Key Federal Income Tax Considerations in Corporate Debt Restructurings

By Keith E. Villmow and Olga A. Loy

Keith Villmow and Olga Loy explain the key federal income tax considerations in corporate debt restructurings.

The aftermath of the high technology boom of the late 1990s has shifted the focus of many tax practitioners from investments and acquisitions to workouts and other forms of debt restructuring. As in any other transactional setting, tax considerations play a critical role in formulating such debt restructurings. This article is intended to provide a primer on the principal federal income tax considerations that must be addressed by a financially troubled corporation and its debt holders to avoid adding the insult of a substantial tax cost to the financial injuries that force the restructuring of the corporation's debt.

The generic term "debt restructuring" is used to describe any change to the terms of a corporation's indebtedness or any exchange of an existing debt instrument (DI) of a corporation for a new instrument (which may be debt, equity or other type of security, such as a stock purchase warrant). The federal income tax issues discussed in this article are limited to those that arise in the context of the restructuring of debt acquired on original issue from a stand-alone corporation (referred to in this article as the "issuer"). Accordingly, complexities created by, *e.g.*, market discount or amortizable bond premium on the issuer's outstanding debt or application of the consolidated return rules to the issuer, are not addressed in this article.

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I. Corporation's Issues

A. Deductibility of Unpaid Interest or Original Issue Discount (OID)

An issuer that uses the cash method of accounting generally is entitled to deduct interest when paid, while an issuer that uses the accrual method generally is entitled to deduct interest as it accrues.[1] However, an issuer generally is permitted to deduct OID as it accrues in the same amounts, and at the same times, as OID is included in the income of the instrument's holder, regardless of the issuer's regular method of accounting.[2]

The relevant Code provisions do not explicitly condition the deductibility of interest or OID on issuer's solvency. However, the IRS has asserted, sometimes successfully, that an insolvent issuer or issuer in bankruptcy may not deduct interest that is not paid as it comes due because the issuer's obligation to pay interest is contingent either (1) as a matter of law under the Bankruptcy Code or (2) as a practical matter by reason of its insolvency.[3] For example, in *In re Continental Vending Machine Corp.,* the court held that an accrual method issuer could not deduct interest on its outstanding unsecured debt as such interest accrued because either (1) under the Bankruptcy Code the debtor had no "actual liability for the interest until the happening of a future event" (payment of principal amount claimed by creditors) or (2) payment of the interest was improbable because of the debtor's insolvency.[4]

However, one recent and several older decisions provide a reasonable reporting position for deducting accruing interest on certain preferred classes of debt.[5] In *In re Dow Corning,*[6] the Bankruptcy Court held that an issuer in Chapter 11 could deduct post-petition interest expense with respect to its pre-petition bank debt and capital loans, but was not entitled to deduct interest on "trade debt" (defined in the case as trade payables, forward contracts, swaps and settlement agreements with certain creditors).[7] The Bankruptcy Court rejected the argument that Code Sec. 163 only permits interest to be deducted by solvent issuers because (1) various provisions of the Code indicate that Congress did not intend to make solvency a pre-condition to expense accrual, (2) measuring solvency is inherently difficult and (3) the burden and cost of enforcing solvency requirement may not be worthwhile. However, the Bankruptcy Court denied the issuer's deduction for interest on trade debt, concluding that the obligation to pay interest on such debt arose only by operation of Section 726(a)(5) of the Bankruptcy Code (which requires a bankruptcy estate to pay interest to creditors if the estate has more than enough money to pay all priority claims) and thus such debt was not fixed for purposes of Code Sec. 163.

Accrued but unpaid interest not deducted as a result of the rules described in the preceding paragraph may of course be deducted if it is paid at a later date. If the debt on which such interest accrued is settled at a discount, the amount of the issuer's deduction depends on the portion of the payment that is allocated to accrued but unpaid interest.[8] Past case law suggested that where debt is settled for an amount equal to or less than the principal of the debt, no portion of the payment should be allocated to accrued but unpaid interest.[9] However, regulations issued in 1994 generally require payments to be allocated first to accrued but unpaid interest or OID.[10]

B. Cancellation of Debt Income (CODI)

1. CODI Rules in General. An issuer generally recognizes CODI to the extent that (1) a holder of its debt agrees to forgive, or reduces the amount of, the debt for no consideration, or (2) the issuer satisfies a debt obligation for an amount less than the adjusted issue price of the obligation.[11] However, where the restructuring occurs in a Title 11 bankruptcy proceeding, the issuer may exclude any CODI that otherwise would be recognized as a result of the restructuring.[12] Additionally, in the case of a nonbankruptcy restructuring, the issuer also may exclude CODI that otherwise would be recognized as a result of the restructuring, but only to the extent that the corporation is "insolvent" immediately prior to the restructuring.[13]

For purposes of the CODI insolvency exception, the amount by which an issuer is "insolvent" generally equals the excess of the issuer's pre-restructuring liabilities over the fair market value (FMV) of the issuer's assets.[14] For this purpose, a contingent liability may be taken into account only to the extent the issuer is able to "prove by a preponderance of the evidence that he or she will be called upon to pay [the] obligation claimed to be a liability."[15]

There usually will be no objective measure of the FMV of the issuer's assets and hence no objective measure of the degree to which the issuer is insolvent. Hence, where an issuer intends to rely on the insolvency exclusion to avoid CODI recognition, it should consider obtaining an appraisal of its assets to support the

insolvency exclusion it intends to claim. Alternatively, the issuer should consider conducting an internal valuation and then documenting the methodology and results in writing.

With respect to nonrecourse liabilities, the IRS has ruled that the excess of the amount of any nonrecourse liability over the FMV of the property that secures such liability is only included as a liability for purposes of the CODI insolvency exception to the extent that the nonrecourse liability is discharged in the transaction that triggered the CODI.[16] In addition, the IRS has ruled that a solvent issuer may not exclude CODI triggered by a reduction in the principal amount of a nonrecourse liability by a holder of the nonrecourse liability that is not the seller of the property that secures the nonrecourse liability, even if the FMV of that property is less than the nonrecourse liability it secures.[17] An issuer that satisfies a nonrecourse liability by transferring the property that secures the nonrecourse liability recognizes gain to the extent the amount of the nonrecourse liability satisfied by the transfer exceeds the taxpayer's tax basis in such property (which gain is not CODI and therefore not eligible for the CODI insolvency exception), but recognizes no CODI as a result of the transaction.[18] On the other hand, an issuer that satisfies a recourse liability by transferring property in satisfaction of the recourse liability (1) recognizes gain to the extent the FMV of the property exceeds the taxpayer's tax basis in such property (which gain is not CODI and therefore not eligible for the CODI insolvency exception) and (2) recognizes CODI (eligible for the CODI insolvency exception) to the extent the amount of the recourse liability satisfied by the transfer exceeds the FMV of the transferred property.[19]

The issuer must reduce its tax attributes to the extent that it excludes CODI under the bankruptcy or insolvency exception.[20] In general, attributes must be reduced in the following order: (1) net operating loss (NOL) for the tax year in which CODI is realized (the "CODI year"), and NOL carryovers to the CODI year; (2) general business credit carryovers to or from the CODI year; (3) minimum tax credit available in the tax year following the CODI year; (4) net capital loss (NCL) for the CODI year, and NCL carryovers to the CODI year; (5) tax basis the taxpayer's assets; (6) passive activity loss or credit carryover from the CODI year; and (7) foreign tax credit carryovers to or from the CODI year.[21] However, the issuer may elect first to reduce the tax basis of its depreciable assets to the extent of such tax basis before applying the preceding ordering rule to the amount of any remaining required attribute reduction.[22]

Attribute reductions are applied in the first tax year following the CODI year, and hence such reductions not taken into account in determining the issuer's taxable income for the CODI year.[23] If the CODI excluded exceeds the amount of the total amount of the attributes available to reduce, then no additional tax consequences are imposed.

2. Debt Modification Rules. Where the debt holder simply agrees to reduce the amount owed to it under the debt, the determination of the amount of the issuer's CODI generally is straightforward. However, debt restructurings are rarely that simple. Typically, the holder agrees to exchange the existing DI for a new instrument, or agrees to amend the terms of the existing DI. In either case, the threshold question for tax purposes is whether the exchange or modification is treated as the issuance of a new instrument in exchange for the existing DI.

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In 1996, the IRS issued final regulations (the "debt modification regulations") that address the circumstances under which an existing DI will be treated as surrendered in exchange for a new instrument.[24] The debt modification regulations generally provide that an exchange occurs for tax purposes if a "significant modification" of the original DI occurs.[25] This standard applies to an actual exchange of a new instrument for an existing DI as well as to the modification of an existing DI (*i.e.*, a transaction in which an actual exchange occurs nevertheless is not treated as a taxable event if the new instrument does not represent a "significant modification" of the old instrument).[26]

Under the debt modification regulations, an existing DI is deemed to have been exchanged for a new instrument for tax

purposes if (1) there is a "modification" of the existing DI and (2) the modification is "significant." A "modification" generally is defined as "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 DI, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise."[27] However, with certain exceptions, a change in rights or obligations that occurs pursuant to the original terms of a DI (either automatically or pursuant to an option granted to one of the parties) does not constitute a modification.[28]

If a corporation's debt restructuring results in an exchange for federal income tax purposes, then interest on the new instrument may be subject to one or more limitation or disallowance rules.

A modification does not occur solely as the result of either (1) the issuer's failure to perform its obligations under a DI or (2) the failure of either party to exercise an option to change the terms of a DI.[29] A holder's temporary forbearance from exercising collection rights, an acceleration clause or "similar default right" in the event of the borrower's nonperformance also does not constitute a modification so long as (1) the parties do not alter any other terms of the DI and (2) the forbearance period does not exceed two years (beginning on the date of the issuer's initial failure to perform) plus any additional period during which the issuer and holder conduct good faith negotiations or the issuer is in a bankruptcy proceeding.[30]

The debt modification regulations provide several specific rules for determining whether a modification constitutes a "significant modification," plus a general rule for modifications not covered by the specific rules. The following is a summary of the specific rules for determining whether a modification constitutes a significant modification:

Change in Yield. A modification that results in a change in the annual yield of a DI that exceeds the greater of 25 basis points or five percent of the annual yield of the unmodified instrument is a significant modification.[31] This rule only applies to fixed rate, variable rate and alternative payment schedule DIs; changes to the yield of other DIs (*e.g.*, contingent payment DIs) are tested under the general rule described below.[32]

Change in Timing of Payments. A modification that results in a "material deferral" of scheduled payments is a significant modification.[33] The determination of whether payment deferrals are "material" is based on all of the facts and circumstances, but a safe harbor provides that the deferral of one or more scheduled payments is not a significant modification if the period of deferral does not exceed the lesser of five years or 50 percent of the original term of the instrument.[34] If a deferral period is less than the full safe harbor period, then the remaining portion of the safe harbor period may be used to defer subsequent scheduled payments on the same instrument without triggering a significant modification.[35]

Change in Obligor or Security. The substitution of a new obligor on recourse debt generally is a significant modification.[36] Certain limited exceptions to this general rule are provided, including exceptions for substitutions that occur in connection with the sale of substantially all of the assets of a business and that satisfy certain additional requirements.[37] The substitution of a new obligor on nonrecourse debt is not a significant modification.[38]

The addition or deletion of a co-obligor is a significant modification if it results in a change in payment expectations.[39] A "change in payment expectations" is defined as (1) a substantial enhancement of the obligor's capacity to meet the payment obligations under the DI, where such capacity was primarily speculative prior to the modification and adequate after the modification; or (2) a substantial impairment of the obligor's capacity to meet the payment obligations under the DI, where such capacity was adequate prior to the modification and primarily speculative after the modification.[40]

A change in collateral, guarantee or other form of credit enhancement for recourse debt is a significant modification only if it results in a change in payment expectations.[41] With very narrow exceptions (*e.g.*, substitution of fungible collateral such as government securities with the same type of collateral), a change in collateral, guarantee or other form of credit enhancement for nonrecourse debt is a significant modification.[42] Finally, a change in priority is a significant modification if it results in a change in payment expectations.[43]

Change in Nature of Debt Instrument. A modification that

causes the original DI to become an instrument that is not debt for federal income tax purposes is a significant modification,[44] and a change in the recourse nature of a DI (*i.e.*, from recourse to nonrecourse or vice versa) is generally a significant modification.[45] However, a modification that changes a recourse obligation to a nonrecourse obligation is not a significant modification if the DI continues to be secured only by the original collateral and there is no change in payment expectations.[46]

Change in Financial Covenants. An alteration to "customary accounting or financial covenants" is not a significant modification.[47]

The specific rules summarized above are applied on a cumulative basis to successive changes to the terms of a DI.[48] For example, an increase in the annual interest rate on a DI from 6.0 percent to 6.2 percent is not by itself a significant modification, but a subsequent increase in the interest rate on the same DI to 6.4 percent would result in a significant modification because the cumulative change in the interest rate of the instrument after the second increase (as compared with the interest rate under the original terms of the instrument) exceeds the greater of 25 basis points or five percent of the original interest rate. On the other hand, changes to two or more terms of a DI, each of which is described in a separate specific rule, do not result in a significant modification if none of the changes alone constitutes a significant modification under the specific rules summarized above.[49]

A modification that is not described in any of the specific rules summarized above is a significant modification if the nature and degree of change in legal rights or obligations of the parties to the DI are "economically significant," based on all the facts and circumstances.[50] Unlike modifications that are the subject of the specific rules described above, all modifications described in this general rule are taken into account collectively in applying this test.[51]

3. Tax Treatment of Debt-for-Debt Exchanges. If an exchange of a DI for a new instrument occurs for tax purposes under the rules discussed above, the issuer is treated as satisfying the existing debt with the new instrument. If the new instrument is debt for federal income tax purposes, then the issuer is treated as satisfying its original debt with an amount of money equal to the "issue price" of the new DI as determined under Code Secs. 1273 and 1274.[52]

The issue price of a new DI, a substantial amount of which is traded on an established market ("traded"), equals the FMV of the new DI at the time it is issued.[53] If a substantial amount of the new DI is not traded but a substantial amount of the original DI was traded, then the issue price of the new DI equals the FMV of the original DI at the time of the exchange.[54] In either case, a debt-for-debt exchange involving traded debt by a financially troubled corporation is likely to produce significant CODI under this rule.

Example 1. Lossco has $25 million of traded 10-percent current-pay debentures outstanding. As part of a workout of Lossco's outstanding debt, Lossco exchanges the debentures for new traded 12-percent debentures that permit Lossco to pay interest in the form of additional debentures ("payment in kind" or PIK debentures) for the first 30 months, which new debentures trade initially at 60 percent of face. Assuming the new debentures are treated as debt for federal income tax purposes, Lossco is treated as satisfying $25 million of existing debt for $15 million, and therefore realizes $10 million of CODI.

If neither the original DI nor the new DI are traded, then the issue price of the new DI generally will equal its stated principal amount if the new DI has adequate stated interest.[55] The new DI has "adequate stated interest" if its stated principal amount is less than or equal to the sum of the present values of all payments (including stated interest) required to be made under the instrument.[56] The present values of the payments due under the DI are determined using a discount rate generally equal to the lowest applicable federal rate (AFR) in effect during the three months ending with the month in which the new DI is issued (the "test rate").[57]

The rule for determining the issue price of a new DI where neither the original DI nor the new DI are traded can produce tax consequences that differ significantly from the tax consequences of an otherwise equivalent exchange involving a traded DI, as illustrated by comparing the following example with Example 1 above:

Example 2. The facts are the same as in Example 1, except that neither the existing debentures nor the new debentures are traded. Assuming the new debentures are treated as debt for federal income tax purposes and the test rate for the new debentures does not exceed 12 percent, Lossco is treated as satisfying $25 million of existing debt for $25 million and hence realizes no CODI.

4. Tax Treatment of Stock-for-Debt Exchanges. A corporation that issues stock in satisfaction of indebtedness realizes CODI to the extent that the FMV of the stock is less than the adjusted issue price of the debt satisfied in the exchange.[58] The favorable issue price rule described in the immediately preceding section does not apply to a stock-for-debt exchange even if the exchange involves nontraded stock and debt, and hence such an exchange is generally likely to cause a financially troubled issuer to realize CODI.

Under the debt modification regulations, a DI is deemed to be exchanged for equity if the DI is modified in a manner that causes it to be classified properly as equity for tax purposes.[59] For purposes of applying this rule, "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 issuer'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."[60] While this ameliorative language facially appears limited to the specific provision in which it appears, IRS officials have stated publicly that it applies to any significant modification under the debt modification regulations.[61]

5. Related Party Purchase of Corporation's Debt. If a person that is "related" to a debt issuer purchases the issuer's debt from a person that is not related to the issuer, the issuer is treated as acquiring the purchased debt (the "related party debt purchase rule") for CODI purposes.[62] In general, the purchaser of an issuer's debt is related to the issuer if the purchaser bears a relationship to the issuer described in Code Secs. 267(b) or 707(c)(1), as modified by Code Sec. 108(e)(4)(B) and (C).[63] Hence, where the issuer is a corporation, the purchaser will generally be related to the issuer if the purchaser owns (actually and/or by application of the constructive ownership rules of Code Sec. 267(c)) more than 50 percent of the issuer's stock by either vote or value.

The related party debt purchase rule applies if the purchaser either (1) is related to the issuer at the time of the purchase ("direct acquisition") or (2) becomes related to the issuer after the purchase and purchased the debt "in anticipation" of becoming related to the issuer ("indirect acquisition").[64] Generally, the determination of whether a person purchases debt in anticipation of becoming related to the issuer is based on all of the facts and circumstances, but a purchaser is always treated as purchasing debt in anticipation of becoming related to the issuer if the purchaser become related to the issuer less than six months after the date the debt is purchased.[65]

For purposes of determining the amount of CODI realized by the issuer as a result of a related party acquisition of its debt (other than in a substituted basis transaction), the issuer is treated as satisfying its debt for an amount generally equal to (1) the related party's cost basis in the debt on the "acquisition date" if the acquisition date occurs within six months after the date the debt was purchased[66] or (2) the FMV of the debt on the acquisition date if the acquisition date occurs more than 6 months after the date the debt was purchased.[67] The "acquisition date" is defined as (1) the purchase date in the case of a direct acquisition and (2) the date the purchaser becomes related to the issuer in the case of an indirect acquisition.[68]

Example 3. Lossco has $10 million of subordinated notes outstanding, which mature on September 30, 2005. A partnership (P/S) that is not related to Lossco acquires all of Lossco's subordinated notes for $9 million on April 1, 2002. On March 15, 2003, when the purchased notes have an FMV of $4 million, P/S becomes related to Lossco. If P/S is treated as acquiring the Lossco notes in anticipation of becoming related to Lossco, then Lossco is treated as satisfying the subordinated debt held by P/S for $4 million, and hence Lossco realizes $6 million of CODI.

The related party debt purchase rule does not apply (1) if the purchased debt has a maturity date and is in fact retired on or before the first anniversary of the date the purchaser acquires the debt (in the case of a direct acquisition) or the purchaser becomes related to the issuer (in the case of an indirect acquisition) or (2) to certain acquisitions in the ordinary course of business by securities dealers.[69]

6. Exceptions and Special Rules

a. Shareholder Contribution of Debt to Capital of Issuer. If a shareholder of a corporation also owns debt issued by the corporation and transfers the debt to the corporation as a capital contribution, then the corporation is treated as satisfying the debt with an amount of money equal to the shareholder's adjusted tax basis in the contributed debt.[70] Such a contribution generally produces no CODI where the contributing shareholder acquired the debt at original issue or from a third party at a time when the debt was worth its face amount, since the shareholder's adjusted tax basis in

the contributed debt in those cases will normally equal the issuer's adjusted issue price in such debt. However, if the shareholder acquired the debt from a third party at a significant discount to face before the contribution (and CODI was not triggered under the related party debt purchase rule described above), then the contribution generally will cause the issuer to realize substantial CODI.

b. Purchase-Money Debt Reduction for Solvent Issuer. Where debt is issued to acquire property, and the seller of the property subsequently agrees to reduce the amount of such debt, and the reduction does not occur in a Title 11 case or when the issuer is insolvent, the issuer reduces its adjusted tax basis in the acquired property rather than realizes CODI.[71] This rule only applies where the property seller holds the debt issued to acquire the property.[72]

c. Realization of CODI by an Insolvent S Corporation. Where an S corporation realizes CODI, the insolvency exception and attribute reduction rules are applied at the corporate level.[73] For purposes of applying the attribute reduction rules to an S corporation, any "suspended losses" arising in the year the S corporation realizes CODI are treated as NOLs, and hence such suspended losses are the first attribute the S corporation is required to reduce.[74] As a result of the amendment to Code Sec. 108(d)(7)(A) enacted as part of the Job Creation and Worker Assistance Act of 2002 (the "Job Creation Act"),[75] shareholders of an S corporation that realizes CODI after October 11, 2001, are not allowed to increase the tax basis of their S corporation stock by the amount of CODI realized by the S corporation that is excluded under the insolvency exception (and hence will permanently lose the ability to deduct suspended losses to that extent).[76] Under a special effective date provision, this amendment does not apply to a discharge of indebtedness occurring before March 1, 2002, pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001.[77] The amendment to Code Sec. 108(d)(7)(A) reverses the Supreme Court decision in *Gitlitz*.[78] Shareholders of an S corporation realizing CODI prior to the effective date of that amendment should be able to increase the basis of their S corporation stock by the full amount of CODI realized (including any excluded portion of such CODI) in reliance on *Gitlitz*.

C. Impact of Restructuring on Corporation's Interest Deductions

If a corporation's debt restructuring results in an exchange for federal income tax purposes, then interest on the new instrument may be subject to one or more limitation or disallowance rules. The rules most likely to come into play are the following.

1. Instrument Treated As Equity for Federal Income Tax Purposes. If the new instrument is characterized as equity for federal income tax purposes (even though labeled as debt by the parties), then the corporation is not permitted to claim deductions for any purported interest paid or accrued on the instrument. The determination of whether an instrument is properly characterized as debt for federal income tax purposes is based on several factors which have been identified and applied in court decisions and published IRS rulings.[79] Some of the more important factors include the following:

- The instrument has a fixed maturity date not too far removed in the future.
- The instrument is an unconditional obligation to pay.
- The creditor has reasonable remedies upon default (*e.g.*, acceleration).
- There is no significant overlap in the ownership of the instrument and the ownership of the issuer's equity.
- The issuer's debt-to-equity ratio is not excessive.
- The instrument has a fixed interest rate, or interest rate that varies with an interest rate index (*e.g.*, London Interbank Offered Rate (LIBOR), federal funds rate, prime rate, *etc.*).
- The reasonable anticipated cash flow of the issuer is sufficient to make required payments on the instrument as they come due.
- The instrument does not have equity-like features (*e.g.*, conversion, participation or voting rights).
- Payment rights under the instrument are not subordinated to those of other creditors.

However, as discussed above in section I.B.4, the issuer's anticipated cash flow should not be taken into account in determining the proper classification of a modified instrument where the original instrument was properly classified as debt for federal income tax purposes.

2. Applicable High-Yield Discount Obligation (AHYDO) Rules. If the new instrument is an AHYDO (defined below), then all or a portion of the corporation's OID deductions may be disallowed and the remainder deferred until the OID is paid.[80] An AHYDO is a DI that (1) has a maturity date that is more than five years after the issue date, (2) has a yield to maturity that equals or exceeds the AFR for the month in which the instrument is issued plus five percentage points, and (3)

is issued with "significant OID."[81] A DI is issued with "significant OID" if, assuming all payments on the DI are made on the last day each such payment is unconditionally required to be made, the amount of accrued but unpaid OID at the end of any accrual period that ends after the fifth anniversary of the issue date of the DI will exceed the product of the DI's issue price and its annualized yield to maturity.[82]

The issuer may not deduct OID on an AHYDO to the extent of the lesser of (1) the total OID on the AHYDO or (2) the portion of the total return (*i.e.*, OID plus qualified stated interest) on the AHYDO that exceeds the portion of the total return attributable to a yield to maturity equal to the AFR for the month the AHYDO is issued plus six percentage points (the "disqualified portion").[83] In addition, the issuer of an AHYDO may not deduct the nondisqualified portion of the OID on an AHYDO until the OID is paid.[84]

In applying the AHYDO definitional rules to a DI that is deemed to be issued as the result of a significant modification to an existing DI with OID, it should be noted that the "issue date" of the deemed new DI is the date the new DI is deemed to be issued, not the date the original DI was issued. For example, if a DI with a maturity date of December 31, 2007, was originally issued on December 31, 1998, and the DI undergoes a significant modification on or after December 31, 2002 (but continues to be unconditionally payable in full on December 31, 2007), then the DI deemed issued as a result of the significant modification cannot be an AHYDO since it has a maturity date not more than five years from its issue date.

Restructured debt is most likely to be an AHYDO where either the original debt or the new debt is traded and trades at a substantial discount to face.

> If certain requirements are met, the holder of debt that has declined in value or has become completely worthless may deduct the unrealized loss on the debt.

Example 4. Lossco has $25 million of traded 12-percent current-pay debentures outstanding, which mature on September 30, 2006. On March 31, 2002, when the long-term AFR is 8.0 percent, Lossco exchanges the debentures for new traded 6.0-percent current-pay debentures, which mature on September 30, 2009, and trade initially at 60 percent of face. The new debentures have an annualized yield-to-maturity of approximately 16.2 percent (assuming semi-annual accrual periods), which exceeds the AFR plus five percent. Based on the schedule of required payments, the new debentures will have $10 million of accrued but unpaid OID outstanding at the end of the first accrual period ending after the five-year anniversary of their issuance (*i.e.*, September 30, 2007), which is well in excess of the product of the issue price of the new debentures ($15 million) and the debentures' yield-to-maturity. Hence, the new debentures are AHYDOs.

3. Disqualified Debt Instrument Rules. If the new DI is a "disqualified debt instrument" ("disqualified DI"), then no deductions are allowed for interest paid or accrued on the DI. A DI is a disqualified DI if a "substantial amount" of the interest or principal on the DI is payable in, or determined with reference to the value of, equity of the issuer or a person related to the issuer within the meaning of Code Sec. 267(b) or 707(b)(1).[85] This provision applies regardless of whether the equity payment feature is mandatory, at the issuer's (or related person's) option, or at the holder's (or related person's) option; however, in the latter case, the instrument is a disqualified DI only if the option is "substantially certain" to be exercised.[86] All of the interest on a disqualified DI is disallowed, even the portion of any interest required to be paid in cash or property other than issuer equity.

The circumstances under which the new DI may constitute a disqualified DI include the following:

- New instrument is convertible into equity of the issuer (or a related party). As noted above, the statute provides that a DI that is payable in issuer equity solely at the holder's option is not a disqualified DI unless the option is "substantially certain" to be exercised. The words "substantially certain" imply a very high threshold; hence, a reasonable interpretation of this language is that convertible debt clearly is not a disqualified DI where the conversion feature is at, or out of, the money, and probably is not a disqualified DI if the conversion feature is only

slightly in the money.[87] Unfortunately, the legislative history to the disqualified DI provision does not confirm (but does not necessarily conflict with) this interpretation.[88]

- New instrument is issued together with a warrant to acquire equity of the issuer (or a related party). The warrant should be treated as a separately-purchased instrument, and not as payment of principal or interest on the simultaneously-issued debt, unless (1) the warrant and debt are not separately tradable, (2) the warrant is exercisable solely by delivery of the debt, and (3) the warrant is substantially certain to be exercised. However, there is a risk that, even where the debt and warrant are separately tradable, the debt may be a disqualified DI (at least while the debt and warrant are held together) if (1) the holder has the option to exercise the warrant by delivering the debt and (2) the warrant is substantially certain to be exercised.

As of the date this article was written, the application of this disallowance rule to the situations described above (and many other situations) is unfortunately subject to great uncertainty because of a lack of guidance regarding, among other issues, the standard for "substantially certain" to exercise, the time(s) at which the "substantially certain" to exercise standard is applied (*e.g.*, just at issue, at issue and at any subsequent material modification, or periodically), and the determination of what constitutes a "substantial amount" of interest or principal. Guidance from IRS on these, and many other aspects of this provision, is sorely needed.

D. Issuer's Net Operating Loss Carryforwards (NOLCFs)

1. Alternative Minimum Tax. A corporation with NOLCFs from one or more of its tax years prior to the tax year in which it undergoes a debt restructuring that results in CODI may generally use its NOLCFs to offset CODI that is (1) not excludible under the insolvency or bankruptcy exceptions and (2) not offset by other deductions in excess of income other than CODI for the year in which the restructuring occurs. However, even if the corporation's NOLCFs are sufficient to offset all of the CODI it recognizes, the corporation will likely have some alternative minimum tax (AMT) liability because (subject to an exception limited to NOLs carried back from, or carried forward to, tax years ending in 2001 or 2002) the NOLCF deduction allowed for AMT purposes may not exceed 90 percent of a taxpayer's alternative minimum taxable income (AMTI) determined without regard to its NOLCF deduction.[89] In addition, a corporation's NOLCFs may be less for purposes of calculating its AMTI than its NOLCFs for calculating its regular taxable income, because its AMTI NOLCFs are determined by applying all relevant AMT adjustments and preference item exclusions to its prior year NOLs.[90]

> **Example 5.** In its 2000 tax year, Lossco recognizes $5 million of CODI as a result of the restructuring of its debt and $1 million of deductions (other than NOLCF deductions) in excess of income other than CODI. Lossco has $6 million of NOLCFs from prior tax years, after adjusting prior year NOLs for relevant AMT adjustments and preference items. Lossco has no regular taxable income in 2000 because its NOLCFs exceed its 2000 taxable income determined without regard to its NOLCFs. Assuming Lossco's 2000 AMTI is also $4 million without regard to its AMTI NOLCFs (*i.e.*, Lossco has no AMT adjustments or excluded preference items in 2000 other than its NOLCF adjustment), its 2000 AMTI is $400,000 (equal to the 10 percent of its AMTI which may not be offset by NOLCFs), and Lossco's AMT liability is $80,000 (20 percent of $400,000).
>
> On the other hand, if the items described in this example arose in Lossco's 2001 or 2002 tax year, Lossco could use 100 percent of its AMTI NOLCF to offset its AMTI, and hence would have no AMT liability in such year.

2. Code Sec. 382 Limitation. A restructuring that involves one or more stock-for-debt exchanges, new equity investments and/or other changes in the ownership of the restructured corporation's stock may cause the corporation to undergo an ownership change within the meaning of Code Sec. 382. If that occurs, the amount of the corporation's NOLCFs that may be used to offset its post-ownership change taxable income generally will be subject to an annual limit (a "Code Sec. 382 limitation") equal to the product of (1) the value of the corporation's stock immediately before the ownership change and (2) the "long-term tax-exempt rate" in effect for the month in which the ownership change occurs.[91] The long-term tax-exempt rate generally equals the lowest long-term AFR in effect dur-

ing the three-month period ending in the ownership change month, as adjusted for differences between taxable and tax-exempt obligations.[92]

An "ownership change" generally occurs on any date on which (1) a five-percent shareholder of the corporation increases the percentage of the corporation's stock he, she or it owns (a "testing date") and (2) the percentage of the corporation's stock owned by each of one or more five-percent shareholders has increased in the aggregate by more than 50 percentage points over the lowest percentage owned by each such five-percent shareholder at any time during the three-year period ending on such testing date (or, if shorter, the period from the most recent ownership change until the testing date) (the "testing period").[93] A "five-percent shareholder" is defined generally as an individual, entity or, in certain cases, group that actually or constructively owns five percent or more of a corporation's stock at any time during the testing period.[94] For purposes of these rules, stock ownership percentages are based on stock value.[95]

Example 6. Throughout the relevant period prior to the issuance of stock for debt described below in this example, Lossco had 7,000 shares of common stock (and no other classes of stock) outstanding. On July 31, 2001, A acquired 2,400 shares of Lossco stock from an unrelated person. On March 31, 2002, when Lossco's stock has a value of $1,000 per share, Lossco issues 3,000 shares of common stock to Noteholder in satisfaction of $8 million of Lossco subordinated notes held by Noteholder. Immediately after such issuance, Noteholder's percentage ownership of Lossco stock is 30 percent more than the lowest percentage of Lossco stock it owned during the preceding three years (zero percent), and A's percentage ownership of Lossco stock is 24 percent more than the lowest percentage of Lossco stock owned by A during the preceding three years (also zero percent). The combined increase in the percentage ownership of Noteholder and A as of March 31, 2002, is 54 percent, and hence the issuance of stock to Noteholder causes Lossco to undergo an ownership change on that date.

Avoiding an ownership change is often an important planning objective in the restructuring of a financially troubled corporation's debt, because the value of the corporation's stock at such a time is typically very low, hence, the Code Sec. 382 limitation produced by an ownership change may effectively nullify the corporation's NOLCFs. One method for avoiding an ownership change in a stock-for-debt restructuring is for the corporation to issue stock in the form of preferred stock described in Code Sec. 1504(a)(4),[96] because such stock does not count for purposes of determining whether the corporation has undergone an ownership change.[97]

Example 7. Same as Example 6, except that, in exchange for Noteholder's Lossco subordinated notes, Lossco issues Code Sec. 1504(a)(4) preferred stock with a stated value of $2 million plus nominal exercise price warrants to purchase 1,000 shares of Lossco common stock. Assuming no other changes in the ownership of Lossco stock occurred during the three-year period ending on June 15, 2002 (except for A's acquisition of 2,400 shares on July 31, 2001), the issuance of Lossco preferred stock and warrants does not trigger an ownership change.

If a corporation undergoes an ownership change, it allocates its taxable income or NOL for the tax year of the ownership change between the portion of the year ending on the date of the ownership change and the portion of the year beginning on the day after the date of the ownership change either (1) by ratably allocating an equal portion of its taxable income or NOL to each day in the year or (2) at its election, under a modified "closing of the books" method.[98] The Code Sec. 382 limitation for the post-change portion of the year is the annual Code Sec. 382 limitation resulting from the ownership change multiplied by a fraction, the numerator of which is the number of days in the post-change portion of the year, and the denominator of which is the number of days in the year.[99]

Example 8. Same as Example 6, and Lossco's net taxable income (without regard to NOLCFs) for the tax year ending December 31, 2002, is $4 million, consisting of (1) $5 million of CODI triggered by the March 31, 2002, stock-for-debt exchange, $500,000 of net ordinary income arising after March 31, 2002, and $1.5 million of net ordinary losses (excluding Lossco's CODI) arising before April 1, 2002.

Lossco has $10 million of NOLCFs from prior tax years, and Lossco's Code Sec. 382 limitation resulting from the March 31, 2002, ownership change is $280,000 ($7 million pre-ownership change stock value *times* an assumed long-term tax exempt rate of four percent).

If Lossco does not make a closing-of-the-books election, $1 million (*i.e.*, 25 percent) of its taxable income for its 2002 tax year is allocated to the pre-change portion of the year, and the remaining $3 million is allocated to the post-change portion of the year. Lossco is not limited in the amount of its NOLCFs that it may use to offset the taxable income allocated to the pre-change portion of its 2002 tax year, and hence, all of such taxable income is offset by NOLCFs (disregarding AMT). Lossco may only use $210,000 (75 percent of its $280,000 post-ownership change Code Sec. 382 limitation) of its NOLCFs to offset the $3 million of taxable income allocated to the post-change portion of its 2002 tax year, and hence Lossco's taxable income for its 2002 tax year is $2.79 million (*i.e.*, $3 million *minus* $210,000).

If Lossco makes a closing-of-the-books election, $3.5 million of its taxable income ($6 million CODI *minus* $2.5 million net ordinary loss) is allocated to the pre-change portion of its 2002 tax year, and $500,000 of its taxable income is allocated to the post-change portion of its 2002 tax year. Lossco's taxable income (disregarding AMT) for its 2002 tax year is $290,000 (*i.e.*, $500,000 *minus* $210,000).

A corporation that undergoes an ownership change pursuant to a Title 11 or similar case may use one of two rules that ameliorate the effect of Code Sec. 382. The first rule applies only if the pre-ownership shareholders and historic creditors of the corporation own 50 percent or more (by vote and by value) of the corporation's stock immediately after the ownership change.[100] If that requirement is satisfied (and the corporation does not elect to instead use the second rule described below), then (1) the corporation is not subject to a Code Sec. 382 limitation as a result of the ownership change, but (2) the corporation's pre-ownership change losses and credits for (a) the pre-change portion of the ownership change year and (b) the three-year period preceding the ownership change year are recomputed by adding back any interest deducted in those periods on debt that is converted to equity in the ownership change.[101] In addition, if the corporation undergoes a subsequent ownership change within two years of the ownership change to which this rule is applied, then the Code Sec. 382 limitation resulting from such second ownership change is zero.[102]

The second rule applies if the first rule's requirements are not satisfied or the corporation elects out of the first rule. Under the second rule, the corporation is subject to a Code Sec. 382 limitation as a result of the ownership change, but, for purposes of calculating the amount of that Code Sec. 382 limitation, the value of the corporation's equity is determined immediately after the ownership change (*i.e.*, generally taking into account the value of stock issued in exchange for debt) rather than immediately before the ownership change.[103] The election to apply the second rule rather than the first rule is irrevocable and must be made by the due date (including extensions) for the corporation's tax return for the tax year of the ownership change.[104]

II. Debtholder's Issues

A. Current Inclusion of Unpaid Interest and OID

The holder of a DI that uses the accrual method of accounting generally is required to recognize interest on the DI when "all events have occurred which fix the right to receive the income and the amount thereof can be determined with reasonable certainty."[105] Hence, an accrual method holder normally includes interest on a DI when it becomes unconditionally due and payable under the terms of the DI, whether or not paid at that time.

However, where the issuer encounters financial difficulties and is not making (or is not expected to make) interest payments on the DI as they come due, an accrual method holder may stop including interest in income as it accrues if the holder establishes that there is a reasonable expectation that the interest will never be paid.[106] Substantial uncertainty of ultimate collection is necessary to avoid income inclusion; the mere expectation that interest will not be paid in a timely manner is not sufficient to avoid accrual if the debtor's financial difficulties are expected to be temporary.[107]

As of the date this article was written, no court decisions or published ruling has addressed the issue of whether the "doubtful collectibility" exception to current inclusion for accrual method interest applies to OID, but the IRS has ruled privately that such exception does not apply to OID.[108] The authors believe that the statutory OID provisions do not facially compel this result and that the arguments advanced by the IRS in support of this ruling are not entirely convincing.[109]

Example 9. Lossco has 12 percent subordinated notes outstanding, the terms of which provide that Lossco is required to pay 50 percent of stated interest annually but may accrue the remaining 50 percent (and stated interest accrues on any deferred interest). Lossco misses three consecutive required quarterly interest payments on the notes, and members of its senior management have stated publicly that Lossco's survival as a going concern is in doubt. Based on the IRS position set forth in the private ruling referred to above, accrual method holders of Lossco notes may stop including in income the portion of the interest on Lossco's notes that is required to be paid currently, but all holders of the notes must continue to include currently the portion of such the interest Lossco is permitted to accrue under the terms of the notes (since such interest constitutes OID), even though there is a reasonable expectation that such interest will never be paid.

B. Deduction for Wholly or Partially Worthless Debt

If certain requirements are met, the holder of debt that has declined in value or has become completely worthless may deduct the unrealized loss on the debt. The requirements that must be satisfied, and the nature and timing of the loss, depend generally on whether the debt is or is not a security, and, if the debt is not a security, whether or not the debt is subject the nonbusiness bad debt limitations imposed by Code Sec. 166(d).

1. Debt Is Not a Security. The holder of debt that is not a security and is not subject to the nonbusiness bad debt provisions of Code Sec. 166(d) is entitled generally to an ordinary deduction in an amount equal to the amount by which the debt becomes wholly or partially worthless in a tax year of the holder.[110] If the debt becomes wholly worthless, then the amount of the deduction equals the holder's adjusted tax basis in the debt.[111] If the debt becomes partially worthless and the holder does not use the bad debt reserve method of accounting, then the amount of the deduction equals the amount by which the holder charges the debt off on its books (but not in excess of the holder's adjusted tax basis in the debt).[112] If the debt becomes partially worthless and the holder uses the bad debt reserve method of accounting, then the amount of the deduction is the amount of its "reasonable addition to reserve for bad debts" for the tax year (which generally takes into account the holder's reasonable assessment of the collectibility of all obligations it holds).[113]

The determination of whether, and the extent to which, debt becomes worthless is based generally on the relevant facts and circumstances.[114] To be eligible for a bad debt deduction in a particular tax year, a holder generally must establish that the debt became wholly or partially worthless in that tax year (rather than in a prior tax year).[115] Hence, to avoid losing the opportunity to claim a bad debt deduction, a holder generally should claim a bad debt deduction in the earliest tax year in which the facts provide reasonable support for the deduction.

A noncorporate holder of "nonbusiness" debt is only entitled to a bad debt deduction with respect to debt if and when the debt becomes wholly worthless, and such deduction is characterized as a short-term capital loss rather than an ordinary deduction.[116] A "nonbusiness" debt is defined as debt (1) not created or acquired in connection with the trade or business of the taxpayer or (2) the loss from which is not incurred in the taxpayer's trade or business.[117]

2. Debt Is a Security. A DI is treated as a "security" for purposes of the worthlessness deduction rules if it is a "bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form."[118] If a DI is a security as so defined, the holder's ability to claim a deduction for a decline in value of the DI is governed by Code Sec. 165(g) rather than Code Sec. 166.[119]

A worthless securities deduction may be claimed for a DI only for the tax year of the holder in which the DI becomes wholly worthless.[120] A worthless security deduction is generally a capital loss unless (1) the security was not held as a capital asset or (2) the security was held by an affiliated corporate owner and substantially all of the income of the issuer for all tax years has consisted of income other than passive income.[121]

C. Restructuring Gain or Loss and Post-Restructuring OID

1. Debt-for-Debt Exchange. The tax consequences to a holder of the exchange of existing debt for new debt depend initially on whether or not the exchange qualifies as a "reorganization" within the meaning of Code Sec. 368(a). A debt-for-debt exchange qualifies as a reorganization only if both the DI surrendered and the DI received in the exchange constitute securities.[122] The determination of whether a DI constitutes a "security" for this purpose is based on several factors, the most important of which is the DI's term to maturity. A DI with a maturity of 10 years or more generally will constitute a security, while a DI with a term to maturity of less than five years generally does not constitute a security. The status of DIs with a maturity of at least five, but less than 10, years is uncertain, although taxpayers often take the position that such DIs do constitute securities so long as other relevant factors favor such treatment.[123] (The definition of "security" discussed in section II.B.2 above applies only for purposes of the worthless securities deduction provision of Code Sec. 165(g) and hence is not relevant for determining whether a DI constitutes a security for purposes of the reorganization provisions of the Code.)

Where a deemed exchange occurs as the result of a significant modification, the new DI's maturity is measured from the date of the deemed exchange rather than the issue date of the original DI. Hence, the new DI generally will not be a security if the significant modification that produces the new DI occurs less than five years from the DI's maturity (even though the original DI may have constituted a security).

a. Exchange Qualifies As a Reorganization. If the exchange qualifies as a reorganization, the holder may recognize gain but is not permitted to recognize loss.[124] The holder recognizes gain to the extent, if any, of (1) the FMV of the excess of the principal amount of the securities received in the exchange over the principal amount of the securities surrendered, and (2) the amount of cash and the FMV of property other than issuer stock or securities received in the exchange.[125] In addition, securities received in exchange for interest that accrued on the securities surrendered while the holder held such securities constitute taxable consideration (resulting in gain or loss to the extent that the accrued interest was previously included in the holder's income or ordinary income to the extent that the accrued interest was not previously included in the holder's income).[126]

The tax consequences to a holder of the exchange of existing debt for new debt depend initially on whether or not the exchange qualifies as a "reorganization" within the meaning of Code Sec. 368(a).

The holder's tax basis in the new DI equals the holder's tax basis in the DI surrendered in the exchange, increased by the amount of gain recognized in the exchange.[127] However, the issue price of the new DI (for purposes of determining the amount, if any, of OID on the new DI) is determined under Code Secs. 1273 and 1274. This can produce unfortunate tax consequences to the holder where there is public trading of the original or new DI and the traded instrument trades at a significant discount to face at the time of the exchange.

Example 10. Noteholder owns $10 million face amount of Lossco's 10-percent notes due on June 30, 2006. The notes were originally issued on July 1, 1996, and constitute "securities" within the meaning of Code Secs. 354 and 356. On March 31, 2002, Noteholder exchanges the notes for traded 14-percent notes with stated principal of $8 million. Interest on the new notes is payable in the form of PIK notes for three years following the date of the exchange and thereafter interest must be paid currently in cash, and all principal and unpaid interest (including principal and interest on the PIK notes) is due on September 30, 2009. The new notes trade at 45 percent of face (*i.e.*, $3.6 million in the aggregate) immediately after the exchange. Assuming the new notes constitute securities, Noteholder may not recognize the $6.4 million loss realized in the exchange. The issue price of the new notes is $3.6 million, and hence the new notes have $4.4 million of OID attributable to the difference between their issue price and stated principal, which must be included in Noteholder's income (together with the stated yield of the new notes, all of which also constitutes

OID) on an economic accrual basis over the 7 1/2-year life of the new notes.

If the holder in Example 10 is able to take the position that the new notes are not securities and therefore recognizes its $6.4 million loss, then such loss will be capital in nature assuming the original notes were held as capital assets and accordingly may not be used to offset OID on the new notes (and may not be usable to offset any of the holder's other taxable income if the holder is a corporation that does not have any capital gains). In the alternative, the holder may have been able to claim a partial worthlessness deduction prior to the exchange and thereby obtain an ordinary deduction for the loss.

OID on the new DI could be avoided by taking the position that the new notes should be treated as equity for federal income tax purposes. However, as discussed above in section I.B.4, the issuer's financial condition should not be taken into account in classifying the new instrument. In addition, assuming the issuer also treats the new instrument as equity (and therefore does not file information returns that reflect interest payments or OID on the instrument), the issuer will forego interest deductions on the instrument. Moreover, even if the new notes constitute equity for federal income tax purposes, the holder may be required to recognize constructive dividend income on the instrument under the rules described in section II.C.2.a below.

OID on the new DI also could be avoided by taking the position that there is a reasonable expectation that the OID will not be paid and therefore that OID does not have to be included in income currently under the "doubtful collectibility" exception for accrual method interest. However, as noted above, the IRS appears to have taken the position (albeit not publicly) that such exception does not apply to OID. Moreover, the fact that the holder just agreed to restructured terms may undercut the factual basis for claiming that the "doubtful collectibility" exception applies to the new instrument.

On the other hand, application of Code Secs. 1273 and 1274 can produce beneficial tax consequences to a holder that exchanges a DI originally issued with an issue price substantially less than face for a new DI where (1) the exchange qualifies as a reorganization and (2) neither the original DI nor the new DI is traded on an established market.

Example 11. Noteholder owns $10 million face amount of Lossco's eight-percent subordinated notes due on January 1, 2008. The notes originally were issued as part of investment unit that included nominal exercise price warrants to acquire seven percent of Lossco's common stock. Eighty percent of the $10 million paid for the notes and warrants was allocated to the notes, and hence the notes had an original issue price of $8 million.[128] On January 31, 2002, when $1.6 million of OID remains to be amortized over the remaining life of the notes, Noteholder and Lossco agree to increase the interest rate to nine percent and to permit Lossco to pay half of the stated interest in the form of PIK notes, which changes constitute a significant modification of the notes. Neither the original notes nor the new notes deemed issued as a result of the significant modification are traded or constitute "securities." Noteholder does not recognize the $1.6 million gain realized in the exchange since the principal amount of the deemed new note is the same as the principal amount of the original note. In addition, although the deemed new note has a tax basis of $8.4 million ($8 million issue price plus $400,000 OID recognized as of the time of the deemed exchange), it has an issue price equal to its stated principal amount of $10 million (assuming the test rate at the time of the exchange does not exceed nine percent). Accordingly, Noteholder does not include the remaining $1.6 million of OID on the original note in income over the remaining life of the note and, on retirement of the note, recognizes capital gain of $1.6 million (assuming the note is retired for its full principal amount).[129]

b. Exchange Does Not Qualify As a Reorganization. If the exchange does not qualify as a reorganization, the holder generally recognizes gain or loss equal to the difference between the amount realized in the exchange and the holder's tax basis in the DI surrendered in the exchange.[130] The amount realized in the exchange equals the new DI's issue price.[131] In general, any gain or loss recognized will be capital in nature if the original DI was a capital asset in the hands of the holder (subject to the bad debt deduction recapture rule described below); however, any portion of the issue price of the new DI treated as a payment of accrued but unpaid interest or OID on the original DI

will constitute ordinary income to the extent the holder has not previously included such interest or OID in income.

Gain (but not interest income) recognized by the holder in a debt-for-debt exchange may be deferred until principal is paid on the new DI, if the installment method may be used to report such gain.[132] In the context of a corporate debt restructuring, the installment method generally will be available to the holder so long as (1) the new DI is not payable on demand; (2) neither the DI surrendered in the exchange nor the new DI trades on an established securities market; and (3) subject to certain exceptions, the new DI is not convertible into stock that trades on an established securities market.[133] However, to the extent that the principal amount of the new DI (together with the principal amounts of all other installment obligations received by the holder during the tax year of the exchange that are still outstanding at the end of such year) exceeds $5 million, the holder generally is required to pay interest at the underpayment rate determined under Code Sec. 6621(a)(2) on the federal income tax deferred with respect to the amount of such excess.[134]

In the case of a taxable debt-for-debt exchange involving a financially troubled corporate issuer, there are circumstances in which the holder may incur a tax liability on the exchange even though the FMV of the new debt does not exceed (and may even be substantially less than) the holder's tax basis in the original debt. Those circumstances include the following:

(i) Holder previously claimed a bad debt deduction for the debt surrendered in the exchange. Under these circumstances, the issue price of the new DI received in the exchange may exceed the holder's reduced tax basis in the original debt, especially if there is no public trading of the original or new DI (so that the issue price of the new DI typically equals its face amount). However, if the exchange is the result of a significant modification, the holder is generally permitted to claim an offsetting bad debt deduction on the new debt.[135]

(ii) Issue price of original DI is less than principal amount and no public trading of original or new DI. Under these circumstances, the issue price of the new DI will equal its stated principal amount (assuming the new DI bears adequate stated interest), with the result that the exchange causes the holder to recognize immediately all of the unamortized OID on the original instrument attributable to the difference between the original instrument's stated principal amount and its initial issue price.

Example 12. The facts are the same as Example 11 above, except that the deemed new notes do not constitute securities. Assume the notes have an FMV of $6 million at the time of the modification ($2.4 million less than Noteholder's tax basis in the notes at such time). Since the deemed exchange of new notes for the original notes is taxable, Noteholder recognizes $1.6 million of gain (equal to the difference between the $10 million issue price of the new notes and Noteholder's $8.4 million adjusted tax basis in the old notes), even though Noteholder realizes a $2.4 million loss on the deemed exchange. Payment of tax on such gain may be deferred under the installment method, but Noteholder will be required to pay interest under Code Sec. 453A on at least a portion of the deferred tax since the amount of the note exceeds $5 million.

In addition, even where a taxable exchange results in a recognized loss to the holder, if a portion of the issue price of the new DI is allocable to accrued but unpaid interest or OID that the holder has not previously included in income, the holder will recognize interest income to that extent and a correspondingly larger loss (which generally will be capital in nature) on the exchange.

2. Stock-for-Debt Exchange. As in the case of a debt-for-debt exchange, the holder's treatment of the exchange of an existing DI for a equity of the issuer (including a purported DI treated as equity for federal income tax purposes) depends initially on whether or not the exchange qualifies as a "reorganization" within the meaning of Code Sec. 368(a). A stock-for-debt exchange generally qualifies as a reorganization if the debt surrendered in the exchange constitutes a "security."[136]

a. Exchange Qualifies As a Reorganization. If the stock-for-debt exchange qualifies as a reorganization, the holder may recognize gain but is not permitted to recognize loss.[137] The holder will recognize gain to the extent, if any, of the amount of cash and the FMV of property other than issuer stock or securities received in the

exchange.[138] In addition, as in the case of debt-for-debt reorganization, stock received in exchange for interest that accrued on the securities surrendered while the holder held such securities constitutes taxable consideration (resulting in gain or loss to the extent that the accrued interest was previously included in the holder's income or ordinary income to the extent that the accrued interest was not previously included in the holder's income).[139] The holder's tax basis in the issuer stock received in the exchange equals the holder's tax basis in the DI surrendered in the exchange, increased by the amount of gain recognized in the exchange.[140]

A holder that receives stock in exchange for debt may face a phantom income issue similar to the one faced by a holder that receives debt with OID if the stock is redeemable preferred stock that does not participate in the issuer's growth to a significant extent. In this regard, where redeemable preferred stock is issued at a price lower than its redemption price (by more than a *de minimis* amount), the difference between the redemption price and issue price is treated generally as a constructive distribution (or series of distributions) of additional stock on preferred stock in amounts determined under OID principles (sometimes referred to as "preferred OID").[141] Any such deemed distribution is taxable as ordinary income to the holder in any tax year in which the issuer has current or accumulated earnings and profits to the extent of the holder's ratable share of such earnings and profits.[142]

For purposes of Code Sec. 305, the "issue price" of preferred stock is its FMV on the date it is issued.[143] Unlike the case of a debt-for-debt exchange, this rule for determining issue price applies (and hence the preferred stock received in the exchange may have significant preferred OID) even if neither the DI surrendered nor the stock received in the exchange is traded on an established securities market.

> [A] holder of nontraded debt ... must take care not to agree to modify the terms of the purchased debt in a manner that would constitute a significant modification of the debt ...

b. Exchange Does Not Qualify As a Reorganization. If the stock-for-debt exchange does not qualify as a reorganization, the holder generally recognizes gain or loss equal to the difference between the FMV of the stock received in the exchange and the holder's tax basis in the debt surrendered in the exchange.[144] In general, any gain or loss recognized will be capital in nature if the original debt was a capital asset in the hands of the holder (except to the extent such gain represents the recapture of a prior bad debt deduction); however, any portion of the FMV of the stock treated as payment of accrued but unpaid interest or OID on the original DI will constitute ordinary income to the extent the holder has not previously included such interest or OID in income. Gain recognized by the holder in a stock-for-debt exchange may not be deferred under the installment method.

Because the amount realized in a stock-for-debt exchange equals the FMV of the stock even where there is no public trading of the surrendered debt or newly issued stock, the holder generally will not realize a gain so long as the FMV of the stock received does not exceed the tax basis of the surrendered debt. However, the stock received in exchange for debt for which a bad debt deduction has previously been claimed (or where the holder recognizes ordinary loss on the exchange) is treated as Code Sec. 1245 property, and hence any gain recognized by the holder on a subsequent disposition of such stock (or substitute property received in certain tax-free exchanges for such stock) is taxed as ordinary income.[145]

3. Third-Party Purchaser of a Financially Troubled Corporation's Debt. If the purchase of an issuer's debt by a person related to the issuer causes the issuer to recognize CODI pursuant to Code Sec. 108(e)(4), the purchased debt is treated as new debt issued to the purchaser on the acquisition date with an issue price equal to the amount deemed realized by the issuer for purposes of determining the CODI recognized by the issuer.[146] The related purchaser does not recognize gain or loss as a result of this deemed issuance, but may be required to recognize substantial OID on the purchased debt going forward if the related purchaser purchased the debt at a significant discount to face.

Example 13. Partnership owns 60 percent of Lossco's outstanding stock. On April 30, 2002, Partnership purchases (from a lender unrelated to Lossco) Lossco's nine-percent subordinated notes, a stated principal amount of $10 mil-

lion, for $4.5 million. As a result of the purchase, Lossco realizes $5.5 million of CODI, and the notes are treated as newly issued to Partnership on the acquisition date with an issue price of $4.5 million. Partnership will be required to recognize $5.5 million of OID ($10 million principal amount less $4.5 million issue price) over the remaining term to maturity of the notes.

The holder in Example 13 may be able to avoid recognizing OID on the notes by taking the position that either (1) the notes should be treated as equity for federal income tax purposes or (2) the OID on the new notes is uncollectible. However, for the reasons discussed above in section II.C.1.a, there are likely to be significant obstacles and/or undesirable alternative tax consequences to either such approach.

If the purchaser of the issuer's debt is not related to the issuer (or the purchaser is related to the issuer but purchases the debt from a person that is also related to the issuer), then the deemed new issuance rule described above does not apply. Instead, any difference between the amount paid for the debt and (generally) the principal amount of the debt is treated as amortizable bond premium or market discount.[147] Unlike OID, market discount does not have to be included in the holder's income currently unless the holder makes an affirmative election to do so.[148]

In any case where a holder of nontraded debt acquired such debt at a significant discount to stated principal, such holder must take care not to agree to modify the terms of the purchased debt in a manner that would constitute a significant modification of the debt, since the holder would recognize gain on the resulting deemed exchange of the debt for new debt in an amount generally equal to the stated principal amount of the debt (assuming the debt provides for adequate stated interest) over the holder's adjusted tax basis in the debt.

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1 Sections 163(a) and 461(h) of the Internal Revenue Code of 1986, as amended ("the Code"). Under Code Sec. 461(h), interest accrues when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."

2 Code Secs. 163(e)(1) and (2).

3 *See In re Continental Vending Machine Corp.,* DC N.Y., 77-1 USTC ¶9121 (disallowing interest deduction on unsecured debt, but allowing a deduction on secured debt to the taxpayer in bankruptcy); *Tampa & Gulf Coast Railroad Co.,* CA-5, 72-2 USTC ¶9746, 469 F2d 263 (disallowing interest deduction to insolvent taxpayer not in bankruptcy); *In re Southwestern States Marketing Corp.*, DC Tex., 95-1 USTC ¶50,057, 179 BR 813, aff'd, CA-5, 96-1 USTC ¶50,165, 82 F3d 413 (disallowing interest deduction to the taxpayer in bankruptcy).

4 *See Continental Vending, id.*

5 *In re Dow Corning Corp.*, BC-DC Mich., 2002-1 USTC ¶50,155; *Zimmerman Steel Co.,* CA-8, 42-2 USTC ¶9697, 130 F2d 1011; Rev. Rul. 70-367, 1970-2 CB 37.

6 *See Dow Corning Corp., id.*

7 It appears that both the bank debt and the trade debt were unsecured. *See In re Dow Corning Corp., supra* note 5, at note 2.

8 For the year in which the interest is actually paid by the debtor, the deduction may be limited only to the amount actually paid. *See McConway & Torley Corp.,* 2 TC 593, Dec. 13,444 (1943) (where taxpayer's sole stockholder cancelled an indebtedness, including interest accrued on taxpayer's books, taxpayer could not deduct interest so forgiven which had been accrued during the tax year of forgiveness).

9 *See G.R. Newhouse,* 59 TC 783, Dec. 31,885 (1973); *E.G. Lackey,* 36 TCM 890, Dec. 34,500(M), TC Memo. 1977-213.

10 Reg. §§1.446-2(e)(4) (accrued interest) and 1.1275-2(f) (accrued OID). These provisions each contain an exception for "*pro rata* prepayments" (generally defined as a payment made prior to maturity that is not made under the contract's payment schedule and that leads to a substantial *pro rata* reduction of each remaining contractual payment). If a payment is treated as a "*pro rata* prepayment," then the payment is apportioned between outstanding principal and interest in proportion to the amount of each such component. However, these provisions do not appear apply to the complete settlement of a DI.

11 Code Sec. 61(a)(12); Reg. §1.61-12(a) and (c)(2)(ii). The adjusted issue price of a DI equals its issue price (as determined under Code Secs. 1273 or 1274), increased by the amount of OID included in gross income of the holder, and decreased by any payments made on the instrument other than payments of qualified stated interest (within the meaning of Reg. §1.1273-1(c)). Reg. §1.1275-1(b).

12 Code Sec. 108(a)(1)(A).

13 Code Sec. 108(a)(1)(B) and (a)(3).

14 Code Sec. 108(d)(3).

15 *D.B. Merkel,* CA-9, 99-2 USTC ¶50,848, 192 F3d 844, aff'g, 109 TC 463, Dec. 52,423 (1997).

16 Rev. Rul. 92-53, 1992-2 CB 48.

17 Rev. Rul. 91-31, 1991-1 CB 19.

18 Reg. §1.1001-2(a)(1) and (c), Example (7).

19 Reg. §1.1001-2(a)(2) and (c), Example (8); Rev. Rul. 90-16, 1990-1 CB 12.

20 Code Sec. 108(b)(1).

21 Code Sec. 108(b)(2). NOLs, NCLs and tax basis are reduced one dollar for each dollar of CODI excluded, while all other attributes are reduced 33 1/3 cents for each dollar of CODI excluded. Code Sec. 108(b)(3).

22 Code Sec. 108(b)(5).

23 Code Sec. 108(b)(4)(A).

24 T.D. 8675, 1996-2 CB 60. Although these regulations address the question of whether the holder has exchanged property for purposes of Code Sec. 1001, Congress has indicated that the same standard applies to determine whether the issuer has satisfied an existing obligation by issuing a new instrument. *See* H.R. CONF. REP. NO. 964, 101st Cong., 2d Sess. 1097 (1990) ("The COD rules generally apply to the exchange of an old obligation for a new obligation, including a modification of the old debt that is treated as an exchange (a debt-for-debt exchange)").

25 Reg. §1.1001-3(b).

26 Reg. §1.1001-3(a)(1).

27 Reg. §1.1001-3(c)(1)(i).

28 Reg. §1.1001-3(c)(1)(ii). Examples of the exceptions to this rule include substitution of a new obligor, addition or deletion of a co-obligor, change in recourse nature of the instrument, change that causes the instrument to no longer be debt for federal income tax purposes, and changes occurring pursuant to a nonunilateral option or option of the holder to defer or reduce a scheduled payment. *See* Reg. §1.1001-3(c)(2) and (c)(3).

29 Reg. §1.1001-3(c)(4)(i), (c)(5).

30 Reg. §1.1001-3(c)(4)(ii).

31 Reg. §1.1001-3(e)(2)(ii).

32 Reg. §1.1001-3(e)(2)(i).

33 Reg. §1.1001-3(e)(3)(i).

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[34] Reg. §1.1001-3(e)(3)(ii).
[35] *Id.*
[36] Reg. §1.1001-3(e)(4)(i)(A).
[37] Reg. §1.1001-3(e)(4)(i)(B), (C) and (E). The regulations also state that an issuer's election under Code Sec. 338 does not result in the substitution of a new obligor.
[38] Reg. §1.1001-3(e)(4)(ii).
[39] Reg. §1.1001-3(e)(4)(iii).
[40] Reg. §1.1001-3(e)(4)(vi).
[41] Reg. §1.1001-3(e)(4)(iv)(A).
[42] Reg. §1.1001-3(e)(4)(iv)(B).
[43] Reg. §1.1001-3(e)(4)(v).
[44] Reg. §1.1001-3(e)(5)(i).
[45] Reg. §1.1001-3(e)(5)(ii)(A).
[46] Reg. §1.1001-3(e)(5)(ii)(B).
[47] Reg. §1.1001-3(e)(6).
[48] Reg. §1.1001-3(f)(3).
[49] Reg. §1.1001-3(f)(4).
[50] Reg. §1.1001-3(e)(1).
[51] *Id.*
[52] Code Sec. 108(e)(10).
[53] Code Sec. 1273(b)(3); Reg. §1.1273-2(b). Reg. §1.1273-2(f) provides detailed rules for determining when a DI is traded on an established market.
[54] Code Sec. 1273(b)(3); Reg. §1.1273-2(c).
[55] Code Secs. 1273(b)(4) and 1274(a)(1); Reg. §§1.1273-2(d)(1) and1.1274-2(b)(1). However, the issue price of the new DI is its FMV if it is issued in a "potentially abusive situation" as defined in Reg. §1.1274-3. Reg. §1.1274-2(b)(3).
[56] Reg. §1.1274-2(c)(1).
[57] Reg. §1.1274-4(a)(1)(ii)(B).
[58] Code Sec. 108(e)(8), generally effective for transactions occurring after Dec. 31, 1993. Prior to a series of amendments to Code Sec. 108 culminating in the 1993 enactment of the current version of Code Sec. 108(e)(8), corporations were often able to avoid realizing CODI in a stock-for-debt exchange under the judicially-created stock-for-debt exception. *See, e.g.,* Rev. Rul. 59-222, 1959-1 CB 80; *Carpento Securities Corp.,* CA-1, 44-1 USTC ¶9170, 140 F2d 382; *Tower Building Corp.,* 6 TC 125, Dec. 14,947 (1946). The general theory underlying the stock-for-debt exception was that the stock represented a continuing liability of the issuer in an altered form.
[59] Reg. §1.1001-3(e)(5)(i).
[60] *Id.*
[61] *See* comments of Thomas J. Kelly (principal IRS drafter of the 1996 regulations), reported in 72 TAX NOTES 1104–1105, Aug. 26, 1996.
[62] Code Sec. 108(e)(4)(A).
[63] *Id.*
[64] Reg. §1.108-2(a)-(c).
[65] Reg. §1.108-2(c)(3).
[66] Reg. §1.108-2(f)(1). However, the amount of the issuer's CODI is measured with reference to the FMV of the debt on the acquisition date if the debt is acquired in a transaction in which the principal purpose is tax avoidance. Reg. §1.108-2(f)(4).
[67] Reg. §1.108-2(f)(2).
[68] Reg. §1.108-2(d)(1).
[69] Reg. §1.108-2(e).
[70] Code Sec. 108(e)(6).
[71] Code Sec. 108(e)(5).
[72] Rev. Rul. 92-99, 1992-2 CB 35.
[73] Code Sec. 108(d)(7)(A).
[74] Code Sec. 108(d)(7)(B). "Suspended losses" are deductions and losses that an S corporation shareholder may not include in determining his or her taxable income because such deductions and losses exceed the shareholder's tax basis in his or her S corporation stock (and debt, if applicable). *See* Code Sec. 1366(d)(1).
[75] Job Creation and Worker Assistance Act of 2002 (P.L. 107-147).
[76] Code Sec. 108(d)(7)(A), as amended by Act Sec. 402(a) of the Job Creation Act, states that "in the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, *including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section* [emphasis added]."
[77] Act Sec. 402(b)(2) of P.L. 107-147, *supra* note 75.
[78] *D.A. Gitlitz,* SCt, 2001-1 USTC ¶50,147, 531 US 206, 121 SCt 701, rev'g, CA-10, 99-2 USTC ¶50,645, 182 F3d 1143.
[79] *See, e.g., The John Kelley Co.*, SCt, 46-1 USTC ¶9133, 326 US 521, 66 SCt 299; Rev. Rul. 68-54, 1968-1 CB 69; Rev. Rul. 73-122, 1973-1 CB 66; Rev. Rul. 83-98; 1983-2 CB 40; Rev. Rul. 85-119, 1985-2 CB 60. Code Sec. 385 authorizes the IRS to issue regulations to determine the proper classification of an instrument as debt or equity for federal income tax purposes. Regulations under this provision of the Code were promulgated in the early 1980s but withdrawn before their effective date. As of the date this is written, no regulations are in effect under this provision.
[80] Code Sec. 163(e)(5)(A).
[81] Code Sec. 163(i)(1).
[82] Code Sec. 163(i)(2) and (3).
[83] Code Sec. 163(e)(5)(A)(i). A corporate holder of an AHYDO may claim a dividends-received deduction for the "disqualified portion" of OID to the extent that the disqualified portion would have constituted dividend income if it had been distributed with respect to the stock of the issuer. Code Sec. 163(e)(5)(B).
[84] Code Sec. 163(e)(5)(A)(ii).
[85] Code Sec. 163(l).
[86] Code Sec. 163(l)(3).
[87] *Compare* Reg. §1.1361-1(l)(4)(iii)(A) and (C) (call option that is not more than 10 percent in the money is not a second class of stock for purposes of the one class of stock requirement of Code Sec. 1361(b)(1)(D), where test of whether an option constitutes a second class of stock for such purpose is that option is "substantially certain" to be exercised).
[88] *See* H.R. REP. NO. 148, 105th Cong., 1st Sess. 209 (1997) ("it is not expected that the provision will affect debt with a conversion feature where the conversion price is *significantly higher* than the market price of the stock on the issue date of the debt") (emphasis added).
[89] Code Sec. 56(a)(4) and (d)(1)(A). P.L. 107-147 provides a special rule for NOLCFs to tax years ending during 2001 or 2002 and for NOL carrybacks (NOLCBs) from tax years ending during 2001 and 2002, under which such NOLCFs and NOLCBs can offset 100 percent of the taxpayer's AMTI. Act Sec. 102(c)(1), P.L. 107-147, amending Code Sec. 56(d)(1)(A). This amendment is effective for tax years ending before Jan. 1, 2003.
[90] Code Sec. 56(d)(1)(B) and (d)(2).
[91] Code Sec. 382(a) and (b). A corporation's post-ownership change deductions and losses may also be subject to this annual limit to the extent such deductions and losses are attributable to a net unrealized loss at the time of the ownership change. *See* Code Sec. 382(h).
[92] Code Sec. 382(f).
[93] Code Sec. 382(g) and (i). A Code Sec. 382 limitation may also be triggered if a 50-percent shareholder of the issuer claims a worthless securities deduction with respect to issuer stock held by such shareholder. *See* Code Sec. 382(g)(4)(D).
[94] The complex rules for identifying five-percent shareholders are beyond the scope of this article. For a more detailed discussion of these rules, *see, e.g.,* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS (Dec. 2001 ed.), at ¶1208.1.7.
[95] Code Sec. 382(k)(7).
[96] Preferred stock described in Code Sec. 1504(a)(4) is preferred stock that has no voting, conversion or participation rights and is not redeemable at a premium to its issue price.
[97] Code Sec. 382(k)(6)(A).
[98] Code Sec. 382(b)(3) and (d)(1); Reg. §1.382-6.
[99] Code Sec. 382(b)(3)(B).
[100] Code Sec. 382(l)(5)(A) and (E).
[101] Code Sec. 382(l)(5)(A) and (B). An additional rule provides that the amount of the corporation's debt is reduced by the disallowed interest that would otherwise be taken into account under Code Sec. 108(e)(8) in determining the corporation's CODI.
[102] Code Sec. 382(l)(5)(D).
[103] Code Sec. 382(l)(6). Reg. §1.382-9(j)–(l) provides special rules for determining the value of the corporation's equity where Code Sec. 382(l)(6) applies to an ownership change.
[104] Reg. §1.382-9(i).
[105] Reg. §1.451-1(a).
[106] Rev. Rul. 83-106, 1983-2 CB 77 ("[u]ncertainty as to collection must be substantial and not

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simply technical in nature for the accrual of income to be prevented ... Substantial evidence as to the financial instability or even the insolvency of the debtor must be presented for this exception to the accrual of income to apply"); *see, e.g., Jones Lumber Co.,* CA-6, 69-1 USTC ¶9113, 404 F2d 764, aff'g, 26 TCM 398, Dec. 28,426(M), TC Memo. 1967-81; *Chicago and North Western Railroad,* 29 TC 989, 996, Dec. 22,867 (1958).

[107] *Union Pacific Railroad,* 14 TC 401, Dec. 17,528 (1950).

[108] TAM 9538007 (Jun. 13, 1995). In this ruling, the DI in question traded at 10 percent of face, the issuer had missed payments on debt senior to the DI and the issuer had stated publicly that its viability as a going concern was doubtful. The IRS conceded that the doubtful collectibility exception to accrual method interest would apply on these facts.

[109] The IRS position in TAM 9538007 is based principally on a selective reading of the legislative history to the OID provisions of the Code and on the policy argument in favor of matching income with related deductions. With regard to legislative history, the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA) states that the OID rules were intended to "[u]se a method that parallels the manner in which interest would accrue through borrowing with interest-paying, nondiscount bonds." *See* S. REP. 97-494, 97th Cong., 2d Sess 212 (1982). Moreover, the legislative history of the amendments to the OID provisions state that "the application of the OID rules will require the issuer and the holder of the DI to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently." S. REP. 99-83, 99th Cong., 1st Sess. 5 (1985). These statements suggest Congressional intent to conform OID accounting with accrual method principals and therefore support the view that "doubtful collectibility" principles should apply to OID. Moreover, violating the matching principle in this context is unlikely to jeopardize the fisc to any significant degree since the issuer in such circumstances is unlikely to have current taxable income against which its interest deductions may be offset.

[110] Code Sec. 166(a).

[111] Code Sec. 166(b); Reg. §1.166-1(d).

[112] Code Sec. 166(a)(2); Reg. §§1.166-1(d) and 1.166-3(a)(2)(i).

[113] Reg. §§1.166-1(a) and (b) and 1.166-4.

[114] *See* Reg. §1.166-2 and Rev. Rul. 71-577, 1971-2 CB 129.

[115] *See C.C. Wilson,* CtCls, 67-1 USTC ¶9378, 376 F2d 280, 179 CtCls 725; *but see* Reg. §1.166-2(d) (providing certain ameliorative rules where a bank or other regulated corporation is required by law to charge off debts even though the federal income tax standard for partial or complete worthlessness has not been satisfied).

[116] Code Sec. 166(d)(1).

[117] Code Sec. 166(d)(2); Reg. §1.166-5(b).

[118] Code Sec. 165(g)(2)(C).

[119] Code Sec. 166(e).

[120] *See S. Morton,* CA-7, 40-2 USTC ¶9495, 112 F2d 320 (deduction allowed where "it appears that the taxpayer received all the return that is possible for him to receive from the property"). One of the identifiable events recognized by the courts as indicating complete worthlessness is the adoption and commencement of a plan of liquidation, sale of assets and distribution in liquidation of a corporation. *See A.S. Genecov,* CA-5, 69-2 USTC ¶9456, 412 F2d 556; *see also Miami Beach Bay Shore Co.,* CA-5, 43-1 USTC ¶9498, 136 F2d 408.

[121] Code Sec. 165(g)(3); Reg. §1.165-5(b)–(d).

[122] Code Secs. 354(a)(1) and 356(d)(2)(A).

[123] *See generally* BORIS I. BITTKER & JAMES E. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th ed.), at ¶12.41[3].

[124] Code Sec. 356(c).

[125] Code Secs. 354(a)(2)(A)(i) and 356(a)(1)(B), (d)(2)(B). The meaning of the term "principal amount" as used in these provisions is not entirely clear. In general, it probably means the stated principal amount of the instrument rather than (where different than stated principal) the "issue price" of the instrument as determined under Code Secs. 1273 and 1274. *See, e.g.,* GINSBURG & LEVIN, *supra* note 94, ¶605, at note 5.

[126] Code Sec. 354(a)(2)(B).

[127] Code Sec. 358(a)(1).

[128] *See* Reg. §1.1273-2(h)(1).

[129] Code Sec. 1271(a)(1).

[130] Code Sec. 1001.

[131] Reg. §1.1001-1(g)(1).

[132] Code Sec. 453(a)(1) and (c).

[133] Code Sec. 453(f) and (k)(2); Reg. §15A.453-1(e)(5).

[134] Code Sec. 453A(a)–(c).

[135] *See* Reg. §1.66-3(a)(3).

[136] Code Sec. 354(a)(1).

[137] Code Sec. 356(c).

[138] Code Secs 354(a)(2)(A)(i) and 356(a)(1)(B). Nonqualified preferred stock (as defined in Code Sec. 351(g)(2)) is not taxable where received in exchange for securities in a reorganization. *See* Code Sec. 354(a)(2)(C)(i) (nonqualified preferred stock not treated as stock or securities if received in exchange for "stock other than nonqualified preferred stock") (emphasis added).

[139] Code Sec. 354(a)(2)(B).

[140] Code Sec. 358(a)(1).

[141] Code Sec. 305(b)(4) and (c); Reg. §1.305-5(b)(1).

[142] Code Secs. 301(c)(1) and 305(b)(4).

[143] *See* Rev. Proc. 81-60, 1981-2 CB 680, §4.02; Rev. Rul. 75-179, 1975-1 CB 103.

[144] Code Sec. 1001.

[145] Code Sec. 108(e)(7)(A).

[146] Reg. §1.108-2(g)(1).

[147] *See generally* Code Secs. 171 (amortizable bond premium) and 1276–1278 (market discount).

[148] Code Secs. 1276 and 1278(b).

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