

TAX SECTION

New York State Bar Association

Report on Proposed Regulation

§1.1001-3 Relating To Modification of Debt Instruments

Committee on Tax Accounting Matters

January 20, 1994

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# TAX SECTION

## New York State Bar Association

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Dear Assistant Secretary Samuels and  
 Commissioner Richardson:

Enclosed is a report prepared by the Committee on Tax Accounting Matters of the Tax Section of the New York State Bar Association relating to Proposed Regulation §1.1001-3. The report deals with the specific questions posed by the Internal Revenue Service in its notice of proposed rulemaking dated December 1, 1992, and other substantive issues raised by the proposed regulation. I hope it will assist you in finalizing the regulation.

Yours truly,

Peter C. Canellos

Enclosure

cc: Peter V.Z. Cobb, Esq.

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Report on Proposed Regulation  
§1.1001-3 Relating To Modification  
of Debt Instruments

New York State Bar Association  
Committee on Tax Accounting Matters\*  
January 20, 1994

This Report sets forth the comments of the Committee on Tax Accounting Matters of the New York State Bar Association (the "Committee") on Proposed Treasury Regulation §1.1001-3 (the "Proposed Regulations"), which is proposed to govern the circumstances under which modifications to debt instruments will result in a "deemed exchange" for purposes of §1001 of the Internal Revenue Code. In general, the Committee believes that the Proposed Regulations provide useful guidance to practitioners and others regarding when a change to a debt instrument will be treated as a "significant modification," and, therefore, as a deemed exchange of the debt instrument. Such guidance is particularly necessary in view of the many debt workouts that are currently taking place.

Areas in which the Committee believes further guidance, clarification, or modification is necessary are discussed below.

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\* The principal authors of this report are Elliot Pisem, Romina Field Weiss, and Harold L. Adrion. Helpful comments were provided by Harvey P. Dale, Stuart J. Goldring, David Hariton, Stephen B. Land, Kurt F. Rosell, Michael Schler, Willard B. Taylor, and Ralph O. Winger.

I. ISSUES WITH REGARD TO WHICH THE SERVICE HAS SPECIFICALLY REQUESTED COMMENTS

1. Use of Bright-Line Rules Versus a Facts and Circumstances Approach.

a. In general.

The Committee supports the use of a bright-line rules approach in determining whether the alteration of a debt instrument should be treated as a deemed exchange. Bright-line rules are useful in that they allow taxpayers to structure transactions falling within the guidelines with knowledge of what the effects of a specific transaction will be. While bright-line rules may cause unintended hardships for some taxpayers who are caught unawares within the technicalities of the law, these results can often be alleviated by the Service through a prospective application of the Proposed Regulations and by taxpayers through careful planning. Those situations to which it is either impossible or impractical to apply bright-line rules or which do not lend themselves to be governed by bright-line rules should continue to be governed under a facts and circumstances regime.

A substantial minority of the members of the Executive Committee believes that the bright-line rules provided in the Proposed Regulations should be treated as safe-harbor provisions and that a general facts and circumstances test should be applied to determine whether a particular modification is significant. These members believe that the bright-line rules are not flexible enough to accommodate many of the situations that will arise. For example, they argue that whether a change in yield of 25 basis points is, in reality, "significant" depends on whether the

environment is one of high or low interest rates. Note, however, that changing the bright-line rule to provide that, if the original yield of an instrument changes by more than a given percentage, the modification will be significant would eliminate the problem of using a specific number that does not adjust relative to the interest rate climate. Another argument that has been made is that using bright-line rules may result in harsh and unintended consequences for taxpayers who do not engage in modification transactions for tax purposes (most do not) or who are not advised by tax practitioners. However, this problem arises in every situation that is governed by bright-line rules and appears to be a plea against the use of any and all bright-line tests.

Although a "facts and circumstances with safe harbors" approach does provide some guidance to taxpayers, it still leaves many open questions. Until now, the test for determining whether an alteration to a debt instrument constitutes a deemed exchange has been a facts and circumstances test. This regime created much uncertainty and culminated in the Supreme Court's decision in Cottage Savings Association v. Commissioner, 111 S. Ct. 1503 (1991). The Proposed Regulations were a direct response to that decision and "an effort to provide certainty" in this area. Accepting a facts and circumstances regime recreates all the problems that the Proposed Regulations were intended to address. Ease of administration and clarification would not be improved. In addition, providing safe harbors encourages aggressive planning outside the safe harbor, while bright-line rules do not.

b. Implementation of bright-line approach.

There remain a number of undefined parameters in the Proposed Regulations that may warrant further clarification:

(1) In the case of a variable rate instrument, a change in the mechanism used to determine the interest rate for each period is a significant modification if the change can reasonably be expected to affect the annual yield on the instrument by more than 25 basis points. Prop. Reg. §1.1001-3(e)(2)(i). How might this "reasonable expectation" be determined?

One possibility would be to compare the yields generated by each of the mechanisms over the prior two years. If the annual yields differed by more than 25 basis points, then a change from one mechanism to the other should be treated as one that can reasonably be expected to affect the annual yield on the instrument by more than 25 basis points.

(2) A change in the timing and/or amounts of payments is a significant modification if it materially defers payments due under an instrument. Prop. Reg. §1.1001-3(e)(2)(i). In the example provided to illustrate this rule, four annual interest payments are deferred by four, three, two, and one year, respectively, with compounding of interest. Prop. Reg. §1.1001-3(g), Example 4. This results in an effective extension of the weighted average life of all payments due under the 20-year debt instrument by less than one year. The Committee believes that such a deferral is not a "material" deferral. A different example, such as one in which the extension of the weighted average life of all payments is more than one year, or, equivalently, more than 5% of the total time to maturity of the instrument, should be provided.

(3) An extension of the final maturity date of an instrument is treated as a significant modification if it exceeds the lesser of five years or 50 percent of the original term of the instrument. If, however, the extension of the final maturity date is only for de minimis payments, the extension will be disregarded. Prop. Reg. 51.1001-3(e)(2)(ii). No definition of what constitutes a de minimis payment for this purpose is provided. If the amount of the payment that is extended is less than 5% of the amount due, that payment should be treated as de minimis.

Note, also, the inconsistency between the rule regarding interim deferrals, which applies a facts and circumstances test, and the rule regarding extensions of maturity, which applies a bright-line test. Because of this inconsistency, the treatment of the deferral of a payment on an instrument such as a serial note is left in doubt. The inconsistency could be eliminated by applying the same bright-line test to both interim deferrals and extensions of final maturity. It would then be irrelevant whether a particular payment were labelled principal or interest. The test could be based on a percentage change in weighted average maturity of all payments under the instrument.

(4) The addition or deletion of a put, call, conversion, or exchange right to or from an instrument is a significant modification if such right has significant value at the time of its addition or deletion. The alteration of an existing put, call, conversion, or exchange right is a significant modification

if the alteration significantly affects the value of the right, or, in the case of a conversion or exchange right, if the corporation whose stock is to be received in the exchange is changed. Prop. Regs. §§1.1001-3(e)(2)(iv) and 1.1001-3(e)(4)(iii)(A). What constitutes "significant value" and when is the value of a right treated as "significantly affected"? The Committee suggests that a put, call, conversion, or exchange right should be treated as having significant value if its value is equal to or greater than a fixed percentage of the value of the debt instrument to which it relates. The value of a right should be treated as significantly affected if its value changes by more than a fixed percentage of the value of the debt instrument.

In addition to adding liquidity and security, a put right may also constitute a disguised payment term that changes the yield of an instrument. In such a case, the addition or deletion of a put right should also be tested for significance under the rules regarding changes in yield.

(5) A change in the collateral securing a nonrecourse note generally is a significant modification if a substantial portion of the collateral is released or replaced with other property. Prop. Reg. §1.1001-3(e)(3)(iv). The Service should provide additional guidance regarding what constitutes a "substantial portion" of the collateral and what facts would be sufficient to create an exception to the general rule.

(6) Certain modifications, such as the addition of a co-obligor on a debt instrument or the addition of a guarantee or other form of credit enhancement on a recourse instrument, are not significant modifications, unless the addition is intended to circumvent the rules regarding a change in obligor. Prop. Reg.

§1.1001-3(e)(3)(ii) and (iii). Rather than having an anti-avoidance rule based on the subjective intent of the parties, which is difficult to administer, a facts and circumstances test based on such factors as the relative creditworthiness of the obligor and guarantor should be applied to determine whether there has, in fact, been a change in obligor. For example, if, at the time of the addition of a co-obligor, it is reasonably certain that the co-obligor, and not the original obligor, will make the payments under the instrument, then it might be appropriate to treat the addition of the co-obligor as a change in obligor.

## 2. Effect of Regulations on Other Sections of the Code.

The Proposed Regulations do not deal explicitly with the tax treatment of the issuer after there has been a deemed exchange. The logical conclusion, and the one that seems to be mandated by the legislative history of §108(e)(11),<sup>1</sup> is that, when there has been a deemed exchange, the issuer will be treated as having issued new debt. This result should be explicitly stated.

The rules governing whether the modification of a debt instrument constitutes a disposition of such instrument for purposes of §1001 have, in the past, differed from those under other sections of the Code, such as §453B.<sup>2</sup> There is no reason

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<sup>1</sup> H.R. Rep. No. 881, 101st Cong., 2d Sess. 354 (1990).

<sup>2</sup> Under the language of §453B, which provides that if an installment obligation is "satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result..." a deemed exchange of an installment obligation under §1001 should invoke the realization of gain or loss under §453B. This, however, is not the law. See Cunningham v. Commissioner, 44 T.C. 103 (1965), acq. 1966-2 C.B. 4; Rev. Rul. 82-122, 1982-1 C.B. 80. Modifications of the magnitude described in Cunningham (change in obligor coupled with a release from liability of the original obligor) and Rev. Rul. 82-122 (increase in the interest rate on the note of 2%, coupled with the substitution of a new obligor and release of the old

that rules which may be useful for one purpose must govern for all purposes, and such a result, although easy to administer, may not be desirable. For example, the provisions of the Code relating to installment obligations (§§453 et seq.) are based on the need to provide relief from recognition of gain when the taxpayer does not have funds available to satisfy his tax liability. Thus, it is appropriate that, until the need to postpone recognition of gain ceases, gain is not recognized.

If, however, there has been a deemed exchange under §1001, provisions of the Code that are triggered as collateral consequences of deemed exchanges, such as testing for original issue discount ("OID") under §§1271-1275, should apply. This result is consistent with the repeal of former §1275(a)(4) by the Revenue Reconciliation Act of 1990.<sup>3</sup>

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obligor), which did not result in "dispositions" under §453B, would generally result in dispositions under §1001.

<sup>3</sup> Note, however, that the reenactment and expansion to noncorporate debtors of former §1275(a)(4), as previously proposed by the Tax Section, would render less significant many of the issues raised by the Proposed Regulations. See New York State Bar Association Tax Section Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges, March 25, 1991, reprinted in 51 Tax Notes 79 (April 8, 1991).

There are cases in which application of the Proposed Regulations may result in unfair, harsh, and/or unintended consequences. In such circumstances, specific rules can be carved out under the relevant Code sections. For example, in the case of a tax-exempt bond that would be treated as reissued because of a "significant modification" and would therefore lose its tax-exempt status, a specific rule can be added that will provide that the bond will not be treated as exchanged for purposes of determining its tax-exempt status. Likewise, it may be necessary to provide for an exception from the denial of a deduction under §163(f) (relating to interest on registration-required obligations that are not in registered form) for deemed reissuances of bearer-form debt, because such debt may not be able to meet the "arrangements reasonably designed" requirement of §163(f)(2)(B)(i).

There are situations in which the effective date provision of a Code section, for example, that with respect to high yield debt obligations under §163(e), provides grandfathered status to debt instruments issued prior to a certain date. The question then arises as to whether the deemed exchange of such a debt instrument will cause the instrument to lose its grandfathered status. We suggest that, with respect to any outstanding debt obligations to which grandfather provisions apply, the principles of current law that are used to determine whether there has been a sale or exchange of the debt instrument should apply. However, a deemed exchange under the Proposed Regulations should not cause the instrument to lose the benefits of the grandfathered status, i.e., there should be no retroactive application of other Code provisions by reason of the Regulations, at least prior to the original maturity date of the debt instrument. It should be presumed, with respect to future amendments to the Code that provide for grandfather clauses with

respect to their effective dates, that modifications of debt instruments that cause deemed exchanges under the Proposed Regulations will be treated as reissuances unless the statute specifically provides otherwise. The decision as to whether the grandfather provision should apply after a deemed exchange in a particular case should be made with emphasis on the question of whether the goals of the provision in question could be avoided by continuing the grandfathered status after a deemed exchange.

3. Expansion of Proposed Regulations to Include Modifications of Other Types of Financial Instruments Such as Forwards, Options, and Notional Principal Contracts.

Rules governing when an alteration of any of these types of instruments will constitute an exchange of the instrument have not yet been developed. In fact, many of the rules relating to the substantive taxation of these instruments have not yet been clarified; for examples, the OID regulations and rules governing the application of §246 in the case of stock that is the subject of a straddle are still in proposed, rather than final, form.

Furthermore, the Proposed Regulations, and the changes which the Committee expects will be made to them, have not yet been put into practice. Rather than acting now to apply them wholesale to other types of financial instruments, the detailed rules in the Proposed Regulations in their final form should be allowed to govern only debt instruments for a period of time; when the application of these rules has been proven to be effective, they can then be used as a basis upon which to construct rules governing other types of instruments.

Because of a lack of any other guidance in the area, however, practitioners will tend to base their determinations of whether there has been an exchange of a warrant, forward, option, or notional principal contract on analogies to the rules provided in the Proposed Regulations. In fact, Treasury Regulation §1.446-3(h)(1) provides that, in the case of an assignment of a notional principal contract to a third party, the original nonassigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under §1001. We believe it may be appropriate to apply the general principles of the Proposed Regulations, though not all of their detailed provisions, by analogy to other types of financial instruments. For example, it would appear appropriate to apply a general principle regarding "unilateral changes" to treat a change in a warrant made pursuant to the original terms of such warrant as not a deemed exchange for tax purposes.

4. Change in Statute or Governmental Regulation as a Realization Event.

A change in a statute or governmental regulation may, in effect, modify a debt instrument in a manner that would cause a "significant modification" and, therefore, an exchange under §1001. These types of modifications, however, may fall outside the control of the issuer and holder of the debt instrument, and may, in fact, be contrary to their intent or expectations. For example, a state may change its usury laws and thereby cause the yield on certain types of bonds to increase or decrease beyond the expectations of either of the parties.

From a theoretical perspective, the Proposed Regulations appear to apply even to debt instruments that are modified because of circumstances that are not within the control of the issuer or the holder. Because these changes are outside the control of the issuer and the holder and, therefore, do not lend themselves to abuse, a rule that would specifically exempt such alterations from the definition of modification should be provided.<sup>4</sup> Additional support for such a rule is the fact that every debt instrument implicitly contains a provision that it is subject to governing law, and, therefore, a modification that results from a change in law is a modification pursuant to the original terms of the instrument.

Furthermore, from a tax administration perspective, the parties may not even realize that a deemed exchange has occurred. Taxpayers should not be expected to report transactions with respect to which they are unaware that they are parties.

A change in terms imposed by statute must be distinguished from a situation in which a statute changes the economic or other background against which the debt was originally issued. In such a case, the issuer and holder may decide, or, in effect, be "forced" to modify the debt instrument. Such a change is akin to a change in the financial circumstances of the debtor. In the case of such a modification, the parties are agreeing to the modification and the deemed exchange rules should apply.

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<sup>4</sup> In a case in which the sovereign changing the law is also the issuer of the debt instrument, however, the considerations for determining whether there has been a modification might be different.

## II. OTHER SIGNIFICANT ISSUES

### 1. "Unilateral" Waiver.

If the exercise or waiver of a right requires consideration that is not fixed on the issue date, it is not considered unilateral. Prop. Reg. §1.1001-3(c)(2)(A). This result is appropriate because it requires a new settlement of terms among the parties. (The Proposed Regulations, in fact, provide that the waiver of a right is not unilateral if it represents a settlement of terms among the parties. Prop. Reg. §1.1001-3(c)(2)(B).)

It is difficult to determine when the exercise or waiver of a right will be considered unilateral under the Proposed Regulations. For example, in the typical workout situation, it is often unclear whether a quid pro quo has been given for nonexercise of a right such as an acceleration clause. A creditor might agree not to accelerate debt upon nonpayment, knowing that the issuer would in any event not be able to repay it and would be forced into bankruptcy. Is it a modification, then, when, without discussing this possibility, the seller does not exercise its right? Is the result changed if the borrower threatens to go into bankruptcy and the seller then waives its right? What if the buyer merely states this outcome as a fact or hints at it and the seller knows not to accelerate? The distinctions between these fact patterns are difficult to discern. The problem is exacerbated by the fact that there can be a deemed exchange even when there is no written agreement as to the terms of a modification, but one can be implied from the conduct of the parties. Prop. Reg. §1.1001-3(c)(1).

Although the Committee finds difficulty with the unilateral exercise rule, it has been unable to devise a better rule for curbing abuse through modifications of debt instruments and therefore agrees with the rule provided in the Proposed Regulations. Further clarification of this rule would, however, be helpful.

## 2. Reduction in Principal Amount

Proposed Regulation §1.1001-3(e)(1)(ii) provides that, in the case of a change not described in paragraph (e)(1)(i) or (iii) of that section (i.e., change in interest rate or change in index), a modification that changes the annual yield on the instrument is a significant modification if the annual yield on the instrument after the modification, measured from the date the parties agree to the modification to the instrument's final maturity date, varies from the yield on the original, unmodified instrument for the same period by more than 1/4 of one percent (25 basis points). Proposed Regulation §1.1001-3(g), Example 3, provides that, for purposes of paragraph (e)(1)(ii), an instrument's yield after modification is computed based on the adjusted issue price of the debt instrument before the modification. Consequently, under the Proposed Regulations most reductions in principal will result in a change in yield which is not de minimis and, thus, will result in a significant modification. Similarly, in Rev. Rul. 89-122, 1989-2 C.B. 200 (Situation 2), the Service ruled that if a creditor and a noncorporate issuer agree to reduce the principal amount of a debt, the agreement constitutes an exchange of an old debt for a new debt and the creditor realizes gain or loss; however, the creditor would not recognize a gain or loss if the issuer were a corporation and the old and new debts constitute securities, since the exchange would constitute a recapitalization. This

result has been criticized because a reduction in principal does not change any terms of the remaining portion of the debt.<sup>5</sup>

Even when a creditor receives property in settlement of a debt, the transfer constitutes neither a sale nor an exchange of the unsatisfied portion of the debt. Where the property received is worth less than the face amount of the debt, the portion of the indebtedness that remains unsatisfied constitutes a bad debt. Treas. Reg. §1.166-6(a)(1). The reason for this treatment is that an obligation disappears when it has been settled.

This is consistent with the holding of the Supreme Court in Fairbanks v. United States, 306 U.S. 436 (1939). While much of the holding in Fairbanks v. United States has been reversed by statute, it nevertheless continues to be good law in this respect and is consistent with Reg. §1.166-6(a)(1).

Consequently, the rule should be that a creditor does not have a sale or exchange when all or part of a debt is canceled. This rule should be applicable even in situations where debt instruments are actually exchanged. For example, if a debtor gives a creditor a \$50 debt in extinguishment of a \$100 debt, the receipt of the \$50 debt, assuming all of the other terms of the instrument remain the same, is not an amount received on retirement of the entire \$100 debt; rather it represents a continuation of only a portion of the \$100 debt.

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<sup>5</sup> New York State Bar Association Tax Section Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges, March 25, 1991, reprinted in 51 Tax Notes 79 (April 8, 1991).

### 3. Change in Obligor.

The Proposed Regulations provide, with certain exceptions, that a change in obligor on a recourse instrument constitutes a significant modification. Prop. Reg. §1.1001-3(e)(3). The Preamble to the Proposed Regulations asks whether an additional exception should be made for a change in obligor resulting from the assumption of a recourse debt instrument in connection with the sale of the property securing the instrument. The Committee believes that there are circumstances in which such an additional exception should be made, provided that the original obligor is not released from liability in the transaction.

The case in which there is an addition of a new obligor without the release of the old obligor is analytically similar to the addition of a co-obligor, discussed at I.1.b.(6), above. Nevertheless, it should be recognized that it is difficult to have a single formulation that addresses all of the different factual circumstances that may be present in the case of the assumption of a debt instrument in connection with the sale of the underlying security. For example, the underlying security may be income-producing property that produces the funds used to pay the debt, and the income produced by the property may or may not be sufficient to cover the debt. The answers to these questions should be relevant to determining whether the assumption of a debt instrument should be treated as a significant modification. The Committee proposes that the determination of whether, in a given case, the assumption of a debt instrument in connection with the sale of the underlying security be treated as a

significant modification, be based on the surrounding facts and circumstances rather than having a bright-line rule apply.<sup>6</sup>

For similar reasons, the assumption of recourse debt in connection with the sale of substantially all of the assets of a debtor should also be governed by a facts and circumstances test.

In the case of a novation in which the original obligor is released from liability, the rule should be different. The holder made a bargain with the issuer and was willing to take the risk inherent in lending money based on the credit of the particular issuer. When the obligor changes and the original obligor is released, even if the collateral securing the note remains intact, the debt instrument has changed, and treating such a modification as a deemed exchange is appropriate. In contrast, in the case of a nonrecourse note, the holder looks to the collateral securing the note for satisfaction of the debt and a change in obligor should not be treated as a significant modification.

An interesting question arises if the general partner of a partnership that is the obligor on a recourse note changes. (It is assumed that the instrument effectively prohibits a change in general partner without the creditor's consent, because, if that were not the case, the change should be treated as pursuant to the original terms of the instrument and would not be a modification. Prop. Reg. §1.1001-3(c)(2).) The obligor, i.e., the partnership as an entity, has not changed, but a party to whose

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<sup>6</sup> There is, however, a potential inconsistency between this rule and the rule in §1274(c)(4), which provides that if a debt is assumed in connection with the sale or exchange of property, the assumption of the debt will not be taken into account in determining whether §483 or §1274 applies to the instrument.

ultimate credit the holder of the instrument is looking for payment has changed. If the change is viewed as a change in obligor, then the modification is significant. If the change is viewed as a material alteration in a guarantee, for example, then the modification will be significant if it is akin to a change in obligor and the change is intended to circumvent the rules regarding changes in obligor. Prop. Reg. §1.1001-3(e)(3)(iii). In the posited case, the change in "guarantor" is not, presumably, intended to circumvent the rules regarding a change in obligor. Therefore, because of the inconsistency between the treatment accorded to changes in obligor and that accorded to changes in guarantor, a line must be drawn to dictate how this case should be treated. However, if a facts and circumstances test with respect to whether the alteration of a guarantee is a significant modification, as recommended in I.1.b.(6) above, is applied, such a modification would probably be treated as a change in obligor and as a significant modification.

#### 4. Defeasances.

Proposed Regulation §1.1001-3(d), Example 6, explicates the rule that a taxable exchange does not occur if the debt is altered pursuant to the original terms of the debt instrument. The example illustrates that the rule even applies to an assumption of a debt obligation by a third party, at least if the assumption occurs in connection with the sale of mortgaged property. The example should be clarified to provide that it applies to an assumption of a debt instrument pursuant to its original terms.

Consider, however, a debt instrument issued by corporation X that provides that X may, at its option, redeem X's note by giving the noteholder an outstanding publicly traded note of unrelated corporation Y, where Y is not a party to the exchange. Although this case is not very different from the case where Y agrees to assume the X debt with a predetermined change in terms, we assume that this type of exchange was not intended to be tax-free to the holder. The ultimate example of this situation is where Y is the U.S. Government, and X places Treasuries in a defeasance trust in a "true defeasance" (where X is released from liability under the terms of the X debt after doing so). The Proposed Regulations should be clarified to make clear that this type of debt exchange, where the obligor on the new debt is not a party to the exchange, is not protected by the rule relating to the original terms of the debt instrument.

5. Change in the Recourse Nature of Debt.

The Proposed Regulations provide that changes from recourse to nonrecourse debt and vice versa constitute significant modifications. Prop. Reg. §1.1001-3(e)(4)(iv). When a debt instrument is changed from being a nonrecourse to a recourse obligation, it is tantamount to the addition of collateral or the enhancement of credit. In such a situation, therefore, the rules with respect to the addition of collateral should apply. One of the factors that should be used in making the determination of whether there has been a change in obligor for purposes of determining whether credit enhancement is a significant modification should be whether the instrument has changed from nonrecourse to recourse. That factor might be considered so important that such a modification would create a rebuttable presumption that a significant modification had occurred.

When a debt instrument is changed from recourse to nonrecourse, the holder of the instrument is agreeing to limit its recourse to certain property -- whether it be all, a significant amount, or almost none, of the property of the debtor -- from which to collect the debt. In any event, the holder is generally agreeing not to seek repayment out of after-acquired property of the debtor. The holder has, in effect, agreed to change its bet from one on the creditworthiness of the debtor to one on the value of the assets securing the debt. As provided in the Proposed Regulations, this should constitute a significant modification.

An exception might be appropriate, however, for recourse obligations of single-purpose entities that are, in substance, nonrecourse obligations. For example, in the case of a corporation that is formed to purchase a particular parcel of real property, that property may be the only asset of the corporation and the only collateral securing the loan that was made to the corporation for purposes of purchasing the property. In such a case, the lender has no recourse to other assets (because there are none). Such a transaction is the equivalent of a nonrecourse loan, and changing such a loan from recourse to nonrecourse has no economic effect. It is merely a technical change.

#### 6. Temporary Failure to Perform.

The Proposed Regulations provide that a temporary failure by the issuer to perform will not be deemed a modification. Prop. Reg. §1.1001-3(c)(2)(ii). It is unclear; however, what constitutes a temporary failure.<sup>7</sup>

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<sup>7</sup> A temporary failure to perform, moreover, may have ancillary effects such as causing a change in the instrument's yield. Such change might

One way to deal with this is to provide safe harbors describing what constitutes a temporary inability to perform.

The Service has already suggested, with respect to an inability to perform, that such an inability will be considered temporary as long as the yield on the instrument is not changed by more than 50 basis points. Statement of David P. Madden at a February 25, 1993, meeting of the District of Columbia Bar (quoted in Tax Notes, March 8, 1993, p. 1285). This leads to the conclusion that a temporary inability to perform coupled with an agreement to compound interest for the period of missed payments so that the yield on the instrument is unchanged would not constitute a significant modification.

Another issue arises with respect to Prop. Reg. §1.1001-3(d), Example 9, which provides that if the holder of an instrument waives a right for a period of three months, the waiver is temporary. Workouts and reorganizations often take longer than three months, however. Therefore, is three months to be understood to be the outer limit for what would be a temporary waiver? The Service has stated that the provision should not be so understood, but rather should be viewed merely as an example. Statement of David P. Madden, supra.

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constitute a significant modification under other provisions of the Proposed Regulations and, therefore, cause a deemed exchange.

A better rule would be for the entire period required for a workout or reorganization to be deemed a period of temporary inability to perform. In this manner, the parties could work out various issues with respect to the debt without having constantly to worry that they are creating unintended exchanges with the compliance burdens and tax consequences attendant thereto. At the end of the workout, it is likely that significant modifications would take place and an exchange would occur at that time. Nevertheless, any actual intermediate modification should be treated as a deemed exchange, even if it may be difficult to determine when such a modification has occurred. In order to prevent abuse, an outer time limit for workouts could be set.

#### 7. Conversion into Stock.

The Proposed Regulations provide that conversion of a debt instrument into stock of the issuer pursuant to the terms of the instrument is not a modification. Prop. Reg. §1.1001-3(c)(3). (Compare Revenue Ruling 72-265, 1972-1 C.B. 222, which provides that "no gain is realized" when a convertible bond is converted into the stock of the obligor corporation, suggesting, however, that an "exchange" has taken place.) A stock-for-debt exchange pursuant to a workout will be a significant modification.

Conversion of a debt instrument into stock of a corporation other than the issuer (pursuant to the terms of the instrument) should be treated as an exchange, whether or not it constitutes a modification. See Rev. Rul. 69-135, 1969-1 C.B. 198.

## 8. Debt/Equity.

The Proposed Regulations provide that when an instrument has been converted from debt to equity ("an instrument that is not debt") a significant modification has occurred. Prop. Reg. §1.1001-3(c)(3) and (e)(4)(i). The Committee agrees. An assumption that appears to underlie the Proposed Regulations, however, is that whenever a modification occurs is an appropriate time for testing to see whether an instrument has been converted from debt to equity.<sup>8</sup> That should not be the rule, however, because an instrument that is initially debt remains debt in its unmodified form even if the likelihood of repayment decreases drastically. Therefore, any attempt to restore the original likelihood of payment, even if such attempt constitutes a taxable event, should not automatically require retesting under the traditional debt/equity tests. In addition, in the current financial climate, the retesting requirement may impose a significant barrier to workouts.

One possibility is a rule that provides that a revised debt instrument will not be considered to have changed its character to equity as long as the modification represents a good faith effort to improve the likelihood of payment of the original debt and does not give the holder the possibility of receiving a return greater than it would have received on the original debt (including interest at the AFR).

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<sup>8</sup> A related question is whether, if there has been a deemed exchange under §1001 and the new instrument constitutes debt (and not equity), the instrument should be retested to determine whether it is a "security" within the meaning of §354. The Committee believes that the time of a deemed exchange is an appropriate time for retesting whether the instrument is a security.

Another possibility would be for the debt/equity determination to be made based on the instrument's modified terms, but as of the time the instrument was originally issued. This is because many modifications occur when the issuer is in financial distress and even the debt instrument in its unmodified form, tested against such a background, might constitute equity.<sup>9</sup> The Committee believes that applying such a rule balances the various policies implicated in such a transaction.<sup>10</sup>

#### 9. Filing Petition for Bankruptcy

There is little authority on whether, upon a debtor's filing for bankruptcy, the debtor's outstanding debt obligations are deemed to have been exchanged.<sup>11</sup> Although there are changes in substantive rights of holders of the debtor's debt obligations as a result of a bankruptcy filing, the Committee believes that, in view of the policy of facilitating the rehabilitation of debtors and the administrative difficulties in determining the amount of debt canceled, an exchange should not occur until either a binding agreement is reached by the debtor and its creditors or the discharge or modification of the debt by the Bankruptcy Court. Furthermore, the changes in the substantive rights of the parties wrought by the filing of a petition in bankruptcy can be seen as changes pursuant to the original terms of the instrument because the bankruptcy law is inherently an

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<sup>9</sup> An analogous suggestion, but one that is perhaps too favorable to taxpayers, was made in the report on the Proposed Regulations by the Association of the Bar of the City of New York. The suggestion of that report was that the test to determine whether an instrument had been converted from debt to equity should be based only on the terms of the modified instrument, apparently without regard to the financial condition of the debtor at any time.

<sup>10</sup> Compare Prop. Reg. §1.1274-3(b)(1).

<sup>11</sup> The American Bar Association Report of the Section 108 Real Estate and Partnership Task Force, (July 17, 1992) was divided on this issue; see pp. III-4 to III-5.

original term of the debt instrument and represents the exercise of a unilateral right.

The Regulations should clarify that a significant modification does not occur upon filing of a bankruptcy petition, but rather only upon an actual change to the terms of debt.

#### 10. Multiple Changes over Time.

If there are multiple changes to a debt instrument over time, none of which is significant by itself, the changes will be aggregated to determine whether a significant modification has occurred. Prop. Reg. §1.1001-3(f)(3)(ii). This is an anti-abuse rule that prevents the avoidance of the application of the exchange provisions through the use of multiple changes to the same instrument.

Nevertheless, there may be situations in which there are multiple changes to a debt instrument over time, each one unrelated to the next. One way to deal with this would be to create a presumption that multiple changes over time should be aggregated for purposes of determining whether a substantial modification has occurred, unless the taxpayer can establish that the modifications were independent and not contemplated at the start or used as an avoidance technique. There should, however, be a limit on the period over which multiple changes will be aggregated, e.g., two years. This would ensure that transactions that cause minor modifications and that are independent of each other, will not be aggregated to create an exchange.

### III. SUMMARY OF CONCLUSIONS

The Committee believes that the Proposed Regulations provide useful guidance as to when the alteration of a debt instrument will result in a deemed exchange for purposes of §1001. Nevertheless, there are a number of areas in which the Proposed Regulations, if modified, could be improved.

A summary of the conclusions reached and proposals offered by the Committee are outlined below:

1. Adopt the bright-line rules approach used in the Proposed Regulations.

2. Clarify the undefined parameters and other issues raised by the adoption of bright-line rules regarding:

a. a change in mechanism used to determine the interest rate of a variable rate instrument;

b. a change in timing and/or amounts of payments;

c. an extension of final maturity;

d. an addition or alteration of a put, call, conversion, or exchange right;

e. a change in the collateral securing a nonrecourse note;

f. an addition of co-obligor, guarantor, or other form of credit enhancement.

3. The Proposed Regulations should not govern whether there has been a disposition under other Code sections, but should be relevant in applying rules relating to the consequences of deemed exchanges under §1001.

4. Apply the principles, but not the specific rules, of the Proposed Regulations to other types of financial instruments.

5. A change in statute or governmental regulation outside the control of the holder and issuer that directly affects the terms of the debt instrument should not be treated as a realization event.

6. Explain when the exercise or waiver of a right tender the instrument will be treated as unilateral.

7. The reduction in the principal amount of a debt obligation without any other changes should not be treated as a significant modification.

8. A change in obligor on a recourse instrument should, with certain exceptions based on the facts and circumstances surrounding a particular case, be a significant modification.

9. A defeasance transaction should be treated as a significant modification.

10. A change in the recourse nature of a debt should generally be treated as a deemed exchange.

11. Expand the rule providing that a temporary failure to perform is not a modification to the entire period necessary for a debt workout.

12. The conversion of a debt instrument into stock of a corporation other than the issuer of the debt instrument should be treated as a deemed exchange, other than in a §381(a) transaction, even if pursuant to the original terms of the instrument.

13. An instrument should not be tested to determine whether it has been converted from debt to equity every time a modification occurs; a liberal rule for determining if and when such a conversion has taken place should be adopted.

14. The filing of a petition for bankruptcy should not be deemed a significant modification.

15. Provide for a rebuttable presumption that multiple changes to a debt instrument over time should be treated as a significant modification and a time limit for aggregation.