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January 23, 2012

The Honorable Emily S. McMahon

Acting Assistant Secretary

(Tax Policy)

Department of the Treasury

1500 Pennsylvania Avenue, NW

Washington, D.C. 20220

The Honorable William J. Wilkins

Chief Counsel

Internal Revenue Service

1111 Constitution Avenue, NW

Washington, D.C. 20224

The Honorable Douglas H. Shulman

Commissioner

Internal Revenue Service

1111 Constitution Avenue, NW

Washington, D.C. 20224

Re: Report on Application of Treasury Regulation Section 1.382-2T(f)(18)(iii) With Respect to Trading in Distressed Debt Instruments

Dear Ms. McMahon, Mr. Wilkins and Mr. Shulman:

We are pleased to submit New York Bar Association Tax Section Report No. 1255. This report discusses whether Treasury Regulation Section 1.382-2T(f)(18)(iii) should apply to treat distressed debt instruments as stock for purposes of Section 382 of the Internal Revenue Code of 1986, as amended (the "Code").

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Section 382 limits a corporation's ability to utilize its net operating loss carryovers and certain built-in losses and deductions following a change in the corporation's stock ownership. Section 382(k)(6)(A) defines stock for purpose of determining whether an ownership change has occurred as stock other than certain preferred stock. Section 382(k)(6)(B) provides that the Secretary shall promulgate regulations as necessary to determine (i) when to treat options, warrants, convertible debt and similar instruments as stock and (ii) when to treat stock as not stock for purposes of testing for an ownership change. Treasury Regulation Section 1.382-4(d) was promulgated in response to (i) and Treasury Regulation Section 1.382-2T(f)(18)(ii) was issued in response to (ii).

Treasury Regulation Section 1.382-2T(f)(18)(iii) provides that in certain instances a non-stock instrument may be treated as stock for purposes of determining whether there is a Section 382 ownership change with respect to a corporation. One of the significant factors under the regulation for purposes of determining whether a non-stock instrument should be treated as stock under Section 382 is whether the instrument provides the holder a "significant participation in the growth of the corporation." A debt instrument that, as a result of a deterioration in the financial condition of the obligor, has a value that is significantly below the amount owing by the obligor may be considered to offer the holder a significant participation in the growth of the corporate issuer.

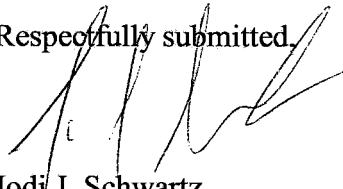
Our report recommends revising Treasury Regulation Section 1.382-2T(f)(18)(iii) to provide that an instrument properly treated at original issuance as debt for federal income tax purposes and not treated as stock for Section 382 purposes at such time, will not be treated as stock solely as a result of the transfer of the debt at a time when, due to a deterioration in the issuer's financial condition from the time of original issuance, the likelihood that the instrument will be repaid is based in significant part on the future growth of the issuer's business. In support of our recommendation our report notes the general rule in the tax law that the status of an instrument as debt or equity is determined at original issuance and such status is generally not retested. The report also notes that application of the regulation in a manner that may treat distressed debt as stock on transfer of the debt would be inconsistent with the legislative history and purpose of Section 382. Specifically, our report notes the absence of any reference in the statute or legislative history to treating non-stock instruments as stock other than in the limited case of options, warrants and other similar instruments. We also believe that treating distressed debt as stock at the time the debt is transferred would frustrate the purpose of Sections 382(l)(5) and (l)(6) which were designed to mitigate the potentially harsh application of Section 382 to companies in bankruptcy. We also believe that the difficulty in administering a rule that treats distressed debt as stock for Section 382 purposes at the time the debt is transferred would make it very difficult for corporations to determine whether they have, or are likely to undergo, an ownership change.

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In addition to our principal recommendation, our report recommends that any revisions to the regulations consistent with the above provide that, if there is a deemed exchange under Treasury Regulation Section 1.1001-3(e) of an instrument that was properly treated as debt at original issuance and not as stock within the meaning of Treasury Regulation Section 1.382-2T(f)(18)(iii), deterioration in the financial condition of the issuer should not cause the modified debt instrument to be considered stock under Treasury Regulation Section 1.382-2T(f)(18)(iii). We believe that this recommendation is consistent with recently issued Treasury Regulation Section 1.1001-3(f)(7) which provides that a significant modification to the terms of a debt instrument will not cause the new debt instrument to be treated as a other than debt solely as a result of a deterioration in the financial condition of the issuer.

We appreciate your consideration of our recommendations.

Respectfully submitted,



Jodi J. Schwartz
Chair

Cc: Lisa Zarlenga
Acting Tax Legislative Council (Regulatory Affairs)
Department of the Treasury

Lee Kelley
Senior Counsel (Tax Policy)
Department of the Treasury

Karl Walli
Senior Counsel
Department of the Treasury

Erik Corwin
Deputy Chief Counsel (Technical)
Internal Revenue Service

Steve Larson
Associate Chief Counsel (FIP)
Internal Revenue Service