CC:DOM:FS:CORP
TL-N-640-98
UILC: 382.11-06
382.11-07
1001.02-07

December 2, 1998

Number: **199910009**
Release Date: 3/12/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR [redacted]
SNR. ATTORNEY CC:NER:MAN

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Determining the Section 382 Limitation and Debt Modification

This Field Service Advice responds to your memorandum dated September 2, 1998 ("your memo"). Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

X =
SH1 =
SH2 =
SH3 =
Lender =
Acquiring =
Sub =

a =
b =
c =
d =

e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
p	=
q	=
r	=

a%	=
b%	=
c%	=
d%	=
e%	=
f%	=
g%	=
h%	=
i%	=
j%	=
k%	=
l%	

$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$o	=

$p	=
$q	=
$r	=
$s	=
$t	=
$u	=
$v	=
$w	=
$x	=
$y	=
$z	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=

Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=

Month 1	=
Month 2	=
Month 3	=
Month 4	=

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=

Date 9 =

ISSUES:

1. What facts are necessary to determine whether the debt in this case should be treated as stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii)?

2. What facts are necessary to determine whether the warrants issued in this case should be treated as stock for purposes of I.R.C. § 382(k)(6)(B)(i), Treas. Reg. § 1.382-2T(h)(4) and Treas. Reg. § 1.382-4(d)(2)?

3. What facts are necessary to determine whether the stock in this case should be treated as not stock for purposes of I.R.C. § 382(k)(6)(B)(ii) and Treas. Reg. § 1.382-2T(f)(18)(ii)?

4. Whether modifications to the debt instrument on Date 3 are material resulting in a taxable exchange under I.R.C. § 1001 and applicable regulations.

CONCLUSION:

1. Based on all the facts and circumstances, it does not appear that the debt of X to Lender can be recharacterized as stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii).

2. Based on all the facts and circumstances, it appears that: (1) the warrants issued in Year 1 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-2T(h)(4), (2) the warrants modified on Date 3 by X do constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-2T(h)(4), (3) the warrants issued on Date 4 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-4(d)(2), and (4) the warrants issued in Year 6 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-4(d)(2).

3. Based on all the facts and circumstances, it appears that the stock of X in this case constitutes stock for purposes of I.R.C. § 382(k)(6)(B)(ii) and is not treated as "not stock" under Treas. Reg. § 1.382-2T(f)(18)(ii).

4. The principal amount of the debt instrument was amended, the maturity of the term loan within the debt instrument was extended, and the interest rate on a portion of the principal was amended; these amendments together cause the new instrument to embody legally distinct entitlements, and the new debt instrument is

materially different from the old instrument. Accordingly, the old debt instrument is deemed to have been exchanged for the new, amended instrument under I.R.C. § 1001.

FACTS:

X purchased its assets in Year 1 through a leveraged buyout. The stock of X was originally owned as follows:

Shareholder	# of Shares	Percentage
SH1	j	j%
SH2	i	h%
SH3	f	e%
Total	n	100%

As a part of the leveraged buyout in Month 2 of Year 1, X borrowed a total of $y from Lender pursuant to a Loan Agreement dated as of Date 1 ("Loan Agreement," or "debt instrument"). This debt instrument was divided into three separate loans: a term loan in the amount of $x, evidenced by the term loan promissory note; a fixed rate loan in the amount of $s, evidenced by the fixed rate promissory note; and a commitment for $u in revolving credit from Lender.

In conjunction with the leveraged buyout and concurrent with the loan agreement between X and Lender, X issued a warrant to purchase k shares to Lender. The warrant was valued at $k. On a fully diluted basis, the warrant, if exercised, would constitute a g% interest in X.

This loan agreement for the three loans is the debt instrument at issue, and the modifications to the terms of the fixed rate and term loans within the debt instrument are the modifications at issue. All of these loans arising under this debt instrument, however, "constitute one general obligation of Borrower secured, until the Termination Date, by all of the Collateral." Loan Agreement, at 30.

The term loan was due and payable in full on Date 7. The stated interest on the term loan was the same as the stated interest on the revolving credit loan. The interest was payable on the first day of each month, and payable in an amount equal to:

> the quotient of (i) an amount equal to (A) the sum of the daily unpaid principal amounts of the Revolving Credit Loan and the Term Loan outstanding on each day during the previous month multiplied by (B) a rate equal to the Index Rate plus a% (the "Stated Rate"), divided by (ii) b; provided, however, that upon a days written notice to Lender from Borrower, Borrower may direct that the Stated Rate for the period specified in such notice shall be equal to the LIBOR Rate plus b%.

Loan Agreement, at 30.

The fixed rate loan was due and payable in full on Date 7. The stated annual interest on the fixed rate loan was f%. Loan Agreement, at 30.

The term of the revolving credit loan was to expire on Date 7, but was subject to one-year renewals thereafter.

The Loan Agreement states that it:

> may not be modified, altered or amended except by an agreement in writing signed by Borrower and Lender. Borrower may not sell, assign or transfer any of the Loan Documents or any portion thereof, including, without limitation, Borrower's rights, title, interests, remedies, powers and duties hereunder or thereunder. Borrower hereby consents to Lender's and each Assignee Lender's sale of participations in, or assignment, transfer or other disposition of, at any time or times, any of the Loan Documents or of any portion thereof or interest therein, including, without limitation, Lender's and each Assignee Lender's rights, title, interests, remedies, powers or duties thereunder, whether evidenced by a writing or not.

Loan Agreement, at 88.

The debt instrument was first amended on Date 2, by the First Amendment to Loan Agreement ("First Amendment"). The First Amendment modified the debt ratios to be maintained by X. The First Amendment added a new definition on Base Compensation, and amended the section concerning compensation of employees. In the First Amendment, the Lender waived its enforcement rights against X with respect to certain matters listed in Exhibit B to the First Amendment, which included submission of monthly and quarterly financial statements, written confirmation of verbal notices of default, projected financial statements, sale of assets under $a, and submissions of other corporate information. Lender and X agreed in the First Amendment that X could issue additional stock to certain individuals.

The First Amendment “is limited as specified and shall not constitute a modification, acceptance, waiver or amendment of any provision of the Loan Agreement or any other Loan Document, except as specifically provided and limited hereby.” First Amendment, at 9.

X paid approximately $q of the term loan to Lender before Month 3 of Year 4, and the outstanding principal amount on the term loan was then $t. In addition, X paid approximately $p of the outstanding principal amount of the fixed rate loan to Lender before Month 3 of Year 4, and the outstanding principal amount of the fixed rate loan was then approximately $r.

X and Lender again modified the debt instrument on Date 3, by the Second Amendment to Loan Agreement (“Second Amendment”), as a result of the poor financial condition of X. The Second Amendment made the following changes to the term loan: (1) $o of the principal amount of the fixed rate loan was converted to $o in additional principal of the term loan; (2) $i of the amount of the revolving credit loan was converted to $i in additional principal of the term loan; (3) the new outstanding principal amount of the term loan was $w; (4) the principal payments of the term loan were rescheduled; and (5) the maturity date of the term loan was extended from Month 1 of Year 7 to Month 4 of Year 8. Second Amendment, at 2.

The Second Amendment made the following changes to the fixed rate loan: (1) the outstanding principal amount was reduced by $o, which was incorporated into the term loan, and the new outstanding principal amount of the fixed rate loan was now $n; (2) the maturity date was accelerated, from Month 1 of Year 7 to Month 4 of Year 5; and (3) the principal payments of the fixed rate loan were rescheduled. In addition, the initial commitment term of the revolving credit agreement was extended from Year 7 to Year 8, and the debt ratios were revised. Second Amendment, at 4. The capital expenditures that X was allowed to make for the years Year 4 through Year 7 were reduced. Second Amendment, at 8.

The Second Amendment is “limited as specified and shall not constitute a modification, acceptance, waiver or amendment of any provision of the Loan Agreement or any other Loan Document, except as specifically provided and limited hereby.” Second Amendment, at 13-14. The Lease Agreement of Year 1 contemplated an amendment to its terms that must be in writing and must be signed by X’s lenders to be effective. Both the First Amendment and the Second Amendment are in writing and appear to have been signed by the lenders, and therefore appear to be effective.

Thus, when considering the term and the fixed rate loan principals as one obligation, a total amount of $m in outstanding principal on the term loan was forgiven by Lender.

The number of shares which could be purchased by Lender by exercise of the warrant previously received was increased from k shares to p shares. If the warrant was exercised by Lender, Lender would then own i% of the shares of X. The expiration date of the warrant was extended from Date 8 to Date 9. The warrant exercise amount was reduced from $i to $h.

On Date 3 X was in poor financial condition. If X were to have liquidated on Date 3, there would not have been sufficient value from the sale of its assets to have paid all its liabilities.

On statement 10 of its Year 4 tax return, X stated that it is a loss corporation, as defined in I.R.C. § 382(k), which is entitled to use a net operating loss carryover and no testing occurred during the taxable year with respect to the loss carryover generated in prior years. You note that there is no indication that X on its Year 4 return stated that the debt would be treated as stock under I.R.C. § 382.

Effective Date 4, SH1 and SH2 each transferred its X stock to Lender. Lender, in turn, tendered the shares to X for retirement. Concurrent with the receipt and retirement of these shares, X issued two stock purchase warrants to Lender. Lender then assigned all of its rights in one of the warrants to SH1 and SH2. This warrant was subsequently tendered to X and was reissued to SH1 and SH2 in the form of two separate warrants. Thus, after these series of transactions, SH3 was the only shareholder of X.

On Date 5, an agreement and plan of merger was entered into by and among X, Lender, Acquiring and Sub (wholly owned by Acquiring). The closing took place on Date 6. Through the merger, Sub merged into X with X being the surviving corporation. Acquiring and its affiliates then acquired k% of the issued and outstanding common stock of X. Equityholders of X at the end of the merger received both cash consideration and stock purchase warrants. The warrants are exercisable for an aggregate of d% of the outstanding shares of common stock of X on a fully diluted basis. All stock and warrants outstanding prior to the merger were canceled. Lender continued to own its debt of X.

The amounts that the equityholders of X received through the merger are:

entity	stock	warrant for stock	cash received
Lender			$g*
Lender warrant 1		p	
Lender warrant 2		l**	
SH1		d	$d
SH2		e	$e
Management direct	g		$c
Management options	c		
Total	h	q***	$j

* $f paid directly to Lender and $b to their attorneys ($f + $b = $g).
** full amount was m, but is reduced by options for c shares.
*** total stock if warrants exercised = r (q + h)

For Year 6 and subsequent years, X computed its I.R.C. § 382 limitation as $z ($v multiplied by c%). The $v was the total outstanding Lender debt on Date 5.

<u>NOLs and Credits Generated by X</u>

For Year 1, X generated an NOL of $l, which it used in Year 2 and Year 4.

For Year 3, X generated an NOL of $aa, $bb of which it used in Year 4.

For Year 9, X generated an NOL of $dd and for Year 5, X generated an NOL of $ee, both of which were carried forward. Thus, the total amount of NOLs being carried forward is $ff

For Years 1 through 5 and Year 9, X generated certain credits in the aggregate amount of $gg, all of which was carried forward.

Issue 1 - What facts are necessary to determine whether the debt in this case is stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii)?

Taxpayer's Position

The taxpayer contends that the total outstanding non-revolving debt of X to Lender on Date 3 is treated as stock for purposes of determining whether an ownership change occurred and, if so, the value of the loss corporation. The taxpayer contends that the above-stated debt meets all the requirements of Treas. Reg. § 1.382-2T(f)(18)(iii). The taxpayer points out that Treas. Reg. § 1.382-2T(f)(18)(iii)(A) requires the debt to offer potential significant participation in the growth of the corporation in order for the debt to be treated as stock under Treas. Reg. § 1.382-2T(f)(18)(iii). X contends that it restructured the loan agreement on Date 3 with Lender because of financial difficulties. X contends that if it were to have liquidated on the date the debt was modified there would not have been sufficient value for the sale of the assets for X to have paid off the liabilities. The taxpayer claims that Lender clearly had a vested interest in the growth and well-being of X. The taxpayer argues that only by future growth in X would Lender be assured that the outstanding debt would be paid in full. The taxpayer further contends that Lender benefitted from the growth of the corporation by reason of the warrants that were received from X in connection with the new loan agreement on Date 3. Therefore, the taxpayer contends that the debt offers potential significant participation in the growth of the corporation as required by Treas. Reg. § 1.382-2T(f)(18)(iii)(A).

The taxpayer claims that by treating the debt as constituting stock an ownership change has clearly occurred and thus the requirement of Treas. Reg. § 1.382-2T(f)(18)(iii)(B) is satisfied.

The taxpayer claims that the pre-change loss at the testing date in Year 4 is greater than twice the amount determined by multiplying the value of the loss corporation by the long-term tax exempt rate. Thus, the taxpayer claims that the requirement found in Treas. Reg. § 1.382-2T(f)(18)(iii)(C) is also met.

The taxpayer contends that the total outstanding debt of X to Lender on Date 6 of $v should be used to determine the value of X in Year 6 since the debt was determined to be stock for I.R.C. § 382 purposes in Year 4. The $v debt multiplied by the applicable long-term tax-exempt rate of c% resulted in an annual I.R.C. § 382 net operating loss limitation of $z according to the taxpayer. The taxpayer used this limitation on the Year 6 return and on all subsequent filings.

<u>LAW AND ANALYSIS</u>

We do not believe that the debt of X to Lender can be recharacterized as stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii). That section provides three tests. Our focus is on the first test: whether the debt offers the Lender the potential for significant participation in the growth of X, is the most important.

As noted above, X argues that this first test is met because, as of Date 3, it was unable to repay its debt to Lender. That is, if X had liquidated as of that date, it would not have had sufficient assets to pay off all its liabilities, including its obligation to Lender. Thus, X argues that, as of that date, Lender had a vested interest in the growth of X. Moreover, X argues that only by its future growth would Lender be assured that the outstanding debt would be repaid.

If X were correct, then possibly every lender to a debtor that subsequently became insolvent or bankrupt would be considered as automatically having a potential for significant participation in the growth of the debtor. This cannot be correct.

If a debtor exchanged its debt interest in a company for stock or warrants in that company, then it may be appropriate to take the position that the former debtor is now participating in the growth of the company. In that case, it is possible that the former debtor could recover not only the amount it loaned (as well as expected interest payments), but also additional value depending on the growth of the company.

On the other hand, if the debtor simply modifies the terms of the debt interest, <u>e.g.</u>, in order to make it more likely that the debtor can repay its debt, then it may be appropriate to take the position that the debtor is not participating in the growth of the company.

In the instant case, it appears Lender modified the terms of the debt instrument to make it more likely that X will repay the debt, and Lender will not receive more than the amount it loaned plus interest payments. Also, the interest rate on the debt under the circumstances appears to be in a range consistent with treating the debt as debt for section 382 purposes. Assumedly, X was expected to have sufficient assets, in conjunction with the cash flow from its projected future earnings and proceeds of anticipated additional debt financing, to meet all required payments of principal and interest. Additionally, X's financial projections used in negotiations with creditors assumedly indicated that the debt holder's participation over the term of the debt in X's cumulative net income, prior to any deductions for debt service, did not represent a significantly high percentage of that net income so as to make the risk of the debt holder analogous to that of an equity holder.

Overall, we believe it would be difficult for X to argue that Lender has the potential to offer significant participation in the growth of X, and that the debt is stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii). However, we believe a definitive conclusion that the debt is not stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii) could be dependent upon such facts and circumstances as the reasonableness of the credit risk, the reasonableness of the projections of earnings and cash flow that X used at the time of the debt modification, the percentage of projected income and cash flow that X was required to commit to debt service, the security provided for the debt, the market interest rates on similar types of debt, the terms of the warrant, and the likelihood of the exercise of the warrant.

However, even if X were correct that the debt constituted stock for purposes of Treas. Reg. § 1.382-2T(f)(18)(iii), it does not follow that X's value, for purposes of determining the I.R.C. § 382 limitation as of Date 3, would include the value of the debt.[1]

Section 382(l)(1)(A) provides that, for purposes of I.R.C. § 382, any capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under I.R.C. § 382 shall not be taken into account for purposes of I.R.C. § 382.

Pursuant to I.R.C. § 382(k)(2), X is an old loss corporation. Moreover, as explained in the last section of this letter, the change in the terms of the debt on Date 3 constitutes a modification of that debt for purposes of I.R.C. § 1001. Thus, Lender is treated as transferring the old debt instrument to X and receiving a new debt instrument on Date 3.

It can be argued that that deemed transfer of the old debt instrument by Lender to X (in exchange for an instrument which X believes should be characterized as stock for purposes of I.R.C. § 382) should be considered a capital contribution within the meaning of I.R.C. § 382(l)(1)(A). Certainly, if a transferor transfers money to a corporation in exchange for stock, that transfer would be characterized as capital contribution. Similarly, the deemed contribution of the old debt by Lender (upon the modification of the terms of the debt instrument) should also be a capital contribution within the meaning of I.R.C. § 382(l)(1).

Section 382(l)(1)(B) provides that, for purposes of I.R.C. § 382(l)(1)(A), any capital contribution made during the 2-year period ending on the change date shall, except

---

[1] Moreover, even if the value of the debt were included in determining X's value, that value would be based on the fair market value of the debt and not, as X contends, the face amount. Treas. Reg. § 1.382-2T(f)(18)(i).

as provided in regulations, be treated as part of a plan described in I.R.C. § 382(l)(1)(A). Additionally, the legislative history notes that, except as provided in regulations, a capital contribution made during the 2-year period ending on the change date is irrebuttably presumed to be part of a plan to avoid the limitations. H.R. Rep. No. 841, 99th Cong. 2d Sess., Sept. 18, 1986, II-189. In this case, since the deemed capital contribution occurred on the change date (the date on which the ownership change occurred, see I.R.C. § 382(j)), the amount of such capital contribution would not be included in determining X's value as of Date 3 even if the debt were treated as "stock" (as X argues).[2]

Moreover, such amount would also not be included in determining X's value as of Date 4, the date of the second ownership change, because such date is within two years of Date 3.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Since, as explained above, X underwent an ownership change in Year 4, we do not know whether [redacted]

Note that it is position of the Service for the tax years at issue that any NOLs and credits limited by one ownership change are treated as pre-change losses for any subsequent ownership changes. Thus, an NOL or credit could be subject to one or more I.R.C. § 382 limitations, but the subsequent ownership changes reduce (but never increase) the I.R.C. § 382 limitation with respect to such losses and credits. See, e.g., Treas. Reg. § 1.382-5T(d)(1), effective for tax years of a loss corporation beginning on or after January 1, 1997.

Issue 2 - What facts are necessary to determine whether the warrants issued in this case are stock for purposes of I.R.C. § 382(k)(6)(B)(i), Treas. Reg. § 1.382-2T(h)(4) and Treas. Reg. § 1.382-4(d)(2)?

---

[2] Regulations have not been promulgated under I.R.C. § 382(l)(1). The legislative history of this provision, cited above, provides limited exceptions to this 2-year capital contribution rule. However, none of these exceptions appear applicable in this case. Id.

Taxpayer's Position

The taxpayer does not address the question of whether the warrants in this case constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-2T(h)(4). The taxpayer solely treats X's debt to Lender as stock for purposes of determining the value of X and states that the value of X is equal to the amount of the outstanding debt of X to Lender.

LAW AND ANALYSIS

Based on all the facts and circumstances, it appears that: (1) the warrants issued in Year 1 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-2T(h)(4), (2) the warrants modified on Date 3 by X do constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-2T(h)(4), (3) the warrants issued on Date 4 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-4(d)(2), and (4) the warrants issued in Year 6 do not constitute stock for purposes of I.R.C. § 382(k)(6)(B) and Treas. Reg. § 1.382-4(d)(2).

The warrants issued in Year 1 on a fully diluted basis, if exercised, would constitute a g% interest in X. Therefore, exercising the warrants in Year 1 would not have resulted in an ownership change since the change in ownership over the testing period if Lender exercised the warrants would be g% which is thus less than a 50% ownership change. Therefore, under Treas. Reg. § 1.382-2T(h)(4)(i) the warrants issued in Year 1 would not be treated as stock.

The warrants for stock in X previously received by Lender were modified on Date 3 so that Lender could own i% of the shares of X if the warrants were exercised. Therefore, exercising the warrants on Date 3 would result in an ownership change since the change in ownership over the testing period if Lender exercised the warrants would be i% which is a greater than 50% ownership change. Therefore, under Treas. Reg. § 1.382-2T(h)(4)(i) the warrants modified on Date 3 would constitute stock.

Effective Date 4, SH1 and SH2 surrendered all of the X stock and ultimately received warrants from X. Lender also received warrants, even though it does not appear that Lender transferred anything of value to X in exchange therefor. Thus, as of the end of Date 4, SH3 owed all of the outstanding stock of X. Since this is a greater then 50% change in the ownership of X, there is an ownership change of X. Moreover, treating the warrants received by SH1, SH2 and Lender on Date 4 as outstanding would prevent this ownership change from occurring. Consequently, there is no basis for treating these warrants as outstanding.

On Date 5, Sub merged into X with X being the surviving corporation. Acquiring and its affiliates then acquired k% of the issued and outstanding common stock of X. Equityholders of X received stock purchase warrants exercisable for an aggregate of d% of the outstanding shares of common stock of X on a fully diluted basis. All stock and warrants outstanding prior to the merger were canceled.

Since the warrants issued in Year 6 were only exercisable for an aggregate of d% of the stock of X and Acquiring acquired k% of X's stock, the exercise of the warrants would not create or prevent an ownership change. Acquiring became the new owner of X in Year 6 and increased its ownership in the stock of X by k% of the stock of X. Under Treas. Reg. § 1.382-4(d)(2) the warrants issued in Year 6 would not be treated as stock for purposes of determining whether an ownership change occurs.

Issue 3 - What facts are necessary to determine whether the stock in this case is not stock for purposes of I.R.C. § 382(k)(6)(B)(ii) and Treas. Reg. § 1.382-2T(f)(18)(ii)?

Taxpayer's Position

The taxpayer contends that the stock meets all of the tests of Treas. Reg. § 1.382-2T(f)(18)(ii) and that all of the outstanding stock of X is treated as not stock for I.R.C. § 382 valuation purposes. The taxpayer argues that such a treatment is appropriate since, according to the taxpayer, the total outstanding debt of X was greater than its assets and thus the stock had minimal, if any, value.

LAW AND ANALYSIS

Based on all the facts and circumstances, the stock of X in this case constitutes stock for purposes of I.R.C. § 382(k)(6)(B)(ii) and is not treated as “not stock” under Treas. Reg. § 1.382-2T(f)(18)(ii).

There appears to be no evidence that as of the time of issuance of or transfer of X stock that the likely participation of the stock in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation.

Issue 4 - Whether modifications to the debt instrument are material resulting in a taxable exchange under I.R.C. § 1001 and applicable regulations.

Taxpayer's Position

The taxpayer claims that on Date 3 when X restructured the loan agreement with Lender, there was a "significant modification" of the debt terms because the principal payments of the term loan and the fixed rate loan were rescheduled, the term loan maturity date was extended, and the fixed rate loan maturity was accelerated.

Under Treas. Reg. § 1.1001-3(a), a "significant modification" results in a deemed issuance of new debt. Taxpayer says that treating the debt as stock at that point does result in an ownership change, so that if the other two factors of Treas. Reg. § 1.382-2T(f)(18)(iii) are met, it is proper to treat the debt as stock for purposes of determining the value of the loss corporation on that date. Thus, it would not matter that Lender had the same rights with respect to the new stock as the old, as long as those rights met the first factor (the interest "offers potential significant participation in the growth of the corporation"), and the third factor is also met.

LAW AND ANALYSIS

Gain from the sale or other disposition of property is determined under I.R.C. § 1001(a) to be the excess of the amount realized therefrom over the adjusted basis, and the loss is the excess of the adjusted basis over the amount realized. The amount of gain or loss realized from the sale or exchange of property is determined under I.R.C. § 1001(b), and the entire amount of the gain or loss on the sale or exchange of property shall be recognized under I.R.C. § 1001(c).

Treas. Reg. § 1.1001-1(a), reads, in relevant part: "[T]he gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially* either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received." (Emphasis added). If the modified property is deemed sold or exchanged, the resulting property is treated as newly issued.

In Cottage Savings v. Commissioner, 499 U.S. 554 (1991), Cottage Savings had exchanged "participation interests" in mortgages, but not the underlying mortgages themselves, for another lender's participation interests that were made to different obligors and secured by different homes. The Court held that for an exchange of properties to be taxable, the properties need only represent different property rights and that property rights are different in a "material" way if their respective possessors enjoy legal entitlements that are different in kind or extent. This decision gave rise to the "hair trigger" theory that any and all modifications of debt instruments may give rise to a deemed exchange under I.R.C. § 1001, thereby obviating the “de minimis” alterations accepted under prior law as not giving rise to an exchange.

Determining that Treas. Reg. § 1.1001-1 was a reasonable interpretation of I.R.C. § 1001 and that it was consistent with precedent on realization, the Court in Cottage Savings applied the materially different requirement set forth in Treas. Reg. § 1.1001-1(a). The Court looked to case law to give meaning to the material difference test, and determined that property exchanged for other property was materially different as long as the exchanged properties “embody legally distinct entitlements.” Cottage Savings, 499 U.S. at 566. The Court determined that Cottage Savings received entitlements that were materially different from those that it gave up because the participation interests that they received were made to different obligors and were secured by different homes. Therefore, the transaction was taxable and Cottage Savings realized a loss on the exchange. The interests that were exchanged were considered “substantially identical” for federal banking regulatory purposes, but that fact did not affect the tax treatment of the exchanged instruments. Id.

Cottage Savings was decided in April 1991, and applies to the second modification of the debt instrument which occurred on Date 3.

Proposed regulations relating to the treatment of modification of debt instruments as realization events under I.R.C. § 1001 were published in a Notice of Proposed Rulemaking on December 22, 1992. FI-31-92, 1992-2 C.B. 683. The Service and the Treasury Department acknowledged that, “Uncertainty exists, however, with respect to when particular types of modifications result in deemed exchanges of debt instruments.” 1992-2 C.B. 683. These proposed regulations were intended to clarify the confusion created by the Cottage Savings case. The Explanation of Provisions stated,

> Questions have arisen, however, concerning the Court’s interpretation of the material difference standard and its possible application to modifications of debt instruments by issuers and holders. It has been suggested that the parties to a debt instrument should be able to adjust certain terms of their instruments without the modification rising to the level of a deemed exchange.

1992-2 C.B. 683.

Final regulations on the modification of debt instruments were published in 1996 as Treas. Reg. § 1.1001-3. T.D. 8675, 1996-2 C.B. 60. Although Treas. Reg.

§ 1.1001-3 addresses whether a sale or exchange has occurred when there has been a "significant modification" to a debt instrument, this regulation applies to alterations to the terms of a debt instrument that have occurred on or after September 24, 1996, and can only be relied on by taxpayers for alterations that occurred after December 2, 1992, and before September 24, 1996. The debt instrument at issue was amended in the Year 3 pursuant to the First Amendment and in Year 4 pursuant to the Second Amendment. Accordingly, X may not rely on the regulations.

In Shafer v. United States, 204 F.Supp. 473 (S.D. Ohio 1962), aff'd 312 F.2d 747 (6th Cir. 1963), the plaintiffs, holders of Japanese bonds, could not collect on their bonds between the years of 1942 and 1950. In 1952, the Japanese government proposed a settlement extending the maturity date of the bonds for ten years, and the plaintiffs accepted the settlement. There was no actual exchange of bonds, but only an extension of the maturity date on the bonds. The court held that the acceptance of the offer of settlement and presentment did not constitute an exchange of property resulting in gain or loss under I.R.C. § 112, the predecessor to I.R.C. § 1002. H.R. Rep. 1337, 83d Cong., 2d Sess., at A265 (1954). Section 1002 was repealed by Pub. L. No. 94-455, § 1901, 90 Stat. 1520, 1799, and the language that was repealed was reincorporated for the most part as I.R.C. § 1001(c). Pub. L. No. 94-455, § 1901, 90 Stat. 1520, 1784.

The court in Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948), determined that the voluntary exchange by the taxpayer of outstanding City of Philadelphia bonds for refunding Philadelphia bonds was a taxable exchange. The new bonds bore interest at the same rate until the first date at which the old bonds could be called by the city, at which point they bore a lower rate of interest; the new bonds bore a later redemption date, but an earlier maturity date; the new bonds could be converted to registered form upon the holder's option, and the new bonds had a higher fair market value. The court looked to the fact that the new bonds were "not only legally different, but . . . actually had a different financial value." Emery, 166 F.2d at 30. The court found that the new bond was not merely evidence of an old obligation, but rather, it was a taxable exchange under I.R.C. § 112(a).

Girard Trust v. Commissioner, 166 F.2d 773 (3d Cir. 1948), involved a transaction nearly identical to that in Emery. The taxpayer had surrendered City of Philadelphia bonds pursuant to a City of Philadelphia refunding plan. In exchange, the taxpayer received new bonds with an earlier maturity date and a later optional maturity date; with the same interest rate until maturity and after that with a lower interest rate; and with a higher fair market value. The court determined that these were important basic differences between the old and the new bonds, and affirmed the lower court's finding that the exchange was taxable and did not fit under the like-kind exception of I.R.C. § 112.

In contrast to Emery and Girard, in Mutual Loan and Savings Co. v. Commissioner, 184 F.2d 161 (5th Cir. 1950), the Fifth Circuit determined that the surrender of defaulted municipal bonds for refunding municipal bonds was not a taxable sale or exchange of property under I.R.C. § 112. The court stated that, "the incidents of changed maturity dates, lessened interest rates, and provision for a sinking fund, do not under the circumstances here evidence that the refunding bonds were 'a thing really different' from the old bonds." Mutual Loan, 184 F.2d at 167. Furthermore, the fair market values of the defaulted bonds and the replacement bonds were identical, and the transaction was legally equivalent to the transfer of property for property of a like kind.

In Rev. Rul. 73-160, the Service determined that when the maturity date of a note was extended, and the holder of the note agreed not to resort to the underlying security until the other note holders had been paid, the "mere extension of the maturity of the notes . . . does not constitute in substance the exchange of the outstanding note for a new and materially different note." Rev. Rul. 73-160, 1973-1 C.B. 365. Thus, this one factor was determined to be insufficient for the modification of the note to qualify as a taxable exchange under I.R.C. § 1001.

In Rev. Rul. 81-169, 1981-1 C.B. 429, a municipal bond with 9% interest with a sinking fund provision was replaced by a new municipal bond with 8.5% interest, no sinking fund, and a maturity date of 10 additional years. The holders of the bonds had the choice of either exchanging their instruments or having the provisions of the new bonds stamped onto their old bonds. The Service determined that the two instruments were materially different, and therefore, this was a taxable exchange and gain or loss was recognizable on the transaction. The Service noted that, "The difference in the fair market value of the bonds is not a material factor in determining whether there is a taxable exchange."

The Service determined that an adjustment to only the interest rate on a bond, pursuant to an interest adjustment clause on the bond, did not result in an exchange under I.R.C. § 1001 in Rev. Rul. 87-19. 1987-1 C.B. 249. The bond holder in Rev. Rul. 87-19, a bank, however, had waived its right to receive the higher rate of interest on the bond that was available to it, and this waiver of their right represented a material change in the terms of the bond, resulting in an exchange taxable under I.R.C. § 1001. There was no actual exchange of bonds in this case, only the holder's waiver of a right.

In Rev. Rul. 89-122, 1989-2 C.B. 200, a debt instrument issued by a bank was modified in two different situations. In Situation 1, the interest rate was reduced from 10% to 6.25% annually (which was not adequate stated interest under I.R.C. § 1274), but the principal amount of $1,000,000 remained unchanged. In Situation 2, the stated principal amount was reduced from $1,000,000 to $650,000. The Service stated in Rev. Rul. 89-122 that, “In general, the modification of a debt instrument constitutes a deemed exchange of debt instruments under I.R.C. § 1001 if the modified debt instrument is materially different from the original debt instrument.” Both modifications represented a material change in the terms of the obligations and resulted in a deemed exchange of the instruments. The holders of the instruments were to realize and recognize gain or loss on the exchanges.

X and Lender modified the terms of the debt instrument that was issued to Lender. Section 1001 addresses a sale or other disposition of property, and Treas. Reg. § 1.1001-1(a) concerns an exchange of property for other property differing materially either in kind or in extent, but neither directly addresses when a debt instrument has been modified. <u>See, e.g., Shafer</u>. The Service’s position has been that a modification of a debt instrument can result in a deemed exchange of the old instrument for the new, modified instrument if the old and new instruments are materially different. In Rev. Rul. 73-160, the Service determined that, where the changes to a debt instrument “are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if the new security were actually issued.” <u>See also</u> G.C.M. 37884 (stating “the resolution of this type of issue does not turn on whether or not there was a physical exchange.”) Thus, if the modifications caused the amended instrument to be materially different from the original instrument, the modifications would cause a taxable exchange of the old debt instrument for the new debt instrument.

In the First Amendment, there were few substantive amendments to the debt instrument. Certain financial covenants were amended, mostly debt-to-cash flow ratios were amended, requirements on board meetings were amended, and employee compensation limitations were amended. None of these amendments embody legally distinct entitlements, and none of the amendments cause the amended debt instrument to be materially different from the original debt instrument.

The Second Amendment to the debt instrument amended more terms of the debt instrument. The maturity date of the fixed loan was accelerated, and the maturity date of the term loan was extended. Under the applicable case and administrative law prior to the adoption of the final regulations in 1996, the mere change in the maturity of a debt instrument, without more, did not constitute a material change in the instrument warranting exchange treatment under I.R.C. § 1001(a). <u>See</u> Rev.

Rul. 73-160. Although the debt instrument states that all of the loans within the instrument constitute one obligation of X, the transfer of $o from the fixed rate loan is significant because the term and the fixed rate loans bear different interest rates. Thus, the effect of this transaction is that the interest on the $o has been amended. An amendment to an interest rate, together with an extension of maturity date, causes a new instrument to differ materially from the original instrument, and it is generally treated as an exchange. See Emery, Girard; see also Rev. Rul. 81-169.

More significant than the changes to the maturity are the reductions in the principal amount of the debt instrument in the Second Amendment. The net outstanding principal amount of the term loan was reduced by approximately $m. This reduction in principal decreased the principal of the debt instrument itself. The reduction in principal is significant because one of the elements of debt is that it has a sum certain. See Church of Scientology v. Commissioner, 823 F.2d 1310, 1319 (9th Cir. 1982); see Gilbert v. Commissioner, 248 F.2d 399, 402 (2d Cir. 1957). Because debt principal is a fundamental element to debt, any change in the principal will be material. Thus, the new debt instrument differs materially from the original debt instrument because of the change in principal. Also, under Cottage Savings, the new instrument embodies a legally distinct entitlement, that is, the right to a lesser sum of principal.

The principal amount of the debt instrument was amended, the maturity of the term loan within the debt instrument was extended, and the interest rate on $o of the principal was amended; these amendments together cause the new instrument to embody legally distinct entitlements, and the new debt instrument is materially different from the old instrument. Accordingly, the old debt instrument is deemed to have been exchanged for the new, amended instrument under I.R.C. § 1001.

If the regulations were applicable to this transaction, the extension of maturity date would not fall within the safe-harbor period in Treas. Reg. § 1.1001-3(e)(3)(ii), because the three year extension is greater than 50 percent of the original term of the loan.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Determining whether there has been an exchange of property is highly fact-specific. If additional facts are discovered, please contact us. However, based on the facts as currently developed, we believe that the debt instrument was exchanged and that there are few litigating hazards on this issue.

In that case, the amount of loss to Lender determined under I.R.C. § 1001(a) is the excess of the adjusted basis of the old instrument over the amount realized of the new instrument. X, the issuer, is deemed to have paid off the old instrument for an amount equal to the issue price of the new instrument. Because the principal amount of the debt instrument which X exchanged was reduced by approximately $m, I.R.C. § 108 will apply. Under that section, X will either have discharge of indebtedness income (if it is solvent) or reduction of tax attributes, including net operating losses (if it is insolvent). [redacted]

We recommend that you [redacted]

If you have any further questions, please call (202) 622-7930.

Deborah A. Butler
Assistant Chief Counsel

By: ______________________________
MARY E. GOODE
Special Counsel (Corporate)

cc: CC:NER (TL)