Taxing Market Discount on Distressed Debt

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ABSTRACT

The statutory rules regarding the timing and character of income and losses on debt instruments overtax distressed debt investors. Investors that make profitable investments in distressed debt are likely to have some or all of their income tainted as market discount and hence ordinary income, whereas investments that turn out badly are highly likely to generate capital losses. Taxable income is also sometimes accelerated relative to economic income. Despite widespread agreement on the nature and extent of the problems, there is lack of consensus on whether the inappropriate outcomes that are generated by the statutory rules are tempered by common law doctrines. There is also disagreement regarding how policymakers should address the problem. I first summarize how the statutory rules generate inappropriate outcomes, then offer a new perspective on how the statutory and common law rules governing distressed debt interrelate, and finally explain and evaluate the options for reform.

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I. Introduction

The normal tax rules governing debt holders produce nonsensical results when applied to debt of borrowers that are in financial distress—so called “distressed debt.” The most glaring problem is application of the market discount rules to return on distressed debt, which results in gains being taxed as interest, whereas losing bets on distressed debt are highly likely to be classified as capital losses. This is a classic “head’s I lose, tails you win” proposition for taxpayers. This and other problems surrounding the tax treatment of distressed debt have been discussed in bar association reports and other commentary since the 1990s. Existing commentary on the problem evidences disagreement regarding what positions are supportable under present law, and which of the potential options for reform is optimal.

The importance of tax rules governing distressed debt vary with the amount of distressed debt trading in the marketplace. The problem is thus less acute now than it was at the height of the financial crisis. Yet the problem remains of significant importance, as reflected in the sustained attention it has received from prominent practitioners, bar association, and in the tax press. Practitioners report that it has become common for taxpayers to disregard statutory rules, based on crude rules of thumb, in circumstances where the application of these rules results in egregious overtaxation.1 Apparently Treasury agrees that it is time for a more thoughtful solution; revising the taxation of distressed debt has been on the Treasury-IRS priority guidance

1 John Kaufmann, The Treatments of Payments on Distressed Debt Instruments, 26 Journal of Taxation of Investments 15 (2008) (“it is not uncommon for taxpayers to cease accruing interest and OID, and to stop accounting for market discount, on debt instruments which trade at a 50% or greater discount to par, regardless of time to maturity or other relevant factors”); id. at 33 (“the Service's practice may indicate that it admits that the statutory market discount rules as drafted are not well suited for accounting for payments on distressed debt instruments. We understand anecdotally that it is common market practice for taxpayers to report market discount upon payments on or the proceeds of the disposition of market discount bonds which have been purchased for more than 50 cents on the dollar, and for taxpayers to allocate payments on or the proceeds of a disposition of market discount bonds which have been purchased for less than 50 cents on the dollar to a return of basis before recognition of market discount or other gain on the bonds, regardless of whether the bonds in question are in default. To our knowledge, the government has not challenged this practice to date.”); David H. Schnabel, Great Expectations: The Basic Tax Problem with Distressed Debt, 89 Taxes 177 (March 2011); David C. Garlock, Federal Income Taxation of Debt Instruments ¶1107.02[D] (6th ed.) (“Garlock Treatise”) (“Assuming one wants to take the position that the market discount rules do not apply to deeply discounted debt instruments, what does "deeply discounted" mean? Absent any guidance on this point, a taxpayer should simply adopt a reasonable rule and apply it consistently. One simple and generally reasonable rule is that a debt instrument is deeply discounted if its price is less than, say, 50 percent of its face amount.”).
plan since 2008. There are recent indications from Treasury that a guidance project on distressed debt presently underway.

I should be explicit at the outset regarding the assumptions I make as to the scope of potential reforms to address the shortcomings in the present tax treatment of distressed debt. I will assume that the fundamental tax treatment of investment securities—including both stock and debt—remains as is, warts and all. The biggest warts are the realization rule, preferential tax rates for capital gains of individuals and trust, and the distinction between debt and equity. Correcting the inappropriate tax treatment of distressed debt might well be a collateral benefit of a more fundamental revision of our tax system that changes one or more of these three features. As I am endeavoring to make a contribution to an ongoing debate regarding a more discrete question, however, I will assume that these features of our system are locked in place, as has been true for most of the past century.

In Section II.A, I describe the statutory rules governing the taxation of market discount, and then, in Section II.B, I explain and illustrate the problems that arise if these rules are applied to distressed debt. Section II.B is largely a summary of criticisms collected from prior commentary. Although the criticism of present law are persuasive on balance, I suggest that there are some policy considerations that militate against revising the present statutory rules.

In Section III, I examine the extent to which taxpayers may rely on common law rules to avoid the problems created by the unqualified application of the statutory rules. Some have argued that the “doubtful collectability exception”—a common law rule that allows debt holders to arrest interest accruals when the issuer is unlikely to make scheduled payments on a debt—acts as a broad-gauge exception to the statutory market discount rules. Were this correct, it might imply that the failure to include special exceptions for distressed debt in the statutory rules is a minor problem. I agree that the doubtful collectability exception has a bearing on the taxation of distressed debt in some circumstances, but I conclude that it does not qualify the statutory rules to the extent that has been suggested by other commentators.

In Section IV, I explain and evaluate the options for reform. There are two primary options: a definitional approach, under which “distressed debt” is defined and debt instruments meeting

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2 Matthew Dalton, Potential Distressed Debt Treatment Discussed, 134 Tax Notes 637 (Feb. 6, 2012)

3 Id.; Remarks by Emily S. McMahon, Acting Assistant Secretary for Tax Policy, New York State Bar Association Tax Section Annual Meeting, 2012 TNT 17-36 (“another area in which the financial and economic crises have presented us with an opportunity to update our guidance is in the treatment of distressed debt. We received a very thoughtful report from the [NYSBA] Tax Section in November, and we are actively working to develop guidance that will clarify the accrual of interest and OID on distressed debt instruments.”); T.D. 9599, 77 FR 56533, 56536 (preamble to final regulations on determination of issue price and issue date indicates that “[p]otential distortions created by distressed debt situations are the subject of a separate guidance project.”).
the definition are subject to special rules tailor-made for distressed debt, rules that correct the problems that arise when rules of general application are applied to distressed debt; and a yield cap, under which interest in excess of a specified threshold is classified as principal (or, under some proposals, deferred). In my view the yield cap approach is superior to the definitional approach because it would be easier to implement and administer.

II. The Statutory Market Discount Rules

A. Present Law

The market discount rules are codified at §§1276-1278. These rules require holders of debt instruments to report gain on disposition or at maturity as ordinary income to the extent their return is attributable to market discount.4 Market discount is defined as the excess of (a) stated redemption price at maturity (a term of art usually corresponding to the bond’s principal amount) over (b) the holder’s cost.5 Consider a bond, originally issued at par with a ten-year term and a $1000 face amount, paying 3% semi-annual interest with exactly five years remaining until maturity. If a taxpayer buys this bond for $900 and holds the bond until maturity, the taxpayer will collect $1000 of principal, and will have a $100 gain. The gain is classified as interest, and must be reported in the year the bond matures.

Gain on the disposition of a market discount bond is deemed to be attributable to market discount to the extent that discount has accrued during the holder’s ownership.6 By default, market discount accrues ratably (equal daily portions from purchase to sale or maturity). Thus, in the example if the taxpayer sold the bond exactly one year from purchase, the first $20 of gain would be market discount and hence ordinary income. Any income (gain) in excess of market

4 §1276(a).
5 §1278(a)(2). If the bond has OID, then the computation in the text is performed after substituting “revised issue price” for stated redemption price at maturity. Revised issue price is the issue price plus OID accrual up the date of the purchase less payments made on the debt (other than payments of qualified stated interest). §1278(a)(4).
6 As John Kaufman has explained, the term “accrual” is used in two different senses by tax lawyers. Kaufmann, supra note 1, at 13, 16-17. When accrual method taxpayers are said to have “accrued” an item of income or expense, “accrual” is generally understood to mean that the amount in question is properly included or deducted for tax purposes. On the other hand, the term is also used to refer to the process by which implicit interest on a security purchased at a discount to face value is allocated among periods, without regard to its inclusion in income (in this latter sense, the terms accrual and accretion are synonymous). In this paper, I use “accrual” in this second sense, and will be explicit when I am discussing whether some amount should or must be included in taxable income.
discount would be classified as capital gain. Taxpayers may elect to accrue market discount at a constant yield.\textsuperscript{7}

If the holder so elects, market discount is included in income as it accrues.\textsuperscript{8} For electing taxpayers, inclusion of accrued market discount triggers a basis increase to prevent double taxation on realization of earlier included accrued discount.\textsuperscript{9} Once a taxpayer makes this election, current inclusion of market discount as it accrues is required for all bonds acquired during or after the year of the election\textsuperscript{10}; inclusion of market discount on bonds acquired in prior years is still deferred until realization. Consent of the Secretary is required to revoke the election.\textsuperscript{11}

The market discount rules include an anti-abuse rule that suspends interest deductions on a loan “incurred or continued to purchase or carry” debt with market discount.\textsuperscript{12} In the absence of this rule, taxpayers could enter into a debt financed purchase of market discount bonds and shelter income by coupling (currently deductible) interest payments with (tax deferred) market discount. The legislative history indicates that tax shelters fitting this pattern motivated enactment of the market discount rules.\textsuperscript{13}

An amount included as ordinary income under the market discount rules is generally classified as interest for tax purposes.\textsuperscript{14} There are however several exceptions to this rule. Taken together these exceptions blunt most of the important effects of classifying market discount as interest.\textsuperscript{15}

\textsuperscript{7} §1276(b)(2). A holder making this election accrues market discount as though it were OID (with the caveat that accrued market discount is not included until realization, absent an election under §1278(b), described in the text accompanying footnote 8). In the example in the text, the accrued market discount is $19.17 with the election, versus $20 without it.

\textsuperscript{8} §1278(b). The elections currently to include accrued market discount in income and to accrue market discount at a constant yield are independent.

\textsuperscript{9} §1278(b)(4).

\textsuperscript{10} §1278(b)(2). In contrast, the election to accrue market discount at a constant yield may be made bond by bond.

\textsuperscript{11} §1278(b)(3).

\textsuperscript{12} §1277. See generally Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts ¶56.4.3 (3d Ed.) (describing and illustrating the mechanics of §1277).


\textsuperscript{14} §1276(a)(4); 1278(b)(1) (flush language).

\textsuperscript{15} Exceptions are made for the rule excluding from taxable income interest earned on municipal bonds (§103), for rules imposing tax on outbound interest payments from U.S. issuers to nonresident holders (§§871, 1441, 1442), for the rule requiring third-party information reporting by issuers (§6049), and such other exceptions as are listed in regulations (presently none).
(These exceptions negate the rule characterizing market discount as interest, but not the rule characterizing market discount as ordinary income.)

B. Problems with Present Law as Applied to Distressed Debt

By their terms, the statutory market discount rules brook no exception for distressed debt. There is nevertheless some doubt regarding whether and how these rules apply to distressed debt. Prior commentary has identified five reasons why literal application of the statutory rules to distressed debt is problematic:

1. risk-based return (akin to equity gains eligible for capital gains treatment) are classified as ordinary income for tax purposes;
2. gains and losses for most holders are taxed asymmetrically (gains are ordinary, losses capital), which increases the effective tax rate on holders of distressed debt above the rate normally burdening investment securities;
3. holders of economically comparable debt are taxed differently based on purely formal distinctions;
4. applying the rules to distressed installment debt generates uneconomic timing results—taxable income in the absence of economic income on receipt of installment payments, followed by a corresponding loss which is deferred until disposition or settlement; and
5. in some cases, applying the rules as written is infeasible because certain necessary information does not exist.

I illustrate and evaluate these critiques of current law below. I then offer two countervailing considerations that may indicate that the treatment under the statutory market discount rules serve a useful function. First, the statutory market discount rules may prevent original lenders and other holders in whose hands debts are ordinary (not capital) assets from harvesting their tax (ordinary) losses in sales to buyers who would—but for the market discount rules—be accorded preferential capital gains rates on ensuing gains. Second, the statutory market discount rules might diminish the tax preference for debt finance by increasing the effective tax rate on debt instruments. All things considered, I agree with prior commentary that application of the statutory market discount rules to distressed debts is an inappropriate policy, though relevant policy considerations do not all favor reform.

(1) Mischaracterizing risk-based returns

Example 1. Suppose a debtor issues a $100 face value bond for $100. The bond pays 3% interest, compounded and paid semi-annually, and matures six years from issuance. On the first anniversary of issuance, Holder, a U.S. resident investor,
purchases the bond on the market for $40. Holder buys the bond as a portfolio investment.\textsuperscript{16} In Example 1, Holder’s yield to maturity is 24.4%. Under the normal rules, in Holder’s hands, the bond has $60 of market discount that will that will accrue ratably over the five years remaining in the bond’s term, $12 per year. If Holder sells the bond after two years for $80, $24 of the $40 gain will be characterized as market discount and hence ordinary income (and, for most tax purposes, interest). If instead Holder holds the bond until maturity and collects the full stated redemption price of $100, all $60 of Holder’s gain will be classified as market discount.

Some share of Holder’s return is attributable to risk bearing, not to the time value of money. Distressed debt investing is more akin to investing in common stock than in fixed income securities; investors are primarily rewarded for correctly predicting that the creditworthiness of the issuer will surpass the expectation reflected in market prices, far less so for the passage of time or for correctly predicting fluctuations in interest rates.\textsuperscript{17} Because risk-based return on common stock and distressed debt are economically similar, they ought to be treated the same absent some compelling justification for different treatment.\textsuperscript{18} The market discount rules have the effect of imposing ordinary income tax on Holder’s risk-based return, and no justification is evident.

Although the argument that the gain-loss asymmetry should be eliminated is persuasive, it is subject to a basic criticism. Our tax system is replete with circumstances in which time value returns are classified as capital gains; and, very often, risk-based returns are classified as ordinary income. This is the inevitable result of classifying financial instruments as debt or equity at issuance based on a multidimensional array of factors. Raising this frailty as a reason to modify the statutory market discount rules as applied to distressed debt raises questions without ready answers. If policymakers are inclined to tinkering around the edges of the debt-

\textsuperscript{16} The holder in this example is not a bank or a dealer, and is not purchasing the bond as part of a hedge, so none of the specialized rules applicable to such taxpayers is implicated. The same is assumed with respect to all taxpayers throughout.

\textsuperscript{17} Andrew W. Needham, Do the Market Discount Rules Apply to Distressed Debt? Probably Not, 8 Journal of Taxation of Financial Products 21-22 (2009) (surveying empirical studies finding that “[w]hen a borrower becomes distressed, the market price of its debt will depend on where the debt sits in the capital structure, not when it matures. Even before the event of default, therefore, bonds of the same rank in the capital structure will drop roughly the same price, even if the bonds mature on different dates.”).

\textsuperscript{18} Needham, supra note 17, at 30 (return to distressed debt investors “hardly compensates the buyer for the use of money”); Deborah L. Paul, The Taxation of Distressed Debt Investments: Taking Stock, 64 Tax Lawyer 37, 42 (2010) (“under circumstances of distress, where the note trades at a significant discount to its issue price, the spread no longer bears any resemblance to interest”).
equity distinction, why focus on problems related to distressed debt rather than other problems that are arguably more pressing? And why just tinker around the edges? Fundamental reform might eliminate the distinction and have the incidental effect of resolving this issue, along with all of the others.19 The most I can say about criticism of this sort without drifting too far from the topic of this article is that, for present purposes, I am assuming that these background features of our tax system remain unchanged and that incremental reform might be the best that we can reasonably expect in the current political climate.

(2) Asymmetrical treatment of gains and losses

The second problem illustrated by Example 1 is that the market discount rules create an asymmetry between the tax rates on gains and losses. If Holder’s bet turns out badly and Holder either sells the bond at a loss or owns the bond when the issuer defaults and the bond becomes worthless, Holder’s loss will be classified as a capital loss.20 On the other hand, as emphasized above, if Holder’s investment pays off, most or all of Holder’s return will be classified as ordinary income.

To see why this is a problem from a policy perspective, suppose Holder makes several investments of this sort and breaks even because profits and losses within the portfolio exactly offset before tax. As a consequence of the tax asymmetry, Holder will wind up losing up to 20% of his gains, after tax. The 20% figure is the spread between the tax imposed on gains within the portfolio (which assumes all gains are ordinary income under the market discount rules, as would be true if the winning investments are held until maturity) and the tax benefit of the offsetting capital losses.21 If Holder has insufficient capital gains to absorb these losses, the tax cost of Holder’s break-even portfolio of distressed bonds will be even greater.22

The same point can be made by imagining what Holder would be willing to pay for a given distressed bond. If the payoff on the bond in Example 1 were destined to be $100 or $0, and if the stated interest compensated Holder for the time value of money, then given its $40 market price, in the absence of taxes we could infer that a marginal risk-neutral investor would assign a 40% likelihood to the good outcome. Given the asymmetrical tax treatment, however, the bond


21 Holder is assumed to be in the 35% bracket for ordinary income, 15% for capital gains, and the 3.8% surtax under §1411—set to take effect in 2013—is assumed not to apply.

22 See Garlock Treatise, supra note 1, at ¶1107.01.
would be worth only $28, given these odds. A taxable holder would only pay $40 for the bond if she thought there were at least a 62% chance of the good outcome.

The effect of this systematic bias against U.S. portfolio investors in the market for distressed debt will be to drive them from the market. They cannot be expected to compete with tax exempt (including foreign) investors in distressed debt, investors who are not punished by this tax bias. Thinning of the pool of potential buyers in the market for U.S. corporate bonds ultimately can be expected to increase the cost of debt finance for U.S. companies generally and in particular those of lower credit quality. Asymmetrical treatment of gains and losses is likely to depress prices of debt from all issuers, not just issuers presently in distress: which of today’s non-distressed debt securities will be in peril of default tomorrow is uncertain, and a holder owing a bond when it becomes distressed—a risk for all holders—will find fewer potential buyers.

(3) Arbitrary treatment of holders

Example 2. Suppose two issuers with identical assets and operations each have a single bond outstanding, which, for each issuer, represents their only liability. In each case the bond has four years remaining in its term. The bond issued by Corporation #1 has a principal amount of $100, whereas the Corporation #2’s bond has a principal amount of $200.

Assuming both bonds are in default and the market price is determined by the expected payment in the issuers’ bankruptcy or other extra-bankruptcy settlement, one would expect the

\[
\text{Value} = 0.4 \times [\text{principal} \times (1 - \text{probability}) + 0.6 \times (\text{principal} - 0)]
\]

\[
= 0.4 \times [100 \times (1 - 0.7) + 0.6 \times (100 - 0)] + 0.6 \times [200 \times (1 - 0.5) + 0.4 \times (200 - 0)]
\]

\[
= 0.4 \times [28 + 0] + 0.6 \times [100 + 0]
\]

\[
= 0.4 \times 28 + 0.6 \times 100
\]

\[
= 11.2 + 60
\]

\[
= 71.2
\]

Nonresident portfolio investors in distressed debt are not likely to be subject to the market discount rules; indeed, to the extent they enjoy gains that would be classified as market discount if they were residents, their gain will likely escape taxation entirely. This assumes the gains are not effectively connected to a U.S. trade or business. See note 15, supra (explaining that market discount is not classified as interest for purposes of the rules imposing withholding tax on outbound interest payments); Garlock Treatise, supra note 1, at ¶2005.

Enron was rated investment grade by the major credit rating agencies four days prior to its bankruptcy; the California utilities were rated A- two weeks before defaulting; WorldCom was rated investment grade three month before it filed for bankruptcy; and so on. See Letter from Sean J. Egan and W. Bruce Jones to Jonathan G. Katz, Secretary, United States Securities and Exchange Commission, Nov. 10, 2002, available at http://www.sec.gov/news/extra/credrate/eganjones2.htm.

This example is modeled on one found in the excellent article by David Schnabel. See Schnabel, supra note 1, at 188.
market price of the bonds to be roughly the same. Suppose the market price of both is $40, which means that the first has market discount of $60 whereas the second has market discount of $160. Buyers #1 and #2 purchase the bonds issued by Corporations #1 and #2, respectively, and one year later both corporations extinguish the bonds in exchange for an $80 payment. Payment on Corporation #1’s bond generates $40 of gain, split 15/25 between ordinary income (market discount) and capital gain, whereas the payment by Corporation #2 generates $40 of ordinary income (market discount). Buyers #1 and #2 made economically identical investments (or at least nearly so), apart from tax consequences, yet their tax treatment is distinctly different — with no apparent justification.27

(4) Inappropriate timing results (and complexity) for installment debt

Example 3. Debtor borrows $100 from (issues a debt instrument to) a lender. The debt instrument is a self-amortizing installment obligation with a five year term. The stated interest rate is 3%, compounded annually. Payments of $21.84 on the debt are due annually. On the first anniversary of the loan, following the first payment of $21.84, Holder purchases the loan from the original lender for $51.16.

At the time of Holder’s purchase the outstanding principal balance on the loan is $81.16, so Holder’s market discount is $30. Assume that Debtor makes the next payment of $21.84. Under the amortization schedule for a self-amortizing loan with these terms, $2.43 of the payment is interest, and must be reported by Holder in the period to which it is allocable under the normal rules governing accounting for interest income.28

Some fraction of the $19.40 balance (rounded) is market discount (taxable as ordinary income), and the rest is principal (nontaxable basis recovery). There is no clear rule for determining what fraction is market discount. Section 1276(b)(3) indicates that for installment notes “the amount of accrued market discount shall be determined under regulations prescribed by the Secretary.” Although this statute was enacted over a quarter century ago, no regulations have been issued.

The legislative history to the 1986 amendment adding §1276(b)(3) explains that until regulations are issued, the Conference Committee intended that holders “may elect” the constant yield

27 True, a difference exists between the two bonds from the perspective of the issuers. Considerations of issuer-holder symmetry might in some circumstances support different treatment of two holders who at first appear similar, but gauging the amount of market discount is not one of them. American Bar Association, Section of Taxation, Options For Tax Reform in The Financial Transactions Tax Provisions of The Internal Revenue Code 6-7 & n.9 (December 2, 2011) (“2011 ABA Report”), 2011 TNT 234-25.

28 The normal rules depend on the holder’s method of accounting. Cash method taxpayers include qualified stated interest when paid; accrual method taxpayers accrue qualified stated interest ratably over the accrual period to which it is attributable. Reg. §1.446-2(a), (b).
method, familiar from the OID rules, or a second method which differs depending on whether the debt has OID. For debts with OID, the second method is to accrue market discount in proportion to OID accrual. For debts with no OID, market discount is accrued in proportion to the accrual of stated interest. Table 1 sets forth the amortization schedule of the debt instrument in Example 3 (Panel A) and then illustrates the choices open to the holder in the example, assuming she chooses one of the methods of accounting sanctioned by the legislative history (Panel B).

The two sanctioned methods can be seen in Table 1, Panel B, columns (I) and (J). The constant yield approach (column (I)) is better for Holder; both the constant yield approach to market discount accrual and accrual in proportion to QSI (column (J)) result in the same aggregate accrual (the 30 of market discount is accrued in both cases), but income under the constant yield approach is deferred. (Although this elaborate table is not necessary to an adequate conceptual understanding of this example, the table will be useful later when this example is recycled to make additional points.)

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30 More specifically, the legislative history calls on holders to figure their market discount (“MD”) accrual as follows:

\[
\text{current MD accrual} = \text{total remaining MD} \times \frac{\text{current OID accrual}}{\text{total remaining OID}}
\]

where total remaining MD and total remaining OID are determined as of the beginning of the accrual period in question. Id.

31 The computation is the same as the one indicated in footnote 30, substituting current qualified stated interest (“QSI”) and total remaining QSI for the terms in the fraction on the right hand side of the equation. QSI is defined at Reg. §1.1273-1(c).
Table 1: Amortization Schedule and Interest Accrual Schedules for Installment Debt in Example 3

Panel A: Amortization Schedule (Based on 3% Stated Rate)

<table>
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<th>(B)</th>
<th>(C)</th>
<th>(D)</th>
<th>(E)</th>
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<td>Accrual period</td>
<td>Payment</td>
<td>Interest</td>
<td>Principal</td>
<td>Principal Balance (ending)</td>
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Panel B: Market Discount Accrual

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<th>(G)</th>
<th>(H)</th>
<th>(I)</th>
<th>(J)</th>
<th>(K)</th>
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</thead>
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<tr>
<td>Accrual period</td>
<td>Payment to (by) Holder</td>
<td>Interest, Constant Yield (2)</td>
<td>Principal, Constant Yield</td>
<td>Market Discount, Constant Yield</td>
<td>Market Discount, Proportionate to QSI</td>
<td>Difference Between Sanctioned Methods ((I) less (J))</td>
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<td>(51.16)</td>
<td></td>
<td></td>
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<tr>
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<td>$21.84</td>
<td>$13.02</td>
<td>$8.82</td>
<td>$10.58</td>
<td>$11.83</td>
<td>($1.24)</td>
</tr>
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<td>$11.06</td>
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<td>$30.00</td>
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<td></td>
</tr>
</tbody>
</table>

Notes:
(1) Yield to maturity based on Holder’s purchase price (51.16).
(2) This is the portion of each payment that is classified as interest using the YTM derived from Holder’s purchase price.

In the absence of regulatory guidance, may taxpayers color outside the lines Congress set forth in the legislative history? The answer is unclear. In setting out the permissible methods, the legislative history uses the phrase “may elect,” which can be read to imply that the prescribed methods are not exclusive. Had Congress intended to preclude use of other methods, it should have written “shall elect,” but instead it chose “may elect.” On the other hand, one could argue that use of the permissive “may” is simply acknowledgment that there are two permissible methods, and taxpayers may elect to use either of those two methods, but no others.

David Garlock favors the argument that use of “may elect” in the legislative history is a sufficient basis on which to conclude that taxpayers such as the holder in this example may depart from the sanctioned methods.32 Although I am not convinced that this is the best

32 Garlock Treatise, supra note 1, at ¶1107.02[D].
reading of the legislative history, I agree with the conclusion that the holder is not bound to use the sanctioned methods, for reasons discussed at length below.33

(5) Application infeasible for lack of necessary information

Example 4. Issuer issues a 10 year note with a stated principal amount and issue price of $100. The note bears 3% interest, compounded and paid semi-annually. On the second anniversary of issuance, when issuer has defaulted on the note, Holder purchases the note for $20.

The note has market discount of $80. The market discount ordinarily would be deemed to accrue ratably from the date Holder purchased the bond until maturity.34 The difficulty is that the bond is now due and payable, since the indenture surely provides that default on interest payments accelerates all amounts due on the note. If the note is payable now, then arguably zero replaces eight years as the denominator of the proration fraction, which means that the accrual schedule is undefined (a fraction over zero).

The Joint Committee Blue Book explaining the 1984 Act addresses this issue, though in a different context. The Blue Book states that it is expected that regulations will specify that the market discount rules do not apply to “an obligation that was demand debt when issued” because of the infeasibility of applying time-based proration in the absence of a maturity date.35 One could draw the negative inference that the market discount rules continue to apply to term debt that becomes demand debt after it is issued, given the absence of any similar exclusion. For this to make sense, “maturity” as that term is used in §1276(b)(1)(B) would have to denote the original maturity date of the debt when it is issued (without regard to acceleration). It seems more likely however that Congress (and the Joint Committee staff) simply overlooked the issue.

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To sum up the objections to present law that have been lodged by prior commentary, applying the statutory market discount rules by their terms to distressed debt result in income measurement problems of the two basic types—mischaracterization of gains and losses, and timing problems. In addition, the rules result in distinctions that are arbitrary and unjustified (as illustrated by Example 2), and they are needlessly complex (in particular, as applied to installment debt, as illustrated by Example 3 and Table 1).

33 See Section III.B(1), infra page 19.

34 As Garlock explains, defaulted debt like that in the example is usually sold flat, meaning that no amount of the purchase price is allocated to accrued, unpaid interest. Garlock Treatise, supra note 1, at ¶1602.02[E].

C. Countervailing Considerations

In my judgment, the strongest case in favor of an exception to the present-law rules for distressed debt is asymmetrical treatment of gains and losses. There are, however, competing versions of how symmetry might be identified and measured. If a reform is made to correct the gain-loss asymmetry and, as a necessary consequence, symmetry along some other dimension is undermined, then the argument for some type of modification of the present statutory rules might be less convincing.

Consider, first, issuer-holder symmetry, which is based on the observation that the borrower’s deduction for interest paid and the lender’s interest income are two sides of the same coin. This form of symmetry requires that the borrower’s deduction and the lender’s inclusion be matched in terms of timing, amount, and character. This is the conceptual underpinning of many rules relating to the taxation of debt instruments. Issuer-holder symmetry is through to be desirable because it is evidence that the governing rules operate consistently on both sides of what is a zero-sum transaction. The fisc will inevitably lose if borrower deductions are not matched inexorably with lender income given that planning will inevitably pair tax-deductible interest payments with interest income that is excluded from the tax base.

Issuer-holder symmetry, it turns out, should have no bearing on the correct tax treatment of market discount on distressed debt. Most (though not all) of the issues relating to the tax treatment of distressed debt relate to the taxation of market discount, which is only like interest from the lender’s (holder’s) perspective. Market discount is not a sum that the borrower (issuer) promised to pay the lender (holder); the interest deduction that corresponds to the holder’s market discount simply does not exist.

The observation that market discount does not flow from the borrower to the lender begs the question “what is the source of the discount buyer’s market discount?” The answer is that the discount buyer’s market discount stems from the loss suffered by the original lender or some successor who owned the debt when the borrower became financially distressed. This suggests a third form of symmetry—seller-buyer symmetry. Seller-buyer symmetry exists if the tax treatment of the seller’s loss (or gain) on its disposition matches the buyer’s gain (or loss) that results from ownership of the same investment. If this is not true then more or (if debt market investors are shrewd) less than all of the income generated by a given debt instrument might be taxed. Because of the realization rule, one would expect the seller’s loss an the buyer’s income to be reportable in different periods, but—arguably—the loss and subsequent income should be characterized the same (both ordinary or both capital); or, if they are to be treated differently, the difference should have some policy rationale.

Seller-buyer symmetry is directly related to gain-loss symmetry. If (counterfactually) all taxpayers are subject to the same rules then gain-loss symmetry implies buyer-seller symmetry, at least from a character-of-income perspective (ordinary versus capital). To demonstrate this point in the simplest possible setting suppose there are two holders over the term a given debt

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36 See 2011 ABA Report, supra note 27; see also Paul, supra note 18, at 39.
is outstanding, H1 and H2. H1 purchased the debt at original issue for par (no discount) and sometime later H1 sold to H2 for half of the original issue price. Suppose that H2 will hold until maturity (or default) when the borrower will repay the principal (or will pay nothing). Gain-loss symmetry means that H2’s gains and losses are subject to the same rate; it follows that if H2 enjoys a gain, it will be taxed at the same rate as H1’s earlier loss, as H1’s losses are taxed at the same rate as those that H2 might have suffered.

Gain-loss symmetry does not imply seller-buyer symmetry if taxpayers are not taxed alike. If H1, the seller, was either the original lender or is a bank or a security dealer, it is likely that H1’s loss will be set off against ordinary income. If the debt will be a capital asset to H2, the buyer, then H1’s ordinary loss might well beget H2’s capital gain. Allowing H2 capital gains treatment is required to maintain gain-loss symmetry, but allowing H2 capital gains treatment violates seller-buyer symmetry which is just another way of saying that there is an unfavorable (from the government’s perspective) whipsaw characterization by the two holders.

If transactions fitting this pattern are significant in terms of the overall volume of distressed debt outstanding, which is empirical question regarding which data is hard to find (and will presumably will change over time), then policymakers would have to decide whether it is more important that the rules produce sensible results (and hence incentives) taxpayer-by-taxpayer, or instead whether it is more important that the debt instrument be taxed appropriate over the term it is outstanding. A taxpayer-centric approach suggests that gain-loss symmetry is more important than seller-buyer symmetry; an instrument-centric approach suggests the converse.

Application of the present statutory rules governing market discount to distressed debt can be defended from a different perspective, one that does not involve symmetry or its absence. I have argued that the market discount rules increase the effective tax rate on debt instruments generally. Increasing the effective tax rate on debt instruments might mitigate the debt-equity distinction, and diminish the tax preference for debt finance. Whether this amounts to a persuasive defense of present law depends on whether greater emphasis is placed on rationalizing the taxation of debt instruments or, rather, rationalizing the taxation of financial instruments more generally. As I have said, this second project is one I am leaving for another day.

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To sum up, calls for reforming the treatment of distressed debt are supported by pointing out the many harsh results that arise from applying the statutory market discount rules to

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38 See notes 24-25 and accompanying text, supra.
distressed debt. I am persuaded that there is a real problem here that needs fixing but, as just discussed, there is at least one countervailing idea—seller-buyer symmetry—that, in concept, cuts in favor of applying present law to distressed debt in at least some circumstances. Whether seller-buyer symmetry is important depends on how many sellers are claiming ordinary losses on their dispositions of distressed debt investments, which is not something I was able to ascertain. Treasury—which has access to the data on this point—should consider this question in evaluating the benefits and drawbacks of potential reforms.

III. Do The Statutory Market Discount Rules Apply to Distressed Debt?

A. There is no broad-gauge exception

Some have argued that the market discount rules do not apply to distressed debt. Boiled down to its essence, the argument is that prior to 1984, when the market discount rules were added, there was a common law rule allowing for taxpayer favorable accounting for returns attributable to distress induced discount, and that this rule was not displaced in 1984 by the codified market discount rules. In my view, this argument is unpersuasive.

The argument relies on an analogy to how case law-based rules and statutory rules are (or should be) reconciled. Essential background is familiarity with the “doubtful collectability exception” to the usual rules of interest accrual. Ordinarily, cash method taxpayers take interest into account when it is actually or constructively received; accrual method taxpayers take interest into account when all events have occurred which fix the holder’s right to receive the interest and the amount of interest can be determined with reasonable accuracy. Under the doubtful collectability exception, accrual method debt holders may halt accrual of interest income when the issuer is unlikely to pay the interest.

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39 Andrew W. Needham, Do the Market Discount Rules Apply to Distressed Debt? Probably Not, 8 Journal of Taxation of Financial Products 19, 21 (2009); Kauffman, supra note 6, at 14. For a more equivocal view, see Garlock Treatise, supra note 1, at ¶11,045 (“Since the market discount statute has no exceptions or special rules for deeply discounted debt and there are no regulations or other guidance that create such exceptions or special rules, it is not clear taxpayers have any choice but to suffer these adverse consequences or, if possible, plan around them. Even under current law, however, a taxpayer may have some grounds for deviating from a literal application of the market discount rules, at least in some cases.”); Garlock Article, supra note 20, at 1010 (characterizing Needham’s and Kauffman’s views as at a more likely than not confidence level, and stating “even assuming that this is a correct assessment of the state of current law, a more likely than not level of comfort leaves substantial uncertainty as to whether the IRS will agree and if not, whether it will attempt to enforce the statutory rules literally.”).

40 Reg. §1.446-1(c)(1)(ii).

41 See generally Garlock Treatise, supra note 1, at ¶1602.01.
The scope of the doubtful collectability exception is unclear. Just how unlikely does payment of interest need to be? *Corn Exchange Bank*, the seminal doubtful collectability exception case, is imprecise on this question. At times *Corn Exchange Bank* indicates that the requirement is “doubtful collectability” and at other times that the holder must show it is “reasonably certain that [the interest] will not be received.”42 Mere doubt is a much lower standard than reasonable certainty of nonpayment, so read as a whole the *Corn Exchange Bank* decision is of limited usefulness in divining the precise contours of the doctrine. Subsequent cases are divided,43 with some courts finding that the doctrine should be construed narrowly,44 and others adopting more permissive standards.45

Uncertainty is not limited to the degree of doubt required to trigger the doctrine. Although all agree that when the doubtful collectability exception applies stated interest accruals are suspended, it is an open question whether OID accruals are also suspended. The IRS has taken the position (in unpublished guidance) that the doubtful collectability exception does not apply to OID,46 but every commentator to have considered the question (including me) has concluded that the IRS’s position on this point is incorrect.47

To frame the issue imagine accrual method taxpayers A and B hold debt instruments issued by the same debtor. Suppose the debts held by A and B are similar in all material respects (time until maturity, security, priority in bankruptcy, rate of interest, and so forth) except A’s debt bears stated interest whereas B’s debt bears OID. If it becomes reasonably certain that the issuer

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42 37 F.2d 34, 35 (1930). The court was clear that the doubtful collectability exception standard is more forgiving (less onerous on taxpayers) than the standard for writing off a bad debt, which generally requires a showing that the debt is utterly worthless (no potential future value).

43 For a helpful summary of the caselaw interpreting the doubtful collectability exception, see NYSBA Tax Section, Report on The Taxation of Distressed Debt at 8-13 (Report No. 1248), Nov. 22, 2011.


45 Jones Lumber v. Commissioner, 404 F.2d 764, 766 (6th Cir. 1968); Clifton Mfg. Co. v. Commissioner, 137 F.2d 290, 292 (4th Cir. 1943). The NYSBA Tax Section has stated its view that where there is a 60% chance of collecting interest, an accrual method holder would have to include the interest under the narrower “no reasonable possibility of payment” formulation, but not under the more forgiving “reasonable doubt” formulation. See 2011 NYSBA Report, supra note 43, at 11-12.

46 TAM 9538007, 95 TNT 187-20 (June 13, 1995).

47 Martin D. Pollack, Stuart J. Goldring, and Larry J. Gelbfish, Uncollectible OID: To Accrue or Not to Accrue?, 84 Journal of Taxation 157 (March 1996); Garlock Article, supra note 20, at 1007; Needham, supra note 17, at 26-28; Kaufmann, supra note 1, at 19-21; Schnabel, supra note 1, at 179-181.
will pay neither A nor B, it is settled law that A may invoke the doubtful collectability exception and suspend interest accruals. May B do likewise?

The answer depends on an understanding of when statutory enactments are presumed to displace preexisting common law rules. As a general proposition, when a common law rule is well established at the time a statute is enacted, Congress is presumed to know of the common law rule and will only be found to have abrogated it if it evidences such an intention. B should invoke this principle and argue that when Congress codified the OID rules, it did not intend to abrogate the common law doubtful collectability exception. It is likely that this argument would succeed.

What does this have to do with the treatment of returns attributable to market discount on distressed debt? Andrew Needham has argued that if the doubtful collectability exception to interest accrual qualifies the OID rules, it must also be true that return on debt instruments attributable to market discount escapes classification as ordinary income under the market discount rules. As I understand it, the logic underlying this argument follows this circuitous path: (1) OID and market discount are conceptually identical from the holders’ perspective, interest in both cases; (2) applying the doubtful collectability exception to arrest OID accruals is an acknowledgement that OID on distressed debt is not properly classified as interest; (3) if collection of market discount is doubtful, it should not be classified as interest because of the similarity of market discount to OID; (4) if market discount is not classified as interest, it must be capital gain.

The primary authority cited by John Kaufmann and Andrew Needham for reading common law qualifications and exceptions into the market discount rules is been Republic of Honduras v. Philip Morris, 341 F.3d. 1253 (11th Cir. 2003). Both Kaufmann and Needham note that Republic of Honduras is not a tax case, and then correctly note that there is no reason why the principal for which it is cited — “where a common-law principle is well established . . . the courts may take it as given that Congress has legislated with an expectation that the principle will apply except when a statutory purpose to the contrary is evident,” id. at 1259—ought not to apply to tax law.

Though I agree with this, it is worth noting that there are many tax cases, including some decided by the Supreme Court, that subjugate statutory rules to the common law. These cases are more closely analogous to the matter at hand. See, e.g., Hillsboro National Bank v. Commissioner, 460 U.S. 370, 398 (1983) ("Despite the breadth of the nonrecognition language in [the relevant code section], the rule of nonrecognition clearly is not without exception."); Womack v. Commissioner, 510 F.3d 1295, (11th Cir. 2007) ("We acknowledge the merits of the Taxpayers’ statutory interpretation argument. But in order to effect congressional intent, courts applying the substitute for ordinary income doctrine sometimes reach a different result than they would applying bare interpretive canons without context.").

Among the articles condemning the IRS’s unpublished guidance concluding that doubtful collectability is not relevant to OID accruals, the ones by Pollack, Goldring, and Gelbfish, supra note 47, and Needham, supra note 17, are particularly trenchant.

Needham, supra note 17, at 30.
John Kaufmann has made a similar claim, one that leads to the same overall conclusion:

[The doubtful collectability exception] was well established and widely accepted when the relevant statute was passed. The statutory market discount rules do not evidence a legislative purpose or intent to extend[d] the default rules to distressed debt instrument. [There is evidence in the legislative history] that Congress intended for market discount to be treated as ordinary income [because it is like interest]. This may be read as evidence of Congressional intent to keep the common law rule regarding the treatment of return on [distressed] debt investments . . . in place [because market discount on distressed debt is not like interest]; at least, it may be read as evidence that that Congress’ failure to include an exception for distressed debt ought not be read as an intent to preempt existing common law doctrines on point.\(^51\)

One difficulty with these arguments is their assumption that the doubtful collectability exception to interest accrual has any bearing on the tax treatment of market discount. The observation that OID and market discount are conceptually identical from the holder’s perspective is an observation about the economic nature of the discount, not about the application of tax law to the two types of discount. The tax rules are starkly different for OID and market discount. Recall that the usual rules of interest accrual normally require inclusion of OID (and, sometimes, stated interest) before the interest is paid, so collectability of the interest that would be included in income (but for the doubtful collectability exception) might reasonably be in doubt. The market discount rules, by contrast, have no application until payment is made, at which point all doubts about collectability have been resolved. Invoking the doubtful collectability exception in the context of market discount clashes with the reality that if there is market discount to report, it means the discount has in fact been collected by the holder.\(^52\)

A second difficulty relates to the assertion that if return attributable to distress induced market discount is not interest it “can only be capital in nature” (what I refer to above as step (4) Needham’s argument).\(^53\) This assertion is based on the observation that prior to adoption of the market discount rules there was support for treating distress induced market discount as capital

\(^{51}\) Kaufman, supra note 1, at 33.

\(^{52}\) This might not be true for installment debt, which is a special case where the doubtful collectability exception might have some bearing, as I discuss below. See Part III.B(2), page 22 infra. Deferred inclusion of accrued market discount is the default rule, and the discussion in the text assumes no election under §1278(b) has been made.

\(^{53}\) Needham, supra note 17, at 30.
gain. If the support for this treatment were based on a common law rule predating the market
discount rules, then possibly the rule could be invoked as a limitation on the statutory market
discount rules, much as the doubtful collectability exception is thought to be a limitation on the
OID rules. Prior to the market discount rules, however, there was no established common law
rule regarding the proper characterization of returns to market discount. During this period,
some returns attributable to market discount were taxed as capital gain, but this was a result of
a statutory rule that was repealed in 1984 when the market discount rules were added.

To sum up, the existence of a broad-gauge exception to the market discount rules for distressed
debt is not well supported under existing law. Given the nonsensical results this produces,
surely it is time to change the law, as discussed in Section IV. In the meantime, however, all is
not lost. There are more narrowly tailored arguments that, if accepted, ameliorate some of the
harsh effects of applying the market discount rules to distressed debt. I discuss these next.

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54 Id. at 22 (“Until 1984, the Code permitted a secondary buyer to report market discount
as capital gain”), 24 (same), 30 n. 108 (same, citing §1232(a)(2), and Tobey v. Commissioner,
discussed infra note 55).

55 By way of background, in 1939 Congress added §117(f) (predecessor to §1271(a)(1)
under present law) to counter decisions akin to Fairbanks v. United States, 306 U.S. 436
(1939), in which the Supreme Court held that the maturity of a bond was not a sale or
exchange, foreclosing capital gains treatment. In the Revenue Act of 1954, which added
the first statutory OID rule, the successor to §117(f) was amended to clarify that any
excess gain over amounts classified as ordinary income under the nascent OID rule
would be classified as capital gains. S. Rep. No. 1622 at 112 (1954) (describing §1232 of
the 1954 Code); H.R. Rep. No. 1337 at 83 (1954) (same). The language making this
clarification — i.e., that discount in excess of OID is taxed as capital gain — was then
repealed in 1984 by a section adjacent to the one that added the market discount rules.

In the only case I have found involving a tax year before 1954 in which market discount
was at issue, Tobey v. Commissioner, 26 T.C. 610 (1956), the Commissioner acquiesced in
the taxpayer’s reporting position that so much of the income as was attributable to
market discount was capital gain. This is some indication that market discount was
treated as capital. Cutting the other way are two oft-cited cases involving market
discount (both involving years after the 1954 amendment); in both, the taxpayers
conceded that income attributable to market discount was ordinary income. Liftin v.
Commissioner, 36 T.C. 909 (1961); Underhill v. Commissioner, 45 T.C. 489 (1966). The
reporting position taken by the taxpayers in these cases would not make any sense if
there were a common law rule that market discount generated capital gain prior to
enactment of the statutory market discount rules. See Garlock Article, supra note 20, at
1001 n.17 (noting that in Liftin and Underhill it was unclear why the taxpayers reported
their market discount as ordinary income: “it may have been on the theory that market
discount is inherently ordinary income as an economic matter, but it might also have
been on the grounds that collections do not give rise to a sale or exchange”).
B. Harsh timing effects of the payment-ordering rules might be avoided

There are two payment ordering rules that bear on the tax treatment of distressed debt. First, there is a payment ordering rule specific to debt with market discount, §1276(a)(3), which provides that any partial principal payment is treated as ordinary income to the extent of accrued market discount. Second is the payment ordering rule under the tax accounting regulations, Reg. §1.446-2(e)(1), which has broad application to all types of debt. This rule provides that payments under a loan are classified as interest to the extent there is accrued, unpaid interest on the loan on the date the payment becomes due. Straightforward application of these rules to distressed debt produces anomalous results. I conclude that when the issuer’s distress is sufficient so that the doubtful collectability exception can be invoked these results can be avoided. Assuming I am correct, this resolves most of the timing problems caused by applying the market discount rules to distressed debt. Unfortunately, however, the character problem (asymmetrical treatment of gains and losses) still remains.

(1) Partial principal payments and §1276(a)(3)

To see the problem caused by applying §1276(a)(3) to partial principal payments on distressed debt, recall the facts of Example 3: a secondary purchaser of installment debt, Holder, paid $51.16 for a debt with an unpaid principal balance of $81.16. At the time of Holder’s purchase there are four remaining payments. Suppose that Holder collects the second and third installment payments on the debt (the first two due during Holder’s ownership) and then the Debtor defaults and, on the fourth anniversary of the loan, settles with Holder for a payment of $7.49. The facts are summarized in Table 2.

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Notes:

(1) Column (C) corresponds to column (G) in Table 1; this is the total interest (qualified stated interest plus market discount) based on Holder’s YTM (25%).
(2) Calculation: prior period ending basis less this period principal payment (column (D)).
(3) The period 4 payment is allocated to principal for the reason explained in footnote.
From a cash flow perspective Holder broke even (payments to and by Holder sum to zero, see column (C)). Nonetheless, if §1276(a)(3) is applied as spelled out in the Conference Committee report, without benefit of the doubtful collectability exception or some other rule of mitigation, Holder would pay tax at ordinary income rates on 23.79 of the installment payments she received (column (D)). Holder would get a compensating loss deduction of 23.79 on settlement with Debtor; this is the difference between Holder’s tax basis (31.28) and the settlement payment from Debtor (7.49). Holder suffers a bad timing result: income in the tax years that include second and third accrual periods, and an offsetting loss in the year of the fourth accrual period. Holder also likely suffers from a character mismatch: Holder’s market discount income is ordinary, whereas his loss will most likely be capital. Assuming Holder pays tax on ordinary income at 35% and the capital loss can be set off against capital gains otherwise taxed at 15%, the net effect is that, on an after-tax basis Holder will lose $4.76, or more than 9% of his original investment.

The correct treatment as a matter of policy, assuming perfect foresight, is to allow the holder to recover his basis first. If this rule applies here, there would be no ordinary income on receipt of the second and third installment payments. These payments would be treated as principal, and Holder’s basis would be reduced to 7.49 (cost less installment payments, or 51.16 – 28.84 × 2), so that there would be no gain or loss on receipt of the final payment. This avoids mismatching both the timing and character of Holder’s (nonexistent) income, and conforms the tax treatment to the economics of the investment.

Happily, there are strong arguments under present law for taking this approach. The first argument is essentially similar to the argument raised by Kaufmann and Needham for a broad-gauge exception to the market discount rules for distressed debt—that legislation does not abrogate common law rules in the absence of clearly expressed congressional intent to that effect. As applied in this narrower context, the argument is much more convincing. Before 1984, holders of debt instruments purchased with market discount were treated differently depending on whether the holder’s ability to collect the market discount was reasonably certain or doubtful. In cases where the holder’s ability to collect was reasonably certain, the holder was required to divide payments on the debt between basis and income according to the ratio of

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56 Arguably the payment ordering rule under Reg. §1.446-2(e) would require that the entire $7.49 payment in the fourth accrual be classified as interest. In accordance with the predominant view, however, I assume that this payment is not subject to Reg. §1.446-2(e) because it is not a payment “under a loan” as the regulation requires, given that the payment is made in derogation of the terms of the indenture. See Garlock Treatise, supra note 1, at p.16,010; New York State Bar Association, Tax Section, Report on The Taxation of Distressed Debt at 34 (November 22, 2011), 2011 TNT 226-20.

57 See §§165(g), 166(d); Jarred G. Blanchard, Jr. and David C. Garlock, Worthless Stock and Debt Losses, 83 Taxes 205, 213-14 (March 2005).
basis to face value of the debt. Thus if the holder bought a 100 face value bond for 70 cents on the dollar and then received a principal payment of 10, 7 would be return of capital and 3 income. On the other hand, in cases of doubtful collectability the holder was allowed to allocate all payments to basis to the extent thereof, and was only required to book income after basis had been fully recovered. Thus if a 100 face value bond was purchased for 30 cents on the dollar, a 10 principal payment would be all return of capital, and would reduce the holder’s basis to 20.\(^{58}\)

On their face, §§1276-1278 do not indicate that the common law rules were displaced by codification of the market discount rules. The statutory payment ordering rule for market discount (§1276(a)(3)) begs the question: it provides that partial payments are first classified as market discount, but only to the extent of accrued market discount. The correct rule of accrual is not specified. The most that the statute says about the rule of accrual, at §1276(b)(3), is that it “shall be determined under regulations prescribed by the Secretary,” regulations that have never been issued.

Neither is there any suggestion in the legislative history of the market discount rules that Congress intended to displace the common law rules. The government might argue, nevertheless, that because the legislative history delineates with particularity the rules that should be implemented in the absence of regulation (constant-yield accrual or accrual in proportion to qualified stated interest or OID, at the taxpayer’s election, as illustrated above),\(^{59}\) Congress has demonstrated that it intended to abrogate the common law. This argument has some force if one focuses narrowly on the legislative history of the 1986 amendment that added §1276(a)(3), where the permissible methods are specified.

If, instead, one takes into account the many statements in the legislative history to the initial codification of the market discount rules that the overarching purpose of the market discount rules is to conform the tax treatment of market discount and other forms of interest, things are not so clear.\(^{60}\) Treating market discount like interest for tax purposes, if taken seriously, means that taxpayers should be permitted to invoke the doubtful collectability exception to interest accrual when the issuer is not likely to pay. The basis-first approach to the accounting for partial payments is consistent with this way of thinking. Thus, the legislative history paints a mixed picture, and does not tip the balance heavily in favor of what I imagine would be the government’s position, since some aspects of the legislative history can (and should) be read to favor a basis-first approach.

Turning now to the second argument in favor of a basis first approach, an argument which grows out of the unfulfilled statutory directive to Treasury to write governing regulations.

\(^{58}\) See, e.g., Shafta Realty Corp. v. Commissioner, 8 B.T.A. 283 (1927); Gilbert v. Commissioner, 6 T.C. 10 (1946); Hatch v. Commissioner, 190 F.2d 245 (2d Cir. 1951).

\(^{59}\) See Section II.B(4), supra at 7.

\(^{60}\) Quotations from and citations to these statements are collected Garlock Treatise, supra note 1, at 11,046 and in Pollack et al., supra note 47, at 159.
There is a considerable body of caselaw that considers the issue of spurned regulatory delegations. The courts have focused on the statutory edict to write regulations, and asked whether Congress indicated that Treasury is to determine whether the rule in question applies, or merely directs Treasury to flesh out the details of how it applies (the “whether or how” test). If Congress directs Treasury to determine whether the rule applies and Treasury has remained silent, courts have been reluctant to step into the breach: regulatory silence is taken as an indication that the whether question has been answered in the negative, and the rule is taken not to be self-executing.

On the other hand, delegations of the how-type—the type at issue here—are deemed to be self-executing. When confronted with a spurned delegation to figure out the details of how a particular statutory rule applies, courts do their best to resolve what the correct rule should be in light of the overall purpose of the statutory rule, as articulated in the legislative history. The courts have been resistant to arguments by the Government that are based on a crabbed reading of the statutory delegation, or the legislative history.

If a taxpayer receiving partial principal payments on distressed debt is required to use one of the two methods suggested in the legislative history to figure the amount of accrued market discount, the result will be to overstate its income—perhaps vastly—in the years during which the initial payments are made. Given that the share of the payments thus attributable market discount will be classified as interest, they will not reduce basis and so the taxpayer will ultimately be compensated for the excess accruals with corresponding loss, but the loss deduction will be too little (capital rather than ordinary), and too late. Frequently the result will be to impose an exorbitant effective tax rate on distressed installment debt purchased with significant market discount. This result would be in direct contravention of the statements, pervasive throughout the legislative history, that market discount is a substitute for qualified stated interest or OID and that the overarching legislative objective was to harmonize the tax treatment of all types of debt instruments.

If either (or both) of these argument are accepted—that is, if the doubtful collectability exception is found to temper the market discount payment ordering rule in §1276(a)(3), or if a court writes a “phantom regulation” allowing for deferral—it avoids the anomaly of taxing holders under the market discount rules on receipt of payments that, from an economic standpoint, are not income. These arguments, however, have no direct bearing on the tax treatment of the payments received by holder that are classified as QSI, an issue that I turn to now.

62 Id. at 430.
63 First Chicago Corp. v. Commissioner, 842 F.2d 180 (7th Cir. 1988) is perhaps the best example. For an excellent summary, see Gall, supra note 61, at 419-422.
64 See note 61, supra.
Qualified stated interest payments and basis recovery

Under the payment ordering rule in the §446 regulations, payments under a loan are treated as interest (rather than principal) to the extent of any accrued and unpaid interest as of the due date for the payment. Reg. §1.446-2(e)(1), provides as follows:

(e) Allocation of interest to payments—(1) In general. [Subject to exceptions,] each payment under a loan . . . is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

This rule—classifying payments as interest first—is exactly the opposite of the doubtful collectability exception, which classifies payments as principal first. David Garlock has taken the view that §1.446-2(e) applies by its express terms to situations akin to Example 3, and that there is only limited legal support for avoiding an interest-first accounting for qualified stated interest, even when the holder is not likely to recover her investment. Strictly speaking this issue is not related to the correct treatment of market discount, but it is worth considering carefully because if Garlock’s view is correct it casts a shadow over the analysis in the prior part of this article. The arguments in the prior part, if accepted, lead to the conclusion that payments nominally attributable to market discount can be characterized as principal when the investor is not likely to recover his investment; if Garlock is correct, then §1.446-2(e)(1) requires QSI on the very same debt to be included in income. Harmonious treatment of different forms of interest requires elevating the doubtful collectability exception above both §1276(b)(3) and §1.446-2(e), or neither of them; viewing the doubtful collectability exception as trumping one of these rules but not the other produces incongruous results.

To see the incongruity in the context of Example 3, refer back to Table 1. The arguments advanced in the prior part all supported the conclusion that the market discount (Table 1, Panel B, column (I)) is not includable by the Holder, notwithstanding the market discount rules. None of the arguments were directly relevant to the tax characterization of so much of the payments received by Holder that are classified as QSI (Table 1, Panel A, column (C)).

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65 Garlock Treatise, supra note 1, at ¶1602.02[C].
66 It also suggests some internal tension in Garlock’s own views on related subject. Like me, he concludes that the doubtful collectability exception (or some analogue) excuses inclusion of market discount on installment debt, even when it is arguably compelled by §1276(a)(3) and (b)(3), supra note 65, which does not mesh with his view of regarding the interrelationship between §1.446-2(e) and the doubtful collectability exception, for reasons described in the text.
67 See page 8, supra.
§1.446-2(e)(1) applies to QSI notwithstanding the doubtful collectability exception, then the QSI must be included by Holder in the period it is received.68

A careful reading of Reg. §1.446-2 in its entirety suggests this result is not compelled by the regulation. The limiting clause at the end of §1.446-2(e), quoted above, restricts the amount characterized as interest to the “accrued and unpaid interest . . . as of the date the payment becomes due,” and includes a cross-reference to Reg. §1.446-2(b), the rule of accrual for qualified stated interest. Regulation §1.446-2(b) provides that QSI “accrues ratably over the accrual period (or periods) to which it is attributable.” There is no further specification in the §446 regulations regarding how to figure the period to which any given amount of QSI is attributable, aside from the statement in §1.446-2(a) that “[a]ccured interest determined under this section is taken into account by the taxpayer under the taxpayer’s regular method of accounting.”69

By invoking of “the taxpayer’s regular method of accounting” as relevant to the question of when interest is deemed to accrue, the regulation apparently endorses common law accounting principles, including the doubtful collectability exception.70 Thus, when §1.446-2(e) is read in the context of the other paragraphs of §1.446-2, there is a strong case that it does not require Holder to include the QSI portions of the first two payments (in periods 2 and 3) in income when received.71

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68 Put differently, interest in Table 1, panel B, column (G) IS subdivided into market discount (which would be deferred under the doubtful collectability exception) and QSI (which would be accrued under Reg. §1.446-2(e)). There is no coherent reason why the rule of inclusion should be different for one category than for the other.

69 Reg. §1.446-2(a)(1) (third sentence). This is true despite the initial promise that “[t]his section provides rules for determining the amount of interest that accrues during an accrual period.” Reg. §1.446-2(a)(1) (first sentence).

70 There is language in the OID regulations that could be read to indicate that doubts about collectability should be ignored; properly understood, however, this has no bearing on the correct interpretation of §1.446-2(e). To fit within the definition of QSI under Reg. §1.1273-1(c) interest must, among other things, be unconditionally payable. This requirement is met if the lender has reasonable legal remedies to compel timely payment of interest called for under the debt instrument (or some substitute mechanism exists to diminish the likelihood of late payment or nonpayment). The regulation indicates that “the possibility of nonpayment due to default, insolvency, or similar circumstances” be ignored. §1.1273-1(c)(1)(ii). The point of this directive to ignore the possibility of nonpayment, when read in the context of the scheme of which it is a part, is to allow for the application of the constant yield method of OID accrual based on the schedule of cash flows that is most likely at the time the debt is issued. There is no suggestion in the OID regulations that doubtful collectability should be ignored for any other reason, let alone that it should be ignored for purposes of the §446 payment ordering rule.

71 The condition in Reg. §1.446-2(e) that the payment in question be made under the loan is understood to require that the payment is made pursuant to the loan agreement’s terms,
There is a revenue ruling that suggests (obliquely) that the IRS does not share my view regarding the interrelationship between the doubtful collectability exception and Reg. §1.446-2(e).\textsuperscript{72} This indicates the IRS might reject the construction of Reg. §1.446-2 I have suggested, and should give taxpayers pause regarding whether and how to apply the §1.446-2 regulations in the context of distressed installment debt. As the IRS cautions in every Internal Revenue Bulletin, however, “[i]n applying published rulings . . . Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same,” which is not the case with this ruling, as described in the margin.

(3) Invoking Arrowsmith as a backstop

If the arguments in the prior parts fail to carry the day for the holders of distressed debt, there is a final argument that, if successful, would allow the holder to avoid the character mismatch identified above (interest income and an offsetting capital loss). The holder should report the loss as ordinary on the basis of the Arrowsmith doctrine (sometimes referred to as the relation-back doctrine).

rather than in settlement of the debt for less than the amount owed. This construction prevents the final payment on the debt in Example 3 (payment of 7.49) from being classified as interest, since it is not made \textit{under the loan} in this sense. See note 56, supra.

\textsuperscript{72} In Revenue Ruling 2007-32, a bank owned a loan to a distressed borrower. The bank expected the borrower to make some, but not all, of the payments on the loan. At a time when interest was $32,000 in arrears, the borrower made a $31,000 payment. Issues included (a) whether the $31,000 payment should be included in income when received, and (b) whether the payment should be classified as interest for tax purposes even though it was regarded as a return of principal under bank regulatory accounting guidelines. (What I have styled issues (a) and (b) are issues 1 and 3 in the ruling. Issue 2 is not relevant.)

As to issue (a), the ruling stated that the taxpayer could not prove that it had no reasonable expectation of payment of the accrued interest on the loan, and therefore that the factual predicate doubtful collectability exception was not satisfied. One could read the ruling to imply its converse: that if conditions necessary to application of the doubtful collectability exception are present there would be no income, §1.446-2(e) notwithstanding. In its discussion of issue (b), however, the ruling states that the characterization of the $31,000 payment as interest would be required under §1.446-2(e) even if the taxpayer “had not yet recognized the $32,000 of uncollected accrued interest on [the loan] as income under its method of accounting,” as would be true if the taxpayer had involved the doubtful collectability exception. This supports the view that if a taxpayer invokes the doubtful collectability exception to suspend interest accrual and then receives a payment, the suspended interest must be included on receipt under Reg. §1.446-2(e). This is a reasonable inference based on the language of the ruling, but there is no explicit consideration of this scenario given the stipulation that the doubtful collectability exception could not be invoked in the first place.
In Example 3, assume that (contrary to the arguments laid out above) on receipt of the two installment payments in the second and third accrual periods the holder is required to report both the QSI and accrued market discount as interest (ordinary income). It follows that on receipt of the final payment in settlement of the debt at the end of the fourth accrual period, there will be an equal and offsetting loss. Under the normal rules, retirement is treated as a realization, and the holder’s loss is a capital loss.

The Arrowsmith doctrine allows the gain or loss on a transaction to be determined by reference to an earlier correlated transaction, rather than according to the normal rules that would apply if the earlier transaction were ignored. In Arrowsmith, the shareholders of a liquidating corporation paid capital gains tax on receipt of their liquidating distribution. In a subsequent year, the shareholders as successors in interest to the corporation were required to make good a judgment debt of the corporation. The Supreme Court held that it was proper, and not in derogation of the annual accounting principle, to take cognizance of the tax treatment of the earlier liquidation (capital gain) in assessing the proper classification of the shareholders’ debt payment (claimed by them to be deduction against ordinary income). The Court found that the shareholders must report their losses as capital losses.

The Supreme Court reaffirmed the relation-back doctrine of Arrowsmith in United States v. Skelly Oil Co. The taxpayer in Skelly Oil has booked as income receipts from customers that entitled it to a $0.275 percentage depletion deduction for each $1 received. Later, it was discovered that the taxpayer had overcharged its customers and the taxpayer was obligated to repay some of these receipts. The taxpayer claimed the repayment was deductible in full; the Commissioner argued that the subsequent deduction must be reduced by the percentage depletion deduction that had been (with the benefit of hindsight) claimed improperly. The Supreme Court agreed with the Commissioner, and explained that “the rationale for the Arrowsmith rules is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.”

This rationale maps almost perfectly onto the facts assumed above (from Example 3), in mirror image. Courts and commentators concur that the Arrowsmith doctrine applies without regard

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73 None of the payment will be classified as market discount. As a discrete transaction, the final payment generates a loss, not a gain. It is basic that only gains, not losses, are classified as market discount. §1276(a). Furthermore, for reasons discussed previously, the payment ordering rule in Reg. §1.446-2(e) likely does not apply to the final payment. See note 56, supra.

74 See text accompanying note 20, supra.


76 Id.

77 On the facts assumed above, mutatis mutandis, the rationale would read as follows: “If money was taxed at a special [higher] rate when received, the taxpayer would be
to whether the benefit accrues to the taxpayer or the government.\textsuperscript{78} The unresolved question in determining whether invocation of \textit{Arrowsmith} would succeed in this context is whether there is a close enough link between the earlier ordinary income inclusion and the loss on final settlement.

At first glance, the answer seems to be clear that there is: after all, both the income and the loss are attributable to the same debt instrument. Consider, however, a taxpayer who purchases corporate stock for $100, collects $5 in dividends during two years of ownership, and then sells the stock for $95. If the $5 of dividends were taxed as ordinary income, could the taxpayer claim an ordinary loss on disposition? I believe most knowledgeable observers would say no. Is the example involving the debt instrument meaningfully different from this stock example? The basis for distinguishing the two scenarios is not self-evident.

In \textit{Arrowsmith}, the Court noted that had the earlier income item and the later deduction occurred within one tax period the two would have been combined and so disparate treatment avoided. If a counterfactual of this type is constructed for the stock example, the answer remains that the dividend and ensuing loss are treated as distinct transactions and any resulting character mismatch is corrected (if at all) by anti-abuse rules designed for that purpose.\textsuperscript{79} Unless some basis is identified to distinguish the stock example from cases involving distressed debt instruments, it is not apparent that an argument based on the \textit{Arrowsmith} doctrine would be successful.

Nonetheless, this argument has a meaningful chance of success based on the obvious over-taxation of the debt holder, the close connection between the earlier interest income and the subsequent loss, and recognition by the courts in cases such as \textit{Skelly Oil} that the tax law should not be interpreted in a way that generates inequitable outcomes absent a clear declaration from Congress that is what was intended.\textsuperscript{80}

\section{C. Doctrinal arguments are a poor substitute for reform}

Observe that the basic thrust of this section of the article has been that there are more or less persuasive arguments that taxpayers can raise to avoid application of, or to blunt the harsh effects of, the market discount (and related) rules in circumstances when application of those rules is inappropriate as a matter of policy. Even if these arguments are effectively deployed by taxpayers, the arguments are not a substitute for a more rational statute.

\textsuperscript{78} Bittker & Lokken, supra note 12, at ¶47.9 (noting that taxpayers as well as the IRS have been permitted to gain a benefit from the \textit{Arrowsmith} doctrine).

\textsuperscript{79} E.g., §§1059, 246(c).

\textsuperscript{80} United States v. Skelly Oil Co., 394 U.S. 678 (1979). See also Stephen F. Gertzman, Federal Tax Accounting ¶12.04 (2d. ed) (“application of the doctrine may depend on the ingenuity of the taxpayers or the courts in showing the equity of applying the doctrine”).
A fundamental problem with supposing that resort to caselaw based doctrinal arguments can fix the broken statutory structure is that the arguments I (and others) have considered persuasive or at least relevant in this context necessarily depend on a determination that the debt in question is sufficiently distressed for the doubtful collectability exception successfully to be invoked. It follows that the domain within which the doctrinal arguments have purchase has an exceedingly fuzzy boundary. Even well intentioned taxpayers paying for top-drawer legal advice will not have a high degree of confidence in their reporting positions. It follows that those taxpayers, as buyers of distressed debt, will know if they buy they are risking asymmetrical treatment of gains and losses and adverse timing rules, or possibly buying into a time-consuming and expensive controversy to avoid this result.

This should drive down the price buyers are willing to pay for distressed debt, meaning the ambiguity under present law imposes a form of putative tax on debt-holders who own bonds when they became distressed. Thus even those who think all of the arguments raised in this part would ultimately be resolved in favor of enlightened tax policy should favor a more comprehensive solution, one providing certainty and predictability to both taxpayers and the Service.

IV. Options for Reform

Several reform proposals have been suggested to retrofit the statutory market discount rules so they apply sensibly to distressed debt. The reform proposals fall into two categories, the definitional approach and the yield cap approach. Under the definitional approach, debt instruments meeting a regulatory definition of “distressed debt” would be excepted from the usual rules of accounting for QSI, OID, and market discount. Under the yield cap approach, what would be classified as interest income would be reclassified as return of capital to the extent that market discount caused the yield on the debt to exceed the cap. Below I explain the two approaches in further detail. I then explain why—in my view—the yield cap approach is more promising.

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A. Definitional Approach

The key to successful implementation of the definitional approach to correcting overtaxation of distressed debt is identifying unique attributes of debt instruments that are overtaxed. If unique attributes can be identified, then it is possible to draft a definition of distressed debt and, for debt instruments falling within the definition, to modify the normal interest accounting rules. As demonstrated above, overtaxation of distressed debt occurs when the holder is receiving payments classified as income in circumstances in which there is a high probability that the issuer will stop paying before the holder has recovered her investment—circumstances in which there will likely be an overall loss. It is in precisely these circumstances that holders invoke the common law doubtful collectability exception, suggesting that the common law standard is a good starting point in designing a definition of distressed debt, not surprising when one recalls that the goal of the definitional approach is to systematize and codify the common law rules ameliorating overtaxation of distressed debt.

For debts that fall within the definition, the proposals that have been made generally recommend (1) that QSI and OID accruals be suspended; (2) that the market discount rules be shut off (including the basic rule characterizing gain as interest, as well as current inclusion for electing taxpayers under §1276(b)(2), and rule governing partial payments under §1276(a)(3)); and (3) that the payment ordering rule be modified—some have suggested that the payment ordering rule should be reversed, so that payments are classified as basis first, income last; others have suggested that the regulatory rule (Reg. §1.446-2(e)) be suppressed so that the parties’ characterization of payments as interest or principal be respected.

A preliminary issue that arises when thinking through how to craft a definition of distressed debt—an issue not dealt with by the doubtful collectability caselaw—is figuring which cash flows must be of doubtful collectability before a given debt should be classified as distressed. Garlock has aptly described this as the “doubtful collectability of what?” problem. Recall again

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82 Payments in the sense I intend it here includes QSI payments, partial payments on market discount bonds, and OID accruals (which are not technically payments).

83 One aspect of the market discount rules should not be shut off, namely the provision deferring interest deductions on debt tied to leveraged purchases of distressed debt. Schnabel, supra note 1, at 191.

84 Id.; 2011 ABA Report, supra note 27, at 9; 2011 NYSBA Report, supra note 27, at 33-34.

85 See Garlock Article, supra note 20, at 1006:

On the question of income accruals, it is clear from case law that accrual of stated interest can cease when there is no reasonable expectation of collection. The precise meaning of this rule, however, is unclear. The unresolved question is, no reasonable collection of what? The interest that most recently accrued? Any interest on the debt? Anything at all on the debt?

See also Schnabel, supra note 1, at 182-183.
the facts of Example 3, the installment debt issued by the shaky debtor. As the example was embellished in Part III.B(1), the after-market buyer received total cash inflows equal to the price paid for the debt, and so broke even. Suppose the holder became aware that things would likely turn out this way shortly after buying the debt but before receiving any payments, and they did. Could the holder successfully invoke the doubtful collectability exception with respect to the first payment? Collection of that first payment was not reasonably in doubt, but income on the overall investment was in doubt.

At a theoretical level — putting to one side for now questions of administration, taken up below — the correct resolution of this issue is that if overall income is doubtful, then the normal rules of interest accrual should be modified and possibly shut off entirely: if there is no income on a given debt instrument then payments received by the holder should be classified as return of capital, and any excess basis should give rise to a loss. Taxing any payments received as interest cannot be justified. It is from this vantage point that Garlock has suggested that accruals of interest income should cease if and when the taxpayer arrives at a point when there is no reasonable expectation that it will collect any more than its basis in the debt. One might also justify a rule that would stop any further accruals when there is no reasonable expectation that the borrower will be able to pay more than the outstanding loan balance, that is, principal plus accrued and unpaid interest. In the case of the original lender, the two rules are equivalent, but in the case of a subsequent purchaser at a discount, the latter rule will result in income accruals ceasing considerably earlier. The more pro-taxpayer rule can be justified on the ground that accruals beyond the borrower’s capacity to pay do not increase the value of the debt and hence do not constitute an accretion to the wealth of the debt holder. However, if a taxpayer has invested in a debt instrument and expects to receive more than its investment, it seems reasonable to require some form of interest-like accrual as long as that expectation remains valid.

This statement was made in the context of a discussion of the present state of the caselaw. It seems clear, though, that Garlock is explaining what he believes to be the correct resolution of the issue at a conceptual level. If this is right, then “distressed debt” should be defined to include debts with respect to which it is unlikely that the issuer will pay any more than the holder’s basis.

On the surface this approach seems unobjectionable, perhaps even obvious. But it militates against the use of market price or yield information (such as discount in market prices

86 See page 22, supra.

87 Garlock Article, supra note 20, at 1007.
compared with issue price, or the excess of yield over some benchmark such as AFR) in the
definition of distress, which could be a serious shortcoming from the standpoint of
administration. Every proposal that has been made suggesting the definitional approach has
indicated that the definition should be based, at least in part, on price discounts or yield spreads
or both. Using taxpayer-specific data also results in what some believe to be unfair distinctions
among taxpayers whose tax bases differ from one another, because bonds that are part of the
same issue would be classified as distressed for some holders but not others.\textsuperscript{88}

To understand the tension between basing the definition on the likelihood of profit for a given
holder and the use of market price or yield data, it is useful to divide both debt instruments and
debt holders into two groups: debt instruments are either trading at a significant discount to
their issue price (or adjusted issue price for OID bonds), or not\textsuperscript{89}; some holders are likely to
profit, and others not. Both types of holders can own both types of debt, so there are four
permutations.

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<thead>
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<th>TYPES OF DEBT INSTRUMENTS</th>
<th>TYPES OF HOLDERS</th>
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<tr>
<td>debts trading at a price \textit{not} significantly below issue price (yield \textit{not} significantly above benchmark yield)</td>
<td>holders likely to profit on their investment</td>
</tr>
<tr>
<td>debts trading at a price significantly below issue price (yield significantly above benchmark yield)</td>
<td>holders \textit{not} likely to profit on their investment</td>
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Accepting likelihood of profit as the correct test, cases 3 and 4 should be “distressed debt” and
cases 1 and 2 should not. Use of significant price discounts or yield spreads as proxies for
distress will result in cases 2 and 4 being classified as “distressed debt” and cases 1 and 3 not.

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\textsuperscript{88} 2011 NYSBA Report, supra note 27, at 7; Schnabel, supra note 1, at 182-83.

\textsuperscript{89} This division could also be made by dividing debts into those that are trading at a yield
not significantly in excess of some benchmark (e.g., AFR) and those that are. Below I
take up the factors that bear on the choice between using price data and yield data in the
definition. See text accompanying notes 90-92, infra.
Including case 2 as distressed debt makes the definition overinclusive; excluding case 3 makes it underinclusive.

To see a scenario that might fall under case 2, imagine a debt is issued for $1000 by a borrower assumed to be creditworthy. The debt is secured by an asset with a market value of $400. The borrower goes bankrupt and will not pay any more stated interest on the debt, but the property that secures the debt and the security interest in favor of the holder both remain intact. When 12 months remain before the debt holder can expect to receive payment equal to the $400 value of the collateral, a buyer pays $381 for the debt, representing an implied interest rate of 5%, stipulated to be the market rate. From an economic standpoint the return earned by the buyer is interest, but under all proposals that have been made, the price discount and yield premium are so great that the debt would be classified as distressed debt per se. This demonstrates the overinclusiveness of a definition that compares market price and issue price.

A scenario fitting into case 3 might involve a holder who purchased secured debt at original issue for $1000 (par). Suppose that the debt is secured by property with market value of $900, constant throughout; that the issuer goes bankrupt; and that holder will recover $900, but no more. If the outcome for the holder of the issuer’s bankruptcy proceeding was clear from the date of the bankruptcy petition, interest accruals should have stopped at that point. Yet the price discount (yield premium) is insufficient to qualify the debt as distressed under the price discount (yield premium) tests that have been suggested.\footnote{The 2011 NYSBA Report and Schnabel both suggest that distress be defined using a broad standard that would be met when there is an insufficient likelihood that the holder will recover the principal amount of the debt, and that, to ease administrative burdens, safe harbors and presumptions be added based on price and yield data. Both proposals suggest that in this context “principal amount” be understood at the face amount of the debt (adjusted issue price for OID bonds), increased by any interest (QSI and OID) accrued but unpaid up to the time the bond becomes distressed. The 2011 NYSBA Report coins the phrase “Tax Principal Amount” to capture the idea. The example in the text would meet the broad standard for distress in these proposals, but would not qualify for the safe harbors.}

It is possible, perhaps likely, that in the real world debts and holders overwhelmingly fall into case 1 and case 4, and the over- and underinclusiveness is a minor problem in light of the administrative benefits of using price or yield data. Particularly so when the alternative seems to be handicapping every individual holders’ likelihood of income, a daunting task. In the end, the choice here is between basing the definition on the thing that really matters from a policy perspective (likelihood of income) but that is difficult to detect, or using an imperfect proxy (market price or yield data) that is usually easy to detect.

Assuming the decision is made to use a proxy, further technical questions arise. The first is what proxy or proxies to use. Most proposals suggest using both price \textit{and} yield data in combination. The difficulty in relying on price information (such as a rule that any bond trading at a 50%+ discount to issue price [or adjusted issue price] is distressed) is that the price
effect of changes in market interest rates depends on duration, a measure of weighted average time until maturity; bonds with longer duration suffer steeper price declines than shorter duration bonds for an equivalent change in market interest rates. As a result, if interest rates rise, a threshold price discount that does a reasonably clean job of separating distressed and non-distressed short dated bonds will classify many long dated bonds as distressed when the discount is a consequence of idiosyncrasies of bond math, rather than the likelihood the issuer will pay the long dated debts.

Yield suffers from a related problem: relatively minor price discounts can sent yields skyrocketing when time until maturity is short. Yet minor price discounts are not indicative of a market consensus that the issuer is not likely to pay. Thus using yield could result in false positives. Another issue with using yield which must be considered, but which is easily dealt with, is that the yield benchmark must take into account the term structure of interest rates (as AFR does, albeit in a crude way).

The next two (related) issues are (1) when to test a given debt instrument to see if it is distressed, and (2) what to do when there is no market data on price or yield. Many of the proposals are silent on the first issue, but the issue is confronted at some length in the 2011 NYSBA Report. The 2011 NYSBA Report recommends that distress be tested once per year, on December 31: if the debt is distressed on this date it would be deemed to be so for the next calendar year, until the next test. Certain extraordinary events—bankruptcy of the issuer, sale of substantially all of the issuers assets, or cessation of the issuer’s business—would trigger application of the test at other times.


92 Conversely, if the discount is set right for long dated bonds, it is more likely that short dated bonds that are distressed will be classified as non-distressed. The 2011 NYSBA Report, supra note 27, includes appendices with numerical illustrations of price sensitivity of bonds with different maturities to equivalent changes in market yield.

93 §1274(d) defines short-, mid-, and long-term rates and delineates the protocol to be used in setting rates.

94 There is no explicit mention of this point in the 2011 ABA Report, but the definition of distress that is suggested indicates a tacit understanding on the part of the drafters that the test would be applied at acquisition. 2011 ABA Report, supra note 27, at 9 (comparing “acquisition price” to adjusted issue price, and suggesting use of AFR “at the time of purchase”).


96 Id. at 28.
The 2011 NYSBA Report equivocates on whether distress should be tested when a bond trades in the market. The equivocation is understandable since the issue is complex and involves many tradeoffs. Focusing narrowly on the tax treatment of market discount, testing on the date of every trade makes perfect sense — acquisition is the time when market discount is measured, and when market discount accrual begins. If this process is to be shut off for distressed debt, it should be shut off at the beginning. But testing on acquisition could result in inconsistent treatment of different taxpayers who hold identical bonds.

Suppose accrual method holders A and B both own bonds of the same issue. The bonds pay QSI but have no OID. A bought her bond at original issue, and B bought her’s in the secondary market at a steep discount. If the discount is steep enough to classify the debt as distress, then B presumably would be permitted to halt interest accruals (both market discount and QSI); meanwhile A would have to wait until the next year (after the next retesting date) to halt her QSI accruals. This seems unfair to A. The unfairness could be mitigated by requiring B’s QSI to continue to accrue; that is, the trade-date testing could be done for purposes of market discount accruals only. But from the standpoint of measuring B’s income accurately, this is not the correct approach.

Next, suppose that the definition is applied at acquisition, and that the debt instrument is distressed on that date. If, on a later testing date, the debt no longer meets the definition, what is the correct treatment? For QSI and OID the correct result is presumably to resume interest accruals beginning on the date the debt is no longer distressed, but that does not seem like the right result for purposes of the market discount rules. If the bond was purchased at a steep discount (and hence classified as distressed at acquisition) and then subsequently recovers, the price appreciation is analogous to stock gain and should not be classified as interest, particularly if the taxpayer was risking losses that would have set off income taxed at capital gains rates had things turned out badly.

Consider also the converse case where there is market discount falling short of distress at acquisition, and that distress sets in at a later testing date. In this case it makes sense to halt all interest accruals — including market discount. Otherwise unjustified distinctions would arise. Suppose two OID bonds of the same issuer are purchased at the same price; the price of the first is equal to the adjusted issue price (so there is no market discount) and the price of the second is below the adjusted issue price (so there is market discount in addition to OID). If the two bonds are both classified as distressed at some later testing date, they should be treated similarly, which would require halting accrual of both OID and market discount on the second bond.

My goal here was to demonstrate that deciding the how often and when to test debt instruments for distress is complex. Use of a simple, easy-to-administer rule is likely to be highly imperfect. Many of the imperfections can be eliminated by adding qualifications and

97 Id. at 30-31.
98 See generally id.
exceptions to the testing date rule. Yet if all of the necessary qualification and exceptions were added, the system would be complicated, perhaps unwieldy.

Moreover, as noted, a critical underlying assumption is that the data necessary to apply the test—price or yield or both—are readily available, which is very often false. The ABA Report indicates that debt that is not publicly traded would be tested once at acquisition, whereas publicly traded debt would be tested ongoing; the 2011 NYSBA Report acknowledges that the annual valuation of debt that is not publicly traded is time consuming and expensive, but the drafters apparently think the time and cost are justified.99

B. Yield Cap Approach

In President Clinton's Fiscal Year 2001 revenue proposals (the 2001 Greenbook), Treasury proposed implementing a yield cap:

In cases where the credit of the issuer is severely impaired, it may be inappropriate to treat the entire difference between the holder's basis and the principal amount as market discount. A significant portion of this difference, if realized, is more in the nature of a gain on an equity investment in the issuer than income from a lending transaction. 100

Treasury therefore proposed that “the holder's yield for purposes of determining and accruing market discount would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus 5 percentage points, or (2) the applicable Federal rate at the time the holder acquired the debt instrument plus 5 percentage points.” 101

99 The obvious alternative to using market price or yield data is to use credit ratings from the major credit rating agencies, an idea that was considered and rejected by the 2011 NYSBA Report, which concluded that using credit ratings is impermissible under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010), §939A(a). See id. at 14 n.46; see also T.D. 9533, IRB 2011-33. See John Carney, Goldman Declares the Distressed Debt Market Dark (5/10/2011) (explaining that in 2011, Goldman Sachs classified most of its portfolio of distressed debt as “Level 3,” meaning prices are not observable based on market trading), see http://www.cnbc.com/id/42973414/Goldman_Declares_the_Distressed_Debt_Market_Dark

100 2001 Greenbook, supra note 81, at 140.

101 Id. The proposed change was a component of a more comprehensive plan to revamp the market discount rules (1) to require accrual method holders to include market discount in income as it accrues, and (2) to require them to accrue market discount using the constant yield method. Had they been enacted, the changes would have reversed the default timing and accrual rules under present law for accrual method holders.
Similar revisions have twice been proposed by the ABA, first in 1991 and again in 2011. The 1991 ABA Report focuses only on market discount, and suggests that when a holder receives a partial payment, the amount characterized as market discount “would be the amount which would have accrued during the relevant period on the bond in question if market discount accrued at a maximum rate equal to [the cap, set at some function of AFR].”

The 2011 ABA Report proposes capping QSI, OID, and market discount accruals, not just market discount. Under the proposal the holder would be required to accrue interest up to the cap each year, in the following order: QSI first, OID second, and market discount third. To illustrate how this would work, consider the debt instrument in Example 1, above. Six-year debt was issued at par (100), and bore interest at 3%, compounded and paid semi-annually. The debt was purchased for 40 on the first anniversary of issuance (five years remaining in its term). If the yield cap is 15%, then interest accruals could not exceed $6 per year (cost times cap, $40 \times 15\%). The $3 annual QSI payments would exhaust one-half of the cap; market discount accruals of $12 per year would be reduced to $3; and the $9 balance of putative market discount would be eliminated. For the cap to eliminate QSI in addition to market discount the product of the yield cap and the holder’s cost would have to be less than the annual QSI accruals, as would occur with a purchase price (or cap) less than one-half of the price (cap) assumed in this example.

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102 Supra note 81.

103 1991 ABA Report, supra note 81, at 15. Take for example a $1000 bond that the pays semi-annual QSI of $15 (3% per year), and no OID. If a holder buys the bond for $400 when there is exactly five years remaining in its term, and the yield cap is 15% per year (annual compounding), then the maximum interest that would accrue in any of the five years would be $400 \times 15\% = $60. This implies that the cap on market discount accruals would be $60 less two semi-annual $15 coupon payments, or $30. Aggregate market discount accruals would thus be capped at $30 \times 5 \text{ years} = 150 \text{ total}, which is one-fourth of the uncapped market discount ($1000 face amount less $400 purchase price).


105 There are two technical questions that would have to be resolved under the yield cap approach, issues that are not addressed by the proposals that have been made to date. First, should the cap be updated period-by-period or should the applicable cap for a given debt be the one that exists when the debt becomes distressed? The answer is that the cap should be periodically updated. The cap would presumably be aimed at distinguishing returns that might reasonably be attributed to the time value of money from other returns, and if the dividing line changes over time as market interest rates vary, this should be taken into account.

Second, should the amount of interest that is eliminated by the cap reduce the holder’s basis? If the interest shaved off by the cap is QSI, the answer is yes. But if the interest eliminated by the cap is OID or market discount, the correct approach is simply to deny the basis increase that would have followed from including the “interest” in income under §§1272(d)(2) or 1278(b)(4), as the case may be. This ensures that if—contrary to
Under the proposal in the 1991 ABA Report, market discount accruals in excess of the cap would be deferred: after the holder’s basis is reduced to zero, additional payments by the issuer (or amount realized on sale) would be characterized as ordinary income (interest) to the extent of accrued market discount, as under present law. The drafters of the report were concerned with what they called the “ordinary income/capital loss timing mismatch,” which is corrected by their deferral regime. A deferral rule is, however, not an adequate solution. It does not address the fact that risk-based returns are being mischaracterized as interest, nor does it adequately address the asymmetrical treatment of gains and losses across a portfolio of bond investments (or in expectation for a given bond investment). This defect was not perpetuated in the 2011 ABA Report, under which putative market discount in excess of the cap would be eliminated.

Under all of the yield cap proposals, the cap is applied to holders one-by-one—application is based on reckoning the yield to maturity for the particular holder and the cap. Every holder has enough information to compute their YTM, which is done once at the time of acquisition. Applying the yield cap approach to debt instruments that are not publicly traded thus presents no difficulty administratively; issues regarding the timing and frequency of testing do not arise.

C. Superiority of the Yield Cap Approach

The yield cap approach is superior to the definitional approach, for two reasons. First, primarily for the reason just mentioned—less necessary data that is hard to come by—a yield cap would be much easier to implement and enforce than the definitional approach. Second, the definitional approach creates a cliff effect, which would likely result in significant economic distortion in the market for distressed debt, a consequence that is largely avoided by a yield cap.

Implementing the definitional approach would be complicated. As described above, there are several challenges, including (1) whether the definition should be taxpayer-specific or debt-

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106 1991 ABA Report, supra note 81, at 13, 15.

107 To see this, begin with the example in footnote 103. If the holder in the example were to sell the bond for $530 after one year, gain would be $130 = $530 - $400, total market discount during the holder’s ownership would be $120 = [$1000 purchase price - $400 cost]/5 years, and market discount under the cap would be $30. Under the 1991 ABA Report proposal the $90 of market discount over the cap would be included as ordinary income (interest) because the holder recovered all of her basis in the bond on disposition. Likewise, if the holder had held the bond until maturity and the issuer made good on the $1000 principal, the $450 of market discount accruals over the cap ($600 total market discount less $150 under the cap) would be included as ordinary income (interest).

instrument specific, (2) whether it is possible to define “distressed debt” so the system is capable of implementation, including for debt with no publicly available price or yield data, and, if the first two problems can be solved, (3) how often to test debt instruments under the chosen definition (if the definition is easier to apply, greater frequency in testing is justified, and conversely).

In addition to greater ease of implementation the yield cap approach is superior in that it does not create a cliff effect, which is an unfortunate consequence of the definitional approach. The definitional approach creates two regimes, the default regime (background rules of general application) and a special regime that applies to debt that falls within the definition. The special regime is more taxpayer-favorable than the default regime: interest accruals are smaller and slower and payments are more likely to be treated as principal, rather than interest. These benefits are either all supplied to, or are all withheld from, holders depending on whether their debt meets or flunks the definition.

Think about the effect this is likely to have on the price (and yield) of debt instruments that are near the cliff. Assume the definition of “distressed debt” is set a price discount of 50 percent or more of the issue price. If market prices were set without regard to tax rules (or on the assumption that the same tax rules apply to all holders, without regard to level of distress) there would be some debts that meet the definition and others that do not, and there would be no reason to suppose that bond prices would bunch around a 50 percent discount. Now relax the assumption that prices are set without regard to tax rules. Imagine two seminal bonds, both very near the cut-off for the tax preference; one bond just meets the test for distress and the other barely flunks the test. The bond that meets the test (less desirable from the standpoint of credit quality) might well supply a higher after-tax return to a taxable holder than the otherwise similar bonds on the non-distressed side of the definitional cliff.

Taxable holders will sell bonds on the not-distressed side of the definitional cliff and buy ones on the distressed side so long as (a) the resulting upward pressure on the price of the distressed bond does not cause it to flunk out of the “distressed debt” category, and (b) the incremental after-tax yield on the distressed bond is sufficient compensation for the incremental risk. For bonds near the cliff, changes in risk will be small and changes in after-tax yield will be large, given that risk is likely to vary more or less continuously, whereas the tax burden will make a large discontinuous jump at the cliff. The result will be a bunching of debt on the distressed side of the cliff and barren price range on the other side. Such a market response, which seems likely, would be evidence of tax distortion and economic inefficiency.109

The yield cap would also cause a distortion, but it would be much smaller. A yield cap would cause a kink in the effective tax rate of bonds that hit the cap, where the normal rules apply to (and hence usual effective tax rates are imposed on) yield up to the cap. Thereafter, incremental yield would be taxed under more favorable rules (at a lower effective rate). There would likely be some bunching near the kink—the price of bonds that become subject to the cap would

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diminish more slowly after the kink point, since yield above the cap would draw a lower rate, implying a better risk/reward trade off above the cap. The important point is that the amount of bunching and economic distortion is likely to be smaller than under then yield cap than under the definitional approach.

V. Concluding comment

This article is intended to shed light on the state of current doctrine regarding the taxation of distressed debt, and the path forward. Much more could be written about this timely and important subject including, for example, consideration of (1) whether either of the two basic reform proposals could be implemented by regulations or whether either or both would require a statutory amendment, (2) how the issues discussed in this Article intersect with the deduction allowed for partial worthlessness under §166 (a deduction permitted only for debts that are not securities\(^{110}\)), (3) how to treat debt-for-debt and debt-for-stock exchanges involving distressed debt, and (4) issues raised by contributions of distressed debt to a partnership, among many others. Fortunately, these issues have been capably discussed by others.\(^{111}\)

\(^{110}\) §166(e).

\(^{111}\) Some of these issues are discussed in Schnabel, supra note 1; and others are discussed in Deborah L. Paul, The Taxation of Distressed Debt Investments: Taking Stock, 64 Tax Lawyer 37 (2010).