The Treatment of Payments on Distressed Debt Instruments

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The current rules for accounting for payments on debt instruments are not well-suited for the treatment of payments on distressed debt instruments. These include the rules for accruals of interest and OID under Reg. 1.451-1(a) and Sections 1272 to 1275 and the regulations thereunder, the rules for accounting for market discount under Sections 1276 to 1278, and the rules for allocating payments to interest and principal under the "interest first" rules of Regs. 1.446-2(e) and 1.1275-2(a). This article examines the applicability of the foregoing rules to distressed debt obligations, as well as the potential for treating pools of distressed debt obligations as single mass assets. The article notes the need for regulatory guidance in this area, and ends with a suggestion regarding the proper treatment of "distress" in this context.

The article first examines whether owners of distressed debt are required to accrue coupon interest and OID on obligations that are substantially certain never to pay these amounts. Since 1930, taxpayers have not been required to accrue coupon interest that is substantially certain never to be paid. However, the Service took the position in unpublished guidance in 1995 that taxpayers are required to accrue OID on debt instruments outside the bankruptcy context, even if it is substantially certain that no such OID will be paid. The article discusses the inconsistency of this position with the rule regarding accrual of coupon interest, and suggests that Treasury issue new guidance on point.

Second, the article examines whether payments on distressed debt obligations should be treated wholly or in part as market discount. It begins by reviewing pre-1984 common law rule governing the proper method for accounting for market discount. Prior to the passage of the statutory market discount rules, holders of healthy debt instruments purchased below par were required to allocate payments other than interest pro rata to discount income and return of basis, but holders of "speculative" debt instruments (as defined) were permitted to allocate payments to basis recovery first. Although the current statutory market discount rules in Sections 1276 to 1278 do not contain

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an explicit exemption for payments on distressed debt, the legislative history makes it clear that Congress crafted the rules with healthy debt instruments in mind, and there is no evidence of a Congressional intent to preempt pre-existing common law doctrines applicable to distressed debt instruments. Under general principles of statutory interpretation, statutes which invade preexisting common law are read with a presumption favoring retention of the common law rule, except where a contrary statutory purpose is evident. Because there is evidence the Congress understood that the statutory market discount rules are best suited to payments on healthy debt instruments, and because there is no evidence of an intent to dislodge pre-existing common law doctrines applicable to payments on distressed debt instruments, a strong argument can be made that pre-1984 common law on point survived passage of Sections 1276 to 1278.

Third, the article discusses the proper method for allocating payments on distressed debt instruments to accrued interest other than market discount and principal. Prior to 1994, relevant authorities were split; some held that, absent a specific allocation, liquidating payments on debt instruments of this type could be allocated first to a return of principal, and some held that these payments had to be allocated pro rata to a return of principal and accreted interest. As with the statutory market discount rules, the plain meaning of the "interest first" rules contained in Regs. 1.446-2(e) and 1.1275-2(a) seem to overturn prior law, because they do not contain an exception for payments on distressed debt. The article notes that there is support for the position that the pre-1994 law regarding the allocation of payments on distressed debt instrument survives; however, the issue is not clear, and regulatory guidance would be useful.

Fourth, the article examines whether pools of debt instruments may qualify for "mass asset" treatment under current law. Old case law allows mass asset treatment in case apportionment of tax attributes such as basis, fair market value, yield, and face value between assets in a pool is wholly impracticable. The mass asset doctrine was recognized but narrowed by the three courts that decided *Cottage Savings* during the late eighties and early nineties.[1] Therefore, there is a risk that taxpayers may not be permitted to use pool accounting in the case of pools for which it is administratively feasible to accrue OID and other items on an individual basis.

Finally, the article suggests that regulatory guidance on point would be useful. Regardless of the specific solution enacted by the government, the article argues that, if an exception to the general rules is made for distressed debt instruments, "distressed" should be defined more precisely. It is understood anecdotally that taxpayers often use a certain threshold discount

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[1] 90 TC 372 (1988); 890 F.2d 848 (6th Cir., 1989); 499 U.S. 554 (1991).

amount as a proxy for distress. For example, it is not uncommon for taxpayers to cease accruing interest and OID, and to stop accounting for market discount, on debt instruments which trade at a 50% or greater discount to par, regardless of time to maturity or other relevant factors. Although the pre-1984 common law regarding market discount provides some guidance regarding when a debt instrument should be treated as "speculative," the nominal yield on a debt instrument is the best proxy for distress. Because of this, the article suggests that debt instruments with a nominal yield of greater than a specified threshold "spread" over the current applicable federal rate ought to be treated as distressed.

Historical Background

The First Report on Public Credit reads in part:

> [A]s on the one hand, the necessity for borrowing in particular emergencies cannot be doubted, so on the other, it is equally evident, that to be able to borrow upon *good terms*, it is essential that the credit of a nation should be well established.
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> For when the credit of a country is in any way questionable, it never fails to give an extravagant premium, in one shape or another, upon all the loans it has occasion to make. Nor does the evil end here; the same disadvantage must be sustained upon whatever is to be bought on terms of future payments.[2]

True enough. But the political conundrum facing Alexander Hamilton was who should be left holding the bag once the new country's credit was restored. When Hamilton assumed the office of Secretary of the Treasury, he inherited a train wreck. The Continental Congress had issued bonds to finance the Revolutionary War and to pay veterans. Given the credit quality of the United States in 1789, many of these bonds had been purchased by speculators and merchants for pennies on the dollar. To establish the government's credit, Hamilton suggested that the federal government should assume the debts of the states, that a national bank be established, and that all war bonds be redeemed at face value; the plan was to be funded with tariff revenues, and refinancings. Critics of the plan lamented the fact that it would profit the speculators to the detriment of the veterans who had sold the war bonds at deep discounts. After some political horse trading (involving, inter alia, moving the new capital to

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[2] Alexander Hamilton, Report of the Secretary of the Treasury to the House of Representatives, January 9, 1790 (the "First Report on Public Credit") (posted various sites including http://18thcenturyreadingroom.blogspot.com/2006/06/item-of-day-alexander-hamiltons-report.html).

a swampy area in northern Virginia), Thomas Jefferson lent his support to the plan, and the rest is history.

History repeats itself. Practitioners who until last year spent most of their time helping clients securitize debt or structure IPOs of private equity firms are now being inundated with questions from said firms regarding investments in debt instruments whose value has taken a hit. In examining these investments, four questions usually emerge:

- First, should accrual-method taxpayers take coupons on a distressed debt instrument into account currently (and should all taxpayers accrue OID thereon) even though no payments are made, or are reasonably expected to be made, on the debt instrument?
- Second, if a payment is made on a distressed debt instrument, or if a distressed debt instrument is sold, should any of that payment or proceeds be treated as market discount?
- Third, assuming no market discount, how should payments on distressed debt instruments be allocated to recovery of basis, return of principal, interest, OID and capital gain?
- Fourth, may investors who buy large groups of distressed debt obligations account for them as a single "mass asset," with a single aggregate basis, issue price and stated redemption price at maturity?

This article attempts to gather and summarize the existing case law and guidance relevant to these issues. As discussed in more detail below, the law on point is often ambiguous. In the hope of helping taxpayers achieve some certainty in the face of this ambiguity, the final section of this article offers some suggestions that might usefully be adopted in forthcoming guidance by the Treasury.

Meaning of "Accrual"

At the outset, it is necessary to define what "accrue" means, because the term can be used ambiguously. For example, Section 1276(a)(1) says that gain on the disposition of a market discount bond is ordinary income to the extent of "accrued market discount" thereon. In this sense, "to accrue" means "to increase over time regardless of inclusion in taxable income." Unless the taxpayer elects under Section 1278(b) to include this "accrued" market discount in taxable income currently, it is not included in taxable income until there is a disposition, redemption, or partial principal payment made on the debt instrument.[3] However, the same phrase is often used to mean "to include in

[3] Sections 1276(a)(1), 1276(a)(3). For a more detailed description of the market discount rules, see below.

taxable income prior to receipt of cash." For example, under Reg. 1.451-1(a), an accrual method taxpayer is required to include an item of income in taxable income when all events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy.[4] Similarly, subject to certain exceptions, a taxpayer is required to include OID that "accrues" during a given accrual period in taxable income for that accrual period.[5] Practitioners often refer to the current inclusion of items in taxable income prior to their receipt as the "accrual" thereof. For purposes of this article, the economic process by which an amount increases over time, whether due to the compounding of interest or otherwise, will be referred to as "accretion," while the legal requirement that taxpayers currently include certain items in taxable income prior to receipt of cash or an other realization event will be called "accrual." Therefore, for purposes of the present discussion, under Section 1276(b), market discount "accretes" (unless the taxpayer elects to accrue it currently under Section 1278(b)), while Section 1272(a) requires taxpayers to "accrue" OID, and accrual method taxpayers are required to "accrue" income under Reg. 1.451-1(a) once the "all events" test is satisfied.

Accrual of Interest and OID

As early as 1930, the Second Circuit held that coupon interest on distressed debt need not be currently accrued, so long as it is reasonably certain that the issuer will not pay the interest:

> When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received. A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectable, and, where it is of doubtful collectibility or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation.[6]

This rule has been followed by the Service in published guidance.[7] It is worth noting that, although interest need not be currently accrued if it is

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[4] Id.

[5] Section 1272(a); Reg. 1.1272-1(b).

[6] Corn Exchange Bank v. U.S., 37 F.2d 34 (C.A.2 1930) (holding that interest on loan to B.R.T. need not be accrued after issuer went into receivership).

[7] Rev. Rul. 80-361, 1980-2 CB 164.

substantially certain that it will not be paid, courts have held that such interest still accretes, and must be taken into account by the holder either when actually paid or when the issuer's economic condition improves to a point where it becomes substantially certain that the interest will be paid.[8]

Despite the foregoing, the Service has held in unpublished guidance that the doubtful collectibility rule does not apply to accruals of original issue discount. In TAM 9538007,[9] a cash-basis taxpayer held junior bonds which had OID due to a PIK feature. The description of the facts in the TAM makes it clear that it was reasonably certain that OID would never be paid on the bonds:

> The factual submission indicates that the Taxpayers reasonably believed that the financial condition of Corporation was such that the Debentures would never be redeemed according to their terms. In August of Year 1, Corporation defaulted on its senior debt by failing to make the required cash interest payments. That same day, the Debentures traded at less than 10 percent of their face value. Corporation, in its annual report for Year 1, expressed doubt about its ability to continue as a going concern.
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> The financial situation did not improve in Years 2 and 3. In Year 2, Corporation missed both cash interest payments on its senior debt. Finally, in Year 3 the Corporation underwent a bankruptcy reorganization. Pursuant to the bankruptcy plan, Taxpayers exchanged their Debentures with a principal amount of $X for new common stock with a fair market value of $Y.[10]

Nevertheless, the government took the position that the taxpayer was required to accrue OID on the instruments until the date on which they were converted. The government argued that, under Reg. 1.451-1(a), an item is includible in the gross income of an accrual method taxpayer when all events have occurred that fix the right to receive the item and the amount thereof can be determined with reasonable accuracy. Therefore, an accrual method holder of a debt instrument is required to accrue stated interest in income as it is economically earned over the instrument's term, regardless of when it is actually paid. Under the "doubtful collectibility" exception, to the extent

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[8] Clifton Mfg Co., 137 F.2d 290 (4th Cir., 1943) (interest must be included in income in year when doubt regarding collectibility is removed); Atlantic Coast Line Railroad, 31 BTA 730 (1934) (interest whose payment is doubtful includible in income in year in which actually paid).

[9] September 22, 1995.

[10] Id.

that it is reasonably certain that stated interest payments will not be made, this test is not met with respect to those payments, because the "all events" test is not met. However, the government argued that the OID rules should be distinguished from the rules requiring current accrual of stated interest payments, because the OID rules recharacterize accruals of OID as deemed current payments of accrued OID amounts from the borrower to the lender, followed by immediate re-lending of the paid amounts by the lender to the borrower.[11] Because these are actual deemed current payments made to the lender under these rules, the government argued that OID under the OID rules is included "in lieu of" receipt, while interest is accrued by an accrual method taxpayer "in advance of" receipt.[12] Therefore, despite the surface similarities between the accrual of OID under the OID rules and the accrual of coupon interest under the "all events" test of the regulations under Section 451, the government's position is that the "doubtful collectibility" exception should not extend to OID.

TAM 9538007 is problematic for two reasons. First, the government's argument assumes that "actual deemed" payments of OID on a distressed debt instrument are more beneficial to the deemed recipient than real future payments due on the same instrument, even though it is substantially certain that neither stated interest nor any premium over the issue price will be paid. This is something of a leap; it is not clear why deemed current payments of OID that are substantially certain never to cease being "deemed" represent more of an accession to wealth than do real future payments of stated interest which are substantially certain to never be paid.[13] Second, the basis for the characterization of OID accruals as a deemed actual payment of interest is the anticipation of actual future payment. Under the current OID rules, total OID is equal to the difference between a debt instrument's issue price and its stated redemption price at maturity (its "SRPM").[14] A debt instrument's SRPM is the sum of all payments to be made on the instrument other than qualified stated interest ("QSI").[15] Absent actual future payments to be included in an instrument's SRPM, there are no OID accruals. To say that OID is somehow accrued "in lieu of" these payments, rather than "in advance" thereof misstates the issue.

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[11] Id, citing Sections 1272(a)(1) and 1272(d). This reading of the OID rules is not evident from the statute, but it is articulated in the legislative history, also cited in the TAM. HR Rept. 432, Part 2, 98th Cong., 2d Sess. 1034 (1984) (the "House Report").

[12] Id.

[13] See, e.g. Andrew W. Needham and Christian Brause, 736 T.M., Hedge Funds, XI.B.2; see, also, Martin D. Pollack., Stuart J. Goldring, and Larry Gelbfish, "Uncollectible OID: To Accrue or not to Accrue," 84 J. Tax'n 157 (March 1996).

[14] Reg. 1.1273-1(a).

[15] Reg. 1.1273-1(b).

Shortly after the issuance of TAM 9538007, the Service issued unpublished guidance to the effect that it would not follow the rule enunciated therein in the bankruptcy context.[16] Pursuant to this guidance, the Service adopted the position that an issuer may not deduct from, and a holder need not include in gross income, interest, including original issue discount, on unsecured prepetition debt instruments after the issuer files a petition for bankruptcy under Title 11 and while the issuer remains in bankruptcy.[17] Two reasons were cited as support for this position. First, the Service stated that the Bankruptcy Code suspends the legal right of creditors to collect interest on an obligation once a petition has been filed.[18] Because the legal right to collect interest (including OID) is suspended as of the petition date, the Service felt that the net taxable income of the parties involved should be adjusted accordingly. Second, the Service stated that, absent the promulgation of guidance, it would be possible for the government to be "whip-sawed" by holders and issuers treating postpetition interest inconsistently.[19] Since this guidance was issued soon after TAM 9538007, it may have appeared that the Service was reconsidering the validity of the rule articulated therein. In fact, the better view seems to be that the Service continues to adhere to the rule of TAM 9538007 outside of the bankruptcy context.[20] However, given the inconsistency of TAM 9538007 with settled law regarding the accrual of

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[16] Litigation Guideline Memo (LGM) TL-103 (May 6, 1996).

[17] Id.

[18] Id.

[19] Id. Note LGM TL-103 does not remove the danger of government "whip-saw." In Rev. Rul. 70-367, 1970-CB 37, the Service held that interest on debt of a railroad corporation involved in bankruptcy proceedings could be currently accrued and deducted even though it was unlikely that the full amount of this interest would be paid. Similarly, in CCA 200801039 (September 24, 2007), the Service took the position that postpetition interest on debt issued by an issuer in bankruptcy could be currently accrued and deducted because any contingency that may result from the effect of the bankruptcy proceedings is not the type of contingency that may prevent accrual (although the Service also took the position that post-petition interest that was discharged in bankruptcy had to be included in the issuer's income as cancellation of debt interest in the year in which the bankruptcy proceedings settled, to the extent of prior accruals thereof). Cf. In Re West Texas Marketing Corp, 155 B.R. 399 (Bankr. ND Tex., 1993), aff'd sub. Nom. Kellogg v. U.S., 54 F3d 1194 (5th Cir. 1995) (holding that postpetition interest may not be deducted). See, also, Deanna Walton Harris and Mark Hoffenberg, "Postpetition Interest: The IRS Gets One Right (And One Wrong)," 120 Tax Notes 51 (July 7, 2008). Given the rule enunciated in Rev. Rul. 80-361, this creates a risk that a holder of a debt instrument in bankruptcy may not accrue inclusions of interest payments, while the issuer of the same instrument may accrue deductions thereof.

[20] TAM 9538007 was cited favorably in FSA 20003009 (January 21, 2000), FSA 200003001 (January 21, 2000), and FSA 200004011 (January 28, 2000). See, also the comments of William E. Blanchard, Senior Technical Reviewer in the IRS Office of Chief Counsel (Financial Institutions and Products), summarized in Lee A. Sheppard, "News Analysis: Questions Raised by Distressed Debt," 2008 TNT 102-13 (June 27, 2008) (hereinafter Sheppard, Distressed Debt).

coupon interest on distressed debt as well as with economic reality, new guidance on point would be welcomed by taxpayers and practitioners.

Recognition of Market Discount

Pre 1984 Law. Prior to 1984, courts generally treated market discount as ordinary income.[21] For these purposes, the total amount of the difference between a holder's basis in a debt instrument and the face amount thereof was treated as ordinary income, regardless of the amount of time the taxpayer had held the debt instrument.[22] The appropriate method for accounting for this income depended on whether the obligation at issue was speculative or not. Generally, taxpayers who held speculative bonds were permitted to recover basis prior to recognition of market discount; any principal payments in excess of the taxpayer's basis were treated as ordinary income.[23] However, to the extent that the bonds at issue were not speculative, courts required that payments of principal be allocated pro rata between discount income and return of basis.[24]

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[21] See, e.g. Liftin, 36 TC 909 (1961); Underhill, 45 TC 489 (1966); Shafpa Realty Corporation, 8 BTA 283 (1927); Victor B. Gilbert, 6 TC 10 (1946); Hatch, 190 F.2d 254 (2d. Cir. 1951); Phillips v. Frank, 295 F.2d 629 (9th Cir. 1961); Willhoit, 308 F.2d 259 (9th Cir., 1962); Darby Investment Corp., 315 F.2d 551 (6th Cir. 1963); Walter H. Potter, 44 TC 159 (1965).

[22] Id. See, e.g. Phillips v. Frank ("Often, the fair market value of the note or mortgage is less than its face value. In such case, the amount of the difference between the face value of the note or mortgage and the fair market value thereof as determined at the time of sale is regarded as ordinary income and periodic payments on the unpaid principal of the note or mortgage received by a cash basis taxpayer must be apportioned between return of principal and income."). However, note that the same court declined to treat market discount as interest (although it did treat it as ordinary income), because market discount does not constitute a fee for the use of money by the issuer of a debt instrument to the holder thereof. Id. It is also worth noting that all of these cases assumed the conclusion that market discount should be ordinary income. Although the reasons for this conclusion were not discussed in the cases, the most likely bases therefore were probably (1) as discussed in the Congressional guidance published in connection with the Deficit Reduction Act of 1984 (discussed below), from the holder's perspective market discount is often functionally equivalent to interest, and (2) prior to the passage of Section 117 in the Revenue Act of 1934 (the predecessor of current Section 1271(a), amounts received by the holder of a debt instrument upon redemption thereof were not treated as amounts received in exchange therefore. U.S. v. Fairbanks, 306 U.S. 436 (1939).

[23] See Lifton; Underhill; Harris Trust; Phillips v. Frank; Willhoit, above.

[24] See Shafpa Realty Corporation; Darby Investment Corporation; Walter H. Potter, above. The rule was best stated by the court in Lifton: "a rule of law applicable to the instant case may be stated as follows: Where a taxpayer acquires at a discount contractual obligations calling for periodic payments of parts of the face amount of principal due, where the taxpayer's cost of such obligations is definitely ascertainable, and where there is no 'doubt whether the contract[s] [will] be completely carried out'... it is proper to allocate such payments, part to be considered as a return of cost and part to be considered as the receipt of discount income; but, conversely, where it is shown that the amount of realizable discount gain is uncertain or that there is 'doubt whether the contract [will] be completely carried out," the payments should be considered as a return of cost until the full amount thereof has been recovered, and no allocation should be made as between such cost and discount income.'"

Therefore, a fair amount of ink was used in determining whether a bond was "speculative" or not for these purposes. Although the determination required an examination of all relevant facts and circumstances, courts tended to look to the following factors in making this determination:

- The value of the obligation at the time of purchase. To the extent that an obligation did not have fair market value in excess of the taxpayer's basis therein, courts tended to treat an obligation as speculative, because the most likely source of income or gain with respect to this type of obligation is from payments made on the obligation by the (potentially distressed) issuer thereof.[25]
- The liquidity of the obligation. To the extent that there was a liquid market for a bond, courts tended to treat an investment therein as less speculative;[26]
- Whether, at the time of acquisition, the obligor on the debt instrument was in substantial default on payments due;[27]
- The subordination of the obligation and, if applicable, the value of security underlying the obligation;[28] and
- The size of the discount. Although the existence of a discount does not per se make obligations speculative (and although courts did not use, or propose the use of, a specific threshold amount of discount to determine whether an obligation is speculative), courts acknowledged that the extent thereof did have a bearing thereon.[29]

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[25] See, e.g. Phillips v. Frank ("There is no evidence in the record that such rights had any market value, fair or unfair, or any other value in excess of taxpayer's costs. There is no evidence in the record that taxpayer at any time could have sold such contracts at a profit. The only source from which he might reasonably expect to realize any part of his profit is from periodic payments subsequent to the return to him of his invested capital."); Willhoit, above (similar).

[26] Underhill; Phillips v. Frank; Darby Investment Corporation, above.

[27] Phillips v. Frank; Willhoit, above.

[28] Underhill; Darby Investments; Harris Trust, above.

[29] Underhill; Lifton. Holders in cases which allowed up-front basis recovery tended to purchase obligations at significant discounts to par. For example, the obligations in Lifton were purchased at discounts "ranging up to 45 percent." Although the amount of the discount on the obligations purchased in Willhoit was not mentioned as a factor, it appears that the loans were purchased at a discount of almost 70% to the amount of their face value less prior liens. The taxpayers in Gilbert had bases in their obligations equal to approximately 60% of the face value thereof. By contrast, the taxpayer in Shafpa Realty, Darby Investment Corporation, and Walter H. Potter (all cases in which the taxpayer was required to allocate principal payments to discount and return of basis currently) purchased their obligations at discounts to par of 20%, 25-27%, and 17%, respectively.

Principal payments in excess of basis received on speculative bonds were treated as ordinary to the extent of the entire difference between the taxpayer's basis in the bond and the face amount thereof.[30]

Statutory Market Discount Rules. The foregoing common law was significantly modified by the Deficit Reduction Act of 1984 (the "1984 Act").[31] Since 1984, the treatment of the character and timing of payments on market discount bonds has been governed by Sections 1276, 1277, and 1278 (the "market discount rules"). As defined in the statutory market discount rules, a market discount bond is a bond with market discount, and market discount is the excess, if any, of the "stated redemption price at maturity" of the bond over the buyer's tax basis at the time of purchase (or, if the bond has OID, market discount is the excess of the bond's "revised issue price" over the taxpayer's basis therein).[32] Market discount accretes using a straight-line method, unless the taxpayer elects to use a yield-to-maturity method.[33] Market discount is generally treated as interest income to the holder when taken into account.[34] However, it is not treated as interest for purposes of withholding tax and for information reporting purposes, and market discount on bonds issued by State and local governments and other tax-exempt obligations is not treated as tax-exempt interest thereon.[35] Additionally, because market discount is usually not taken into account currently, there are rules that defer the deduction of "net direct interest expense" associated with indebtedness incurred to purchase or carry market discount bonds until the year in which offsetting market discount is recognized.[36] This last rule prevents taxpayers from front-loading deductions associated with debt incurred to purchase or carry market discount bonds while back-loading recognition of market discount.

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[30] See, e.g. Lifton ("The parties agree that where note obligations are purchased at a discount the receipt of such discount is ordinary income").

[31] PL 98-369, section 41(a) (1984).

[32] Sections 1278(a)(1)(A), 1278(a)(2).

[33] Section 1276(b). An election to use a yield to maturity accrual method is done on a bond-by-bond basis, and is irrevocable.

[34] Section 1276(a)(4).

[35] Id. Market discount on tax-exempt bonds is taxable because it is a product of the secondary market, and does not affect the issuer; as such, tax exemption would not subsidize State and local governments and other issuers of tax exempt bonds in the way that exemption for coupon payments on exempt bonds does. Market discount is not deductible by the issuer of a market discount bond for similar reasons.

[36] Section 1277.

In relevant part, Section 1276 contains two rules regarding the timing of inclusions of market discount:[37]

- First, gain on the sale or redemption of a market discount bond is generally treated as ordinary income to the extent of accreted market discount (other than *de minimis* market discount) on the bond.[38] Effectively, this means that gain on the sale of a market discount bond is treated as ordinary income to the extent of market discount that has accreted up to the date of disposition. If the market discount bond is a capital asset in the holder's hands, any gain in excess thereof is capital.
- Second, any partial principal payment on a market discount bond is treated as ordinary income to the extent of market discount that has accreted thereon as of the date of the partial principal payment.[39] This has the effect of allocating non-interest payments to market discount first to the extent of market discount accreted to the date of the payment, and to a return of capital to the extent that the payment exceeds accreted market discount.[40] Accreted market discount is reduced to the extent of the portion of partial principal payments treated as ordinary income under this rule.[41]

The statutory market discount rules differ from pre-1984 common law in three relevant ways:[42]

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[37] A taxpayer may elect to accrue market discount currently, either using a straight-line or using a yield-to-maturity method of accrual. Section 1278(b). This election applies to all market discount bonds acquired by the taxpayer on or after the first day of the tax year for which the election is made, and is revocable only with the consent of the government.

[38] Section 1276(a)(1). For the calculation of de minimis market discount, see Section 1278(a)(2)(C).

[39] Section 1276(a)(3)(A).

[40] See, also the "interest first rule," discussed below.

[41] Section 1276(a)(3)(B).

[42] The statutory market discount rules also include a limitation on deductions for payments of interest on acquisition indebtedness incurred to purchase market discount obligations that did not exist prior to 1984. The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, (the "Bluebook") makes it clear that Congress inserted this provision because the rule for the timing of inclusion of market discount introduced by the 1984 Act would create the potential for a timing and character "whipsaw" in the case of debt-financed purchases of market discount bonds absent a rule that limits the deduction of interest on acquisition indebtedness until market discount is recognized. Joint Comm. Staff, General Explanation of the Tax Reform Act of 1984, H.R. 98-4170 at 41 (December 31, 1984) ("The Congress was informed that tax-shelter transactions arose in which taxpayers acquired market discount bonds, using borrowed funds, to take advantage of the opportunities under prior law to defer tax liability on ordinary income and to convert ordinary income to capital gain.")

Change the method for the timing of recognition of market discount. Under the statutory market discount rules, principal payments and sale proceeds not allocated to accrued interest are allocated first to accreted market discount, and then to payments of principal. Under pre-1984 law, payments of principal and sales proceeds on non-speculative bonds not allocated to accrued interest were allocated pro-rata to market discount and principal payments, and payments of principal and sales proceeds on speculative bonds not allocated to accrued interest were allocated first to a return of basis. Since the statutory market discount rules only require recognition of accreted market discount, but require that the recognition of such market discount be front-loaded, this can lead to fairly significant differences:

Example 1. X purchases a bond issued at par with a face amount of $100 for $60 in the secondary market on Jan. 2, 2009. All interest and OID is paid up as of this date. The bond matures on December 31, 2013. On July 2, 2009, X receives a partial principal payment of $3 on the bond.[43]

Under the statutory market discount rules, all of the $3 received would be treated as market discount, because $5 of market discount would have accreted on the bond by the date of the payment. Accreted market discount would be reduced to $1 by the payment.

Under pre-1984 law, if the bond were non-speculative, $1.20 of the $3 ($3 x 40%) would be treated as market discount, and $1.80 ($3 x 60%) would be treated as a return of basis. However, if the bond were treated as speculative, the entire $3 would be treated as a return of basis.

Limit the amount of gain or principal payment that can be treated as market discount to accreted market discount. Since only accreted discount is recognized under the statutory market discount rules, this may, in some cases, lead to taxpayer-friendly results:

Example 2. The facts are the same as in Example 1, except the holder receives a payment of $20 on July 2, 2009.[44]

Under the statutory market discount rules, the holder would recognize $5 of market discount upon receipt of the payment. The excess would be treated as a return of principal that would reduce the holder's basis.

Under pre-1984 law, to the extent that the bond is non-speculative, 40% ($8) of the payment would be treated as market discount, and 60% ($12) would be treated as a return of principal that would reduce the holder's basis.

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[43] For purposes of the example, assume that the pro rata prepayment rules of Reg. 1.1275-2(f) do not apply because the payment is a scheduled payment of principal.

[44] For purposes of the example, assume that the pro rata prepayment rules of Reg. 1.1275-2(f) do not apply because the payment is a scheduled payment of principal.

If the bond were speculative, the entire $20 would be treated as a return of principal that would reduce the holder's basis.

No distinction between the treatment of payments on speculative debt obligations and payments on non-speculative obligations. This lack of a specific mention in the statutory market discount rules creates uncertainty regarding the continued applicability of the pre-1984 rules to payments on distressed debt. Since Congress did not clarify whether it intended for the statutory market discount rules to preempt the pre-1984 common law rules in the context of distressed debt instruments, arguments regarding this issue have generally focused on whether the economic reality of investments in speculative debt instruments is consistent with Congressional intent expressed in the legislative history to the statutory market discount rules.[45] However, as discussed below, general rules of statutory interpretation are also useful in this regard.

The current statute makes no mention of an exception to the general rules for the treatment of market discount applicable to payments on distressed instruments. The legislative history does not specify whether silence on this point indicates that Congress intended for the statutory market discount rules to apply to all market discount bonds regardless of the credit quality of the issuer, or whether it intended for pre- existing common law to continue to apply where not explicitly overruled by statute.[46] A failure to interpolate such an exception can lead to results that are inconsistent with economic reality, because the default rules for accounting for market discount are not well suited to the treatment of payments on distressed debt instruments. Once the credit quality of an issuer has depressed the price of its debt below a certain level, many of the hallmarks of debt status disappear, because it becomes much less certain whether there will be complete payment of all amounts of principal and interest, and there is a risk that the holder's rights to sue as a creditor may morph into the rights of an equity holder in bankruptcy.[47] It does

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[45] See, e.g. James Eustice, "The Tax Reform Act of 1984, A Selective Analysis," 2-31, (Warren, Gorham & Lamont) (1984); Anne M. Barr, Peter J. Connors, and George C. Howell III, "ABA Members Consider Application of Market Discount Rules to Speculative Bonds," 91 TNT 113-28 (1991) (hereinafter the "ABA Report").

[46] See the Bluebook, above. See, also, Conf. Rept. 861, 98th Cong., 2nd Sess. 806 (1984) (the "Conference Report").

[47] See below. For a general discussion of the distinction between debt and equity investments, see, e.g. William T. Plumb, Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax L. Rev. 369 (1971) and the cases cited therein. Most cases and guidance that distinguish between debt and equity point to a list of "debt-like" and "equity-like" factors, which must be balanced in light of all relevant facts and circumstances. These include whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; whether holders possess the right to enforce the payment of principal and interest; whether the rights of the holders of the instruments are subordinate to the rights of general

not make sense to tax such an inherently speculative investment as debt.[48] Congressional silence on this point led the Committee on Financial Transactions of the American Bar Association to describe the potential inconsistency that could result from an application of the statutory market discount rules to speculative investments in distressed debt instruments in a report published in 1991 (the "ABA Report"):

> This points up a paradox in the market discount structure: The deeper the financial difficulties of an obligor are, the lower the market price of its bonds will presumably be. The lower the market price of its bonds, the greater the market discount which must be taken into account as ordinary income with respect to the bond. This is the case even though it is clear that, in such a situation, a portion of the discount is attributable to extraordinary credit risks typically associated with an equity investment.[49]

Does this mean that Congress intended to eliminate the exception for distressed debt? One influential view is that, although the failure of current law to directly address the treatment of payments on speculative debt investments may constitute substantial authority for the position that the pre-1984 common law rules regarding the treatment of payments on speculative debt instruments survived the 1984 Act, the better view is that they likely did not. For example, Garlock's treatise summarizes the issue as follows:

Two Tax Court cases from the 1960s, *Liftin v. Comm'r* and *Underhill v. Comm'r;* held that investors who specialized in purchasing high-risk second mortgages at a discount could treat all principal payments of sufficiently troubled mortgages first as a recovery of basis. (In both cases, the investors had treated all scheduled interest as ordinary income.) The Tax Court set forth the following rule:

> Where a taxpayer acquires at a discount contractual obligations calling for periodic payments of parts of the face amount of principal due … and where there is no "doubt whether the contract[s]

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creditors; whether the instruments give the holders the right to participate in the management of the issuer; whether the issuer is thinly capitalized; whether there is identity between the holders of the instruments and stockholders of the issuer; the label placed on the instruments by the parties; and whether the instruments are intended to be treated as debt or equity for nontax purposes. See Notice 97-47, 1994-1 CB 357.

[48] See, e.g. Eustice, ABA Report, above.

[49] ABA Report, above.

> [will] be completely carried out" . . . it is proper to allocate such payments, part to be considered as a return of cost and part to be considered as the receipt of discount income; but, conversely, where … there *is* "doubt whether the contract [will] be completely carried out," the payments should be considered as a return of cost until the full amount thereof has been recovered. . . .
>
> . . . .While the result of these cases is sensible, the question is whether they survive the enactment of the market discount rules in 1984. The answer is "probably not," as Congress did not carve out an exception to the market discount rules for deeply discounted obligations, nor did it limit the yield at which market discount accrues to a "reasonable" rate of interest. . . . .[50]

The Service cited the foregoing in recent unpublished guidance, and indicated that pre-1984 common law allowing for return of basis prior to allocation of payments to market discount has been "largely" superseded by the market discount rules.[51]

Despite the foregoing, an examination of the legislative history and pre-1984 common law in the light of general doctrines of statutory interpretation indicate that there is a strong argument that the pre-1984 common law rules regarding the treatment of market discount survive the 1984 Act. In

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[50] David C. Garlock, *Federal Income Taxation of Debt Instruments,* 6.03[D][3] (4th ed. 2003) [hereinafter "Garlock"]. See, also David Garlock's comments on this issue summarized in Sheppard, "Distressed Debt," above; Boris Bittker and Lawrence Lokken, *The Federal Taxation of Income, Estates and Gifts* 41.6.5 (3d. ed. 2006) ("Cases decided before the enactment in 1984 of the present statutory rules on market discount recognized an exception, under which the basis of speculative claims that may not be collected in full could be recovered before any income was realized. A conventional explanation for the cost recovery exception is that ultimate realization of gain by the purchaser of speculative claims at a discount is conjectural. An alternative rationale is that early installments of doubtful claims are more likely to be paid than later installments and that the differential is so uncertain that an equitable apportionment of the taxpayer's basis is not feasible. Whatever the rationale, the exception probably does not apply to obligations issued after July 18, 1984, because the statutory rules applicable to such obligations do not recognize the exception."); Michael Levin, "The Purchase of a Mortgage Loan at a Discount (and the New Proposed Regulations)," J. Real Estate Tax'n, (1993) ("The basis recovery rule, however, will not apply to the extent of accrued market discount"); Lee Sheppard, "Why Vultures should not be Nice Guys," 2001 TNT 38-3 ("There is, strictly speaking, no special consideration for troubled debtors or the holders of their debt in the OID rules.") However, cf. Needham and Brause, 736 T.M., Hedge Funds, XI.B (stating that the common law rule of Lifton survived passage of the market discount rules).

[51] CCA 200451030, (December 17, 2004) ("The treatment of market discount and contingent debt in such older cases as Underhill and Liftin has largely been superseded by subsequent developments in the law and it is questionable what, if any, precedential value they now have. See §§ 1276-78; § 1.1275-4; Garlock, § 6.03[D] [3]. . . . The fact that a lender on a bona fide debt obligation ultimately fails to recover all or part of the loan principal may result in a deduction under § 166; it does not, however, justify retroactive recharacterization of payments properly included in income in prior years.").

the Bluebook, the Joint Committee on Taxation discussed the reason for the institution of the market discount rules as follows:

Prior Law

> A market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond (or less than the amount of the issue price plus accrued original issue discount (or OID), in the case of an OID bond). Market discount generally arises when the value of a debt obligation declines after issuance (*typically, because of an increase in prevailing interest rates or a decline in the credit worthiness of the borrower*). Capital gain treatment was accorded to the appreciation in value attributable to market discount on an obligation that was issued by a corporation or governmental unit and held for more than one year. In many cases, interest on indebtedness incurred to purchase or carry a market discount bond was deductible currently against ordinary income, even though some of the income eventually generated by the investment was taxed on a deferred basis at capital gain rates.

Reasons for Change

> The Congress recognized that, from the standpoint of the holder of a bond, market discount is indistinguishable from OID. In each case the discount is a substitute for stated interest, and the holder of the obligation receives some of his return in the form of price appreciation when the bond is redeemed at par upon maturity. When a taxpayer makes a leveraged purchase of a market discount bond, the taxpayer effectively converts the ordinary income that is offset by current interest deductions to capital gain that is taxed on a deferred basis and at preferential rates.
>
> The Congress was informed that tax-shelter transactions arose in which taxpayers acquired market discount bonds, using borrowed funds, to take advantage of the opportunities under prior law to defer tax liability on ordinary income and to convert ordinary income to capital gain. The Congress appreciated that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity. The Congress believed, however, that the prior-law rules should be modified to prevent the use of market discount bonds as a basis for tax-shelter transactions, under an approach that would be more easily administered by taxpayers.

> The Congress also believed that it is appropriate to provide tax treatment for market discount on bonds that is more closely comparable to the tax treatment of OID, without regard to whether market discount bonds are held in a tax-shelter context. Capital gain treatment should not be afforded to *a largely predictable return (such as that available on the typical purchase of a market discount bond*).[52]

This wording evinces a Congressional intent to craft a statutory tax accounting regime for the treatment of payments on healthy debt instruments. As mentioned above, the rules themselves are not well-suited to payments on distressed debt. For example, assume that on Date 1, a taxpayer purchases a bond issued at par with a face amount of $100 for $30. All coupon interest and OID is paid in full when the bond is purchased, and payments thereof continue to be made.[53] If the bond matures two years after the acquisition date, the holder will have $70 of market discount income as of the maturity date, assuming that the holder receives par. This works out to an annual yield of 82.57% (not including interest attributable to coupon payments), a return more often associated with very successful equity investments, rather than with debt. Is there a way to read an exception for distressed debt that will avoid this kind of absurd result into the statute? The answer seems to be "possibly." Under general doctrines of statutory interpretation, statutes which invade preexisting common law are to be read with a presumption favoring retention of the common law rule, except where a contrary statutory purpose is evident; by the same token, a party contending that legislative action has changed settled law has the burden of showing that the legislature intended such a change.[54] However, to the extent that a statute evinces Congressional intent to change a com-

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[52] Id. (emphasis added).

[53] For a discussion of allocation of payments to coupon interest, OID and principal payments, see "Allocation of Payments" below.

[54] See, e.g. Pasquantino v. U.S., 544 U.S. 349 (2005); Republic of Honduras v. Philip Morris, 341 F.3d 1253 (11th Cir., 2003). Outside the tax law context, See Green v. Bock Laundry Machine Company, 490 U.S. 504 (1989) (holding that provisions in the Federal Rules of Evidence limiting the right to impeach a witness in criminal trials does not preempt the common law right to do so in the context of civil suits); U.S. v. Texas, 507 U.S. 529 (1993) (Federal Debt Collection Act of 1982 did not preempt the United States' common law right to collect prejudgment interest on debts owed to it by the States).

[55] See Isbrandtsen Co. v. Johnson, 343 U.S. 779 (1952) (Statutes passed by Congress for the protection of seamen should be construed to preempt the common law right of employers to offset wages for the cost of damage caused by seamen even given the statutes' failure to address the issue directly, because the statutes evince a clear Congressional intent to protect the rights of seamen); Astoria Federal Savings and Loan Association v. Solimino, 501 U.S. 104 (1991) (A federal civil rights statute must be construed to allow preemption of the common law doctrine that a suit is precluded absent exhaustion of administrative remedies, because the purpose of the statute would be unattainable otherwise).

mon law rule, the statute may be read as preempting the common law rule.[55] For example, in *Republic of Honduras v. Philip Morris*,[56] the governments of several Central American countries brought a civil suit under the Racketeering Influenced and Corrupt Organizations Act ("RICO")[57] to recover excise taxes due on the sale of tobacco by the defendant in their territories. The plaintiffs claimed that, because the defendant had conspired to evade taxes imposed by them on the sale of tobacco within their territories, they could sue as a civil plaintiff under the Rico statute. The 11th Circuit refused to enforce the claim due to the common law "revenue rule (i.e., the doctrine that courts of one sovereign will not enforce or adjudicate tax claims from another sovereign). The plaintiffs admitted the existence of the revenue rule, but argued that the RICO statute preempted it:

> The essence of the Republics' argument is that the civil RICO statute impliedly preempts the revenue rule because its broad and plain language does not contain an exception for cases involving foreign tax claims. We are not persuaded by this argument because it misapprehends basic rules of statutory interpretation.
>
> Congress is understood to legislate against a background of common-law adjudicatory principles. Thus, where a common-law principle is well established . . . the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident. Statutes which invade the common law . . . are to be read with a presumption favoring the retention of long-established and familiar principles, except when a statutory purpose to the contrary is evident. In order to abrogate [such] a common-law principle, the statute must speak directly to the question addressed by the common law.
>
> Little question exists that the revenue rule is a "long-established and familiar principle." The RICO act does not speak directly to the applicability or inapplicability of the revenue rule to actions brought under it. Furthermore, the Republics have not demonstrated, nor has this court discovered, any evidence of a statutory purpose in the RICO statute that would except actions brought under it from the strictures of the revenue rule. Without such a showing, we presume that Congress originally passed, and subsequently amended, the RICO statute against a background of common-law adjudicatory principles that included the revenue rule with an expectation that the principle [would] apply.

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[56] Above.

[57] 18 U.S.C.A. §§1961-1968.

> Therefore, the mere fact that the RICO statute is written in broad terms does not, standing alone, preempt application of the revenue rule to the Republics' RICO claims.[58]

Because there was no statutory purpose in the RICO statute that would justify preemption of the revenue rule, and because Congress is presumed to legislate "against a background of common-law adjudicatory principles," the court held that the ambiguity due to the RICO statute's failure to specifically address the revenue rule should be construed as reflecting an intent to keep it in place.[59]

The interaction between the revenue rule and a federal statute was revisited by the Supreme court two years later in *Pasquantino v. U.S*.[60] Although the Court held that a taxpayer could be prosecuted under a federal wire fraud statute for conspiracy to defraud the Canadian government of liquor excise taxes, it recognized the existence of the revenue rule, and went to pains to distinguish *Honduras v. Philip Morris*.[61] The Court's reasoning was that, because the action that was prosecuted in *Pasquantino* was fraudulent activity that took place within the U.S., rather than the evasion of foreign taxes, unlike the RICO statute, the federal wire fraud statute evinced a Congressional intent that in the instant case justified preemption because it conflicted directly with the revenue rule. This was further born out by the fact that the statute at issue in *Pasquantino* was a criminal statute, while the RICO action brought in *Honduras v. Philip Morri*s was a civil action. The fact that a criminal action by a domestic sovereign enforces the sovereign's own penal laws was held by the Court to be indicative of Congressional intent to preempt the revenue rule in this context.[62]

The general topic of when a statute may be deemed to preempt a common law rule could be the subject of a separate article, if not a treatise.[63] However, in the instant case the preemption doctrine supports the position that the pre-1984 common law rule regarding the treatment of payments on distressed

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[58] Id (internal cites and quotations omitted).

[59] Id. See, also Attorney General of Canada v. R.J. Reynolds Tobacco Holdings, Inc., 268 F.3d 103 (2d. Cir. 2001) (similar).

[60] Above.

[61] Id, 354.

[62] Id, 364.

[63] See, e.g. Jarod S. Gonzalez, "State Antidiscrimination Statutes and Implied Preemption of Common Law Torts: Valuing the common Law," 59 Southern California L. Rev. 115 (2007); Julia B. Meister, "Ahmed v. Ahmed: The Ohio Slayer Statute, Common Law, and ERISA Preemption," 16 Ohio Prob. L.J. 53 (2005); Georgia L. Adams, "Federal common Law Still survives Under ERISA: State Redesignation Statute Clearly Preempted but Revived Through Implementing Federal common Law: Weaver v. Keen, 43 S.W. 3D. 537 (Tex. App-Waco, 2001)," 43 S. Tex. L. Rev. 303 (2001).

debt instruments survived the 1984 Act. Like the RICO statute, Sections 1276 to 1278 are broadly and plainly drafted without an exception for payments on distressed debt instruments. Like the revenue rule, the common law doctrine that payments on speculative debt instruments may be first applied to a return of basis was well established and widely accepted when the relevant statute was passed. The statutory market discount rules do not evince a legislative purpose or intent to extent the default rules to distressed debt instruments. To the contrary, the rules are drafted in a manner best suited for accounting for payments on healthy debt instruments rather than or payments on speculative investments. Furthermore, as quoted above, the Bluebook indicates that Congress intended for market discount to be treated as ordinary income because from the issuer's perspective it reflects an interest-like "largely predictable return."[64] This may be read as evidence of Congressional intent to keep the common law rule regarding the treatment of returns on debt investments that are not "largely predictable" in place; at least, it may be read as evidence that Congress' failure to include an exception for distressed debt ought not be read as an intent to preempt existing common law doctrines on point.

It is worth noting that the Service's practice may indicate that it admits that the statutory market discount rules as drafted are not well suited for accounting for payments on distressed debt instruments. We understand anecdotally that it is common market practice for taxpayers to report market discount upon payments on or the proceeds of the disposition of market discount bonds which have been purchased for more than 50 cents on the dollar, and for taxpayers to allocate payments on or the proceeds of a disposition of market discount bonds which have been purchased for less than 50 cents on the dollar to a return of basis before recognition of market discount or other gain on the bonds, regardless of whether the bonds in question are in default. To our knowledge, the government has not challenged this practice to date.[65]

Solutions Proposed to Date. The ABA Report proposed three alternative ways to address the foregoing problem. First, it proposed that the Service could issue regulations under the grant of regulatory authority in Section 1278(c) excluding distressed debt from the market discount rules. Second, it suggested that regulations could allow for accrued market discount to be recognized upon disposition or receipt of a principal payment, but only after

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[64] Bluebook, above. The fact that the Blue Book notes that credit quality may be one cause of market discount should most likely not be taken as evidence that Congress intended for the statutory market discount rules to extend beyond market discount that reflected a predictable, interest-like return to the holder.

[65] In fact, it is unlikely for bonds trading at a 50% discount not to be in technical default. As discussed below, there is often a much stronger position that bonds which are in default under their terms should not accrete market discount.

the holder had recovered its basis. Finally, it suggested that regulations could allow accrued market discount to be recognized upon disposition or receipt of a principal payment, but only to the extent of a multiple of the applicable federal rate (the "AFR") less any stated interest or OID accruals. Any remaining principal payments would be taken into account as ordinary income only after the bondholder has recovered its basis in the bond.[66] Although subsequent commentators have cited the ABA Report as the most complete discussion of the issues surrounding the accrual of market discount on distressed debt, none of its proposals have been adopted.[67]

A proposal by the Clinton Administration to change the taxation of market discount on distressed debt cited similar problems and proposed a similar solution. The proposal stated the problem as follows:

> In cases where the credit of the issuer is severely impaired, it may be inappropriate to treat the entire difference between the holder's basis and the principal amount as market discount. A significant portion of this difference, if realized, is more in the nature of gain on an equity investment in the issuer than income from a lending transaction.[68]

The Clinton administration's proposed solution was to require current accrual of market discount by accrual-method taxpayers using a constant-yield method, but to limit accruals to no more than the greater of five percentage points above the applicable federal rate (the "AFR") on the date of issue or the date of acquisition.[69] However, this proposal has not been followed.

Applicability to Defaulted Debt Obligations. Fortunately, defaulted debt obligations may provide an opportunity to cut the Gordian knot. Under their terms, most bonds become callable upon demand upon the occurrence of an event of default. The legislative history to Sections 1276 to 1278 states that Congress intended that regulations issued under these sections should provide that the market discount rules will not apply to a bond that was payable on demand when issued.[70] This makes sense; because a demand note has no maturity date, it is not possible to calculate accruals of market discount using either a straight-line method or an economic accrual method on this kind of note. The legislative history does not, however, discuss the treatment

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[66] Id.

[67] See, e.g. Sheppard, above.

[68] General Explanations of The Administration's Fiscal Year 2001 Revenue Proposals, available at 2000 TNT 27-26 (Pt. 1).

[69] Id.

[70] Conference Report, above.

of bonds which become demand notes *after* they are issued. This creates a problem in the case of notes which become callable upon demand upon default. Notes of this type become de facto demand notes upon default, and the calculation of market discount on these notes is impossible for the same reason that it is impossible to calculate on instruments that are callable upon demand at issue, i.e., a literal application of the market discount rules would lead to a potentially infinitely large yield and a potentially infinitely short term. Commentators have noted that, even though the plain language of the statute does not except defaulted bonds from the application of the market discount rules, compliance is impossible in this situation. For example, the ABA Report said the following regarding this issue:

> In order to calculate market discount which has been accrued on a bond, it is necessary to know the term of the bond. Presumably, for this reason, the legislative history of the market discount rules states that regulations will provide that the market discount rules will not apply to a bond that was payable upon demand when issued. Thus, if a bond which is payable on demand is issued by a corporation which defaults on the bond, the market discount rules would be inapplicable even though the defaulted bond is subsequently purchased at a substantial market discount. Consequently, no portion of the discount would constitute "market discount" within the meaning of the market discount provisions.
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> The legislative history does not address the situation where a bond becomes payable on demand subsequent to its issuance (e.g., upon the happening of specific event). For example, bonds which are not demand debt when issued are often subject to provisions that accelerate payment in the event of default. If such defaulted bonds are subsequently purchased on the open market, there will be no term for the bonds at the time of purchase and thus it may be impossible to calculate accrued market discount. Even if it were possible to calculate market discount on bonds which were in default, a question arises as to whether any payments on such a bond should be treated as market discount since most, if not all, of the yield in such a case would be purely speculative. The bonds would nevertheless be subject to the market discount rules since they were not payable on demand when issued.[71]

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[71] Id. See, also, Needham and Brause, above ("a true discount demand loan is a paradox. Accordingly, neither the OID nor market discount provisions of the Code acknowledge their existence. But the presence of discount on defaulted debt is not a contradiction. Discount and immediate maturity do co-exist in a "broken" bond, but time value of money is not the reason. The source of the discount is an expected recovery below par on an uncertain date. Returns of this type bear none of the hallmarks of interest.")

Given the foregoing, there appears to be a strong position that taxpayers ought not be required to report market discount upon payments on or disposition of market discount bonds which have become callable upon demand due to default.

Allocation of Payments

Regardless of how market discount should be accounted for, it is necessary to allocate payments received with respect to a debt instrument to interest, return of basis, and capital gain. Although the matter was not litigated in the pre-1984 market discount cases, it appears that holders of speculative debt prior to 1984 included coupon interest as interest when paid, even if it was substantially certain that the holder would receive less than the principal amount due on the loan. For example, the taxpayer in Underhill included the portion of payments treated as coupon interest as such in taxable income in the year payments were made; the Tax Court only allowed the Underhill to treat the portion of current payments allocated to principal as a return of basis first.[72] The court in Lifton held similarly.[73] Furthermore, it appears that taxpayers in these cases followed a general rule that payments should be allocated first to accreted interest, and then to principal payments, unless the terms of the debt instrument specifically provided otherwise.[74]

Under current law, payments on "healthy" debt instruments are generally allocated first to interest and OID, and next to principal (the "interest first" rule).[75]

Prior to 1994, authorities regarding the treatment of liquidating payments on distressed debt instruments were split. In some such cases and guidance, the IRS and courts held that payments made to extinguish debt issued by financially troubled companies should be allocated to return of principal first, in order to

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[72] Id ("Petitioner on his 1961 return reported the amount of $9,282..48 as 'Interest and Discount' income, of which he reported $6,183.16 as "interest" income and $3,099.32 as 'earned discount' income. Respondent does not question the $6,183.16 interest income but in his deficiency notice determined that petitioner understated his earned discount income by $4,837.07.")

[73] Id. The notes which Lifton purchased allocated payments to interest first by their terms.

[74] For example, in Underhill, the taxpayer agreed that the portion of payments received by him labeled as interest should be treated as such, and in Lifton, the terms of the debt instruments provide (as do most debt instruments) that payments should be allocated to interest first. The debt instruments in Harris Trust appear to have allocated payments to principal until a specified maturity date, after which they were to be allocated to interest. Id, at 501 ("the balance of $300,000 was to be paid as follows: One monthly payment of $1,670.86 on the date of the execution of the contract and the balance in 179 equal monthly amounts of $1,666.66 each until the sum of $300,000 was paid in full, with interest on the deferred payments at the rate of 6 per cent per annum after maturity.")

[75] Reg. 1.446-2(e), 1.1275-2(a).

ensure that holders who realize an economic loss on an investment in a debt instrument are not required to include phantom interest in taxable income.[76] This guidance also held that taxpayers who receive an amount in redemption of a bond less than their basis therein should be allowed to take a capital loss on the bond.[77] Stated otherwise, a payment in such a case was allocated first to principal and then to interest, and applied to basis before any gain was recognized (the "principal first" rule). However, there is also pre-1994 authority to the effect that payments received in retirement of a distressed debt obligation should be allocated proportionately between return of principal and interest payments (the "pro rata" rule).[78] Under the pro rata rule, a portion of a liquidating payment equal to the product of total proceeds and a fraction, the numerator of which is the face amount of the debt instrument and the denominator of which is the face amount of the debt instrument, plus accrued interest, should be allocated to principal repayment, and the rest should be allocated to accrued interest,[79] and the amount allocable to market discount is the amount of a payment allocated to principal in excess of the taxpayer's basis in the instrument.[80] Courts also

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[76] See Rev. Rul. 73-328, 1973-2 CB 296; PLR 8650035 (September 12, 1986); George R. Newhouse, 59 TC 783 (1973); E. Gerald Lackey, TCM 1977-213. Max M. Greenberg, 1996-281; FSA 1998-459 (March 31, 1998).

[77] See, e.g. Rev. Rul. 73-328 (taxpayer with a basis in an instrument equal to the principal amount recognized capital loss to the extent of the difference between amounts received and the basis in the instrument"), Max M. Greenberg, above ("the payments represented a return of petitioners' investment and should not be included in income as interest simply because the payments were reported as interest on Forms 1099-INT.")

[78] See, Warner Company, 11 TC 419 (1948); PLR 8819068 (February 17, 1988); PLR 8141100 (July 17, 1981). Interestingly, the two private letter rulings cited herein make reference to Rev. Rul. 63-57 (in which the Service held that taxpayers' allocations of liquidating payments to principal and interest should be respected, if negotiated at arm's length), but they do not cite Rev. Rul. 73-328, which allowed taxpayers to use a "principal and basis first" allocation rule in the case of liquidating payments on a distressed instrument.

[79] See, e.g., PLR 8819068 ("For example, if the principal amount of a Debenture is $100 and the unpaid interest on such Debenture is $25, each dollar received by the Debenture holder is allocated 80 cents to principal and 20 cents to interest.")

[80] PLR 8141100 ("The amount realized must be allocated between the defaulted bond principal and the accrued but unpaid bond interest. The portion of the amount realized attributable to the defaulted bond principal bears the same relationship to the total amount realized as the defaulted bond principal bears to the sum of the defaulted bond principal and the accrued but unpaid bond interest. The bondholders' recognizable loss is computed by subtracting the defaulted bond principal portion of the amount realized from the bondholders' $850,000 basis in the bonds . . . Payments made by the Trustee Bank to the bondholders must be apportioned among return of basis in the foreclosure rights and obligations, discount income, and stated interest. The amount of each payment attributable to discount income shall be that portion of each payment that exceeds the sum of the stated interest (as described on the debt service schedule for the Purchaser's installment note) and the return of basis in the foreclosure rights and obligations. The discount income shall be taxed as ordinary income.")

applied the "pro rata" rule in cases in which a bond was sold with accrued interest payments prior to maturity for an amount greater than par but less than the sum of par plus accrued interest.[81] The sale cases are easy to distinguish from the "principal first" cases, because the "principal first" cases all involved liquidating payments of less than par; the courts reasoned that a final payment of anything less than par could not reasonably be treated as interest income.[82] However, the "pro rata" authorities involving final payments are more difficult to square with the "principal first" cases, because these authorities all involved final payments of amounts less than par.[83] The application of these three rules may yield disparate results, as indicated in the following examples.

Example 3. A cash-basis taxpayer purchases a coupon-paying debt instrument with a face amount of $100 at par. The issuer stops making interest payments. After several years, the holder receives $115 from the issuer in retirement of her debt. When the bond is redeemed, there is $95 of accrued but unpaid interest due on the bond. Total proceeds would be allocated as stated in Figure 1 under the "interest first" rule, the "pro rata" rule and the "principal first" rule.

A complexity is added if the bonds have market discount. Although the interest allocation authorities generally did not deal with the treatment of market discount, one private letter ruling issued prior to 1984 indicated that the Service took the position that all payments allocated to principal should be accounted for using the rule for the treatment of market discount on speculative bonds described above - i.e., all such payments should be allocated first to a return of basis, and then to market discount, to the extent of total market

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[81] Fisher, 209 F.2d 513 (6th Cir., 1954); Jaglom, 303 F.2d 847 (2nd Cir., 1962); U.S. v. Langston, 208 F.2d 729 (5th Cir., 1962); First Kentucky Co. v. Gray, 309 F.2d 845 (6th Cir., 1962). Note that the Jaglom court stated in dicta that it may have been appropriate to use an interest first rule in the individual case, had the Service requested it ("In a case like this where the taxpayers sold in anticipation of the imminent payment of back interest, the fair market value of interest would very nearly approximate face value while the fair market value of the principal of a bankrupt company's bonds, not due for years, would probably be substantially below face value. Therefore, allocating according to the fair market value of the various items rather than by their face value would have charged the taxpayers with approximately the amount of ordinary income which they would have received if they had held the bonds until payment of the back interest by Missouri Pacific. However, since the Commissioner did not appeal, we do not pass upon the validity of the method of allocation used by the Tax Court.")

[82] See, e.g. Drier v. Helvering, above ("[I]t is stipulated here that the value of petitioner's property at the time it was acquired by her was equal to the full sum received by her under the award of the Claims Commission. That award was final-it was intended to close the transaction and to fix the total compensation or reparation for petitioner's entire loss. It is perfectly obvious, therefore, that, whether one part of the sum be denominated principal and another part interest, the total sum received was sufficient only to restore the capital value that existed at the commencement of the period under consideration. . . . [I]t seems to us to follow, . . . that, without regard to what the payments are called, the inescapable conclusion is that in the transaction there was no realized gain, and hence no income.")

[83] See Warner Company, PLR 8819068, and PLR 8141100, above.

discount on the instrument.[87] Since these authorities all dealt with defaulted debt instruments, this is consistent with the pre-1984 rules regarding the treatment of market discount on speculative debt instruments.

Example 4. On June 1, 2006, a cash-basis taxpayer purchases a bond with a face amount of $100 for $80 with a maturity date of 2010. On June 1 2007, the taxpayer receives a liquidating payment of $110. At the time the payment is received, the bond had $20 of accrued but unpaid coupon interest that accrued after purchase.

Assuming that market discount is accounted for using the pre-1984 method applicable to speculative debt instruments, payment proceeds will be allocated as indicated in Figure 2.

Figure 1: Allocation of total proceeds in Example 3 under "interest first rule"

	Interest First	Pro Rata	Principal First
Interest	$95	$56.02[84]	$15
Principal	$20	$58.97[85]	$100
Return of Basis	$20	$58.97	$100
Gain (loss)	($80)	($41.03)[86]	$0

Figure 2: Allocation of payment proceeds in Example 4 using the pre-1984 method applicable to speculative debt instruments

	Interest First	Pro Rata	Principal First
Interest	$20	$18.33[88]	$10
Principal	$90	91.67[89]	$100
Market Discount	$10	11.67	$20
Return of Basis	$80	$80	$80
Capital Gain (Loss)	$0	$0	$0

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[84] $56.02 = $115 - $58.97.

[85] $58.97 = $115 x 100/195.

[86] $41.03 = $100 - $58.97.

[87] PLR 8141100, above.

[88] $18.33 = $110 - $91.67.

[89] $91.67 = 110 x 100/120.

Figure 3: Allocation of proceeds in Example 4 under Sections 1271 to 1278			
	Interest First	Pro Rata	Principal First
Interest	$20	$18.33[90]	$10
Principal	$90	$91.67[91]	$100
Market Discount	$5	$5	$5
Return of Basis	$80	$80	$80
Capital Gain (Loss)	$5	$6.67	$15

Assuming that the rules of Sections 1276 to 1278 apply, proceeds would be allocated as indicated in Figure 3.

On their face, Regs. 1.446-2(e) and 1.1275-2(a) overturn pre-1994 law, because they require payments to be allocated to interest and/or OID first without regard to agreements between the parties or an exception for distressed debt. In comments to the proposed OID regulations, the New York State Bar Association said that the final OID regulations should not apply to payments that extinguish debt instruments, because the "interest first" rule will lead to the anomalous result that, if a final payment is less than the amount of accrued interest and OID and the principal balance, a taxpayer will be required to include ordinary income to the extent of accrued interest and OID, and to take a capital loss to the extent of any shortfall in the payment:

> **Reg. section 1.446-2(e)**: payment ordering rule. Under this regulation, every payment under a debt instrument is treated first as a payment of interest to the extent of any accrued but unpaid interest and then as a payment of principal. We recommend that this payment ordering rule not apply to a payment that cancels a debt instrument in its entirety. Under limited case law dealing with accrued interest on par bonds, a payment in cancellation of a bond with accrued but unpaid interest apparently is treated first as a payment of principal. In effect, to the extent the final payment is less than the aggregate of the principal balance and accrued interest, the holder reverses the inclusion of accrued but unpaid interest. Application of the payment ordering rule in the regulations to these cases would force lenders to treat accrued interest as fully paid and thus to permanently accrue income that never was received, with any shortfall being allocated entirely to principal and allowed only

[90] $18.33 = $110 - $91.67.

[91] $91.67 = 110 x 100/120.

> as a capital loss on the bond. It also would permit the obligor on the instrument to deduct accrued but unpaid interest and recognize offsetting forgiveness of indebtedness income, which would be a favorable result if section 108 applied to eliminate the latter.[92]

Does this mean that the "interest first" rule does not apply to distressed instruments? Because there was common law regarding the proper allocation of sales proceeds and liquidating payments on distressed debt obligations to principal and interest, because the regulations that prescribe the "interest first" rule do not address the distinction between payments on distressed and healthy debt instruments in the way that the pre-existing common law did, and because the "interest first" rule can produce irrational results if applied to payments on certain distressed instruments, there is an argument that pre-1994 common law regarding the allocation of payments made on defaulted debt instruments survived passage of the regulations.[93] Because many of the pre-1994 cases that dealt with this issue adopted the "principal first" rule, and because the "principal first" rule is consistent with the pre-1984 common law rule that holders of speculative debt instruments may recover basis prior to recognition of market discount, the stronger argument is that of the two pre-1994 methods for allocating payments on defaulted debt instruments, the "principal first" rule, rather than the "pro rata" rule survived the 1994 regulations.

In unpublished guidance in 2000, six years after the "interest first" regulations were published, the Service stated that the "principal first" rule should apply to liquidating payments on distressed debt, for substantially the same reasons as those set forth by the New York State Bar Association.[94] That's the good news. The bad news is that unpublished guidance of this type can not be relied on by taxpayers, and it is not clear whether this position has been uniformly adopted by the relevant branches of the Service.[95] Nevertheless,

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[92] NYSBA, Comments on the Final OID Regulations, Reprinted in 64 Tax Notes 1747 (September 26, 1994) (hereinafter the "NYSBA Report").

[93] See discussion of Pasquantino, above.

[94] PLR 200035008 (September 1, 2000) ("[I]n the case of an insolvent borrower, a final payment in an amount less than the principal amount of the debt should be allocated all to principal, in part because the total repayment of cash, or the value of the property, transferred in the foreclosure is less than the outstanding principal amount of the indebtedness. Upon a liquidation of the Bonds, the Bondholders' claims for debt service payments will become worthless and the Bondholders will have been paid less than the amount owed."). See, also, Gordon D. Henderson and Stuart J. Goldring, Failing and Failed Businesses § 401.1, Note 7 (2005) ("IRS Letter Ruling 200035008 is consistent with [the NYSBA's comments to the final OID regulations]").

[95] According to Section 6110(k)(3), taxpayers may not rely on Technical Advice Memoranda and Private Letter Rulings as authority. Regardless, Technical Advice Memoranda and Private Letter Rulings are often helpful in identifying the IRS's prior ruling policies. Rowan Companies, 452 U.S. 247, 261, n. 17 (1981). In addition, Technical Advice Memoranda and Private Letter Rulings issued after October 31, 1976, are considered "authority" for purposes of determining whether a taxpayer may be subject to accuracy-related penalties. Reg. 1.6662-4(d)(3)(iii).

although considerable ambiguity remains, a strong argument can be made for the position that, to the extent that an issuer is in default and it is reasonably certain that liquidating payments will be less than total principal payments due on the instrument, all such payments ought to be allocated to principal, and the taxpayer is entitled to recover her basis prior to recognizing gain on any such payments.[96]

Mass Asset Treatment

An additional complexity arises from the fact that most distressed debt investors buy distressed debt obligations in pools, and keep track of basis, interest accruals, market discount and gain or loss on a "mass asset" basis. There is some support for this treatment in older case law and administrative guidance, although the continuing validity thereof appears to have been severely narrowed under later case law. This position is best supported by the holding in *United Mercantile Agencies, Inc*.[97] The taxpayer in *United Mercantile* purchased pools of assets, including "notes, judgments, accounts, mortgages and other evidences of debt" from the liquidators of a number of banks. The taxpayer did not attempt to allocate basis between the assets, and treated all receipts on the assets as a return of its basis in the entire pool until the aggregate basis was recovered. Citing earlier case law, the Tax Court stated that, where allocation between assets is impractical, taxpayers may recover basis from payments on a pool of assets on an aggregate basis as though the pool were a single "mass asset:"

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[96] It is worth noting that, in this context, "amounts attributable to principal" may include amounts attributable to interest accrued prior to the taxpayer's acquisition of the instrument. Reg. 1.61-7(c) states that, if a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is "not income and is not taxable as interest" if subsequently paid. It states further that these payments are returns of capital which reduce the remaining cost basis, but that interest which accrues after the date of purchase is taxable. This rule is most easily read as characterizing the purchase of a bond sold "flat" as a purchase of two assets, i.e., the right to payment of already-accrued interest, and the right to the bond itself (payment of principal and future interest payments). However, this characterization does not fit perfectly with some of the pre-existing case law. Prior to promulgation of Regs. 1.61-7(c) and 1.446-2(e), pre-maturity payments on bonds purchased "flat" could be allocated to pre-acquisition interest before they were allocated to post-acquisition interest. See, e.g. Jaglom above, and U.S. v. Langston above (both holding that payments made prior to maturity on bonds purchased flat should be applied against basis). However, neither Jaglom nor Langston required the taxpayer to allocate their basis between the right to payment of pre-acquisition accrued interest and the bond itself, i.e., both courts treated the right to payment of pre-acquisition interest and the bond itself as a single asset, in which the taxpayer had a single aggregate cost basis. Therefore, although not entirely clear, it appears that a strong argument may be made that payments attributable to pre-acquisition interest can be offset by the taxpayer's basis in the bond and the right to pre-accrued interest dollar-for-dollar.

[97] 23 TC 1105 (1955).

> In the instant case apportionment would be wholly impracticable. In each purchase United acquired hundreds of differing items, each having a highly speculative value if any value at all. Only years of attempting to collect on the various items would disclose which were worthless, the amount collectible on others, and whether the over-all purchase would result in a gain or loss.
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> Respondent argues that as United's bid was influenced by whether the individual debtors were listed in the telephone book, by competitive bids which were made either on individual items or groups of individual items, and by information furnished by the liquidator concerning various items, there was a practical basis for allocation. We disagree. While this information was useful in determining an aggregate bid price, where the number of items involved would tend to balance out errors in estimates, it would not constitute a proper, rational, or reasonably accurate basis for allocating to each individual item a part of the cost. Under the circumstances, we think United properly recovered its cost before reporting a profit.[98]

Two factors may limit the application of this rule to current-day purchases of pools of distressed debt. First, the timing and character rules discussed above all came into being after *United Mercantile* was decided. Therefore, even if an investor is comfortable that payments on a pool of debt obligations may be accounted for as a though made on a single agglutinated debt instrument, the investor will still need to run through the analysis regarding the application of the market discount rules, the "interest first" rule, and the rules regarding the accrual of coupon interest and OID on speculative debt instruments described above.[99] Second, the scope of *United Mercantile* and related cases was restricted by the holding in *Cottage Savings*.[100] *Cottage Savings* is best known as the case that gave birth to Reg. 1.1001-3, but it also discussed the "mass asset" theory in some detail. *Cottage Savings* was a

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[98] Id, citing Inaja Land Co., Ltd, 9 TC 727 (1947) (apportionment of basis between easements and land not possible because easements can not be measured by "metes and bounds"); William T. Piper, 5 TC 1104 (1945) (allocation of purchase price between stock and warrants not practicable because the warrants could not be valued); Nathan Blum, 5 TC 702 (Warren, 193 F.2d 996 (1st Cir., 1952) (whether allocation of purchase price between preferred stock and a guarantee practicable is a question of fact); Nathan Blum, 5 TC 702 (1945).

[99] See Sheppard, Distressed Debt ("[V]ultures are not allowed to account for pools as pools, because the OID rules are written for individual instruments").

[100] 90 TC 372 (1988) (the "Tax Court decision"); 890 F.2d 848 (6th Cir., 1989) (the "Sixth Circuit decision," or the "appellate decision"); and 499 U.S. 554 (1991) (the "Supreme Court decision").

product of the "savings & loan crisis" of the 1980s.[101] In the years leading up to *Cottage Savings*, the values of pools of mortgages held by certain savings & loan associations ("S&Ls") were hit hard by increases in market interest rates.[102] Because these pools could not be marked to market, this meant that the S&Ls had economic losses on their books, which could not be taken into account for tax purposes until the loans were disposed of in a sale or other taxable exchange; the S&Ls were loathe to do this, because such a sale or disposition would reduce their regulatory capital.[103] In response to this, the Federal Home Loan Bank Board (the "FHLBB") issued Memorandum R- 49 in 1980, which stated that S&Ls would not incur losses for regulatory accounting purposes upon an exchange of mortgage loans for "substantially identical" mortgage loans. To qualify for this exemption, the mortgage loans were required to be single family residential loans of the same type, with the same stated terms to maturity and stated interest rates, similar remaining terms to maturity, fair market values, and loan-to-value ratios. In addition, the loans had to be sold without recourse, secured by property in the same state, and exchanged in nearly equal aggregate principal amounts.[104] The FHLBB's acknowledged purpose for issuing Memorandum R-49 was to facilitate S&Ls' ability to enter into transactions that would generate tax losses without affecting their economic position or regulatory capital.[105] In order to take advantage of Memorandum R-49, S&Ls would enter into "loan swaps," pursuant to which two or more S&Ls would exchange pools of loans of equal value and terms with each other for the express purpose of recognizing loss on the exchange. The Service disallowed the recognition of loss realized in these transactions in two published rulings.[106] Both rulings used a two-step approach to reach this conclusion. First, citing *United Mercantile*, they stated that these pools should be treated as mass assets. Because the risks inherent in individual mortgages should cancel each other out due to the size of the

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[101] A good précis of the savings & loan crisis is available on the FDIC's website (www.fdic.gov/bank/historical/s&l/index.html).

[102] For example, the yield on one-year Treasury securities in the mid 1970s reached a low of near 5%, while it shot up to over 15% in the early 1980s. The Federal Reserve Bank of St. Louis publishes a fairly complete list of interest rates on different types of government debt over the past 50 years (http://research.stlouisfed.org/fred2/categories/115).

[103] Under current law, there is a chance that the S&Ls would have been required to mark the mortgages on their books to market as dealers under Section 475(a), added by the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66. See Rev. Rul. 60-346, 1960-2 CB 217 (holding that a bank that originated mortgages, some of which it transferred in the ordinary course of its business as a mortgage originator, was a dealer in mortgages); See, also Rev. Rul. 72-513, 1972-2 CB 242 (similar).

[104] See the Supreme Court decision, above.

[105] Id.

[106] Rev. Rul. 81-204, 1981-2 CB 157; Rev. Rul. 85-125, 1985-2 CB 180.

pools, and because the fair market value, principal amount, collateral and other terms of the pools were substantially similar to each other, the Service took the position that the owners' economic position did not change upon exchange of one pool for another. Second, the Service stated that, since the exchanges had no economic effect and were purely tax driven, they should not cause loss to be recognized:

> [T]he mortgage pools exchanged constituted mass or indivisible assets that averaged out the unique characteristics and risks inherent in each constituent mortgage. The existence of different mortgagors and different collateral in the mortgages that made up the mortgage pools did not prevent the aggregation of the mortgages into a mass or indivisible asset.
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> In this situation, as in Rev. Rul. 81-204, the mortgage pools "sold" and "purchased" by *X, Y,* and *Z* possessed sufficient economic correspondence to each other that the mortgage pools cannot be considered as differing materially either in kind or extent from each other, despite the differences in the identities of the individual mortgagors and in the underlying collateral. All three pools consisted of single family residential, conventional mortgages with the same contract interest rate and the same stated terms to maturity. The average remaining lives as well as the aggregate unamortized balances and the aggregate fair market values of the mortgages in each of the three mortgage pools "sold" and "purchased" were substantially the same at the time of the transfers.[107]

Given the breadth of this practice in the banking industry, this issue was litigated in several cases contemporaneously with *Cottage Savings*.[108] In *Cottage Savings*, the Tax Court held for the taxpayer, the Sixth Circuit held for the Service, and the Supreme Court reversed the appellate decision, holding that the taxpayer could deduct losses upon the exchanges of the debt pools.[109] All three of the courts found the Government's "mass asset" argument wanting, although their treatment thereof varied. The Tax Court acknowledged the validity of the mass asset doctrine set forth in *United Mercantile*, but said that it was not applicable in the instant case, because all of the assets in the pools that were transferred had a basis that could be easily determined on an individual basis, and each of the participations which

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[107] Rev. Rul. 85-125.

[108] See San Antonio Savings Association and Subsidiaries, 887 F.2d 577 (5th Cir., 1989); First Federal S&L of Temple, 887 F.2d 593 (5th Cir., 1989); Federal National Mortgage Association, 896 F.2d 580 (D.C. Cir., 1990).

[109] 90 TC 372 (1988); 890 F.2d 848 (6th Cir., 1989); 499 U.S. 554 (1991).

the taxpayer received pursuant to the transfers had an easily determinable cost. Since *United Mercantile* allows use of mass asset accounting only in cases where individual accounting is not practicable, the Tax Court refused to apply it in this case.[110] Neither the Sixth Circuit's decision nor the Supreme Court's decision addresses this issue head on; however, both may be read to leave the Tax Court's reasoning intact. The Sixth Circuit found that the exchange of one pool for another caused a realization event because the loans in the respective pools had different obligors and were secured by different parcels of property; however, the court refused to allow a deduction in this case because the exchange was entered into for purely tax motivated reasons, and did not change the taxpayer's economic position.[111] The Supreme Court agreed that the exchange constituted a realization event; however, it went on to hold that, since the loans in each pool were issued by different issuers and backed by different collateral, they embodied distinct legal entitlements, and as such, the taxpayer should recognize gain or loss upon the exchanges in question.[112] In effect, the Tax Court decision took issue with the first step of the Service's argument ("the pools are mass assets"), while the appellate decision and the Supreme Court decision focused on the second step thereof ("the pools are substantially similar"). Because both the Sixth Circuit and the Supreme Court stated that the exchange of the mortgage pools constituted a realization event because the transferred pools and the purchased pools constituted separate legal entitlements, they may have meant to imply an assumption that the pools should not be treated as mass assets, because the "distinct legal entitlements" are the issuers, collateral and terms of the underlying individual loans. However, the cases may also be read to allow mass asset accounting treatment where individual accounting treatment is not practicable, even while acknowledging that different legal rights associated with more than one asset underlie a mass asset.

It is worth noting that, in Rev. Rul. 81-204 and Rev. Rul. 85-125, and in *Cottage Savings* and in the related litigation, the Service took a position contrary to that which it had taken in *United Mercantile*, where it argued that the taxpayer was required to account for gain and loss on each asset in the pool individually, rather than waiting to recover the pool's aggregate basis prior to recognizing gain on the disposition of any portion thereof.

Where does this leave investors who purchase pools of distressed debt? *Cottage Savings* seems to leave the mass asset doctrine intact, but it also seems to have greatly narrowed its scope. As mentioned above, the Tax Court refused to apply the mass asset theory because each of the loans in the pools

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[110] 90 TC 372 (1988), 396.

[111] 890 F.2d 848 (6th Cir., 1989), 850, 854.

[112] 499 U.S. 554 (1991), 567.

that the taxpayer transferred had an easily determinable basis (presumably because the taxpayer had originated the loans that were transferred) and because each of the loans in the pools that were purchased had an easily determinable individual cost. The Tax Court did not state how the cost of the individual loans could be calculated, but it is most likely that the S&Ls which participated in the loan swaps had a model for valuing the individual loans, and that the values thereof were aggregated to determine the value of the relevant pools. This should have been administratively feasible in the case of the loan swaps that were litigated in *Cottage Savings* and the related cases, because the pools in these cases contained large, but not extremely large, numbers of mortgages.[113] However, we understand that this is not administratively feasible in certain other situations. For example, when banks transfer portfolios of credit card receivables, they generally do not value each account individually, because doing so would constitute an unconscionable drain on resources.[114] Therefore, the better reading of *United Mercantile* in light of current law is that investors may account for pools of distressed debt using a mass asset approach, but the burden is on the investor to prove that individual valuation is not administratively feasible.

Need for Regulatory Guidance

As should be clear at this point, regulatory guidance clarifying the proper treatment of payments on distressed debt instruments would be exceedingly useful. Any such response to the ambiguities described above should address two points. First, it should provide clarity to taxpayers and the government regarding the proper treatment of payments and accruals on distressed debt instruments. All too often, the correct answer to investors' questions regarding the proper treatment of payments and accruals on distressed debt is "it depends;" this hinders investors' efforts to plan their business, and it also makes IRS agents' jobs difficult. Second, the guidance should provide that only an amount of income that is consistent with a reasonable return on a debt instrument be accrued as interest, and that the remainder (if any) be taxed as capital gain or loss upon receipt of a partial principal payment, redemption

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[113] For example, in Cottage Savings, the taxpayer entered into four mortgage pool swap transactions on December 1, 1980, pursuant to which it transferred pools containing 8, 44, 188, and 12 loans, and received pools with 8, 45, 240, and 12 loans, respectively. 90 TC 372 (1988).

[114] We understand that it is common practice for banks to break credit card portfolios into groups of accounts, or "buckets," according to the promptness of payments to be received, and the "vintage" of the account. Once accounts have been allocated to a bucket, the aggregate value of the bucket is discounted by a factor that is meant to be a rough approximation of the credit risk associated with the receivables in the bucket. Since these portfolios may contain tens or hundreds of thousands of accounts, it is not administratively feasible to value each account on an individual basis.

or disposition. This would avoid the unreasonable result that, for example, excessive market discount accruals prevent the deduction of interest on debt incurred to purchase market discount bonds or that OID that is substantially certain never to be paid accrue; it would also prevent taxpayers from taking positions that do not treat a reasonable portion of their return on a portfolio of distressed debt instruments as interest income.[115]

As discussed above, several proposals have been made to bring the treatment of market discount on distressed debt instruments in line with economic reality.[116] Guidance on point should also address the applicability of the "interest first" rule to the allocation of partial principal payments on, and sales proceeds from the disposition of, distressed debt instruments to accreted coupon interest and OID.[117] Regardless of the specific solution, any tax regime that provides an exception to the general rules for the taxation of debt instruments for distressed instruments requires a workable definition of "distressed debt" that is consistent with economic reality. As discussed above, some taxpayers take the position that market discount does not accrue on debt which is purchased at a discount of 50% or more. Although we are not aware of challenges to this position by the government, it is imprecise, because the discount at which a debt instrument is acquired is a function of the time to maturity, as well as the credit quality of the issuer and prevailing interest rates.[118] A definition that makes reference to a stated threshold yield to maturity would be more consistent with economic reality. There is some precedent for this in the rules applicable to Applicable High Yield Discount Obligations (the "AHYDO rules").[119] Briefly, the AHYDO rules provide that, to the extent that the yield on a debt instrument exceeds a certain threshold and the debt instrument has "significant" OID, a portion of the OID on the instrument is treated as a non-deductible dividend and the remainder of the

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[115] For example, we understand that it is not uncommon for taxpayers to take the position that no income should be reported on a portfolio of distressed debt until the aggregate basis in the portfolio has been recovered, and that any excess should be treated as capital gain. While this avoids the Scylla of over-inclusion, this risks being dashed upon the rocks of the Charybdis of under-inclusion.

[116] See the proposals put forth in the ABA Report and the Clinton Administration proposal, discussed above.

[117] For a discussion of the anomalies that such guidance should prevent, see the discussion of the NYSBA Report and PLR 200035008 above.

[118] To give an easy example, a zero-coupon bond with a 20-year maturity purchased for $37.69 would have a yield to maturity of 5%, compounded annually (well within the range of the cost of funds for a healthy business), while the same bond would have a yield to maturity of 21.55% compounded annually if it matured five years hence.

[119] Sections 163(e)(5), 163(i).

OID on the instrument is not deductible until actually paid.[120] The portion that is treated as a dividend is the lesser of (1) total OID on the instrument, and (2) the portion of the total return on the instrument which bears the same ratio to the total return as the disqualified yield on the obligation bears to the yield to maturity on the obligation.[121] For these purposes, the disqualified yield is the excess of the yield to maturity on the instrument over the sum of the applicable federal rate and six percentage points, and the "total return" on the instrument is the amount that would be OID includible in gross income under Section 1272(a) if qualified stated interest payable on the instrument were includible in its stated redemption price at maturity.[122] The portion of the AHYDO rules that treats the disqualified portion of the yield on an AHYDO as a dividend is meant to ensure that the portion of an investment that reflects a speculative bet more representative of an equity investment than debt be taxed as equity.[123] As discussed above, the greatest source of discomfort regarding the applicability of the market discount rules to distressed debt is the fact that it is economically inconsistent to accrue market discount to investments whose yield is sufficiently speculative to reflect an equity-like investment.[124] Therefore, if Congress or the Treasury were to define "distressed debt," one reasonable way to do so, with precedents in current law, would be to treat every debt obligation with a yield to maturity greater than six percentage points over the applicable federal rate upon the purchase date as distressed.

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[120] Id. For these purposes, a debt instrument is treated as having "significant" OID if the aggregate amount of OID to be included with respect to the instrument for periods before the close of any accrual period ending after the date five years from issue exceeds the sum of (1) the aggregate amount of interest to be paid under the instrument before the close of that accrual period, plus (2) the product of the instrument's issue price and its yield to maturity. Section 163(i)(2).

[121] Section 163(e)(5)(C)(i).

[122] Section 163(e)(5)(C)(ii).

[123] The "disqualified portion" of OID on an applicable debt instrument (i.e., the portion of the return most similar to a return on an equity investment) is not merely treated as a non-deductible payment; it is also treated as a dividend for purposes of the dividends received deduction of Sections 243, 245, 246, and 246A. Section 163(e)(5)(B)(i).

[124] See, e.g. the ABA Report, discussed above.