REPORT #775

TAX SECTION

New York State Bar Association

REPORT AND RECOMMENDATION FOR THE TREATMENT
OF CONTINGENT DEBT INSTRUMENTS UNDER
PROPOSED REGULATION SECTION 1.1275-4
NOVEMBER 5, 1993

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M E M O R A N D U M

November 9, 1993

TO: Leslie B. Samuels
Margaret Richardson
Harry L. Gutman

FROM: Peter C. Canellos

Enclosed is the report of the Tax Section on the treatment of contingent debt instruments under Proposed Regulation §1.1275-4. The Report is the product of a joint undertaking by the Tax Section and certain individual members of the Committee on Financial Transactions of the Tax Section of the American Bar Association. David P. Hariton is the principal draftsman of the Report.

The Report deals with the complex and important question of the tax treatment of debt instruments which bear contingent payments. The Report deals with a wide range of contingent payment obligations, which are of growing importance in the financial marketplace. Some of these instruments provide for variable interest rates but fixed payments of principal, while others provide for contingent principal.

The Treasury Department has expressed concern about income-deferral and deduction-acceleration possibilities generated by contingent payment obligations. The Report has assumed the necessity for dealing with both of these problems and suggests a series of rules designed to deal with different types of contingent payment obligations.

First, the Report recommends the expansion of the existing variable rate debt instrument rules to cover virtually all contingent payment obligations which provide for fixed payments of principal and do not involve front-loading or back-loading of interest. We believe that such expansion would represent a major simplification.

Second, the Report recommends the adoption of a minimum accrual rate with respect to contingent payment obligations not brought within the variable rate rules, as expanded in accordance with the first recommendation. The main impact of this regime will be on instruments providing for contingent principal. This approach reflects the assumption that invested amounts are expected to earn a yield no less than a minimum threshold yield. It mirrors the approach in Section 1274 in that known present values are presumed to earn a yield at a minimum rate just as in Section 1274 known future values are discounted at a presumed minimum rate to determine issue price.

The minimum accrual rate approach prevents excessive deferral of interest income. At the same time, it avoids certain problems in alternative approaches to contingent payment obligations which have been considered in the past.

The Report also deals with ancillary issues such as the taxation of payments prior to maturity, gains and losses on disposition, hedged obligations and other important considerations.

We hope that this Report will assist you in dealing with this complex area. If you have any questions please call David Hariton or myself.

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Tax Report #775

NEW YORK STATE BAR ASSOCIATION TAX SECTION

AND

MEMBERS OF THE AMERICAN BAR ASSOCIATION TAX SECTION

COMMITTEE ON FINANCIAL TRANSACTIONS

REPORT AND RECOMMENDATION FOR THE TREATMENT OF CONTINGENT DEBT INSTRUMENTS UNDER PROPOSED REGULATION SECTION 1.1275-4

NOVEMBER 5, 1993

I. INTRODUCTION

The purpose of this report (the "Report") is to offer recommendations to the Internal Revenue Service (the "Service") and the Treasury Department concerning the treatment of contingent debt instruments under Prop. Reg. Sec. 1.1275-4, which was issued under the authority of Section 1275(d) of the Internal Revenue Code (the "Code").[1/] The Report is in response to a request for comments contained in a notice of proposed rulemaking which was filed with the Federal Register on January 19, 1993 and was scheduled to be published on January 25, 1993 (the "January Notice"). The January Notice contained proposed regulations that set out several alternative treatments of contingent debt instruments, some of which could be applied by taxpayers on an elective basis (the "January Regulations"). The January Notice was withdrawn prior to its publication, along with other pending federal rules, in connection with the change in administrations. deals primarily with the treatment of contingent debt instruments issued for cash and does not consider the treatment of non-publicly traded contingent debt instruments issued in exchange for non-publicly traded property, which is ordinarily governed by the rules of Section 1274 of the Code.

[1/] The Report is a joint project undertaken by the Tax Section of the New York State Bar Association and individual members of the Committee on Financial Transactions of the Tax Section of the American Bar Association, hereafter referred to collectively as the "Tax Section" in this report. David P. Hariton was the principal draftsman, and the following persons participated in the preparation of the Report: Reuven Avi-Yonah, Daniel J. Breen, Peter C. Canellos, Steven D. Conlon, Peter J. Connors, John A. Corry, George W. Craven, III, Glenn H. Eichen, Peter L. Faber, David C. Garlock, George C. Howell, III, Bruce Kayle, Professor Lawrence Lokken, James N. Peaslee, Michael L. Schler, Jodi J. Schwartz, Esta E. Stecher, and Willard B. Taylor.

Consistent with the mandate of Section 1275(d) of the Code, the recommendations made below seek to apply the principles of Sections 1271 through 1275 of the Code, and the principles which govern the federal income tax treatment of debt instruments generally, to debt instruments providing for deferred contingent interest and contingent principal. These recommendations take into account the stated objectives of the Service and the Treasury, including the objectives of limiting the deferral of interest income or the acceleration of interest deductions on contingent debt instruments.[2/] They also reflect certain implied objectives, including promoting uniformity in the treatment of contingent debt instruments and conformity with the treatment of non-contingent debt instruments to whatever extent possible, and providing the simplest, clearest and most practical treatment possible consistent with these objectives. Finally, they seek to provide a treatment that will work when applied not only to the kinds of contingent debt instruments most frequently issued today, but also to those which may be issued in the future.

II. BACKGROUND

Prop. Reg. Secs. 1.1275-4 and 1.1275-5 were issued in 1986, along with most of the proposed original issue discount regulations issued under the authority of Sections 1271 through 1275 of the Code (the "1986 Proposed Regulations"). Prop. Reg. Secs. 1.1275-4 and 1.1274-5 are issued under the specific authority of Section 1275(d) of the Code, which authorizes the

[2/] While our recommendations are designed to meet these objectives, we do not necessarily endorse all of them. We have not specifically considered, for example, whether it is important to eliminate the deferral of interest income on contingent debt instruments and do not know whether we would have reached consensus on this issue if we had discussed it.

Secretary of the Treasury to modify the treatment set out under Sections 1271 through 1275 of the Code where, by reasons of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment of an instrument under Sections 1271 through 1275 does not carry out the intended purpose of those sections. We believe that this grant of authority is sufficiently broad to permit the Secretary to adopt the recommendations made in this Report.

In general, the 1986 Proposed Regulations divided contingent debt instruments into two categories: “variable rate debt instruments”, or “VRDIs”, and all other contingent debt instruments. The rules dealing with VRDIs were set out in Prop. Reg. Sec. 1.1275-5. In essence, a VRDI was defined to include what was then the typical “floating rate” debt instrument, i.e., an instrument that was issued at par, paid or accrued interest at least annually, and paid or accrued an amount of interest which floated with current interest rates, as determined by an objective interest rate index. The general treatment of contingent payments set out under Prop. Reg. Sec. 1.1275-5 was fairly simple: the holder included, and the issuer deducted, as interest, the amounts that actually became fixed, when paid or accrued, in accordance with their respective methods of accounting (or simply when accrued in the case of payments which became fixed in arrears or more than six months prior to payment).No one has seriously criticized this treatment, other than to recommend that the definition of a VRDI be expanded to cover an increasing number of floating-rate debt instruments which, for one reason or another, appeared to fall outside the technical definition of a VRDI.

All other contingent debt instruments were dealt with under Prop. Reg. Sec. 1.1275-4. The most important, and least controversial, treatment under Prop. Reg. Sec. 1.1275-4 was that of a debt instrument with fixed principal which paid or accrued interest at least annually, but which did not qualify as a VRDI because the amount of interest to be paid under the instrument was not determined by current rates of interest (hereafter, a "fixed-principal, current-pay" instrument). In general, the holder included, and the issuer deducted, interest on such an instrument when its amount became fixed, subject to a special deferred payment rule which applied only where a contingent amount was paid more than six months after it became fixed.[3/] All amounts which became fixed were treated as payments of interest, regardless of how they were characterized.

Setting the deferred payment rule aside, this treatment resembled the treatment of VRDIs under Prop. Reg. Sec. 1.1275-4, and differed significantly only in that amounts which became fixed towards the end of a taxable year were included and deducted in that taxable year, rather than as they were paid or accrued over the succeeding interest payment period, as in the case of a typical VRDI.[4/] As such, this treatment was subject to little criticism, other than to the theoretical views of some (but not all) members of the Tax Section that large amounts received because, for example, a stock or commodity index had

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[3/] In such a case, the promise to pay the interest was itself treated as a payment of interest in the form of a bond. The value of the bond, and therefore the amount of interest included and deducted, was the present value of the promised amount, discounted at the applicable federal rate of interest.

[4/] Interest on a VRDI is accrued when fixed regardless of when paid, however, if interest becomes fixed in arrears or more than six months prior to payment.

greatly increased in value over the course of the year might more properly be treated as capital gain than as interest income.[5/]

The treatment under the 1986 Proposed Regulations of a fixed principal instrument providing for deferred contingent interest (e.g., a single payment of contingent interest at maturity) was more troubling. In general, the 1986 Proposed Regulations followed the "all-events test" of accrual basis accounting and provided that interest could not be included or deducted until its amount became fixed. Thus, in the typical case of a 5-year zero-coupon debt instrument issued for $1,000 and promising at maturity $1,000 plus an additional amount determined by reference to the increase in value of a stock or commodity index, the holder did not include, and the issuer did not deduct, any interest prior to maturity. Both taxpayers and the Service found the resulting deferral of interest troubling.

Taxpayers found it troubling because it inhibited a substantial number of economically beneficial, non-tax-motivated financial transactions. During the period between 1986 and 1993, mutual funds and other sophisticated investors developed an increasing appetite for "derivative" debt instruments providing for deferred contingent interest, and financial institutions developed an increasing capacity to offer these instruments,

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[5/] The deferred payment rule, on the other hand, led to some surprising results. For example, if all of the interest on a 30-year fixed-principal, current pay instrument became fixed one year after issuance, the amount of interest included and deducted in the first year (the present value of all of the remaining interest on the instrument) almost equaled the entire issue price of the instrument. The rule presumably should have limited inclusion and deduction to the present value of the excess, if any, of the amount of interest which became fixed over interest accruing at a "reasonable rate" for the remaining life of the instrument.

either directly or through credit intermediaries, and hedge the associated risks in the marketplace using dynamic hedging models. These transactions, which were economically efficient, were uneconomic on an after-tax basis, because the interest deduction associated with the borrowing was deferred until maturity. For example, the debt instrument described above might be viewed as economically equivalent to an investment unit consisting of a five-year zero-coupon debt instrument, issued for $700 and promising $1,000 at maturity, and a cash-settled call option on a stock index, issued for $300. In the case of the investment unit, however, the issuer could deduct $300 of original issue discount on a yield-to-maturity basis over the 5-year life of the instrument, whereas the interest deduction was deferred if the components of the unit were merged into a hybrid debt instrument.

The Service found the deferral troubling for similar reasons. The Service was concerned, for example, that an issuer not subject to full U.S. federal income taxation (e.g., a foreign corporation, or a corporation with substantial net operating loss carryforwards) might issue such an instrument to taxable U.S. investors, who would otherwise have been required to include $300 of original issue discount in income over the life of an economically equivalent investment unit.[6/] An investor could "hedge out" of the associated contingency by selling the right to

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[6/] Prop. Reg. Sec. 1.1275-4(h) gives the Service authority to reallocate interest on such an instrument if a principal purpose of the resulting back-loading of interest is the avoidance of federal income tax. Avoidance of federal income tax was generally not a principal purpose of these issuances, however. In addition, it was not clear that the authority was intended to extend to an instrument providing for deferred contingent interest, and it was not clear how the reallocation would be effected even if it was so intended. The relevant example in Prop, Reg. Sec. 1.1275-4(h) involved an instrument providing for interest equal to 0% of the issuer's profits in years one and two and 5% of the issuer's profits in years three, four and five. The issuer actually had $5 million of profits in year one, and the example required current accrual based on the assumption that the issuer's profits would continue to be $5 million per annum.

receive the contingent payment to an unrelated party and achieve the economic equivalent of a zero-coupon noncontingent debt instrument on which original issue discount did not accrue for federal income tax purposes.

In light of these problems, Prop. Reg. Sec. 1.1275-4 was amended, in February, 1991, to provide for the "bifurcation" of certain contingent debt instruments into contingent and non-contingent components. The bifurcation rule, which is set out in Prop. Reg. Sec. 1.1275-4(g), caused the simple fixed-principal, deferred-interest instrument described above to be treated like its economically equivalent investment unit; i.e., it in effect required the holder to include, and the issuer to deduct, $300 of original issue discount over the life of the instrument, and treated any difference between $1,300 and the amount actually received or paid at maturity as capital gain or loss recognized at maturity. The bifurcation rule also extended by its terms, however, to current-pay fixed-principal instruments, so long as the contingent interest payments were determined by reference to the value of publicly traded property. The application of the bifurcation rule to instruments providing for more than one contingent payment was unclear and, in many cases, unsatisfactory.[7/]

The bifurcation rule was also criticized on other grounds. In the case of an unhedged holder, the bifurcation rule could cause a holder to accrue ordinary interest income over the life of a contingent debt instrument and, if the interest was never received, recognize a "mismatched" capital loss at

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[7/] see American Bar Association Section of Taxation, Report on Amendments to Proposed Regulation Section 1.1275-4, 53 Tax Notes 1187 (December 9, 1991) (prepared by individual members of the Committee on Financial Transactions) and New York State Bar Association Tax Section Report (April 30, 1991).

maturity. In addition, the treatment of instruments under the bifurcation rule diverged dramatically from the treatment of similar instruments that were not covered by the bifurcation rule. An instrument was generally not covered by the rule if a significant portion of the payment at maturity was also contingent, or if contingent interest payments were not determined by reference to the value of publicly traded property. Thus, taxpayers appeared capable of steering into and out of bifurcated treatment by, for example, making a significant portion of the payment at maturity contingent, or characterizing payments as determined by reference to the yield on Treasuries, rather than the price of Treasuries.

The treatment under Prop. Reg. Sec. 1.1275-4 was most troubling, however, in the case of a debt instrument providing for a contingent payment at maturity and not promising a return of its issue price (hereafter, a “principal-indexed instrument” or a “contingent principal instrument”). For example, a 5-year principal-indexed instrument might be issued for $1,000, pay $50 per annum of interest and, at maturity, pay $1,000 multiplied by a formula based on the prices or yields of various actively traded stocks, securities, commodities, interest rates or foreign currencies; the formula could cause the payment to go up or down, and under a realistically possible set of circumstances, to be zero. Instruments of this sort were issued with increasing frequency during the period between 1986 and 1993.

Under Prop. Reg. Sec. 1.1275-4, the fixed payments of interest on the instrument described above were recharacterized as payments of principal. Thus, deferral of interest, of the sort described above with regard to fixed-principal deferred-interest instruments, was arbitrarily imposed on taxpayers seeking to make arm's-length interest payments in the ordinary course. Such an

instrument was not subject to the bifurcation rules described above because it did not promise a return of its issue price. Indeed, the bifurcation rule could not be applied to such an instrument, because the instrument did not have any non-contingent principal. Bifurcation into an installment obligation providing for 5 payments of $50 per annum and a right to receive a wholly contingent payment at maturity would have effectively recharacterized (i) most of the interest as principal by treating the $50 payments as returns on an installment obligation and (ii) equally troubling, most of the interest income as capital gain.

On December 22, 1992, the Service issued a notice of proposed rulemaking designed to simplify and otherwise improve upon the treatment in general of debt instruments with original issue discount (the "1992 Proposed Regulations")[8/] Shortly thereafter, as discussed above in the Introduction, the Service issued and withdrew the January Regulations, which, had they been made effective, would have provided for an entirely different treatment of contingent debt instruments under Prop. Reg. Sec. 1.1275-4. The January Regulations were withdrawn, however, prior to their publication in the Federal Register. The January Regulations were in any event intended to be effective only for debt issued after they were finalized and were accompanied in their preamble by an explicit request for comments. The January Regulations were for this reason viewed by the Tax Section as more of an invitation to comment on the various proposals contained within them than as a tentative decision to adopt those proposals.

[8/] 37 Fed. Reg. 60749.

In the case of debt instruments providing for contingent payments determined by reference to the values of actively traded property, the January Regulations provided several different methods of accounting for income over the life of the instrument, any one of which could be applied by taxpayers on an elective basis. Three of the methods, the “non-contingent bond method,” the “market yield method,” and the “yield adjustment method,” accrued current income on the basis of estimates of the amounts of anticipated contingent payments. In addition, the non-contingent bond method and the market yield method provided for current recognition of income and loss based on the difference between anticipated payments and the amounts that actually became fixed, whereas the yield adjustment method generally provided for adjustment of the rate of income accrual in light of revised estimates of anticipated contingent payments. Another of these methods, the “spot price method,” effectively marked contingent debt instruments to market by treating any change in the spot price of underlying property as income or loss for the current taxable year.

The January Regulations provided a different set of rules for instruments with contingent payments not determined by reference to the value of actively traded property. In effect, these rules bifurcated such instruments into contingent and non-contingent components and accrued interest on the non-contingent component at the applicable federal rate.

For reasons described more fully below under “Current Accrual Approach,” the various treatments proposed in the January Regulations are troubling. In addition, we are concerned about the proposal to adopt a number of different approaches to the treatment of contingent debt; the resulting inconsistencies in the treatment of similar instruments might lead to counter-

intuitive results and permit tax-motivated transactions. Confusion would likely arise, moreover, from the effort to determine which set of rules applies in any given case. Rather, we favor application of a single treatment to all contingent debt instruments falling under Prop. Reg. Sec. 1.1275-4. This treatment should produce satisfactory results when applied to both instruments with deferred contingent interest and instruments with contingent principal. As discussed more fully under “Extension of VRDI Treatment” below, we believe that current-pay fixed-principal instruments can be dealt with primarily under Prop. Reg. Sec. 1.1275-5.

As is the case under the current proposed regulations, nothing in this report is designed to answer the question of whether a given instrument should be treated as a debt instrument, as opposed to a stock, an option, a forward contract, or some other financial instrument. Given the significance of that question and prior experience regarding the difficulties in developing rules to answer it, we do not believe it should be answered in regulations under Section 1275(d) of the Code. For now, we assume that question will continue to be dealt with on an instrument-by-instrument basis, in light of common law principles and all of the relevant facts and circumstances.

Consistent with prior reports, however, we are advising against the retention of a “bifurcation approach,” under which a hybrid debt instrument is treated for federal income tax purposes as more than one instrument, one of which is a debt instrument and one of which is an option, forward contract or other financial instrument. Once the conclusion has been reached, on the basis of all of the facts and circumstances, that a given instrument is a debt obligation, we believe the principles that govern the tax treatment of debt obligations generally should

govern the treatment of the instrument, including the treatment of the embedded option, forward contract or other feature which gives rise to its hybrid character. In this regard, the treatment of hybrid debt instruments will necessarily diverge from the treatment of economically equivalent investment units and of other transactions which, for various reasons, fall under another tax rubric. This divergence should not be viewed as surprising or inappropriate, but rather as a routine consequence of the characterization of financial instruments. While we acknowledge that the characterization of financial instruments may give rise to some difficult judgment calls, and to the substantially different treatment of relatively similar instruments falling on different sides of a characterization "line", we believe that it is for now the only approach available. Efforts to bifurcate hybrid instruments into their component parts have so far proven more, rather than less, problematic.[9/]

We recognize, however, that, if the unitary approach is to be retained, more guidance is needed with regard to the characterization of financial instruments, particularly in drawing lines among equity, debt and options. A considerable amount turns on such characterization, including not only the timing and character of income and deductions, but a wide variety of collateral consequences, such as whether a given instrument generates UBTI, can be held by a regulated investment company or a real estate investment trust, or can be held by a foreign

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[9/] The divergence in tax treatment between hybrid debt instruments and investment units often results from the fact that the current tax treatment of options and forward contracts generally does not reflect time value of money concepts. Accordingly, the divergence in many cases results from the application of anachronistic tax principles to certain types of financial instruments, rather than from any fault of the recommended method of taxing hybrid debt instruments.

investor free of U.S. withholding tax. (Whether such differences in timing, character and collateral consequences make sense is an interesting question but one which is beyond the scope of this report.)

III. SUMMARY OF RECOMMENDATIONS

The recommendations set forth in this report are summarized below:

1. Extension of VRDI Treatment. Under the rules of Prop. Reg. Sec. 1.1275-5 applying to variable rate debt instruments ("VRDIs"), issuers deduct, and holders include, whatever amounts of interest are paid or accrued over the life of the instrument. VRDI treatment should be extended to a broader range of contingent debt instruments. Specifically, the definition of a VRDI should be expanded to include any debt instrument which (a) pays or accrues contingent interest throughout its term based on a single objective formula (or multiple formulas which do not result in a front- or back-loading of interest) and (b) does not provide for any other contingent payments. A VRDI should include, for example, (a) a debt instrument issued at par, paying par at maturity, and promising interest based on a fixed percentage of the issuer's profits, and (b) a floating rate debt instrument issued for $1,000 and promising $800 (but no contingent principal) at maturity. If this recommendation is adopted, Prop. Reg. Sec. 1.1275-4 will deal primarily with instruments providing for contingent principal, instruments providing for deferred contingent interest, and instruments otherwise designed to produce a front- or back-loading of interest.

2. Integrated Treatment. A fully-hedged issuer should be required to integrate the issuance of a contingent debt instrument with all of the associated hedges, under rules similar to the rules set out in regulations under Section 988(d) of the Internal Revenue Code. We believe that there is ample authority under Section 1275(d) to require such integration, and we do not see how a coherent treatment of contingent debt instruments is otherwise possible. The requirement should be broad enough to limit any potential for abuse and should cover, for example, associated hedges entered into by related parties.

Holders should be permitted to integrate fully-hedged positions. Holders should be required to do so, however, only if the rate of minimum accrual, as discussed below, is less than a market rate. Holders electing integrated treatment should in any event be required to identify their hedges.

The disposition of a hedge should not terminate integration if the taxpayer remains fully hedged by entering into new positions (e.g., an issuer should not be able to avoid integrated treatment through “dynamic hedging”). Failure to maintain a fully-hedged position, on the other hand, should be treated as a taxable event resulting in the recognition of gain or loss on all of the positions comprising the integrated transaction.

3. Minimum Accrual. Under Prop. Reg. Sec.1.1275-4, interest should accrue on a contingent debt instrument at no less than a “Minimum Rate” on the entire issue price of the instrument. Accrued but unpaid interest should increase the adjusted issue price and basis of the instrument. Actual payments under the instrument should be treated first as returns of any

previously accrued but unpaid interest, reducing the adjusted issue price and basis of the instrument.

Minimum Accrual should apply only to the extent necessary to assure that a minimum amount of interest accrues over the life of a debt instrument. If, for example, a debt instrument issued for $1,000 pays $300 of contingent interest in year one and no contingent interest thereafter, accrual at the Minimum Rate should not begin again until aggregate accrual at the Minimum Rate exceeds $300 (e.g., sometime in year four, assuming a Minimum Rate of 8% per annum). Minimum Accrual should not apply if it is exceeded by accrual under the original issue discount rules based on a fixed excess of minimum remaining payments under the instrument over the current adjusted issue price. Likewise, Minimum Accrual should be replaced by accrual under the original issue discount rules once all of the remaining payments under the instrument have become fixed.

We recommend that the Minimum Rate be the applicable federal rate of interest. We think it would be reasonable, however, to choose some higher percentage, such as 110% or 120% of the applicable federal rate. Although it would also be reasonable to permit the multiple used in computing the Minimum Rate to vary based on either the issuer's credit rating (e.g., 110% for AAA and 140% for BBB), or its fully-hedged cost of capital, we do not actively support either of these alternatives. In the interest of simplicity, we favor the use of a single multiple of the applicable federal rate.

4. Current Interest Payments. There should be no qualified stated interest on an instrument governed by Prop. Reg. Sec. 1.1275-4. All fixed payments should be treated as part of

the instrument's stated redemption price. (Interest will still accrue, however, at no less than the Minimum Rate.)

If a debt instrument promises fixed payments at least equal to its issue price, and does not provide for a front-loading of interest, all contingent payments should be treated as payments of interest. If, on the other hand, a debt instrument provides for fixed payments that are less than its issue price, contingent payments prior to maturity should be treated as tax-free returns of principal, which reduce both the adjusted issue price and basis of the instrument (such adjusted issue price and basis having already been increased by the accrual of interest at the Minimum Rate), until the issue price of the instrument equals the remaining fixed payments under the instrument; thereafter, all contingent payments should be treated as payments of interest. As a corollary to this approach, there should be no amortization of bond issuance premium on an instrument governed by Prop. Reg. Sec. 1.1275-4.

As a simple example, an instrument is issued for $1,000, promises at least $900 (plus an additional contingent amount) at maturity and provides for annual contingent payments. Eighty dollars of interest accrues, at the Minimum Rate, in year one, increasing the issue price and basis of the instrument to $1,080. At the end of year one, a $300 contingent payment is made. The first $180 reduces the adjusted issue price and basis of the instrument to $900. The remaining $120 is a payment of interest which the issuer deducts and the holder includes in income.

If an instrument is designed to produce a front- loading of interest, any interest in excess of the Minimum Rate should be recharacterized as principal. In effect, such excess interest will be recognized as original issue discount over the remaining

life of the instrument. Suppose, for example, that a debt instrument promising $1,000 at maturity, and issued for $1,000, makes a $500 contingent payment at the end of one year. Under the general rule, the entire payment is interest. If the instrument is designed to produce a front-loading of interest, however, only $80 of the payment is interest (assuming Minimum Accrual at a rate of 8%) and the remaining $420 decreases the issue price and basis of the instrument to $580. As a result, $420 of original issue discount accrues over the remaining life of the instrument.

There should be a special exception to cover an instrument providing for contingent principal and current interest based on the current cost of funds, provided that the initial floating rate approximates the Minimum Rate, or alternatively, in the case of a fully hedged issuer, that it approximates the issuer's all-in floating cost of capital. In that case, neither minimum nor maximum accrual should apply, and contingent interest payments should be respected as qualified stated interest.

5. Contingent Payments That Become Fixed Prior to Payment. In the interest of simplicity, and consistent with the notion that interest is earned over the life of an instrument, contingent payments that become fixed prior to payment should be ignored. If a contingent payment becomes fixed within two years of payment, it should be respected as a payment of principal or interest, as the case may be, when it is actually paid. If a contingent payment becomes fixed more than two years prior to payment, the fixed payment should be added to the stated redemption price of the instrument (due when actually paid), regardless of whether it would otherwise be treated as a payment of principal or interest. At some point, accrual under the general original issue discount rules, based on the excess of the

minimum remaining payments under the instrument over the current adjusted issue price, may exceed, and therefore replace, accrual at the Minimum Rate.

Once all of the remaining payments have become fixed, the instrument should be subject to the rules which generally apply to non-contingent instruments, e.g., interest might accrue over the remaining life of the instrument at less the Minimum Rate if that is the result under the general original issue discount rules based on the excess of the remaining payments over the adjusted issue price. Likewise, at any point where, because one or more payments have become fixed, the current adjusted issue price exceeds the maximum remaining payments under the instrument, any accrual at the Minimum Rate should cease, and the excess of the adjusted issue price over such maximum amount of remaining payments should be amortized, like bond issuance premium, over the remaining life of the instrument.

Alternatively, a more complex "minibond approach" might reasonably be adopted, but this approach would have to focus on the "excess realization," defined as the excess of the amount that becomes fixed over the amount that would have accrued at the Minimum Rate, considering the projected adjusted issue price of the instrument. The amount of the excess realization would be added to the stated redemption price of the instrument, and the present value of the excess realization discounted at the Minimum Rate (the "discounted excess realization") would be added to the adjusted issue price of the instrument. The discounted excess realization would then be deducted by the issuer and included in income by the holder. As a corollary, the excess loss, defined as

the excess of the current revised issue price over the maximum remaining payments under the instrument, would be deducted immediately, rather than amortized over the remaining life of the instrument.

6. Character of Gain and Loss. The excess of the amount received on disposition of an instrument governed by Prop. Reg. Sec. 1.1275-4, whether at maturity or on disposition in the secondary market, over the basis of the instrument should be treated as interest. The excess of the basis of the instrument over the amount received should be deductible by a holder as an ordinary loss to the extent of any interest previously included in income in respect of the instrument but never received, and thereafter as a capital loss.

7. Secondary Holders. The holder of a contingent debt instrument acquired in the secondary market should apply the rules described herein as if the debt had been originally issued at the time of acquisition for the price paid by the holder.

8. Foreign Currency Indexed Debt. Consistent with prior reports, and with Announcement 86-92, the rules of Prop. Reg. Sec. 1.1275-4 should not apply to a debt instrument providing for contingent payments if the contingencies are based solely on the values of foreign currency, regardless of the complexity of the relevant foreign currency formula. Rather, anticipated future payments should be translated into U.S. dollars based on spot rates of exchange in effect on the date of issuance, and the basic original issue discount rules of Section 1272 and 1273 should be applied accordingly. Any difference between such translated U.S. dollar amounts and the amounts ultimately received should be accounted for as foreign currency

gain or loss under Section 988 of the Code, consistent with the legislative history of Section 988.

9. Tax-Exempt Debt. We believe there are arguments for permitting a holder to earn relatively large, or relatively small, amounts of tax-exempt interest on a contingent debt instrument governed by Section 103 because, in the aggregate and over the long run, holders of such instruments should receive no more than a market rate of return on their investments. If the Service disagrees, however, then the amount of tax-exempt interest earned by such a holder should be governed by notional accrual at a tax-exempt Minimum Rate, regardless of how much interest is actually received. Thus, interest received on such an instrument, and gain from the disposition of the instrument, should be treated as tax-exempt interest until the amount of tax-exempt interest received equals the amount which would have accrued, at the tax-exempt Minimum Rate, during the period for which the instrument was held. Interest and gain in excess of this amount should be taxable interest income.

Loss from the disposition of the instrument should be ordinary loss only to the extent of taxable interest previously included in income but not received, and thereafter capital loss. The Service should consider permitting accrual of tax-exempt interest at the tax-exempt Minimum Rate in the absence of any actual receipt to increase the basis of the instrument, with the result that a holder recognizes capital loss to the extent that such tax-exempt interest is not ultimately received, on the grounds that this is consistent with the notion that the holder must recognize taxable income if the amount of interest ultimately received exceeds accrual at the tax-exempt Minimum Rate.

IV. EXTENSION OF VRDI TREATMENT

The 1992 Proposed Regulations, if they are made effective in their current form, would substantially expand the definition of a VRDI under Prop. Reg. Sec. 1.1275-5.[10/] The revised definition would make it easier for a variety of instruments providing for fixed principal, and periodic interest based on the current cost of funds as determined by a variety of objective formulas, indexes or factors, to qualify for treatment under the VRDI rules. In addition, the revised definition would include certain fixed principal instruments providing for current interest based on changes in the value of actively traded property, e.g., based on the increase or decrease in value of a stock or commodity index.

As noted in prior reports, we support this expansion of the VRDI definition, and the resulting extension of VRDI treatment to a broader range of fixed principal, current-pay instruments.[11/] It is, however, a principal tenet of our recommendations in this Report that the definition of a VRDI should be further expanded to encompass all current-pay, fixed principal instruments, unless they provide for a front- or back-loading of interest.

The treatment provided under the VRDI rules, i.e., that the holder includes, and the issuer deducts, the interest that actually becomes fixed over the life of the instrument as it is

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[10/] The 1992 Proposed Regulations specifically did not revoke or alter the treatment of contingent debt instruments under Prop. Reg. Sec. 1.1275-4.

[11/] See New York State Bar Report on the Revised Original Issue Discount Regulations, 60 Tax Notes 270 (July 19, 1993); American Bar Association Comments on Proposed Regulations on Original Issue Discount (July 2, 1993).

paid or accrued, is simple and well suited to all current-pay, fixed principal instruments. It is well-suited, for example, to an instrument issued at par and promising annual payments of interest determined by reference to the issuer's profits, or even to wholly arbitrary, non-objective, or initially unmeasurable factors. As long as interest is paid or accrued currently,[12/] and the instrument is not designed to produce a front- or back-loading of interest, holders should simply include, and issuers deduct, interest as and when it actually becomes fixed over the life of the instrument.

It is likewise well-suited to a current-pay fixed principal instrument that is issued at a premium (i.e., with an issue price in excess of its stated principal amount), so long as the instrument does not provide for additional payments of contingent principal and (as is generally required for VRDI treatment) is not designed to produce a front- or back-loading of interest. A typical example is a 5-year debt instrument issued for $1,000, promising $800 at maturity and LIBOR plus 400 basis points per annum. The amortization of $200 of bond issuance premium will adjust the accrual of interest to an appropriate arm's-length rate, as it does in the case of a non-contingent debt instrument.

If this recommendation is adopted, Prop. Reg. Sec. 1.1275-4 will no longer govern the treatment of fixed principal, current-pay instruments, which are still the most frequently

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[12/] An instrument may be a VRDI notwithstanding that it does not pay interest currently if the principal amount of the instrument is increased to reflect accrued but unpaid interest, so that subsequent variable rate accruals increase accordingly.

issued kind of contingent debt instrument.[13/] Rather, Prop. Reg. Sec. 1.1275-4 will deal primarily with instruments providing for deferred contingent interest (or instruments designed to produce a front- or back-loading of interest) and instruments providing for contingent principal. The specific recommendations set out below are based on the assumption that Prop. Reg. Sec. 1.1275-4 should be primarily designed to govern the treatment of these kinds of instruments, in as rational and consistent a manner as possible.

Under the recommendations made below, there will be important differences between the treatments of instruments qualifying as VRDIs under Prop. Reg. Sec. 1.1275-5 and instruments governed by Prop. Reg. Sec. 1.1275-4. For example, no minimum interest will accrue on the former, and gain or loss from disposition of the former prior to maturity will generally be capital gain or loss. Whether an instrument qualifies as a VRDI depends partly on whether it is designed to produce a front- or back-loading of interest.[14/] We appreciate that concerns about front and back-loading underlay the restricted ambit of the VRDI rules prior to the revisions made by the December Regulations and that our proposal for retaining those revisions, and further expanding the scope of the VRDI rules, will only be viable if clear and objective rules can be developed to deal with front and back-loading. We believe it is important, therefore, to have

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[13/] Alternatively, rules identical to those in Prop. Reg. Sec. 1.1275-5 could be set out in Prop. Reg. Sec. 1.1275-4 and applied to fixed principal, current pay instruments.

[14/] If the suggestions made in this report are adopted, moreover, the question of whether an instrument that provides for non-contingent principal but is governed by Prop. Reg. Sec. 1.1275-4 is subject to certain interest recharacterization rules will depend on whether it is designed to provide for a front-loading of interest. See “Current Interest Payments” below.

guidelines with regard to when an instrument provides for a front- or back-loading of interest.

For example, there is a significant difference between (a) a 30-year debt instrument providing for annual interest based on the percentage increase in the value of a stock index and (b) a 30-year debt instrument providing for annual interest based on the actual increase in the value of the index. The former may vary greatly, but there is no reason to think that the percentage increase in the index in year 29 will be greater than the percentage increase in year 2. Assuming, however, that the value of the stocks comprising the index is expected to increase by 5% per annum, and that the index is therefore likely to be four times higher in year 29 than it was in year 2, annual interest based on the actual increase in the value of the index is likely to be four times greater in year 29 than in year 2. The same holds true, of course, for annual interest based simply on the current value of the index.

On the other hand, a debt instrument providing for interest based on the current values of an objective interest index, such as LIBOR, should not be considered designed to produce a back-loading of interest merely because, in the current financial environment, short-term interest rates are expected to rise over time. Front and back-loading of interest may therefore involve some linedrawing. While it would be difficult to draft a set of rules to determine whether a given instrument is designed to produce a front- or back-loading of interest, it would be helpful to have some specific examples, with a procedure for supplementing these examples through notices or revenue rulings.

V. CURRENT ACCRUAL APPROACH

A. Minimum Accrual

In general, we recommend that interest accrue currently at no less than a specified rate (the “Minimum Rate”) on the entire issue price of a contingent debt instrument governed by Prop. Reg. Sec. 1.1275-4, regardless of when payments are made or when the amounts of anticipated payments become fixed. Accrued but unpaid interest should increase both the adjusted issue price and the basis of a contingent debt instrument. This approach mirrors the approach of Section 1274, under which known future payments are discounted to present value at a presumed minimum rate of return to determine the instrument's issue price and therefore the amount of original issue discount. Here, a known issue price is increased by a presumed minimum rate.

For example, assume that the Minimum Rate is 8% per annum. If a 5-year zero-coupon contingent debt instrument is issued for $1,000, the issuer should deduct, and the holder should include in income, $80 of interest for the first taxable year. The issue price and basis of the instrument should increase to $1,080 at the end of the first taxable year, and $86.4 of interest ($1,080 x .08) should accrue for the second taxable year, increasing the issue price and basis of the instrument to $1,166.4 by the end of the second year.

Minimum Accrual would only apply to the extent necessary to assure that interest accrues on a cumulative basis to any date at no less than the Minimum Rate. Minimum Accrual would therefore not apply until cumulative interest accrued at the Minimum Rate exceeded aggregate interest previously paid or accrued on the instrument. Actual payments tinder the instrument would be

treated first as a return of any previously accrued but unpaid interest which would reduce the adjusted issue price and basis of the instrument.

Thus, suppose the instrument in the example above provided for contingent payments every two years and actually paid $300 at the end of year two. The first $166.4 of the payment would be treated as a return of previously accrued but unpaid interest and would reduce the adjusted issue price and basis of the instrument back to $l.000.[15/] The remaining $134.6 would be treated as a payment of either interest or principal, based on the rules described below under “Current Interest Payments”.

Assuming that the remaining $134.6 would be treated as a payment of interest, interest would not accrue at the Minimum Rate during year three, because the notional accrual of $80 of interest at the Minimum Rate would not exceed the $134.6 of

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[15/] There are two alternative mechanics to deal with the case in which interest in excess of the Minimum Rate is paid at the end of a given accrual period. Under the first mechanic, interest simply does not accrue at the Minimum Rate, because interest in excess of the Minimum Rate is paid at the end of the accrual period. Under the second mechanic, interest accrues at the Minimum Rate over the course of the accrual period, increasing the adjusted issue price and basis of the instrument, but the payment at the end of the period reduces the adjusted issue price and basis of the instrument to the extent of interest previously accrued at the Minimum Rate. The two mechanics are equivalent, and the first mechanic has generally been adopted by the Service in prior proposals, such as the January Regulations. Nevertheless, we recommend the second mechanic, for several reasons: The first mechanic would only apply in cases where interest was paid by the end of the accrual period. As described in the text above, the second mechanic would apply if interest was paid in a subsequent accrual period. We see no reason to create an additional set of rules to implement the first mechanic, given that the second mechanic suffices in all cases. In addition, because the December Regulations adopted a “flexible” accrual period (i.e., a holder may choose the length of the accrual period), the first mechanic would likely prove difficult to implement. Finally, the first mechanic requires special rules to deal with the case in which a holder disposes of an instrument midway through an accrual period. Under the first mechanic, which involves a “wait and see approach” to Minimum Accrual, the holder has not yet accrued any interest income for the relevant period at the time of disposition.

interest in excess of the Minimum Rate that was previously paid under the instrument. During year four, notional accrual at the Minimum Rate would be based on a notional $1,080 adjusted issue price. Notional accrual would not become actual accrual, however, until midway through the fourth year, when $134.6 of unpaid interest had notionally accrued at the Minimum Rate. At that point, actual accrual at the Minimum Rate would resume--$31.4 of interest ($80 + $86 - $134.6) would accrue at the Minimum Rate over the remainder of the fourth year (which the issuer would deduct and holders would include in income), and the issue price and basis of the instrument would increase to $1,031.4 by the end of the fourth year. If there was an actual payment at the end of the fourth year, $31.4 would be treated as a return of previously accrued but unpaid interest, reducing the issue price and basis back to $1,000, and the remainder of the payment would be characterized under the rules described below for “Current Interest Payments.”

Minimum Accrual would also cease if all of the remaining payments under the instrument became fixed. At that point, the accrual of original issue discount, if any, would be based on the excess of the remaining payments under the instrument over the then current adjusted issue price, as provided in rules set out under Sections 1272 and 1273 of the Code.

B. Rate of Accrual

We recognize that there are competing considerations in the choice of a Minimum Rate, some of which are set out below. In general, we recommend minimum accrual at the applicable federal

rate of interest[16/] but we believe it would be reasonable to provide for a Minimum Rate that is higher than the applicable federal rate, such as 110% or 120% of the applicable federal rate. In addition, set out below are two alternative approaches, one for contingent debt issued by fully hedged issuers and the other for debt of issuers with established credit ratings, which might allow for a more precise Minimum Rate in a substantial number of cases. The cost of this greater precision is, of course, additional complexity.

The arguments for choosing the applicable federal rate as the Minimum Rate include (a) such a rate minimizes the incentive for issuers with low borrowing costs to issue unhedged debt and seek deductions at a higher Minimum Rate, (b) such a rate eliminates the argument that unhedged holders are burdened as compared to a system under which they accrue by reference to estimates of anticipated future payments, (c) such a rate is consistent with the rate ultimately chosen by Congress under Section 1274 of the Code, after dealing with the competing considerations in an analogous context and (d) given that the system results in accrual in the absence of payment, it is not unreasonable to limit the accrual of interest income and deductions to the applicable federal rate. The principal arguments for minimum accrual at a higher percentage of the applicable federal rate include first that most issuers of contingent debt are likely to be fully hedged, and will be subject to mandatorily integrated treatment as discussed more

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16/ This approach of course means that interest will accrue at a different, and generally lower, rate on short-term debt (maturing in less than three years) than on mid-term debt (maturing in more than three, but less than nine, years), and on mid-term debt than on long-term debt (maturing in more than nine years).

fully below, so that the revenue impact of the choice of Minimum Rates is likely to turn on the treatment of holders. Second, a low Minimum Rate leaves some incentive for taxpayers to hold contingent debt and "hide" the associated hedges.[17/]

He recommend accrual at a uniform rate, based on the applicable federal rate, partly in view of its simplicity and ease of administration. If the proposals in this Report are adopted, accrual at a uniform rate will be primarily a "fallback" treatment applying to unhedged issuers and holders of debt instruments providing for contingent principal or deferred contingent interest. The majority of issuers of contingent debt instruments in today's market hedge out of the associated contingencies and will therefore be subject to mandatory integration as discussed below under "Integrated Treatment." Moreover, most sophisticated taxable holders of contingent debt instruments are regulated investment companies, insurance companies and other financial institutions that hedge out of the associated contingencies and, for the reasons explained below under "Integrated Treatment," are likely to elect integrated treatment. Unhedged holders, therefore, will tend to be relatively unsophisticated holders investing, for example, in indexed certificates of deposit to whom a simple and easily administered approach is best suited.

[17/] While the same could be said of issuers in the case of a higher Minimum Rate, the universe of issuers who could otherwise borrow at rates substantially below 120% of the applicable federal rate is generally limited to the largest corporations, and it seems unlikely that such corporations would seek to "hide" their associated hedges given that their hedges are integrated with the debt under applicable accounting rules. To the extent that associated hedges could be hidden by such corporations, however, the problem is not cured by a lower Minimum Rate, since any rate of accrual may be too high if the borrowing is hedged by a hidden option on which no interest accrues. Rather this problem, and the proposed solution, is discussed more fully below under "Integrated Treatment".

We recognize that the applicable federal rate approach is a rough approximation, and that accrual at the Minimum Rate, whether at the applicable federal rate or a higher rate, will in some cases permit an unhedged holder to include less interest in income than would be included on a non-contingent debt instrument of the same issuer with a similar term. Even so, we believe that this approach represents a considerable improvement over current law, under which the holders of contingent debt instruments are not required to accrue any interest at all. Even on contingent debt instruments that are subject to "bifurcation" under current law, holders are required to accrue interest on only a portion of the issue price.

Notwithstanding the above, two more complex alternative approaches may be worth considering in an effort to strike a balance between the competing considerations for a lower or higher rate, as discussed above. First, in the case of contingent debt issued by a large, solvent issuer with an established credit rating, the Service could devise a simple table designed to provide a more accurate Minimum Rate, based on that credit rating. For example, the Minimum Rate for debt of an issuer rated AAA by Moody's or Standard & Poor's might be 110% of the applicable federal rate, whereas debt of an issuer rated BB8 might be 140% of the applicable federal rate. There would then be a "fallback rate" for unrated issuers. This approach may also address the concern that, because the Minimum Rate of accrual may be too low, issuers will be unable to issue contingent debt if their hedging practices leave them uncertain of obtaining integrated treatment.

The second alternative approach is based on the fact that many issuers of contingent debt are likely to fully hedge the relevant contingencies. The all-in cost of the issuer's fully

hedged capital should, under these circumstances, be easy to determine. Since this all-in cost of capital is, by definition, the cost of comparable non-contingent debt of the same issuer with the same term to maturity, it could provide an accurate measure of the proper rate of interest accrual for holders. This approach should be at the option of the issuer, however, for two reasons. First, some issuers might not want to reveal their all-in cost of capital. Second, many issuers hedge into a floating rate cost of capital (e.g., LIBOR plus 30 basis points).This floating rate would have to be converted into a comparable fixed rate cost of capital, using, for example, a hypothetical interest rate swap. Third, some issuers may be only partially hedged, but the Service could later assert they are substantially fully hedged. Such an assertion should not, however, retroactively affect the treatment of holders.

To implement the equivalent cost of capital approach, an issuer would obtain a letter from the underwriter or placement agent of the debt instrument stating the issuer's all-in fixed cost of capital, based either on the issuer's actual fixed cost of capital or the issuer's deemed fixed cost of capital using hypothetical interest rate swaps or other market transactions. The resulting Minimum Rate would be disclosed either in relevant offering materials or in a legend on the face of the instrument. All unhedged holders would be required to accrue interest at the disclosed Minimum Rate, and the issuer would report interest income on this basis on Form 1099.

C. Approaches Not Recommended

The Minimum Rate Approach achieves one of the principal objectives of the Service -- to prevent the holder of a contingent debt instrument from obtaining the benefit of a

deferral of interest income as compared to an economically equivalent investment, such as an investment unit consisting of a zero-coupon debt instrument and a cash settlement option on a stock or commodity index. The Minimum Rate Approach is also relatively simple and easy to administer.

In making our recommendations, we considered and decided against several alternative approaches. For example, we considered the general approach taken by the 1986 Proposed Regulations under which interest does not accrue unless and until the amount of a contingent interest payment becomes fixed. We decided against this approach partly because it does not appear to meet the principal objective of the Service in revising Prop. Reg. Sec.1.1275-4, which was to prevent the deferral of interest on contingent debt. Under the 1986 Proposed Regulations, no interest accrues on the typical fixed-principal deferred interest contingent debt instrument until maturity.

Another problem with this approach, as discussed under “Background” above, is that it gives rise to substantial complexity and unsatisfactory results when applied to instruments providing for contingent principal. In particular, the 1986 Proposed Regulations contain a widely criticized rule which recharacterizes fixed interest payments as tax-free returns of principal until the fixed payments under the instrument exceed the instrument's issue price. In the absence of such a recharacterization rule, however, it would be difficult to prevent the deduction of overstated interest on contingent “installment obligations.” Consider a 5-year debt instrument issued for $1,000, promising $200 of interest per annum, and a wholly contingent payment at maturity which is likely to be small. Failure to recharacterize at least some of the interest as principal would give the issuer interest deductions at a rate of

20% per annum. Amortization of $1,000 of bond issuance premium over the life of the instrument, on the other hand, would completely offset and eliminate the current accrual of interest if the contingent payment at maturity was likely to equal the issue price.

For similar reasons, we decided against an approach under which interest would nominally accrue on a contingent debt instrument but would not be included or deducted unless and until amounts were actually paid under the instrument.

Serious consideration was given to an approach under which, similar to the "market yield," "non-contingent bond" and "yield adjustment" approaches set out in the January Regulations, the accrual of interest would be based on estimates of the amounts of the anticipated contingent payments under the instrument. We decided against this approach because it would be difficult or impossible to estimate the amount of anticipated contingent payments in many cases. Accordingly, such a rule would likely result in substantial uncertainty, inconsistent treatments and, in some cases, time-consuming litigation. Contingent debt instruments are, with increasing frequency, being issued to the public, including to individuals who are not familiar with sophisticated financial valuation concepts and methodologies. It is therefore important to have a method of accounting for income from contingent debt instruments which can be easily understood and readily applied by most of the issuers and holders of contingent debt instruments. Likewise, even among large and sophisticated investors, there are many theories and bases for estimating the amounts of anticipated contingent payments. We do not believe, as a matter of tax policy that an approach should be adopted which would lead to different results depending on the financial assumptions made by different taxpayers.

Finally, we are reluctant to support an approach that would apply one set of rules for sophisticated investors and another for unsophisticated investors, one set of rules to contingent payments which are easy to estimate and another to contingent payments which are difficult to estimate, along with sets of rules designed to determine which set of rules applies in any given case. Such an approach would add needless complexity to the tax treatment of contingent debt instruments, create opportunities for taxpayer abuse, increase the degree of inconsistency in the treatment of economically similar instruments and would not, in the end, lead to treatments that were "better" or "more correct" than those arising from a single, simpler set of rules designed to govern all contingent debt instruments.

We considered and decided against an approach under which contingent debt instruments would be marked to market annually, for several reasons. First, it would only be feasible to apply this approach to contingent debt instruments that are publicly traded, i.e., instruments which can easily be valued at the end of each taxable year. A different, and to a large degree inconsistent, approach would have to be applied to other contingent debt instruments. For the reasons discussed above, we have sought to devise a single set of rules to govern the treatment of all contingent debt instruments under Prop. Reg. Sec. 1.1275-4.

Second, such an approach would be out of step with general principles of federal income taxation, under which gains and losses attributable to changes in the value of property are not included in income until they are realized. The resulting

inconsistencies would likely be a source of trouble and confusion.

Third, it is questionable whether the Service would have the authority to issue mandatory mark-to-market regulations under Section 1275(d) of the Code, broad as that mandate is. Such an approach would be fundamentally inconsistent with, rather than "carry out," the principles of Section 1271 through 1275 of the Code.

Another approach that was considered involves the current accrual of interest only on the discounted present value of the non-contingent payments under the instrument. This approach resembles the approach applied under the January Regulations to instruments providing for contingent payments that are not determined by reference to the value of actively traded property. This approach also resembles in part the "bifurcation approach" of the current proposed regulations, except that rights to contingent payments are not necessarily treated "in accordance with their economic substance".

We decided against this approach primarily because it could not be applied satisfactorily to instruments providing for contingent principal, an increasingly visible component of the contingent debt market. The approach could not be applied, for example, to an instrument providing for wholly contingent interest and wholly contingent principal, because there would be no non-contingent payments. Likewise, it could not be applied satisfactorily to debt providing for fixed interest and wholly contingent principal, because the fixed payments of interest would be improperly recharacterized largely as returns of principal on an installment obligation.

Moreover, for the reasons discussed more fully above, we do not advocate adopting one set of rules to govern the treatment of fixed-principal contingent debt instruments and another set of rules to govern the treatment of contingent principal instruments.

In addition, as discussed in Background above, we have chosen, as a theoretical matter, to embrace a unitary approach, rather than a bifurcated approach, to the treatment of hybrid debt. This means that once it has been determined, on the basis of all of the relevant facts and circumstances, that a hybrid instrument is a debt instrument, rather than a forward contract, option or other financial instrument, all, rather than merely a portion, of the lender's return on the instrument should be accounted for as interest.

Finally, for the reasons set out immediately above, under “Background”, and in prior reports,[18/] we advise against the “bifurcation approach” adopted by regulations proposed in February, 1991, which is based on economically equivalent investment units. As discussed immediately above, this approach could not reasonably be applied to instruments which do not provide for fixed principal; because there would be nothing to apportion to the fixed component, there would be no basis for the current accrual of interest. Even in the case of instruments providing for fixed principal and contingent interest, however, it is difficult, if not impossible, under such a system, to determine what the right to contingent payments is economically equivalent to and how it should properly be treated for federal income tax purposes.

[18/] See n. 3, supra.

Consider, for example, a five-year debt instrument providing for fixed principal and annual interest based on the annual increase in a stock index. Is the right to the annual contingent interest payments (a) a single equity swap giving rise to ordinary income or loss under the Proposed Section 446 regulations, (b) a single "installment" cash settlement option, resulting in "open transaction" treatment and capital gain or loss at maturity, or (c) five separate cash settlement options, resulting in gain or loss each year? Furthermore, if it is five separate cash settlement options, how is a portion of the issue price of the instrument to be allocated to each of them? Given the increasing complexity of the formulae determining the amount of the payments under contingent debt instruments, it is simply not feasible to base the tax treatment of contingent debt instruments, in whole or in part, on economic equivalence.

D. Difficulties with the Minimum Accrual Approach

One of the principal difficulties with the Minimum Accrual Approach involves the treatment of hedged issuers and holders. This subject is discussed more fully in the next section, where additional recommendations are made to deal with this concern.

Another potential concern involves the fact that holders might in some cases be required to include interest in income notwithstanding that it is clear, under the circumstances, that the hoped for interest will never materialize. For example, consider a fixed-principal instrument providing for annual interest based on the issuer's net profits.[19/] The issuer

[19/] Such an instrument might be treated, on a prospective basis, as part debt and part equity under regulations that are yet to be issued under Section 385 of the Code.

unexpectedly has no net profits for the first year; it seems clear that interest for the first year has been forever “lost”, even though large profits in subsequent years may ultimately compensate. Under the Minimum Rate Approach, however, the holder would be required to include “phantom” interest in income at the Minimum Rate.

Our principal responses to this concern are (a) as discussed more fully above, to recommend a further expansion of the VRDI definition under Prop. Reg. Sec. 1.1275-5 to cover most fixed-principal current-pay or current-accrual contingent debt instruments, and (b) as discussed more fully below, to permit the integration of contingent debt instruments with associated hedges in a manner similar to the rules under Section 988(d) of the Code. If these recommendations are adopted, Prop. Reg. Sec. 1.1275-4 will apply primarily to unhedged issuers and holders of contingent instruments providing for deferred interest, front- or back-loaded interest, or contingent principal. We believe that it is appropriate under these circumstances for the Secretary to make reasonable assumptions designed to protect the fisc and prevent the deferral of interest. This is expressly within the mandate of Congress set out under Section 1275(d), and a taxpayer can always reverse the accrual by disposing of the instrument to take an offsetting loss.

VI. INTEGRATED TREATMENT

A principal concern under the Minimum Accrual Approach is that it is not consistent with the treatment of options under current law. Specifically, interest does not accrue on the premium paid or received for a cash settlement option. Under the Minimum Accrual approach, however, interest accrues at the Minimum Rate on the entire issue price of a debt instrument,

including on an embedded option premium. This inconsistency could whipsaw the fisc.

For example, a corporation which issues a 5-year zero-coupon debt instrument for $1,000 which promises $1,000 plus a contingent amount at maturity could pay a financial institution $320 for the right to receive the contingent amount at the end of five years. On a net basis, such an issuer would be borrowing $680 ($1,000 - $320) in exchange for a promise to pay $1,000 at the end of five years. An issuer who actually borrowed $680 in exchange for a fixed zero-coupon note promising $1,000 at maturity could deduct only $54 of interest (i.e., original issue discount) in the first taxable year ($680 x .08), and $320 of interest over the life of the instrument ($1,000 - $680). Under the Minimum Rate Approach, the issuer would deduct $80 of interest in the first taxable year, and $469 over the life of the instrument.

For similar reasons, a fully hedged holder would include too much interest in income over the life of the hedged position. For example, a holder of the instrument described above who promises, in exchange for $320 received on the date of issuance, to make a payment at the end of five years equal to the amount of the contingent payment received on the debt instrument has in effect acquired, for $680 ($1,000 - $320), a zero-coupon debt instrument promising $1,000 at maturity. Under the Minimum Rate Approach, the holder would include $80, rather than $54, of interest in income in year one, and $469, rather than $300, of interest in income over the life of the instrument.

In addition, mismatches in the character of a holder's hedged position would have the potential to whipsaw both the holder and the fisc. Thus, in the above example, if the

contingent debt instrument ultimately paid $2,000 at maturity, the holder would recognize an additional $531 of ordinary interest income (see discussion below under “Character of Gain and Loss”) and might have a mismatched $531 capital loss on the hedge position.[20/] If the contingent debt instrument ultimately paid only $1,000, however, the holder would reverse the $469 of interest included in income over the life of the contingent debt instrument with an ordinary deduction (see discussion below under Section IX) but might recognize $469 of capital gain on the hedge position, taxable at lower capital gains rates.[21/]

The timing and character mismatches described above could discourage many hedged investors, such as regulated investment companies and other financial institutions, from holding hedged portfolios of contingent debt instruments, despite the fact that such investors normally acquire contingent debt instruments and associated hedges as part of their routine

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[20/] see Section 1234A of the Internal Revenue Code.

[21/] Regulations under the straddle rules contain a conversion provision under which the holding period of property which is part of a straddle does not begin until the taxpayer disposes of the offsetting position. Reg. Sec. 1.1092(b)-2T. If the contingent debt instrument was issued in a private placement (i.e., was not actively traded), however, the holding period would arguably not be tolled under the straddle regulations. Although Section 1092(d)(7) treats foreign currency denominated debt as a “position” in the underlying foreign currency, there is no similar authority for treating the ownership of stock or commodity indexed debt as a position in the underlying stocks or commodities. Thus, the straddle regulations apparently would not apply to the contingent debt instrument, in addition, Section 1233(b) would arguably not apply to make the gain from termination of a bilateral hedge contract short-term capital gain because, although the bilateral contract might be a short sale of the embedded option, it technically would not be a short sale of the contingent debt instrument itself or of substantially identical property. Finally, Section 1258 of the Code, which is designed to prevent the conversion of ordinary income into long-term capital gain under similar circumstances, would not necessarily apply in the absence of regulations, because the hedge would be a sale of a position embedded within the contingent debt instrument, rather than a sale of the contingent debt instrument itself, and would therefore not come within the literal terms of Section 1258(c)(2)(A).

portfolio management activities or for other reasons that have nothing to do with federal income tax consequences. Accordingly, such mismatches in character or timing would serve only to impede economic efficiency.

There would be no timing mismatches if interest accrued, at the Minimum Rate, on the premium paid for an option with a term of more than one year, as if the option were a contingent debt instrument issued for an amount equal to the option premium. In the example above, the issuer would include $26 of interest in income in the first taxable year ($320 x .08) and $149 of interest in income over the life of the premium.[22/] Such an approach might reduce some of the pressure placed on the characterization of financial instruments as debt instruments, options or forward contracts, and would mitigate timing mismatches arising from hedged positions which serve not only to impede legitimate financial transactions but, in many cases, to whipsaw the fisc. Long-term publicly traded options and forward contracts generally did not exist at the time that the tax treatment of options first developed, and the treatment of these

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[22/] The issuer would presumably elect to integrate the two positions for purposes of foreign tax credit limitations under Reg. Sec. 1.861-9T(b)(6).

contracts under current law could be viewed as "out of step".[23/] Such an approach would still leave serious character mismatch problems, however. In light of the Supreme Court's decision in Arkansas Best v. Commissioner, a solution for these problems is beyond the scope of this report.[24/]

We believe, therefore, that the best way of dealing with the timing and character mismatches described above is to integrate contingent debt instruments with their associated hedges under rules similar to those laid out in the regulations under Section 988(d) of the Internal Revenue Code. It is our understanding that in a majority of cases, domestic issuers of contingent debt instruments do in fact hedge out of the

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[23/] In fact, the Service may already be heading in this direction. Interest would accrue, for example, under the Section 446 regulations on the premium paid for a cash-settled stock or commodity option that is embedded in the terms of an equity or commodity indexed swap, cap or floor. The up-front payment made by the "in-the-money" party for the position in the swap, cap or floor would, if significant, be treated as a loan. Reg. Sec. 1.446-3(g)(4).

Moreover, The Service apparently is considering a proposed Reg. Sec. 1.446-5 which might bifurcate an in-the-money option into debt and option components based on intrinsic and extrinsic values. (The "intrinsic value" of an in-the-money call option, for example, is the excess of the value of the underlying over-the- strike price, and the "extrinsic value" is the remainder of the value of the option, generally based on (a) the value of the ability to share in the potential appreciation of the underlying, albeit at the cost of sharing in the depreciation of the underlying, without laying out capital equal to the strike price to hold the underlying, and (b) the value of the implicit put option, under which the holder does not share in depreciation of the underlying below-the-put price.) Unfortunately, this approach would not mitigate the timing mismatches described above--the $320 premium in the example described above is paid for a long-term option that is at the money, rather than for one that is in the money. Nor would such an approach mitigate the inconsistency with Reg. Sec. 1.446-3, since a significant upfront payment for an equity derivative or commodity swap is treated as a loan without regard to whether the deemed embedded option is in the money.

[24/] Temporary regulations recently issued under Section 1221 of the Code, i.e., Reg. Sec. 1.1221-2T, would alleviate these problems for issuers, but not for holders. Contingent debt instruments are capital assets in the hands of most investors, and the regulations are not available for hedging capital assets.

associated contingencies to obtain the economic equivalent of a fixed or floating rate debt instrument, and the economically equivalent instrument is easy to identify and tax accordingly. Indeed, the debt and the associated hedges typically are treated as a single transaction for financial accounting purposes under FASB 80. We believe that identification and integration should be mandatory in these cases, but the Service should retain its authority to integrate other substantially hedged positions in appropriate circumstances. In addition, we believe the Service should apply the broadest possible mandatory integration rule to prevent issuers from "hiding" associated hedges. For example, the rule should require disclosure of any positions entered into by a related party, whether foreign or domestic, which substantially reduce the risks associated with issuance of the debt and require integration of these positions where appropriate.[25/]

Holders should likewise be permitted to integrate fully hedged positions. As discussed above, unless a holder can integrate, the holder may accrue too much interest income over the life of the position and may realize mismatched ordinary income and capital loss. There may be no reason to require holders to integrate, however, if the Minimum Rate generally reflects a market rate of interest, such as 120% of the applicable federal rate.[26/] Holders seeking integrated treatment should be required to identify the components of any fully hedged position, as under the regulations under Section 988(d). Issuers or their paying agents, however, will presumably report the

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[25/] Given that corporations rarely issue unhedged contingent debt, auditors would presumably expect integration as a norm and examine the facts and circumstances in cases where an issuer purported to be issuing unhedged contingent debt.

[26/] Any concern that substantially hedged positions might permit holders to convert ordinary income attributable to the time value of money into capital gains could be dealt with in regulations under Section 1258 of the Code.

accrual of interest income, on Form 1099, assuming no integration or other modification.

There is, in our view, ample authority to permit or require such integration. The Service already has authority, under the Section 446 regulations, to require the integration of two notional principal contracts undertaken with two different counterparties into an economically equivalent fixed installment borrowing.[27/] The Service also has authority, under Reg. Sec. 1.988-5, to require integration of a contingent foreign currency denominated debt instrument and an associated hedge into an equivalent non-contingent debt instrument. We believe that mandatory integration is consistent with the Secretary's mandate under Section 1275(d) of the Code to prescribe regulations modifying the original issue discount rules, to the extent appropriate to carry out their purpose, to deal with contingent debt instruments. Integration of a contingent debt instrument with its associated hedge permits the establishment of a fixed yield to which the remainder of the original issue discount rules can be applied. It therefore permits the Secretary to “carry out the principles” of Sections 1271 through 1275 of the Code. Moreover, this approach best reflects economic reality -- i.e., this is the way issuers and holders in the market actually look at what they are doing.

The mere disposition of a hedge should not necessarily be treated as a “legging out” which terminates integration and results in the recognition of gains and losses, as it does under Reg. Sec. 1.988-5. Taxpayers are developing an increasing

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[27/] Reg. Sec. 1.446-3(e)(4)(i), concerning certain “com-pound and disguised” notional principal contracts.

capacity to “dynamically hedge” positions in contingent debt (i.e., to hedge such positions by continually acquiring and disposing of offsetting positions). If an issuer engaged in dynamic hedging is not treated as maintaining a fully hedged position, and is therefore not subject to mandatory integration, sophisticated issuers, including particularly financial institutions, may have the ability to deduct above-market interest.

The Service should simply require issuers, and holders who elect integrated treatment, to identify the hedged debt and the related hedging positions, including the gains and losses from such hedging positions, as they are entered into and/or disposed of. Failure to maintain a hedged position, however, should be treated as a legging out. Hedged issuers, and holders electing integration, should be required to report failure to maintain a hedged position as a legging out transaction on their returns. The Service would, as always, have authority to challenge the taxpayer's position if it appeared that the taxpayer had continued hedging on a dynamic basis.

VII. CURRENT INTEREST PAYMENTS

A. Fixed Payments

In general, in the case of any debt instrument governed by Prop. Reg. Sec. 1.1275-4, all fixed payments should be treated as part of the stated redemption price of the instrument, rather than as qualified stated interest, regardless of how the payments are characterized. Any resulting excess of stated redemption price over issue price should result in the accrual of original issue discount, although this would not increase the rate of accrual on the instrument until it exceeded accrual at the

Minimum Rate. For the reasons set out in C. below, however, an excess of issue price over fixed payments should not result in the amortization of bond issuance premium.

B. Instruments with Fixed Payments Equal to Issue Price.

In the case of an instrument which provides for fixed payments that are equal to, or greater than, its issue price, and which is not designed to produce a front-loading of interest, we recommend treating all contingent payments under the instrument as interest. (See discussion below under "Character of Gain or Loss".) Thus, if an instrument is issued for $1,000 and promises at least $1,000 at maturity, a first year's contingent payment of $300 would be treated entirely as interest.[28/] This approach is consistent with (a) the approach for variable rate debt instruments under Reg. Sec. 1.1275-5, (b) the approach, under current Prop. Reg. Sec. 1.1275-4(e), for instruments with non-contingent principal, and (c) the general approach taken under case law.[29/]

This rule would also govern a 10-year debt instrument that is issued for $1,000, promises $100 of interest per annum, and provides for wholly contingent principal, because the instrument provides for fixed payments equal to its issue price. As discussed above, the stated interest on such an instrument would be treated as principal. That recharacterization would not result in the deferral of interest, however, because interest

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[28/] An instrument issued for $1,000 and promising at least $1,100 at maturity would have $100 of original issue discount under the general original issue discount rules, i.e., the discount would accrue, on a yield-to-maturity basis, over the life of the instrument.

[29/] United States v. Midland-Ross Corp., 381 U.S. 54 (1965); Utility Trailer Manufacturing Company v. United States, 212 F. Supp. 773 (S.D. Cal. 1962).

would still accrue at no less than the Minimum Rate. If the instrument promises at least $500 at maturity, however, then $500 of original issue discount (based on the excess of $1,500, the amount of the minimum payments, over $1,000, the instrument's issue price) would accrue over the life of the instrument in addition to any contingent payments, which would still be treated as interest.

C. Instruments With Fixed Payments Less Than the Issue Price

Treating all contingent payments as payments of interest is not appropriate for an instrument providing for contingent principal. If the payment at maturity is likely to be smaller than the issue price, the instrument is in the nature of an installment obligation, and some of the contingent payments should be treated as principal. There is no practical way to distinguish this case, however, from the case in which the payment at maturity is expected to equal the issue price without attempting to value the payment at maturity.

It appears appropriate, therefore, to apply a “modified open transaction” approach under which contingent payments are treated as returns of principal, rather than as payments of interest, to the extent that the total remaining non-contingent payments are less than the instrument's adjusted issue price.

Thus, suppose an instrument is issued for $1,000 provides for wholly contingent principal and pays $300 of contingent interest at the end of year one. Assume that $80 of interest accrues at the Minimum Rate over the first year of the instrument, increasing the issue price and basis of the instrument to $1,080. The $300 payment at the end of the first

year should reduce the issue price and basis of the instrument from $1,080 to $780, but should not result in any additional deductions or income inclusions. Once similar contingent payments reduce the issue price and basis of the instrument to zero, however, all further payments should be treated as payments of interest and deducted and included in income accordingly. This approach is consistent with the approach under the 1986 Proposed Regulations for an instrument with fixed payments that are less than its issue price.

Suppose in the example above that the instrument guarantees minimum payments of $900 (e.g., $450 in each of the last two years). The instrument still accrues $80 of interest at the Minimum Rate, increasing its issue price to $1,080. In this case, however, $180 of the first year's interest payment should reduce the issue price and basis of the instrument from $1,080 to $900, but the remaining $120 of the payment should be treated as interest.[30/]

It follows as a corollary to the open transaction approach that there should be no amortization of bond issuance premium on a contingent debt instrument. Any excess of the issue price over the stated redemption price should be dealt with through a recharacterization of overstated interest as principal under the foregoing methodology. This should be clearly stated in the proposed regulations and in an amendment to Reg. Sec. 1.61-12(c).

[30/] As discussed under “Current Accrual Approach” above, accrual at the Minimum Rate would cease until the aggregate amount of “notional accrual” equaled the aggregate amount of interest previously paid (i.e., $120, assuming no further payments of interest), and interest would then begin accruing again at the Minimum Rate on an adjusted issue price of $900.

We considered as an alternative to this approach the amortization of contingent principal, i.e., of the excess of the issue price over the minimum guaranteed payment at maturity, over the life of the instrument. We decided against this primarily because it produces an unreasonable result in the most common case -- the one where the payment at maturity is expected to be approximately equal to the issue price, even though there is no guaranteed minimum amount. Amortization in such a case would completely offset the accrual of interest on the instrument and, therefore, would not meet the Service's objective of preventing the deferral of interest on contingent debt. Furthermore, we did not recommend an approach that calls for amortization of the excess of the issue price over the anticipated amount of the payment at maturity because, for the reasons discussed above under “Current Accrual Approach”, we do not believe that an approach based on the estimation of future contingent payments is workable.

We did not consider as an alternative the allocation of a portion of the issue price of the instrument to each anticipated payment under the instrument, with a corresponding recognition of income or loss when the amount of each contingent payment becomes fixed (an “interim realization approach”). For reasons discussed under “Current Accrual Approach” above, we do not believe an approach based on the valuation of rights to receive future contingent payments is workable, and there would be no means of making such an allocation in the absence of valuation. In addition, such an approach is inconsistent with the assumption that a contingent debt instrument is a single financial instrument, rather than a series a “mini” instruments, and with the application of general principles of federal income

taxation to a single financial instrument.[31/] Thus, interim payments on a single cash settlement option receive open transaction treatment and do not result in the recognition of interim gains and losses.

It is worth noting that neither issuers nor holders are necessarily benefitted by an open transaction approach. Thus, where a contingent interest payment turns out to be less than anticipated, a holder is not entitled to take any loss under an open transaction approach, but would be so entitled under an interim realization approach. Likewise, where a contingent interest payment turns out to be greater than expected, an issuer is not entitled to a larger deduction, but would be under an interim realization approach.

In summary, we recommend an open transaction approach because it generally is not feasible to distinguish between an instrument with a contingent principal payment that is expected, at the time of issuance, to be close to the instrument's issue price, and one with a contingent principal payment that is expected to be close to zero. In other words, it will normally not be possible to “recognize” contingent installment obligations and provide a separate set of rules for them. Failure to adopt an open transaction approach, therefore, would permit unhedged issuers of contingent debt instruments to deduct, and require unhedged holders to include, overstated interest.

[31/] The “mini-instrument approach” was disavowed by the Service in the preamble to final regulations under Section 446 of the Code that was released on October 8, 1993.

D. Front-loaded Interest

Although the mandatory accrual of interest at no less than the Minimum Rate should limit any potential for serious back-loading of interest, there would still be a potential for the front-loading of interest, regardless of whether the instrument provides for contingent principal. Thus, if an instrument issued at par but designed to produce a front-loading of interest pays $300 of contingent interest in year one, it might not be clear whether the payment is large because of an unanticipated increase in the amount of the factors determining interest under the instrument, in which case it should be treated as a payment of interest, or because those factors were designed to produce larger payments in the early years and smaller payments in the later years, in which case it should be treated partly as a return of principal.

Consequently, we recommend that all interest in excess of accrual at the Minimum Rate ("Excess Interest") be recharacterized as principal in any case where the Service determines that an instrument has been designed to produce a front-loading of interest. (As previously noted, clear criteria for determining when an instrument is designed to produce a front or back-loading of interest are indispensable to the proposed approach.) Recharacterization should cease when the issue price of the instrument equals zero, after which all payments on the instrument, including the payment at maturity, should be treated entirely as payments of interest. Excess Interest would in effect accrue as original issue discount over the remaining life of the instrument, rather than when paid.

Thus, suppose an instrument is issued for $1,000, promises $1,000 at maturity, and is designed to produce a front-

loading of interest. Accrual at the Minimum Rate in year one increases the issue price and basis to $1,080, and the instrument makes a $500 contingent payment at the end of year one. The entire $500 payment should reduce the adjusted issue price and basis of the instrument from $1,080 to $580. As a result, the additional $420 ($500 - $80) will accrue as original issue discount over the remaining life of the instrument (because the $1,000 stated redemption price now exceeds the $580 adjusted issue price), rather than at the end of year one.

E. Floating-Rate Interest

Minimum Accrual, and recharacterization of contingent interest as principal, are poorly suited to one particular kind of instrument, an instrument providing for contingent principal and current interest at a floating rate which generally measures the current cost of borrowed funds. If such an instrument pays interest at a rate higher than the Minimum Rate in effect on the date of issuance because market rates of interest have increased, it seems counterintuitive to require that a portion of this amount be treated as a return of principal. Likewise, if such an instrument pays interest at a lower rate because market rates have declined, it seems counterintuitive to require accrual at the Minimum Rate.

It should be pointed out, however, that such instruments are rarely issued in today's market. Instead, instruments with indexed principal are generally issued for an amount equal to the principal that would be paid if the relevant index factors did not change (i.e., the amount determined under the principal formula using spot rates in effect on the date of issuance). Since spot values generally differ from anticipated forward values, the interest rate, whether floating or fixed, is a “plug”

designed to compensate for the difference between spot and forward rates, rather than a true measure of market interest rates.

We favor a limited exception to the open transaction approach that would respect floating rate interest on instruments with interest rate formulas actually designed to measure the current cost of funds. An instrument with contingent principal might qualify for this treatment if it provides for the payment or accrual of interest based on a single formula intended to measure current rates of interest on short-term funds and if the initial rate of interest under the formula approximates the Minimum Rate (plus or minus some number of basis points) or, in the case of a fully hedged issuer, if the issuer provides evidence that the formula approximates the issuer's all-in floating-rate cost of capital. For this purpose, the Minimum Rate would have to be adjusted to reflect the cost of funds obtained for a relatively short period of time (i.e., the period between interest adjustment dates). The Minimum Rate might also have to be adjusted if it is systematically lower than market rates, e.g., if it is the applicable federal rate.

We are not in favor, however, of an approach, similar to the one proposed in the January Regulations, designed to accommodate an instrument which is issued at par based on spot values of underlying property but at a discount or premium based on forward values of the property and which therefore does not pay interest at a market rate. The approach in the January Regulations relied on a discretionary estimation of the amount of the payment at maturity. For the reasons discussed above under “Current Accrual Approach”, we do not advocate that approach.

VIII. REALIZATION PRIOR TO PAKMEKT

The current Prop. Reg. Sec. 1.1275-4 includes a deferred payment rule which applies when the amount of an anticipated contingent payment becomes fixed more than six months before the payment is due. In the case of an instrument providing for non-contingent principal, the general rule is that the present value of the anticipated payment at the time it becomes fixed (the "fixing date"), discounted at the applicable federal rate, is treated as a payment of interest (i.e., is included and deducted) in the taxable year of the fixing date. The remainder of the payment (i.e., the excess of the amount of the payment over its discounted present value) is included in income on a yield-to-maturity basis over the period between the fixing date and the payment date. In other words, the parties are treated as if the borrower had used a zero-coupon bond to pay the lender the discounted amount on the fixing date.

There is, however, a difficulty with this approach. Consider a 30-year non-contingent principal obligation issued for $100 and providing for contingent interest based on an index which for some reason does not permit the instrument to qualify as a VRDI under Prop. Reg. Sec. 1.1275-5. One year from the date of issuance, all of the remaining 29 years of interest payments become fixed at $8 per annum, a market rate of interest. The discounted present value of these interest payments approaches the entire issue price of the instrument, since interest on a 30-year instrument represents most of the present value of the instrument. As a result, the issuer deducts, and the holders include, interest in year one in an amount almost equal to the entire issue price of the instrument.

This result is, of course, inconsistent with general principles of tax accounting. What the rule presumably should do in this case is treat the excess, if any, of the discounted present value of the fixed future payments over the adjusted issue price of the bond (the “excess realization”) as a deemed payment of interest for the first taxable year. Since no cash is paid in year one, the deemed payment should increase the issue price of the bond. The fixed payments should simply be added to the stated redemption price of the instrument, and the original issue discount rules should then govern accretion of the excess of the increased stated redemption price over the increased issue price.

Thus, suppose in the example above that the floating interest became fixed at the end of one year at $20 per annum (i.e., the relevant interest index unexpectedly vent up), and the present value of the instrument was therefore $235, discounting at 8% per annum. The issuer would deduct, and the holder would include, $135 of interest for year one, and the adjusted issue price would increase to $235. The excess of $680 ((29 x $20) + $100), the new stated redemption price, over $235 would be included and deducted over the remaining 29 years, under the general original issue discount rules.

As discussed more fully below, however, this approach grows rather complicated when some, but not all, of the future contingent payments become fixed. As a theoretical matter, moreover, the inclusion and deduction of interest in year one in the example above is arguably incorrect. The additional interest which becomes fixed at the end of the first year is paid and received for the use or forbearance of money. Under the economic performance test of Section 461 of the Code, therefore, such interest should be included and deducted over the 30-year life of

the loan, rather than in the first taxable year. An approach which requires realization in year one merely because that is when the amount of the taxpayer's gain becomes fixed is more consistent with a “bifurcated approach” to contingent debt, rather than with treatment of the instrument entirely as a loan transaction. While immediate inclusion and deduction is more correct in cases where payments become fixed towards the end of the life of the loan,[32/] it would be too complex to devise an approach which distinguished between these two cases. As discussed below, any approach involving current realization would likely be complex enough.

In light of these considerations, we recommend an “open transaction approach” for realization prior to payment. No amount should be included or deducted merely because an anticipated future payment becomes fixed. Rather, payments which become fixed more than two years before they are scheduled to be paid should be treated as part of the stated redemption price of the instrument, regardless of whether they would otherwise be treated as interest. Since accrual under the original issue discount rules will at all times be based on the excess of the minimum remaining payments under the instrument over the current revised issue price, accrual under the original issue discount rules may as a result exceed, and therefore replace, accrual at the Minimum Rate. Thus, in the example above, $20 per annum should be added to the payments due under the instrument, but no amount should be added to the issue price, and no amount should be included or deducted in year one. As a result, the $20 per annum will be

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[32/] Consider, for example, a 30-year zero-coupon debt instrument providing for a large contingent payment at maturity which becomes fixed at the end of the 29th year. It appears reasonable to require inclusion and deduction of the present value of the amount that has become fixed, since most of this amount is arguably paid for the use of funds over the preceding 29 years.

included and deducted over the remaining life of the instrument under the general original issue discount rules.

Likewise, if as a result of one or more anticipated contingent payments becoming fixed, accrual under the general original issue discount rules based on the excess of the maximum remaining payments under the instrument over the then current adjusted issue price is less than accrual at the Minimum Rate, accrual at the Minimum Rate should cease and be replaced by such lesser accrual of original issue discount. If the then current adjusted issue price exceeds the maximum amount of all remaining payments under the instrument, all accrual should cease, and the excess of the current adjusted issue price over the maximum remaining payments under the instrument should be amortized over the remaining life of the instrument, under the rules set out for the amortization of bond issuance premium. Since, consistent with the notion that all interest is earned over the life of the loan, established increases in the minimum amount payable are added to the stated redemption price of the instrument rather than included and deducted immediately, established decreases in the maximum amount payable should decrease the maximum stated redemption price at maturity but should not be included or deducted immediately. For this purpose, regulations under Sections 61 and 171 of the Code should treat amortized amounts as deductible by the holder, and includable by the issuer, rather than as reducing interest from the instrument under Section 171(e) of the Code, since the instrument might not provide for any more interest.

We recognize that this approach creates some divergence between the treatments of relatively similar bonds. For example, suppose a debt instrument issued for $1,000 and promising $1,000 at maturity provides for a contingent payment at the end of year

three and does not provide for a front-loading of interest. If the contingent payment turns out to be $300 and becomes fixed immediately before it is paid, it is treated as a payment of interest under the general rules above. If, however, it becomes fixed at $300 significantly before it is paid, it is treated as a return of principal rather than as a payment of interest and the payment is in effect accrued under the original issue discount rules over the remaining life of the instrument, rather than at the end of the third year. In other words, the instrument is treated with regard to this payment as if it provided for a front-loading of interest. To justify this divergence (which in any event is not as great as it might appear, in light of required accrual at the Minimum Rate), we believe that a payment of interest should be recharacterized as principal tinder the early realization rule only if it becomes fixed more than two years prior to the date on which it is paid, as opposed to the more-than-s ix-months approach of the current proposed regulations. Otherwise, the payment should simply be respected as a payment of interest when it is paid.

If the Service does decide to apply a current realization approach, based on “excess realization,” to instruments providing for non-contingent principal and no front-loading of interest, we have a number of comments. Beginning with the simplest, in conformance with the general approach recommended by this Report, payments which became fixed should presumably be discounted at the Minimum Rate, rather than at the applicable federal rate.

Next, the approach will be complicated if less than all of the payments under an instrument become fixed. Suppose, in the example above (a 30-year $100 debt instrument issued at par and providing for contingent interest) that only the twelfth interest

payment becomes fixed at $20. Presumably under this approach, the regulations would want to deal with the excess of $20, the amount payable in the twelfth year, over interest expected to accrue in the twelfth year at the Minimum Rate ("expected interest"), and discount this amount to present value at 8% per annum. Assuming that such excess would be $12 ($20 - $8), and that the present value of such excess would be $5, an additional $5 of interest would be deducted and included in the first taxable year, and $15 of original issue discount would then accrue over the next 11 years. The $20 payment in year 12 would be treated as a payment of $20 of principal on a "minibond", rather than as a payment of interest.

Expected interest may not be $8, however, if the revised issue price of the instrument is expected to exceed the original issue price by the end of the twelfth year. In the case of an instrument accruing unpaid interest at the Minimum Rate or under the original issue discount rules, the revised issue price might be say $300, rather than $100, by the end of the twelfth year, and expected interest might therefore be $24, rather than $8. The regulations would therefore have to require estimation of the revised issue price at the beginning of the twelfth year and multiply such estimated issue price by the Minimum Rate to arrive at expected interest for the twelfth year.

Rules designed to deal with the early realization of losses would likewise be more complicated. If, as a result of an anticipated future payment becoming fixed, the current adjusted issue price exceeds the maximum (undiscounted) amount of all remaining payments under the instrument, the excess should be immediately deducted by the holder, and included in income by the issuer, rather than amortized over the remaining life of the instrument. This would be consistent with the fact that an

increase in minimum payments is deducted and included immediately, rather than amortized as original issue discount. The adjusted issue price and basis would of course be reduced to equal the maximum amount of the remaining payments. Thus, suppose the issue price of a 10-year zero-coupon debt instrument issued for $1,000 accretes, at the Minimum Rate, to $1,200 at the end of year three, at which point the payment at maturity because fixed at $1,100. Accrual at the Minimum Rate would of course cease. In addition, however, the issuer would immediately include, and the holder would deduct, $100, and the issue price and basis of the instrument would be reduced to $1,100.

This is a more limited loss realization rule than might be adopted. For example, proposed regulations could provide for immediate deduction and inclusion of the excess of the current adjusted issue price over the present value of the maximum remaining payments under the instrument discounted at the Minimum Rate. Using the example above, under the broadest loss realization rule, the issue price of the instrument would be reduced to $600, the present value of the right to receive $1,100 in seven years, discounted at the Minimum Rate (here, 8% per annum). As a result, the issuer would include $500 of cancellation of indebtedness in income and the holder would have a $500 ordinary deduction. (See discussion below under “Character of Gain and Loss”.) Five hundred dollars of original issue discount would then accrue over the remaining life of the instrument. Under a somewhat less broad realization rule, the issue price would be adjusted back to $1,000, reversing prior accruals at the Minimum Rate. The issuer would include, and the holder would deduct, $200 of ordinary income, and $100 original issue discount would accrue over the remaining life of the instrument. On balance, however, we would recommend the first approach, because we see no need to create deductions and

inclusions offset by subsequent accruals of original issue discount.

IX. CHARACTER OF INCOME AND LOSS AT MATURITY

The appropriate character of a holder's Income or loss from contingent debt at maturity, as capital or ordinary, has been the subject of considerable discussion among the persons who participated in the preparation of the Report. As a matter of theory, there are good arguments both ways. As a matter of practice, however, we believe that all gain from a contingent debt instrument at maturity should be treated as ordinary interest income, and loss at maturity of the instrument should be treated as ordinary loss to the extent of any previously accrued income from the instrument that was never received. A convenient way to implement this rule would be to treat loss as ordinary loss to the extent of the excess of the basis of the instrument at maturity over the original purchase price of the instrument.

With regard to the recognition of loss, we do not believe that unhedged holders should suffer a “mismatch” of ordinary interest income and capital loss. For example, a person who acquires a contingent debt instrument for $1,000, receives no interest over the life of the instrument but nevertheless includes $469 of interest in income over the life of the instrument based on accrual at the Minimum Rate, thereby increasing the basis of the instrument to $1,469, should not recognize a $469 capital loss if only $1,000 is received at maturity. Such a holder would not be permitted to use such a capital loss to offset more than $3,000 of ordinary income (or none in the case of a corporation) and, therefore, would generally not be able to use the capital loss to offset the previously accrued income from the instrument. In addition, the

previously accrued income would be taxable at ordinary rates, while the capital loss generally would offset capital gains taxable at lower rates. Consequently, we believe that loss from the disposition at maturity of a contingent debt instrument governed by Prop. Reg. Sec. 1.1275-4 should be ordinary loss to the extent of the excess of the basis of the instrument over the instrument's original purchase price. Treating such loss as ordinary is in our view consistent with general principles of federal income taxation -- if a taxpayer includes interest in income which is not ultimately received, the taxpayer should be entitled to an ordinary loss.

On the other hand, we believe that any loss in excess of accrued but unreceived income on the instrument should be treated as a capital loss (assuming that the instrument is held as a capital asset), consistent with general principles of federal income taxation and Section 1271(a)(1) of the Code.[33/]

We believe that all gain on maturity of a contingent debt instrument should be treated as ordinary interest income for four reasons. First, if the Service agrees that loss from a contingent debt instrument generally should be deductible against ordinary income taxable at ordinary rates to the extent of any accrued but unreceived interest income, then gain from a contingent debt instrument should not be eligible for taxation at lower capital gains rates. Treatment of the loss as ordinary amounts to a downward adjustment of the amount of interest earned from the instrument, to the point where a given holder could in

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[33/] As discussed more fully above under “Realization Prior to Payment,” however, the Service could adopt a treatment under which holders might, in relatively rare cases, recognize losses prior to maturity and still accrue interest income over the remaining life of the instrument. If such an approach is adopted, such losses also should be treated as ordinary to the extent of the income yet to be accrued on the instrument at the Minimum Rate.

effect be treated as having earned no interest at all. It follows that gain should be treated as an upward adjustment to the amount of interest earned, to the point where a given holder could be treated as having earned far more interest than the market rate. Ex ante, a holder is as likely to lose as to win in this regard (or else the instrument is improperly priced). Furthermore, the fisc could be whipsawed under any other approach.

Second, all of the contingent amounts received on a VRDI are treated as interest under Prop. Reg. Sec. 1.1275-5. As discussed more fully under "Extension of VRDI Treatment" above, recently proposed regulations expand the definition of a VRDI to include not only instruments providing for contingent payments based on the cost of funds, but also for contingent payments based on changes in the value of actively traded property, including stock and commodity indices. We recommend, moreover, a further expansion of the definition of a VRDI to include all instruments providing for non-contingent principal and interest at a single variable rate (or interest which otherwise is not designed to produce front- or back-loading of interest). It would be inconsistent to treat similar amounts received under Prop. Reg. Sec. 1.1275-4 as capital gains. Suppose, for example, that Instrument A is a 5-year instrument issued for $1,000 promising $1,000 at maturity and annual interest based on the annual increase in the S&P 500 Index. Instrument B is a zero-coupon 5-year instrument issued for $1,000 and promising $1,000 plus an additional amount at maturity based on the aggregate increase in value of the S&P 500 Index. If the holder of each instrument ultimately receives $1,700 from the issuer, and the holder of Instrument A has $700 of ordinary income, the holder of Instrument B should not have $700 of capital gain.

Third, a principal argument for treating gain from the redemption of a contingent debt instrument as capital gain is that gain from a direct investment in the underlying property, or from a cash-settled option or forward contract on the underlying property, would be capital gain.[34/] This argument is inconsistent, however, with a unitary approach, rather than a bifurcated approach, to the treatment of contingent debt. For reasons discussed above under "Current Accrual Approach", and as more fully discussed under "Background", we do not advocate a bifurcated approach to the treatment of contingent debt. Under a unitary approach, consistent with general principles of federal income taxation, an instrument is categorized as a whole, as debt, equity, an option, a forward contract, etc., on the basis of all of the relevant facts and circumstances, but once the characterization is made, the entire instrument is treated consistently in accordance with that characterization. If an instrument is characterized as debt, therefore, any amount received in excess of the amount loaned should be treated as interest income, i.e., as an amount received for the use or forbearance of money, even though this may cause the holder to recognize substantially more interest income than would be earned on a non-hybrid debt instrument.

Finally, gain from a direct investment in the underlying property, or from an analogous cash-settled option or forward contract, would generate ordinary income, rather than capital gain or loss, in some cases. The factors that determine the amount of contingent payments on a debt instrument under Prop. Reg. Secs. 1.1275-4 often reflect variations in the current cost of borrowed funds or in the values of foreign currencies. To the extent that these contingencies represent, as an economic matter,

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[34/] See generally Sections 1234 and 1234A of the Code. The application of Section 1234A of the Code is in many cases unclear, however.

contracts “embedded” in the terms of a debt instrument, the contracts are analogous to interest rate swaps, crosscurrency interest rate swaps, foreign currency positions, or other agreements which generally give rise to ordinary income or loss. It would be impracticable to determine whether gain from a contingent debt instrument should be treated as capital or ordinary based on a case-by-case enquiry into the true economic character of the contingencies underlying the instrument.

Our recommendation is consistent with current Prop. Reg. Secs. 1.1275-4(e) and (f), which treat all amounts received in excess of the issue price of the instrument as interest income, and with relevant rulings and case law.[35/] Consistent with this approach, and as provided under Section 163(e) of the Code, the unhedged issuer of a contingent debt instrument should be entitled to deduct, as interest expense, amounts included by unhedged original holders as interest income. Such interest expense would be allocated and apportioned partly to foreign source income for purposes of determining foreign tax credit limitations. Likewise, consistent with the unitary approach to contingent debt and with general principles of federal income taxation, an issuer should treat any excess of the revised issue price of an unhedged contingent debt instrument over the amount paid to redeem the instrument (at maturity or otherwise) as cancellation of indebtedness income.[36/]

[35/] See e.g., Dorzback v. Collisen, 195 F.2d 69 (3d Cir. 1952) (interest based on borrower's net profits was interest, even though it exceeded the entire amount of the loan); Kena, Inc. v. Commissioner, 44 B.T.A. 217 (1941); Rev. Rul. 83-51, 1983-1 C.B. 48. Rev. Rul. 72-2, 1972-1 C.B. 19.

[36/] Reg. Sec. 1.61-12(c).

X. ACQUISITIONS AND DISPOSITIONS IN THE SECONDARY MARKET

Gain or loss from the disposition prior to maturity of an instrument governed by Prop. Reg. Sec. 1.1275-4 should be characterized in the same manner as gain or loss from the redemption of the instrument at maturity. In other words, gain should be treated as ordinary interest income, and loss should be treated as ordinary loss to the extent of previously accrued but unreceived income from the instrument, i.e., to the extent of the excess of the basis of the instrument over the original purchase price of the instrument. This treatment diverges from the treatment of non-contingent debt instruments, where holders generally recognize capital gains and losses from changes in the value of the instrument, which changes are generally attributable to changes in market rates of interest or the issuer's credit rating. Nevertheless, we have adopted this recommendation for two practical reasons.

First, treatment of such dispositions as giving rise to capital gain or loss would not be consistent with how holders would be treated if they held their instruments to maturity. There is no apparent way of preventing this inconsistency from whipsawing the fisc. Holders of instruments which had risen in value would otherwise dispose of them prior to maturity, recognizing capital gains taxable at lower rates,[37/] while holders of instruments which had declined in value would hold to maturity to take an ordinary loss. In a theoretical sense, it would be better to treat as ordinary income only the portion of gain attributable to changes in the factors which determine the amounts of anticipated contingent payments, so that, consistent

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37/ Such holders would presumably sell their instruments to tax-exempt institutions or foreign persons. It would therefore not be reasonable to assume that the fisc would be made whole by secondary holders recognizing ordinary interest income and mismatched capital loss.

with the treatment of non-contingent debt, changes in value attributable to changes in interest rates and credit could give rise to capital gain and loss. Like the Service in the preamble to the January Regulations, however, we do not see any practical means of bifurcating gain from the disposition of a contingent debt instrument on this basis.

Second, because gain from the disposition of the instrument would be subject to tax at ordinary rates, and the fisc would therefore participate fully in the income derived from such gain, the Service would be in a position to provide an attractive and relatively simple treatment of persons who acquire debt instruments in the secondary market. Specifically, as was suggested in the January Regulations, such holders can be treated as if their instruments were originally issued on the date they were acquired, with an issue price equal to their purchase price.

For example, suppose a holder acquires a 5-year $1,000 instrument at original issuance promising $1,000 at maturity and annual contingent interest based on the value (as opposed to the increase in value) of a specified group of stocks. Assume that the instrument is governed by Prop. Reg. Sec. 1.1275-4 because it is designed to produce a back-loading of interest. Immediately prior to the third interest payment, the third, fourth and final interest payment are expected to be approximately $700 each (although they are not yet fixed). The holder sells the instrument to a second holder for $3,000, recognizing $2,000 of ordinary interest income. The second holder has an initial issue price and basis in the instrument of $3,000, and assuming adoption of the rules recommended in this Report, the $700 interest payment received by the holder immediately after acquisition of the instrument is treated entirely as a return of principal. (See “Current Interest Payments” above.) This payment

reduces the adjusted issue price and basis of the instrument to $2,300, and $184 of interest accrues at the Minimum Rate over the first year of the remaining two-year life of the instrument.

We view this as an attractive and relatively simple treatment of a secondary holder. It should be noted, however, that under this approach, secondary holders could not easily derive their treatment from the original issue discount information received from the issuer, as they do in the case of non-contingent debt instruments under I.R.C. § 1272(a)(7).

As discussed in the previous section, loss should be ordinary loss to the extent of previously accrued but unreceived interest. In the case of holders acquiring instruments in the secondary market, the portion of any loss treated as ordinary should not exceed the accrued but unreceived interest of that particular holder.

In the case of a VRDI governed by Prop. Reg. Sec. 1.1275-5, gain or loss from disposition generally should be capital, rather than ordinary. A VRDI does not have contingent principal. Furthermore, the increase in the size of interest payments is more limited than in the case of a contingent debt instrument governed by Prop. Reg. Sec. 1.1275-4, because the instrument is designed not to produce a front- or back-loading of interest. It would be troubling, for example, if gain or loss from the disposition of a simple floating-rate debt instrument (attributable, for example, to a change in the issuer's credit

rating) was ordinary, rather than capital.[38/]

XI. FOREIGN CURRENCY INDEXED PRINCIPAL

The New York state Bar Association has recommended that final regulations under Section 988 of the Internal Revenue Code exclude a contingent debt instrument from the application of Section 1275(d) of the Code and Prop. Reg. Sec. 1.1275-4 if it provides for payments that are contingent solely on changes in the values of one or more foreign currencies.[39/] While the general treatment of foreign currency indexed debt instruments under Section 988 of the Code is beyond the scope of this Report, we recommend that certain clarifications be expressly included in Prop. Reg. Sec. 1.1275-4, as more fully described below.

Section 988 of the Code sets out a detailed treatment of certain foreign currency transactions, which include debt instruments denominated in, or providing for payments determined

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[38/] We do observe that there is a qualitative difference between, for example, interest based on the percentage change in the value of a stock or commodity index and interest based on the actual value of the index, adjusted for the anticipated inflation (or, if different, the anticipated increase in the index). In the former case, although the index may increase dramatically, and the increase may result in a large accrual of interest in a given year, the increase should not affect how much interest will be paid in subsequent years. In the latter case, if the index increase exceeds inflation in a given year, future interest payments will increase correspondingly. Neither of these instruments is designed to produce a front- or back-loading of interest. While it seems appropriate, however, to treat gain or loss from disposition of the former instrument as capital gain or loss, consistent with the treatment of non-contingent debt instruments (since such gain or loss is unlikely to relate to changes in the value of the relevant index), gain or loss from disposition of the latter instrument arguably might reasonably be treated as ordinary income or loss, consistent with the treatment of gain or loss from an instrument governed by Prop. Reg. Sec. 1.1275-4. We have no suggestion to provide greater consistency, however.

[39/] NYSBA Report on Foreign Currency Debt Instruments, 57 Tax Notes 742 (Nov. 9, 1992).

by reference to the value of, foreign currency.[40/] Under this treatment, anticipated changes in the value of a foreign currency denominated debt instrument, attributable to anticipated changes in the U.S. dollar value of the relevant foreign currencies, are not taken into account until the relevant payments are made.[41/] Thus, a debt instrument providing for a payment at maturity that is denominated in a relatively high-interest inflationary currency, such as the Italian Lira, is not treated as issued at a premium, notwithstanding that an unhedged issuer may therefore deduct, and an unhedged holder must therefore include, interest accruing at an above-market rate in relation to interest on a loan denominated in U.S. dollars. Similarly, a debt instrument denominated in a relatively low-interest deflationary currency, such as the Japanese Yen, is not treated as issued at a discount.

Foreign currency denominated debt instruments may of course be issued at a premium or discount relative to the foreign currencies in which they are payable. Thus, a zero-coupon debt instrument promising a payment at maturity denominated in, or determined by reference to the value of, the Japanese Yen, is treated as issued at a discount for U.S. tax purposes. The amount of discount is determined, however, by reference to the amount payable at maturity assuming no change in the U.S. dollar value of the Yen over the life of the instrument, rather than by attempting to estimate the anticipated amount of the payment at maturity based on forward rates of exchange. This decision, which

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[40/] I.R.C. § 988(C)(1).

[41/] See I.R.C. § 988(c)(2) (defining the “booking date” and the “payment date” with regard to a debt instrument).

appears to have been made intentionally by Congress,[42/] is consistent with this Report, which does not recommend a treatment of contingent debt instruments based on the estimated amounts of anticipated payments.

For the reasons set out above, in the case of a debt instrument providing for a payment at maturity determined by reference to the values of one or more foreign currencies, the original issue discount rules of Sections 1271 through 1275 of the Code should be applied as if the instrument provided for a fixed payment at maturity based on the values of the relevant foreign currencies on the date of issuance. Any difference between such fixed payment and the amount ultimately paid at maturity should be dealt with as foreign currency gain or loss under the rules set out in Section 988 of the Code and the regulations thereunder.

It follows that a debt instrument providing for a contingent payment at maturity determined solely by reference to the value of foreign currencies should not be subject to the rules of Prop. Reg. Secs. 1.1275-4, and interest should therefore accrue on the instrument as its stated rate, rather than at the Minimum Rate. It should not matter, for this purpose, whether the amount of the payment at maturity is determined by reference to the value of a single foreign currency, the value of several different foreign currencies, or a formula expressing a variety of algebraic relationships among the values of various foreign currencies because all changes in the value of a debt instrument that are determined solely by reference to the values of foreign currency should be governed by Section 988 of the Code. We believe that this approach is consistent with Announcement 86-92,

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[42/] See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 1088.

1986-32 I.R.B. 46, which states that “it was not intended that the rules contained in proposed Treas. Reg. Sec. 1.1275-4 be applied to lending transactions merely because some or all of the payments are denominated in or determined by reference to the value of one or more foreign currencies.” It is also consistent with the unchallenged treatment of foreign currency indexed debt instruments over the past 10 years. We recommend, therefore, that this approach be expressly recognized in Prop. Reg. Sec. 1.1275-4.

XII. TAX-EXEMPT DEBT

Under the December Proposed Regulations, a debt instrument governed by Section 103 of the Code is excluded from the definition of a VRDI under Prop. Reg. Sec. 1.1275-5 if it provides for interest based on changes in the value of actively traded property, such as a stock or commodity index, and the issuer enters into one or more financial contracts that substantially offset the variations in the stated interest on the instrument. The exclusion causes such an instrument to be governed by the rules of Prop. Reg. Sec. 1.1275-4. We assume that it was intended to deal more directly with such instruments under Prop. Reg. Sec. 1.1275-4, and we understand that the Service may be concerned that holders of tax-exempt debt not be permitted to receive relatively large amounts of tax-exempt interest income (e.g., because of an unanticipated increase in the value of the relevant actively traded property) in cases where the issuer of the instrument is not making large payments after taking associated hedges into account.

We observe, however, that in the absence of any limitation on tax-exempt interest, a discrepancy between the amount paid (after taking hedges into account) by a municipal

issuer and the amount of tax-exempt interest received by holders would work both ways: a holder of such debt would in some cases wind up receiving little or no tax-exempt interest notwithstanding that the issuer was making market interest payments after taking associated hedges into account. On average, the total amount of tax-exempt interest received by holders of contingent debt instruments governed by Section 103 would differ from the total amount of tax-exempt interest received by holders of an equivalent amount of non-contingent debt only to the extent of the "risk premium" associated with the ownership of contingent, rather than non-contingent, debt. It does not appear, therefore, that the mere fact that some holders of contingent debt may receive more, and others less, tax-exempt interest should result in large losses of revenue, although holders may in the aggregate earn more tax-exempt interest because of the risk premium.

Nevertheless, if the Service ultimately concludes that holders should not, under the circumstances set out above, be permitted to earn relatively large amounts of tax-exempt interest income, then the proposed Minimum Accrual rules present a ready means of limiting the receipt of tax-exempt interest. In general, interest received on an instrument governed by Section 103 of the Code could be treated as tax-exempt interest only to the extent of the notional accrual of interest on the instrument at some Minimum Rate. This could operate under the same rules as would be provided for notional accrual to determine when Minimum Accrual is necessary, as discussed under "Current Accrual Approach" above. Thus, if a contingent debt instrument issued for $1,000, promising annual contingent payments and $1,000 at maturity, paid $300 at the end of year one, $60 (assuming a tax-exempt Minimum Rate of 6%) would be treated as tax-exempt interest and $240 would be treated as taxable interest. If instead the instrument

paid nothing at the end of year one but paid $300 at the end of year two, $125 would be treated as tax-exempt interest and $175 would be treated as taxable interest.

The Service might want to publish a tax-exempt rate for shorter-term instruments, since the rate provided under Section 382 of the Code is based on the yields of long-term debt instruments. Also, as discussed under Current Accrual Approach above, the Service could permit a fully-hedged tax-exempt issuer to provide for a Minimum Rate based on its all-in cost of capital.

The limitation would likewise apply on disposition or redemption of the instrument. Thus, if the instrument described above paid no contingent interest but was disposed of, at the end of five years, for $1,800, then $338 of the resulting $800 of income (based on accrual for five years at a tax-exempt Minimum Rate of 6% per annum on an initial issue price of $1,000) would be tax-exempt interest, and the remainder would be taxable interest.

Loss at maturity or on disposition of such an instrument would be ordinary loss only to the extent of any previously accrued but unreceived taxable interest, and would be capital loss thereafter. The Service should consider permitting a holder to increase the basis of a tax-exempt instrument, based on notional accrual at the tax-exempt Minimum Rate in the absence of any payment, even though such notional accrual does not result in any tax, i.e., the taxpayer should recognize capital loss to the extent of any tax-exempt interest that is notionally accrued but never received. The rationale for this treatment is that under the rule set out above, a holder cannot derive more tax-exempt income than the Minimum Rate. Any additional income is taxable

interest income. It follows that a holder should not lose the benefit of accrual of tax-exempt income at the tax-exempt Minimum Rate because interest is never received.