

Report No. 1383

**New York State Bar Association
Tax Section**

**Report on Debt Issued by Disregarded Entities and Treasury Regulations Section
1.1001-3**

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New York State Bar Association Tax Section
Report on Disregarded Entities and Treasury Regulations Section 1.1001-3

I. INTRODUCTION AND OVERVIEW

This report (the “Report”)¹ of the New York State Bar Association Tax Section addresses possible revisions to the regulations under section 1001 of the Code,² specifically the rules of Treasury Regulations Section 1.1001-3 (the “-3 Regulations”) that apply when determining whether a modification to the terms of a debt obligation results in a “significant modification” thereby resulting in a tax realization event. The report is primarily focused on the question of how debt issued by an entity that is disregarded for federal income tax purposes (*e.g.*, a single-member eligible entity that has not elected corporate treatment under the entity classification regulations (the “check-the-box regulations”)), commonly referred to as a “disregarded entity” or “DRE,” should be tested under the -3 Regulations.³ Currently, the -3 Regulations do not contain any special rules for debt issued by DREs. The Report also comments on a more limited-scope issue affecting another aspect of the -3 Regulations, relating to the test that applies when there are changes to or substitutions of collateral on a non-recourse debt.

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² References in this report to the “Code” are to the Internal Revenue Code of 1986, as amended. References to “sections” are to sections of the Code or the Treasury regulations promulgated under the Code.

³ To be complete, the recommendations in this report for DREs would apply equally to any entity that is disregarded as an entity separate from its owner for federal income tax purposes, such as a domestic single-member limited liability company (“LLC”) that does not elect to be classified as a corporation for federal income tax purposes pursuant to Treasury Regulations Section 301.7701-3 of this chapter or a foreign equivalent thereof, a corporation that is a qualified REIT subsidiary (within the meaning of Section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of Section 1361(b)(3)(B)).

The -3 Regulations provide a set of generally clear, administrable rules for determining when alterations to the terms of debt obligations create realization events for holders.⁴ Within the analytic framework the rules have set forth, the threshold question of who the obligor is a key starting point. For recourse debt, a change in obligor is a “significant modification” unless it occurs in connection with a Section 381(a) transaction, a transfer of substantially all the original obligor’s assets or certain other enumerated circumstances. For nonrecourse debt, a change in obligor is not considered significant, presumably because the source of repayment for the lenders has not changed.⁵ Identifying the relevant “obligor,” therefore, is fundamental under the current approach of the -3 Regulations.

It is perhaps relevant that the proposed version of the regulations did not treat a change of obligor on a recourse debt as a *per se* modification. The preamble to the final version of the regulations states that, “[t]he IRS and Treasury believe that these changes may be so fundamental that they should be considered modifications even if they occur by operation of the terms of an instrument.”⁶ It does not explain the reasoning further, leaving room for differing views about what motivated this approach and what it may suggest for debt issued by a DRE.

Under Treasury Regulations Section 301.7701-3, it is possible for a state law juridical entity to be classified for tax purposes as a corporation, a partnership, or a DRE of its single owner. It is also possible for an entity to change its tax status from one of these characterizations to another, either by tax election (“checking” the entity open or closed for example), transfers of equity in the entity between holders (which can cause a partnership to become a DRE or *vice versa*) or state-law conversions or

⁴ A realization event under Treasury Regulations Section 1.1001-3 gives rise to potential recognition of income to issuers, by cross-reference, under Treasury Regulations Section 1.61-12(c) (income to issuers from a retirement or exchange of a debt instrument) and is generally understood to give rise to a potential repurchase premium deduction under Treasury Regulations Section 1.163-7(c).

⁵ See Treas. Reg. § 1.1001-3(e)(4)(i) and (ii). Mechanically, the regulations first test alterations to see if they are “modifications” within the meaning of Treasury Regulations Section 1.1001-3(c) and, if so, then test whether they are “significant” within the meaning of Treasury Regulations Section 1.1001-3(e). An alteration that constitutes a “significant modification” is treated as causing a retirement of the original debt instrument in exchange for a new debt instrument having the now-altered terms.

⁶ T.D. 8675, *Modifications of Debt Instruments*, 1996-2 C.B. 60, at 61 (originally released June 26, 1996).

mergers.⁷ If the entity is the borrower under a debt instrument, the change in the “regarded” tax status of the entity raises a question under the -3 Regulations, namely whether this change constitutes a “significant modification” of the debt and therefore a deemed debt-for-debt exchange.⁸

This question highlights a fundamental contradiction that exists between tax law, on the one hand, and state law, on the other, in relation to DREs. When a change in tax classification occurs as a result of a check-the-box election (for example), for state law purposes there is no change whatsoever. The DRE is respected under state law; it can borrow funds, sue, and be sued. A change in the “regarded tax status” of the borrower would not change underlying state-law legal rights or terms of the debt. Thus, the question arises whether the -3 Regulations should be applied by treating the entity itself as the obligor – meaning, in the case of a DRE, that the entity would be treated as the obligor despite being disregarded for other purposes – or whether instead the -3 Regulations should import the general tax treatment of DREs in whole, viewing the parent of the DRE as the obligor.⁹ This contrast seems starkest where there is a *mere tax election* that results in a change in the tax status of the borrower, but it also arises where there is a conversion of the borrower under state law or a merger of the borrower into a DRE.

Two possible answers

This Report discusses two possible answers to the question of how a DRE should be treated under the -3 Regulations. The two answers are described briefly in this introduction and are discussed later in

⁷ A state law conversion is a change in the legal status of an entity, for example from corporation to LLC, by operation of state law. Typically this is effected by filing papers with the appropriate state office. *See, e.g.* Delaware Code, title 6, section 18-214 (Delaware law addressing conversion of corporation to LLC).

⁸ In an attempt to reduce confusion, the report uses the following terminology: References to the “borrower” are to the entity that, under state law, is liable for repayment of the debt. References to the “issuer” are to the entity that the tax law identifies as the taxpayer, entitled to take the interest expense deductions associated with the debt. References to the “obligor” are to the entity that the -3 Regulations treat as relevant – the question that is the main topic of this report.

⁹ Of course, it is the parent that is the taxpayer entitled to interest expense deductions associated with the debt.

the Report in greater detail. They are referred to throughout the Report as the “Legal Rights” and “Tax Status” approaches.¹⁰

Legal Rights. The “Legal Rights” approach is one based on an analysis of the legal rights of creditors *under state law*. It is the approach favored by a significant majority of the Executive Committee of the Tax Section. In situations where nothing substantive has occurred under state law to change a holder’s rights (*i.e.*, where there has been no change to the holder’s legal rights or the economic terms of the debt instrument), a Legal Rights approach would dictate that no tax realization event occurs for a holder.

There are different ways that the -3 Regulations could achieve the answer dictated by a Legal Rights approach. One would be for the regulations to acknowledge a tax-law-only status change as a technical tax law “change in obligor,” but explicitly to treat this change as one that does not give rise to a modification under Treasury Regulations Section 1.1001-3(c). Alternatively, under the “significance” rules, a tax-law-only status change could be carved out, and treated as not being significant under Treasury Regulations Section 1.1001-3(e). Another path to achieve this same end result, however, would be to include a new provision in the -3 Regulations treating a DRE, where it is the borrower under state law, as the relevant “obligor” for purposes of both the “modification” and “significance” rules. In that event, changes in the tax status of an entity alone would not be treated as the substitution of a new obligor on a debt instrument, or therefore as a modification (let alone a “significant” one).

The Report puts forward the latter of these alternatives as the means by which “Legal Rights,” should be incorporated into the current regulatory framework. We believe this has the advantage of being more easily crafted into the current framework of the regulations. The -3 Regulations throughout incorporate references to the term “obligor,” and those references would need to be revised under the first articulated means of adopting a Legal Rights approach.¹¹ Thus, a rule providing that in relation to DREs,

¹⁰ The terms “legal rights” and “tax status” were suggested by James M. Peaslee in his article, *Disregarded Entities and Debt Modifications*, 150 TAX NOTES 1145 (Mar. 7, 2016).

¹¹ In addition, the first approach would require more changes to the rules for recourse and nonrecourse debt than the second approach.

the terms “obligor” as well as “changes in obligor” should be determined by direct reference to state law, not tax law—for *this one purpose*, the -3 Regulations – would achieve the result supported by the majority of the members of the Executive Committee. Of course, the normal tax rules (disregarding the DRE) would continue to apply for other purposes of the Code. Consequently, events that might not give rise to a deemed exchange for purposes of Section 1001 could nonetheless have consequences under other provisions of the Code. Those consequences typically would affect the issuer, its owners and possibly related parties, but not holders.

Tax Status. The second possible answer to how DREs should be treated under the -3 Regulations, to which we refer as the “Tax Status” approach, is one that focuses on consistency with the general treatment of DREs under the tax law. A minority of the members of the Executive Committee support this approach. While it is true that that a mere change of an entity’s tax status, without more, generally should not affect a holder’s legal or economic rights under the debt instrument, from the perspective of the Tax Status approach, this does not necessarily dictate how the -3 Regulations ought to view tax status changes. There is no “real world” effect (under the terms of the instrument itself) of *any* change of a borrower’s tax status – for example, checking the box to turn a partnership into a corporation. Moreover, inconsistency between state law and the tax law is inherent in the very nature of DREs as a tax law concept; the tax rules accord significance to their (non)existence, while state law does not. The Tax Status approach would therefore support an application of the same principles to DREs under the -3 Regulations as under the other rules of the Code.

The lack of “real world” effect is a critical aspect of the Tax Status approach. Because checking the box has no economic effect, under a Tax Status approach the touchstone for determining whether a change of obligor has taken place is not whether there is any economic difference between the before and after states. It would often be the case under the Tax Status approach that there would be a change of obligor notwithstanding the lack of any economic difference between the before and after states. As noted above, that derives from the fact that the tax status of an entity has no economic effect, notwithstanding that the entity’s status is often fundamental to the tax treatment of the entity and its

owners. Consequently, determining whether there has been a change of obligor by reference to the tax status of an entity is inherently a tax conceptual test rather than an economic test. By contrast, under a Legal Rights approach it is relevant to ask whether there is an economic difference between the before and after state.

A related aspect of the Tax Status approach is that it may treat events that are in fact different as an economic matter as identical for tax purposes. For example, an actual liquidation of a wholly owned company into its corporate parent is not the same as an economic matter as checking the box on the company to turn it into a DRE. In the former case, assets and liabilities move from subsidiary to parent; recourse creditors at the subsidiary level now have access to parent assets, and recourse creditors at the parent level now have direct rather than subordinated access to subsidiary assets; other real-world consequences may also follow. Indeed, those real world consequences may preclude an actual liquidation. Whether or not an actual liquidation is possible, however, and regardless of the fact that the various consequences described above do not occur if the subsidiary merely makes a check-the-box election, for purposes other than the -3 Regulations, the tax law treats checking the box on the subsidiary as if it were an actual liquidation. From a Tax Status perspective, it follows that the same should be true under the -3 Regulations and therefore that there should be a change of obligor (although there might not be a significant modification solely as a result of the deemed liquidation, depending in part on whether the debt is deemed to become nonrecourse).¹² From a Legal Rights perspective, by contrast, there is a significant economic difference between the actual and the deemed liquidation; in the latter case, because nothing has happened as a legal or economic matter, there should not be a change of obligor.¹³

¹² In the deemed liquidation case, if the debt is deemed to become nonrecourse, a further question is whether Treasury Regulations Section 1.1001-3(e)(5)(ii)(B)(2) applies. That rule states that a change from recourse to nonrecourse is not a significant modification if the debt “continues to be secured only by the original collateral” and there is no change in payment expectations.

¹³ Some advocates of the Legal Rights approach would draw a distinction between how the corporation becomes a DRE, meaning checking the box vs. conversion under state law vs. merger into a DRE, and would treat the merger as different from the other two methods. Others would view all of those as essentially identical. For an example of the former view, see Peaslee, *Disregarded Entities and Debt Modifications*, *supra* note 10, at 1150-51 (under a legal rights approach, checking the box is a nothing; a state law conversion could be viewed as giving rise to no alteration of legal rights or obligations; merger

Similar contrasts exist for other “simple” transactions, including an actual contribution of assets to and assumption of liabilities by a subsidiary as compared to a deemed contribution if a DRE with those assets and liabilities becomes a disregarded entity; an actual vs deemed change from corporation to partnership status; an actual vs deemed change from partnership to corporation status; a change from DRE to partnership status; and a change from partnership to DRE status. Under the Legal Rights approach, the results of the deemed transactions will always be that there is no modification, assuming that the change of entity status takes place through an election or by adding or subtracting owners. Under the Tax Status approach, all of these are changes of obligors, although the bottom-line results depend in the first instance on whether the “sub all” rule applies, and then on the issues (described below) with respect to recourse/nonrecourse distinctions and whether debt of a DRE is nonrecourse debt of its sole owner, or not.

All of this raises questions about electivity. Indeed, arguably both approaches allow for some form of electivity. From a Tax Status perspective, the approach advocated by at least some Legal Rights proponents would permit electivity because different forms of transactions – that is, actual transactions vs. deemed transactions – with the same tax substance may allow for different “change of obligor” rules to be applied. At least in cases where there is a modest economic difference between the actual and the deemed transaction – for example, a liquidation into a parent that holds only equity in the liquidating subsidiary – taxpayers could choose between actual and deemed transactions. Moreover, one version of the Legal Rights approach would permit electivity even for different variations of deemed transactions, by treating a merger into a disregarded entity as giving rise to a change of obligor while not so treating “checking the box open.”¹⁴ Another version of the Legal Rights approach, however, would view each of these events as the same – an economically irrelevant change in the form of organization of the borrower, which might

into a DRE would involve a change in legal rights and obligations and also a change in obligor). Because these distinctions are highly formalistic in nature, the -3 Regulations should reach the same bottom-line result under a Legal Rights approach for all of these cases.

¹⁴ See Peaslee, *Disregarded Entities and Debt Modifications*, *supra* note 10.

or might not be viewed as a change of obligor but in any event ought not to be viewed as a significant modification.

The electivity concern on the part of Tax Status supporters is strengthened if there are different consequences under other rules of the Code after the deemed transaction takes place (for example, different consequences associated with satisfying the debt, which may often be the case). The Legal Rights approach would thus appear to allow taxpayers to elect into other rules of the Code, by carrying out deemed rather than actual transactions, without recognizing income or expense as a “cost” of doing so.

Conversely, from the Legal Rights perspective, the Tax Status approach leaves room for electivity-- because taxpayers can cause a change of obligor to take place simply by making a tax election, with no change to any significant “real world” consequences. From this perspective, allowing a change in tax status to trigger a taxable event (for example, a loss for investors, or a repurchase premium deduction for the issuer), when nothing substantive has occurred, is problematic. This concern is strengthened if the “actual” transaction could not in fact take place (or would be expensive/burdensome) for commercial reasons, for example because of the difficulty of transferring contracts from one legal entity to another.

The divergence between the Legal Rights approach and the Tax Status approach rests on a disagreement as to what the government intended to achieve (or should have been intending to achieve) in the -3 Regulations, and perhaps also as to the law prior to the issuance of these regulations was (up to and including the decision in *Cottage Savings*).¹⁵ From the Legal Rights perspective, it is important that the -3 Regulations are holder-side rules and that a change of the borrower’s tax status typically has no (or no material) economic or legal effect on its creditors. A change of status therefore should not trigger a recognition event under Section 1001 because the property (the debt held by the holder) does not *differ materially in kind or extent* after the transaction. The Tax Status perspective is influenced more heavily

¹⁵ *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).

by concerns over special carve-outs from general tax treatment for DREs, and the potential for a slippery slope given the inherent inconsistency between the tax law and state law in the treatment of DREs. From the Tax Status perspective, “turning off” of the fiction of disregarding a DRE in a limited context is incompatible with the way the tax law treats DREs.

Some Other Considerations

Other issues that relate to the operative provisions of the -3 Regulations have arisen in the course of evaluating the DRE question considered in this Report. We comment very briefly on these considerations here. We believe that these issues are worthy of further study in connection with a broader revision of the -3 Regulations. This Report, however, addresses only how DREs should be treated. We believe the treatment of DREs is a distinct question that can be addressed independently of the other questions identified below, and that resolving the question of how debt issued by a DRE is treated under the regulations will provide a degree of clarity and certainty that will be welcomed by practitioners.

The most significant of these other issues is whether the -3 Regulations should be revised to define the terms “recourse” and “nonrecourse.” Inevitably, discussions about the way the “modification” rules ought to work in connection with tax status changes and DREs implicate questions about the proper distinction between recourse and nonrecourse debt. It can be extremely difficult to distinguish the question how to draw the line between recourse and nonrecourse debt from the question how changes in tax status should affect creditors’ tax consequences.

In evaluating the recourse/nonrecourse distinction, broadly speaking we identified three alternatives: (i) one might look solely to the legal characterization of a debt instrument as between the borrower and the creditor, so that an instrument that is recourse by its terms would ordinarily be treated as recourse, regardless of the tax status of the borrower; (ii) one might look to the tax status of the borrower, in which case nominally recourse debt of a DRE would presumably be treated as nonrecourse debt of its regarded owner; or (iii) one might take into account factors relevant to the core distinction between recourse and nonrecourse as a conceptual matter, such as whether the borrower has assets that the relevant creditor cannot reach, whether the borrower can remove specified assets from the reach of the relevant

creditor and whether other creditors could make a claim against the borrower's assets, which could affect the treatment of either nominally recourse or nominally nonrecourse debt. The Legal Rights approach would naturally fit with alternative (i),¹⁶ although possibly also with alternative (iii), while the Tax Status approach would most naturally fit with alternative (ii).¹⁷ Furthermore, a significant component of the concerns embodied in the Tax Status approach arises from the possibility that a "mere" change in tax status could change recourse debt to nonrecourse debt (without any other economic consequences), which – especially if that change applies for purposes other than the -3 Regulations – can lead to considerable taxpayer electivity (as well as traps for the unwary), which we do not view as in the interest of good administration of the tax law. If this issue is considered in relation to the question of possible revisions of the -3 Regulations, we would favor rules that are specially targeted to the -3 Regulations only, given the pressing need for guidance on DREs and the scope of the recourse/nonrecourse question as a general matter.

Apart from the recourse/nonrecourse distinction, other important issues are: (a) whether the general tax consequences associated with a change in a borrower's tax status ought to be considered as a factor under the -3 Regulations when evaluating the "significance" of a modification to a debt instrument; (b) whether and to what extent there ought to be symmetry in the tax treatment of issuers and debt holders, and (c) how the considerations discussed herein are affected if the issuer is insolvent rather than solvent.

¹⁶ See Peaslee, *Disregarded Entities and Debt Modifications*, *supra* note 10, at 1158-59: "The operative rules in the debt modification regulations are consistent with a conventional understanding of recourse and nonrecourse.... [t]he fact that recourse debt of a DE may properly be considered nonrecourse debt of the owner of the DE for purposes of some rule governing the tax treatment of the owner may say little about how the debt should be classified in applying the debt modification regulations."

¹⁷ DREs tend to highlight questions about the meaning of the terms recourse and nonrecourse, because DREs make it somewhat easy to create "synthetic nonrecourse debt." A parent entity can drop assets into a single-member LLC and have it issue debt, limiting other creditors' ability to reach those assets, thereby converting what would otherwise have needed to be structured as nonrecourse parent debt into recourse debt of the DRE. Conversely, as noted in the examples above, when a corporate debtor becomes a DRE, the question whether its debt has become nonrecourse debt of its regarded owner is a critical one that is not entirely clearly answered under the current -3 Regulations (or otherwise in the tax law).

We do not believe that a change in a borrower's tax status should be tested under the general "economic significance" test of Treasury Regulations Section 1.1001-3(e)(1), though one could consider whether the more prescriptive rules of Treasury Regulations Section 1.1001(e) ought to be revised to take a change in a borrower's tax status into account.¹⁸ In terms of symmetry, we do not believe the -3 Regulations are concerned with symmetry in tax treatment between issuers and holders.¹⁹ Finally, we note that the consequences of a change of obligor where an issuer is insolvent are potentially more dramatic than where the issuer is solvent. Some of those consequences are the result of other provisions of the Code, *e.g.*, section 108. However, the -3 Regulations themselves contain rules that apply differently when insolvency is combined with a change of obligor. In particular, Treasury Regulations Section 1.1001-3(f)(7)(ii) contains a special rule that applies when debt of an obligor is modified at a time when the borrower is in financial difficulty. As drafted, this rule does not apply if the *obligor* changes. Consequently, a change of obligor at a time when the borrower is insolvent could transform debt into equity. The treatment of the change in tax status of an insolvent debtor under the -3 Regulations merits further study.

We now turn to the main topic of the Report, which is broken down into the following Sections and includes a more detailed discussion of the two approaches we outlined above:

II. Background and History of the Issues relating to DREs – A discussion of the relevant history of the -3 Regulations, the check-the-box regulations and a brief summary of IRS guidance that has addressed the impact of changes in entity classification for purposes of the -3 Regulations.

III. The Legal Rights Approach

¹⁸ For example, if the Legal Rights approach is adopted, it would be useful to clarify whether the rule that applies when a new obligor acquires substantially all of the assets of the original obligor is intended to apply when assets do not physically move but the borrower becomes a DRE, or alternatively the borrower becomes a DRE and some or all of its assets are distributed to its owner.

¹⁹ How a holder's gain or loss is measured is unrelated to how the issuer's cancellation of indebtedness income is determined, for example. Further, a "deemed reissuance" may be a recapitalization to a creditor under Sections 368(a)(1)(E) and 354, which will often mean that no gain or loss is recognized to the creditor even though the issuer has income or expense. Even more generally, many "assignments" in which a new issuer (and obligor) assumes the debt of the original issuer (and obligor) are non-"events" for Section 1001 purposes, *e.g.*, in the case of many Section 381 transactions or the transfer of substantially all of the original issuer's/obligor's assets to a new entity along with that entity's assumption of the original entity's liabilities.

- IV. The Tax Status Approach
- V. Substitutions of Collateral on Nonrecourse Debt

II. BACKGROUND AND HISTORY OF THE ISSUE

A. History and description of the -3 Regulations and the Check-the-Box regulations

The -3 Regulations were adopted in June 1996 in response to the Supreme Court’s 1991 decision in *Cottage Savings*.²⁰ In that case, the Supreme Court held that a savings and loan association had triggered a tax loss when it swapped a pool of mortgages for another pool of mortgages that were economically substantially identical. Acknowledging first that “a taxpayer realizes taxable income only if the properties exchanged are ‘materially’ or ‘essentially’ different,”²¹ the Court in *Cottage Savings* concluded that the pools were sufficiently different to allow a tax loss to be triggered. The Supreme Court observed that, “[p]roperties are ‘different’ in the sense that is ‘material’ to the Internal Revenue Code if their respective possessors enjoy legal entitlements that are different in kind or extent,”²² and held that because the pools of mortgages had different obligors and different (in the sense of being distinct) assets serving as collateral, a tax loss was recognized. The Court rejected the IRS’s argument that the standard ought to be one based on differences in economic entitlements (an “economic substitute” argument). Indeed, the Court stated that under an economic substitute concept of material difference, “differences [would be] material . . . only when the parties, the relevant market . . . , and the relevant regulatory body . . . would consider them material,”²³ a test that would result in administrative complexity.

Because the Court’s decision was founded in part on predecessor cases treating legal differences with fairly trivial economic consequences (*e.g.*, the re-domiciliation of a New Jersey corporation to

²⁰ 499 U.S. 554 (1991).

²¹ *Id.* at 562.

²² *Id.* at 566.

²³ *Id.* at 565.

Delaware) as material, the Court’s decision gave rise to concerns that economically insignificant alterations to a debt instrument’s terms could in the right circumstances trigger a realization event. Taxpayers therefore might be able to control the timing of recognition events with respect to debt exchanges somewhat easily, or conversely might find it difficult to avoid triggering recognition events. The Court articulated a “legal entitlements” standard in attempting to provide guidance on the meaning of the phrase “material difference,” but the application of the Court’s decision to future modifications was left quite unclear. The earlier cases dealing with modifications to debt instruments had applied a facts-and-circumstances analysis to test whether a change (or series of changes) was material enough to give rise to an exchange.²⁴ Earlier decisions had also looked more favorably on situations that involved involuntary exchanges. The full scope of the Supreme Court’s decisions was unclear, as the case itself did not even deal with *modifications* of debt instruments, but with an actual exchange.

In response to the uncertainty presented in light of the Court’s decision, Treasury proposed a series of objective and administrable rules, and, in 1996, the -3 Regulations were adopted as final regulations.²⁵ For the first time, taxpayers as well as the government had at their service a comprehensive set of tests to help determine whether a modification in a debt instrument’s terms triggers a realization event.

Later in the same year that the -3 Regulations were adopted, Treasury issued the check-the-box regulations, introducing for the first time in the tax regulatory framework the concept of a DRE – a tax “nothing.”²⁶ In the preamble, Treasury observed that the first step in determining an entity’s classification for tax purposes is to ask if there is indeed a “separate” entity, noting that not all entities formed under local law are necessarily separate entities for federal income tax purposes. The preamble then stated explicitly that the rights and obligations of an entity, and its owners, under local law are not

²⁴ Treas. Reg. § 1.1001-1(a).

²⁵ T.D. 8675, *supra* note 6.

²⁶ T.D. 8697, *Simplification of Entity Classification Rules*, 1997-1 C.B. 215 (originally released Dec. 18, 1996).

affected by how the federal tax law treats the entity. “For example, if a domestic limited liability company with a single individual owner is disregarded as an entity separate from its owner under § 301.7701-3, its individual owner is subject to federal income tax as if the company's business was operated as a sole proprietorship.”²⁷

Although the -3 Regulations and the check-the-box regulations were adopted in the same year, and had been under consideration for several years before that, there does not appear to have been any anticipation of how DREs would be treated for purposes of the -3 Regulations. Since the check-the-box regulations were adopted, DREs have become commonplace in tax structuring arrangements of all kinds, both domestic and international. Yet many questions remain unanswered about the treatment of a DRE for purposes of the -3 Regulations.

The -3 Regulations are generally mechanical in their application. A change in the terms of a debt instrument is treated as triggering a deemed exchange only if the change constitutes a “modification” of the debt instrument, and the modification is a “significant modification.” Paragraph (c) of the -3 Regulations defines “modifications” broadly to include “any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.”²⁸ However, an alteration that occurs by operation of the terms of the debt instrument is not a modification unless the alteration results in the change of certain identified terms, which the IRS and Treasury evidently considered so fundamental that they “should be considered modifications even if they occur by operation of the terms of an instrument.”²⁹ An alteration that results in the substitution of an obligor is one of these changes, and it is always tested for significance, even if it happens by operation of the terms of the debt instrument.

²⁷ *Id.* at 216.

²⁸ Treas. Reg. § 1.1001-3(b).

²⁹ T.D. 8675, *supra* note 6, at 61.

An alteration that is determined to be a “modification” is then tested for significance under the rules of paragraph (e) of the -3 Regulations, which provides specific rules for determining the significance of certain types of modifications (including specific rules to test changes in obligor), and a general rule based on “economic significance” that applies to modifications not otherwise addressed by the special rules. As described above, a change in the debt instrument’s obligor is significant unless one of certain enumerated exceptions applies. Consequently, determining whether a change in an issuer’s tax classification (for example, from a corporation to a DRE or *vice versa*) gives rise to a change of obligor for purposes of the -3 Regulations is a crucial starting point in the analysis under the -3 Regulations as currently drafted.

To complicate things, the -3 Regulations, which were clearly issued in response to *Cottage Savings* and thus focus in the first instance on a “legal entitlements” standard, in fact treat many changes to legal rights and obligations as not giving rise to a deemed exchange, presumably on the ground that they are not *material* modifications. More generally, many things that clearly are changes to the legal entitlements of creditors are entirely irrelevant to the analysis under the -3 Regulations. For example, removing even a substantial amount of assets from a corporate borrower has in general no effect on its recourse creditors. Thus it can be difficult to form a coherent principled articulation of the approach taken by the -3 Regulations to determining both what is a modification and when a modification is significant, or therefore to determine how best to think about the change in tax status of an entity in this context.

The -3 Regulations are incorporated by cross-reference in regulations under Section 61 determining when an issuer has cancellation of indebtedness income.³⁰ Under current law, therefore, a deemed exchange can arise, or not arise, for both issuers and holders under the same standard. However, it is less clear whether the -3 Regulations are incorporated directly into the rules for determining when an

³⁰ Treas. Reg. § 1.61-12(c) (income to issuers from a retirement or exchange of a debt instrument).

issuer has incurred “repurchase premium.”³¹ And it is also clear that neither of these “symmetries” is required by the Code; rather, where they arise, it is a choice made under regulations. Further, even when the issuer and creditors do have “symmetry,” the consequences of the deemed exchange may vary considerably (for example the deemed exchange may be treated as a recapitalization, generally resulting in no tax consequences for creditors, but this does not affect the issuer’s COD or repurchase premium consequences).

B. IRS guidance addressing the application of the -3 Regulations to changes in an entity’s tax status

The IRS has addressed the treatment of an entity’s change in tax status under the -3 Regulations in four private letter rulings and one advice memorandum.³² The guidance has considered whether a tax status change – effected via a check-the-box election and state-law conversion of a corporation into an LLC – has resulted in the deemed exchange of the issuer’s debt obligations. Although the private letter rulings and the memorandum held that no deemed exchange occurred in each of the fact patterns, their reasoning seems to vary. Unfortunately, the informal guidance does not resolve the existing uncertainty with respect to the treatment of DREs under the -3 Regulations.

³¹ Treasury Regulations Section 1.163-7(c) generally provides that if a taxpayer repurchases its debt for an amount that exceeds the adjusted issue price of the debt, the excess (repurchase premium) is deductible as interest. If the debt was acquired in a debt-for-debt exchange, the repurchase price is treated as equal to the issue price of the new debt instrument. The regulation does not specify when a transaction is treated as a debt-for-debt exchange for this purpose. However, the regulation was originally issued as part of the package of final OID regulations, which also included an amendment to Treasury Regulations Section 1.1001-1 (g), dealing with the determination of the amount realized when debt is issued in exchange for property, such as in a debt-for-debt exchange. T.D. 8571, 1994-1 C.B. 38. Because the -3 Regulations are integrally related to the rules of Treasury Regulations Section 1.1001-1(g) and the OID regulations, it has been understood by taxpayers that the -3 Regulations determine when a debt-for-debt exchange has taken place for purposes of Treasury Regulations Section 1.163-7. It is also logical that rules applied to determine whether a taxpayer has repurchase premium from a debt-for-debt exchange also apply to determine whether the taxpayer has COD income from a debt-for-debt exchange

³² Private Letter Ruling 200315001; Private Letter Ruling 200630002; Private Letter Ruling 200709013 ; Private Letter Ruling 201010015; AM 2011-003. A later private letter ruling addresses the distinction between recourse and nonrecourse debt, for purposes of Treas. Reg. § 1.1001-2. Private Letter Ruling 201525010.

Private Letter Ruling 200315001 concluded that a reorganization that included a change in an entity's tax status from a corporation into a DRE as a result of a conversion under state law from corporation to LLC did not result in a modification of the entity's outstanding recourse debt for purposes of the -3 Regulations. The ruling states that, "[t]he legal rights and obligations referred to in section 1.1001-3 are rights that are determined under State law." The ruling therefore examines the extent to which the legal rights and obligations between debt holders and the issuer changed, as a matter of state law, as a result of the conversion. Under applicable state law, the resulting DRE remained the same legal entity as the original corporation. The entity's debt holders continued to "have exactly the same legal relationship with [the resulting DRE] that they previously had with [the original corporation]", and there was no change in the rights and obligations of the parties with respect of the debt. The change in tax status of the issuer did not result in either a change of obligor or a change in the recourse nature of the debt, and because the conversion did not otherwise involve a modification, testing for significance was unnecessary. This ruling is consistent with the Legal Rights approach.

However, on almost identical facts, Private Letter Ruling 200630002 concluded that the reorganization did not change the recourse nature of the debt and that no significant modification occurred for purposes of paragraph (c) of the -3 Regulations. It is unclear whether the drafters of this ruling (by the same branch of the same Associate Chief Counsel office that issued the 2003 ruling) deliberately took a different approach to the analysis, in light of the fact that much of the wording and analysis of the two rulings is the same. However, the quoted sentence from the 2003 Private Letter Ruling is not present, and the reference to paragraph (c) of the -3 Regulations implies that, unlike in the 2003 ruling, the analysis was that the reorganization and conversion resulted in a modification – albeit not a significant one. Although the ruling does not explain what type of modification existed, it is possible that the drafters believed that the conversion involved a change in obligor that was not significant because it fell under one of the Treasury Regulations Section 1.1001-3(c)(4)(i) exceptions. A deemed change in obligor due to a change in tax status (when for state law purposes the borrower was unchanged) would be, of course, inconsistent with the Legal Rights approach of Private Letter Ruling 200315001.

Private Letter Ruling 200709013 involved a series of steps that included (i) the conversion of a corporation into a single member LLC that then elected to be treated as a DRE and (ii) the change of tax status of the DRE into a partnership. Without specifying which steps, the ruling stated that several steps of the transaction “involve[d] the substitution of a new obligor on the [d]ebt, resulting in a ‘modification’ of the [d]ebt within the meaning of section 1.1001-3(c)(2)(i).” A change in obligor (and therefore, a modification) occurred even though, as in Private Letter ruling 200315001, the relationship between the issuing entity and its creditors remained unchanged after the transaction, and the state-law borrower remained unchanged. The ruling went on to explain that the modification was not significant because each change in obligor qualified for an exception under paragraph (B) or (C) of Treasury Regulations Section 1.1001-3(c)(4)(i).

The IRS was more explicit in Private Letter Ruling 201010015. In this ruling, a corporate issuer of debt took part in a series of steps that were the subject of a prior ruling concluding that they would be treated as a reorganization pursuant to section 368(a)(1)(D). One of the steps was a change in the issuer’s tax status from a corporation to a DRE via a conversion to an LLC under state law. The ruling states that the steps involved a substitution of the obligor for purposes of the – 3 Regulations. The modification was not significant because it qualified for the Treasury Regulations Section 1.1001-3(c)(4)(i)(B) exception for section 381(a) transactions (evidently taking all of the steps into account, rather than just the deemed liquidation of the issuer as a result of the conversion). Counterintuitively, the ruling describes the disregarded LLC (and not its owner) as the successor obligor after the conversion, suggesting inconsistency with both the tax status approach (where one would expect the owner of the DRE to be the new obligor), and the Legal Rights approach (where one might expect a finding of no change in obligor).

Advice Memorandum 2011-003 does not involve a DRE, but applies the -3 Regulations to another type of change of entity status. It is significant in part because it illustrates complex fact patterns in which the issues discussed herein with respect to DREs may arise, and in part because of the difficulty that practitioners have had in understanding its logic. The facts in the Advice Memorandum involve an issuer of recourse debt that was an insolvent foreign corporation that was wholly owned by two affiliates.

The foreign corporation checked the box to be treated as a partnership. The purpose of the transaction appeared to be to allow the U.S. affiliate to take a worthless stock deduction as a result of the deemed liquidation of the foreign corporation, and the ruling holds that a worthless stock deduction may be available.

The application of the -3 Regulations in the Advice Memorandum does not, however, appear to treat the issuer as having liquidated and then separately recontributed its assets and liabilities to a new partnership. Instead, the Advice Memorandum states that, “a corporation’s change in entity classification to a partnership under § 301.7701-3 results in a substitution of a new obligor under § 1.1001-3.” Similar to the previous guidance, the memorandum concludes that, although there was a modification of the entity’s debt, the modification was not significant because, in the case of recourse debt, Treasury Regulations Section 1.1001-3(c)(4)(i) applied. It is not clear how, or whether, the drafters thought Treasury Regulations Section 1.1001-3(f)(7), which generally requires a standard debt-equity analysis for debt deemed newly issued, applied to this transaction.³³

III. THE LEGAL RIGHTS APPROACH

We turn now to a discussion of the Legal Rights approach, supported by a substantial majority of the Executive Committee of the Tax Section. The Legal Rights approach is focused on two fundamental points. First, as a matter of law, Section 1001 is a rule that applies to holders of property, and the test for whether an exchange that is material in kind or extent has taken place therefore should – or must – take place by reference to its effect on holders.³⁴ Under *Cottage Savings*, the question therefore is whether the legal entitlements – that is, the “rights and powers”³⁵ (restated in the -3 Regulations as “rights and obligations”) -- of holders of debt are changed. Second, as a matter of policy, changes to the tax status of

³³ Under general debt-equity principles, the newly “issued” debt of the partnership presumably would not have qualified as debt, because the issuer was insolvent. Treasury Regulations Section 1.1001-3(f)(7)(ii) contains an exception to that rule, but, as noted earlier, by its terms it applies only to transactions involving a single obligor.

³⁴ The Tax Court has recently articulated this view of Section 1001, in *Estate of McKelvey*, 148 T.C. No. 13 (2017).

³⁵ 499 U.S. at 564 (quoting *Marr v. United States*, 268 U.S. 536, 541 (1920))

a borrower have no legal or economic effect on holders, and therefore should not visit upon them wholly random and unpredictable tax consequences. In sum, as a policy matter, the Legal Rights approach advocates for a pure holder-based approach to Section 1001.

As described in more detail below, the Legal Rights approach does not hold that there are no tax consequences to a check-the-box election or conversion or merger into (or out of) DRE status, or that there are no other consequences for the issuer. All of the other rules of the Code apply to the relevant transaction, and indeed even the holders of the debt can have (tax) consequences as a result of the event, including for example a change of source of their interest, a change from a convertible debt instrument to a nonconvertible debt instrument, or *vice versa*, and perhaps even a change to (or from) a “contingent payment debt instrument.”

To elaborate on the first point above, the starting point is Section 1001(a), which states that, “[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . .” Section 1001 applies to property. It applies by reference to basis, which is a concept that applies only to property. Treasury Regulations Section 1.1001-1(a) correspondingly applies to “gain or loss realized from the conversion of property to cash, or from the exchange of property for other property differing materially either in kind or in extent.” Treasury Regulations Section 1.1001-3(a) states that it provides rules for determining “whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001-1(a).”

Under current law, therefore, the -3 Regulations apply to exchanges, or deemed exchanges, of debt instruments that are property, which is to say they apply in the first instance to creditors. As noted above, a cross-reference in the regulations under Section 61 applies these rules to issuers of debt (when there is a COD issue), but that does not have the effect of transforming the Section 1001 regulations into regulations that operate by reference to the effect of events on issuers. The cross-reference merely ensures conformity as to whether a deemed exchange has taken place, when the relevant Section 61 rule applies.

Ordinarily tax rules take into account real-world changes to a taxpayer's legal, economic or other non-tax position. A check-the-box election by an issuer typically has no effect of that kind on a creditor. While it may be the case that an entity checked closed becomes liable for corporate tax, or that an entity that becomes a partnership is deemed to acquire assets in a manner that changes the basis of its assets and/or other tax attributes that could ultimately affect a creditor, the terms of recourse unsecured debt instruments permit issuers to take other steps that may be much more significant to a creditor without giving rise to a deemed exchange to the creditor. For example, an issuer may issue other debt or take on significant other liabilities, may impair its assets, or may engage in a wide range of other transactions that do not affect the legal relationship between the issuer and creditors. The fact that checking the box affects the tax status of the issuer does not mean that it should have any direct effect on unrelated creditors.

As stated in the introductory section of this Report, one could ask why the -3 Regulations treat a change of obligor on a recourse debt instrument as a *per se* modification. The proposed version of the regulations did not. The preamble to the final version of the regulations states that, “[t]he IRS and Treasury believe that these changes may be so fundamental that they should be considered modifications even if they occur by operation of the terms of an instrument.”³⁶ However, the same change of policy, and the same explanation, applied to a change in the recourse nature of an instrument. That may suggest that the fundamental characteristic of concern was the credit risk on the instrument, which is considered a fundamental characteristic for commercial purposes as well.³⁷ If that is right, then as described above, a Legal Rights approach is consistent with the policy underlying the current -3 Regulations, because checking the box ordinarily has no effect on the perceived credit risk of the issuer.

³⁶ T.D. 8675, *supra* note 6, at 61.

³⁷ One illustration of this point is that bonds issued to investors in the capital markets often provide that investors can “put” the bonds – that is, require immediate repayment of the bonds – if there is a designated change of control of the issuer. That is, an issuer that is acquired by another company is viewed as a different credit risk than prior to the acquisition and the difference is sufficiently fundamental that investors are not required to bear this new credit risk.

While it is true that under at least one version of the Legal Rights approach, becoming a DRE through a check-the-box election or a conversion under state law would be treated differently from a merger into a DRE, that is the result of the fact that in the latter case there is a different borrower, which is to say something in the real world has actually changed. If a Legal Rights approach is adopted, the -3 Regulations should provide that a merger of this sort also would not be treated as a modification, assuming no other changes to a creditor's rights and obligations.

As noted above, the Legal Rights approach does not hold that a check-the-box election will never have an effect on a creditor. Particularly where a creditor is a related party, it is quite possible that other rules of the Code will give rise to tax consequences for a creditor. For example, assume that a wholly owned corporate subsidiary has borrowed money from its parent. If the subsidiary becomes a DRE, the debt vanishes. That is a transaction that obviously should have tax consequences to both the debtor and the creditor, and we believe that under a Legal Rights approach it would, under provisions of the Code other than the -3 Regulations. That transaction is viewed as a repayment by the subsidiary of the debt, if the subsidiary is solvent, under Section 337(b)(1) and Treasury Regulations Section 1.332-7.

Conversely, assume that a corporation has loaned money to a DRE that it owns. If the lower-tier entity checks the box closed, or the corporation transfers an interest in the DRE to another person so that the DRE becomes a partnership, the debt comes into being for tax purposes at that moment in time. The deemed issuance of the debt to the shareholder/partner has potential consequences under subchapter C (for example, boot in a Section 351 transaction) or subchapter K (for example, allocating basis to the partner) for the shareholder/partner. The deemed issuance also has consequences to the newly minted issuer. The -3 Regulations are irrelevant to this transaction. Because this example is the inverse of the prior example, it should not matter that the -3 Regulations do not govern the prior example either.

The general point that the -3 Regulations ought to be viewed as one part of a multiple-part inquiry into the effect of a change of obligor can be illustrated by a number of other examples. In fact patterns not involving a DRE, by way of comparison, the issuer of a debt instrument may change for tax purposes if a new issuer assumes the liability and the original issuer is released, or if the original issuer is not

released but the parties agree that the new issuer will make all of the payments on the debt, or where property is transferred subject to debt. In all of these cases, the original issuer is relieved of liability, and either has corresponding income or, if the debt is secured by property, takes the relief from liability into account in determining its amount realized. In corporate and partnership distributions where the transferor also shifts liability for its debt, the subchapter C and subchapter K rules will also come into play. All of this takes place separate and apart from the inquiry under the -3 Regulations as to whether there has been a realization event. That is, there can be consequences under other provisions of the Code even if there is no deemed exchange under the -3 Regulations.

As these examples demonstrate, the analysis of a transaction under the -3 Regulations is only the first step in determining the tax consequences of a transaction. There may be situations where the lack of a deemed exchange combined with the lack of adequate rules elsewhere in the Code permit taxpayers to engage in transactions that are undesirable as a policy matter. That problem ought to be addressed primarily in those other rules.

For example, one issue that we have considered at length is whether checking the box on a borrower could result in debt that was treated as recourse debt of the pre-checked borrower becoming nonrecourse debt of its regarded parent issuer for other purposes of the Code. We view this question as unresolved and unclear under current law. It is however highly significant, in light of the different COD and other consequences of then terminating the debt.³⁸ But this is an issue about what constitutes recourse or nonrecourse debt, which exists regardless of whether a DRE is involved. For example, is nominally nonrecourse debt of an SPV that is secured by all of the assets of the SPV, and where the SPV actively buys and sells the secured assets, properly regarded as nonrecourse? Conversely, is nominally recourse secured debt of an SPV that is contractually bound to incur no other expenses and to hold no

³⁸ See, e.g., Private Letter Ruling 201644018 (July 28, 2016) (holding that secured (presumably recourse) debt of a disregarded entity with no personal liability on the part of the entity's owner is nonrecourse debt for purposes of measuring gain or loss realized upon a transfer of property of the entity to its creditors in discharge of the debt, and that section 108 does not apply).

assets other than those securing the debt properly regarded as recourse? DREs add fuel to this fire, but neither the Legal Rights nor the Tax Status approach to the -3 Regulations would put the fire out.

Consequently, the Legal Rights answer to the issue raised in the Report is that, both as a matter of law and as a matter of policy, the -3 Regulations should be revised to provide that a DRE is treated as an obligor. This would affect not only the question of whether a “modification” takes place when a borrower becomes or ceases to be a DRE, but also the determination of whether a modification that arises because of other changes is “significant.” Ideally, the “significant modification” rules would be modified so that a liquidation and a contribution would be treated as significant, or not significant, under rules that give rise to symmetrical results. The “substantially all” rule in principle treats a liquidation or, when relevant, a contribution as not significant (on the basis, presumably, that the original relationship between the liability and the assets that supported it has not changed). However, as discussed earlier, the relationship between a liability and assets may change under both a liquidation and a contribution.³⁹ Under the “substantially all” rule, however, the effect on a liability of a liquidation is never significant, assuming no other changes to terms or facts, while the effect on a liability of a contribution may or may not be significant.)

In addition, the -3 Regulations should state that a change of entity status does not affect whether debt is treated as recourse or nonrecourse for purposes of the -3 Regulations. That conclusion follows logically from treating the borrower (the legal entity) as the obligor under the -3 Regulations. That is, regardless of whether one believes that recourse status should be determined under the -3 Regulations solely by reference to the legal terms of the debt (alternative (i) in the recourse/nonrecourse discussion above) or by reference to all the facts and circumstances (alternative (iii) in the recourse/nonrecourse discussion above), because neither of those changes when an entity’s tax status changes, the

³⁹ For example, in a liquidation, the assets of the liquidated entity may become subject to other liabilities of the shareholder, thus impairing the claim that the creditors of the debt of the liquidated entity had to those assets. Similarly, although perhaps less relevant, those creditors may now have recourse to other assets of the shareholder. These consequences do not seem any more or less significant than a transaction in which a shareholder with assets of X and Y and liabilities W and Z contributes asset X to a subsidiary that also assumes liability W. In both cases, the relationship between the original assets and liabilities of the entity holding those assets has changed as a real-world matter.

recourse/nonrecourse status of the debt also should not change. Of course, we would welcome clarification as to which of these approaches should be used for purposes of the -3 Regulations; however, the Report does not make a recommendation in that regard. As stated earlier, we believe that the 3-Regulations can, and should, be revised to address the change of obligor issues discussed herein even if this recourse/nonrecourse question is not addressed.

IV. THE TAX STATUS APPROACH

The Tax Status approach rests on the understanding that the Code should treat DREs consistently, for all purposes of the federal income tax rules. That is to say, one who favors Tax Status would argue that it does not make sense for the “check the box” regulations to apply for all purposes of the Code *except* for purposes of determining whether a holder of debt instrument issued by an entity has a taxable event when the entity’s tax status changes. A change of obligor resulting from a change of entity tax status would always be treated as a modification, in recognition of the fact that a different taxpayer is now entitled to take interest expense deductions, and that other tax attributes of the debt may have changed.⁴⁰

From a Tax Status perspective, the current Regulations’ somewhat technical standards for testing modifications influence the approach that ought to apply to a DRE issuer. This is because the technical standards allow for circumstances where economically meaningful changes could occur without triggering a realization event. For example, changes in the credit quality of an issuer, or changes in the “source” of the relevant interest income, may be economically meaningful, yet they do not trigger a realization event under the current -3 Regulations. Thus, these rules could be manipulated.

Introducing a divergence between how an entity (in particular, a DRE) is treated for all other purposes of the Code and how it is treated for purposes of Treasury Regulations Section 1.1001-3 would increase the potential for tax structuring/manipulation of the rules. Under a “legal rights approach” a taxpayer can change tax consequences for the purposes of *other* areas of the Code, while avoiding taxation under Section 1001, when the tax status of an entity changes. From a Tax Status perspective an

⁴⁰ This is in contrast to the first way of adopting a Legal Rights approach described earlier, under which a change of entity tax status would be treated as a non-modification change of obligor.

expansion of the universe of circumstances where economically significant changes might occur without the friction of a realization event is not to be recommended.

A fundamental premise of the Legal Rights approach is that the Section 1001-3 standards should be based on economic realities. A further step in that argument is that mere changes in tax status of an entity do not, by themselves, alter legal entitlements or economic rights, and that the rules should make this explicit. For one who favors Legal Rights, this logic is considered a natural extension of the *Cottage Savings* analysis.

However, *Cottage Savings* predated the arrival of DREs, and therefore did not address the changes to the tax law to which DREs have given rise, or the base conflict between state law and tax law when it comes to DREs. *Cottage Savings* acknowledged prior Supreme Court cases that treated transactions as giving rise to realization events even though the actual changes that triggered the realization events were not, it appears, reflected in any documents to which the taxpayer creditors were party and had no immediate or obvious impact on the taxpayer creditors.⁴¹ *Cottage Savings* thus leaves open the possibility of taking into account this new kind of change (in the tax status of an entity when considering the circumstances under which a debt instrument is issued. It is at least possible to read *Cottage Savings* as supporting either a Legal Rights approach or a Tax Status approach.

With respect to the economic impact of a change in tax status, it is possible that the change could have an economic impact on a creditor. For example, if a state law LLC that is wholly-owned by Parent is disregarded, the borrower itself is not a taxpaying entity. Once the entity is checked closed, the borrower becomes liable for federal as well as state taxes on its income. If the borrower is part of a consolidated group, it can have liability for the entire group's taxes, under Treasury Regulations Section 1.1502-6. These borrower-level consequences are potentially economically meaningful. While it is true that many events (*e.g.*, additional extensions of credit) that can alter a borrower's economic position are

⁴¹ In *United States v. Phellis*, 257 U.S. 156 (1921), for example, the articles of association of the new and old companies are not part of the record. We note that in *Phellis*, there were indeed different corporations as a matter of state law before and after the reincorporation events, so that one could distinguish *Phellis* on this basis.

ignored under the current framework of the -3 Regulations, changes in tax classification (which potentially trigger a change in obligor) might well be considered different in character from other factual changes in the issuer's financial position.

A change in obligor is, under the current framework of the regulations, a modification even if it occurs by operation of the terms of the instrument. Similarly, a change in the nature of an instrument from recourse to nonrecourse is a modification, even if it occurs by operation of the terms of the instrument. The preamble to the final regulations stated that the IRS and Treasury saw these types of changes as being so fundamental “that they should be considered modifications even if they occur by operation of the terms of an instrument. Thus, these modifications always must be tested for significance to determine whether they result in exchanges.”⁴² From the Tax Status perspective, this motivation for the provisions adopted in 1996 informs the analysis in relation to a DRE issuer—and this is especially so if one takes into account the fact that issuers (and holders) of debt obligations can treat a debt security issued by a DRE as “parent debt” in connection with an exchange of the DRE's debt for parent debt (or *vice versa*) in a reorganization transaction. Under Section 354, even though the legal rights of creditors of a DRE could differ from the legal rights of creditors of the parent, the tax treatment as “parent debt” may be beneficial to the creditors. From a Tax Status perspective, it is overly generous to permit this result while not applying a consistent view (i.e., that there is a new obligor) for purposes of Section 1.1001-3.

From the Tax Status perspective, there is also some concern that a Legal Rights approach would require the adoption of special rules to address anomalies, because the -3 Regulations are quite technical in their operation.⁴³ As one commentator has written:

. . . the debt modification regulations reflect an acceptance of a greater degree of taxpayer discretion than has been historically accorded. The fact that a decision that is pretax is costly to a taxpayer, but beneficial after tax, is the kind of circumstance it was long thought the mission of the tax law and of tax administration to eliminate. Both the Supreme Court's Cottage Savings decision, and the regulations, by permitting recognition in the presence of certain changes not likely to have too large an

⁴² T.D. 8675, *supra* note 6, at 61.

⁴³ See Stanley I. Langbein, FEDERAL INCOME TAXATION OF BANKS & FINANCIAL INSTITUTIONS, Chapter 4, para. 4.03.

effect on the value of an obligation, invite the result. The modern trend, then, is a greater trust in the taxpayer to avoid abuse, and in the tax system to allocate tax burdens fairly even with some degree of taxpayer control of the timing of items of income, gain, or loss.⁴⁴

A Tax Status approach therefore places greater emphasis on the gate-keeping function of the -3 Regulations. For example, depending on one's view of what constitutes nonrecourse debt, a Legal Rights approach could make the concept of nonrecourse debt entirely elective. Viewed from a Tax Status perspective, however, if a corporate Parent issues debt secured only by certain limited assets (whether via a nominally nonrecourse loan or by contributing assets to a DRE and having the DRE be the borrower), the debt would, for tax purposes, be treated as nonrecourse, because it is Parent debt and is not secured generally by other assets of the Parent. If the DRE is the "obligor," by contrast, the DRE will have more flexibility (and greater optionality) in terms of whether the same instrument, secured by the same assets, is structured as recourse or nonrecourse debt for purposes of other rules of the Code.⁴⁵

Another consideration animating the Tax Status approach is that there are other types of entities that are functionally "disregarded entities," such as grantor trusts, qualified REIT subsidiaries and qualified S subsidiaries, so that if special rules are adopted under the -3 Regulations for DRE borrowers, the same special rules should apply to those entities. This suggests that if the rules are changed, the situations in which this question could be relevant are potentially larger than only those circumstances where a single-owner LLC that borrows funds would be treated as the obligor under the -3 Regulations.

One practical disadvantage of the Tax Status approach deserves mention. There is general agreement that if the regulations are to adopt a Tax Status approach, some greater clarity on the question of when, and whether, debt of a DRE is treated as recourse or nonrecourse for purposes of the -3 Regulations will be needed. To return to an example discussed earlier in the Report, if a corporate subsidiary that has issued recourse debt checks the box "open," the tax analysis of the transaction depends

⁴⁴ *Id.*

⁴⁵ Those who support the Legal Rights approach agree that this should not necessarily be the case, but would address it directly by clarifying what is and what is not nonrecourse.

in part on whether the debt is also then deemed to have been converted into nonrecourse Parent debt.⁴⁶ In one sense, the debt is of course nonrecourse to the parent, at least if the parent has other assets. On the other hand, if the subsidiary is carrying on an active business, and the debt is recourse to all of the subsidiary's assets, the debt is not "nonrecourse" in the commercial and generally understood sense of the word.⁴⁷

A Legal Rights approach sidesteps this question (has the debt now been converted into nonrecourse parent debt?) because from a Legal Rights perspective, there has been no modification. Moreover, if the -3 Regulations were to treat a disregarded entity as an obligor, from the Legal Rights perspective it might also be appropriate to apply state law in assessing the nature of the debt instrument as recourse or nonrecourse. By contrast, a Tax Status approach would require taxpayers to confront the recourse/nonrecourse question each time tax status changes occur, because the -3 Regulation analysis would (without more) remain divorced from state law concepts.

As previously stated, a significant majority of the Executive Committee of the Tax Section favors the Legal Rights approach. We nevertheless set forth below a couple of examples illustrating the concerns animating the Tax Status perspective. (These examples treat debt issued by a DRE as nonrecourse debt of its sole owner.)

1. Example 1 – F reorganization⁴⁸:

Assume the lenders hold recourse debt of corporation X. As part of a transaction that is an "F" reorganization, the stock of X is contributed to new corporation Y and, immediately afterwards, X is checked open. For tax purposes, Y is a continuation of X. Also assume that X transfers some of its assets to Y (not uncommon in an F

⁴⁶ A change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) generally is a significant modification. Treasury Regulations Section 1.1001-3(e)(5)(ii)(B)(2) provides an exception to this rule where the instrument continues to be secured only by the original collateral, and the modification does not result in a change in payment expectations. A legally unsecured debt instrument does not naturally fit into this exception. However, if the debt is treated as "secured" by the original assets for tax purposes as an attribute of being nonrecourse for tax purposes, then one might further ask whether the debt can be, or should be, treated as "continuing" to be secured in light of the fact that there has been no change to the legal terms in that regard.

⁴⁷ The considerations underlying distinctions between recourse and nonrecourse in *Commissioner v. Tufts*, 461 U.S. 300 (1983), are not relevant here.

⁴⁸ This example may or may not be realistic, in the sense that this is something lenders might not permit a borrower to do. The example is provided for illustrative purposes nonetheless.

reorganization) and as a result, the payment expectations on the debt have changed (gone down).

Under the Tax Status approach, the debt has gone from recourse debt of X to nonrecourse debt of the continuation of X, and there would be a taxable event. Under the Legal Rights approach, the debt would remain recourse debt of the same legal entity, and there would be no taxable event – even if there was a change in payment expectations. The Legal Rights approach would view the push up of assets as isolated from the “F reorg” (just as a corporate debtor can distribute assets to its shareholders with no tax consequences to creditors).

2. Source of income

Assume P (a US corporation) has a finance sub that is a DRE in a foreign jurisdiction. DRE issues debt and lends the money to affiliates of P doing business outside the United States. Interest on the debt issued by DRE would ordinarily be US source. P now elects to treat DRE as a corporation. Thereafter, the “source” of the interest will no longer be US source.

Under the Tax status approach, once the DRE is “checked closed,” the obligor has changed.

Assuming none of the exceptions in Treasury Regulations Section 1.1001-3(e)(4) applies, there would be a 1001 taxable event.

Under the Legal Rights approach, there would be no change to legal rights of creditors, so no Section 1001 event would occur – even though the *tax* impact of this change in tax status is potentially significant. From the Legal Rights perspective, this is not troubling; many other situations can arise where the source of income on a debt instrument changes (for example, a transfer of substantially all of a U.S. corporation’s assets to, and assumption of its liabilities by, a non-U.S. corporation). Further, a change in the source of income is not a change in any legal right or obligation.

V. SUBSTITUTIONS OF COLLATERAL ON NONRECOURSE DEBT

Treasury Regulations Section 1.1001-3(e)(4)(iv) contains a mechanical rule for substitutions and/or modifications to the collateral on nonrecourse debt. The rule provides that that if a “*substantial amount* of the collateral for, or guarantee on, or other form of credit enhancement” is changed, a significant modification has occurred. The test as written does not look to the potential economic impact,

the percentage of collateral being replaced, or the overall materiality of the change in collateral or security on the nonrecourse debt.

This rule can give rise to practical problems, simply because what is a “substantial amount” may not correspond to the actual significance of the change to the collateral. By way of illustration, consider two examples. In the first one, nonrecourse debt is secured by \$10,000 of assets. There is a substitution of \$500 of the collateral, or 5%. We believe there would be broad agreement that \$500 does not constitute a “significant amount.” In the second example, debt is secured by \$1,000,000,000 of assets. There is a substitution of \$50 million of the collateral, or 5%. \$50 million of collateral is more likely to be considered to constitute a “significant amount.” Yet these two substitutions are identical in terms of their overall significance to the relevant transaction.

Others have written about the potential problems to which this mechanical test can give rise,⁴⁹ suggesting that the rule should be revisited. One suggestion is that the regulations should include a requirement that when a change affects a substantial “amount” of the collateral, there must also be a change in payment expectations in order for a taxable event to occur. In conjunction with this approach, an additional revision would be to add a rule that looks to whether there has been a change in a “substantial portion” of the collateral (instead of a “substantial amount”), in which case there would be an automatic trigger of a significant modification (without a need to test for changes in payment expectations).⁵⁰ We would support a change along these lines, and believe it would be consistent with the intent of the -3 Regulations.

⁴⁹ See Peaslee, *Disregarded Entities and Debt Modifications*, *supra* note 10, at 1163-64.

⁵⁰ *Id.* at 1164.