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Report No. 1366
March 10, 2017

The Honorable Thomas C. West Acting Assistant Secretary (Tax Policy) Department of the Treasury 1500 Pennsylvania Avenue, NW Washington, DC 20220	The Honorable John Koskinen Commissioner Internal Revenue Service 1111 Constitution Avenue, NW Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1366 on Possible Regulations Interpreting Rules Governing Applicable High Yield Discount Obligations*

Dear Messrs. West, Koskinen, and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report contains comments regarding possible regulations for the treatment of applicable high yield discount obligations ("**AHYDO**").

The AHYDO rules under section 163 generally defer and in some cases deny the ability to take deductions of accrued original issue discount ("**OID**") for issuers of certain high-yield debt instruments ("**DIs**"). The statute provides specific authority for the Treasury Department ("**Treasury**") to issue regulations modifying the AHYDO rules to carry out the purposes of those rules, including in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of DIs, conversion rights, or other circumstances where such modifications are appropriate to carry out the

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purposes of sections 163(e)(5) and 163(i). The attached report contains our recommendations and requests for guidance with respect to the AHYDO rules.

Our primary recommendations are as follows:

1. We recommend that Treasury promulgate a rule under section 163(e)(5)(F)(iii) or 163(i)(1) that would automatically suspend the effects of the AHYDO rules upon the occurrence of certain economic triggers.

2. For purposes of determining (1) the maturity date of a DI under section 163(i)(1)(A) and (2) which accrual periods must be tested under the "significant OID" definition in section 163(i)(2), the last-day presumption in section 163(i)(3)(A) should be operative, and the deemed exercise of puts and calls in Treasury regulations section 1.1272-1(c)(5) should not apply.

3. For purposes of determining if the yield on a DI exceeds the threshold of the applicable Federal rate (**"AFR"**) plus 5% in section 163(i)(1)(B) and for purposes of calculating disqualified yield within the meaning of section 163(e)(5)(C)(ii), the regulations should specify whether (1) a DI's yield to maturity is its yield at issuance under the OID rules (taking into account Treasury regulations section 1.1272-1(c)(5)) or (2) the last-day presumption in section 163(i)(3)(A) should be operative. Furthermore, the AFR used to test for AHYDO status (and compute disqualified yield) for purposes of section 163(i) should be determined in a manner consistent with the determination of the yield.

4. For purposes of determining if a DI has significant OID, a DI's yield to maturity should be its yield at issuance under the OID rules.

5. We recommend that the disqualified portion of a DI's OID should be based on a ratio of "disqualified yield" to "yield to maturity" (the "**Disqualified Fraction**") that remains fixed for the entire term of the DI, even if the issuer makes payments in a manner inconsistent with the presumption used to determine the yield. We also recommend that regulations clarify the definition of "significant OID" under section 163(i)(2) to provide that the issue price and yield of a DI used for determining the product of the DI's issue price and its yield to maturity should be the original issue price, and should remain constant for the term of the DI. Also, the regulations should clarify that upon a deemed reissuance of a DI for purposes of sections 1272 and 1273 if certain contingencies occur, the Disqualified Fraction, as of the issue date, should continue to apply to the new OID interest schedule resulting from the deemed reissuance.

6. With respect to modifications of DIs, if the borrower is related to the lender, we recommend that regulations provide a presumption that any modification results in a retroactive retesting of the DI for AHYDO purposes as of the original issue date of the DI taking into account the modified terms, and that if the redetermination causes the DI to be an AHYDO, the

determination should have retroactive effect to the issue date. For open tax years, the consequences should be the same as upon an audit adjustment. To the extent any deductions for OID were claimed in one or more closed tax years in excess of what would have been allowed under the AHYDO rules in those years (if any), we believe that the amount of improperly claimed OID deductions in such closed tax years should be recaptured as additional taxable income in the year of the retroactive retesting.

7. With respect to deferrals or modifications of so-called AHYDO "catch-up payments"[1] the regulations should provide that with respect to related lenders, any deferrals or modifications of the terms relating to catch-up payments should result in the DI being presumptively retested for AHYDO retroactively to its issue date based on the modified terms.

8. In the event of a "significant modification"[2] when a DI has accrued and unpaid OID, we believe regulations should clarify that after accrued OID on the new DI is deemed to be paid under the ordering rules of Treasury regulations section 1.1275-2(a)(1), payments that would otherwise be treated as paying down principal on the new DI should be treated as first paying down accrued OID on the old DI – *i.e.*, the accrued and unpaid OID on the old DI would "roll over" to the new DI and continue to be tracked going forward until deemed repaid.

9. Regulations should confirm that the yield for purposes of determining if a contingent payment debt instrument ("**CPDI**") is an AHYDO is the comparable yield of the CPDI under Treasury regulations section 1.1275-4(b)(4)(i). The Disqualified Fraction of a CPDI should be used for purposes of determining the amount of disqualified and deductible OID for accruals of OID under the projected payment schedule, including being applied to positive and negative adjustments, and repurchase premium and cancellation of debt income (if any), upon an early retirement of the CPDI, subject to a specific exception.

10. For purposes of determining the appropriate AFR to use with respect to variable rate debt instruments ("**VRDIs**") under the AHYDO rules, we believe that: (1) the three-month rule in section 1274(d)(2) and Treasury regulations section 1.1274-4(a)(1)(ii) should not apply, (2) regulations should explicitly state whether the rule of Treasury regulations section 1.1274-4(c)(2) (determining the term of a VRDI for purposes of determining AFR generally) also applies to determining AFR under the AHYDO rules, and (3) consistent with recommendation 3 above, regulations should clarify for purposes of determining such AFR, whether the presumptions in the OID rules (such as with respect to deemed exercise of puts and calls), or the last-day presumption in section 163(i)(3)(A) should be applied.

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1 Payments due and payable at the end of the first accrual period following the 5th anniversary of the DI (and each accrual period thereafter), which are designed to ensure a DI does not have any significant OID.

2 Within the meaning of Treasury regulations section 1.1001-3(e).

11. Guidance should affirmatively provide that for convertible DIs, the fact that the DI may be satisfied in stock upon the exercise of a conversion right does not cause the convertible DI to have an indefinite term for AHYDO purposes, and the conversion right is not taken into account for purposes of determining a convertible DI's yield for AHYDO purposes, same as under the OID rules.

12. For a qualifying DI that has been integrated with a hedge under Treasury regulations section 1.1275-6 (which can be treated as a single "synthetic" DI having the same cash flows as the combined cash flows of the DI and the hedge), the regulations should clarify that the synthetic DI is tested for AHYDO status by reference to the terms of the synthetic DI, and not by reference to any particular term of the component parts of the synthetic DI.

13. Regulations should include guidance providing that: (1) if a subordinated junior DI has a term less than five years plus one accrual period, or calls for an appropriately structured AHYDO catch-up payment, the ability of any senior DIs to prevent the junior DI from being paid according to its terms will not cause AHYDO classification, provided that certain standards are met – *i.e.*, a failure to pay the junior note would trigger an event of default or other material adverse consequences (such as an actionable breach) that would make the required payment "unconditionally payable" within the meaning of Treasury regulations section 1.1273-1(c), and (2) that reasonable "standstill" provisions pursuant to which a junior creditor has agreed with other lenders to wait a certain amount of time before pursuing remedies should not change this result.

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,

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Report No. 1366

New York State Bar Association Tax Section

Report on the AHYDO Rules of Sections 163(e)(5) and 163(i)

March 10, 2017

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Report No. 1366

New York State Bar Association Tax Section

Report on the AHYDO Rules of Sections 163(e)(5) and 163(i)

This Report[1] provides observations and recommendations for guidance concerning the Applicable High Yield Discount Obligation ("**AHYDO**") rules under sections[2] 163(e)(5) and 163(i). Congress promulgated these rules to address concerns about certain debt instruments ("**DIs**") that provided paid-in-kind ("**PIK**") interest and generated tax deductions for accrued, long-term original issue discount ("**OID**").[3] To prevent perceived abuses of the OID rules, Congress enacted the AHYDO rules in 1989 to defer (and in some cases partially disallow) deductions for OID on AHYDOs.

Due to the potential economic impact of possible suspension or disallowance of interest deductions, the potential classification of a DI as an AHYDO is a common concern of parties in borrowing transactions. Furthermore, because of the complexity of the AHYDO statutory provisions, and the lack of regulatory guidance, the application of the AHYDO rules can be unclear and complicated. This Report analyzes various ambiguities and challenges in applying the AHYDO rules and makes recommendations for regulatory guidance to be promulgated.

This Report is divided into three parts. Part I is a summary of our recommendations for guidance. Part II provides an overview of the AHYDO rules and some of the issues faced by taxpayers with the application of the AHYDO rules. Part III discusses the issues and recommendations in greater detail, identifying those areas where we believe the IRS and Treasury should consider issuing guidance and offering recommendations relating to such guidance.

I. SUMMARY OF OUR RECOMMENDATIONS

Below is a summary of our recommendations and requests for guidance. In general, we believe that the recommendations relating to whether a DI qualifies as an AHYDO are much more important than those that pertain to the operation of the

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[1] This Report was prepared by a working group led by Daniel Dunn, and composed of Tyler Arbogast, Lucy Farr, David Garlock, Kenneth Wang and Sara Zablotney, with helpful comments from Howard Adams, Andrew Braiterman, Michael Farber, Kathleen Ferrell, Stuart Goldring, Jeffrey Maddrey, Deborah Paul, Michael Schler, David Sicular, and Eric Sloan. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] All references in this Report to "section" and sections" are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or to the regulations issued thereunder, unless otherwise indicated. References to the "IRS" are to the Internal Revenue Service, references to "Treasury" are to the United States Department of the Treasury, and references to "Secretary" are to the Secretary of the Treasury.

[3] *See* H.R. REP. NO. 101-247, at 1220 (1989) (the "**1989 House Report**"); S. REP. NO. 101-56, at 51-52 (1989) (the "**1989 Senate Report**").

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AHYDO rules to a DI that is determined to be an AHYDO because AHYDO instruments are relatively rare in practice.

A. Request for Guidance on AHYDO Suspension in Distressed Capital Markets

We recommend that Treasury promulgate a rule under section 163(e)(5)(F)(iii) or 163(i)(1) that, upon the occurrence of certain economic triggers, would automatically suspend the effects of the AHYDO rules for qualifying exchanges of DIs, and limit the applicability of AHYDO for new DIs issued for cash.

B. Requests for Guidance on Qualification as AHYDO and Operation of AHYDO Rules

1. For purposes of determining (1) the maturity date of a DI under section 163(i)(1)(A) and (2) which accrual periods must be tested under the "significant OID" definition in section 163(i)(2), we recommend that the rules regarding the deemed exercise of puts and calls in Treasury regulations section 1.1272-1(c)(5) should not apply. Instead, the last-day presumption in section 163(i)(3)(A) should be operative even in the case of a DI with a put or call that would be presumed exercised under Treasury regulation section 1.1272-1(c)(5).

2. For purposes of determining if the yield on a DI exceeds the threshold of the applicable federal rate (**"AFR"**) plus 5% in section 163(i)(1)(B) and for purposes of calculating disqualified yield within the meaning of section 163(e)(5)(C)(ii), the regulations should specify whether (1) a DI's yield to maturity is its yield at issuance as determined under the OID rules (taking into account Treasury regulations section 1.1272-1(c)(5)) or (2) the last-day presumption in section 163(i)(3)(A) should be operative. If the latter approach is taken, the regulations should include an anti-abuse rule as a backstop. Furthermore, the AFR used to test for AHYDO status (and compute disqualified yield) for purposes of section 163(i) should be determined in a manner consistent with the determination of the yield.

3. For purposes of determining if a DI has significant OID, we believe that a DI's yield to maturity should be its yield at issuance as determined under the OID rules.

4. We recommend that the disqualified portion of a DI's OID should be based on a ratio of "disqualified yield" to "yield to maturity" (the "**Disqualified Fraction**") that remains fixed for the entire term of the DI, even if the issuer makes payments in a manner inconsistent with any presumption(s) used to determine the yield. We also recommend that regulations clarify the definition of "significant OID" under section 163(i)(2) to provide that the issue price and yield of a DI used for determining the product of the DI's issue price and its yield to maturity ("**Permitted Amount**") should be the original issue price, and should remain constant for the term of the DI.

5. We think it is appropriate generally to ignore remote and incidental contingencies for purposes of the AHYDO rules, other than for determining the maturity date of the DI.

6. With respect to modifications of DIs, if the borrower is related to the lender, we recommend the regulations provide a presumption that any modification, whether or not a "significant modification"[4] ("**Significant Modification**"), results in a retroactive retesting of the DI for AHYDO purposes as of the original issuance date of the DI taking into account the modified terms, and if the redetermination causes the DI to be an AHYDO, the determination should have retroactive effect to the issue date.

7. In the event retesting of a DI results in retroactive AHYDO status, for open tax years, the consequences should be the same as upon an audit adjustment (*i.e.*, any claimed OID deductions over what would be allowed under the AHYDO rules (if any) would be reversed out and any resulting increase in tax would have to be paid, together with interest for underpayment of tax to the extent applicable). To the extent deductions for OID were claimed in one or more closed tax years in excess of what would have been allowed under the AHYDO rules in those years (if any), we believe that the amount of improperly claimed OID deductions in those closed tax years should be recaptured as additional taxable income in the year of the retroactive retesting. In addition, it may also be appropriate in cases involving closed years to impose an interest charge similar to the interest charge on a tax underpayment.

8. With respect to deferrals or modifications of so-called AHYDO "catch-up payments"[5] we believe the regulations should provide that with respect to related lenders, any deferrals or modifications of the terms relating to catch-up payments should result in the DI being presumptively retested for AHYDO retroactively to its issue date based on the modified terms.

9. We ask that the regulations explicitly clarify that provisions that use a formula to calculate the amount of any catch-up payment based on the language in the statute, rather than setting forth a specific dollar amount, will be given effect for tax purposes, provided there are appropriate remedies for failing to make the AHYDO catch-up payment. Further, guidance should also clarify that a catch-up payment is deemed to be required to be paid when due notwithstanding any so-called "cure period" (a period that allows a payment default to be cured by a payment within a short date after the due date) so long as (1) the cure period is a reasonable amount of time and (2) the period is no longer than the cure period that applies for stated interest payments on the DI.

10. We recommend guidance be issued clarifying that upon a deemed reissuance of a DI for purposes of sections 1272 and 1273 if certain contingencies occur, the Disqualified Fraction, as of the issue date, should continue to apply to the new OID interest schedule resulting from the deemed reissuance.

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[4] *See* Treasury regulations section 1.1001-3(e).

[5] By this we mean payments due and payable at the end of the first accrual period following the 5th anniversary of the issue date of the DI (and each accrual period thereafter), that are designed to ensure a DI does not have any significant OID.

11. In the event of a Significant Modification of a DI that has accrued and unpaid OID, we believe regulations should clarify that after accrued OID on the new DI is deemed to be paid under the ordering rules of Treasury regulations section 1.1275-2(a)(1), payments that would otherwise be treated as paying down principal on the new DI should be treated as first paying down accrued OID on the old DI – *i.e.*, the accrued and unpaid OID on the old DI would "roll over" to the new DI and continue to be tracked going forward until deemed repaid.

12. We believe regulations should confirm that the yield for purposes of determining if a contingent payment debt instrument ("**CPDI**") is an AHYDO is the comparable yield of the CPDI under Treasury regulations section 1.1275-4(b)(4)(i). The Disqualified Fraction of a CPDI should be used for purposes of determining the amount of disqualified and deductible OID for accruals of OID under the projected payment schedule, and should also be applied to positive and negative adjustments. The Disqualified Fraction should also be generally applied to repurchase premium and cancellation of debt ("**COD**") income, upon an early retirement of the CPDI, except to the extent of COD income that arises from a retirement of the DI for an amount less than its original issue price.

13. For purposes of determining the appropriate AFR to use with respect to variable rate debt instruments ("**VRDIs**") under the AHYDO rules, we believe that: (1) the three-month rule in section 1274(d)(2) and Treasury regulations section 1.1274-4(a)(1)(ii) should not apply, (2) regulations should explicitly state whether the rule of Treasury regulations section 1.1274-4(c)(2) (determining the term of a VRDI for purposes of determining AFR generally) also applies to determining AFR under the AHYDO rules, and (3) consistent with section II.B.2 above, regulations should specify for purposes of determining the AFR whether the presumptions in the OID rules (such as with respect to deemed exercise of puts and calls), or the last-day presumption in section 163(i)(3)(A) should be applied.

14. We believe guidance should affirmatively provide that for convertible DIs, the fact that the DI may be satisfied in stock upon the exercise of a conversion right does not cause the convertible DI to have an indefinite term for AHYDO purposes. We likewise recommend that the conversion right not be taken into account for purposes of determining the yield to maturity of convertible DIs for AHYDO purposes, as under the OID rules.

15. For a qualifying DI that has been integrated with a hedge under Treasury regulations section 1.1275-6 (which can be treated as a single "synthetic" DI having the same cash flows as the combined cash flows of the DI and the hedge), we believe regulations should clarify that the synthetic DI is tested for AHYDO status by reference to the terms of the synthetic DI, and not by reference to any particular term of the component parts of the synthetic DI.

16. We believe the government should consider revisiting the anti-abuse rule described in Example 1 of Treasury regulations section 1.701-2(f), which treats a partnership as an aggregate of its partners for purposes of applying AHYDO to a DI

issued by the partnership. In particular, it would be helpful to provide for a minimum ownership threshold by a corporate partner before the rule would apply to DIs issued by a partnership.

17. We recommend regulations include guidance providing that: (1) if a subordinated junior DI has a term less than five years plus one accrual period, or calls for an appropriately structured AHYDO catch-up payment, the ability of any senior DIs to prevent the junior DI from being paid according to its terms will not cause AHYDO classification, provided that certain standards are met – *i.e.*, a failure to pay the junior note would trigger an event of default or other material adverse consequences (such as an actionable breach) that would make the required payment "unconditionally payable" within the meaning of Treasury regulations section 1.1273-1(c), and (2) reasonable "standstill" provisions pursuant to which a junior creditor has agreed with other lenders to wait a certain amount of time before pursuing remedies should not change this result.

C. Other Ambiguities for Which Guidance Is Requested.

1. If the disqualified portion of OID exceeds the total amount of OID for a particular period, we believe that the excess should be carried forward to successive periods until the disqualified portion is fully applied against the DI's OID.

2. With respect to timing of OID payments, we believe guidance should clarify that payments of OID will be allocated on a *pro rata* basis between accrued and unpaid deductible OID and the disqualified portion of OID.

3. We believe guidance should clarify that testing for significant OID occurs on the last day of each accrual period ending more than 5 years after the issue date and that a payment due on that date is taken into account in applying the test for that period (*i.e.*, is treated as a payment to be made "before the close" of the accrual period).

4. Finally, we believe it would be helpful if guidance could confirm that that the AHYDO rules do not apply to and do not take into account (1) debt issuance costs, notwithstanding Treasury regulations section 1.446-5, which generally treats debt issuance costs "as if" they were OID, and (2) repurchase premium under Treasury regulations section 1.163-7(c).

II. BACKGROUND

A. The AHYDO Rules Generally

Interest on a DI is a normally deductible expense under section 163. When a DI has interest that is not required to be paid in cash at least annually (*i.e.*, OID), deductions for such OID are allowed over the life of the DI on a constant yield-to-maturity basis.[6] To prevent debt issuers of very high-yield DIs from taking deductions for large amounts of accrued OID, Congress enacted the AHYDO rules in sections 163(e)(5) and 163(i) to

[6] Section 163(e).

defer (and in some cases disallow) OID deductions taken by AHYDO issuers.[7] The purpose of these rules was to limit the deductibility of interest on bonds Congress believed had a resemblance to equity.[8]

An AHYDO is a DI with (1) a term of more than five years, (2) a yield to maturity that equals or exceeds the AFR in effect for the calendar month of issuance plus five percentage points, and (3) "significant OID."[9] Section 163(i)(2) provides that a DI is treated as having significant OID if the aggregate amount which would be includible in gross income with respect to such DI for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date five years after the date of issue, exceeds the sum of the aggregate amount of interest to be paid under the DI before the close of such accrual period, and the product of the issue price of such DI (as defined in sections 1273(b) and 1274(a)) and its yield to maturity. In other words, "significant OID" generally occurs when the amount of accrued but unpaid OID at the end of an accrual period that occurs more than five years after the issuance is greater than the first year's yield on the DI.

If the yield of an AHYDO does not exceed the AFR by more than six percentage points, the issuer may take deductions for the full amount of the accrued OID when the OID is actually paid in cash. If the yield of an AHYDO exceeds the AFR by more than six percentage points, a portion of the OID with respect to the DI is not deductible at all.[10]

The statute provides specific authority for the Secretary to issue regulations modifying the AHYDO rules to carry out the purpose of those rules, including "in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of DIs, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes" of sections 163(e)(5) and 163(i).[11] In addition, the Secretary is granted the authority to issue additional regulations "to prevent avoidance of [the AHYDO rules] through the use of issuers other than C corporations, agreements to borrow amounts due under the DI, or other arrangements."[12]

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[7] *See supra* note 3.

[8] *See* H.R. REP. NO. 101-386, at 553 (1989) (Conf. Rep.) (the "**Conference Report**").

[9] Section 163(i).

[10] Section 163(e)(5)(C). Instead, consistent with the equity characterization of such amount, the disallowed portion of the OID is treated as a stock distribution for purposes of sections 243, 245, 246 and 246A, potentially allowing a corporate holder of the DI to claim dividends-received deductions.

[11] Section 163(i)(5)(A).

[12] Section 163(i)(5)(B).

B. Suspension of the AHYDO Rules and Statutory Authority to Grant Relief

Under the American Recovery and Reinvestment Act of 2009,[13] Congress temporarily suspended the application of the AHYDO rules for certain DIs (the "**2009 Suspension**").[14] The temporary AHYDO suspension was a welcome relief for debt issuers who were unable to modify or refinance debt in a depressed credit market without losing interest deductibility under the AHYDO rules. Under the temporary suspension, an AHYDO issued during the period beginning September 1, 2008 until December 31, 2009, in exchange for non-AHYDO debt, was not subject to the AHYDO rules.[15] Congress also provided the Secretary with the authority to reintroduce the suspension of AHYDO treatment for certain debt-for-debt exchanges in subsequent periods if the Secretary determined at any time that there were "distressed conditions in the debt capital markets."[16]

In addition to this authority to grant relief, the Secretary is given broad authority to issue regulations to further the purposes of the AHYDO rules and provide certain relief when there are "distressed conditions in the debt capital markets."[17] Under section 163(i)(1)(C), the Secretary may issue regulations permitting the use of a higher rate than the AFR in testing whether a DI's yield exceeds the AHYDO threshold if the higher rate is based on the same principles as the AFR and is appropriate for the term of the DI. The Secretary may also temporarily increase the yield threshold required to trigger AHYDO classification in light of distressed conditions in the debt capital markets.[18]

With one exception, regulations under the AHYDO rules have not yet been issued.[19] This Report requests guidance in areas that need clarification and provides proposals for new regulations to further the purposes of the AHYDO rules.

III. DETAILED ANALYSIS AND RECOMMENDATIONS

A. Proposal for AHYDO Suspension in Distressed Capital Markets

In the 2008-2009 financial crisis, interest rates on corporate bonds rose significantly relative to those on Treasury securities, as there was a "flight to safety" in

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[13] Pub. L. No. 111-5, 123 Stat. 115.

[14] Section 163(e)(5)(F)(i).

[15] *Id.*

[16] H.R. REP. NO. 111-16 (Conf. Rep.) (2009); Section 163(e)(5)(F)(iii).

[17] Section 163(i)(1)(C).

[18] *Id.*

[19] Treasury regulations section 1.163-7(d) is the sole AHYDO regulation to date.

the capital markets.[20] As a result, the AHYDO rules potentially impacted a much larger set of corporations than would have been affected in "normal" capital markets.

Because the AHYDO rules apply only to debt issued with significant OID,[21] debt that was newly issued for cash could potentially be structured so as to avoid being subject to the AHYDO rules. However, for corporations restructuring existing debt, the discounted prices at which the existing debt traded relative to their principal amount determined the issue price of the restructured debt, which meant that the "new" DI was often treated as having significant OID.[22] Corporations seeking to restructure their debt under these circumstances were often required to recognize large amounts of COD income upon the restructuring without benefiting from the entire amount of the corresponding OID deductions on the newly issued debt as a result of the AHYDO rules.

For example, assume a publicly traded "plain vanilla," non-AHYDO debt with a principal amount of $1,000 and a ten-year maturity was trading for a market price of $600 at the end of year three. If the issuer and the debt holders agreed to lower the interest rate in a way that resulted in a Significant Modification, absent an exception, the issuer would recognize COD income of $400[23] and the "new" debt would have OID of $400.[24] Assuming the "new" debt would have significant OID (as would be the case in this example and any other case in which the trading discount was large) and a high enough yield, a portion of the OID deductions would be deferred or possibly disallowed.

As described above, the 2009 Suspension provided a temporary suspension of the AHYDO rules during a limited time period for debt issued in exchange for non-AHYDO debt.[25] Although the legislative history does not provide detail as to Congress's intent in enacting the provision, presumably it reflected a recognition of the significant expansion of the scope of the AHYDO rules that resulted from the widening of corporate credit spreads relative to U.S. Treasury securities. Because the purpose of the AHYDO rules was to limit the deductibility of interest on bonds Congress believed had a resemblance to equity,[26] the purpose of the AHYDO rules would not be carried out by making a broad swath of the market, including investment grade bonds, subject to the AHYDO rules.

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[20] *See*, *e.g.*, Bryan J. Noeth & Radjeep Sengupta, *Flight to Safety and U.S. Treasury Securities*, THE REGIONAL ECONOMIST, July 2010, https://www.stlouisfed.org/publications/regional-economist/july-2010/flight-to-safety-and-us-treasury-securities (last visited Jan. 28, 2017).

[21] Section 163(i)(1)(C).

[22] Debt that is "traded on an established market" (*i.e.*, "publicly traded") that is issued in exchange for other debt has an issue price equal to its fair market value on the issue date. *See* Treas. Reg. § 1.1273-2(b)(1), (f).

[23] *See* Treas. Reg. § 1.61-12(c)(2)(ii); Section 108(e)(10).

[24] *See* Section 1273(a)(1); Treas. Reg. § 1.1273-1(a).

[25] Section 163(e)(5)(F) was enacted as part of the American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, § 1232(a), 123 Stat. 115, 341 (2009).

[26] *See* Conference Report, at 553.

The legislation included a corresponding provision allowing taxpayers to elect to defer COD income.[27]

The 2009 Suspension included section 163(e)(5)(F)(2)(iii), which authorizes Treasury to extend or return to a suspension of the AHYDO rules during subsequent time periods if Treasury determines it appropriate in light of distress in the capital markets. The legislation also added language to section 163(i)(1), (the definition of AHYDO), authorizing Treasury to permit, on a temporary basis, the use of a rate that is higher than the applicable federal rate if it determines that such rate is appropriate in light of distressed conditions in the debt capital markets.

In Notice 2010-11,[28] Treasury did in fact extend the temporary AHYDO suspension for an extra year, so that it applied to debt issued in 2010. The scope of the relief was largely the same as that provided by the legislation, in that it applied to debt issued in exchange for non-AHYDO debt, although Treasury added the condition that the new DI could benefit from this provision only if it would not otherwise be an AHYDO if its issue price were increased by the amount of any COD income realized by the issuer upon the exchange. Through this condition, Treasury essentially limited the relief to the case where restructured debt was within the AHYDO definition only because its value was depressed.[29]

We recommend that Treasury promulgate a rule under section 163(e)(5)(F)(iii) or 163(i)(1) that would automatically suspend the effects of the AHYDO rules upon the occurrence of certain economic triggers similar to conditions that prevailed in the recent financial crisis. While Treasury can always provide relief under section 163(e)(5)(F)(iii) or 163(i) on an ad hoc basis, there are a number of reasons to put an automatic rule in place that would operate without the need for subsequent action.

Such a rule would provide predictability and consistency for debt issuers and markets generally. Because such a rule would operate automatically, it avoids delays that would otherwise likely occur. The only significant downside of which we are aware regarding an automatic rule is that, if drafted too broadly, it could turn off the AHYDO rules in a manner not consistent with the underlying policy behind the AHYDO rules. Accordingly, the principal challenge is to craft a rule that applies only in genuine distressed market situations and not in other situations.

While there are a number of ways such a rule could operate, we believe that the simplest would be a trigger based on an appropriate spread in yields between corporate

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[27] *See* Section 108(i). The IRS and Treasury believed the deferral rules of section 108(i) were ". . . intended to facilitate debt workouts and to alleviate taxpayer liquidity concerns by deferring the tax liability associated with COD income." *See* Preamble to Treasury Decision 9497.

[28] 2010-4 I.R.B. 326 (Jan. 25, 2010).

[29] The relief would not apply, for instance, to debt issued in exchange for an existing AHYDO (including pursuant to a Significant Modification of any existing AHYDO) or to debt issued for non-AHYDO debt that was trading for its par value at the time of the exchange. In the latter case, the OID on the new debt would presumably have arisen because of a particular feature of the new debt, such as PIK interest.

bonds and Treasury securities published by the Federal Reserve Bank. For instance, a prevailing spread between Treasury securities and bonds that are at the lower end of the investment grade spectrum (for example, bonds rated BBB by Standard & Poor's) that is greater than five percentage points would seem to be an indication that the AHYDO rules are applying to an overly broad set of DIs. In the last approximately twenty years, this condition would have been present only between September 2008 and May 2009, based on data made available by the Federal Reserve Bank of St. Louis.[30] It therefore would seem to be a good indicator of serious distress in the capital markets.

The IRS could obtain and publish monthly data (for example, along with the applicable federal rate) regarding the market credit spread between the lowest category of bonds deemed by the major credit rating agencies[31] to be investment grade and Treasury securities of a comparable tenor based on information reported by the Federal Reserve Bank.[32] Assuming this spread is adopted, then, if, in the course of the previous month, the spread were greater than five percentage points for ten or more trading days during the month, the AHYDO rules could be suspended automatically until the next month in which the spread is greater than five percentage points on fewer than ten of the trading days in the month.

In general, we believe that relief should take the form of a suspension of the AHYDO rules, which would be consistent with the 2009 Suspension. However, if there are concerns about whether Treasury has authority to create a suspension rule that is broader than that in section 163(e)(5)(F)(i), an alternative approach would be to increase the AHYDO threshold as authorized by section 163(i)(1)(C), for example by one percentage point if the BBB/Treasury spread reported by the Federal Reserve Bank is in excess of five percentage points, and for another percentage point for every additional percentage point by which the BBB/Treasury spread exceeds five percentage points (the "**Increased Threshold Approach**").

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[30] BofA Merrill Lynch, BofA Merrill Lynch US Corporate BBB Option-Adjusted Spread © (BAMLC0A4CBBB), Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/BAMLC0A4CBBB, (last visited Jan. 30, 2017). An alternative trigger could be based on the "TED Spread," the spread between three-month Treasury bills and three-month LIBOR, which in the last thirty years has generally been below 1.5% other than in 1987 and for periods in 2007-2008. Federal Reserve Bank of St. Louis, TED Spread (TEDRATE), Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/TEDRATE (last visited Jan. 28, 2017).

[31] There is existing precedent in the Code for the government relying on privately published rates. *See*, *e.g.*, Section 264(e)(2)(B) (reliance on Moody's for determining the cap on interest deductions for DIs with respect to a life insurance, annuity, or endowment contract covering a key person).

[32] Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111–203, 124 Stat. 1376 ("**Dodd-Frank**") required federal agencies to review issued regulations that required an assessment of the credit-worthiness of a security or money market instrument to remove any reference to or requirement of reliance on credit ratings, and instead to substitute new standards of credit-worthiness as the agency determines is appropriate. While outside the scope of this Report, it did not appear to us that this proposal would implicate concerns under section 939A(b) of the Dodd-Frank because the proposal does not refer to any determination of creditworthiness, but appropriate agencies tasked with interpreting the statute should be consulted for confirmation.

A further question arises as to whether the AHYDO suspension should apply only to debt issued in exchange for non-AHYDO debt, as it did in the 2009 Suspension, or more broadly to all debt (*e.g.*, new debt issued for cash).

Certainly, debt issued in exchange for non-AHYDO debt presents the most sympathetic case, in that the combination of the COD and AHYDO rules means that the corporation, already in distress, effectively suffers a non-economic tax. Moreover, an issuer may have no choice but to issue "new" debt with OID as a result of the distressed price of its bonds and the need for a restructuring as a way to alleviate its debt burden. These concerns would not necessarily apply to other debt, such as new debt issued for cash. Accordingly, it is not clear whether it would be appropriate to suspend the AHYDO rules more broadly with respect to all debt.

However, we believe some form of relief should be provided to new debt issued for cash. First, if the principle underlying relief in the form of AHYDO suspension is that wide credit spreads are not an accurate indicator of a DI being akin to equity, that principle should apply equally to debt issued for cash as well as debt exchanged for other debt. Second, giving no relief to debt issued for cash would disadvantage corporations that are entering the debt capital markets for the first time as compared with corporations that already have debt outstanding; it would also create incentives for corporations to use their existing debt as a vehicle for an "exchange" into new debt (*e.g.*, by having an investment bank buy up the existing debt and exchange it with the corporation for new debt). Finally, for publicly traded debt, the OID rules generally provide consistency of treatment between debt issued for cash and debt issued in exchange for other debt, and we view it as desirable generally to adhere to this principle by providing AHYDO relief to both types of debt. For these reasons, in distressed market situations, we recommend increasing the threshold in section 163(i)(1)(B)(ii) (the yield used to test for AHYDO status) with respect to new debt issued for cash in the manner consistent with the Increased Threshold Approach described above. Given the broad grant of authority under section 163(i),[33] we believe that the Treasury would not be exceeding its authority in increasing the AHYDO threshold with respect to debt that would otherwise not qualify for the proposed AHYDO suspension.

B. General Application of AHYDO Principles

1. Yield to Maturity and Related Matters

The AHYDO statute uses the concept of "yield to maturity" in three places: (1) in determining whether a DI is an AHYDO, section 163(i)(1) compares the yield to maturity

[33] As previously mentioned, section 163(i)(1)(C) permits the Secretary to issue regulations authorizing the use of a different rate from the rate prescribed in section 163(i)(B)(i) (the relevant AFR in the month a DI is issued plus 5%) for purposes of testing whether a DI is an AHYDO, which authority does not appear to be limited to DIs issued in exchange for non-AHYDO debt. Additionally, section 163(i)(5) seems to grant broad power to prescribe regulations modifying the provisions of sections 163(e)(5) and (i) in a variety of situations, including to address "other circumstances where such modifications are appropriate to carry out the purposes of [section 163(i)] and subsection (e)(5)." *See* Section 163(i)(5)(A).

on the DI to the AFR, (2) in determining the disqualified yield, section 163(e)(5)(C)(ii) again compares the yield to maturity to the AFR, and (3) for purposes of determining whether a DI has "significant OID," section 163(i)(2)(B)(ii) refers to the product of the DI's issue price and its yield to maturity. Also, for this same purpose, the parties must determine the accruals on the DI, which are computed using the DI's yield to maturity.

Yield to maturity is not defined in the Code, even for purposes of the OID rules. Treasury regulations section 1.1272-1(b)(1)(i) and (c) provide rules for determining yield to maturity for purposes of determining the accrual of OID, but these rules are not by their terms applicable for AHYDO purposes.

"Yield to maturity" is a finance concept; its application is not limited to tax. Even the rules governing issuer calls and holder puts in Treasury regulations section 1.1272-1(c)(5) are based on finance principles – borrowers generally can be expected to minimize their borrowing costs and lenders can be expected to maximize their rate of return. Accordingly, one would generally expect that the yield to maturity rules in the OID regulations would be applicable for AHYDO purposes.

Nevertheless, guidance is needed for two reasons. First, section 163(i)(3)(A) provides that, for purposes of determining whether a DI is an AHYDO, any payment under the DI is assumed to be made on the last day permitted under the DI. This rule is inconsistent with the put and call rules in Treasury regulations section 1.1272-1(c)(5), which can deem a DI to mature on a put or call date for the put or call price in determining yield to maturity for OID purposes. Second, the purposes of the OID and AHYDO rules are somewhat different, which might justify differences in the way yield to maturity is determined for the two purposes, but there is no guidance reconciling the two regimes.[34] Section 163(i)(5) authorizes Treasury to issue regulations to deal with, among other items, puts and calls.

Assumptions Regarding Puts and Calls

We believe that, in view of the express language of section 163(i)(3)(A), the put and call rules of Treasury regulations section 1.1272-1(c)(5) should not apply for purposes of determining (i) the maturity date of the DI under section 163(i)(1)(A), and (ii) which accrual periods must be tested under the significant OID definition in section 163(i)(2). We believe the purposes of the AHYDO rules are best served, and potential abuses best avoided, by leaving the last-day presumption of section 163(i)(3)(A) operative even in the case of a DI with a put or call that would be presumed exercised under the OID regulations. Ignoring the put and call rules of Treasury regulations section 1.1272-1(c)(5) would require the maturity date and accrual periods to be determined for AHYDO purposes based on the actual facts at issuance, without taking into account hypothetical future events that may (or may not) occur. We believe this is consistent with

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[34] *See* Jiyeon Lee-Lim & Y. Bora Bozkurt, *Relevance of the OID Principles in Applying the AHYDO Rules*, TAX NOTES, June 17, 2013, pp. 1399-1400 [hereinafter Lee-Lim].

the general requirement under section 163(i) to test a DI for AHYDO status at issuance, and the express language of section 163(i)(3)(A).

Yield to maturity is also relevant for purposes of applying the yield test of section 163(i)(1) (comparing the yield to the AFR plus 5%) and computing the disqualified yield under section 163(e)(5)(B)(ii) (defined as the excess of the yield over the AFR plus 6%). Here, the policy considerations are more ambiguous. Consider, for example, a DI issued for its face amount and that permits the issuer in each accrual period to pay interest in cash at a rate of 10% or pay in kind at a rate of 11% (a **"PIK Toggle Note"**). Under Treasury regulations section 1.1272-1(c)(5), the issuer is presumed to exercise its right to pay in cash at every opportunity because doing so results in a lower yield to maturity. It is not clear, however, that this presumption should permit the issuer to use the lowest possible yield (*i.e.*, the cash-pay yield) for purposes of the AFR plus 5% and AFR plus 6% tests.

On the other hand, in determining whether a DI is a "high-yield" obligation of the type that Congress was targeting in the AHYDO rules, it is arguable that the yield determined under the presumptions in the OID regulations is the appropriate measure. While abuses are theoretically possible, a borrower generally cannot obtain the consent of the holder to an issuer call right that will decrease the yield on the debt instrument without being compensated for that right in the form of an up-front fee or a materially higher interest rate.[35] Also, we think that the regulatory authority granted by Congress in section 163(e)(5)(A) is broad enough to override section 163(i)(3)(A) in the case of issuer call rights (*i.e.*, to deviate from the last-day presumption).[36]

Furthermore, a rule that always applies section 163(i)(3)(A) and ignores all issuer calls and holder puts would allow easy avoidance of the AHYDO rules. For example, suppose the parties wished to issue a seven-year PIK DI with a yield of 10%. The AFR is 3%, so this DI would be an AHYDO. If the issue price and stated principal amount of the DI are 100, the redemption price would be approximately 198 (assuming semiannual compounding). Instead, the parties issue a ten-year DI for 100 with no current interest payments, maturing for 198 and with a holder put at 198 after seven years. If the holder put were ignored, the DI would be tested with a ten-year maturity, and the yield on the DI would be 6.95%, which is below the threshold of AFR plus 5%. Thus, if the regulations take the approach of applying section 163(i)(3)(A) for these purposes, an anti-abuse rule will be necessary as a back-stop.

Given these competing considerations, we have not reached a consensus on which approach we would recommend to be taken. However, we believe this is an important issue that warrants further consideration and on which the regulations should provide guidance.

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[35] However, we would not object to an anti-abuse rule for related party loans if that would provide comfort in alleviating concerns about any potential for abuse in the related lender context.

[36] We think the authority also exists to deviate from the last-day presumption in the case of PIK Toggle Notes and to follow the presumption applicable under the OID regulations.

However this issue is resolved, we believe that the AFR used to test AHYDO status (and compute the disqualified yield) should be determined consistently. For example, suppose a ten-year DI has an issuer call that be may be exercised on or after the third-anniversary. If the call right is deemed exercised under the OID rules and if the OID rule is used for AHYDO testing purposes, then the relevant AFR for this DI would be the mid-term rate. On the other hand, if the AHYDO test is based on the yield to the final maturity (either in all cases or just in cases of calls that are presumed not exercised under the OID rules), the long-term rate should be used.

A subsidiary issue is whether the Disqualified Fraction should change if there is a change to the yield on the instrument from the initial yield used to determine the Disqualified Fraction, but that is not a Significant Modification. Pursuant to section 163(e)(5)(C), the calculation of the Disqualified Fraction depends on the DI's yield.[37] Thus, the Disqualified Fraction of a DI's OID arguably needs to be recalculated upon a change in yield.

Note that this issue arises whether the initial Disqualified Fraction is based on the OID rules or the last-day presumption of section 163(i)(3)(A). In the PIK Toggle Note example above, if the OID presumption is used to determine the initial Disqualified Fraction and the issuer elects to PIK on the first interest payment date (which is contrary to the OID presumption), the yield increases for the remaining term of the DI, and arguably the Disqualified Fraction should be recomputed. Conversely, if the last-day presumption is used and the issuer elects to make one or more interest payments in cash, the maximum yield for the debt is reduced and arguably the Disqualified Fraction should also be reduced.

We recommend that the regulations adopt the simple rule that the disqualified portion is based on a ratio of disqualified yield to total yield that is fixed at the time of original issuance. A rule that requires a recomputation of disqualified yield, and hence the Disqualified Fraction, upon each change in yield would be quite difficult to draft and to apply. This concern is especially relevant to instruments with both OID and qualified stated interest, because the computations depend on the total amount of OID on the instrument as well as the total return on the instrument (QSI and OID). Properly applying different Disqualified Fractions to different periods is possible, but in our view would add more complexity to the regulations than is warranted.

The last AHYDO issue for which yield is relevant is the significant OID test in section 163(i)(2). For this purpose, we believe that a DI's yield to maturity should be its yield at issuance as determined under the OID rules, including Treasury regulations section 1.1272-1(c). This seems clearly correct because the test explicitly references OID principles. The test should be based on the OID that actually accrues on the DI, not a hypothetical amount of OID that might be based on a higher or lower yield.

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[37] The disqualified portion is calculated based on the "disqualified yield," which is defined as the excess of the DI's yield over the AFR plus 6%. *See* Section 163(e)(5)(C)(ii).

We would also suggest guidance on the following technical point in applying the significant OID test. If a put or call is deemed exercised for purposes of the OID rules, but that deemed exercise would occur before the first relevant testing date under section 163(i)(2) for determining a DI's amount of significant OID,[38] (1) the put or call should be treated as if it would be exercised for determining OID accruals up to the put or call date and (2) the DI should be deemed reissued and its yield redetermined under the rules of Treasury regulations section 1.1272-1(c)(6) for purposes of computing the OID accruals after the put or call date as if the put or call had not been exercised.

By way of example, suppose a seven-year DI has a call option that may be exercised on the third anniversary of the issue date (and is deemed exercised under the OID rules). To determine significant OID: (1) the OID deemed to accrue during the first three years would be calculated under the OID rules assuming the call would be exercised and (2) the OID deemed to accrue from the beginning of year 4 through the close of the first accrual period ending after the five-year anniversary would be calculated assuming the call were not exercised and the DI were deemed reissued pursuant to Treasury regulations section 1.1272-1(c)(6).

Finally, for purposes of the definition of "significant OID" under section 163(i)(2), we recommend that regulations clarify that the issue price and yield used for determining the Permitted Amount should be the original issue price and should remain constant for the term of the DI. Thus, for example, the Permitted Amount (and hence the amount of a required AHYDO catch-up payment) should not change as a result of a deemed reissuance under Treasury regulations section 1.1272-1(c)(6).

Remote and Incidental Contingencies

Treasury regulations section 1.1275-2(h)(1) provides that for purposes of the OID rules, remote and incidental contingencies are disregarded. The regulations provide that this rule is applicable for all purposes of section 163(e) other than section 163(e)(5).

We can think of no substantive reason why contingencies that are ignored for other tax purposes should be taken into account under the AHYDO rules. The one possible exception could be for purposes of determining the maturity date of the DI for purposes of section 163(i)(1)(A) (the last-day presumption) . However, while section 163(i)(3)(A) could be read to require all contingencies be taken into account, and we think such an approach applies appropriately to puts and calls (as discussed above), we think it is appropriate to ignore remote and incidental contingencies for purposes of determining the maturity date. To do otherwise creates significant disconnect between the AHYDO rules and other tax regimes (including, but not necessarily limited to, the OID rules) and ignores the purposes for ignoring such contingencies in those regimes.

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[38] An example where this would be relevant is a DI that matures in eight years and has one-year accrual periods, and as to which the issuer has a call right starting from the second anniversary of the issue date. The call right is presumed to be exercised under the OID rules. As a result, the first relevant date for determining whether the DI has significant OID under section 163(i)(2) (the end of the first accrual period after five years) will occur after the call is deemed exercised under the OID rules.

Because the contingencies at issue are by definition remote or incidental, the potential for abuse is extremely limited. Moreover, it is not at all clear how a remote or incidental contingency would be taken into account under the AHYDO rules, given that the payment is contingent. Therefore, we recommend that Treasury regulations section 1.1275-2(h)(1) be amended to remove the exclusion for the AHYDO rules.

2. Testing for AHYDO Status in Connection with Debt Modifications

A Significant Modification is treated as an exchange of the original (*i.e.*, unmodified) DI for a new DI (as modified).[39] For this purpose, a modification includes any alteration, whether in whole or in part, of a legal right or obligation of the issue or holder under the DI, other than an alteration that occurs by operations of the terms of the DI.

A modification of a DI can implicate the AHYDO rules.[40] For example, in the event of a Significant Modification, the new DI deemed to have been issued would be tested under the AHYDO rules to determine if the new DI were an AHYDO. If the remaining term of the "new" DI were less than five years and one accrual period, then under current law the DI would avoid AHYDO status. Thus, a DI could change from an AHYDO to a non-AHYDO, or vice versa, as the result of a Significant Modification.

Even a modification that is not a Significant Modification could raise a question about whether a DI should be re-tested as an AHYDO. For example, assume a non-AHYDO debt instrument were modified to allow deferral of payments, but the deferral did not result in a Significant Modification. Assume further that, if the DI had been tested upon the date of original issuance, but using the payment schedule resulting from the modification, that the DI would have been an AHYDO. Given that the Significant Modification rules treat the DI as the same DI as originally issued, the conventional view would be that the DI would not be retested.

We believe that where the lenders are not related to the borrower, any modification to a DI is a commercial transaction that would presumably occur as a result of arm's length bargaining. As a result, at the time a DI is issued to unrelated lenders, there can be no assurance that the borrower could secure an amendment, and any modification would also be on arm's length terms. Any meaningful opportunity for abuse seems unlikely or remote under such circumstances. Accordingly, we recommend that the regulations specifically provide that any modification of a DI between a borrower and unrelated lenders should not cause a retroactive retest of the DI's status as an AHYDO to the original issue date.

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[39] Treas. Reg. § 1.1001-3(b).

[40] Commentators and practitioners alike have struggled with the application of the AHYDO rules in situations where the terms of DIs are modified. *See*, *e.g.*, Lee-Lim, *supra* note 34, at 1402; David C. Garlock & Matthew Urbina, *Modifications of Debt Instruments and the High-Yield Discount Obligation Rules*, TAXATION OF FINANCIAL PRODUCTS, Summer 2003, at 14-16.

In instances where the borrower is related to the lender(s), we believe there may be greater concern because upon the date of issuance, the DI can be structured with terms that would not cause the DI to be an AHYDO, but with the knowledge that later modifications could be made if needed or if desirable. However, where a modification is made in connection with circumstances that were not reasonably foreseeable at the time the DI was originally issued, the parties should be permitted to show that they did not intend or expect to make the relevant modification. For example, if the modification is occurring because the borrower is insolvent or nearly insolvent, or there are regulatory constraints that were not applicable at the time the DI was issued that make it difficult or impossible for the borrower to comply with the DI terms, it is difficult to see any meaningful opportunity for abuse resulting from a modification.

Accordingly, we recommend that where the borrower is related to the lender(s), the regulations provide a presumption that a modification (whether a Significant Modification or otherwise) results in a retroactive retesting of the DI for AHYDO purposes to the original issuance date of the DI, taking into account the modified terms, and if that determination causes the debt instrument to be an AHYDO, the determination should have retroactive effect to the issue date. The regulations should further provide that the presumption can be rebutted if the taxpayer can demonstrate that the modification was not reasonably foreseeable at the time the DI was issued. Examples include: (1) an unanticipated default on another loan that prohibits a payment on the DI being modified, (2) the issuer has become insolvent, (3) where the issuer and/or lender are subject to intervening regulatory constraints preventing them from engaging in transactions or economic arrangements (including modifying existing arrangements) that are not on an arm's length basis, and (4) the occurrence of other challenging circumstances that were unforeseen at the time the DI was issued.

Finally, we believe the standards for relatedness under sections 267 and 707 would be appropriate for determining whether a borrower and its lender(s) are related for these purposes.

3. DIs Retroactively Characterized as AHYDOs

As described above, in certain circumstances, we believe it would be appropriate to retest a DI for AHYDO status retroactively to the issue date, *e.g.*, if the DI is issued to a related lender and is later modified, and the borrower cannot rebut the presumption that the DI should be retested.[41] If such a retest causes a DI to become an AHYDO retroactive to the date it was issued, a question arises as to what the consequences should be. Depending on the terms of the AHYDO, a portion of the OID deductions may have been required to be deferred, or completely disallowed,[42] but deductions likely would have already been claimed for the OID reported in prior tax years. Further, depending on

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[41] We also recommend such retroactive testing in circumstances where "catch-up payments" are not made when due to related lenders. *See* Section III.B.4. of this Report, *infra*.

[42] Section 163(e)(5).

when the retest occurs, one or more of the prior tax years might be closed by the statute of limitations.[43]

For any open tax years, we believe the consequences should be the same as upon an audit adjustment. Thus, any claimed OID deductions over what would be allowed under the AHYDO rules (if any) would be reversed out and any resulting increase in tax would have to be paid, together with interest for underpayment of tax, to the extent applicable.

We believe that to the extent deductions for OID were claimed in one or more closed tax years in excess of what would have been allowed under the AHYDO rules in those years (if any), an aggregate amount of all such improperly claimed deductions should be recaptured as additional taxable income in the year of the retroactive retesting.[44] For example, suppose a DI is retroactively determined to be an AHYDO with a Disqualified Fraction of 20% and OID of $100 was deducted in one or more closed years. Because $100 was improperly deducted in the closed year(s), the $100 deduction would be recaptured as additional taxable income of the issuer in the year of the retroactive determination. Subsequently, the issuer would be able to deduct up to $80 of this OID in later tax years as the OID is actually paid, but no deduction would be permitted for the other $20, which represents the disqualified portion of this OID.

In addition, it may be appropriate in cases involving closed years to impose an interest charge similar to the interest charge on a tax underpayment. However, the proper computation of such an interest charge would be rather difficult and the complexity may not be worthwhile given the limited applicability of this rule.

4. AHYDO "Catch-Up" Payments

In order to qualify as an AHYDO, a DI must have significant OID. A DI will have significant OID for this purpose if at the end of the first accrual period following the five-year anniversary of the DI's issue date and thereafter: (i) the aggregate amount of accrued and unpaid interest and OID on the DI includible in income exceeds (ii) the Permitted Amount. As a result, a DI will not be an AHYDO if payments (so-called "catch-up payments") are required to be made on the DI such that the aggregate accrued and unpaid interest and OID on the DI never exceeds the Permitted Amount from and

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[43] Section 6501. Absent fraud or substantial understatement of income, a taxable year stays open for federal income tax purposes for three years from the later of the due date of the tax return for such year or the date such tax return is actually filed. By way of example, suppose a DI is retested for AHYDO status on the fifth anniversary of the issuance. Even if the DI were to be audited immediately upon the filing of the return for the year including the fifth anniversary, the first taxable year the DI was outstanding might well be closed.

[44] Alternatively, such recapture could occur in the earliest open tax year.

after the end of the first accrual period following the five-year anniversary of the issue date.[45]

In practice, it is common for a DI that would otherwise be an AHYDO to avoid AHYDO status by requiring a payment at close of the first accrual period ending after the fifth anniversary of the DI to reduce the accrued and unpaid OID to the Permitted Amount and then, if there are additional testing dates, to make a payment at the end of each subsequent accrual period equal to the total interest and OID that accrues during that period.[46] If a DI requires catch-up payments, the DI should not be considered an AHYDO as long as failure to pay would trigger a default or such payments are otherwise unconditionally payable within the meaning of Treasury regulations section 1.1273-1(c)(1)(ii).

However, as discussed below, there are a number of potential issues that may be implicated by the use of catch-up payments, and we believe it would be helpful for guidance to address some of these situations, particularly those involving related-party lenders.

Modifications of Catch-Up Payment Provisions

When a catch-up payment becomes due, an issuer has three options: (1) pay the required amount (which can be substantial depending on the terms of the DI), (2) default under the DI by failing to the pay the required amount, or (3) request that lender agree to defer or otherwise modify the payment. The first two options clearly have economic significance and should not require any further evaluation under the AHYDO rules. Hence, we will focus on a negotiated deferral of a catch-up payment.

Under current law, any deferral or modification of catch-up payment provisions would require the DI to be retested for AHYDO purposes only if the modification rises to the level of a Significant Modification. If the deferral or other modification is a Significant Modification, it would result in an exchange of the "old" DI for the "new" DI (as previously described).[47] The new, modified DI is generally considered to be a new DI for federal income tax purposes and, accordingly, should be retested under the AHYDO rules based on its new terms (including the modified catch-up payment provisions) and new issue date.[48] As discussed above concerning debt modifications, we believe this is

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[45] Because AHYDO status is tested at issuance, these payments would need to be required as part of the original terms of the DI.

[46] Because the test for significant OID only applies to accrual periods ending after the five-year anniversary of the DI's issue date, such DI's typically provide for a balloon payment of an amount of unpaid interest and OID necessary to avoid significant OID and AHYDO classification that is due before the end of the first applicable accrual period (instead of ratable payments over the entire life of the DI starting from day-one).

[47] Treas. Reg. § 1.1001-3(b).

[48] We acknowledge that in most such cases, the new, modified DI would have less than 5 years before maturity, and thus would not be an AHYDO upon retesting. Nonetheless, the commercial consequences to

appropriate with respect to unrelated lenders. If the deferral or modification is not a Significant Modification, and the DI is held by unrelated lenders, we similarly believe no anti-abuse rule is necessary because the issuer seeking to defer such payment would typically be required to make meaningful economic concessions as part of an arm's-length negotiation in order to secure lender's consent.[49]

However, where the issuer and lender are related,[50] it would be much more difficult to determine whether the lender intends to extract meaningful economic concessions from the issuer in exchange for deferring catch-up payments. In many related-party lender situations, we believe there would be significant risk of abuse. And, it would be difficult, if not impossible, to formulate a reasonable objective standard to determine if a deferral or other modification of a catch-up payment otherwise required to be paid by an issuer to a related-party lender was appropriately bargained for between the parties.

Accordingly, we believe guidance should be issued providing that any deferral or other modification of the catch-up payments vis-a-vis a related-party lender should presumptively be retested for AHYDO retroactively to its issue date, based on the original terms of the DI at the time it was issued, but treating the instrument as if it called for the catch-up payment on the extended payment date. This is consistent with our recommendation in section III.B.2. above for extensions of the maturity date of a DI. The same standards for when a taxpayer is able to rebut the presumption as in that recommendation should apply here.

We also believe the same approach for applying retroactive testing in the case of modifications to related-party DIs, discussed above in section III.B.3., should apply in the case of retroactive testing when catch-up payments are deferred in the related lender context.

Formula AHYDO Catch-Up Payments

Most DIs that rely on AHYDO catch-up payments to avoid being treated as AHYDOs utilize a formula clause for the amount of the payment based on the language in the statute, rather than setting forth a specific dollar amount that must be paid on the testing date. A typical formula clause might read something like: "In addition to any other payments required under this debt instrument, the borrower is required to pay on each Testing Date the amount (if any) necessary to reduce the excess of the accrued interest and OID as of the Testing Date over the total payments through the Testing Date

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an issuer inherent in such deferrals or modifications should be sufficient to prevent abuse where the lender is not related.

[49] The form of such concessions would likely vary depending on the lender(s) and the size of the catch-up payment that would otherwise be required to be paid, but would likely include an increase in rate, additional covenants and/or payment of an additional amount in the form of a consent fee.

[50] Consistent with other proposals described earlier in the Report, our consensus is that a lender should be considered a related-party if such lender bears a relationship to the issuer that is described in section 267(b) or 707(b)(1).

to the Permitted Amount," with appropriate definitions of "Testing Date" and "Permitted Amount." Some DIs might also say more simply that the amount required to be paid on each Testing Date is the minimum amount required to keep the instrument from being an AHYDO.

Practitioners use formula catch-up clauses for three basic reasons. First, the computation of the AHYDO catch-up amount can be difficult. A significant component of the calculation is determining the Permitted Amount, *i.e.*, the product of the DI's issue price and its yield to maturity. As discussed previously in this Report, currently it is not always clear how yield to maturity should be determined for purposes of section 163(i), and using different assumptions can result in different yields for the same DI.[51] Furthermore, in the case of a DI issued for a price that differs from its stated principal amount, the catch-up payment affects the DI's yield and thus the Permitted Amount, hence requiring an interrelated computation. While these computations must be done eventually, it is often difficult to accomplish this in the compressed time frame within which documents are drafted for borrowing transactions.

Second, in the case of PIK Toggle Notes and certain DIs with put or call rights that are presumed not exercised under the OID rules, the amount of the AHYDO catch-up payment will depend on whether the cash or PIK option, or put or call right is exercised. In these cases, it is impossible to specify the amount of the catch-up payment in dollar terms.[52]

Third, if a DI specifies a dollar amount for a catch-up payment and there is an error in the calculation that results in too low an amount being specified, even by a trivial amount, the DI has significant OID and therefore has not successfully avoided the AHYDO rules. Formula clauses protect against this risk.

Most practitioners are comfortable that formula AHYDO catch-up clauses are effective. Nevertheless, because this is such an important issue, we ask that the regulations explicitly state that a formula catch-up clause will be given effect for tax purposes, provided there are appropriate remedies for failing to make the AHYDO catch-up payment, as discussed elsewhere in this Report.

We recognize that the IRS may have some concern that the parties to a DI might not take a formula catch-up clause as seriously as a requirement to make a specified dollar payment on a specified date. The concern may be heightened by the fact that the clause is inserted primarily if not exclusively for tax reasons, and because the lender generally has not bargained for the payment right, it may not be inclined to enforce the right vigorously.

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[51] These uncertainties would be considerably reduced if the proposals described in section III.B.1 of this Report clarifying the calculation of yield for AHYDO purposes are adopted.

[52] Theoretically, one could specify the catch-up payment amount for each possible combination of cash-pay and PIK options on each payment date, but this would require thousands or even millions of possible payment amounts.

Nevertheless, once an AHDYO catch-up clause is included in a DI with appropriate remedies for nonpayment, it is an enforceable right, and a borrower who disregards a payment obligation under a DI it has issued does so at genuine risk. A payment default on one DI typically constitutes an event of default on all DIs issued by the same issuer, which generally accelerates the due date of those DIs. This can cause a serious financial problem for the issuer. Moreover, a lender on a DI with an AHYDO catch-up clause may well wish to enforce the clause, even if it did not bargain for it and even if it was inserted into the DI for tax reasons. In our view, these considerations justify respecting AHYDO catch-up clauses, even when expressed in terms of a formula.

We considered whether an additional test should be applied based on whether the issuer actually makes the AHYDO catch-up payment of the proper amount. We believe such a test is inappropriate in the case of an unrelated borrower and lender. As stated elsewhere in this Report, the test for whether a DI is an AHYDO is made at the time of issuance, and a retroactive recharacterization of a DI as an AHYDO based on the conduct of the parties should be limited to cases with a meaningful potential for abuse, specifically, DIs between related parties.

In the case of related parties, we think that the same rules described above regarding modifications of catch-up payment provisions should apply. That is, if the debtor fails to make a required AHYDO catch-up payment when due, there should be a rebuttable presumption that the DI is retested under the AHYDO rules from its original issue date as if the DI did not contain the AHYDO catch-up provision.

When a Catch-Up Payment Is Required to Be Made

If our proposals described above with respect to catch-up payments are accepted, guidance should also be issued clarifying that under section 163(i)(3)(A), any catch-up payment on a DI is deemed to be required to be paid when due, notwithstanding a so-called "cure period" (a period that allows a payment default to be cured by a payment within a short period after the due date) so long as (i) the cure period is a reasonable amount of time (*e.g.*, thirty days from the original due date) and (ii) the period is no longer than the cure period that applies for stated interest payments on the DI.

Without such a rule, we are concerned that catch-up payment provisions may not be effective to prevent a DI from being considered an AHYDO if the DI has such a cure period that would apply to any catch-up payments (or the due date for the catch-up payment would have to be backed up so that the cure period ends on the AHYDO testing date).

For example, suppose a DI has a one-year accrual period and a thirty-day cure period. Absent valid catch-up payment provisions, the DI would be an AHYDO under section 163. Under section 163(i)(3)(A), any payment required to be made under a DI is assumed to be made on the last day permitted under the instrument (the "**Last Day Rule**"). The first catch-up payment is due on or before the six-year anniversary of the issue date because the DI has an accrual period of one-year. However, if such payment is assumed to be made on the last day of the thirty-day cure period, it would not be

considered made for purposes of section 163 until after the end of the first accrual period following the five-year anniversary of the issuance. Under this application of the Last Day Rule, the DI would be an AHYDO notwithstanding the requirement to make catch-up payments.

Without this proposed guidance, in order for catch-up payment provisions to be effective, all catch-up payments would need to be either (i) excluded from all cure periods that would otherwise apply with respect to payments on the DI or (ii) due no later than the end of the relevant accrual period *minus* the total number of days in the longest cure period that could apply to such payments.[53] If the Treasury does not accept this proposal, we would ask that the regulations specifically state that, after the effective date of the regulations (and not retroactively), a payment is not considered to be required until the end of any applicable cure period so that drafters of DIs can take this rule into account.

5. Determining Non-Deductible OID Following the Occurrence of a Contingency

Under the OID rules, if certain types of contingencies occur that are contrary to initial assumptions, the DI is deemed to be reissued for purposes of sections 1272 and 1273, but not for any other purpose (including the AHYDO rules).[54] The occurrence of such a contingency would not be treated as a modification (let alone a Significant Modification) and, consistent with our recommendation in section III.B.2, above, should not require retesting for AHYDO classification.[55] However, the Code and Treasury regulations are silent as to how a deemed reissuance of an AHYDO with a non-deductible "disqualified portion" should impact the DI's OID and interest schedule going forward.

We believe the application of the Disqualified Fraction,[56] as of the issue date, to the new OID and interest schedule would be the simplest approach, and we recommend that the IRS issue guidance clarifying this. Thus, upon the occurrence of a contingency described in Treasury regulations sections 1.1272-1(c)(6),[57] 1.1275-2(h)(6)[58] or 1.1275-

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[53] If a catch-up payment is due before the end of an accrual period, it arguably creates a new accrual period, which must be then tested for significant OID which may cause the DI to fail to avoid having Significant OID, contrary to the purpose of the provision. This is because Treasury regulations section 1.1272-1(b)(1)(ii) requires that each *scheduled* payment of principal or interest be either on the first or last day of an accrual period.

[54] Treas. Reg. § 1.1272-1(c)(6); *see also* Treas. Reg. § 1.1275-2(h)(6), (j).

[55] Treas. Reg. § 1.1001-3(c)(1)(ii).

[56] *See* Section 163(e)(5)(C)(ii).

[57] Contingencies that provide for an alternative payment schedule (or schedules) under section 1272.

[58] Adjustments are required because a remote contingency occurs or does not occur, or an incidental contingency becomes fixed in an amount that is not insignificant.

2(j),[59] we believes that the same Disqualified Fraction calculated as of the issue date should continue to apply to the new interest and OID schedule to determine any non-deductible disqualified amounts.

We recognize that this simplified rule permits a lesser amount of OID to be nondeductible than under a rule that adjusts the Disqualified Fraction each time there is a deemed reissuance under Treasury regulations section 1.1272-1(c)(6). However, applying a different Disqualified Fraction each time a DI is deemed reissued under Treasury regulations section 1.1272-1(c)(6) would be extremely complex, especially in the case of DIs that permit interest to be paid in cash or in kind.[60]

6. Timing of OID Payment in Connection with Significant Modification of an AHYDO

As previously mentioned, a Significant Modification is treated as a taxable exchange of the original (*i.e.*, unmodified) DI for a new DI (as modified). When this occurs, accrued and unpaid OID on the "old" DI will become part of the principal of the "new" DI. In the event an AHYDO is subject to a Significant Modification, the Code is silent as to when the OID on the pre-modification DI is deemed to be paid (since payment generally does not include a payment in kind). Regulations should clarify that, after accrued OID on the new DI is deemed to be paid under Treasury regulations section 1.1275-2(a)(1), payments that would otherwise be treated as paying down principal on the new DI be treated as first paying down accrued OID on the old DI.[61] In other words, the OID on the pre-modification DI would be required to "roll over" to the new DI and be tracked going forward, until this OID is deemed to be paid as described above.

[Another issue arises if an issuer is a member of a consolidated group. In general, if an issuer issues a new DI in exchange for an existing DI that is an AHYDO, the issuer

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[59] Modifications of a DI that defer one or more payments but that do not rise to the level of Significant Modifications result in the DI being treated as retired and reissued solely for purposes of sections 1272 and 1273.

[60] For example, suppose a ten-year DI is issued at a time when the AFR was 4%, so that the threshold for disqualified OID would be 10%. Interest is payable on the DI semiannually and may be either paid in cash at a 10% rate or PIKed at 11%, at the option of the issuer. The OID rules would presume that the interest is only paid in cash (*i.e.*, that the PIK payment contingency does not occur). Under the rule we are proposing, the Disqualified Fraction would be zero and would remain so for the entire term of the DI. Each time the issuer decides to PIK an interest payment, the DI is deemed to be reissued pursuant to Treasury regulations section 1.1272-1(c)(6), and would thereafter have a higher yield than prior to the occurrence of the contingency. If the Disqualified Fraction had to be recomputed each time the issuer exercised the option to PIK, there could be as many as 19 different Disqualified Fractions. Moreover, because each Disqualified Fraction would apply only prospectively, the result would not be the same as if the DI had no cash-pay option and simply had a yield of 11% and a Disqualified Fraction of 9.09%. However, similar to note 35 above, concerns with respect to related-party loans may apply, and we would also not object to an anti-abuse rule for related-party loans in this context.

[61] The payment ordering rule of Treasury regulations section 1.1275-2(a)(1) requires that payments are treated first as a payment of accrued OID that has not been allocated to previous payments and, second, as a payment of principal.

will not be able to deduct any deferred OID deductions on the AHYDO because a payment on an AHYDO generally does not include a payment in kind (*i.e.*, the issuer's new DI), as mentioned in the prior paragraph. However, if the issuer is a member of a consolidated group, and another consolidated group member issues new debt in exchange for the issuer's AHYDO, the deferred OID deductions arguably become deductible pursuant to Treasury regulations section 1.1502-13(g)(5)(ii).[62] Consequently, in those circumstances, an issuer that is a member of a consolidated group appears to be able to claim deductions for accrued OID that it otherwise would not then be entitled to had the issuer not been a member of a consolidated group. This disparate treatment is inappropriate, and an issuer that is part of a consolidated group should not be able to deduct accrued OID with respect to the exchanged AHYDO any sooner than if the issuer was a stand-alone corporation issuing a new DI to acquire its outstanding AHYDO. Accordingly, we believe that the regulations should include a rule treating members of a consolidated group as divisions of a single corporation for purposes of such exchanges of DIs.[63]]

7. Contingent Payment Debt Instruments

If a CPDI is issued for cash or publicly traded property (or is itself publicly traded), it is subject to the "noncontingent bond method."[64] Under the noncontingent bond method, interest is accrued in the first instance based on the issuer's comparable yield and a projected payment schedule determined at issuance.[65] Positive and negative adjustments are made for differences between the projected payment schedule and the actual payments on the instrument.[66] These adjustments are generally treated as increases or decreases to the issuer's interest deductions, though negative adjustments can result in ordinary income to the issuer.[67] Thus, while the yield and accrual of interest on

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[62] In these circumstances, Treasury regulations section 1.1502-13(g)(5)(ii) generally provides that the acquired DI "is treated for all Federal income tax purposes . . . as having been satisfied by the debtor for cash."

[63] Alternatively, if the existing anti-abuse rule in Treasury regulations section 1.1502-13(h) would already address the disparate treatment described, we believe it would be helpful to clarify that in the regulation (such as through an example).

[64] Treas. Reg. § 1.1275-4(b)(1). As used here, publicly traded means "traded on an established market" within the meaning of Treasury regulations section 1.1273-2(f). This Report does not discuss the impact of the AHYDO rules to contingent payment debt instruments subject to Treasury regulations section 1.1275-4(c) – *i.e.*, those with an issue price determined under section 1274. For these DIs, contingencies are ignored until they are paid or become fixed, and therefore do not implicate the same issues as DIs under the noncontingent bond method.

[65] Treas. Reg. § 1.1275-4(b)(3)(i), (ii). The comparable yield is the yield at which the issuer would issue a fixed-rate noncontingent DI with terms and conditions similar to those of the CPDI. Treas. Reg. § 1.1275-4(b)(4)(i)(A).

[66] Treas. Reg. § 1.1275-4(b)(3)(iv), (b)(6).

[67] Under Treasury regulations section 1.1275-4(b)(6)(iii)(B), a net negative adjustment that exceeds the interest that accrued under the projected payment schedule is treated as ordinary income for the issuer to the extent of previously accrued interest reduced by any previous net negative adjustments treated as ordinary income in prior years (*i.e.*, the issuer's total net interest deductions since issue).

noncontingent DIs[68] is generally computed based on the known yield to maturity of the instrument (with rules for handling certain contingencies[69]), the accrual of interest on a CPDI is based on an assumed yield that is the rate at which an issuer could issue noncontingent DIs with terms and conditions that are the same as the CPDI but without the contingencies.

A consequence of accruing at the comparable yield is that the accruals are essentially an educated guess as to what the instrument will yield, and the positive and negative adjustments are a means to correct the accruals for the amounts that are ultimately paid. Moreover, because of the significant differences in how interest accrues on CPDIs compared to noncontingent DIs, there are many uncertainties as to the application of the AHYDO rules to CPDIs. In recognition of the uncertainties raised by contingencies, section 163(i)(5) provides a broad grant of authority for the Treasury to promulgate regulations providing for modifications of the AHYDO rules in the case of contingent payments.

The most significant issue for CPDIs under the AHYDO rules is what yield to maturity to use in testing whether the DI is an AHYDO under section 163(i)(1). The widespread (and probably universal) practice is to use the comparable yield on the CPDI for this purpose. Most practitioners also believe that positive or negative adjustments on a CPDI, which have the effect of changing the yield on the instrument when viewed retroactively, cannot cause a CPDI that was not an AHYDO to become an AHYDO or vice versa.

For CPDIs that are AHYDOs and that have disqualified yield, an important question is how to treat positive and negative adjustments, as well as income or expense that can arise upon the early retirement of the CPDI. For example, under section 163(e)(5)(A), the AHYDO rules affect only the deductibility of OID. Positive and negative adjustments under the CPDI rules, and repurchase premium and COD income, are technically not OID or offsets to OID. One possible and simple approach is to provide that all of these items are unaffected by the AHYDO rules. However, this may not be the best approach, as illustrated by the following example.

Suppose T issues a $1,000 seven-year stock-indexed note that calls for no fixed interest and a single payment at maturity equal to the stated principal amount multiplied by the ratio of a specified stock index on the maturity date to its value on the issue date, but not less than one. The AFR is 2% and the comparable yield is 10% (both based on semiannual compounding), so the Disqualified Fraction is 20%. The projected payment schedule shows a single payment at maturity of $1,980. Although $980 of OID accrues over the term of the note, T does not deduct any of this accrued OID because the note is an AHYDO. As it turns out, the stock index does not increase over the seven-year

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[68] As used in this Report, "noncontingent DI" means debt that is not subject to the CPDI rules, and therefore this term includes debt that has contingencies covered by Treasury regulation section 1.1272-1(c) (*e.g.*, puts and calls or DIs with a payment schedule that is significantly more likely than not to occur).

[69] Treas. Reg. § 1.1272-1(c).

period, so the amount T is required to pay at maturity is just $1,000. Accordingly, T has a negative adjustment of $980 in the year the note matures. If the permanent disallowance under section 163(e)(5)(A)(i) applies to a portion of the $980 accrued OID but no corresponding exclusion applies to the negative adjustment of $980, T might have $980 of taxable income but a deduction of only $784 (80% × $980),[70] leaving net taxable income of $196. This result is unfair and inconsistent with the objectives of the CPDI and AHYDO rules.

Another area of considerable uncertainty is the interaction between the AHYDO rules and section 249. This issue is important because the largest class of CPDIs that have been issued in the last several decades consists of convertible DIs with contingent interest payments. To see what is at stake, consider the following example:

S issues a contingent payment convertible DI with a comparable yield of 10% and a Disqualified Fraction of 20%. The fixed interest rate on the debt is 2%. It has a term of thirty years and is callable by the issuer starting seven years after the issue date. After seven years, the adjusted issue price of the instrument is $1,784. S's stock price has increased and interest rates have also declined since the debt was issued, so the debt is trading at a value of $1,900 per $1,000 of principal. S exercises its call right and the debt is retired for $1,900, representing a repurchase premium of $116. Assume that, but for the AHYDO rules, half of the $116 ($58) would be deductible under section 249 because of the decline in the issuer's cost of borrowing. What portion should be deductible given that the instrument is an AHYDO and the Disqualified Fraction is 20%? Should the deductible portion be 80% × $58 = $46 (*i.e.*, applying the AHYDO Disqualified Fraction to the amount permitted to be deducted pursuant to section 249), or the entire $58, on the ground that $58 is less than 80% × $116 = $93? (*i.e.*, applying the AHYDO rules and section 249 rules separately to the full redemption amount, so that whichever disallowance is greater would prevail, but not applying the rules cumulatively).

We believe that regulations should confirm that the yield for purposes of determining if a CPDI is an AHYDO is the comparable yield under Treasury regulations section 1.1275-4(b)(4)(i). Thus, a CPDI should not be an AHYDO if the comparable yield is below the AFR plus 5%. We believe that there is no other viable alternative to this approach that is consistent with the general proposition that instruments are tested at issuance to determine if they are AHYDOs.

The regulations should confirm that, for purposes of applying section 163(e)(5)(A)(ii), the issuer of a CPDI should be deemed to have made payments

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[70] Conceivably, T would have no deduction for any portion of the accrued OID under section 163(e)(5)(A)(ii) because the OID was never paid. This result would obviously be wrong, and one of the proposals below is to clarify that this is not the result. Note that this is not a problem if the CPDI is retired before maturity because in that case the issuer could have COD income rather than a negative adjustment and hence could apply the exclusions under the COD rules. However, we note it is not entirely clear that forgiveness of the disqualified portion of accrued OID results in COD income. *See*, *e.g.*, *Comm'r v. Rail Joint*, 61 F.2d 751 (2d Cir. 1932); *Fashion Park v. Comm'r*, 21 T.C. 600 (1954).

according to the projected payment schedule. This addresses the problem described in note 70 above.

Guidance should be issued providing that if a CPDI is an AHYDO, a fixed Disqualified Fraction is computed based on the comparable yield and the AFR. Positive and negative adjustments should not affect the Disqualified Fraction. Adjusting the yield (and hence the Disqualified Fraction) for positive and negative adjustments would arguably be more accurate, but would be unduly complex in our view.[71]

This Disqualified Fraction should be used for purposes of determining the amount of disqualified and deductible OID for accruals of OID under the projected payment schedule and should also be applied to positive and negative adjustments as well as to repurchase premium and, with one exception (discussed below), to any resulting COD income upon an early retirement of the CPDI. Thus, in the stock-indexed note example above, the negative adjustment at maturity of $980 would be 80% taxable and 20% nontaxable. This would correspond to the treatment of the OID, so that T would be left with no net taxable income or deduction when the note matures for an amount equal to the stated principal amount.

However, we acknowledge that because the Disqualified Fraction is fixed, the proposed rule would not operate perfectly fairly in a case in which the negative adjustment is less than the amount of the accrued OID. For example, if the amount payable at maturity in the example above (discussing a seven-year stock-indexed note with a payment at maturity of $1,980) were $1,500, T would have a negative adjustment of $480 and hence a net deductible amount (before applying the AHYDO rules) of $500. After applying the Disqualified Fraction to both components, T would have a deduction of $400. Arguably, under a more accurate rule, T should be able to deduct the entire $500 because, based on the actual payment, the yield on the CPDI was only 7.55%, which is less than the threshold of AFR + 6%. However, as noted above, we believe that a rule that adjusts the disqualified portion of the OID on a CPDI for positive and negative adjustments would be unduly complex.

Also, to achieve neutrality between retirements of CPDIs at maturity and retirements prior to maturity, the Disqualified Fraction should apply to repurchase premium and any COD income arising from the retirement of a CPDI at a price that differs from its adjusted issue price. Accordingly, in the case of COD income, it should be explicitly stated that section 108(e)(2) can be applied in full to the portion of any COD income that is not excluded by application of the Disqualified Fraction.

We recommend an exception to provide that if a CPDI is retired for a price below its issue price, the COD income should be fully taxable to the extent of such excess. In that case, applying the Disqualified Fraction to any COD income would actually make the issuer better off than if the CPDI were not an AHYDO or had a lower Disqualified

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[71] A truly accurate rule could not simply modify the Disqualified Fraction on a prospective basis but would have to redetermine the disqualified portion of the OID on the DI, taking into account prior accruals and payments.

Fraction, and we see no reason for such a result. For example, suppose a CPDI that is an AHYDO with a Disqualified Fraction of 20% was originally issued for $1,000, and has an adjusted issue price of $1,200 (original issue price increased by $200 of accrued OID) at the time it is retired for $950. On retirement, there would be $50 of COD income equal to the difference between the original issue price and the amount paid. If the $200 of accrued OID that is not paid were to be treated as giving rise to COD (a result not clearly supported by case law)[72] $160 of such COD should be excluded from income pursuant to section 108(e)(2) because that amount relates to accrued and unpaid OID that would be deductible if paid, and, under our proposal, $40 should be excluded from income because the Disqualified Fraction of 20% would also apply to the first $200 of COD, but not to the COD that results from the DI being retired for less than its issue price. As a result, the issuer would recognize $50 of COD income, which is the same result as if the Disqualified Fraction were zero.

As discussed above, we acknowledge that this proposal would represent a clear change from the statute in that the AHYDO rules only affect deductibility of OID pursuant to section 163(e)(5)(A). While we think this is a balanced and fair approach, if the Treasury does not accept this proposal, we would ask for a simple rule that the AHYDO rules do not affect either the deductibility of positive adjustments and repurchase premium or the taxability of negative adjustments and COD income, if any.

If a CPDI is also a convertible DI subject to section 249, there are two possible approaches to determining the deduction for repurchase premium.[73] One approach would be to apply the section 249 and AHYDO limitations cumulatively (or sequentially). Under this approach, the Disqualified Fraction would be applied to the amount otherwise allowed after the application of section 249. Thus, in the example discussing the interaction of the AHYDO rules and section 249, the deductible amount would be $46, *i.e.*, applying the 20% Disqualified Fraction to the $58 allowed by section 249. The argument for this approach would be that the intent of section 249 is to limit the issuer's deduction to the portion of repurchase premium that represents what it would be able to deduct on nonconvertible debt, and therefore, it is appropriate to apply the AHYDO Disqualified Fraction to this debt-like deduction.

An alternative approach would be to allow a deduction for repurchase premium to the extent of the lesser of the amount allowed under section 249 and the amount of the premium that is not disqualified under the AHYDO rules determined without regard to section 249. That is to say, the section 249 amount would only limit the amount of repurchase premium that would otherwise be deductible after the application of the Disqualified Fraction. Hence, in the example above (discussing the interaction of the AHYDO rules and section 249), the deductible amount would be the entire $58 permitted under section 249, not 80% of that amount. The argument for this second approach is that section 249 is a limitation on an otherwise deductible amount of repurchase premium

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[72] *See supra* note 70.

[73] This proposal would be moot if the immediately preceding proposal (regarding application of the AHYDO rules to items other than OID) were not adopted.

(*i.e.*, the gross deductible amount not taking into account other Code sections) and the taxpayer should not be required to take a further reduction in the deductible amount that would not occur without the AHYDO rules.

We have not reached a consensus on which of these approaches is the more appropriate. While this is an issue that comes up very infrequently, we do recommend the regulations provide guidance.

8. Determination of the AFR; Variable Rate Debt Instruments

While the determination of the AFR is straightforward in most cases, there are three potential questions that arise: (a) whether the lowest three-month rate rule of section 1274(d)(2) applies when a DI that is a potential AHYDO is issued for property, (b) whether puts and calls are taken into account for purposes of determining the AFR, and (c) which of the short-, mid- or long-term rate should apply to a VRDI.[74]

Section 1274(d)(2) provides that, in the case of a sale or exchange of a DI, the AFR that applies to the DI is the lowest AFR in effect for any month in the three-calendar-month period ending with the calendar month in which there is a binding writing contract. The regulations under section 1274 expand this rule by also looking to determine if the AFR is lower during the three calendar months ending with the month of the sale or exchange.[75] While it is clear that this provision cannot apply in the case of an instrument issued for cash, it is less clear that the provision does not apply for purposes of determining the AFR for an instrument issued for property, such as in a debt-for-debt exchange under Treasury regulations section 1.1001-3. In referring to the AFR, the AHYDO rules say that the AFR is "the applicable Federal rate in effect under section 1274(d) *for the calendar month in which the obligation is issued*."[76] This is in contrast to other references to section 1274(d) that do not make the same calendar month reference.[77] However, other sections of the Code specifically turn off the lowest three-month rate rule.[78] Even though the Code is less than clear, the legislative history of the AHYDO rules is explicit that the three-month rate rule should not apply.[79]

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[74] The VRDI rules are contained in Treasury regulations section 1.1275-5.

[75] Treas. Reg. § 1.1274-4(a)(1)(ii).

[76] Section 163(i)(1)(B)(i).

[77] *See*, *e.g.*, Sections 1274(b)(2), 7872(f)(2)(A), (B).

[78] Section 860B(c)(1) ("…110 percent of the applicable Federal rate (as defined in section 1274(d) without regard to paragraph (2) thereof)"); Section 382(f)(2) ("the Federal long-term rate determined under section 1274(d), except that– (A) paragraphs (2) and (3) thereof shall not apply…"); Section 1298(d)(2)(B)(ii) ("… using a discount rate equal to the applicable Federal rate determined under section 1274(d)– … (I) without regard to paragraph (2) or (3) thereof.").

[79] 1989 House Report, at 1219 n. 21 ("For these purposes, the AFR is determined without reference to the lowest 3-month rate provided by section 1274(d)(2)."); 1989 Senate Report, at 52 n. 24 (same).

Thus, for purposes of determining the AFR, regulations should specifically state that the AFR is determined without regard to the three-month rate rule in section 1274(d)(2) and Treasury regulations section 1.1274-4(a)(1)(ii).

In section III.B.1. above, relating to yield to maturity, we discussed whether issuer call rights and holder put rights could be taken into account under the AHYDO rules under the same presumptions that apply for purposes of the OID rules. An analogous issue arises for determining the AFR for purposes of applying the AHYDO threshold test of section 163(i)(1)(B)(i) as well as the disqualified yield computation under section 163(e)(5)(C)(ii). Specifically, if a DI has a final maturity of more than nine years but a holder put right or issuer call right (or both) within the first nine years but not within the first three years, it is not clear if the AFR is the federal long-term rate or the federal mid-term rate.

With respect to determining the AFR for a VRDI that is being tested to determine if it is an AHYDO (or to determine the Disqualified Fraction), under Treasury regulations section 1.1274-4(c)(2), whether the short-, mid- or long-term federal rate is the AFR is determined by reference to the longest interval between adjustments of the rate (or, if longer, the interval between the issue date and the first adjustment) rather than the entire term of the debt.[80] However, one could argue that the legislative history of the AHYDO rules dictates that this provision does not apply. Specifically, the legislative history says that "[i]n the case of a debt instrument providing for a variable rate of interest (within the meaning of [then] Prop. Reg. [§]1.1275-5) issued before the issuance of regulations, the committee expects…that the determination…will be made by treating the debt instrument as if it provided for a fixed interest rate corresponding to the rate established by the variable rate on the issue date."[81] If the AFR that applies is based on the entire term of the debt, however, it is not clear that this is the most sensible result, as illustrated by the following example.

Suppose a seven-year VRDI calls for interest at the short-term federal rate, reset at least annually, plus a spread of 7%. If the short-term federal rate at issue were 2% and the mid-term rate were 5%, this instrument would be below the AHYDO yield threshold if the taxpayer were permitted to (i) base the yield test on the equivalent fixed-rate DI and (ii) use the mid-term rate as the test rate (because the equivalent fixed-rate DI would have an interest rate of 9% and the AHYDO threshold of mid-term rate plus 5% would be 10%). However, if the short-term rate were required to be used, this instrument would have a yield that is 7% above the AFR, which is the stated spread on the instrument.

Accordingly, the regulations should explicitly state whether the rule of Treasury regulations section 1.1274-4(c)(2)[82] (determining the term of a VRDI for purposes of

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[80] Treas. Reg. § 1.1274-4(c)(2)(i).

[81] 1989 House Report, at 1223; 1989 Senate Report, at 54.

[82] If a VRDI provides for stated interest at a qualified floating rate (or rates), the term of the instrument is to be determined by reference to the longest interval between interest adjustments dates, or, if the VRDI provides for a fixed rate, the interval between the issue date and the last day on which the fixed rate applies (if longer). However, if, the rate in substance resembles a fixed rate pursuant to Treasury regulations

determining AFR) applies to determine the AFR for purposes of the AHYDO rules. If so, the "equivalent fixed rate debt instrument" rule in Treasury regulations section 1.1275-5(e)(3)(ii) would only be used to determine the maturity date of the VRDI under section 163(i)(1)(A), but would not be used to determine which AFR is appropriate for determining whether the any portion of the VRDI's yield is disqualified yield.

We further recommend that, consistent with section III.B.1., regulations should specify whether the AFR under the AHYDO threshold test of section 163(i)(1)(B)(i) as well as the disqualified yield computation under section 163(e)(5)(C)(ii) are determined (1) by applying the OID presumptions or (2) by the last-day presumption in section 163(i)(3)(A). However, as mentioned in section III.B.1, a rule that ignores all puts and calls before maturity may have inappropriate results, such as allowing the parties to use the federal long-term rate for testing, even for an instrument with a holder put within the mid-term rate period that is presumed (and perhaps highly likely to be) exercised.[83]

Furthermore, a more accurate rule would have to be rather complex. For example, the AHYDO regulations might require the parties (i) to compute the yield to each put or call date as well as to maturity, (ii) compute the excess of each yield over the short-, mid- or long-term rate, based on the put, call or maturity date, and (iii) apply the AHYDO threshold tests based on the lowest excess for issuer calls and the greatest excess for holder puts. As with the preceding issue, such complexity seems unwarranted.

Treasury might also consider a rule (or an example in the OID anti-abuse rule) that requires the use of the short-term or mid-term rate for testing purposes if there is both a holder put and an issuer call with substantially similar pricing within the first three or nine years, even if the put and call are not deemed exercised for OID purposes. The determination of whether the instrument is an AHYDO and, if so, the calculation of the Disqualified Fraction, would be based on the greater of the excess of the yield-to-put/call over the AFR for the put/call date and the excess of the yield-to-maturity to the AFR for the maturity date. For example, suppose a ten-year PIK DI has a holder put right and an issuer call right, and each right is exercisable after seven years. If the put is exercised, the holder would be entitled to receive 99.99% of the outstanding amount owed on the DI. If the call is exercised, the issuer would need to pay 100.01% of the outstanding amount owed on the DI. Under the OID rules, the put and call rights would not be deemed to be exercised, resulting in the DI having a ten-year maturity absent a rule to the contrary. However, under such circumstances, we believe that the parties have effectively issued a seven-year DI once the put and call options are taken into account. Thus, it would be inappropriate to test for AHYDO based on the long-term rate (which would generally be higher than the mid-term rate). Instead, the regulations might require

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section 1.1274-4(c)(2)(ii) (due to significant restrictions on variations in a qualified floating rate or the rate is calculated pursuant to Treasury regulations section 1.1275-5(b)(2)), the AFR is to be determined by reference to the term of the DI.

[83] See the example in "Assumptions Regarding Puts and Calls" in section III.B.1. above discussing a seven-year DI with a holder put.

that the yield to the put date (based on the put price) be tested against the mid-term rate in addition to testing the yield to maturity against the long-term rate.

9. Convertible Debt

DIs with conversion features also raise issues that should be clarified under the AHYDO regulations. Most convertible DIs issued in the market today are convertible at the option of the holder (not the issuer) into a fixed number of shares of stock of the issuer, the value of which as of the issue date is significantly less (usually by 20-30%) than the principal amount of the DI at issuance. These instruments have a relatively low stated yield (because of the option value embedded in the conversion feature) and are typically issued for par.[84] The OID rules are entirely clear that the conversion privilege is not taken into account for purposes of calculating the amount of OID that accrues on convertible DI.[85]

That said, the AHYDO rules could apply to convertible DIs if they otherwise satisfy the AHYDO requirements,[86] and the treatment of convertible DIs under the rules is unclear. The measurement of a convertible DI's term and the calculation of "significant OID" for AHYDO purposes are both in doubt as such instruments do not neatly fit within the statutory framework. Recognizing that the basic rules in the statute do not adequately address convertible DIs, in section 163(i)(5)(A) Congress directed Treasury to promulgate regulations providing for modification of the AHYDO rules in the case of DIs with conversion rights. However, the legislative history gives very little guidance as to what those regulations should look like.

Maturity Date of a Convertible Debt Instrument for AHYDO Purposes

The first question is whether the fact that a convertible DI can be paid in either stock (upon conversion) or cash (at maturity) causes the instrument to be treated as having an indefinite term for measuring whether the term exceeds five years. In determining whether an instrument has a term of greater than five years, the AHYDO rules provide that a "payment to be made in the form of another obligation of the issuer [including stock of the issuer] . . . shall be assumed to be made when such obligation is required to be paid in cash or in property other than such obligation."[87] In a typical

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[84] Note that convertible notes do not necessarily always settle in stock upon conversion. Some convertible DIs provide the issuer the right to satisfy the conversion option on a "net share" basis (meaning that the principal amount of the debt is settled in cash, with only the excess settled in stock) or entirely in cash.

[85] Treas. Reg. § 1.1272-1(j). This is notwithstanding the fact that a note/warrant investment unit, that in a sense has similar economics, is bifurcated so that the stock option value does create OID. Treas. Reg. § 1.1273-2(h).

[86] *E.g.*, it is possible that a convertible DI could be deemed re-issued with OID upon a Significant Modification, increasing the likelihood of AHYDO treatment. In addition, some convertible DIs are integrated with a call option with features matching the conversion feature under Treas. Reg. § 1.1275-6(b)(1), creating OID and a higher yield, as described below in section III.B.10 of this Report.

[87] Section 163(i)(3). Note that for purposes of determining the yield to maturity of the DI, the stated maturity date may be used.

convertible DI, the issuer is required to pay the principal of the debt obligation in cash at maturity unless the holder has previously converted. Therefore, commenters have argued that, where only the holder has the right to convert, the stated maturity date should govern as that is the last day on which the obligation is required pursuant to its terms to be paid in cash and the issuer does not have the ability to elect to satisfy the obligation in equity.[88] However, the only guidance in the legislative history throws some doubt on that conclusion. The 1989 Conference Report states:

"The conferees expect that for purposes of determining the maturity of an obligation, . . . regulations would provide that the right to convert an applicable instrument into the stock of the issuer may be disregarded if such right is solely in the hands of the holder and the exercise price is the fair market value, at the date of conversion, of the amount of stock received."[89]

Because of the reference to convertible debt with an exercise price equal to fair market value, which is not typical, this language could be read to suggest that for a typical convertible DI with a fixed conversion price, the conversion option *should* be taken into account in determining the instrument's yield to maturity (making it essentially indefinite).[90]

We believe that no negative implication should be drawn from this example with respect to a typical fixed price convertible DI. We recommend that any regulations should clarify this point and affirmatively provide that the fact the instrument may be satisfied in stock upon the exercise of a holder conversion right does not cause a convertible DI to have an indefinite term for AHYDO purposes.[91] We think this should be a rule of general application -- generally only holders have the conversion option, and in the rare case where the issuer holds the conversion option, we believe that the policy concerns are adequately addressed under section 163(l).[92]

Yield of a Convertible Debt Instrument

The second question regarding the application of the AHYDO rules to convertible DIs is whether the conversion privilege should be taken into account in determining whether the instrument has significant OID for purposes of the AHYDO rules. The

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[88] *See, e.g.,* MARTIN D. GINSBURG ET AL., MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 1303.3.1.4(3) (Sept. 2016) [hereinafter GINSBURG]; *see also* Lee-Lim, *supra* note 34, at 1405.

[89] *See* Conference Report, at 555. Note that interest under the DI described would likely be disallowed under section 163(l), which was enacted several years after the AHYDO statute.

[90] GINSBURG, *supra* note 88, at ¶ 1303.3.1.4(3).

[91] We also believe that the answer should not change if the issuer has the right to satisfy the DI in whole or in part in cash, rather than stock, upon conversion.

[92] Note also that a rule of general application would also solve questions about prioritizing the concurrent application of section 163(l) and the AHYDO rules, including whether a DI that was both an AHYDO and subject to section 163(l) could still confer on corporate holders the dividends received deduction described in section 163(e)(5).

AHYDO rules generally incorporate the OID rules for purposes of determining the issue price of an instrument for AHYDO purposes.[93] As stated above, the OID rules are entirely clear that the conversion privilege is not taken into account for purposes of calculating the amount of OID that accrues on a convertible DI. Thus, any rule which requires that the conversion privilege be valued and taken into account for AHYDO purposes would lead to two separate OID schedules, one for OID purposes and another for AHYDO purposes, giving rise to additional confusion in an area already very confused and the benefit of such rule in carrying out the statutory purpose of the AHYDO rules is unclear at best. Except in the case of convertible DIs that are CPDIs, the issuer is not getting the benefit of a higher amount of deductible interest as a result of the conversion feature. Therefore, Congress' concerns in enacting the statute do not seem to be implicated, and it seems unlikely that it intended to create such a complicated morass. Treasury would be better served here, as elsewhere, by conforming the OID and AHYDO rules.

We therefore recommend that any regulations under the AHYDO provisions confirm that, with respect to traditional convertible DIs, the conversion right not be taken into account for purposes of determining the yield to maturity of convertible DIs for AHYDO purposes, as under the OID rules.

10. Integrated Instruments

The application of the AHYDO rules to a qualifying DI that has been integrated with a hedge under Treasury regulations section 1.1275-6 is also uncertain. Under the integration rules, a qualifying DI and a properly identified hedge can be treated as a single "synthetic" DI that has the same cash flows as the combined cash flows of the DI and the hedge; provided that these cash flows permit the calculation of a yield to maturity under the OID rules.[94] From and after the time that the issuer has entered into both parts of the transaction until the end of the integration period, the two transactions are treated as a single transaction, and the component parts are not considered separately for tax purposes.[95] This synthetic DI is generally subject to section 163(e) and the OID rules, and presumably the AHYDO rules as well.

The biggest uncertainty with respect to the application of the AHYDO rules to the synthetic DI is how the inconsistencies between the AHYDO presumptions and the OID presumptions, including the OID presumptions with respect to such integrated DIs, should be reconciled. First, we believe it is clear, although any regulations should clarify,

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[93] Section 163(i)(2)(B)(ii). However, note that for purposes of determining the yield to maturity of the debt instrument, the rules *do* require the value of stock to be paid to be taken into account. *See* Section 163(i)(3) ("Except for purposes of paragraph (1)(B) [which is the yield to maturity test], any reference to an obligation in subparagraph (B) of this paragraph [assuming that any payment to be made in the form of another obligation of the issuer or a related party is made only when required to be made in cash or property other than such obligation] shall be treated as including a reference to stock").

[94] Treas. Reg. § 1.1275-6(b)(2), (4).

[95] Treas. Reg. § 1.1275-6(f)(1).

that the synthetic DI is tested as of the deemed issue date of the synthetic DI (rather than as of some other earlier or later date by reference to either of the component parts), and the yield to maturity should include all cash flows on both instruments, including the premium paid by the issuer for the hedge.[96]

Second, it is unclear how to reconcile the OID rules' presumptions regarding maturity (*e.g.*, treatment of puts, calls and remote contingencies) for an integrated DI with those that apply for AHYDO purposes. We recommend the same approach for a synthetic DI that we do for a regular DI, treating the synthetic DI for these purposes as if it were a regular DI. In the context of a synthetic DI, to make this recommendation consistent with the recommendation with respect to regular DIs, we believe that the maturity date of the synthetic DI must be tested taking into account all payments that could be required under either component of the synthetic DI, which could treat the synthetic DI as having a different (longer) maturity date for AHYDO testing purposes than it does for all other purposes. Otherwise, we think it makes sense to follow the OID rules to determine yield, significant OID, etc., if that approach is generally adopted with respect to testing DIs for AHYDO status.[97] Without a regulatory rule to the contrary, it is at least possible that, solely for AHYDO testing purposes, the synthetic DI is reimagined as a wholly different instrument with different cash flows and timing.[98] For instance, if an issuer integrates a convertible DI with a call option with features matching the conversion feature in the note, there are a series of remote contingencies that could cause a mismatch between the timing of a payment or settlement of the note and the delivery of stock under the hedge.[99] In those cases, it is at least imaginable that a different synthetic DI should be constructed for AHYDO testing purposes. This potential mismatch provides a particularly good example of why we think that the AHYDO regulations and the OID regulations should be harmonized. The synthetic DI is a creature of the OID regulations in the first place, and is meant to reflect the income of the issuer of the synthetic DI more clearly. Thus, with respect to these instruments, it is not clear what purposes would be served by creating another synthetic DI just for AHYDO purposes.

11. Anti-Abuse Rule for DIs Issued by Partnerships

Under current law, section 163(e) defers or disallows deductions for OID only with respect to an AHYDO issued by a corporation. Section 163(i)(5)(B) expressly empowers the Secretary to prescribe regulations as may be appropriate to prevent the avoidance of the purposes of section 163(i) and section 163(e)(5), including regulations to prevent avoidance of the AHYDO rules through the use of issuers other than C corporations.

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[96] It may also be helpful to clarify how to report properly the cash flows given that the issuer is treated as having issued an integrated DI, but the holders are treated as receiving payments pursuant to the distinct component parts. Treas. Reg. § 1.1275-6(f)(12).

[97] See discussion in section III.B.1. above.

[98] Lee-Lim, *supra* note 34, at 1405.

[99] *Id*. These could include, among other things, a provision that allows a hedge counterparty to postpone settlement under certain (remote) market conditions or to satisfy non-tax regulatory requirements.

Treasury regulations section 1.701-2 provides general anti-abuse rules governing the use of partnerships to conduct joint business activities.[100] The regulation allows the IRS to treat a partnership as an aggregate of its partners (in whole or in part) in order to carry out the purposes of the Code and the Treasury Regulations. The regulation includes an example treating a partnership as an aggregate of its partners for purposes of applying section 163(e)(5).[101] The example indicates that a look-through rule should generally be applied for testing whether a partnership's DI may be considered an AHYDO to prevent corporations from improperly avoiding the application of the AHYDO rules by using partnerships.[102] This can result in DIs issued by a partnership being subject to the AHYDO rules, in whole or in part, with respect to direct or indirect corporate partners. However, the regulation does not contain any minimum ownership threshold before the look-through would apply, and thus indirect corporate partners with only a *de minimis* interest in the issuing partnership could be subject to AHYDO treatment with respect to their share of any such DI. Consequently, there can be significant administrative challenges to applying the rule (especially in the case of multi-tier partnership structures). Additionally, it is unclear how the look-through rules apply when partnership interests change hands, particularly when a corporation acquires a partnership interest from a non-corporate partner or vice versa.

We generally believe the government should consider revisiting the rule described in Example 1 of Treasury regulations section 1.701-2(f), and provide for a minimum ownership threshold before the rule would apply to partnership debt.[103] The benefit of the rule in preventing possible abuse seems to be outweighed by administrative burdens and challenges in applying the rule with respect to corporate partners holding only a small percentage interest in the issuing partnership (particularly in multi-tier partnership structures).

That said, in considering the issue, we acknowledge there are complexities with revising the rule that would need to be thought through and addressed, such as when debt issued by a partnership should be tested for AHYDO (*e.g.*, at issuance, year-to-year, or each time ownership among the partners changes). We considered several possible *de minimis* rules, but did not reach a consensus view on the best way to craft a rule. Nonetheless, we believe the government should consider revising the rule to ease the administrative burdens of compliance and consider whether the scope of the current rule in Example 1 of Treasury regulations section 1.701-2(f) might be broader than necessary.

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[100] Treas. Reg. § 1.701-2, which is titled "Anti-abuse rule." *See also* Preamble to Treasury Decision 8588 ("This document contains a final regulation providing an anti-abuse rule under subchapter K of the Internal Revenue Code of 1986.").

[101] Treas. Reg. § 1.701-2(e), (f), ex. 1.

[102] Treas. Reg. § 1.701-2(f), ex. 1 (noting that treating the issuing partnership as an entity and not an aggregate of its partners could result in the partnership "circumventing the purpose of section 163(e)(5)").

[103] For example, revising the rule so it only applies to corporate partners that, directly and indirectly, hold a 5% or greater interest in the capital or profits of the partnership.

12. Senior-Junior Debt Interactions

A single borrower will often have multiple tranches of debt including a senior DI, typically issued with de minimis or no OID and a lower yield, and one or more junior DIs that are subordinated to the senior DI and feature a higher yield, often with OID. In this context, the interaction between the terms of the senior and junior DIs raises practical issues and uncertainties under the AHYDO rules.

For instance, there is uncertainty as to the treatment of a subordinated junior DI where the senior DI can restrict the junior from being paid, and the junior would be classified as an AHYDO if not for a short term to maturity (*i.e.*, less than five years plus one accrual period) or a catch-up payment before the senior DI is due. In this situation, the central question is whether the term of the junior DI or catch-up payment should be respected. On the one hand, we view a maturity date within five years and one accrual period as having substance if the failure to pay on the junior DI would trigger an event of default. To be sure, in this situation, the borrower would have to take steps to avoid the adverse consequences of a breach or default under either the senior or the junior DI. However, on the other hand, this arrangement might be considered to lack substance if the borrower and the lender under the junior DI are related, with the lender therefore less likely to pursue remedies on default. We therefore recommend that the regulations include guidance providing that, if a subordinated junior DI has a term less than five years plus one accrual period, or calls for an appropriately structured AHYDO catch-up payment (or any other payments after the fifth-year anniversary of the issue date), the ability of the senior DI to prevent the junior DI from being paid according to its terms will not cause AHYDO classification provided that the standards discussed above are met, *i.e.*, a failure to pay the junior note would trigger an event of default or other material adverse consequences, such as an actionable breach, that would make the required payment "unconditionally payable" within the meaning of Treasury regulations section 1.1273-1(c). The regulations should further clarify that a reasonable "standstill" provision, pursuant to which a junior creditor has agreed with other lenders to wait a certain amount of time before pursuing remedies, should not change this result.[104] We further recommend an anti-abuse provision for situations where the borrower and the lender are related.

C. Other Ambiguities for Which Guidance Is Requested

1. Disqualified Portion in Excess of OID

Given how yields are computed, it is possible for the disqualified portion of the total yield for a period to exceed the OID for that period. For example, this can occur if a DI has significant QSI such that OID only represents a small fraction of the total sum of QSI and OID that accrues on the DI during any given accrual period.[105] In that situation,

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[104] *See* Lee-Lim, *supra* note 34, at 1412.

[105] This is particularly relevant for earlier accrual periods, as OID accruals start out relatively small and increase over the life of the DI.

disallowing all OID accruing during the accrual period may not be sufficient to satisfy the disqualified portion. However, the Code and the legislative history are clear that deductions are not disallowed under the AHYDO rules for payments of QSI.[106] As a result, under those circumstances, it is not clear how to treat the excess of the disqualified portion over the total amount of OID for the accrual period given that the AHYDO rules only apply to disallow OID.[107]

One solution that has been proposed,[108] and that we support, would be to carry forward the amount of any disqualified portion for a given period that is in excess of the OID for that period to successive periods, until the disqualified portion is fully applied against the DI's OID.

2. Payments of OID Before Maturity

Section 163(e)(5)(A)(ii) provides that OID on an AHYDO (other than the disqualified portion) is not allowable as a deduction until paid. In cases where there is no payment other than qualified stated interest (QSI) prior to maturity, or where there is no disqualified portion, application of this rule is straightforward. As for the remaining cases, the legislative history states:

> The allocation of payments of OID made under a DI before maturity between the disqualified portion and the remainder is to be made pursuant to Treasury regulations. The conferees expect such regulations to provide that such payments will be allocated on a pro rata basis between accrued but unpaid OID treated as interest, and the accrued but unpaid disqualified portion of the OID.[109]

To eliminate any possible uncertainty, we recommend guidance be issued, consistent with the legislative history, clarifying that payments of OID will be allocated on a *pro rata* basis between deductible OID the disqualified portion.

3. Determination and Choice of Accrual Periods

A DI is treated under section 163(i)(2) as having significant OID if, "for periods before the close of any accrual period" ending after the date that is five years from the issue date, the aggregate interest accrued on the DI exceeds the aggregate amount of interest required to be paid on the DI by more than the product of the debt's issue price and its yield (the permitted amount). Thus, the test for significant OID is applied as of the close of each accrual period ending more than five years after the issue date. This

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[106] *See* Section 163(e)(5)(C); Conference Report, at 554.

[107] For a discussion, see DAVID C. GARLOCK ET AL., FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 606.08, ex. 6-3 (2017 edition) [hereinafter GARLOCK].

[108] *See* GARLOCK, *supra* note 107, at ¶ 606.08.

[109] Conference Report, at 554.

definition relies on establishing (i) what the DI's accrual periods are and (ii) determining what amounts are to be paid "before the close" of any accrual period.

Treasury regulations section 1.1272-1(b)(1)(ii) provides that an accrual period is an interval of time over which the accrual of OID is measured. It goes on to say that an accrual period may be any length of time and may vary in length, so long as each accrual period is no longer than one year and each scheduled payment of principal and interest occurs either on the first or last day of an accrual period. Thus, if a DI calls for semiannual payments, the first testing date for significant OID generally will apply 5½ years from the issue date (assuming the first accrual period is not a long or short period).[110]

Treasury regulations section 1.163-7(d) specifies that the issuer's choice of accrual periods to determine OID accruals is used to determine whether a DI has significant OID under section 163(i)(2). As a result, a technique that can be used to avoid the application of the AHYDO rules for DIs with a term of between five and six years is to avoid any payment date after the fifth anniversary but before maturity and to elect to treat the period from the last payment date before maturity through the maturity date as a single accrual period. Some issuers accomplish this by providing for annual payments over the DI's entire term while others call for more frequent payments during the first five years and use a longer payment interval only in the last year.

We believe it would be helpful for guidance to clarify that testing for significant OID occurs on the last day of each accrual period ending more than five years after the issue date and that a payment due on that date is taken into account in applying the test for that period (*i.e.*, is treated as a payment to be made "before the close" of the accrual period).

4. Debt Issuance Costs and Repurchase Premium

The prevailing view is that the AHYDO rules do not apply to and do not take into account (i) debt issuance costs, notwithstanding Treasury regulations section 1.446-5, which generally treats debt issuance costs "as if" they were OID, and (ii) repurchase premium under Treasury regulations section 1.163-7(c).[111] It would be helpful if this could be confirmed in regulatory guidance, or the preamble to any issued regulations.

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[110] Section 163(i)(2)(A).

[111] While we believe the AHYDO rules should not apply to repurchase premium generally (unless they were expected to be paid at the time of issuance), we do think it appropriate for the AHYDO rules to apply to repurchase premium occurring in specified circumstances in the CPDI context, as discussed above in section III.B.7. of this Report.