REPORT #689

TAX SECTION

New York State Bar Association

Report on Proposed Section 1275 Regulations
Concerning Contingent Debt Instruments
Part I - Technical Issues

April 30, 1991

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The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Contingent Payment Regulations

Dear Commissioner Goldberg:

We are writing in connection with the recently proposed regulations under section 1275 dealing with contingent payment obligations (the "Proposed Regulations"). The Proposed Regulations raise important tax policy issues, as well as presenting a host of problems of a more technical nature. As discussed later in this letter, we do not believe it was wise to issue the Proposed Regulations with an immediate effective date.

Because of the immediate effective date, we are describing our technical concerns in the attached report in order to aid the Treasury and Internal Revenue Service in providing prompt guidance to taxpayers. In doing so, however, we wish to make it clear that we remain concerned about the larger policy issues raised by the Proposed Regulations and the bifurcation approach which they embrace. We expect to address those issues in a subsequent report.

While we have not had time to consider fully the implications of bifurcation, and a consensus as to the theoretical and practical merits of the approach has yet to emerge in our Executive Committee, it may still be helpful to offer at this point a few observations on the topic that may serve to crystalize issues warranting further investigation.

Framework for Evaluating Bifurcation

Contingent payment debt instruments raise important tax policy concerns (particularly relating to the timing and character of income and losses). We agree that a new regulatory system for the taxation of such instruments is required that accords with economic substance, responds to these tax policy concerns, and is reasonably simple and administrable.

Bifurcation is one of several possible, potentially useful approaches that could be used in designing such a system. In addition, we believe that a bifurcation approach could be implemented in many different ways that would produce a range of substantive tax consequences and be more or less simple and administrable.

The principal argument in favor of bifurcating certain contingent debt obligations is that they are economically equivalent to a noncontingent debt plus a separate financial instrument. While we acknowledge that, at least in some cases, a contingent debt instrument may be economically equivalent, or at least quite similar, to debt combined with another financial instrument, we do not think that the merits of bifurcation should be tested primarily by asking whether such equivalence or similarity exists. This question does not seem to distinguish cases where bifurcation advances the analysis from those where it does not. Almost all financial

instruments can be equated to a package of other financial instruments, but it does not follow that better tax results are achieved by breaking instruments into their component parts.[1] Whether they are depends on the circumstances. Also, as indicated above, a range of possible tax results could flow from the core idea of bifurcation. We think that the actual timing, character and administrative consequences of any proposal for taxing a category of financial instruments should be the principal focus of attention in measuring its success.

One way to put to rest the question of the merits of bifurcation would be to adopt a system of taxation of financial instruments that achieves the same results whether an instrument is considered in the aggregate or as the sum of

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[1] To give one simple example, a conventional fixed rate bond with an issuer call right could be analyzed as a package of zero coupon bonds (one for each payment on the instrument, and each with its own yield reflecting its particular maturity) together with a call option written by the holder. Nonetheless, this approach has not been followed in taxing such instruments (or even seriously proposed). Also, in some cases the tax law is clearly (and appropriately) moving in the direction of integrating separate financial instruments (i.e., not recognizing component parts even when they are legally separate) to determine tax consequences. See, e.g., sections 988(d) and 851(g) and Treasury Regulation section 1.861- 9T(b)(6). Presumably, integration has been adopted in these settings on the pragmatic ground that it yields better substantive results (because the integrated instrument corresponds to a bond or other financial instrument for which there are settled tax rules).

its parts. One such system (and perhaps the only one) is a complete mark-to-market regime for all financial assets that draws no distinction between ordinary and capital income or loss. However, avoiding the bifurcation issue through this route seems a very remote prospect. Instead, it seems we will continue to be required to divide financial instruments into categories or “boxes”, and apply different rules to each. In that context, the debate over bifurcation may be described as whether we are better off with a new, separate “box” for contingent debt instruments, or instead should attempt to divide them into two or more other “boxes,” for straight debt and other financial instruments.

Evaluation of Proposed Regulations

With this background in mind, we have begun to evaluate the Proposed Regulations by asking whether the bifurcation of contingent debt instruments of the type subject to the Proposed Regulations produces sensible tax consequences that fairly reflect the economic positions of the parties and can readily be determined by taxpayers and the Government. Our preliminary responses to this question follow:

1. Accrual of Interest. One consequence of the Proposed Regulations is that the holder and the issuer of a contingent debt instrument are required to accrue interest on the “debt

component” of the instrument based on a market rate of interest for the debtor. The current accrual of interest is a consequence of bifurcation. Bifurcation, however, is not the only way to achieve that result. For example, the “comparable noncontingent bond” proposal for taxing contingent debt instruments recommended in our 1987 report on the proposed original issue discount regulations would have required the accrual of interest at an AFR-based rate, but did not purport to divide a debt instrument into parts. (See Tax Notes, January 26, 1987, at 395.) The current accrual of income could also be achieved through a mark-to-market or mark-to-index scheme.

Two noteworthy features of the accrual rule in the Proposed Regulations are that (1) the accrual is based on a market interest rate for the issuer (as contrasted, for example, with an AFR-based rate) and (2) the market rate is applied to the issue price of the debt component, rather than of the instrument as a whole. Resort to a market rate does not strike a blow for simplicity or ease of administration, and also may foment electivity by taxpayers as discussed in paragraph 4 below. While a market rate may well exceed any AFR-based rate that might be selected, the total amount of interest that accrues under the rule in the Proposed Regulations is significantly reduced by applying

the rate only to the debt component of the instrument.[2]

Although the drafters of the Proposed Regulations may have focused primarily on the taxation of holders, we fully expect that taxable issuers would take advantage of any accrual rule by launching issues aimed at tax-exempt holders. Thus, it should not be assumed that an accrual rule would produce adverse results for taxpayers as a group (and indeed could result in a material loss of tax revenues).

2. Taxation of Contingent Rights. The Proposed Regulations cannot be properly judged by looking only at the tax treatment of the straight debt component of a contingent payment instrument. Under the Proposed Regulations, the discount at which the debt component is considered to be issued is treated as the cost of a separate financial instrument. The Proposed Regulations offer no guidance as to the tax treatment of that other instrument, other than to require that it be taxed as if it were issued separately. This result is not very satisfactory for a number of reasons summarize, below (some

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[2] For example, if a debt instrument provided for a payment of principal of J,000 at maturity after ten years, and wholly contins it interest, the AFR were 8%, and a market rate for straight debt were 11%, the interest that would accrue in the first year at the AFR applied to 1,000 would be 80, whereas the interest that would accrue at the market rate applied to the issue price of the debt instrument (the present value on the issue date of the principal payment calculated by discounting at the market rate) would be only 38.7.

of which are discussed further in the attached report).

First, any loss from the hypothetical separate financial instrument will often be capital loss, which cannot be offset against ordinary OID income realized with respect to the debt component. As a result, under the Proposed Regulations, a holder could be subject to a significant tax as a result of holding a contingent payment instrument even if the instrument produces no positive economic return.

Second, the Proposed Regulations will produce sensible results only if there are sensible tax rules governing the hypothetical separate financial instrument, and those rules can be applied to an instrument that is in fact not separately traded. This general concern can be further articulated in a number of different ways: (1) The separate financial instrument may not be a type that has been separately issued and for which the tax treatment is well settled. In that sense, bifurcation is in many cases only a halfway measure in providing guidance as to the treatment of a contingent debt instrument. (2) The separate financial instrument could equate economically to several different types of financial instruments that are subject to different tax regimes. What then? (3) Finally, rules developed for separately traded financial instruments may not work well for component parts of a larger instrument. An obvious example

is the mark-to-market regime of section 1256, which requires separate trading prices.

One conclusion that could be drawn from the foregoing points is that bifurcation will produce sensible and predictable results only in the context of a thorough overhaul of the taxation of financial instruments (particularly options and economically equivalent securities).

3. Interdependence of Components. Bifurcation may not produce results that accurately reflect the economics of the contingent debt instrument because the components of the instrument are economically interdependent. Such interdependence also raises tricky questions as to how to allocate attributes of the instrument between the debt component and the hypothetical separate instrument.

To illustrate the problem of interdependence, consider a convertible bond with a cash settlement feature. The premise of the Proposed Regulations is that such a bond can be equated to two other separate instruments, a noncontingent debt and a warrant. In fact, however, a convertible bond is not economically equivalent to a separate debt and warrant in many respects. For example, should interest rates decline at the same time that the underlying stock appreciates, the holder of a

debt and warrant can profit from both increases in value while the holder of a convertible bond must sacrifice the appreciation in the debt to realize on the warrant.

4. Electivity. At least three features of the Proposed Regulations appear to allow taxpayers latitude in electing different tax results for the same economic transaction. The worst offender is the rule that excepts from bifurcation “straight” convertible bonds, but applies bifurcation to similar instruments with a cash settlement or exchange (rather than conversion) feature. A good deal of freedom in determining tax results also appears to result from the rules allowing issuers and investors to allocate the issue price of the overall debt instrument between the “debt component” and the hypothetical separate financial instrument, and the rule limiting the Proposed Regulations to debt instruments having noncontingent payments that equal (subject to a de minimis exception) or exceed the issue price.

5. Ease of Administration. The Proposed Regulations will be difficult to administer for two principal reasons (in addition to uncertainties as to the proper treatment of the separate hypothetical financial instrument adverted to above): (1) It will not always be easy to determine when payments are or are not based on the value of publicly traded property. (2) It is not clear how allocations are to be

made between the debt component and the separate hypothetical instrument on an ongoing basis, which is needed to determine the tax treatment of secondary market purchasers. For example, a dollar allocated to a debt instrument would generally be amortizable over the remaining life of the instrument, but a dollar allocated to an option exercisable at maturity would not be.

6. Scope. The Proposed Regulations are limited in scope in that they apply only where contingent payments are based on the value of publicly traded property. Thus, while the Proposed Regulations may reduce disparities in the tax treatment of economically similar contingent debt instruments and investment units, they will create greater discontinuities in the taxation of contingent payment debt instruments.

7. Collateral Consequences. Finally, as discussed in our report, it is uncertain to what extent the bifurcation analysis applies for purposes other than determining taxable income. For example, how does bifurcation affect withholding and information reporting?

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It should be noted that while some of the foregoing problems are inherent in any bifurcation approach, others (particularly those described in paragraphs 4, 6, 7 and possibly 5) could be addressed by modifying the proposed

rules and perhaps adopting some simplifying assumptions.

Effective Dates

However one sides on the debate over the utility of bifurcation as a way of analyzing complex debt instruments, the points raised above suggest that turning the approach into a workable system of tax rules is no mean task. Perhaps the one aspect of the Proposed Regulations on which there is near unanimity among the members of the Tax Section's Executive Committee is that it was ill advised for the Internal Revenue Service and Treasury to issue the Proposed Regulations with a February 20 effective date without giving greater forethought to how the system would actually work. The subject of contingent debt obligations is not a new one, and we do not understand the rush. The two equity index linked debt instruments that apparently spawned the February 20 action were essentially identical to other public debt offerings that had been done in the past, and in our view did not pose major tax policy problems that warranted an immediate response. If, as has been reported, there was a fear that contingent debt instruments might have been issued by municipalities in order to take advantage of a tax exemption for contingent interest—which is a development that would have presented real tax policy concerns—an immediate

effective date rule limited to those issues could have been crafted.

One other aspect of the adoption of an immediate effective date for the Proposed Regulations is that it places taxpayers in a position where they must take the Proposed Regulations seriously to the extent they provide adverse results, but cannot rely on them (except in avoiding penalties) to the extent they provide favorable results because they are merely proposed. We think it is unfair to place taxpayers in such a position in the absence of a compelling need.

Technical Report

The technical report that follows revolves around four principal issues raised by the Proposed Regulations: (i) the scope of the Proposed Regulations (that is, which instruments are subject to the bifurcation regime); (ii) the character mismatch (ordinary income/capital loss) that can result to holders; (iii) the valuation and allocation demands required to comply with the bifurcation regime and (iv) collateral consequences.

We would be pleased to work with you or your staff in any way you think helpful in addressing the issues in this difficult area.

Very truly yours,

James M. Peaslee
Chair

Enclosure

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Tax Report #689

April 30, 1991

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed Section 1275 Regulations Concerning Contingent Debt Instruments

Part I - Technical Issues

Introduction

This report, prepared by a subcommittee of the Committee on Financial Instruments of the Tax Section[1/], deals with technical issues raised by recent modifications to proposed regulation § 1.1275-4 that deal with certain contingent payment debt instruments (the "Proposed Regulations").[2/] Our technical comments are as follows:

1/ This subcommittee is composed of Cynthia G. Beerbower, the principal draftsman, Micah W. Bloomfield, Dickson G. Brown, Adrienne S. Browning, Peter C. Canellos, Michael A. Costa, Rory M. Deutsch, Edward C. DuMont, Richard M. Fabbro, David C. Garlock, Harold R. Handler, Denise M. Hintzke, Thomas A. Humphreys, James Kalb, Robert I. Kantowitz, David P. Kelley, Edward D. Kleinbard, Robert M. Kreitman, Clifford W. Losh, Charles M. Morgan, and Michael L. Schler. Helpful comments were received from Erin M. Callan, John A. Corry, Christopher J. LaCroix, James A. Levitan, James M. Peaslee, Richard L. Reinhold, Margaret L. Riess, Dennis E. Ross, Irving Salem, Willard B. Taylor and David E. Watts.

2 Prop. Treas. Reg. § 1.1275-4, 56 Fed. Reg. 8308 (1991), amending Prop. Treas. Reg. § 1.1275-4, 51 Fed. Reg. 12087 (1986), hereinafter the "Proposed Regulations".

I. Scope of Proposed Regulations. $ 1.1275-4.

A. Exception for Debt Convertible Into Stock or Debt of the Issuer. $ 1.1275-4 (a) (the “Convertible Exception”).

The Proposed Regulations do not apply to a bond merely because it “contains a right to convert into stock or another debt instrument of the issuer”.

1. It should be made clear that the Convertible Exception applies where the debt instrument also has a conventional call or put right. For example, the Convertible Exception should apply to a traditional convertible bond that also contains a right of the issuer to call the bond prior to maturity for a premium over the redemption price where the premium is either fixed or set in accordance with a fixed schedule (typically declining over time).

2. The Convertible Exception does not apply, according to the preamble of the Proposed Regulations, if the instrument has a “cash settlement conversion right”. Why? Does the cash settlement right refer to an issuer's right, an investor's right or either? What if under the terms of a convertible debt instrument subject to the Proposed Regulations, the holder is entitled only to receive a fixed number of shares of the issuer's stock but the issuer agrees, on the holder's behalf, to sell the stock for the holder and remit the cash proceeds to him (without deduction for commissions or other expenses)? Cf. Rev. Rul. 85-119, 1985-2

C.B. 60. Is the result any different if the issuer designates a third party to sell the holder's stock and charges the holder a slight fee?

3. Is it intended that a conventional convertible bond can be brought within the Proposed Regulations simply by providing a cash settlement feature? That appears to be the result.

B. Exception for Puts/Calls. $ 1.1275-4(a).

The Proposed Regulations do not apply to a bond merely because it is subject to a put or call option or an option to extend. (As discussed later, puts/calls raise difficult valuation problems.)

1. The Proposed Regulations cross refer to Prop. Treas. Reg. § 1.1272-l(f)(4). As already indicated in the NYSBA Report on the Proposed OID Regulations ("OID Report"), reprinted in Tax Notes, January 27, 1987, at 369, the scope of the put/call rule is unclear. The rule seems to assume that the price at which the put or call is exercisable is fixed from the beginning (or is fixed subject only to remote and incidental contingencies). If that is so, it should be made clear that the exception in the Proposed Regulation is not similarly limited to puts/calls with a fixed dollar exercise price and extends, for example, to cases where the exercise price is adjusted to reflect changes in interest rates, i.e., to protect against reinvestment or reborrowing risks.

II. Scope of 5 1.1275-4(q) ("Paragraph (q)") of the Proposed Regulations.

A. The Fixed Payment Requirement. $ 1.1275-4 (g)(1).

Subject to a de minimis exception, the Proposed Regulations include within Paragraph (g) only a debt instrument having fixed payments at least equal to the issue price.

1. This rule introduces obvious discontinuities. For example, debt with an issue price of $100, 10% fixed interest, and entirely contingent principal is subject to the new rules if its term is 10 years or more, but subject to the substantially different old rules if its term is 9 years or less. Is that what is intended?

B. "Publicly Traded" Requirement, $ 1.1275-4(q)(l).

The Proposed Regulations apply Paragraph (g) to instruments that provide for one or more contingent payments "determined, in whole or part, by reference to the value of publicly traded" property.

1. Is the definition of debt that is publicly traded contained in Internal Revenue Code (the "Code") section 1273(b)(3) and Prop. Treas. Reg. § 1.1273-2(c)(1) intended to be applicable to Paragraph (g) of the Proposed Regulations? This definition treats debt as publicly added if it is part of an issue that is "traded" on "an established securities market". There is no guidance within Code section

1273 as to the meaning of “traded”, and “an established securities market” is defined in Prop. Treas. Reg. § 1.1273-2(c)(1) by reference to Treas. Reg. § 1.453-3(d)(4). Since this definition is very narrow, few debt instruments are considered publicly traded. See NYSBA Tax Section “Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges,” reprinted at 51 Tax Notes 79 (April 8, 1991), at 95-105.Cf. Treas. Reg. § 1.170A-13(c)(7)(xi), particularly Treas. Reg. § 1.170A-13(c)(7)(xi)(B), which treats securities traded by certain interdealer quotation systems as “publicly traded” even absent an “established securities market”.

2. Does the definition of publicly traded extend to property traded on international exchanges and quotation systems? If so, it may be difficult to determine reliably whether a public trading market exists.

3. We understand that various foreign exchanges offer from time to time futures contracts that are intended to be publicly traded which pay the equivalent of interest accrued over a period of time. We understand that Paragraph (g) was not intended to apply to interest rate indices, in the broadest sense, regardless of the existence of futures contracts on such indices. Thus, it should be clarified that Paragraph (g) does not apply to an instrument bearing interest measured by an interest rate index even though the interest falls

outside the definition of “variable interest” (such as interest at a rate of “1.5 times LIBOR plus 1%” or an “inverse floater” of a fixed rate less LIBOR).

4. Paragraph (g) applies to a debt instrument that provides for contingent payments that are determined “in part” by reference to the value of publicly traded property. This raises a general question as to how close the relationship must be between a payment and the price of publicly traded property in order for the Proposed Regulations to apply. We assume that the fact that an obligation is itself publicly traded does not mean that contingent interest on the obligation (e.g., interest payable in the form of “baby bonds”) becomes partly determined by reference to the value of publicly traded property.

5. If property is not publicly traded at the time that an obligation is issued, then can we assume that Paragraph (g) will not apply, even if a trading market develops while the obligations are outstanding? What if a trading market disappears during the term of the obligation, e.g., the instrument is “de-listed”?

6. We read Paragraph (g) to apply to the value as opposed to the income on publicly traded property. For example, it should be clarified that a contingent payment based on the dividend of a publicly traded stock is not within the scope of Paragraph (g). The fact that the income from

property will influence its value should not be a reason for treating an income-linked instrument as being based in part on the value of the property. See paragraph 4 above.

III. Character Mismatch Issues.

A. Holder-Level Mismatches.

1. The Proposed Regulations, when applied to a simple contingent payment bond such as an S&P 500 Index-linked bond, will result in a holder being deemed to acquire an original issue discount debt instrument and (in this case and many other cases) an option. The holder will recognize ordinary income over the life of the instrument equal to the option premium. If the contingent interest feature were to pay an amount less than the option premium at maturity, a holder would have a capital loss on the expiration of his deemed investment in the option. If the investor has no unrelated capital gains, the investor will pay tax over the life of the instrument on taxable income that is economically offset by the amount of the capital loss. Is that result intended?

B. Issuer-Level Mismatches.

1. An issuer that does not hedge would be subject to the risk of incurring a capital loss on what is believed to be a cost of its debt financing. However, this characterization may benefit an issuer that hedges a contingent interest

obligation. If Arkansas Best. 485 U.S. 212 (1988), applies to liability hedging, an issuer may recognize capital gain/loss on many liability hedges. By bifurcating the issuer's contingent payment obligation, income or loss from the contingent payments typically also will be capital in character, so that a match is achieved in many cases between the character of the hedge and the character of the contingent feature that the issuer is deemed to have sold. Are these the intended results?

IV. Allocation Issues. $ 1.1275-4(g)(3)

A. At the Time of Initial Issuance of the Debt Obligation

1. Paragraph (g) provides that unless the rights to a contingent payment are substantially equivalent to publicly traded property, the issue price of the noncontingent debt is generally determined under the “investment unit” rules of Prop. Treas. Reg. § 1.1273-2(d)(2)(iv). Those rules would give the issuer and underwriter considerable freedom to allocate the issue price between the debt and the contingent payment right (e.g., an option). Specifically, can zero or a nominal amount be allocated to the option? Is that the intention?

2. How are allocations done in situations in which there are two or more contingent features associated with the instrument? For example, Paragraph (g) would apply to a 10-year instrument paying fixed interest of 10% with a principal

amount subject to reduction (not below zero) based on upwards movements in a designated stock index. Such an instrument is similar to a Reverse Proposed Exchange Rate Linked Security. (See "Sallie Mae Note Cleared", N.Y. Times, June 22, 1988, at D17, col. 3.) Such an instrument could be "bifurcated" into a debt obligation with fixed interest at a rate of 10%, together with a stock index call option sold by the holder to the issuer and a deep out-of-the-money stock index call option sold by the issuer to the holder (or, alternatively, as such a debt obligation and a capped call option). We understand that there are no options on the market comparable to these hypothetical options and no pricing model to support any particular allocation of purchase price. Since under the analysis first suggested the issuer both receives and makes payments in respect of the options, there may not be even a fixed total amount to be allocated among the two components. (The language in the Proposed Regulations treating the contingent rights as "payments pursuant to one or more options or other property rights" suggests that the authors did not contemplate that the contingent rights could embody a liability.)

3. It is unclear how Paragraph (g) is applied to a case where an instrument has both a contingent payment feature subject to the new rules and a put/call option feature. For example, suppose that a bond paying interest based solely on the increase in the value of a stock index is callable by the issuer beginning in the second year. How would the

call right be analyzed? Would the bond be broken into a noncallable zero coupon bond, an option on the index in favor of the bondholders, and a call option on both of these components (i.e., an option on the entire investment unit) written by the bondholder? If the call option is so analyzed, we understand that the current option pricing models are not designed to price options on investment units. On the other hand, if the call option is not analyzed as a separate element, how would the amount payable on the exercise of the call be allocated between the contingent and noncontingent portions of the bond? Would it be allocated entirely to the noncontingent portion, so that the contingent portion would be treated as conferring rights that could vanish at any moment without compensation?

4. How would the Proposed Regulations be applied where the debt of a subsidiary that is a poor credit is exchangeable by the holder if there is a default for the debt of an affiliate that is a good credit? The economic effect is the same as a guarantee by the affiliate, but the result under the Proposed Regulations could be OID equal to the value of the guarantee.

5. How is a bondholder of an exchangeable bond taxed? What is his amount realized on exchange? Rev Rul. 69-135, 1969-1 C.B. 198, holds that a holder's gain on the exchange of an exchangeable bond is measured by the fair market value of the stock received. Under Paragraph (g), the holder presumably would be

treated as exercising an option, and therefore as purchasing the stock for an amount no greater than the then fair market value of the holder's hypothetical noncontingent bond plus the cost of the option. Is the holder's gain (or loss) under Paragraph (g) limited to the difference between the holder's basis in the noncontingent bond and the fair market value of the noncontingent bond at the date of exercise?

B. Application in the Secondary Market.

1. What rules should apply in allocating the price paid by a secondary market purchaser for a contingent payment obligation between the contingent and noncontingent portions? For example, must there be an allocation of purchase price between the debt and the option based on relative values on the date of purchase, with the allocation to the debt determining whether the buyer has market discount (or, alternatively, reduced OID accruals) over the remaining holding period? There is no assurance that there will be separately traded instruments comparable to either the noncontingent or the contingent interests after original issue, particularly since the issuer's creditworthiness will affect both interests, and it is not clear how the “investment unit” rules could be applied in a secondary market transaction. Consequently, application of the bifurcation approach to secondary market transactions may be very difficult.

2. Similarly, how should the issuer allocate the purchase price between the contingent and noncontingent portions where the issuer repurchases a bond or exercises a call right?

V. Taxation of Contingent Payment. $ 1.1275-4(g)(4).

Subparagraph (g)(4) of Proposed Regulation § 1.1275-4 states that contingent payments shall be treated "in accordance with their economic substance as payments pursuant to one or more options or other property rights".

1. Sometimes, such as is the case with a currency swap which is in economic substance a series of currency forward contracts, it is not clear that economic substance has been followed in fashioning tax rules. Isn't it really intended that the contingent payment is taxed not in accordance with its economic substance but rather as if it had been issued separately?

VI. Effective Date Issues.

The Proposed Regulations are proposed to be effective for debt issued on or after February 20, 1991.

1. Is the reset of a debt instrument issued before February 20th that otherwise would be within the scope of Paragraph (g) a reissuance? What about the strip of a coupon from a pre-February 20th bond (treated for OID purposes as a reissuance of a debt instrument pursuant to Code section 1286)? Other examples of "reissuances"? Other modifications of the terms of a bond?

2. The Proposed Regulations may change significantly the allocation of tax benefits and burdens between tax issuers and holders, and that allocation must be taken into account in pricing securities. However, the fact that the Proposed Regulations are proposed makes it impossible for issuers and investors in pricing transactions to rely on the fact that their decisions will reflect what the rules ultimately turn out to be.

3. As can be seen from the list of issues above, considerable uncertainty will exist in applying the Proposed Regulations. The proper tax treatment of contingent payment instruments is not a new one, and we do not understand why the Treasury has issued the Proposed Regulations with an immediate effective date.

VII. Relationships to the other Code Sections.

1. Code Section 163(i) - Is this section applicable to disallow the disqualified portion of OID?

2. Code Section 249 - Suppose a subsidiary issues debt that is exchangeable for parent stock and the subsidiary arranges to satisfy its exchange obligation by entering into a contract with the parent to buy parent stock ait fair market value. If the stock goes up in value, does the subsidiary recognize a capital loss, on the theory that Code section 249 no longer applies (by implication) to disallow the deduction since the loss is now with respect to a naked option rather than a bond convertible into stock of an affiliate of the issuer?

3. Code Section 988 - The preamble states that the Proposed Regulations generally do not apply to a bond denominated entirely in a single nonfunctional currency with no contingencies, citing Treas. Reg. § 1.988-2T(b) and Ann. 86-92, 1986-32 I.R.B. 46. The preamble goes on to state that the Internal Revenue Service may amplify or amend these rules in regulations published under Code section 988 addressing certain foreign currency obligations (e.g., dual currency bonds). We are confused by these statements. Treas. Reg. § 1.988- 2T(b) provides that a debt instrument is not considered contingent "merely because some ... of the payments are denominated in ... a nonfunctional currency." [emphasis added] Thus, dual currency bonds generally have been viewed as outside the scope of the contingent payment rules of these regulations. In addition, Ann. 86-92 is not limited to single-currency obligations. Is the intent to continue or to change prior law on this point?

4. Section 1256 - Where a listed debt instrument is broken into a noncontingent bond and contingent rights that would qualify as a "nonequity option" under Code section 1256 apart from the requirement of listing, will the contingent rights be subject to Code section 1256? If so, how can the mark-to-market requirements of Code section 1256 be applied to an instrument that is not separately traded -- i.e., when there is no market to which to mark?

5. Information Reporting - What is the effect of the Proposed Regulations with respect to information reporting and withholding?

(a) Assume a U.S. corporation issues indebtedness that bases current interest payments on increases in a stock index and pays fixed principal at maturity. Under the Proposed Regulations, the rights to interest payments would be treated as options (or possibly as an equity swap). Code section 6045 appears to be the only basis for information reporting as this interest is paid. Treas. Reg. § 1.6045-l(a)(9) indicates that a closing transaction in a forward contract is generally a sale subject to reporting but then adds that taking delivery for U.S. dollars is not a sale. Moreover, Treas. Reg. § 1.6045-1(b), Example (2), indicates that a corporation that issues and retires its long term debt on an irregular basis and a clearing organization are not brokers.

(b) On the same type of instrument, payments of current interest to a foreign holder would apparently not be subject to U.S. withholding tax even if (assuming the bond is in registered form) a certificate of foreign ownership on form W-8 is not received because the payment would not be interest or any other kind of FDAP income (or if the payment is considered to be made on a swap, is sourced outside the U.S). If the holder wished to avoid U.S. taxes, it could sell the bond prior to maturity (and hence prior to payment of the original issue discount on the debt portion), and although that sale would be technically taxable, there would be no withholding tax. (Of course, a holder of a zero coupon debt could accomplish the same result except that such a holder would not be receiving current payments.) One solution to this problem would be to require withholding on the “option” payments (even though they are not

interest for tax purposes) to the extent appropriate for current accruals of original issue discount, similar to the present rule that withholding is required on actual payments of interest to the extent of current accruals of original issue discount.

(c) If broker reporting does apply to contingent payments, what is the appropriate reporting to retail clients? Would each holder receive two separate Forms 1099, one for the noncontingent bond (1099-0ID) and one for the contingent portion of the instrument (1099-B)? How does a broker obtain a settlement price (needed to determine unrealized gains) when many publicly traded products upon which these payments could be based have limited price indexes available (gold only goes out 3 years - oil 15 months)?

6. REMIC Provisions - Would the new regulations affect the qualification of an interest in a REMIC as a "regular interest" if that interest otherwise satisfies the definition in Code section 860G(a)(1)? For example, a REMIC might issue two classes of obligations with fixed principal amounts and interest at a fixed rate and provide that the allocation of mortgage prepayments between the two classes will be determined based on the value of publicly traded property. At least where the regular interests are issued at a discount, they might be subject to the contingent payment rules, notwithstanding that the amount of all payments is fixed. See the OID Report at pp. 390-391. Assuming such an interest would otherwise fall within the regular interest definition, would the REMIC be disqualified under the Proposed Regulations?

7. Estate Taxation - Does characterization of part of a debt obligation as an option apply for estate tax purposes? Bonds held by nonresident aliens are often exempt from estate taxation (for example, if they qualify for the portfolio interest exemption) but the treatment of options is unclear. See 5 Bittker, Federal Taxation of Income, Estates and Gifts (1984), 134.2.3, fn. 56 and accompanying text.

8. Nonrecognition Provisions - If a security is bifurcated pursuant to the Proposed Regulations, is the non-debt portion treated as “other property” for purposes of Code sections 354, 355 and 356?