NYC Bar Reports on Accounting for Interest on Nonperforming Loans

By the New York City Bar Committee on Taxation of Business Entities

Mark Stone, chair of the New York City Bar Committee on Taxation of Business Entities, submitted this report on July 23, 2008, to senior members of Congress and to officials at the Treasury Department and the IRS.

The report urges changes, by way of regulatory action or legislation, to the current accounting treatment of interest on distressed debt. It highlights the current ambiguity and potentially harsh results that may arise from some applications of the rules and expresses concern that they are having a negative effect on the liquidity of the secondary market for distressed debt.

Four aspects of interest accruing or otherwise reportable on nonperforming loans are addressed: interest accruing under regular accrual-method rules, original issue discount accruing on the debt, interest includable in income by the creditor but ultimately uncollectible, and interest attributable to market discount. The report concludes that the rules for interest income reporting are based on the premise that the interest will be paid according to its terms. When that premise fails, the rules do not work and should be altered. Two events are identified, the filing for bankruptcy by the debtor, or payment default for a specified period of time, which suggest that the debt will not be paid.

Should either scenario arise, the committee recommends that both the creditor and the debtor be required to convert to the cash method of accounting for interest and OID. Two separate rules are proposed for market discount. Past due debt should not be subject to the market discount statute. For other distressed debt meeting the requirements of bankruptcy or nonpayment for a specified time, or for debt bought at a deep discount and other debt for which facts and circumstances suggest inability to pay, the committee recommends that rules under section 1276(a)(3) requiring acceleration of income on partial payments be supplanted by a rule permitting recovery of basis first.

All other aspects of the market discount rules would continue to apply to distressed debt under the committee's recommendations, although no opinion is expressed as to the propriety of that continuation. To the extent interest on distressed debt falls outside the parameters above, the committee recommends that the ''doubtful collection'' rule should generally apply.

Table of Contents

This report, which is submitted on behalf of the New York City Bar, by its Committee on Taxation of Business Entities, considers various aspects of how interest is accrued on nonperforming loans. The report recommends guidance and, in various instances, clarifications and changes regarding the application of the general interest accrual, original issue discount and market discount rules, respectively, to nonperforming loans and also recommends proposals.[1]

[1]The report was prepared by an ad hoc committee of the Committee on Taxation of Business Entities of the New York City Bar. The authors of the report are Jill Darrow, Daniel Dunn, Amanda Nussbaum, Ray Simon, and Alan Tarr. Significant assistance was provided by Mark Stone and Isaac Tendler. Helpful comments were provided by Marc Teitelbaum, Adam Mukamal, and Deborah Goldstein.

I. Introduction

A. General Background

Due to the current turmoil in the debt markets and general recessionary concerns, there has been an increased focus on the tax issues associated with distressed debt.[2] Accordingly, this report identifies several areas where the Committee believes there is a need for changes in the law and regulations regarding the tax treatment of certain aspects of distressed debt.

There are two reasons for the proposed changes. First, the Committee believes generally that there is a need for greater clarity regarding the interest accrual and market discount rules in the distressed debt context. Second, although the Committee is comprised of attorneys and not economists or bankers, the Committee has witnessed through the collective practices of its members a substantial dislocation in the liquidity of the debt markets, and has seen many clients struggle under these current market conditions. While there are certainly economic and market forces that are predominantly shaping these developments, the Committee has found that the tax rules relevant to distressed debt are contributing to the problem by creating uncertainty, confusion, and in some cases, punitive consequences for market participants. In short, the Committee is concerned that ambiguity in the law, and the potentially harsh results of applying certain of the rules, is having a deleterious effect on the liquidity of the secondary market for distressed debt. The Committee urges Congress and the Treasury Department to take action and proactively shape tax policy in this area.

In particular, the report focuses on the appropriate treatment of interest on nonperforming loans (NPLs). For purposes of this report, NPLs refer to debt instruments in respect of which the debtor (i) is in payment default (for example, has missed a payment), or (ii) is in material default (without having missed a payment), such that the creditors in either case could provide notice of default, and, if not cured, could accelerate the debt and demand full repayment or cause other comparably significant consequences.

The report examines four aspects of the treatment of interest accruing on NPLs. In the second section, the report examines the treatment of interest, other-than original issue discount (OID), accruing on NPLs. In the next section, the report analyzes the treatment of OID accruing on NPLs. Section four examines the appropriate treatment of interest that has been included in income by the creditor, but that later proves to be uncollectible. Finally, in section five, the report reviews the market discount rules as applied to NPLs.

B. Summary of Recommendations

In examining what the Committee believes should be the appropriate treatment for interest on distressed debt, the Committee has generally concluded that the tax reporting of interest with respect to indebtedness — accrual of interest, economic accrual of interest and market discount rules — all involve methods of accounting that are based on the premise that the debt instrument will be paid according to its terms. The fundamental issue with NPLs is that the premise no longer applies, and thus, the method of accounting must be altered as the report sets forth.

Because the recommendations principally implicate accounting issues, the Committee believes that Treasury has the authority to make most if not all of the recommendations made in the report. However, due to Treasury's concern over its authority in this area, particularly in the OID context, the Committee has submitted the report to Congress as well as Treasury, urging that the recommendations be acted on by one body or the other.

Ultimately, the Committee identified certain common events with respect to NPLs that demonstrate a genuine need for special rules of accounting regarding the taxation of those NPLs, regardless of whether the applicable rules are the traditional interest accrual rules, the OID rules or the market discount rules.

First, the Committee believes that on the bankruptcy filing of the debtor, the application of the normal rules of interest accrual, OID and market discount should not apply. For all types of debt instruments covered by this report, the Committee recommends that the debtor and creditors be required to convert to the cash method of accounting for interest and OID on the debt following a bankruptcy of the issuer.[3]

Second, the Committee believes that when nonpayment on a debt has continued beyond a reasonable period, the normal rules of interest accrual, OID and market discount should not apply. In that case, taxpayers would generally be required to convert to the cash method of accounting (although special rules are proposed with respect to distressed market discount debt). The Committee struggled to identify the right period of time after which different rules should apply. While in some circumstances, one month might be adequate to determine that the debt will never be repaid, in other cases, it could take years. The applicable period also appears to be different for different types of debt — for example, a shorter period of payment default might be appropriate for consumer debt, and a relatively longer period might be desirable for asset-based loans. Ultimately, the Committee agreed that a fixed period not to exceed two years was a rational period of time.[4] The Committee believes that Congress and Treasury are in the best position to balance the desire for certainty against the perceived need to allow debtors and creditors sufficient time to suspend payments to permit a debtor to

[2] *See, e.g.*, Lee A. Sheppard, "Questions Raised by Distressed Debt," *Tax Notes*, May 26, 2008, p. 783, *Doc 2008-11209, 2008 TNT 102-13*; and Robert Willens, "No Doubtful Collectability Exception for OID," *Tax Notes*, July 14, 2008, p. 163, *Doc 2008-14456, 2008 TNT 136-32*.

[3] The Committee recognizes that special rules may need to apply in the case of "debtor-in-possession" loans and so-called "pre-packaged" bankruptcies when the extent to which a creditor's right will be impaired can be known.

[4] The two-year period is consistent with the period of forbearance identified in reg. section 1.1001-3(c)(4)(ii) as the period of nonpayment permitted before a modification is deemed to occur.

solve what might be a temporary cash liquidity problem. Regardless of the time period selected, the Committee also believes that the doctrine of ''doubtful collectability'' should still be available, and that the proposed safe harbor and this doctrine are not mutually exclusive.

In the case of market discount rules, additional ''safe harbors'' are proposed, and different accounting recommendations are made, because these approaches seem more appropriate for the market discount rules. Accordingly, while filing for bankruptcy and acquiring a debt that is in payment default for more than a reasonable period are identified as events that would affect the application of the market discount rules, additional events are also proposed as safe harbors in the market discount context, but not in the interest or OID accrual context. For example, the Committee recommends different treatment for market discount debts which have been accelerated or have not been paid at maturity, since there is no period over which to include the market discount. The Committee also recommends that the market discount rules should apply differently to debt that is purchased at a substantial discount (that should not be less than 50 percent) from the then outstanding balance of the debt (including accrued but unpaid interest) or the revised issue price (in the case of OID debt), in either case unless the discount is primarily the result of changes in prevailing interest rates from the issue date to the acquisition date. Moreover, the proposed accounting changes differed in the market discount context due to the somewhat differing policy concerns underlying the market discount rules.

The Committee considered at length other events that could be used as ''safe harbors'' of sorts (for example, events the occurrence of which would permit different interest, OID and market discount accrual rules to apply). For example, the Committee considered whether financial accounting rules should be followed, but ultimately decided against it since those rules serve a different purpose. The Committee's near final draft of recommendations also included an acceleration of the debt for material default (including nonpayment) as a basis for suspending the standard rules for interest accrual and OID. Only after lengthy discussion did the Committee agree not to include such a recommendation. Principally, the Committee was concerned that there might be numerous reasons and motives for creditors to accelerate or not accelerate a debt that do not necessarily reflect a serious risk that the debt will not be repaid. Accordingly, the Committee decided not to treat acceleration of a debt instrument as a ''safe harbor'' event.

II. Non-OID Interest

The rules for determining when interest on an NPL is no longer required to be accrued as income by a lender, or may no longer be deducted by the debtor, have developed through a long history of case law. Before discussing possible concerns over these rules and possible recommendations regarding the continued application of these rules, the Committee thought it would be helpful to provide a summary of the current statutory and case law.

A. Lender

1. Income accrual on nonperforming loans. Under the accrual-method of accounting, income is includable in gross income when all events fixing the right to receive such income have occurred and the amount thereof can be determined with reasonable accuracy (otherwise known as the ''all-events'' test).[5] A fixed right to receive income occurs when (1) the required performance takes place, and either (2) payment is due or (3) payment is made, whichever occurs first.[6] Thus, for an accrual-basis taxpayer, inclusion of income may precede the receipt of the related cash.[7]

The ''all-events'' test is subject to an exception in the case of accruing interest income if the income is ''of doubtful collectibility or it is reasonably certain it will not be collected.''[8]

In determining whether there is doubtful collectibility of an item of income, courts have considered whether the debtor was insolvent, in bankruptcy,[9] or in receivership.

2. Insolvency. In *Jones Lumber Co. v. Commissioner*,[10] the court required accrual-basis taxpayers holding secured notes to include interest as accrued on the notes. The court held that the taxpayers failed to prove the existence of events sufficient to justify overriding the general rule requiring accrual. To allow an accrual-basis taxpayer not to accrue income, ''there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of [the] debtor makes it improbable.''[11]

3. Receivership. In *Corn Exchange Bank v. United States*,[12] an accrual-basis taxpayer was not required to include interest accruing on a loan made to a corporation that went into receivership during the year in which the loan was made. The court held that ''it would be an injustice to the taxpayer'' to impose a tax on accrued income

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[5]Reg. sections 1.451-1(a), 1.446-1(c)(1)(ii).

[6]*Schlude v. Commissioner*, 372 U.S. 128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

[7]*Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-185 (1934); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 938 (9th Cir. 1937); *European American Bank and Trust Co. v. United States*, 20 Cl. Ct. 594, 605 (1990), *aff'd*, 940 F.2d 677 (Fed. Cir. 1991); *Koehring Co. v. United States*, 421 F.2d 715, 721 (Ct. Cl. 1970).

[8]*Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930). *See also Jones Lumber Co. v. Commissioner*, 404 F.2d 764 at 766 (6th Cir. 1968); European American, at 605; *Atlantic Coastline R.R. Co. v. Commissioner*, 31 B.T.A. 730 at 749 (1934); Rev. Rul. 80-361, 1980-2 C.B. 164; *see also Clifton Mfg. Co. v. Commissioner*, 137 F.2d 290 (4th Cir. 1943).

[9]*See Harmont Plaza v. Commissioner*, 64 T.C. 632 (1975) (the court acknowledged that the doubtful collectibility of income exception to the ''all-events'' test, ''has typically been applied where the debtor is insolvent or in fact bankrupt'').

[10]404 F.2d 764 (6th Cir. 1968).

[11]*Georgia School-Book Depositary, Inc. v. Commissioner*, 1 T.C. 463 (1943); *Jones Lumber*, at 766; *see also* Rev. Rul. 80-361 (the IRS held that a creditor was required to accrue interest income up until the date the debtor became insolvent, after which date no accrual was required).

[12]37 F.2d 34 (2d Cir. 1930).

''where it is of doubtful collectibility or it is reasonably certain [that such income] will not be collected.''[13]

4. Other factors. Another factor the courts have used to determine whether an item of income is of doubtful collectibility is whether the creditor can be expected to receive payments within a reasonable period of time after the item accrues.[14]

By contrast, the mere postponement of an interest payment[15] or temporary financial difficulties of a debtor[16] generally are insufficient to allow a creditor not to accrue interest income.

B. Debtor

Section 163(a)[17] allows a deduction for ''all interest paid or accrued within the tax year on indebtedness.'' Under the accrual method of accounting, an expense is deductible in the tax year in which all events have occurred that establish the fact of liability, the amount thereof can be determined with reasonable accuracy, and economic performance has occurred.[18] In the case of interest expense, economic performance generally occurs with the passage of time.[19]

However, the courts are divided on the issue of whether an accrual-basis taxpayer may claim a deduction for interest expense if there is no realistic expectation that such interest will ever be paid.

1. Debtor outside bankruptcy. In *Panhandle Refining Co. v. Commissioner*,[20] the Tax Court allowed the deduction of accrued interest when there was a possibility, ''which in no event can be said to be more than a probability, and is obviously not a certainty,'' that the debtor would never be able to pay the interest.[21]

Then, in *Zimmerman Steel Co. v. Commissioner*,[22] the Tax Court held that an accrual-method taxpayer may not deduct an interest expense from gross income if there is ''no reasonable probability that such interest would ever be paid.''[23] The holding was reversed by the United States Court of Appeals for the Eighth Circuit, which held:

> The law is that if a method of bookkeeping employed by a taxpayer ''does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income'' (Section 41), and the real facts, not forms of entry, must measure the tax. But where interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income.[24]

In *Brainard v. Commissioner*[25] the Tax Court adhered to its decision in *Zimmerman.* In affirming the disallowance of the debtor's interest deductions, the court held that, ''[s]ince we have found that there was no likelihood that the items accrued would ever be paid, it follows that, on the authority of [the Tax Court's opinion in] *Zimmerman*, *supra*, the deficiency should to that extent be approved.''[26]

However, the Tax Court in *Cohen v. Commissioner*[27] limited the holding in *Brainard* to circumstances where, at the time of accrual, it was clear that payment would not be made.[28]

In *Fahs v. Martin*,[29] the Fifth Circuit, relying in part on the Eighth Circuit's holding in *Zimmerman*, held that accrued interest is deductible by an accrual-basis taxpayer, notwithstanding that there was a realistic possibility that it may not be paid.

The Fifth Circuit in *Mooney Aircraft, Inc. v. United States*[30] disallowed a taxpayer's deduction based on the length of time between the incurrence of the liability and the eventual payment of the obligation, even though the expense accrual satisfied the ''all-events'' test.[31]

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[13]*Id.* (The court further held that ''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.'')

[14]*Chicago & Northwestern Ry. Co. v. Commissioner*, 29 T.C. 989 (1958) (the court held that because the debtor was hopelessly insolvent, owed a large amount of past due indebtedness to the creditor, and had no assets producing current cash flow, there was no reasonable expectancy that the interest would be paid to the taxpayer within a reasonable period of time, and thus, the taxpayer was not required to accrue such interest income).

[15]*Georgia School-Book*, at 469; *Jones Lumber*, at 766; *European American*, at 605.

[16]*Koehring Co. v. United States*, 421 F.2d 715, 720 (1970); Rev. Rul. 2007-32, 2007-21 IRB 1278.

[17]All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[18]Section 461(a); reg. section 1.461-1(a)(2).

[19]H.R. Conf. Rep. 98-861, 98th Cong., 2d Sess. 875, *reprinted in* 1984 U.S.C.C.A.N. 697, 1563; 1984-3 (Vol. 2) C.B. 1, 871; reg. section 1.461-4(e) (economic performance occurs as the interest economically accrues).

[20]45 B.T.A. 651 (1941).

[21]*Id.* at 656.

[22]130 F.2d 1011 (8th Cir. 1942), *rev'g* 45 B.T.A. 1041 (1941).

[23]*Zimmerman Steel Co. v. Commissioner*, 45 B.T.A. 1041 (1941), *rev'd*, 130 F.2d 1011 (8th Cir. 1942). (The Tax Court in *Zimmerman* distinguished *Panhandle* on the grounds that in that case, the taxpayer, although technically insolvent, was improving financially, and thus there was ''no uncertainty as to payment.'')

[24]*Id.*

[25]7 T.C. 1180, 1183 (1946).

[26]*Id.* at 1184.

[27]21 T.C. 855 (1954), *acq.*, 1954-2 C.B. 4.

[28]*Id.* at 856 (in upholding the taxpayer's interest deductions, the court held that ''deductions for accrued interest are proper where it can not be 'categorically' said at the time these deductions were claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely doubtful'').

[29]224 F.2d 387, 393 (5th Cir. 1954).

[30]420 F.2d 400, 409-410 (5th Cir. 1970).

[31]*Id.* at 409 (In *Mooney*, the time difference between the incurrence of the liability and the eventual payment of the obligation was between 15 and 30 years. The court held that even where a liability is fixed and certain to occur, ''if the time between when the deduction is claimed and the events that give

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Nevertheless, the Tax Court in *Southeastern Mail Transport, Inc. v. Commissioner*,[32] held that "[i]n the Fifth Circuit, and presumably in the Eleventh Circuit also, the rule is that improbability of payment does not preclude accrual and deduction."[33]

2. Debtor in bankruptcy. Generally, a deduction for postpetition interest by an accrual-basis debtor in bankruptcy is permitted when the liability for postpetition interest is "fixed and absolute,"[34] and "unconditional."[35] Thus, a taxpayer may not deduct a liability that is contingent.[36] That said, courts have held that postpetition interest, for which an accrual-basis taxpayer is presently and unconditionally liable, but which is unlikely to be paid by reason of its insolvency, is still deductible.[37]

However, some courts have held that a liability was not "fixed" when there was sufficient uncertainty (for example, substantial contingency) of the liability itself, and was, therefore, not accruable and deductible. For example, the Fifth Circuit in *West Texas Marketing Corp. v. United States*[38] held, that if the right to postpetition interest arises under Bankruptcy Code section 726(a), then that right is not "fixed" until there are sufficient assets remaining following distributions made under a confirmed plan.[39]

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rise to the deduction occur are so distant . . . as to completely attenuate any relationship between the two," then the deduction is not allowed under the basis of "not clearly reflecting income."); *see also Southeastern Mail Transport, Inc. v. Commissioner*, T.C. Memo. 1992-252 (1992).

[32]T.C. Memo. 1992-252 (1992).

[33]*Id.*; *see Tampa & Gulf Coast*, at 263; *Fahs*, at 393; *Zimmerman*, at 1012.

[34]*United States v. Hughes Properties, Inc.*, 476 U.S. 593, 600 (1986) (*quoting Brown v. Helvering*, 291 U.S. 193, 201 (1934)).

[35]*Id.* (*quoting Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 13 (1930)).

[36]*United States v. General Dynamics Corp.*, 481 U.S. 239, 243 (1987); *Hughes*, at 600-601.

[37]*Fahs*, at 393 (Taxpayer, a railway corporation, filed a section 77 bankruptcy petition claiming that it was insolvent and unable to meet its obligations, which included $45 million worth of first and refunding mortgage gold bonds secured by a mortgage on the taxpayer's property. In the case of a default on the bonds, the taxpayer was obligated to pay a penalty interest on the overdue installments of interest on the bonds. The question in this case was whether the taxpayer was entitled to accrue and deduct the penalty interest, when it was very unlikely that such interest would ever be paid. The Fifth Circuit held that interest legally owed is deductible by an accrual-basis taxpayer, notwithstanding the probability that it would not be paid. "Interest is recognized as a legal obligation whether all, part, or none of it will be recovered in bankruptcy proceedings; for example, consider the rule that a promise to pay a debt barred in bankruptcy is enforceable without considerations — the law recognizes that some kind of obligation still exists." Thus, the court held that the taxpayer was unconditionally liable to pay the penalty interest, and therefore, affirmed the district courts determination that the interest was accruable and deductible, despite the unlikeliness that the penalty interest would eventually be paid.); *West Texas Mktg. Corp. v. United States*, 54 F.3d 1194, 1197 (5th Cir. 1995); *In re Dow Corning Corp.*, 88 A.F.T.R. 2d 2001-7262, 2001-7269 (2001); Rev. Rul. 70-367, 1970-2 C.B. 37 (In this ruling, the IRS confronted the question of "whether the full amount of interest accrued during the year 1969 on the obligations of a railroad corporation that uses the accrual method of accounting is deductible from gross income for Federal income tax purposes, when the financial condition of the corporation is such that there is no reasonable expectancy that it will pay the accrued interest in full." It answered that question in the affirmative, stating that "doubt as to the payment of such interest is not a contingency of a kind that postpones the accrual of the liability until the contingency is resolved."); *also see* Rev. Rul. 72-34, 1972-1 C.B. 132 ("It is the

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position of the Internal Revenue Service that where there exists a contingency as to payment of an obligation, and such contingency relates to other than the ability of the obligor to pay, it cannot be said that the obligation is fixed within the meaning of section 1.461-1(a)(2) of the regulations. In such cases it cannot be said that all the events have occurred that fix the taxpayer's liability and obligation to pay, and, therefore, no deduction is currently allowable for Federal income tax purposes."); Rev. Rul. 77-266, 1977-2 C.B. 236.

[38]54 F.3d 1194, 1197 (5th Cir. 1995).

[39]*Id.* (the taxpayer filed a voluntary bankruptcy petition under chapter 11 of the Bankruptcy Code, which the Bankruptcy Court converted to a chapter 7 liquidation. The question presented to the court was whether the trustee was entitled to accrue and deduct postpetition interest on undisputed and resolved general unsecured claims. The Fifth Circuit held that the fact that it was extremely unlikely that the taxpayer would be able to pay such claims was not dispositive. The issue was whether the taxpayer's liability for postpetition interest was fixed, absolute, unconditional, or not subject to any contingency. The court relied upon the five aspects of an obligation, set forth in *Guardian Investment Corp. v. Phinney*, (253 F.2d 326 (5th Cir. 1958)) for determining the contingent nature of a taxpayer's liability for postpetition interest: (1) Is there a fixed and determinable date of maturity? (2) Is the obligation owed only on the happening of a condition? (3) Is the happening of that condition uncertain? (4) Is that condition to occur in the future? and (5) Is there a fixed or determinable liability? The court held:

> implicit in the obligation under [Bankruptcy Code] section 726 to pay postpetition interest on unsecured claims is the necessary condition that sufficient assets remain following distributions under [Bankruptcy Code] section 726(a)(1)-(4). These distributions could not occur during the taxable years at issue, and there is no fixed or determinable date when these distributions will occur; the condition is in futuro. Because [the taxpayer] seeks to deduct postpetition interest on undisputed claims, the amount of such liability can easily be determined."

Considering the aggregate of the five factors listed in *Guardian Investments*, the court concluded that under the "all-events test," the taxpayer's liability for postpetition interest was not established, and thus was not accruable and deductible. This result was not due to the fact that payment became impossible, but because the condition necessary to create the liability for the postpetition interest (for example, sufficient assets remaining post distributions under a confirmed plan) had not occurred. Therefore, the trustee was not allowed to deduct the interest. However, the dissent criticized the majority opinion for not following its own precedent in *Fahs*, where the court held that an expense such as interest legally owed, may be deducted immediately by an accrual-basis taxpayer, notwithstanding the improbability of payment. "No distinction is made between a debt backed by the full faith and credit of the United States and one owed by a creditor who has not only tottered at the brink of bankruptcy but has fallen into the chasm." The dissent started

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In *In re Dow Corning Corp.*,[40] the Bankruptcy Court dismissed a similar argument by the government that Bankruptcy Code section 502(b)(2), which precludes unsecured creditors from claiming unmatured interest after the filing of a bankruptcy petition, also precludes a creditor's right to accrue postpetition interest for federal income tax purposes.[41] The court held that disallowance of interest under Bankruptcy Code section 502(b)(2), does not render an interest obligation contingent and does not prevent accrual.[42]

Additionally, in *In re Continental Vending Machine Corp.*,[43] the court held that when the debtor is insolvent and in bankruptcy, and there is a remote chance that interest will ever be paid, postpetition interest is not accruable and deductible.[44]

C. Summary

The rules for determining when interest on an NPL is no longer required to be accrued as income by a lender, or may no longer be deducted by the debtor, focus on the facts and circumstances surrounding each taxpayer. However, in short, the rules can be summarized as follows, subject to the numerous court holdings and varied rationales:

- Lenders must accrue interest income until there is ''doubtful collectibility'' regarding that interest.
- Debtors may generally continue to deduct interest as long as there is an unconditional obligation to pay the interest, although when insolvency, bankruptcy or other factors show certainty (or near certainty) that the interest will not be paid, the deductibility of the interest has been denied.

D. Non-OID Instrument Recommendations

The Committee recommends requiring debtors and creditors of an NPL to adopt the cash method of accounting with respect to prospective accruals of interest under certain specified and limited circumstances. We have suggested two possible events, which we have called ''cash-method events.'' On the occurrence of either of the following ''cash-method'' events, the debtor and creditors would adopt the cash method of accounting:

1. A debt instrument has gone into payment default, and such payment default continues for a specified period that should not exceed two year;[45] or

2. The obligor of a debt instrument has filed for bankruptcy.

The Committee believes Treasury has the authority to make this proposed change pursuant to section 446 of the code. If Treasury does not act, the Committee urges Congress to make the change.

If Treasury and Congress decline to make such a change, the Committee does not recommend any changes except for the promulgation of administrative guidance establishing objective standards under which holders of NPLs could cease accruing interest income. In any event, the Committee recommends that Treasury or the IRS should formally acknowledge the application of the ''doubtful collectibility'' rule.

While the Committee considered proposing a rule requiring symmetry of accruing the interest income and interest deductions, as is currently the case under the OID regime, the Committee ultimately decided that such a rule was not advisable. As a matter of administration, it seemed that there were only two likely ways to do this.

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its analysis with the proposition that ''the obligation to pay interest for debts owed on contracts and accounts is a creation of the [state] law of contracts . . . The federal law of bankruptcy is not designed to create debts among parties but to determine how existing debts should be distributed to creditors fairly.'' The dissent concluded that the debtor's obligation to pay its creditors interest continues throughout the bankruptcy proceedings, and ''[o]nly upon discharge . . . is the state law obligation to pay extinguished.'' The dissent then noted that the majority's opinion created an exception to the rule in *Fahs*, namely, ''where there is no possibility of eventual payment, no obligation is fixed, and therefore an interest deduction is improper.'' *West Texas*, at 1200-06). *See also In re Cajun Electric Power Coop., Inc.*, 185 F.3d 446, 455 (5th Cir. 1999) (in a chapter 11 bankruptcy proceeding, the Fifth Circuit, following the dissent's analysis in *West Texas*, held that ''a debtor's obligation with respect to postpetition interest terminates only 'if and when' the debtor obtains a discharge from the Bankruptcy Court. . . . A debtor's obligation to pay interest during bankruptcy 'is not extinguished, but, for purposes of the bankruptcy proceedings, is ignored until the time the court determined whether the debtor's assets can meet the obligation. Only upon discharge, *see* [Bankruptcy Code] section 727, is the state law obligation to pay extinguished.'" (quoting the dissent opinion in *West Texas*, at 1200-06)); *Dow Corning*, at 2001-7269, 7270 (Court held that in a chapter 11 bankruptcy proceeding, the right to postpetition interest on trade debt arose under Bankruptcy Code section 726(a) rather than by contract. Therefore, that right would not be ''fixed'' until distributions were made under a confirmed plan. However, a debtor's obligation with regards to postpetition interest on institutional debt (for example, debt that provides for an interest rate in the debt contract) terminates only ''if and when'' the debtor receives a discharge from the Bankruptcy Court); Chief Counsel Advice 200801039 (Sept. 24, 2007) (The IRS appeared to reconcile the Fifth Circuit's opinions in *West Texas* and *Cajun Electric* by stating that *West Texas* was a chapter 7 case where the postpetition interest that the trustee sought to deduct would become fixed by Bankruptcy Code section 726(a)(5) only if there remained sufficient assets following distributions made under a confirmed plan. Conversely, in *Cajun Electric*, the debtor's obligation to pay postpetition interest was fixed by the prepetition contract, and would terminate only ''if and when'' the debtor obtained a discharge from the Bankruptcy Court).

[40]88 A.F.T.R. 2d 2001-7262 (2001).

[41]*Id.* (The court held: The ''rule'' against post petition interest — a rule which 502(b)(2) of the Bankruptcy Code embodies . . . — has no ramifications outside of the bankruptcy context. . . . A claim for such interest therefore retains its validity even if it has been disallowed. So, while it is true that, as against the estate, ''interest stops accruing at the date of the filing of the petition.'' (H.R. Rep. 95-595, 95th Cong., 1st Sess. at 353 (1977)), postpetition interest can accrue against the debtor notwithstanding 502(b)(2).)

[42]*Id.; see also* Chief Counsel Advice 200801039.

[43]*In re Continental Vending Machine Corp.*, 1976 WL 913 (E.D.N.Y. 1976).

[44]*Id.*

[45]*See* Summary of Recommendations.

A bright line rule could apply, such as in the OID context, when accruals would continue, for example, until the filing of a bankruptcy proceeding. However, the Committee thought such an approach would be inappropriate given the case law that has developed (for example, the doubtful collectibility exception to accrual). Or, alternatively, accruals could cease on a determination of doubtful collectibility. However, under such an approach, the only practicable person to make such a determination would be the debtor, and the Committee was concerned that, for both business and tax reasons, the debtor would likely postpone such a determination inappropriately to avoid admitting insolvency (and giving up the interest deductions).

Accordingly, if the proposal to the conversion to cash method of accounting is rejected, the Committee would propose that the following safe harbors be provided under which lenders could conclude that the debt instruments are of ''doubtful collectibility,'' and cease accruing interest income:

> 1. A debt instrument has gone into payment default, and such payment default continues for a specified period that should not exceed two years;[46] or
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> 2. The obligor of a debt instrument has filed for bankruptcy.

III. Original Issue Discount

This section of the report argues that the existing rules that require current inclusion of OID for distressed debt may not be the best approach, and proposes that the rules for OID be conformed with the rules for stated interest.

A. Current Law

The IRS has taken the position in a technical advice memorandum that holders of debt instruments with OID are required to continue to accrue OID regardless of the financial condition of the issuer.[47] TAM 9538007 concluded that holders must continue to accrue OID for as long as they hold the debt instruments. It also provided that holders could not deduct the unpaid OID in the year of the exchange of the debentures for stock in a tax-free reorganization.[48]

The only relief to this rule was provided in a 1996 litigation guideline, which concluded that a creditor is not required to include in income any accrued OID on prepetition unsecured debt for periods in which the issuer is in bankruptcy.[49] However, the reasoning for this conclusion is that under the Bankruptcy Code, OID ceases to accrue on the debtor's obligations upon the filing of the petition.[50] In the event postpetition OID is awarded as part of the bankruptcy proceedings, that amount would be includable and deductible at that time.

B. IRS Position for Requiring Accrual

TAM 9538007 involved a married couple who owned junior subordinated debentures issued by a corporation. The debentures provided for interest at a stated rate to be paid semiannually either in cash, or, at the corporation's option, in-kind with additional debentures (PIK bonds). The debentures were treated as being issued with OID since the corporation had the right to defer the cash payment of the interest through the issuance of PIK bonds. For all three years at issue, the corporation issued PIK bonds in lieu of making interest payments in cash. During the course of these three years, the corporation defaulted on its senior debt and the debentures traded at less than 10 percent of their face value. In the third year, the corporation underwent a bankruptcy reorganization. Accordingly, the taxpayers took the position that the OID was uncollectible and excluded most of the OID from their income.

The IRS did not question the taxpayers' claim that the OID was uncollectible. Rather, the IRS required taxpayers to accrue the OID for all three years at issue based on the conclusion that the doubtful collectibility exception that applies under the general accrual rules does not apply to OID.

The IRS justified this conclusion on the following grounds:

> 1. OID accrual rules of section 1272 of the code generally require holders, regardless of accounting method, to currently include in income OID on debt instruments having OID. According to the IRS, while sections 1271 through 1275 provide a number of specific and limited exceptions from current OID accrual, there is no exception in these provisions for doubtful collectibility.
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> 2. While the OID provisions may be similar in operation to the accrual method, it does not follow that the doubtful collectibility exception to the accrual method should apply to OID accrual.
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> 3. Citing the legislative history to the OID provisions, the IRS stated that, in contrast to the normal accrual of interest:
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> [OID] is not included in income in advance of receipt; it is included in lieu of receipt. The OID provisions treat the OID transaction as occurring in two steps: First, interest is deemed paid to the holder. Section 1272(a)(1). Second, the holder is

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[46] *Id.*

[47] TAM 9538007 (June 13, 1995). For a critique of TAM 9538007, *see* Pollack, Goldring, and Gelbfish, ''Uncollectible Original Issue Discount: To Accrue or Not to Accrue,'' 84 *J. Tax'n* 157 (1996); Henderson and Goldring, *Tax Planning for Troubled Corporations* (2008 Ed. CCH), section 304 at 25. *See also* New York State Bar Association, Tax Section Report on Proposed Legislation to Amend the Market Discount Rules of Sections 1276-78 (June 22, 1999), at n.24 (''We disagree with the position taken in TAM 9538007 (June 13, 1995) that the common law 'doubtful collectibility' exception for accrual basis taxpayers . . . does not apply to accrual of OID'').

[48] For the same position as to the nondeductibility of a loss from unpaid OID, see LTR 200345049 (Aug. 2, 2002), *Doc 2003-24109, 2003 TNT 217-40* (Ruling 16).

[49] IRS Litigation Guideline Memorandum TL-103 (May 6, 1996), *reprinted at Doc 1999-27904* or *2000 TNT 121-83*.

[50] 11 U.S.C. section 502(b)(2).

deemed to relend the same amount to the issuer. . . . As OID is accrued, the holder is, in effect, receiving current interest and extending additional credit.[51]

4. The application of the doubtful collectibility doctrine to OID without simultaneously denying issuers a deduction for such OID would result in a significant mismatching of income and expenses and thereby undermine one of the primary purposes for the OID provisions.

C. Response to the IRS Position

The reasoning behind the IRS position in TAM 9538007 is inconsistent with the legislative history to the OID rules, which provides that the OID rules ''will require the issuer of the debt instrument to use the accrual method of accounting for any interest.''[52] Accordingly, the OID rules should be read as simply providing specific rules under which the accrual method is required, but not as superseding the common law rules regarding the accrual method such as doubtful collectibility. Also, in light of the fact that the doubtful collectibility doctrine is not listed as a statutory exception in the accrual accounting rules, the fact that the doubtful collectibility doctrine is not listed as an exception under sections 1271 through 1275 is not compelling.

Also, the Committee believes the IRS concern with congressional intent to prevent the mismatch of the holder's income for the OID and the issuer's deduction is misplaced. The mismatch at which the OID legislation was directed was the mismatch between cash method holders and accrual method issuers, rather than the difference between the legal standards when an accrual method holder stops accruing interest income and an accrual-method issuer stops deducting interest.[53] This latter difference is common to all debt instruments.[54] If Congress had intended to correct the mismatch between an accrual method holder and an accrual-method issuer in the situation of a financially troubled issuer, Congress would have eliminated the mismatch with respect to all debt instruments, rather than solely OID instruments.[55]

Further, the IRS concern that taxpayers will take inconsistent positions with respect to accruals on debt seems misplaced. Financially troubled debtors may not derive any tax benefit from interest deductions because they are often in a loss position.[56]

If the holder is required to continue to accrue OID, more is at stake than just timing. Rather, the character of the underlying income or loss is also affected. As described in Part III below, if the debt instrument is a capital asset, a security (within the meaning of section 165(g)(2)), and the holder includes OID in its income that is not eventually collected, the taxpayer generally will not be able to take a bad debt loss for the uncollected interest and instead will have a capital loss when the security is sold or becomes wholly worthless. Also, the use of such capital losses can be subject to some limitations.[57]

Accordingly, the better view is that the doubtful collectibility exception should be a valid exception to OID accrual.

D. Recommendations Regarding OID Instruments

The Committee recommends that Treasury and the IRS abandon the position set forth in TAM 9538007 and formally adopt the position that the doubtful collectibility exception applies to OID instruments. The Committee believes that Treasury and the IRS have the authority to make this change. However, in the event that Treasury and the IRS do not agree with that conclusion, the Committee would request that Congress effect the requested changes.

To provide clear, administrative guidance, the Committee recommends the adoption of rules under which the holder of an OID instrument would be permitted to cease accruing OID, and the debtor would cease deducting the OID, interest under either of the following circumstances:

1. The OID instrument has gone into payment default, and the payment default continues for a specified period that should not exceed two years;[58] or

2. The obligor of the OID instrument has filed for bankruptcy.

Also, given the IRS focus on the mismatch issue, the Committee recommends the following to address the IRS concerns:

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[51]Quoting from H.R. Rep. 98-432 (Part II), 98th Cong., 2d Sess. at 1034 (1984).

[52]*See* S. Rep. 99-83, 99th Cong., 1st Sess. at 5 (1985); Staff of Joint Committee on Taxation, *Description of the Tax Treatment of Imputed Interest on Deferred Payment Sale of Property (H.R. 242 and H.R. 2069)* (JCS-1085) (Apr. 23, 1985) at 5. Concerning the loss deduction, TAM 9538007 is also inconsistent with LTR 8933001 (Aug. 22, 1988) (Ruling 7).

[53]*See* H.R. Rep. 91-413, 91st Cong., 1st Sess. at 109 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. at 146 (1969); *see also* Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 110.

Section 267(a)(2) was enacted to deal with the same mismatch. Under this rule, an accrual-method borrower is not permitted to deduct interest if the amount payable is not actually paid within the borrower's taxable year or 2½ months thereafter, and the lender accounts for the interest on the cash basis. However, this rule is narrower in its application in that it only applies if the borrower and lender are related in specified ways (for example, parent and child, corporation and controlling shareholder).

[54]The IRS has previously limited the deduction for OID that is available to an issuer. In GCM 39668 (Sept. 24, 1987), the IRS took the view that OID on a nonrecourse debt is deductible only to the extent the value of the property exceeds the outstanding amount of the debt at the time of the accrual. The IRS did not

(Footnote continued in next column.)

take this GCM, which created some type of doubtful collectibility exception, into account in TAM 9538007.

[55]*See* Pollack, ''Uncollectible Original Issue Discount: To Accrue or Not to Accrue,'' 84 *J. Tax'n* at 161.

[56]*See* Garlock, *Federal Income Taxation of Debt Instruments* (5th Ed. CCH), section 1602.01 at 16,004.

[57]Sections 165(f) and 1211.

[58]*See* Summary of Recommendations.

1. A holder of an OID instrument that wishes to cease to accrue OID based on the doubtful collectibility exception should be required to provide notice to the IRS, with a copy to the issuer, by filing a statement with the holder's federal income tax return for the first tax year in which the taxpayer determines that collection is doubtful, setting forth in detail why collection is doubtful;[59] and

2. In cases when the issuer's financial condition is such that there is no reasonable expectation of ever paying the interest, the issuer should be precluded from deducting OID.

As stated above, the Committee believes that, based on the foregoing, Treasury has the authority for the suggested changes. However, given Treasury's previously stated view on this issue, we are also addressing these comments to Congress.

IV. Character of Losses

A. Summary of Current Tax Rules

With limited exceptions, interest is includable by the holder of a debt instrument in gross income as ordinary income.[60] The character of a loss for previously accrued interest income on a debt instrument depends on the circumstances of the loss and the nature of the holder. If the debt instrument is held as a capital asset and is sold at a loss, the loss is a capital loss,[61] the deductibility of which is limited. On worthlessness of the debt, the loss is generally a capital loss as well.[62]

B. Possible Character Mismatch

On one level, it seems inappropriate that a taxpayer may be required to include interest in gross income as ordinary income and then, on failing to collect the income, that taxpayer would be limited to a capital loss. However, this is the case under many circumstances outside of the debt context. For example, losses on Pay-In-Kind (PIK) dividends on preferred stock, which are ordinary income when received (although currently taxed at the capital gains rate), would generally yield a capital loss on a later worthlessness. Property received as compensation would also be includable as ordinary income, although a later loss or worthlessness would give rise to a capital loss (assuming the property was held as a capital asset).

When the debtor is not troubled, and there is no concern about the ultimate collectibility of the interest, the character mismatch for debt instruments is not materially different than in the examples above, and it is not clear that there should be any policy reason for deviating from that approach in the case of such debt instruments. Thus, the accrual of interest as ordinary income that *later* turns out to be uncollectible, and capital loss treatment to that extent, is probably the appropriate treatment.

However, there may be more of a divergence, and debt instruments may be distinguishable from other instruments, in which interest is required to be accrued when its collectibility is doubtful. As discussed above, there are many instances when the interest is fully includable in income, with no adjustments to take into account the financial weakness or insolvency of the debtor. In similar circumstances when PIK preferred dividends or compensatory transfers of the debtor's stock are involved and there is a question of the issuer's creditworthiness, the income inclusion would typically be considerably less because the value of the stock received would reflect the creditworthiness concern. Under TAM 9538007, there is no comparable mechanism for the accrual of OID interest when the debt is of doubtful collectibility.

In the foregoing circumstances, requiring inclusion of interest income beyond the point when it is reasonable to expect any payment of the accrued interest will likely result in a character mismatch that imposes a hardship on taxpayers that seems difficult to support on policy grounds.

C. Recommendations Regarding Character

If the Committee's recommendations respecting OID instruments (discussed above) are adopted, there would be no need to address this mismatch issue. Taxpayers would no longer be required to include interest of doubtful collectibility into income. However, in the event the OID rules continue to require inclusion of interest into income beyond the point when the interest is of doubtful collectibility, the Committee believes that it would be appropriate to permit an ordinary loss for OID interest accrued after that point in time, but only on worthlessness of the debt.

While an argument could be made that ordinary loss treatment is also appropriate on a sale or exchange of a debt instrument (or satisfaction), to the extent the loss is attributable to accrued and unpaid interest, this approach may be difficult to administer, as it would require a determination of the extent to which the loss is not simply attributable to market forces. Because of ambiguity over the extent to which Treasury has authority under section 166 to address this issue of character, the Committee addresses this recommendation to Congress.

V. Market Discount Rules Application

This section of the report argues that existing market discount rules are ill-equipped to deal with distressed debt, and proposes clarifications to existing market discount rules as applied to distressed debt.

A. Current Law

The market discount rules were enacted to prevent a purchaser of an outstanding bond at a discount from realizing capital gain on the discount in situations when the market discount is merely a substitute for stated interest (for example, when a debt is purchased after the

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[59]*See* reg. section 1.1275-4(b)(4)(iv) (providing a similar disclosure rule for holders of contingent payment debt instruments).

[60]Reg. section 1.61-7.

[61]Sections 165(f) and 1211.

[62]Section 165(g). For a robust discussion of the various character and related issues respecting debt instruments, see Blanchard and Garlock, ''Worthless Stock and Debt Losses,'' *Taxes* (Mar. 2005).

market interest rate increases).[63] In that case, from the standpoint of the holder, the market discount is indistinguishable from OID. The holder receives part of his return in the form of price appreciation when the debt is sold or redeemed at par at maturity. Unlike OID debt, however, the market discount rules apply only to the holder; the issuer is unaffected.[64] Also, Congress wanted to prevent a taxpayer who finances the purchase of discounted debt from obtaining a tax benefit by currently deducting the interest expense but not currently recognizing market discount income.[65] Tax shelter transactions had arisen based on the ability to convert the character and defer recognition of income.

The market discount (MD) rules apply generally to bonds, debentures, notes, certificates, and other debt instruments that are acquired with market discount, as defined (MD Debt).[66] Subject to a de minimis rule,[67] market discount equals the amount that the holder's tax basis in the MD Debt immediately after it is acquired by the holder is less than either the MD Debt's stated redemption price at maturity (that is, its principal amount) or, if the MD Debt is OID debt, the revised issue price of the MD Debt.[68]

Under the market discount rules, any gain realized on a taxable disposition of an MD Debt, including any gain realized at maturity, is treated as ordinary income to the extent of the accrued market discount with respect to the debt instrument.[69] If a partial payment of principal is made on MD Debt, the payment is treated first as a payment of accrued market discount, resulting in ordinary income, and then as a nontaxable recovery of principal.[70] Accrued market discount is determined either on a straight-line (ratable) basis from the date of acquisition to maturity or, if elected by the holder, on a constant yield-to-maturity basis over that period.[71] To prevent double counting, appropriate adjustments are made to the tax basis of the MD Debt to reflect the gain recognized under the market discount rules.[72] Also, the deduction of any ''net direct interest expense'' (generally, interest expense in excess of interest income) with respect to an MD Debt is deferred until the accrued market discount is recognized.[73] (However, these rules do not apply if the holder elects to include market discount in income as it accrues.[74]) Thus, the market discount rules operate to prevent the conversion of ordinary (market discount) income into capital gain and (in the case of a leveraged purchase of an MD Debt) the current deduction of interest relating to accrued market discount that has not yet been recognized.

In enacting the market discount rules, Congress also recognized that administrability is more important than theoretical correctness. Although current inclusion in the holder's income over the remaining term of the obligation might be correct in theory, applying that rule would have been administratively complex.[75]

Although the statute was enacted in 1984 and various provisions refer to rules as provided in regulations, to date, no regulations have been promulgated or proposed under the market discount rules.

B. Problems With Current Law

The fundamental problem with applying the existing market discount rules to distressed debt acquired at a discount is that the rules fail to distinguish between discount which is essentially a substitute for stated interest, as contemplated by the existing rules, and discount reflecting marketplace concern about the collectability of the debt, which is qualitatively different from a return in the nature of interest. In some instances, such as MD Debt that was not paid at maturity or has been accelerated as a result of a prior default, it is difficult to know how to apply the market discount rules because there is no remaining term over which to calculate the amount of the accrued market discount in the hands of the purchaser. The mere fact that the debt is past due

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[63]H.R. Rep. 98-432 (Part II), 98th Cong., 2d Sess. (1984) at 1170; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, Market Discount: Prior Law and Reasons for Change, at 93.

[64]H.R. Rep. 98-432 (Part II) at 1171; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 94.

[65]H.R. Rep. 98-432 (Part II), at 1170; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 93.

[66]Section 1278(a)(1) and (3). Section 1278(a)(1)(B) provides that MD Debt does not include U.S. savings bonds, installment obligations subject to section 453B, and obligations with a fixed maturity of one year or less from the date of issue.

[67]If the market discount is less than 0.25 percent of the stated redemption price at maturity multiplied by the complete number of years to maturity measured from the acquisition date, then the market discount is deemed to be zero. Section 1278(a)(2)(C).

[68]Section 1278(a)(2)(A) and (B). The ''revised issue price'' of a taxable debt instrument equals the sum of the issue price plus the cumulative amount of OID includable in income by all holders for all periods up to the acquisition date, determined without regard to section 1272(a)(7) or 1272(b)(4). The revised issue price of a tax-exempt debt instrument equals the sum of the issue price plus the cumulative OID accrued under section 1272(a), without regard to section 1272(a)(7), for all periods up to the acquisition date. Section 1278(a)(4).

[69]Section 1276(a)(1). Special rules apply in the case of a nonrecognition transaction to preserve the ordinary income characterization on a subsequent disposition. Section 1276(c).

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

[71]Section 1276(b)(1) and (2). Under the constant-yield method, less market discount accrues in the early years (and more in the later years) than under the straight-line method. The election is made by including the market discount in income using the constant-yield method on a timely-filed return and attaching a statement that market discount has been included and describing the method used to compute the market discount. Rev. Proc. 92-67, 1992-2 C.B. 429; IRS Publication 550, *Investment Income and Expense* (2007) at 15. The election applies to all MD Debt acquired during such year or thereafter. Section 1278(b)(2). Once made, the election cannot be revoked without IRS consent. Section 1278(b)(3).

[72]Section 1276(d)(2).

[73]Section 1277(a). This rule does not apply to tax-exempt MD Debt. Section 1278(a)(1)(C).

[74]*See generally* section 1278(b). The election is made in the manner described at n.71. Like the OID rules, the income inclusion increases the basis in the MD Debt.

[75]H.R. Rep. 98-432 (Part II), at 1170; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 93.

does not permit retesting the nature or character of an instrument.[76] Accordingly, a different method is needed to deal with this issue.

In other situations, such as when market discount is attributable to marketplace recognition that the debt instrument is unlikely to be repaid in full due to the debtor's weak financial condition, applying the existing market discount rules will likely result in the purchaser's having to treat a greater portion of each payment (if any) made by the debtor as interest income than would be the case when repayment is virtually assured. In other words, the greater the discount at which a debt is purchased due to the risk that the debt is unlikely to be repaid in full, the greater the amount of income that the purchaser will have to recognize under the market discount rules each time a partial payment is made. Moreover, unless the purchaser is a dealer in securities or a financial institution, any loss later recognized by the holder when the MD Debt is sold or retired at a discount will be a capital loss[77] which cannot reduce ordinary income.[78] The Committee, like the American Bar Association Section of Taxation,[79] considers these results anomalous and not defensible from a tax policy standpoint.

It is important for the market discount rules to take into account and deal with distressed debt. It is especially important in the current economic climate. Discouraging prospective purchasers of distressed debt merely exacerbates the problem. Rather, the tax rules should encourage (or at least be neutral with respect to) such purchases.

C. Authority for NYC Bar Proposals

Before enactment of the market discount rules, several cases held that a buyer of high-risk debt acquired at a significant (over 30 percent) discount does not recognize income on account of principal payments until the payments exceed the buyer's purchase price.[80] The *Liftin* court succinctly stated the legal principle underlying the decision to allow the taxpayer to recover his purchase price before recognizing income, as follows:

> [w]here 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.[81]

The legislative history of the Deficit Reduction Act of 1984 strongly suggests that Congress did not have distressed debt in mind when it enacted the market discount rules. Both the House Ways and Means Committee report and the *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* prepared by the Joint Committee on Taxation (hereinafter the ''Joint Committee Explanation'') states that market ''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.''[82] Distressed debt, however, is unlikely to be redeemed at par on maturity; indeed, it may already be past due. The Joint Committee Explanation further explains that ''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,'' and that ''[c]apital gain treatment should not be afforded to a largely predictable return (such as that available on the typical purchase of a market discount bond).''[83] The return on distressed debt, especially past due debt, is unlikely to be ''largely predictable'' and might not be predictable at all.

The Joint Committee Explanation also indicates that Congress did not intend to apply the market discount rules to an obligation that was demand debt when issued, for the simple reason that such debt ''is insusceptible to treatment under the rules prescribed for computing accrued market discount (which rules are applied by reference to a maturity date).''[84] We note that the same difficulty is present in the case of an MD Debt that is past due or that has been accelerated as a result of an ongoing uncured event of default.

Congress anticipated that demand debt would be exempted from the market discount rules in forthcoming regulations.[85] Twenty-four years after the enactment of the market discount rules, however, those regulations still have not been issued.

In another context, Treasury recognized that distressed debt is qualitatively different from debt obligations generally. For purposes of determining whether an entity is a ''taxable mortgage pool,'' as defined in the code, real estate mortgages that are seriously impaired are not treated as debt obligations.[86] For this purpose, whether a debt is seriously impaired is based on all the facts and circumstances, including but not limited to the number of days delinquent, the loan-to-value ratio, the debt service coverage (based on the operating income from the property), and the debtor's financial position

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[76]Reg. section 1.1001-3(c)(4). The failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification. Moreover, absent an agreement to alter other terms of the debt instrument, a holder's temporary forbearance of collection or acceleration (including a waiver of those right) does not become a modification for at least two years following the issuer's failure to perform.

[77]Sections 165(g)(1) and 166(e).

[78]Section 1211. A minor exception for noncorporate taxpayers allows capital losses in excess of capital gains to reduce ordinary income up to $3,000 ($1,500 in the case of a married individual filing separately) a year. Section 1211(b)(1).

[79]ABA tax section, *Comments Regarding Application of Market Discount Rules to Speculative Bonds* (May 23, 1991), Part II.A.

[80]*Liftin v. Commissioner*, 36 T.C. 909(1961), *affd*, 317 F.2d 234 (4th Cir. 1963); *Underhill v. Commissioner*, 45 T.C. 489 (1966); *compare Grinsten v. Commissioner*, T.C. Memo. 1964-51.

[81]*Liftin*, at 911.

[82]H.R. Rep. No. 98-432 (Part II), at 1170; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 93.

[83]*General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 94.

[84]*Id.* at 95.

[85]*Id.*

[86]Reg. section 301.7701(i)-1(c)(5)(i).

and stake in the property.[87] Although the regulations state that no one factor in and of itself is determinative of whether a loan is seriously impaired,[88] they provide a safe harbor that treats a mortgage debt as seriously impaired if the debt is more than a particular number of days delinquent, unless the entity holding the mortgage debt is receiving or anticipates receiving, among other payments, principal and interest payments that are substantial and relatively certain as to amount.[89]

The Committee believes that special rules are required to deal with market discount on distressed debt because the debt, when purchased, entails substantial uncertainty about the amount and timing of the borrower's payments.[90]

D. Defining 'Distressed Market Discount Debt'

In this section of the report, we have been contrasting ''distressed'' MD Debt with non-distressed MD Debt. By distressed MD Debt, we mean MD Debt to which there is substantial uncertainty about the amount and timing of the borrower's payments, and as a result, sell at a significant discount. Such distressed MD Debt generally is expected to be discharged primarily by non-scheduled payments. The determination whether MD Debt is (or is not) likely to be discharged primarily by non-scheduled payments should be based on objective facts. Factors might include the following:

- the existence of an uncured continuing payment default and the length of such period;
- the bankruptcy or insolvency of the obligor, or other exigencies indicating that the obligor's ability to meet its payment obligations under the MD Debt is primarily speculative;
- a rating by an established rating agency that is below a specified level;
- the size of the market discount;
- whether the MD Debt is seriously impaired within the meaning of reg. section 301.7701(i)-1(c)(5)(ii)(A) (but without regard to any requirement that the debt be secured by a mortgage on real estate); and
- whether the obligor's capacity to meet the payment obligations under the MD Debt is primarily speculative within the meaning of reg. section 1.1001-3(e)(4)(vi).

In addition to a facts and circumstances test, the Committee recommends the following safe harbors:

1. MD Debt that has been accelerated or that was not satisfied at maturity (that is, past due debt);

2. MD Debt (a) that has gone into payment default, and such payment default has continued for a specific period that should not exceed two years,[91] or (b) the obligor of which is bankrupt (that is, MD Debt for which a ''cash-method'' event, as recommended above, has occurred); and

3. MD Debt that is purchased at a discount greater than a specified percentage (that should not be less than 50 percent) of the then outstanding balance of the debt (including any accrued but unpaid interest) or the revised issue price (in the case of OID debt), in either case unless the discount is primarily the result of changes in the prevailing interest rates from the issue date to the acquisition date.

The Committee believes it is important to have a bright-line safe harbor based on the amount of the discount both as a matter of administrative convenience and tax policy. Although the Committee believes such discount should not be less than 50 percent, the Committee is not able to recommend a specific percentage.

The safe harbor under (3) above would include debt which, although not currently in payment default, is substantially discounted because of the market's concern about the issuer's ability to continue making payments in the future. In that case, the purchaser likely would not expect to be repaid the full amount of the debt. Because of the speculative nature of the debt, the purchaser's expected return may be more like that of an investor, rather than a creditor. Under the current market discount rules, however, the larger the discount, the more ordinary income the purchaser is required to include, even though he does not expect to receive these amounts.

The Committee also recognizes that market discount attributable to significant changes in prevailing interest rates might be captured by a proposed safe harbor that is based solely on the size of the discount. Accordingly, the safe harbor proposed in (3) above contains an exclusion for debt the discount on which results primarily from changes in prevailing interest rules.

The Committee recognizes that such a safe harbor is not perfect. For example, there may be instances when publicly traded debt fluctuates above and below the threshold, so that the purchaser's tax treatment will depend on the exact time he bought the debt. The Committee also understands that such a safe harbor may have an impact on the trading of debt that is valued near the safe harbor discount. If Treasury determines it is necessary, we believe that much of the deleterious effect, if any, of this safe harbor could be ameliorated by treating the safe harbor under (3) as a presumption which can be rebutted by the IRS.[92]

References in the balance of this section of the report to ''distressed MD Debt'' mean MD Debt which is distressed based on the facts and circumstances test described above or by virtue of satisfying one of the safe harbors proposed above. We contemplate that distressed

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[87]*Id.*

[88]*Id.*

[89]Reg. section 301.7701(i)-1(c)(5)(ii)(B).

[90]*See also* Preamble to Proposed FASIT Regulations, 65 *Fed. Reg.* No. 25, Explanation of Provision, Rules Applicable to the FASIT, Assets That May Be Held by a FASIT (Permitted Assets), 4. Debt Instruments in General (Feb. 7, 2000), to the effect that FASITs could not hold debts that are in payment default which are not reasonably expected to be cured within 90 days. According to the preamble to the proposed regulations, the reason for the prohibition is that distressed debts may take on the character of equity.

[91]*See* Summary of Recommendations.

[92]Treasury has used rebuttable presumption safe harbors in other areas. *See, e.g.*, reg. section 1.707-3(d) (with respect to disguised sales between a partner and his partnership).

MD Debt would generally be expected to be discharged primarily by nonscheduled payments.

E. Market Discount Recommendations

The Committee recommends that, with respect to distressed MD Debt, Treasury clarify the existing market discount rules as follows:

1. Past due debt. The Committee believes that the market discount rules should not apply to MD Debt that has been accelerated or whose maturity date has passed before being purchased (in either case, a ''past due debt''). Such debt is equivalent to demand debt, in that it is impossible to calculate the accrued market discount in the hands of the purchaser. As indicated, the Joint Committee Explanation of the market discount provisions enacted in 1984 states that ''[i]t is expected that Treasury regulations will provide that the term 'market discount bond' does not include an obligation that was demand debt when issued.''[93] We believe that an MD Debt which is past due debt when purchased comes within the spirit, if not the letter, of the exception contemplated by Congress. To avoid any abuse of the market discount rules, we would limit this exception to MD Debt that is past due debt when purchased by the applicable holder.

2. Distressed MD Debt other than past due debt. The Committee is most concerned with the application of section 1276(a)(3) to MD Debt that is distressed debt, because the existing rules may cause the holder to recognize income in excess of the holder's ultimate economic income from the investment. Although the holder will ultimately recognize a loss with respect to excess income, the loss generally will be a capital loss, which might not be usable by the holder. Sections 1276(b)(3) and 1278(c) each authorize Treasury to prescribe regulations determining the amount of market discount to be recognized on account of principal payments. The Committee believes that Treasury therefore has the authority to implement the recommendation described below.

The Committee recommends that the market discount rules provide that a holder's accrued market discount shall be deemed to be zero for purposes of applying section 1276(a)(3) to payments on distressed MD Debt (that is not past due debt), until the payments equal the holder's tax basis in the debt. Under this proposal, the holder would not recognize ordinary income under the market discount rules unless the payments made to the holder (including payments at maturity) exceed the holder's tax basis in the debt. The same result should obtain if the holder sells the debt rather than holding it to maturity. These very limited clarifications would avoid the potential for ordinary income recognition and subsequent capital loss recognition that arises under the current rules.[94] The Committee believes that such clarification is consistent with the authority granted to Treasury by sections 1276(b)(3) and 1278(c), and can be made without any statutory changes. If Treasury declines to exempt past due MD from the market discount rules as recommended in (1) above, then we likewise recommend that the holder of the debt should not be required to recognize income in advance of recovering its tax basis in the debt.

The Committee concluded that a ''wait and see'' approach, while generally disfavored by Treasury and the IRS, is reasonable in the limited circumstances of distressed MD Debt. Specifically, the Committee considered and rejected an approach that would require market discount to be recognized based on the holder's projected payment schedule but otherwise using the noncontingent bond method applicable to some contingent payment debt instruments. The contingent payment rules were developed with a view to putting both holders and issuers of contingent payment debt instruments on a consistent schedule for accruing and deducting interest. As originally proposed in 1986, reg. section 1.1275-4 employed a wait and see approach to the accrual of interest on contingent payments. This approach was criticized as resulting in a significant back-loading of interest to the detriment of the obligor, leading Treasury to adopt the current rules requiring accrual based on a projected payment schedule.[95] However, the need for consistency between the obligor and the holder of the debt instrument does not present an obstacle to the adoption of a wait and see approach in the context of accounting for market discount on distressed debt.

Unlike an original issue situation, it is significantly more difficult (if not impossible) to determine a comparable yield and projected payment schedule for distressed MD Debt that is supported by contemporaneous reliable, complete and accurate data.[96] It is unlikely data exists or is obtainable with respect to distressed MD Debt. Also, because the treatment of MD Debt affects only the holder, a projected payment scheduled prepared by the holder would lack the arm's-length check imposed by the OID rules, which (unlike the market discount rules) require consistent treatment between the issuer and the holder. Requiring current accruals of amounts that the marketplace has determined are unlikely to be collected would create a strong disincentive to purchasing distressed MD Debt.

The Committee also considered and rejected an approach that would require market discount to be recognized on a basis that assumes the holder will receive a return of at least a specified rate. In the case of distressed MD Debt, the Committee believes that the definition of distressed MD Debt is intended to (and should) be limited to those debt instruments to which there is substantial uncertainty concerning payment. Accordingly, it is not appropriate to require any minimum

[93] *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 95.

[94] This approach is also suggested by Garlock, in his treatise, *Federal Income Taxation of Debt Instruments*, para. 1107.02 at 11,046.

[95] Preamble to Proposed Regulations and Proposed Amendments of Regulations (FL 59-91) (Dec. 16, 1994), Background. A wait and see approach still applies to nonpublicly traded debt issued for property that is not publicly traded. Reg. section 1.1275-4(c).

[96] *See* reg. section 1.1275-4(b)(4).

accrual on the part of a holder of such debt. We note that our conclusion on this issue echoes the conclusion reached by the New York State Bar Association Tax Section in its report concerning a proposal by the Clinton administration to require accrual basis taxpayers who purchase market discount debt to include market discount in income as it accrues. The tax section stated that ''where a large amount of market discount reflects a troubled obligation on which there is no reasonable expectation of payment, the holder should not be required to accrue income.''[97]

Until the payments received by the holder of a distressed MD Debt equal the holder's tax basis in the debt, the amount of the accrued market discount on the debt and, hence, the amount of ordinary income required to be recognized by the holder, should be zero. However, once the holder recovers its purchase price, the Committee believes that, except in the case of past due debt, Treasury might reasonably determine that it is appropriate to require ordinary income treatment of 100 percent of each dollar later received by the holder, up to the amount of the market discount that accrued during the holder's holding period as determined under the existing market discount rules.

In the case of past due debt, there is no guidance for determining how to calculate the amount of market discount accruing during the holder's holding period. Accordingly, we recommend that all payments made on such debt in excess of the holder's tax basis should be treated as capital gain.[98]

In the event that the Treasury Department declines to take action on the application of the market discount rules to distressed MD debt, the Committee requests that Congress make the foregoing changes statutorily.

VI. Conclusion

The Committee has endeavored to set forth the current state of the law as it pertains to accounting for interest on nonperforming loans, and to make recommendations for changes or clarifications in the law, where merited, to provide for a more coherent implementation of what the Committee genuinely thinks would be sound fiscal policy. Members of the Senate Finance Committee, the House Ways and Means Committee, and the Treasury Department are invited to contact the Committee to discuss any aspects of the foregoing report. We appreciate your consideration of our recommendations.

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[97]New York State Bar Association, Tax Section, Report on Proposed Amendments to Market Discount Rules of Section 1276, at 127 n. 24.

[98]Such treatment is consistent with the tax treatment of payments of defaulted interest accrued before the date of purchase on bonds purchased ''flat,'' as a return of capital rather than interest income. Reg. section 1.61-7(c); *see also Estate of Rickaby v. Commissioner*, 27 T.C. 886 (1957).