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Financial Products

Mark Leeds of Mayer Brown and Donny McGraw of Macquarie Capital look at how the IRS has expanded its use of tax code Section 1001 debt modification regulations beyond their original scope, applying the standards in insurance and government bond cases, for example. The authors explore this recent "mission creep" for the regulations and whether it is consistent with the rules' values when promulgated.

Mission Creep: The Expansion of the Role of the Debt Modification Regulations

BY MARK LEEDS AND DONNY MCGRAW

The 2014 Burning Man Festival was an incredible experience, in part, because it forced one of your authors completely out of his comfort zone and to re-think his approach from things as simple as daily interactions to those involving world issues.

When I returned, I advocated that we send all of our prospective leaders to the 2015 Festival because being able to succeed in a hostile environment (the Festival takes place on corrosive dust) with unforeseeable challenges is a key to successful business leadership. Somehow though, I don't think that the Burning Man community would find an extension of the Festival to a "partner boot camp" as being fully consistent with their underlying values.

The debt modification regulations in Treasury Regulations Section 1.1001-3, however, have been undergoing an analogous expansion of mission. While these regulations were originally promulgated to address only the federal income tax consequences to limited changes to debt instruments, in numerous instances as of late, the Internal Revenue Service has used these regulations beyond their original scope.

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This article explores the recent mission creep of the debt modification regulations and whether such expansion is consistent with the values of such regulations.

A Brief Background

As a general rule, a taxpayer must recognize gain or loss realized from an exchange of property where the property exchanged differs "materially either in kind or in extent" from the property received.[1] This rule isn't limited to actual exchanges. For example, a modification to a bilateral arrangement may be so substantial as to amount to a deemed exchange of the "old" property for "new" property.[2]

Although contractual changes resulting in deemed exchanges isn't a novel concept, significant uncertainty remains with respect to the determination of whether such changes result in a deemed exchange. As a result of this uncertainty, various rules have been developed through judicial decisions, IRS rulings and pronouncements, and regulations. While these rules have been effective at fostering certainty with respect to the tax impact of changes to debt instruments, there continues to be a dearth of authority with respect to many non-debt financial instruments.

[1] I.R.C. Section 1001(c); Treas. Reg. Section 1.1001-1(a).
[2] See, e.g., Treas. Reg. Section 1.1001-3; Treas. Reg. Section 1.1001-4; Rev. Rul. 90-109, 1990-2 C.B. 191.

Prior to the issuance of Treasury Regulations Section 1.1001-3 in 1992, interpretation of the ''material difference'' principle of Treasury Regulations Section 1.1001-1(a) was most notably addressed by the IRS in Revenue Ruling 90-109[3] and the Supreme Court in *Cottage Savings Ass'n v. Commissioner*.[4]

Revenue Ruling 90-109 dealt with a taxpayer that purchased a key person insurance policy on the life of an employee listing the taxpayer as the sole beneficiary under the policy. The policy provided the taxpayer with the right to change the insured. The taxpayer eventually exercised this right. The only change effected by the exercise of the right was the employee insured under the policy; the benefits and premiums under the policy weren't changed.

In its analysis, the IRS articulated the ''fundamental change'' concept, which provides, in relevant part, that ''[a] change in contractual terms . . . is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change [such] that the substance of the original contract is altered.''

The IRS, looking at the exercise of the right by the taxpayer, determined that the essence of a life insurance contract is the life that is insured under the contract and viewed the exercise of the right as substantively the same as an actual exchange of contracts. As a result, the IRS held that the exercise of the option by the taxpayer resulted in a taxable sale or disposition of the policy under Section 1001 of the Internal Revenue Code of 1986, as amended.

In the year following the issuance of Revenue Ruling 90-109, the Supreme Court addressed code Section 1001 exchange principles in *Cottage Savings*. This case involved a strategy by a savings and loan association to trigger losses for federal income tax purposes without impairing net worth for regulatory purposes. Specifically, the taxpayer entered into ''reciprocal sale'' transactions.

The strategy arose from a rule change adopted by the Federal Home Loan Bank Board (FHLBB), which permitted savings and loan associations to exchange pools of residential mortgages without recognition of accounting losses where the mortgage pools are ''substantially identical.''[5] In a transaction structured to qualify for the rule change, the taxpayer sold 90 percent participation interests in mortgage pools to four savings and loan associations while simultaneously purchasing 90 percent participation interests in mortgage pools held by the same savings and loan associations. All of the loans involved in the transaction qualified as substantially identical, as defined in the FHLBB rule.

The taxpayer claimed a loss deduction from the exchange on its tax return for the year of the transaction. The loss was disallowed by the IRS but was ultimately held to be deductible by the Supreme Court. The Supreme Court determined that the realization principle in code Section 1001(a) incorporates a ''material difference'' requirement and provided guidance on what the requirement amounts to and how it applies.[6]

The Supreme Court focused on the fact that the mortgages were recourse obligations and the obligors on the mortgages were different. An exchange of a mortgage issued by individual X was held to be fundamentally different than a mortgage issued by individual Y.

While the Supreme Court's decision in *Cottage Savings* provided some guidance on how to evaluate the material difference requirement, the Supreme Court's ''legally distinct entitlements'' standard didn't provide a high degree of certainty with respect to the types of changes to financial products or contracts that could result in a deemed exchange and the recognition of gain or loss.[7]

Terms of the Debt Modification Regulations

Under the debt modification regulations, once it is determined that a change in a debt instrument's terms constitutes a modification, a deemed exchange will result only where such modification is significant—the general rule turning on whether all modifications, considered collectively, are economically significant.

The regulations also provide that the following changes will result in a deemed exchange:

- a change in yield by the greater of one-quarter of 1 percent or 5 percent of the original yield;
- a change in timing of payments if it results in a material deferral of scheduled payments, although there is a safe harbor for deferred payments that must be made within the lesser of five years or 50 percent of the instrument's original term;
- a change in obligor on a recourse debt instrument;
- a change in security for a recourse debt instrument if it results in a change in payment expectations; or
- a change in the nature of a debt instrument—e.g., a modification that results in a non-debt instrument or property right, or a change from recourse to nonrecourse, or vice versa.

[3] 1990-2 C.B. 191.

[4] 111 S. Ct. 1503 (1991).

[5] Exchanged mortgage loans were substantially identical, and thus qualified for the special treatment, if they were residential mortgages of the same type, bearing the same interest rate, stated maturity and seasoning.

[6] Both the Tax Court and U.S. Court of Appeals for the Sixth Circuit determined that the realization principle in Section 1001(a) didn't incorporate a material difference requirement. *Cottage Savings Ass'n v. Commissioner*, 90 T.C. 372 (1988); *Cottage Savings Ass'n v. Commissioner*, 934 F.2d 739 (6th Cir. 1991). On appeal, the Supreme Court determined that Section 1001(a) incorporates a material difference requirement for two reasons: (i) Treasury Regulations Section 1.1001-1(a) was viewed as a reasonable interpretation of Section 1001(a) as it was essentially unchanged through various reenactments; and (ii) Treasury Regulations Section 1.1001-1(a) was consistent with Supreme Court precedents on realization.

[7] See T.D. 8675, RIN 1545-AR04, 1996-2 C.B. 60 (discussing the intent for the proposed modification regulations to address uncertainly concerning whether the modification of a debt in-

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Of particular concern was the focus of the Supreme Court on differences in legal rights whether or not such rights were economically material. As a result, a number of questions remained as to whether very slight modifications in the terms of a financial product or contract could result in a recognition event.

Treas. Reg. Section 1.1001-3 (The 'Modification Regulations')

The IRS issued Treas. Reg. Section 1.1001-3 (the ''Modification Regulations'') in 1992. The regulations, which were finalized in 1996, address when changes to the terms of a debt instrument cause the debt instrument to be considered to be re-issued.[8] The Modification Regulations clarified the instances in which a change in a debt instrument will be treated as an exchange by limiting the application of code Section 1001 to instances where the change:

- results in a ''modification'' of the debt instrument; and
- such modification is ''significant.''[9]

The Modification Regulations define a modification as ''any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.''[10] In general, an alteration that occurs by operation of the terms of a debt instrument isn't a modification; however, certain fundamental changes (e.g., change in obligor of a recourse debt instrument, nature of debt and tax classification of debt) are treated as modifications even if permitted by the terms of the debt instrument.[11]

Once it is determined that a change in the terms of a debt instrument constitutes a modification, a deemed exchange will result only where such modification is significant. In general, and except as otherwise provided in the detailed rules discussed below, a modification is significant ''only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.''[12] In determining whether changes to legal rights or obligations are economically significant, all modifications to a debt instrument are considered collectively.

Outside of the general significance rule, the Modification Regulations provide that the following changes will result in a deemed exchange:

- **Change in Yield.** A modification to the yield of a debt instrument is a significant modification if the modification varies the yield on the unmodified debt instrument by the greater of one-quarter of 1 percent (0.0025) or 5 percent of its original yield.[13] This rule, however, doesn't apply to contingent payment debt instruments.[14]

- **Change in Timing of Payments.** A modification to the timing of payments is a significant modification if the modification results in the material deferral of scheduled payments.[15] The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred and the time period between the modification and the actual deferral of payments.[16] A safe harbor is provided (i.e., a deemed exchange won't result) where deferred payments are unconditionally payable no later than the lesser of five years or 50 percent of the original term for the instrument.[17]

- **Change in Obligor.** Subject to limited exceptions, the substitution of a new obligor on recourse debt instruments is a significant modification.[18] The substitution of a new obligor on a nonrecourse debt instrument isn't a significant modification and thus doesn't result in a deemed exchange.[19]

- **Change in Security.** A modification to the collateral for, a guarantee on or other form of credit enhancement for a recourse debt instrument that results in a change in payment expectations is a significant modification.[20] A change in payment expectations results where there is a substantial enhancement of the obligor's capacity to meet payment obligations and that capacity was primarily speculative prior to the modification and is adequate after the modification, or where there is a substantial impairment of the obligor's capacity to meet payment obligations and that capacity was adequate prior to the modification. Subject to limited exceptions, a modification to the collateral for a nonrecourse debt instrument is a significant modification.[21]

- **Change in Nature of Debt Instrument.** Subject to limited exceptions, a modification that results in a nondebt instrument or property right, or a change in the nature of a debt instrument from recourse to nonrecourse, or vice versa, is a significant modification.[22]

'Estate of McKelvey v. Commissioner'

In *Estate of McKelvey v. Commissioner*,[23] an individual taxpayer entered into several prepaid forward agreements with two prominent investment banks. Under the forward contracts, each bank agreed to pay the taxpayer a fixed amount in cash at the inception of each agreement in return for the taxpayer's promise to deliver a variable number of shares of a publicly traded

strument results in a deemed exchange of the old debt instrument for a new instrument).

[8] See T.D. 8675.

[9] Treas. Reg. Section 1.1001-3(b).

[10] Treas. Reg. Section 1.1001-3(c)(1)(i).

[11] Treas. Reg. Section 1.1001-3(c)(1)(ii); (c)(2).

[12] Treas. Reg. Section 1.1001-3(e)(1).

[13] Treas. Reg. Section 1.1001-3(e)(2)(ii).

[14] Treas. Reg. Section 1.1001-3(e)(2)(i) (limiting the application of the change in yield rule to fixed payment debt instruments, debt instrument with alternative payment schedules and variable rate debt instruments).

[15] Treas. Reg. Section 1.1001-3(e)(3)(i).

[16] Id.

[17] Treas. Reg. Section 1.1001-3(e)(3)(ii).

[18] Treas. Reg. Section 1.1001-3(e)(4)(i)(A).

[19] Treas. Reg. Section 1.1001-3(e)(4)(ii).

[20] Treas. Reg. Section 1.1001-3(e)(4)(iv)(A).

[21] Treas. Reg. Section 1.1001-3(e)(4)(iv)(B)(1).

[22] Treas. Reg. Section 1.1001-3(e)(5).

[23] U.S. Tax Court Docket No. 26830-14, petition filed 11/10/14.

company (Monster International) or cash on a specified future date.

Specifically, when the stock was trading at approximately $32 per share, the forward contracts provided for a floor price of $30.894 and a cap price of $35.772. In other words, under the forward contract, the taxpayer was ''collared'' on the downside and upside of the stock, and the stock price was in the middle of the collar bands.

Pursuant to the agreement with one bank, the taxpayer received a cash prepayment on Sept. 27, 2007, and agreed to deliver shares to that bank on or about Sept. 24, 2008. In July 2008, the stock price had sunk to approximately $14 per share. On July 15, 2008, the taxpayer and the bank amended the terms of their agreement to extend the delivery date to Jan. 15, 2010. This change wasn't contemplated by the original contract. Other than the change to the delivery date, there were no changes to the agreement with the bank. In consideration for the amendment of the agreement, the taxpayer paid a fixed amount of cash to the bank.

Under the agreement with the second bank, the taxpayer received a prepayment on or about Sept. 14, 2007, in exchange for his promise to deliver a variable number of shares to this bank. The taxpayer's delivery obligation under the agreement was divided into 10 ''components'' and each component was scheduled to be made on a different date in September 2008. The variable forward floor and cap again ''collared'' the value of the stock.

On July 24, 2008, the taxpayer paid more than $3 million to the second bank to amend the terms of their agreement to extend the delivery date of each component to a date in February 2010. Again, this change wasn't contemplated by the original agreement. Other than the change to the delivery date, there were no changes to the agreement with this bank.

The legislative history of Section 1259 makes clear that contracts such as the variable forwards in *Estate of McKelvey* will trigger a constructive sale if the contracts are in-the-money.

The shares to be delivered by the taxpayer to the banks depreciated substantially from the time that the contracts were signed in 2008 and the dates upon which the extensions were signed. As a result, the taxpayer would have received an above-market price for the stock under the forward contracts—more than if he had sold the stock in the open market.

Based upon the Tax Court petition, it appears that the taxpayer would have recognized approximately $200 million in taxable gain if he had settled the forward contract with the shares that he held in 2010. Although not entirely clear, it appears that the IRS asserted that the extensions of the contracts caused the taxpayer to recognize this gain. The taxpayer countered that the contract extension didn't cause gain recognition. The parties apparently haven't been able to resolve their differences of opinion and the taxpayer has brought the legal action in the Tax Court.

The petition states that the IRS asserted that gain should be recognized as though the taxpayer satisfied the contracts with the Monster International stock that he held because the exchange resulted in a constructive sale of the stock.[24] The questions posed by the extensions are three-fold. First, whether the extensions resulted in significant modifications of the contracts. Second, if the contracts were significantly modified, was the value of the obligations to the taxpayer enhanced so that he recognized income as though he had settled the obligations? Third, if there was a significant modification, did it trigger a constructive sale of the stock under code Section 1259?

It is generally recognized that extension of the exercise date of an option is treated as a lapse or settlement of the original option and the writing of a new one. In *Reily v. Commissioner*,[25] the taxpayer had entered into a series of options to lease a tract of land. Each option had a stated expiration date, and when that date arrived or shortly thereafter, the parties negotiated an extension. A new premium was paid for the extension. The last option was sold at a gain less than six months after it was entered into. The option that last preceded it had been entered into more than eight months before the sale date.

The taxpayer argued that the gain was from the sale of property held for more than six months (the then long-term holding period) on the ground that the extension was merely a continuation of the existing option. The two options were related in that the premium paid for both the last option and the next preceding one were to be credited against rentals due under the lease if the option were exercised. Nonetheless, the court held that the last option wasn't a continuation of the prior one because it related to a new period, there was new consideration and also there was a mechanical difference in the way the two options were to be exercised.

In Private Letter Ruling 9819043 (Feb. 11, 1998), the IRS reviewed the issue of whether a proposed modification to make payments on certain notes in property other than money would be construed as a significant modification. The IRS ruled that such modification doesn't alter the legal rights or obligations of the parties and shouldn't amount to a significant modification.

In addition, a five-year extension of the final maturity date on an installment note with an original term of 35 years wasn't a taxable disposition of the installment obligation. The extension didn't result in a substantial modification because the rights of the holders of the note weren't materially altered. It is worth noting that these modifications would have been within the extension safe harbor if the obligation had been a debt instrument.

In each of PLR 8936068 (June 14, 1989) and PLR 8934007 (May 9, 1989), a power purchase agreement (a PPA) was entered into by ''Company'' and ''Utility.'' The PPA included a section that terminated the PPA in the event that the energy deliveries didn't start within five years of the execution date (the ''Sunset Date''). A successor to the Company and Utility agreed to extend the Sunset Date by the time spent on negotiation of

[24] The petition doesn't state whether this assertion is made under the principles of code Section 1259 or common law principles.

[25] 53 T.C. 8 (1969); see also Revenue Ruling 80-134, 1980-1 C.B. 187.

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such project. Such deferral of the execution was mutually beneficial.

The IRS held that the changes are within the ambit of the Conference Report discussion of the substantial modification issue, which provides that similar types of changes won't constitute substantial modification if the taxpayer's obligations to provide the service and construct the facility aren't affected.

While there are authorities on both sides of the issue as to whether the extension of a non-debt financial instrument triggers a substantial modification, these authorities and the Modification Regulations all weigh in favor of the conclusion that the extension of the forward contracts by three times their original terms should be treated as substantial modifications of the forward contracts at issue in *Estate of McKelvey*.

With respect to the second issue, upon the reissuance of the forward contracts, the taxpayer now held a contract that entitled it to receive more than $30 for a stock that was trading for approximately $14 per share. Thus, the contract had substantial value because even if the taxpayer didn't hold the stock, it could purchase the stock in open market purchases (at $14) and sell the stock to the bank counterparties (for approximately $30). Thus, the taxpayer should have experienced gain equal to the excess of the value of the ''new'' forward contracts over the sum of the taxpayer's basis in the ''old'' forward contracts and the amounts paid for the extensions.

Because the contracts were prepaid, however, the issue is whether (effectively) the taxpayer recognized cancellation of indebtedness (really, obligation) income because at the modification, it would have had to repay a much smaller amount than it received at the inception of the transaction.

Conceptually, any gain recognized should have increased the basis in the stock, but support for this conclusion isn't clear. The petition in *Estate of McKelvey* doesn't suggest that this was the basis of the assessment. Instead, it states that the IRS asserted that the forward contract price for the stock over its adjusted basis should be triggered as gain.

While a complete examination of the constructive sales rules is beyond the scope of this article,[26] it is worth noting that code Section 1259 doesn't, on its face, require that a variable forward contract cause a constructive sale only if the value of the stock is within the collar. The legislative history, however, makes clear that contracts, such as the variable forwards in *Estate of McKelvey* will trigger a constructive sale if the contracts are in-the-money. Given the precipitous fall in value of the stock, the ''new'' forward contracts appeared to be substantially in-the-money following the reissuance. Under these circumstances, the reissuance could very well have triggered a constructive sale.

PLR 201443015

In PLR 201443015 (July 15, 2014), a publicly traded corporation had two subsidiaries that wrote life insurance contracts. Certain of these life insurance contracts were grandfathered contracts.[27] The parent taxpayer decided to exit the life insurance business. Pursuant to that plan, the life insurance subsidiaries proposed to enter into an ''assumption reinsurance agreement'' with an unrelated reinsurer.

Under this assumption reinsurance agreement, the life insurance subsidiaries would make payment to the reinsurer to assume its obligations under the life insurance contracts. The assumption would be effective only if the owners of the policies consented to the assumption of obligations by the reinsurer. The only change to the life insurance policies was the assumption of obligations by the reinsurer.

The issue addressed by the IRS was whether the assumption of the obligations under the life insurance contracts would cause the holders of the policies to have exchanged the ''old'' policies for the ''new'' policies with the reinsurer. The IRS framed the issue by asking whether the assumption of obligations by the reinsurer was a ''material change'' to the policies. The issue was a mirror issue of the issue considered in Revenue Ruling 90-109, supra. If the policies had been considered to be reissued, new tax rules would have applied to the policies and the policies would have been subjected to retesting as life insurance contracts.

The IRS held that the assumption of obligations under the life insurance contracts by the reinsurer didn't trigger a reissuance of the contract. It cited to several supporting factors. First, the IRS noted that while policyholder consent was required, the policyholders didn't initiate the change. Second, the assumption by the reinsurer didn't change the existing obligations under the contracts. Last, there was no change to the terms of the contract for the insured.

As a general rule, if there is a substitution of an obligor on a recourse debt instrument (and life insurance contracts are recourse obligations), the obligation is treated as though it underwent a significant modification.

It isn't clear whether there would have been a taxable exchange if the assumption of obligations under the life insurance contracts had been tested for significance under the debt modification regulations. As a general rule, if there is a substitution of an obligor on a recourse debt instrument (and the life insurance contracts are recourse obligations), the obligation is treated as though it underwent a significant modification.[28] If, however, the substitution occurs in connection with an acquisition of substantially all of the assets of the original obligor by the new obligor and the assumption doesn't result in a change in payment expectations, the change in obligor on a recourse obligation doesn't result in a taxable exchange. It is quite possible, on the facts considered in PLR 201443015, that the fact that the group was exiting the life insurance business would have brought the substitution of the reinsurer within this exception.

[26] Please see Leeds,'' A Riff on Cliff: Calloway and Anschutz Expand Tax Ownership Authorities from Debt to Equities,'' American Bar Association Journal (Spring 2011).

[27] See code Section 7702(i).

[28] Treas. Reg. Section 1.1001-3(e)(4)(i).

It is also worth noting that the assumption of obligations by the reinsurer wouldn't have resulted in a taxable exchange if the life insurance contracts had been tested as derivatives. Specifically, the assignment of a derivative contract isn't treated as a taxable exchange of contracts by the non-assigning party if three requirements are met[29]:

- both of the assignor and the assignee are dealers;
- the terms of the derivative contract permit assignment, whether or not such permission is dependent upon the consent of the non-assigning party; and
- the terms of the derivative contract aren't otherwise modified.

In the case of the insurance contracts, each of these requirements were met. Both of the assignor and assignee are licensed insurers. The insurance contract permitted assignment, albeit with the consent of the insured. The terms of the insurance contracts weren't modified. It would have been helpful if PLR 201443015 had analyzed the assumption in these terms.

PLR 201431003

In PLR 201431003 (Aug. 1, 2014), the IRS addressed consent payments made on bonds issued by a publicly traded U.S. corporation. The taxpayer, through a disregarded entity, issued exchangeable bonds. The bonds were treated as contingent payment debt instruments.[30]

The taxpayer planned a split-off transaction. It had previously undertaken such a transaction and had been sued by its bondholders, who contended that the split-off adversely affected the taxpayer's ability to make payments on its outstanding bonds.[31] In order to forestall any such complaints from the holders of the exchangeable bonds, the taxpayer made a one-time payment to the exchangeable bondholders who consented to the corporate transaction.

A change on the yield of a debt instrument causes a deemed exchange if the change varies the yield on the unmodified debt instrument by the greater of one-quarter of 1 percent (0.0025) or 5 percent of its original yield.[32] This rule, however, doesn't apply to contingent payment debt instruments.[33] In all other cases, a change in yield is treated as significant if the change is significant based upon all of the facts and circumstances.[34]

It was clear that the consent payment was a modification to the exchangeable bonds because it was a payment that the bond holders weren't entitled to under the terms of the original bonds. It was also clear that the consent payment increased the yield on the bonds. The IRS treated the consent payment as a taxable ''positive adjustment'' on the exchangeable bonds.[35] It then provided a methodology for determining if the payment would be significant that incorporated the test for other types of bonds.

We have some reservations regarding whether the consent fee was a taxable positive adjustment, but the IRS's methodology for determining whether the payment resulted in a deemed sale or exchange of the exchangeable bonds seems sound.

In *Inaja Land Company, Ltd. v. Commissioner*,[36] the taxpayer purchased 1,236 acres of land that included a river, in California, to operate a fishing club. The city of Los Angeles undertook a construction project near the taxpayer's property. The project resulted in discharge into the river, rendering the river unfishable.

The city paid an amount to the taxpayer that was equal to approximately 82 percent of the price that the taxpayer had paid for the property in exchange for a release of liability and as damages. The payment also granted the city an easement to continue to discharge waste water into the river.

The IRS asserted that the payment was taxable compensation for damages and for the easement. The court concluded that no portion of the payment was for lost profits. The entire payment was ''for the conveyance of a right of way and easements, and for damages to petitioner's land and its property rights as riparian owner.''

The taxpayer argued that it was impractical and impossible to determine what portion of its basis was attributable to the rights represented by the easement granted to the city of Los Angeles. Accordingly, the court permitted the taxpayer to reduce its basis in the property by the amount paid for the easement, instead of treating the easement as taxable income.

We have some reservations regarding whether the consent fee was a taxable positive adjustment, but the IRS's methodology for determining whether the payment resulted in a deemed sale or exchange of the exchangeable bonds seems sound.

The consent fees paid to the holders of the exchangeable bonds considered in PLR 201431003 should be governed by the principle enunciated in *Inaja Land*, supra. Specifically, the payment to the bondholders in exchange for their consent is a payment in exchange for an unspecified portion of their rights against the issuer. It is ''impractical and impossible'' to determine what portion of the original purchase price of the exchangeable bonds was attributable to the right to consent to the corporate transaction. The payment isn't in respect of lost profits.

Accordingly, the proper treatment of the consent fees should have been to reduce the issue price of the bonds and not treat the fee as a positive adjustment on the bonds. Indeed, as we will see immediately below, the IRS took this exact approach in determining whether

[29] Temp. Treas. Reg. Section 1.1001-4T(a).
[30] See Treas. Reg. Section 1.1275-4.
[31] See *Liberty Media Corp. v. The Bank of NY, C.A.*, No. 5701-VCL (Del. Ch. 4/29/11) (Laster, V.C.). PLR 201431003 may relate to this taxpayer but, of course, the PLR is redacted.
[32] Treas. Reg. Section 1.1001-3(e)(2)(ii).
[33] Treas. Reg. Section 1.1001-3(e)(2)(i) (limiting the application of the change in yield rule to fixed payment debt instruments, debt instruments with alternative payment schedules and variable rate debt instruments).
[34] Treas. Reg. Section 1.1001-3(e)(1).
[35] Holding 3, citing Treas. Reg. Section 1.1275-4(b)(6).
[36] 9 T.C. 727 (1947).

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the payment of the consent fee caused the bonds to undergo a taxable deemed exchange.

The IRS's method for determining whether the consent payment caused the bonds to undergo a significant modification was as follows. First, the original yield on the exchangeable bonds was determined based upon a projected payment schedule. This step had been undertaken by the issuer when the exchangeable bonds were originally issued.

The IRS held the yield on the modified exchangeable bonds (referred to as the "go-forward yield") would be determined by reducing the adjusted issue price of the bonds on the date of the consent payment by the amount of the consent payment and then using the same (remaining) cash flow assumptions that had been used in determining the original yield on the bonds. If the go-forward yield was less than 5 percent greater than the original yield on the bond, the modification wouldn't be treated as a significant modification.

Advice Memorandum 2014-009

While each of the items discussed above addressed the application of the principles contained in Treasury Regulations Section 1.1001-3 to a non-debt financial instrument, Advice Memorandum 2014-009 (Dec. 19, 2014) provides a twist. Specifically, in AM 2014-009, the IRS found a deemed exchange of debt instruments when a municipality defeased an issuance of Build America Bonds (BABs). This result is quite surprising because, generally speaking, tax-exempt obligations are exempt from many provisions of the deemed exchange regulations.[37]

BABs allowed state and local governments to issue taxable bonds in 2009 and 2010 for government capital projects and receive a direct federal subsidy payment from the U.S. Treasury for a portion of their borrowing costs. Unlike municipal bonds, which are usually tax exempt, BABs pay interest that is taxed. The BABs issuers could choose whether they offer a tax credit for the buyer (essentially making the yield tax-exempt) or a direct payment from the federal government equal to 35 percent of the interest costs. The payment to the issuer effectively reduced its interest cost to the yield that it would have paid if the BABs paid tax-free interest.

On the BABs described in AM 2014-009, which were issued in 2009, the issuer chose to receive the payment equal to 35 percent of its interest costs from the U.S. Treasury.

In July 2014, Congress cut the subsidy for BABs as part of the budget process called sequestration. The reduction in the BAB subsidy triggered a provision in the BABs that allowed the issuer to redeem the BABs. The interest cost on the BABs was 6.00 percent, which exceeded the rate at which the municipality could borrow in 2014. Accordingly, the municipality exercised its right to call the BABs and issued new bonds, the proceeds of which would be used to repay the BABs.

The proceeds from the new bonds were placed into a defeasance account and were used to purchase government securities. The holders of the BABs were solely entitled to the escrow account for the repayments of the BABs. The IRS had previously ruled that in substance defeasance of a bond didn't trigger an exchange of the bond for the escrow account, but this ruling isn't mentioned in AM 2014-009.[38]

In contrast to the rule for in substance defeasances, the debt modification regulations have treated a legal defeasance as a change in the nature of the debt from recourse to nonrecourse.[39] In other words, if the issuer remains legally obligated to repay the bonds, but has secured its obligation to pay the bonds with a defeasance account, the bonds are still recourse indebtedness. On the other hand, if the issuer is relieved of the legal obligation to repay the bonds by reason of the funding the escrow account, the bondholders should be considered to have exchanged their recourse bonds for nonrecourse bonds.

If the debt instrument is a tax-exempt debt instrument, however, a legal defeasance won't trigger a taxable modification if the defeasance occurs by "operation of the terms of the original bond" and the defeasance occurs through the deposit of government securities.[40]

The IRS explained its exception for tax-exempt bonds as protecting bondholders. The change from a recourse to nonrecourse debt instrument could cause the bondholders to cease to hold debt instruments that paid tax-exempt interest. The IRS noted that the definition of tax-exempt obligation predated the authorization of BABs and that the IRS hadn't amended the definition of a tax-exempt bond to include BABs.[41] It then held that defeasance wasn't protected by the exception for tax-exempt bonds and, as a result, the issuer lost its right to collect the payment from the federal government.

The result in AM 2014-009 seems wrong for several reasons. First, the fact that the IRS could cite to its own inaction in updating a regulation as the basis for not treating the BABs as tax-exempt obligations seems self-serving and inappropriate.

Second, the BABs functioned in the same manner as tax-exempt obligations without the necessity of complex enabling legislation. The net cost to the municipal issuer was identical to the cost of funds it would have experienced if it had issued tax-exempt bonds.

Third, the fact that the municipal issuer chose to receive the rebate instead of passing the tax credit to bond buyers (which scheme appears to meet the definition of a tax-exempt obligation) created a trap for the unwary and seems contrary to the policy behind the exception for tax-exempt obligations.

[37] See Treas. Reg. Section 1.1001-3(f)(6).

[38] Rev. Rul. 85-42, 1985-1 C.B. 36.

[39] Treas. Reg. Section 1.1001-3(e)(5)(ii)(A).

[40] Treas. Reg. Section 1.1001-3(e)(5)(ii)(B)(1).

[41] Treas. Reg. Section 1.1001-3(f)(5)(iii).