

REPORT #788

TAX SECTION

New York State Bar Association

OID Anti-Abuse Rule

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TAX SECTION

New York State Bar Association

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April 22, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: OID Anti-Abuse Rule

Dear Secretary Samuels and Commissioner Richardson:

This letter comments on the original issue discount ("OID") anti-abuse rule, which appears as Temporary Treasury Regulation § 1.1275-2T(g) and the identical Proposed Regulation (the "Regulation"). For the reasons stated below, we support the Regulation as written with some minor suggestions for clarification.

Background

The Regulation reads in its entirety as follows:

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"(g) Anti-abuse rule--(1) In general. If a principal purpose in structuring a debt instrument, engaging in a transaction, or applying the regulations under section 163(e) or sections 1271 through 1275 is to achieve a result that is unreasonable in light of the purposes of the applicable statutes, then the Commissioner can apply or depart from the regulations as necessary or appropriate to achieve a reasonable result. Whether a result is unreasonable is determined based on all the facts and circumstances. A result will not be considered unreasonable, however, in the absence of a substantial effect on the present value of a taxpayer's tax liability. For example, if a principal purpose of including an early call option that is not expected to be exercised by the issuer in the terms of a current-pay, increasing-rate note is to protect the holder from taxable income in excess of the interest payments by virtue of the option rules of § 1.1272-1(c)(5), and if the effect would be to substantially reduce the present value of a holder's tax liability arising from the note, the Commissioner can apply the regulations (in whole or in part) without regard to the rules of § 1.1272-1(c)(5). On the other hand, it generally would be reasonable for a corporation to issue convertible bonds, rather than investment units consisting of bonds and warrants, to reduce or eliminate the amount of taxable OID on the bonds. See § 1.1272-1(e)."

In effect, the rule applies if (a) a principal purpose of structuring the relevant debt instrument, engaging in the relevant transaction or applying the relevant regulation is to achieve the unreasonable result, (b) the result has a substantial effect on the present value of the taxpayer's tax liability, and (c) the tax result is unreasonable in light

of the purposes of the applicable statutes, based on all of the facts and circumstances.

Comments

1. In general. We support the approach set out in the Regulation and note that there are similar provisions in regulations under Sections 446 and 988 of the Code. We believe that the Regulation will appropriately limit the extent to which financial transactions are entered into primarily for tax-motivated reasons. We believe this approach is consistent, moreover, with Section 1275(d) of the Code, which authorizes regulations to modify the treatments provided under Sections 1271 through 1275 and Section 163(e) to the extent appropriate to carry out their purposes.

2. "Principal purpose" test. We believe this test of the Regulation is appropriate for application of the anti-abuse rule.

3. The "tax liability reduction" test. We have considered whether the anti-abuse rule should only apply when there is an aggregate tax reduction taking into account both the issuer and holders of the debt instrument. For example, if an instrument issued by a fully taxable issuer is expected to be held by fully taxable holders throughout its life, it could

be argued that the anti-abuse rule should not apply even if application of the OID regulations as written artificially reduces the tax imposed on the issuer and correspondingly increases the tax imposed upon the holder.

However, we do not believe such an approach would generally be administrable. The application of the anti-abuse rule must be determinable at the time of issuance of the debt instrument in order that all parties can report the proper amount of income over the life of the instrument. At the time of issuance it will often be impossible to determine the likely holders of the instrument (and their tax positions) over the entire term of the instrument. This is particularly so if the instrument produces unusual tax results that would make the anti-abuse rule potentially applicable.

Moreover, if the anti-abuse rule could be avoided by a reasonable belief that the holders of the instrument would be taxable holders, numerous disputes would likely arise as to whether such a belief was reasonable if in fact taxable holders sold the debt to nontaxable holders shortly after its issuance. The IRS would also have considerable difficulty in proving that any such sale was pursuant to a plan in existence at the time of the debt issuance, even if such a plan existed.

As a result of the foregoing, we support the approach of the Regulation.^{1/}

4. The "unreasonable result" test. The Regulation potentially applies the anti-abuse rule if the tax result from application of the general OID regulations is "unreasonable" in light of the "purposes" of the applicable statute. While we believe this test is vague, we are unable to propose a better test that is appropriate for an anti-abuse rule.

We considered the possibility of having this prong of the anti-abuse rule be satisfied if the tax consequences from a literal application of the Regulation does not "clearly reflect income" within the meaning of Section 446 of the Code. Such a test would be similar to Treasury Regulation § 1.446-3(i), which allows the Commissioner to depart from the usual rules for notional principal contracts if a taxpayer enters into a transaction with a principal purpose of producing a "material distortion of income". On balance, however, while we would have no objection to such a reformulation of the test, we do not believe it is any clearer than the reasonableness test in the Regulation.

^{1/} While we have not examined all the implications (including taxpayer confidentiality), we believe consideration should be given to treating an application of the Regulation as analogous to a Section 482 adjustment, permitting the opposite party on the debt instrument a correlative adjustment on its tax return. See Treas. Reg. §§ 1.482-1A(d)(2), -1T(e)(3).

In connection with this test in the Regulations, it seems obvious that the anti-abuse rule was not intended to apply to results specifically contemplated by the Regulations, even if it could be argued that such a result is not "reasonable" in particular circumstances. For example, when the regulations for contingent payment debt are finalized, we expect that there will be situations where the regulations will provide for arbitrary results or elections to apply various arbitrary methods. It would be useful to add to the Regulations, or at least to the Preamble to the final Regulations, a statement that the anti-abuse rule would not apply to such specifically contemplated results. We assume the example in the Regulations concerning convertible bonds was intended to make this point, but that particular example illustrates such a well-established result that it may be read too narrowly.

Finally, we believe the example in the Regulation pertaining to an early call option may go slightly too far. A call right has substance even if inserted into an instrument largely for tax reasons, and depending on the circumstances might in fact be exercised even if not initially expected to be exercised. Moreover, the "not expected to be exercised" test is very open-ended and could lead to unjustified challenges by Service auditors. We

suggest, therefore, that the anti-abuse rule should apply only if objective verifiable factors such as debt covenants make the call right unlikely to be exercised. In that case we believe that respecting the call right creates unreasonable tax results properly within the scope of the anti-abuse rule.

We would be happy to provide further help in the development of the Regulation if you think it would be useful.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Glen A. Kohl