide temporary relief from the "high yield discount" rules for certain refinancings. Pursuant to the Revenue Procedure, certain new debt that is issued in exchange for, and within 15 months of the issuance of, old debt that was issued pursuant to a financing commitment made before January 1, 2009 will not be subject to the "high yield discount" rules. The relief applies only if, among other things, both the old debt and the new debt would not have been subject to the "high yield discount" rules if the issue price of the debt were equal to the net cash proceeds actually received by the borrower when it issued the old debt. In addition, the "high yield discount" rules will not apply to a second refinancing if the second refinancing meets similar requirements.

[iv] Temporary Statutory Relief

The American Recovery and Reinvestment Act of 2009 added new Section 163(e)(5)(F), which temporarily suspended the application of the "high yield discount" rules. The suspension generally applied to new debt instruments issued between September 1, 2008 and December 31, 2009 in exchange for old debt instruments that were not subject to the "high yield discount" rules, if the new debt was issued by the same issuer or obligor as the old debt. The suspension did not apply to debt that provided for certain contingent interest described in Section 871(h)(4) (without regard to subparagraph (D) of that section). In addition, the suspension did not apply to debt issued to a related person within the meaning of Section 108(e)(4). Debt that qualified for the suspension also was not treated as being subject to these rules for purposes of determining whether new debt issued in respect of such debt qualified for the suspension.

Treasury was also granted authority to apply the suspension rules following December 31, 2009 if Treasury determined that application of the suspension was appropriate in light of the distressed conditions in the debt capital markets. In Notice 2010-11, 2010-4 I.R.B. 326 (December 24, 2009), the IRS extended the suspension for new debt instruments issued between January 1, 2010 and December 31, 2010. However, the IRS added two new conditions for the suspension under the Notice to apply. First, the issue price of the new debt instrument must be determined under Section 1273(b)(1), 1273(b)(2), 1273(b)(3), or 1274(b)(3), whichever is applicable, and the regulations thereunder. Thus, the suspensions generally would not apply to exchanges of non-publicly traded debt. Second, the suspension applied only if the new debt instrument would not otherwise be subject to the high yield discount rules if its issue price were increased by the amount of any COD income realized by the issuer upon the exchange.

[c] Deferral of OID Relating to Deferred COD income

The American Recovery and Reinvestment Act of 2009 added new Section 108(i), which allows a debtor to defer COD income in connection with certain reacquisitions of "applicable debt instruments" during 2009 and 2010 (see § 1.02[5][b], below). If a new debt instrument is issued in exchange for the old debt instrument (or is treated as being issued under Section 108(e)(4)) in connection with a "reacquisition" of the old debt instrument and the issuer makes an election to defer COD income, under Section 108(i)(2) all or a portion of any OID deductions with respect to the new debt instrument may be deferred as well. Similar rules will apply to the extent the proceeds of a debt instrument are used, directly or indirectly, to reacquire a debt instrument. In Revenue Procedure 2009-37, 2009-36 I.R.B. 309 (August 17, 2009), the IRS provided exclusive procedures for making an election under Section 108(i).

The amount of OID deductions with respect to the new debt instrument that is subject to deferral is the OID that (i) accrues before the five-taxable-year period during which the COD income with respect to the old debt instrument is includible (see § 1.02[5][b], below), and (ii) does not exceed the amount of the deferred COD income with respect to the old debt instrument. If the amount of OID that accrues with respect to the new debt instrument before such five-taxable-year period begins exceeds the amount of COD income, the OID deferral rule will apply to the OID that accrues first.

The OID deductions that are deferred will be allowed as a deduction ratably over the five-taxable-year period in which the deferred COD income will be included in income. Under Section 108(i)(5)(D), deferred OID will be accelerated upon certain events, such as the death of the taxpayer, the liquidation of substantially all of the taxpayer's assets or the sale, exchange or redemption of an interest in a partnership, S corporation or other pass through entity.

For a detailed discussion of the issues raised by Section 108(i), see New York State Bar Association, Report on the Cancellation of Indebtedness and AHYDO Rules of Section 108(i) and 163(e)(5)(F), April 27, 2009, reprinted at 2009 TNT 80-22 (April 27, 2009). Certain issues raised by the report of the New York State Bar Association were subsequently resolved by the issuance of Revenue Procedure 2009-37.

[4] Market Discount

A holder that acquires outstanding debt at a discount (i.e., below its "adjusted issue price") generally has what is called "market discount." Unlike OID, no portion of the accruing market discount is includible in the holder's income prior to a taxable disposition of the debt – including a taxable exchange of old debt for new debt – or until a repayment of the principal of the debt (absent an affirmative election by the holder). At such time, any gain recognized will be treated as interest income to the extent of the accrued market discount.

The market discount concept has no impact on the debtor. The debtor receives no deduction for the market discount taxed as interest income to the creditor.

[a] Conversion of Market Discount Into OID

In certain cases, a deemed exchange may have the effect of converting market discount into OID, as illustrated by the following example:

Example: Failco currently has outstanding $100 of publicly traded debt with an adjusted issue price of $80. A acquires the debt for $30. Thus, A has market discount of $50, no portion of which is currently includible in income. Shortly thereafter when the debt still has the same value, the interest rate on the debt is reduced sufficiently to result in a deemed exchange of the original debt for "new" debt. Accordingly, A is now deemed to hold new debt with an issue price, under

Section 1273, of $30 and with OID of $70. As a result, A's market discount has been converted into OID, which is includible in income as it accrues.

[b] Tax-Free Recapitalization

In the case of an exchange qualifying as a tax-free recapitalization, the Treasury Department has been expected for some time to promulgate regulations providing for the carryover of any accrued market discount that was not includible in income (either previously or upon the exchange). See Section 1276(c). Even without the promulgation of such regulations, however, it is likely that this rule would apply.

[c] Deemed Exchange under Revenue Procedure 2001-21

As discussed above at § 1.01[2][c][iii], a holder may, under certain conditions, elect to treat a substitution of new debt for old debt (that does not result in a material modification of the debt) as a deemed exchange where several classes of old debt are being consolidated. A holder who so elects recognizes no gain or loss and takes a carryover basis and holding period in the new debt. In general, the difference between the holder's tax basis and the stated redemption price at maturity of the new debt will be treated as market discount (if more than a de minimis amount) or bond premium, as the case may be. Because the stated redemption price at maturity of the new debt will equal or approximate the stated redemption price at maturity of the old debt (or else the substitution would itself have constituted a material modification), and as a condition for the election, the old debt cannot have more than de minimis amount of OID, the general effect will be to carry over any market discount or bond premium from the old debt. Any resulting market discount will be treated as "accrued" market discount to the extent there was any accrued market discount with respect to the old debt that was not included as ordinary income. See § 4.04 of Rev. Proc. 2001-21, 2001-1 C.B. 742, modifying and superseding Rev. Proc. 99-18, 1999-1 C.B. 736, modified by Rev. Proc. 2000-29, 2000-2 C.B. 113.

[5] Debtor COD Income or Premium Deduction

[a] Potential Recognition of COD Income or Premium Deduction

Of great concern for the debtor is the potential for COD income in a deemed exchange. In general, a debtor will recognize COD income to the extent the issue price of the new debt is less than the adjusted issue price of the old debt. See Sections 108(a), (e)(3), (e)(10); Treas. Reg. § 1.61-12; Rev. Rul. 77-437, 1977-2 C.B. 28. The requirement of current inclusion of COD is subject to several exceptions. The two principal exceptions apply to insolvent or bankrupt debtors. See also § 1.02[5][b], below, for a discussion of a temporary election to defer COD income.

It should be noted that a conversion of a debt instrument into equity pursuant to the terms of the debt instrument, while not considered a modification for purposes of Treasury Regulation § 1.1001-3, can nevertheless result in COD income to the issuer if the fair market value of the stock issued in the conversion is less than the adjusted issue price of the debt instrument. See T.A.M. 200606037 (October 27, 2005).

Where the situation is reversed – i.e., the issue price of the new debt exceeds the adjusted issue price of the old debt – the debtor generally will be entitled to an immediate deduction for retirement premium, unless the issue price of the new debt is determined under Section 1273(b)(4) or Section 1274, in which case the debtor will be entitled to amortize the retirement premium over the term of the new debt in the same manner as OID. See Treas. Reg. § 1.163-7(c). If the old debt was convertible into equity of the issuer or into equity of a corporation that is in control of, or controlled by, the issuer (in each case determined under Section 368(c)), Section 249 generally would disallow a premium deduction for amounts paid in excess of the adjusted issue price of the debt plus a normal call premium for nonconvertible debt.

Example — Ltr. Rul. 200742016 (June 21, 2007): An affiliate of a corporate debtor offered to issue new publicly traded debt of its own in exchange for the debtor's outstanding debt. Following the exchange, and in retirement of the old debt acquired by the affiliate, the debtor paid the affiliate the value of the newly-issued debt. Equating the transaction to an issuance of new debt by the affiliate for cash (particularly since the new debt had an issue price equal to its fair market value) followed by the debtor's redemption of the old debt for cash, the IRS ruled that the debtor was allowed a deduction for the excess of the issue price of the new debt over the adjusted issue price of the old debt. Interestingly, although the affiliate and the debtor were members of the same consolidated group, there was no discussion of the rules contained in Treasury Regulation § 1.1502-13(g) regarding outstanding debt becoming intercompany debt.

[b] Section 108(i) – Temporary Election to Defer COD Income in 2009 and 2010

The American Recovery and Reinvestment Act of 2009 added new Section 108(i), which allows a debtor to irrevocably elect to defer COD income in connection with a reacquisition of an "applicable debt instrument" during 2009 or 2010. An "applicable debt instrument" is a debt instrument issued by a C corporation, or by any other person in connection with that person's conduct of a trade or business. Among other things, a "reacquisition" of a debt instrument includes an acquisition of a debt instrument by the issuer or a person related to the issuer (determined under Section 108(e)(4)) in exchange for a new debt instrument.

If the election is made, COD income will be deferred and will be included ratably during the five-taxable-year period beginning with the fifth (if the reacquisition occurred during 2009) or fourth (if the reacquisition occurred during 2010) taxable year following the taxable year in which the reacquisition occurred. If an election is made to defer COD income that would otherwise have been excluded from income pursuant to the bankruptcy, insolvency, qualified farm indebtedness or qualified real property business indebtedness exclusions contained in Section 108(a)(1)(A)-(D), the rules of Section 108(i) will apply instead of the exclusion rules.

Any deferred COD income will be accelerated upon certain events, such as the death of the taxpayer, or the liquidation of substantially all of the taxpayer's assets. Special rules apply in the case of a debt instrument issued by a partnership, including that any election under Section 108(i) must be made by the partnership rather than each individual partner. For a detailed discussion of the issues raised by Section 108(i), see New York State Bar Association, Report on the Cancellation of Indebtedness and AHYDO Rules of Section 108(i) and 163(e)(5)(F), April 27, 2009, reprinted at 2009 TNT 80-22 (April 27, 2009). Certain issues raised by the report of the New York State Bar Association were subsequently resolved by the issuance of Revenue Procedure 2009-37.

[c] Information Return Requirement

The Omnibus Budget Reconciliation Act of 1993 added Section 6050P, which originally required the filing of information returns in the case of cancellations of debt of $600 or more by "applicable financial entities."

[i] Applicable Financial Entities

"Applicable financial entities" to which the filing requirements of Section 6050P apply include banks, savings institutions, credit unions, the FDIC, the Resolution Trust Corporation, the National Credit Union Administration and any other Federal executive agency (as defined in Section 6050M) and any corporation that is a direct or indirect subsidiary of a bank, savings institution or credit union if the corporation, as a result of the affiliation, is subject to supervision or examination by a state or federal agency responsible for regulating financial institutions.

In 1996, Section 6050P was amended to also apply to any other "applicable entity." See Omnibus Consolidated Rescissions and Appropriations Act of 1996, Pub. Law No. 104-134, § 31001(M)(2). An applicable entity means an executive, judicial or legislative agency (as defined in Section 3701(a)(4) of Title 31, United States Code) and an applicable financial entity.

In 1999, the definition of an "applicable financial entity" was expanded to include "any organization a significant trade or business of which is the lending of money" – such as finance companies and credit card companies whether or not affiliated with financial institutions. Ticket to Work and Work Incentives Improvement Act of 1999, H.R. CONF. REP. NO. 106-478, at 159 (1999). However, the effective date of the expanded definition was suspended pending the issuance of interpretive guidance. IRS Notice

2001-8, 2001-1 C.B. 374. In October 2004, the IRS issued Treasury Regulation § 1.6050P-2 to provide guidance as to when "a significant trade or business" of an organization is "the lending of money." Although this language is very broad, the regulation narrows the application of this provision consistent with the legislative history. Accordingly, the regulation provides, as a general matter, that, "if the principal trade or business of an organization is selling nonfinancial goods or providing nonfinancial services [e.g., a manufacturing or retail business] and if the organization extends credit to the purchasers of those goods or services in order to finance the purchases, then, . . . these extensions of credit are not a significant trade or business of lending money." Treas. Reg. § 1.6050P-2(c). This exception is not available, however, to a finance subsidiary of such a taxpayer. See T.D. 9160.

– Three safe harbor provisions are also provided in the regulations to cover small amounts of lending activity or the initial months of a new taxpayer. Treas. Reg. § 1.6050P-2(b). The regulation adds (i) a provision to the effect that lending money includes acquiring a loan (a provision so broad that it might be thought to include investment companies, which presumably was not intended), and (ii) a provision that treats an entity that is formed or availed by an entity to which Code §6050P applies, for the principal purpose of holding indebtedness acquired by that entity, as itself having a significant trade or business of lending money. Treas. Reg. § 1.6050P-2(e); Treas. Reg. § 1.6050P-1(e)(5). See Debt Buyers' Association v. Snow, 2006-1 U.S.T.C. ¶ 50,177 (D. D.C. 2006) (refusing to enjoin the application of the regulations to a company that acquired distressed loans, despite the company's argument that that the regulations were invalid as applied to non-originating holders that only acquire distressed loans).

[ii] Event Triggering Filing of Return

For purposes of this reporting requirement, a debt is considered discharged upon the occurrence of an identifiable event indicating that the debt will never have to be paid by the debtor, taking into account all facts and circumstances. An identifiable event includes, among others, the following:

- a discharge of debt under the federal bankruptcy laws;
- an agreement between the applicable financial entity and the debtor to discharge a debt at less than full consideration; and
- certain cancellations or extinguishments by operation of law that render the debt unenforceable (such as the expiration of the statute of limitations for collection of the indebtedness).

It appears that the second group of identifiable events—namely an agreement between an applicable entity and a debtor to discharge a debt—would include a significant modification to the terms of a debt instrument since, from a tax perspective, the original obligation is discharged in exchange for the modified obligation. Recent comments by the American Bar Association Section of Taxation indicate that they believe otherwise, at least where the significant modification does not involve a reduction in principal. The comments state that while "the Section 6050P Regulations currently do not treat a deemed exchange of debt obligations pursuant to section 1.1001-3 as an identifiable event requiring a Form 1099-C," such an exchange should be included as an identifiable event. They reasoned that there is no policy justification to exclude significant modifications because the creditor has to determine whether a significant modification has occurred (and if it has, the issue price of the new debt instrument) anyway in order to complete its own income tax return. See American Bar Association, Section of Taxation Comments on Guidance Concerning Information Reporting for Discharges of Indebtedness, June 24, 2013, reprinted at 2013 TNT 122-13 (June 25, 2013). In our view, the fact that from a policy perspective, a significant modification ought to be included as an identifiable event supports the reasonable interpretation of the regulation that it is in fact treated as an identifiable event.

A bookkeeping entry (such as a deduction for book or regulatory reporting purposes or a partial or full bad debt deduction for tax purposes) is not, in of itself, an identifiable event, but will be considered as one of the facts and circumstances in determining whether a discharge has occurred. See Treas. Reg. § 1.6050P-1(b)(2).

[6] Section 382

[a] COD Income and Section 382: Beware Midyear Change

Where the deemed exchange also involves the issuance to lenders or others of stock or options to acquire stock, a corporate debtor must also be concerned about Section 382 and the ability to use its net operating loss carryforwards against its COD income. Where an "ownership change" occurs midyear, any current year net income is generally allocated on a pro-rata basis between the prechange and postchange portions of the year, regardless of when in the year it is recognized. In such event, it is possible that a portion of any COD income recognized would be allocable to the postchange portion of the year and not fully offset by the debtor's prechange losses, subject to the following two principal exceptions.

The first is where the debtor is in a net "built-in" gain position immediately before the ownership change. In such event, the debtor can freely use its prechange losses against any built-in gains (including all or a portion of any COD income, see IRS Notice 2003-65, 2003-2 C.B. 747) recognized on or after the date of the ownership change (not to exceed in the aggregate the original net built-in gain). See, e.g., Section 382(h); Ltr. Rul. 9312006 (December 19, 1992).

The second is where the debtor elects to do an interim closing of its books as of the change date. In such a case, any income recognized on or before the date of the ownership change could be sheltered by the debtor's prechange losses. See Treas. Reg. § 1.382-6, providing for a general netting of current year losses and income, with certain exceptions. However, such netting of current year losses and income can result in the use of losses for the post-change portion of the current year prior to the use of earlier year pre-change losses (which pre-change losses would remain subject to the Section 382 limitation as to any future income). Thus, an interim closing of the books may not be a perfect solution in all cases.

[b] Section 382(l)(5): Qualifying as an "Old and Cold" Creditor

Under Section 382(l)(5), a corporate debtor that undergoes an ownership change pursuant to a confirmed plan in a bankruptcy (or similar) case may obtain favorable treatment under Section 382 if its preexisting shareholders and so-called "old and cold" creditors receive or retain 50% of the vote and value of the reorganized company's stock. For this purpose, an "old and cold" creditor is one that either (i) has held its debt since at least 18 months before the bankruptcy or (ii) holds debt incurred in the ordinary course of the debtor's business and has held the debt since its inception. A concern raised by many practitioners was whether a debtor's ability to take advantage of this rule would be adversely affected to the extent that debt which otherwise qualified as "old and cold" were materially modified in an attempted pre-bankruptcy workout within 18 months of the bankruptcy. Such concern was eliminated in March 1994, when favorable regulations were issued which also provided for elective retroactive relief.

Under Treasury Regulation § 1.382-9(d)(5)(iv), the holder of a new debt received in actual or constructive exchange for another debt would be treated (for purposes of the "old and cold" creditor rule) as holding the new debt for the period that it held the old debt. Similarly, the new debt would be treated as having arisen in the ordinary course of the trade or business of the debtor corporation if the old debt so arose.

[7] Section 163(l) — Denial of Interest Deductions on Debt Payable in Equity

A deemed exchange of corporate debt may also implicate the interest disallowance rules of Section 163(l). Enacted as part of the Taxpayer Relief Act of 1997, such section disallows any deduction for interest paid or accrued on corporate debt that is "payable in equity" of the issuer or a related party, within the meaning of Section 267(b) or 707(b). Such section generally applies to all debt issued after June 8, 1997. Subsequently, in the case of debt issued after October 3, 2004, such section was expanded to also apply to debt that is payable in equity held by the issuer or by a related party in any other person.

[a] Payable in Equity

A debt is treated as payable in equity of the issuer or a related party (or in addition, for debt issued after October 3, 2004, payable in equity of any other person that is held by the issuer or a related party) if a substantial amount of the principal or interest of the debt:

(1) is mandatorily payable in or convertible into such equity, or determined by reference to the value of such equity; or

(2) can be so paid, converted or determined at:

- the option of the issuer or a related party; or
- the option of the holder or a related party, but only if there is a "substantial certainty" the holder or related party will exercise such option; or

(3) is part of an arrangement "reasonably expected" to result in such a payment, conversion or determination.

[b] Ordinary Convertible Debt

The legislative history states that it is not expected that this provision will affect convertible debt where the conversion feature is significantly higher than the market price of the stock on the issue date of the debt. Conference Report, at p. 219. Presumably, such differential would be retested at the time of a subsequent deemed exchange, either for good or for bad, depending on whether or not the original debt was already subject to Section 163(l).

[c] Debt of Partnerships With Corporate Partners

The legislative history provides that Section 163(l) also applies to debt issued by a corporation "(or issued by a partnership to the extent of its corporate partners)." However, under Section 163(l)(7), the application of Section 163(l) to debt of a partnership with corporate partners (other than through the anti-abuse rule of Treasury Regulation § 1.701-2) requires regulations to be promulgated and is intended to address the use of partnerships by corporations to circumvent the statute.

[d] Contingent Interest

Interest that is contingent upon the value of the equity may be disallowed under Section 163(l) if a substantial amount of the interest (or, alternatively, a substantial amount of the principal) is tied to the equity. Unfortunately, neither the statute nor the legislative history define the term "substantial amount." Accordingly, if a grandfathered debt obligation (i.e., a debt issued before June 9, 1997) that contains an "equity kicker" is materially modified, the issuer may be disallowed a deduction for the accruing interest, even if the debt is not recharacterized as equity in its own right.

[e] Special Rules Applicable to Debt Payable in Equity of Unrelated Parties

If an issuer of debt is denied an interest deduction under Section 163(l) with respect to a debt because the debt is payable in equity of an unrelated party that is held by the issuer of the debt or a related party to the issuer, the holder of the equity will increase its basis in the equity of the unrelated party in the amount of the interest deduction denied. A dealer (as defined in section 475) will be permitted an interest deduction for debt payable with equity of an unrelated party if the dealer or related party holds the equity in its capacity as a dealer.

[8] Contingent Payment Debt Instruments

Frequent in real estate restructurings is the addition of a contingent interest feature, either in addition to or in lieu of the preexisting interest on the debt. Such interest may be contingent on operational cash flow or the appreciation in or sale of the underlying property. Similarly, a lender may attempt to recoup any current reductions in principal through a contingent payment mechanism or "equity" kicker. Such contingent payment provisions raise a host of tax issues.

[a] Debt Versus Equity

The threshold question is the proper characterization of the contingent payments: Namely, are the contingent payments properly considered a debt or equity interest? Or, alternatively, should the entire debt be treated as an equity interest? The considerations and consequences of equity treatment are discussed below under "Hybrid Debt Instruments."

[b] Final Contingent Payment Debt Regulations

After much anticipation, on June 11, 1996, the IRS issued T.D. 8674, 96 TNT 123-75 (June 24, 1996), which contains final OID regulations dealing with contingent payment debt instruments. The final regulations generally are effective for debt instruments issued on or after August 13, 1996. These regulations should be considered whenever the payment of principal or interest on a modified debt is contingent, assuming such debt is respected as debt for federal income tax purposes. For a further discussion of these regulations, see Asofsky, A Guide to the Tax Treatment of Contingent Payment Debt Instruments, 56 N.Y.U. Ann. Inst. Fed. Tax'n. Ch. 5 (1998).

[9] Hybrid Debt Instruments

As indicated above, the addition of a contingent payment or participation feature geared to the potential appreciation in the value of property securing the debt may raise difficult issues as to the debt/equity status of such interest, as well as the entire debt.

[a] Consequences of Recharacterization

As one would expect, the basic consequences of treating (in whole or in part) a participating mortgage as equity are: the loss of interest deductions; the loss of the loan from the nominal borrower's tax basis in the property (assuming the entire loan is recast); and the treatment of the lender as a direct or indirect owner of the property, both for purposes of profit and loss allocations with respect to the property/entity (other than where the equity interest is considered stock in a corporation) and for purposes of characterizing any repayments.

In the partnership/joint venture context, additional complexities can occur, for example, if the lender is a foreign lender or tax-exempt entity. In the case of a foreign lender, the principal issues include FIRPTA and the risk of being considered engaged in a U.S. trade or business. In the case of a tax-exempt entity, some portion of the project could be treated as "tax-exempt use" property and some portion of the lender's return could be treated as "unrelated business taxable income." In the corporate context, additional complexities could, for example, include deconsolidation issues in the case of a subsidiary, Section 382 ownership change issues and, in the case of a foreign lender, FIRPTA and earnings stripping concerns.

[b] Distinguishing Debt from Equity

We will not belabor the factors bearing on the traditional debt/equity analysis, but simply highlight the Treasury's broad (but unutilized) regulatory authority and the major cases bearing on participating mortgages.

[c] Lack of Regulations

Section 385 grants to the Treasury broad regulatory authority to classify corporate instruments as either debt or stock, and in 1989 was amended to allow Treasury to characterize hybrid debt instruments as part debt and part stock. The 1989 amendment represents a potential change in the Treasury's attitude toward hybrid instruments. In General Counsel Memorandum 36702 (April 12, 1976), the IRS rejected the bifurcation approach employed by the Second Circuit in the Farley Realty case (discussed below) in favor of an "all or nothing" approach based on the predominance of debt or equity characteristics. An "all or nothing" approach similarly was incorporated in the various sets of regulations issued under Section 385 in the early 1980s, but which were quickly withdrawn amidst severe criticism of various positions taken by the regulations.

The IRS departed from the all-or-nothing approach in proposed regulations released on April 4, 2016. Prop. Treas. Reg. § 1.385-1, 81 Fed. Reg. 20,911 (2016). The preamble to the proposed regulations notes how the all-or-nothing approach "frequently fails" to reflect economic substance and how the approach requires close calls to be either debt or equity. Preamble to Prop. Treas. Reg. §§ 1.385-1, 1.385-2, 1.385-3, 1.385-4. Accordingly, the proposed regulations would have permitted the IRS to characterize a purported debt instrument issued between 50%-related parties (by vote or by value) as part indebtedness and part stock (the "bifurcation rule"). Prop. Treas. Reg. § 1.385-1(d). Final and temporary regulations were released on October 13, 2016. Treas. Reg. § 1.385-1. The final regulations eliminate the bifurcation rule and instead reserve on the treatment of a debt instrument as part indebtedness and part stock. Treas. Reg. § 1.385-1(e).

Treas. Reg. § 1.1001-3(f)(7) does not mitigate the need to comply with the new debt-equity regulations. Treas. Reg. § 1.1001-3(f)(7) governs the determination of whether an alteration or modification results in an instrument or property right that is not debt. Generally, a deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of alteration or modification is not taken into account in making that determination. Treas. Reg. § 1.1001-3(f)(7)(ii)(A). The purpose of that provision, as explained in the preamble to the new debt-equity regulations, is to encourage workouts when debtors have difficulty repaying their obligations to *third-party* creditors. T.D. 9790. But in the case of related-party debt, the differing economic interests between a debtor and creditor may not be maintained. Thus, the new debt-equity regulations apply before Treas. Reg. § 1.1001-3(f)(7).

[d] Participating Mortgages

Only a limited number of cases have considered the debt/equity status of participating mortgages, although guidance may be drawn from other areas. The case most often cited in this area is the Second Circuit decision in Farley Realty, discussed below. The so-called "conventional wisdom" in structuring participating mortgages to avoid equity status has been to avoid the trouble spots identified in Farley Realty.

[i] Conventional Wisdom

The traditional tax planning in structuring a participating mortgage to stand up as debt has been, at a minimum, to have (i) a fixed maturity date at which time all rights to contingent payments are determined, including the lender's right to participate in the appreciation in property securing the debt and (ii) a meaningful cap on the participation bearing some relationship to interest rates.

[ii] Farley Realty Corporation v. Commissioner, 279 F.2d 701 (2d Cir. 1960)

This case involved a ten-year mortgage which bore stated interest at 15% for the first two years and 13% for the next eight years. In addition, the creditor was entitled to 50% of the appreciation in the real estate payable on sale. The participation feature had no maturity date and survived irrespective of repayments on the loan. Focusing on the indefinite duration of the payment right as well as the unlimited upside, the Second

Circuit bifurcated the loan and treated the participation right as an equity interest.

[iii] Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987)

The Hardman case reaches an opposite result to Farley Realty on similar facts. In Hardman, a shareholder sold a plot of land to a family corporation for her acquisition cost and the corporation's promise to pay her 1/3 of any net profit it derived from the property. The arrangement had neither a fixed maturity date nor a provision for fixed interest; the return to the seller was wholly dependent upon the profits of the buyer. Notwithstanding these apparent indicia of equity, the arrangement was held to be debt. The Ninth Circuit focused on enforceability (including the company's obligation to pay regardless of earnings), lack of subordination, lack of control over the company and intent of the parties.

[iv] Other Authorities

Historically, the IRS and the courts have expressed considerable liberality with respect to payments denominated as contingent interest. See, e.g., Rev. Rul. 83-51, 1983-1 C.B. 48 (payment on account of the appreciation feature in a shared appreciation residential mortgage was interest); see also Kena, Inc. v. Commissioner, 44 B.T.A. 217 (1941) (interest on the loan consisted solely of 80% of the borrower's annual profits from its stock trading business); Dzorback v. Collision, 195 F.2d 69 (3d Cir. 1952) (debtor-creditor relationship held to exist where lender was entitled to a 25% share of profits and the profits share ultimately was larger than the original amount lent); Stevens Brothers & Miller-Hutchinson Co., 24 T.C. 953 (1955) (to similar effect).

It has been strongly suggested, however, that the cited cases may no longer reflect good law, particularly when considered in light of the 1984 changes to Section 707(a) governing certain transactions between a partner and a partnership. The legislative history to that section indicates that a sharing in the net earnings of an enterprise that is subject to significant risk both as to amount and timing is indicative of partner status. See T. Gallagher, Financing Real Estate Projects § 404.2.1 n.8 (Little, Brown & Co., 1995 ed.).

[10] Mortgage-Backed Securities

[a] REMIC Issues

[i] Effect on "Qualified Mortgage" Status

In the case of a debt instrument that is a "qualified mortgage" held by a REMIC, a deemed reissuance would, with limited exceptions, result in the REMIC being treated as acquiring anew the modified debt instrument at the time of the deemed reissuance. See Example 3 at § 1.01[3][e][ii][b] above. The most important exception is for modifications occasioned by a default or a reasonably foreseeable default. Such modifications, even if rising to the level of a deemed reissuance under Section 1001, will not be treated as such for purposes of the REMIC rules. See Treas. Reg. § 1.860G-2(b). Revenue Procedure 2009-45, 2009-40 I.R.B. 471 (September 15, 2009) provides an exception for the modification of certain commercial mortgage loans where pre-modification there is a reasonable belief that there is a significant risk of default even if the loan is performing, if there is a reasonable belief that the modified loan presents a substantially reduced risk of default.

The regulations permit additional exceptions to exchange treatment for certain modifications that are very common for commercial loans. These include: (1) changes (releases, substitutions, additions or other changes) to the collateral or other credit enhancements to the mortgage loan; and (2) changes in the nature of the loan from recourse to nonrecourse. See Treas. Reg. § 1.860G-2(b)(3)(v), (vi).

In response to the recent economic downturn and the devastating effect it had upon homeowners and the mortgage market, the United States Government announced the Homeowner Affordability and Stability Plan, which includes the Home Affordable Modification Program ("HAMP"). HAMP is intended to help at-risk homeowners to modify their mortgages in order to avoid foreclosure. The criteria to qualify for a modification of a loan under HAMP may not meet the criteria set forth in Treasury Regulation § 1.860G-2(b) described above. Nevertheless, the IRS has announced that it will not challenge a REMIC's qualification on the grounds of the modification of a loan if such modification was undertaken pursuant to HAMP. See Rev. Proc. 2009-23, 2009-17 I.R.B. 884.

Where the default or HAMP safe harbors do not apply, the modified debt instrument would be a qualified mortgage only if it meets the REMIC requirements relating to "qualified replacement mortgages," whereunder a mortgage can be replaced within three months of the REMIC's "start-up" day (or, in the case of replacement of certain defective mortgages, within two years of such date) with what otherwise would have been a qualified mortgage if originally contributed on the start-up day of the REMIC. Failure of the reissued mortgage to be a good "qualified replacement mortgage" would result in the imposition of certain draconian taxes or, depending on the value of the reissued mortgage relative to the value of the REMIC's other assets, possibly in the loss of REMIC status.

One of the requirements for a "qualified mortgage" is that the loan be "principally secured by an interest in real property," which depends in part on the loan-to-value ratio. This ratio may be measured not only upon contribution to the REMIC, but alternatively as of the initial origination of the loan. If a deemed reissuance of a mortgage loan occurs (other than incident to a default or reasonably foreseeable default), the mortgage loan will be viewed as having been "originated" on the date the "modification" occurs, which may adversely affect the status of the mortgage in the wake of declining real estate values. See generally J. Peaslee & D. Nirenberg, Federal Income Taxation of Securitization Transactions and Related Topics, Chapters 6 and 7 (Frank J. Fabozzi Associates 4th ed., 2011) (hereinafter, Peaslee & Nirenberg). Even where one of the safe harbors applies, if the modification entails the release, substitution or addition or otherwise alters a significant amount of the collateral or other credit enhancement of the loan, the mortgage needs to meet the requirements of a "qualified mortgage." The regulations provide that the loan meets the criteria of being principally secured if either (i) the loan servicer has a reasonable belief that the fair market value of the real property interest securing the loan is equal to or exceeds 80% of the adjusted issue price of the loan after the modification, or (ii) the fair market value of the real estate interest after the modification equals or exceeds the fair market value of the real estate collateral before the modification.

This principally secured test prevented the modification of many specially serviced loans where the modification would have released some of the real estate collateral. For example, the following transactions would be problematic: (i) a release of an out parcel (via a unilateral option); (ii) a sale of a portion of the collateral on a defaulted loan; (iii) a sale of a single condo unit; or (iv) a partial condemnation of the property.

To address this issue, the IRS issued Revenue Procedure 2010-30, 2010-36 I.R.B. 316 (August 17, 2010), which provides limited exceptions to the "principally secured" test. These exceptions cover "grandfathered" transactions and "qualified pay-down" transactions. A grandfathered transaction is a transaction that occurs pursuant to the terms of a loan agreement and the loan was executed on or before December 6, 2010. A qualified pay-down transaction is one in which the lien release included a pay-down by the borrower and results in a reduction of the adjusted issue price of the loan by a "qualified amount." In addition to what is permitted by the regulation, under Revenue Procedure 2010-30, a qualified amount includes an amount that (i) is equal to or greater than the net proceeds of the sale, condemnation or issuance award, or (ii) is determined under the loan agreement and equals or exceeds the product of the adjusted issue price of the obligation at the time of the release and a fraction equal to the fair market value of the released interest at the time of origination divided by the aggregate fair market value of the real estate collateral at the time of origination.

[ii] Modification of a Regular Interest and Loss of REMIC Status

A material modification in the terms of a regular interest in a REMIC would result in the loss of the entity's status as a REMIC, because such regular interest no longer would have been issued on the start-up day.

[b] Fixed Investment Trusts

A deemed exchange of a debt instrument held by a "fixed investment trust" also may threaten the classification of the trust as a grantor trust. With very limited exceptions, a fixed investment trust that qualifies as a grantor trust may not reinvest proceeds derived from the sale or disposition of trust property. Although not certain, the deemed exchange of a debt instrument held by such a trust (other than incident to a default or imminent default) might be viewed as a prohibited reinvestment of the trust's assets, which could result in the reclassification of the fixed investment trust as an association taxable as a corporation. See generally Peaslee & Nirenberg, Chapter 4. With respect to a loan modified pursuant to HAMP, however, the IRS announced that it will not treat the deemed exchange as a prohibited reinvestment. See Rev. Proc. 2009-23, 2009-17 I.R.B. 884.

[11] Tax Shelter Regulations Informational Reporting Requirements

In early 2003, the IRS issued final regulations designed to help the IRS identify tax shelters by requiring the filing of certain informational returns. See Treas. Reg. §§ 1.6011-4, 301.6111-2, 301.6112-1. These regulations generally require disclosure by a taxpayer on its federal income tax return of certain types of transactions in which the taxpayer participated on or after January 1, 2003, including, among others:

- a transaction offered under "conditions of confidentiality" that restrict disclosure of the tax treatment and structure of the transaction;
- a transaction where the taxpayer has contractual protection for any fees paid if the intended tax consequences of the transaction are not sustained;
- certain transactions that result in the taxpayer claiming a loss in excess of specified thresholds; and
- a transaction in which the taxpayer's book-tax differences exceed $10 million (gross) in any taxable year (but, in the latter case, as discussed below, only for transactions required to be disclosed prior to January 6, 2006).

At the same time that the IRS issued these regulations, it also issued two Revenue Procedures which exempt certain transactions from the filing requirements, some of which apply specifically to bad debts, COD income, and debt for debt exchanges. See Rev. Proc. 2004-66, 2004-2 C.B. 966; Rev. Proc. 2004-67, 2004-2 C.B. 967, modifying and superseding Rev. Proc. 2003-24, 2003-1 C.B. 599; Rev. Proc. 2003-25, 2003-1 C.B.

601. Nevertheless, many debt modifications may still require disclosure under these regulations.

In IRS Notice 2006-6, 2006-1 C.B. 385 (January 6, 2006), the IRS announced that, effective for transactions not required to have been disclosed prior to January 6, 2006, it was removing the book-tax differences category from the list of transactions requiring disclosure.

[12] Loss of Grandfathered Status

As seen above, in the case of the "high yield discount," "market discount" and Section 163(l) interest disallowance rules of the Code, an existing debt's grandfathered status may be lost as a result of a material modification of the debt and the deemed issuance of new debt. Similarly, a "tax exempt" bond that is deemed reissued may no longer qualify for tax exempt status given intervening changes in law. Also, under the Foreign Account Tax Compliance Act ("FATCA"), certain obligations that undergo a significant modification after June 30, 2014 will lose their grandfathered status and payments on such obligations may be subject to FATCA withholding. These are only a few such examples. The effective date of the contingent payment debt regulations under Section 1275 provides another, and subsequent legislation may provide others.

[13] Tainted Debt Status Unaffected: Sections 279 and 514

A deemed exchange resulting from a significant modification of a debt instrument generally will have no effect for purposes of Section 279 or Section 514.

Section 279 disallows deductions for certain interest expense incurred by corporations on "corporate acquisition indebtedness," namely certain subordinated debt incurred in connection with the purchase of stock or assets of another corporation where the debt is convertible or issued together with warrants and certain debt/equity ratios are met. Under Section 279(d)(2), once an obligation is determined to be corporate acquisition indebtedness, subject to certain exceptions, it remains so treated for all subsequent taxable years. Further, Section 279(h) provides that:

> (1) Any extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness shall not be deemed to be the issuance of a new obligation.
>
> (2) Any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation which becomes liable for such obligation as guarantor, endorser, or indemnitor or which assumes liability for such obligation in any transaction.

Thus, even if there is a significant modification of the original terms of a debt instrument qualifying as corporate acquisition indebtedness (and therefore a refinancing), the new debt obligation will continue to be subject to the interest expense limitations of Section 279 (and vice versa). See G.C.M. 39618 (March 30, 1987).

Section 514 generally treats certain income earned with respect to debt-financed property as "unrelated business taxable income" and taxable to otherwise tax-exempt entities. Debt-financed property is property that, among other things, has "acquisition indebtedness," which is generally debt incurred to purchase or improve property or would not have been incurred but for the purchase or improvement of the property. Similar to corporate acquisition indebtedness discussed above, "an extension, renewal, or refinancing of an obligation evidencing a pre-existing indebtedness shall not be treated as the creation of a new indebtedness." Section 514(c)(3). Thus, here too, a deemed exchange generally will have no impact on the status of a debt instrument as acquisition indebtedness. Note that Treasury Regulation § 1.514(c)-1(c)(1) provides that an extension, renewal, or refinancing of an existing debt will be considered a continuation of the old debt <u>only to the extent</u> that the outstanding principal amount is not increased; any excess principal amount will be treated as a separate indebtedness for purposes of Section 514.