REPORT #743

TAX SECTION

New York State Bar Association

Effective Dates of Proposed OID Regulations

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New York State Bar Association

December 31, 1992

Michael P. Dolan, Esq.
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000
Washington, D.C. 20224

Re: Effective Dates of Proposed OID Regulations

Dear Mr. Dolan:

On December 21, 1992, the IRS issued a new set of proposed regulations (the “proposed regulations”) dealing with debt instruments issued with original issue discount (“OID”). The proposed regulations substantially revise a set of proposed regulations on the same subject issued originally in 1986 (the “1986 proposed regulations”). The proposed regulations do not amend the rules for contingent payment obligations found in section 1.1275-4 of the 1986 proposed regulations. The Tax Section intends to submit comments on the substance of the proposed regulations at a later time. This letter requests that prompt action be taken to clarify the application of the OID rules for periods prior to the effective date of the proposed regulations.

The preamble to the proposed regulations states that they are proposed to be effective for debt issued on or after the date which is 60 days after the date the regulations are finalized. The preamble goes on to state that the IRS “intends to treat the 1986 proposed regulations that are withdrawn in this document as authority under section 6662 for [periods] prior to their withdrawal”. Although not stated in the preamble, the proposed regulations should be treated as substantial authority under the general rules of section 6662.[1]

Recommendations

We recommend that the IRS act promptly to adopt and announce the following positions regarding application of the OID rules for periods prior to the effective date of the proposed regulations:

- the OID rules of the Code may be applied using any reasonable method not inconsistent with the statute;

- a method that applies the proposed regulations or their general principles to debt issued on or after December 21, 1992 is a reasonable method; and

- a method that applies the 1986 proposed regulations (other than the rules relating to contingent payment obligations) or their general principles to debt issued prior to December 21, 1992 is a reasonable method.

Similar approaches have been followed under other Code provisions.[2]

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[1] See Treas. Reg. section 1.6662-4(d)(3)(iii). This regulation lists proposed regulations as one of the types of authority that may be taken into account in determining if there is substantial authority. Presumably, this regulation would apply to the proposed regulations for periods prior to their stated effective date, although this is not entirely clear.

[2] Cf. Notice 92-56 (S corporations can rely on proposed regulations under sections 1362 and 1363); Proposed Section 482 Regulations (January 30, 1992) (a method that applies proposed rules is a reasonable method); Proposed PFIC Regulations (April 1, 1992) (a method that applies proposed rules is a reasonable method).

We further recommend that the IRS promptly announce that, to the extent section 1.1275-4 of the 1986 proposed regulations remains in effect for debt issued on or after December 21, 1992, that regulation should be considered to be modified as necessary to conform to the proposed regulations. Conforming changes would be appropriate in the case of convertible debt and variable rate debt.

Discussion

The reasons supporting our recommendations are as follows:

1. The choice of an appropriate effective date for the proposed regulations requires that the benefit of providing early guidance to taxpayers be weighed against the disadvantage of applying a proposed rule before it has undergone review and comment by taxpayers and their representatives. In this case, the need for guidance is significant. The OID rules have become an important part of the tax law and govern a wide range of transactions, both big and small. Also, the OID rules affect not only the substantive tax treatment of taxpayers but also information reporting. It is important that taxpayers know what the law is and not only the threshold for incurring tax penalties.

On the other hand, the policy against making regulations effective before they are finalized, which we have traditionally supported, is weakened here by the fact that the proposed regulations reflect the substantial comments already received on the 1986 proposed regulations. In that respect, the proposed regulations resemble more closely final than proposed regulations. Further our recommendation that taxpayers be allowed to use any reasonable method in applying the OID rules, including one that reflects the general principles of the proposed regulations or the 1986 proposed regulations, ameliorates the concern that taxpayers will be fully bound by proposed rules before they have an opportunity to comment.

2. The 1986 proposed regulations were proposed to be effective retroactively.

Taxpayers relied on those regulations in determining the consequences of transactions based on the view that the regulations (or something like them) would someday become final and would be applied retroactively. We believe this reliance interest should be protected, particularly given the very long period of time that has elapsed since 1986.

If taxpayers are allowed to rely on the 1986 proposed regulations in applying the OID rules for periods through December 20, 1992, it would be odd not to allow taxpayers to rely on the proposed regulations for periods thereafter. The proposed regulations better reflect the current views of the IRS as to the appropriate treatment of OID instruments. Also, the proposed regulations are in many respects more flexible than the 1986 proposed regulations (for example, in defining accrual periods). It would be paradoxical if the process of finalizing the proposed regulations had the effect of allowing taxpayers less freedom in applying the OID rules, at least for an interim period, than existed under the 1986 proposed regulations.

3. The ability to treat the proposed regulations or the 1986 proposed regulations as authority in determining substantive tax consequences would be less important if they simply interpreted the language of the OID rules of the Code. However, in at least three cases, the OID rules in the statute are not self-executing but can only be applied through regulations.

The first case involves the definition of “accrual period” under section 1272(a)(5). The term is defined,, except as otherwise provided in regulations, as a six-month period (or shorter initial period). Second, under section 1275(c), the requirement to attach an OID legend to a debt instrument applies only as required by regulations. Thus, it appears that, if the proposed regulations are adopted with the proposed effective date, no legending requirement would apply to debt issued before the effective date. While the benefits of OID legends are questionable, if this is not what the IRS intends, then the point should be clarified. Finally, under section 1273(b)(3)(B)(ii), the issue price of a nontraded debt instrument may be based on its fair market value where the instrument is exchanged for traded property other than stocks or securities only to the extent provided in regulations. The proposed regulations expand the categories of such other traded property to include a “contract, commodity or currency. See section 1.1273—2(c)(3).[3]

Moreover, the proposed regulations and 1986 proposed regulations in some circumstances reach results that, while sensible as a policy matter, could not easily be reached without regulations based on a straightforward reading of the Code. In these circumstances, the ability to treat the proposed regulations or 1986 regulations as authority is important.

A few examples will illustrate the point. First, the proposed regulations treat interest payments as qualified stated interest if they are made at least annually, regardless of whether they are made at fixed intervals. This result makes a good deal of sense, but it is not clear if it could be reached in the absence of a regulation, given the language in section 1273(a)(2) including in the stated redemption price at maturity all payments on an debt instrument other than interest “payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument”. Second, both the 1986 proposed regulations and the proposed regulations treat stated interest on short-term obligations as OID. This rule has the effect of allowing stated interest on an obligation having a term of 183

[3] Another example of a rule that is expressly based on OID regulations is found in the final REMIC regulations, which were issued two days after the proposed regulations. Under section 860G(a)(1)(B)(i), regular interests in a REMIC may bear interest at a variable rate only to the extent provided in regulations. The final REMIC regulations (at section 1.860G- 1(a)(3)(i)) state that a permitted variable rate includes “any rate that is a qualifying variable rate for purposes of sections 1271 through 1275 and the related regulations”. There is no concept of a qualifying variable rate except in the OID regulations. It is unclear how the IRS intended this language to be applied to regular interests issued prior to the effective date of the proposed regulations.

days or less to qualify for the withholding tax exemption for short-term OID instruments in section 871(g). However, a straightforward reading of the definition of stated redemption price at maturity would not seem to allow stated interest payable once or at fixed intervals on such instruments to be included in OID. Third, the proposed regulations in section 1.1272-3 allow accrual basis taxpayers to elect to treat all interest on a debt instrument as OID. This election is not provided for in the statute, and thus could not be applied without the regulations. Of course, if for some reason the IRS does not want to make this election available for periods before the proposed regulations become effective, it could do so even if the proposed regulations could otherwise be relied upon as authority. Finally, the proposed regulations provide a uniform issue price for an issue of privately placed debt based on the price paid by the first buyer of debt in the issue. Again, this rule is quite sensible, but section 1273(b)(2) states clearly that the issue price of “each” privately placed debt instrument is the price paid by the first buyer “of such debt instrument”.

4. After issuance of the proposed regulations, section 1.1275-4 is the only proposed regulation relating to OID that remains in effect with a proposed retroactive effective date. The interaction of -4 and the proposed regulations raises certain difficult, and probably unintended, issues. Consider, for example, plain vanilla LIBOR- based debt paying interest quarterly; in the absence of applicable regulations there is no concept of a qualified variable rate and thus no effective exception for such interest from the contingent payment rules of -4, with the arguable result that all the interest on such debt is contingent and subject to the -4 regulations. Moreover, if the quarterly interest were instead based on the value of a publicly traded commodity, the bifurcation miles of -4(g) would be the only proposed regulations applicable to the instrument, even though the new proposed regulations would treat interest of this type as a permitted variable rate. Finally, if debt issued during the interim period is convertible

into stock of the issuer and can be settled in cash, or is convertible into debt of an affiliate of the issuer, the contingent payment regulations by their terms would be applicable, even though the proposed regulations and the preamble thereto clearly intend to change this result and not apply the investment unit rules.

Taxpayers and their counsel might well believe that these results were unintended and would eventually be resolved by modification of the contingent payment regulations. However, as a disclosure matter, it would appear to be necessary to disclose in all public prospectuses during the interim period the results that would arise under the only proposed regulations that at that time were proposed to apply to the issue of debt in question (i.e., the contingent payment regulations). This would create considerable confusion and complexity in disclosure, even in transactions that had clear results under the 1986 proposed regulations. Our proposal, that the contingent payment regulations be modified to conform to the proposed regulations, would avoid this result. Our proposal would also leave the IRS with all their existing options as to how to treat payments that would remain contingent after adoption of the proposed regulations in final form.

We would be pleased to discuss our recommendations with you or your colleagues if you wish.

Very truly yours,

John A. Corry
Chair

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