Corporate Cancellation of Indebtedness Income and the Debt-Equity Distinction

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> *Writers often turn to Lewis Carroll for neat examples of how reasoning, correct in every step, can still lead to nonsensical conclusions when starting from a false premise. Our tax laws and regulations have their share and more of such logically consistent absurdities. But perhaps none [is] more unfortunate at the moment than those flowing from [Internal Revenue Code] Section 61(a)(12), which defines taxable gross income to include gains from the discharge or cancellation of indebtedness . . . . The general rule embodied in that section -- combined with some of the specific "exceptions" introduced by tax laws over the years ... makes it uneconomic for many of today's distressed corporations to seek voluntary, mutually satisfactory agreements with creditors to restructure existing debt contracts.*[1]

I. INTRODUCTION.

This Article considers whether a corporation should have cancellation of indebtedness income when it discharges its debt in exchange for new debt or stock.

The corporate tax[2] distinguishes between debt and equity. The most important distinction between corporate debt and equity is the distinction between

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[1] Merton H. Miller, *Notes of Some Current Tax Obstacles to Voluntary Corporate Restructuring*, 4 J. OF APPLIED CORP. FIN. 20, 20 (1991).

[2] Our income tax system treats corporations as separate taxpaying entities. I.R.C. § 11 (2000).

interest and dividends. Corporations can deduct interest paid or accrued on its debt, but cannot deduct dividends paid on its stock.[3]

The tax law also distinguishes between corporate repurchases of stock and debt. A corporation does not have income if it retires stock for an amount that is less than the amount the corporation received on the issuance of the stock.[4] If, however, a corporation retires debt for less than the amount owed, the corporation has cancellation of indebtedness income (COD income) in an amount equal to the amount owed on the debt less the amount paid to discharge the debt.[5] Courts have applied this rule consistently to the discharge of debt for cash, but have varied their approach to COD income where a corporation discharges its outstanding debt for its new debt or stock.

Early case law established that the exchange of new corporate debt for old corporate debt and the exchange of new corporate stock for old corporate debt did not create COD income.[6] The theory articulated in these debt-for-debt and stock-for-debt cases is generally a substitution of liabilities theory.[7] Courts in some cases also adopted a substitution of liabilities approach for purposes of determining whether a corporation could deduct unstated interest, also known as original issue discount (OID),[8] when it issued new debt in exchange for outstanding stock or debt.[9]

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[3] I.R.C. § 163(a)(2000).

[4] *See* I.R.C. § 311(a) (2000). Section 1032(a) provides that a corporation does not recognize gain or loss on the issuance of stock in exchange from property. Treasury Regulations provide that § 1032 does not apply to a corporation's acquisition of its own shares unless the corporation acquires the shares in exchange for its own stock (although the regulation cross-references the § 311 regulations). See Treas. Reg. § 1.1032-1(b). Section 311(a) provides that a corporation does not recognize gain on the distribution of property with respect to its stock. See I.R.C § 311(a) (2000). Property includes cash. I.R.C. § 317 (2000).

[5] *See* I.R.C. § 61(a)(12) (2000).

[6] *See, e.g.*, Commissioner v. Coastwise Transportation Corp., 71 F.2d 104 (1st Cir.), *cert. denied*, 293 U.S. 595 (1934) (debt-for-debt exchange did not produce COD income to the extent that the face amount of the new debt equaled the face amount of the old debt); Capento Securities Corp. v. Commissioner, 47 B.T.A. 691, *aff'd*, 140 F.2d 382 (1st Cir. 1942) (stock-for-debt exchange did not produce COD income even though the face amount of the debt discharged was $500,000 and the stock issued in exchange for it was worth only $50,000).

[7] 71 F.2d at 105-06; 47 B.T.A. at 695.

[8] Interest on corporate debt may be stated interest or unstated interest. Stated interest is the interest that the corporate issuer must pay the bondholder periodically. Unstated interest is (1) the stated redemption price at maturity of the debt (taking into account the stated interest), less (2) the issue price of the debt. For example, if a three-year bond is issued for $1,000, has a stated redemption price at maturity of $1,340, and no stated

Over time, tax commentators, the Treasury, and Congress rejected the substitution of liabilities theory in favor of a hypothetical cash issuance model , both for purposes of computing COD income and OID.[10] Under current law, COD income in a debt-for-debt exchange or a stock-for-debt exchange equals the amount owed on the outstanding debt less the fair market value of the newly issued debt or stock.[11] It is as if the new stock or debt is issued for cash in an amount equal to the value of the new stock or debt and the hypothetical cash proceeds are used to discharge the outstanding debt. The OID rules also follow the hypothetical cash issuance model. If new debt is issued in exchange for outstanding stock or debt, the issue price of the debt is the fair market value of the debt or stock where either is publicly traded,[12] and the OID on the new debt equals the stated redemption price of the new debt less the issue price of the debt.[13]

This Article considers whether the current tax treatment of corporate debt discharge in debt-for-debt and stock-for-debt exchanges is warranted under two alternative normative approaches. The first approach is a comprehensive tax base or horizontal equity approach.[14] Under this approach, we apply a general theory of COD income to determine the appropriate tax treatment of corporate debt discharge in debt-for-debt and stock-for-debt exchanges. The alternative normative approach is to determine the appropriate tax treatment of such transactions by applying principles of economic efficiency.[15]

To date, tax commentators have consistently adopted the first normative approach.[16] They have stressed the desirability of applying the same debt discharge approach to all taxpayers, regardless of the type of transaction in which

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interest, the bond bears unstated interest of $340. The Internal Revenue Code refers to this unstated interest as Original Issue Discount (OID). I.R.C. § 1273(a)(2) (2000).

[9] *See, e.g.,* Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974) (corporate issuer could not deduct, as unstated interest, the $17 difference between the $50 face amount of new debt the corporation issued and the $33 worth of outstanding preferred stock for which the new debt was exchanged).

[10] *See infra* Part III. The argument in this Article relates to debt-for-debt or stock-for-debt exchanges in which at least one of the securities exchanged is publicly traded.

[11] I.R.C. §§ 108(e)(8) and (10), and 1273(b)(3) (issue price of debt issued in exchange for debt or stock equals fair market value where there is public trading of the stock or debt).

[12] I.R.C. § 1273(b)(3).

[13] I.R.C. § 1273(a)(1). For an example, *see supra* note 8.

[14] *See infra* Part IV.B.1.

[15] *See infra* Part IV.B.1 and 2.

[16] *See infra* Part II.

the debt is discharged, and regardless of the taxpayer's financial circumstances. Said another way, proponents of this approach have tried to fashion a consistent, comprehensive COD income rule for all debt discharge.[17]

Gradually, over a long period of time, we have rejected the substitution of liabilities approach to COD income and OID and adopted a hypothetical cash issuance model in its place.[18] This Article highlights the historical connection between the COD income rules and OID rules and considers the COD income implications of this connection, keeping in mind the error correction function of the COD income rules.[19]

The earlier substitution of liabilities approach to COD, or a variation known as subscription price theory, can be reconciled with the theory underlying existing COD income doctrine, although it may require a different sort of error correction device than we currently employ. Given the fact that we have a corporate tax, and it is not likely to be repealed, synchronizing COD income rules and OID deduction rules may make sense only if we synchronize in the other direction, for example by eliminating the corporate interest deduction, or by adopting a cost of capital allowance system in place of the corporate interest deduction.[20]

If we equated the interest and dividend treatment of corporate issuers, corporations arguably should not have income from debt discharge, just as they currently have no income from dealings in the corporation's own stock.[21] Even if we retain the corporate interest deduction in its current form, we could fashion a different error correction device that requires interest deduction recapture in stock-for-debt exchanges. In debt-for-debt exchanges, we could adopt a rule that precludes COD income where the face amount of the new debt at least equals the face amountof the old debt.

It may be preferable, from a normative perspective, to apply principles of economic efficiency to determine the tax rules for calculating COD income in

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[17] *See, e.g.*, Boris I. Bittker and Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CAL. L. REV. 1159 (1978) (articulating the "loan proceeds" or "symmetry" theory of COD income).

[18] *See infra* Part III.

[19] *Id.*

[20] If Congress replaced the corporate interest deduction with a cost of capital allowance (COCA) system, corporations could deduct a fixed statutory percentage of the corporation's total capital (debt and equity combined), but could not deduct interest. A COCA system equates the treatment of debt and equity for purposes of taking a corporate tax deduction for the cost of capital.

[21] *See infra* notes 230-240 and accompanying text.

debt-for-debt and stock-for-debt transactions.[22] Professor Weisbach has argued that we should determine the tax consequences of various types of transactions by attempting to minimize deadweight losses.[23] For example, he argues that we should use this method to classify hybrid securities as debt or equity.[24] We can apply this method to determine the consequences of debt-for-debt and stock-for-debt exchanges.

The issue is complicated because of the second-best setting in which the issue arises.[25] The debt-equity distinction in the corporate tax creates a discontinuity that causes economic distortions.[26] The hypothetical cash issuance model is designed to produce consistency in the treatment of all debt discharge, but this model may increase certain economic distortions caused by the debt-equity distinction. For example, using the hypothetical cash issuance model to determine COD income in debt-for-debt and stock-for-debt exchanges may increase the costs of financial distress.[27]

This Article asserts that the synchronizing of the COD income rules and OID deduction rules in the 1980s and 1990s, and adoption of the hypothetical cash issuance model, may have taken us down the wrong COD income path, especially for troubled corporate debtors. Instead of justifying our current approach based on notions of a comprehensive corporate tax base and horizontal

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[22] *See infra* Part IV.B. 1. and 2.

[23] David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1664-72 and note 43 (1999) [hereinafter Weisbach, *Line Drawing*]; David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL STUD. 71 (2000) [hereinafter Weisbach, *Efficiency Analysis*].

[24] Weisbach, *Efficiency Analysis, supra* note 23, at 80. Weisbach refines the analysis of Monthly Income Preferred Shares (MIPS) in an earlier article by Gergen and Schmitz. Mark P. Gergen & Paula Schmitz, *The Influence of Tax Law on Securities Innovation in the United States: 1981-1997*, 52 TAX L. REV. 119, 132 n.56 (1997).

[25] The theory of the second best posits that, in a world with multiple distortions, eliminating an economic distortion does not necessarily increase efficiency because of the effects of the other remaining distortions. The classic example is the polluting monopolist. Eliminating the distortion caused by the monopoly will increase production, but will also increase pollution, so it is not clear that eliminating the monopoly will increase efficiency. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57).

[26] *See* Jeff Strnad, Taxing New Financial Products: A Conceptual Framework, 46 STAN. L. REV. 569 (1994).

[27] *See infra* Part IV.B.2.

equity, we should perhaps consider whether the repeal of the debt-for-debt and stock-for-debt exceptions to COD income reduced efficiency losses or not. Congress adopted the hypothetical cash issuance model for COD income without sufficiently considering the economic effects of the new tax rules on workouts and bankruptcy restructurings.

Part II discusses the development of several competing general theories of debt discharge. Commentators apply these theories to both individual and corporate taxpayers. Part III tracks the historical development of the specific body of tax rules applicable to debt-for-debt and stock-for-debt exchanges and illustrates the continuing relationship between the COD income rules and OID rules applicable in debt-for-debt and stock-for-debt exchanges. Part IV considers and critiques the conventional normative justifications for the current treatment of debt-for-debt and stock-for-debt exchanges and suggests a different approach for these types of exchanges.

II. DEVELOPMENT OF THE COMPETING THEORIES OF CANCELLATION OF INDEBTEDNESS INCOME.[28]

This Part tracks the development of competing general theoretical approaches to cancellation of indebtedness income. As early as the 1920's the Internal Revenue Service (the Service) took the position that the discharge of debt at a discount created taxable income if the debtor was solvent,[29] but did not create income if the debtor was insolvent[30] or if the discharge occurred as part of a bankruptcy proceeding.[31] The Service had difficulty convincing courts that its position was correct, however, because, at that time, income was defined as "the gain derived from capital, from labor, or from both combined."[32] Courts concluded

[28] For a detailed treatment of the development and erosion of the COD income doctrine, see James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959) [hereinafter Eustice, *Creeping Confusion*]. *See also*, Bittker & Thompson, *supra* note 17. For an exhaustive list of articles addressing the issue of COD income, see note 2 of Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199 (1996).

[29] Reg. 45, Articles 51 and 544 (1921).

[30] S.M. 1495, III-1 C.B. 108 (1924).

[31] I.T. 1564, II-1 C.B. 59 (1923).

[32] Eisner v. Macomber, 252 U.S. 189 (1920). Later, in Commissioner v. Glenshaw Glass Co., income was redefined as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. 426, 431 (1955).

that cancellation of indebtedness did not produce income within that definition.[33] However, the Service persisted in its position that debt cancellation produced income.

A. The Bowers v. Kerbaugh-Empire *transactional accounting approach to COD income.*

The Supreme Court first addressed the issue of COD income in 1926, in *Bowers v. Kerbaugh-Empire*.[34] Kerbaugh-Empire had borrowed money from a German bank in 1911. The loan proceeds, which were paid (and were to be repaid) in marks, were invested in a subsidiary of Kerbaugh-Empire. The funds invested in the subsidiary were lost in the years 1913 to 1918 and the losses were deducted in those years. The loan was later repaid in 1921 with devalued marks. The Service argued that the difference between the dollar equivalent of what was borrowed and the dollar equivalent of what was repaid was COD income in 1921. The losses taken as deductions in the years 1913-1918 exceeded the income from those years by an amount that exceeded the alleged COD income in 1921. The Supreme Court held that the taxpayer did not realize COD income on the transaction because the taxpayer's losses exceeded its later income. In other words, "[t]he result of the whole transaction was a loss."[35]

Citing the definition of income in *Eisner v. Macomber*,[36] the Supreme Court concluded that the transaction in *Kerbaugh-Empire*:

> did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital....
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> The contention that the item in question is cash gain disregards the fact that the borrowed money was lost, and that the excess of such loss over income was more than the amount borrowed. . . . The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income.[37]

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[33] *See, e.g.*, Meyer Jewelry Co., 3 B.T.A. 1319 (1926).
[34] 271 U.S. 170 (1926).
[35] 271 U.S. at 175.
[36] 252 U.S. 189 (1920).
[37] 271 U.S. at 175.

It seems, therefore, that the decision turned on the narrow definition of income at the time of the case, which has since been expanded to include all realized accessions to wealth.[38]

Five years later, the Supreme Court rejected a transactional accounting approach in *Burnet v. Sanford & Brooks Co*.[39] In the years 1913 to 1916, the taxpayer had included in income payments made under a dredging contract with the United States. The taxpayer also deducted the expenses of performing the contract. The expenses for those years exceeded the income by $176,000. (Although the taxpayer's return showed losses for each of those years, the Internal Revenue Code at that time did not provide for the carryforward of net operating losses, so the excess losses were of no benefit to the taxpayer.) In 1916, the taxpayer sued the United States for breach of the dredging contract. In 1920, the taxpayer recovered $176,000, plus interest, from the suit. The taxpayer did not include the recovery in income, but the Service took the position that the recovery was income to the taxpayer in 1920.[40] The taxpayer argued that it did not realize income in 1920 because it lost money on the whole transaction. The Supreme Court rejected that argument and held that the taxpayer had realized income in 1920, despite the fact that the taxpayer lost money on the entire transaction.[41] In other words, the case upheld the use of an annual accounting period.

B. Kirby Lumber *and the freeing of assets approach.*

Soon after the Supreme Court decided *Burnet v. Sanford & Brooks Co.*, it held, in *United States v. Kirby Lumber Co.*,[42] that a taxpayer realized COD income when it repurchased its bonds at a discount. The taxpayer in *Kirby Lumber* issued $12 million of bonds in 1923 at "par."[43] Later in 1923, the taxpayer repurchased

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[38] Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

[39] 282 U.S. 359 (1931).

[40] Our tax system requires the use of an annual accounting period. I.R.C. § 441.

[41] 282 U.S. at 364, 365. The Court stated:

> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

Id.

[42] 284 U.S. 1 (1931).

[43] The bonds were issued in exchange for preferred stock, on which there were dividend arrearages, although that fact was not apparent from the opinion. Boris I. Bittker, *Income*

some of the bonds at $138,000 less than the face of the bonds. The issue in the case was whether the taxpayer realized income as a result of the repurchase of the bonds at a price less than their face amount. The Supreme Court, in a cryptic two-paragraph opinion by Justice Holmes, held that the taxpayer had realized income as a result of the repurchase of the bonds. The Court distinguished *Kerbaugh-Empire*, saying: "Here, there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings, it made available $137,521.30 assets previously offset by the obligation of bonds now extinct."[44] This "freeing of assets" language became the benchmark for measuring COD income.

The early cases developing the COD income doctrine were Depression era cases involving financially troubled debtors. Debtors can discharge their debts for less than the principal amount owed in two different situations. First, a creditor will discharge debt for less than the full amount owed if the debtor is financially troubled, because the risk of nonpayment of the principal has increased. Second, if interest rates have increased since the loan was made, a creditor may accept repayment of less than the full amount of principal due, because the creditor can reinvest the funds and earn a higher rate of interest on the principal.[45]

Courts in the Depression Era were reluctant to hold that financially troubled debtors incurred a tax liability when they discharged their debt for less than the amount owed.[46] By focusing on the freeing of assets language in *Kirby Lumber*,

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From the Cancellation of Indebtedness: A Historical Footnote to the Kirby Lumber Co. *Case*, 4 J. CORP. TAX'N 124 (1977).

[44] 284 U.S. at 2, 3.

[45] *See* Bittker & Thompson, *supra* note 17, at n.5 (adding that a creditor might also discharge debt for less than the amount owed if the debt was unenforceable, for example because the statute of limitations had run).

[46] Eustice, *Creeping Confusion*, *supra* note 28, at 236, 246 (noting that courts approached COD cases by responding emotionally, not logically, to the debtors' embarrassing financial plight); Patricia Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89, 98 (1984); Paul Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 ST. LOUIS U. L.J. 583, 583 (1983). Asofsky notes Professor Surrey's argument that the financial problems of the debtor do not preclude inclusion of other types of income by the debtor, such as compensation, so perhaps the debtor's financial difficulties should not preclude the inclusion of COD (*citing* Stanley Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L. J. 1153, 1164 (1940)).

courts created numerous exceptions to the COD income doctrine,[47] including the "insolvency exception."[48]

Generally, the financial distress of a taxpayer does not preclude inclusion of the taxpayer's income. For example, if a financially troubled taxpayer receives compensation income, the compensation must be included in income regardless of the taxpayer's financial condition.[49] However, for purposes of computing COD income, courts held, soon after *Kirby Lumber* was decided, that if a debtor was insolvent after the discharge of its debt at a discount, the discharge did not create COD income.[50] The rationale was that no assets had been freed if the debtor's liabilities still exceeded the value of the debtor's assets after the discharge.[51] If the debtor was insolvent before the discharge, but the discharge rendered the debtor solvent, the discharge created COD income to the extent the discharge made the debtor solvent.[52] Under the freeing of assets approach, the focus is on the circumstances in the year of the debt discharge; circumstances in the year of the borrowing are irrelevant.

C. Application of the Bowers v. Kerbaugh-Empire *transactional accounting approach in post-*Kirby Lumber *COD income cases.*

Although some of the case law exceptions to *Kirby Lumber*, such as the insolvency exception, were consistent with the freeing of assets approach, other case law exceptions were not consistent with that approach. In a number of early COD income cases, courts considered "the transaction as a whole," citing *Bowers v. Kerbaugh-Empire*, meaning that they attempted to ascertain exactly how the borrowed funds were used and determine whether the whole transaction resulted in a gain or loss. [53] Courts also followed this approach in a number of later cases.[54]

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[47] These exceptions included the case law stock-for-debt exception and debt-for-debt exception, which are discussed *infra*, in Part III.A.

[48] *See, e.g.*, Dallas Transfer and Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934). Congress later amended the Bankruptcy Code and the Internal Revenue Code to provide that debtors could exclude COD income from corporate reorganizations, but were required to reduce the basis of assets by the amount of debt discharged. For a discussion of these legislative developments, see Eustice, *Creeping Confusion, supra* note 28, at 254-62.

[49] I.R.C. § 61(a)(1).

[50] *See, e.g.*, Dallas Transfer and Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934).

[51] *Id.* at 96.

[52] *See, e.g.*, Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 292 (1937) (the insolvent taxpayer had income to the extent the debt discharge rendered the taxpayer solvent).

[53] Bradford v. Commissioner, 233 F.2d 938 (citing Bowers v. Kerbaugh Empire, 271 U.S. 170 (1926)).

For example, courts created an exception to *Kirby Lumber* in cases in which the discharged debt had originally been issued in exchange for noncash consideration or no consideration.[55] The rationale for this exception was that, viewing the transaction (both incurring the loan and discharging it) as a whole, the transaction did not increase the debtor's net worth.[56] In this line of cases, courts considered circumstances in the year of the borrowing. These cases did not fit with the freeing of assets approach, because they took into account circumstances in the year of the borrowing, while the freeing of assets approach focused only on circumstances in the year in which the debt was discharged.

In *Commissioner v. Rail Joint*,[57] the Second Circuit held that a taxpayer did not realize COD income when it repurchased bonds (which it had issued and distributed as a dividend on common stock) for less than the face amount of the debt, because the debtor did not receive any assets when it incurred the debt. The Second Circuit distinguished *Kirby Lumber*, saying:

> In the *Kirby* case a corporation issued its bonds at par and later in the same year repurchased some of them at less than par. It was held that the sum thus saved was taxable income. The taxpayer's assets were increased by the cash received for the bonds, and, when the bonds were paid off for less than the sum received, it is clear that the taxpayer obtained a net gain in assets from the transaction. The cost of the money

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[54] Seto, *supra* note 28, at n. 48.

[55] For example, in *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956), Mr. Bradford owed a bank $305,000. Mr. Bradford persuaded the bank to cancel his debt in exchange for his wife's note for $205,000. That debt was later discharged for $155,000. The Service argued that Mrs. Bradford had $50,000 of COD income from the transaction. However, the court concluded that no COD income arose on the discharge of the debt. Although the court noted that our tax system uses an annual accounting period rule, citing *Burnet v. Sanford and Brooks*, 282 U.S. 359 (1931), the court added that "in appropriate circumstances" a court could take into account the net effect of an entire transaction. 233 F.2d at 938. Since Mrs. Bradford received no consideration when she incurred the debt, the loan transaction, as a whole, did not increase her net worth despite the fact that she discharged the debt for less than the amount owed. Therefore, the court held that she did not have COD income on the discharge of the debt. Had the court applied the freeing of assets approach, focusing only on Mrs. Bradford's increase in wealth in the year of the discharge, the discharge would have resulted in $50,000 of income to Mrs. Bradford.

[56] *Id.* at 938.

[57] 61 F.2d 751 (2d Cir. 1932).

> acquired by issuing the bond was decreased when the bond was retired at less than the issuing price. . . .
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> [*Kirby Lumber*] is not applicable to the facts of the case at bar. In paying dividends to shareholders, the corporation does not buy property from them. Here the respondent never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired.[58]

Courts, unwilling to apply the freeing of assets approach in circumstances in which taxing the debtor seemed unfair, applied transactional accounting concepts in order to conclude that the debt discharge did not produce COD income. As authority for invoking transactional accounting rules in the COD income area, courts

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[58] *Id.* at 751-52. For many years, courts assumed that the bonds in *Kirby Lumber* had been issued for cash, and distinguished *Kirby Lumber* on that basis. See cases cited at n.6 of Bittker, *supra* note, 43. However, as Professor Bittker pointed out in his 1977 article, the bonds in *Kirby Lumber* were not issued for cash. *Id.* The *Kirby Lumber* opinion states that the bonds were issued "at par," but it does not mention the type of consideration given for the bonds. The briefs in the case indicate that the bonds were issued in exchange for the issuer's preferred stock, on which there were dividend arrearages.

The government had asserted in its petition for writ of certiorari that the bonds had been issued for cash. However, the issuer's brief in opposition to the petition for writ of certiorari responded by stressing that the bonds were not issued for cash. The issuer's brief indicates that the preferred stock "liability" was $231 per share ($105 plus dividend arrearages of $126 per share), and that $11,526,800 in bonds, plus $9,776.94 in cash, was exchanged for the preferred stock "at the price of $231 per share." *Id.* at 126 and n.9. After certiorari was granted, the government argued, and the issuer agreed, that the type of consideration received in exchange for the debt was irrelevant.

Professor Bittker's view is that "having been argued by both parties on the premise that the nature of the consideration received for the bonds was irrelevant (and on a record that did not address itself to this issue), the case almost certainly was decided on the same assumption." *Id.* at 129. Professor Bittker's point is that the decision of the Supreme Court was not limited to bonds issued for cash, as some courts had interpreted the decision in order to distinguish the decision. *Id.* at 125 and n.6. In his view, *Kirby Lumber* therefore applies to bonds whether the bonds were issued for cash or noncash consideration. Professor Bittker's discovery about the noncash consideration received for the bonds in *Kirby Lumber* called into question the status of cases such as *Rail Joint*, which had erroneously distinguished *Kirby Lumber* as a case involving debt issued for cash.

In a later article, Bittker and Thompson criticized the Second Circuit's decision in *Rail Joint*. Bittker & Thompson, *supra* note 17, at 1167. They argued that the transaction in *Rail Joint* could be analogized to a hypothetical cash sale of the bonds, followed by a distribution of the cash proceeds as a dividend. *Id.* The subsequent discharge of the debt for less than the cash equivalent of the debt at the time of the distribution should, in their view, therefore have been taxable.

often cited the pre *Kirby Lumber* case, *Bowers v. Kerbaugh-Empire*.[59] Citing *Kerbaugh-Empire* in support of a transactional accounting approach to COD income was, however, controversial. *Kerbaugh-Empire* was inconsistent with *Burnet v. Sanford & Brooks Co.*, the case in which the Supreme Court had upheld the use of an annual accounting period, even where application of the annual accounting period arguably resulted in unfair tax treatment of an entire transaction.[60] Although *Kerbaugh-Empire* has never been overruled, commentators assume that it is no longer good law.[61]

D. Erosion of the freeing of assets theory and emergence of the loan proceeds theory.

In 1978, Bittker & Thompson articulated a new theory of debt discharge.[62] Under this approach to COD income, often referred to as a "loan proceeds" theory[63] or "symmetry" theory,[64] the debtor may exclude loan proceeds from income in the year in which they are received because of the offsetting liability to repay the principal. If the debtor later breaks the promise to repay the principal, the failure to fully repay the principal is inconsistent with the earlier exclusion and an income inclusion is warranted. In other words, the debtor should not be allowed to exclude loan proceeds in the year of the borrowing and in the year of the discharge where the loan is not repaid.

This approach focuses on the tax benefit of the exclusion of loan proceeds in the year of the borrowing, so the facts in that year are relevant. Under this approach,

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[59] For example, the court, in *Rail Joint*, cited *Kerbaugh-Empire* as support for adopting a transactional approach to COD income. 61 F.2d at 652 (2d Cir. 1932).

[60] 282 U.S. 359 (1931).

[61] *See, e.g.*, Joseph M. Dodge, Zarin v. Commissioner, *Musings About Debt Cancellations and Consumption in an Income Tax Base*, 45T AX L. REV. 677, 678, text at n.8 (1990); Seto, *supra* note 28, at 211. In *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986), the Ninth Circuit Court of Appeals held that *Burnet v. Sanford & Brooks* precluded application of the earlier transactional approach in *Kerbaugh-Empire.* Professor Schenk has also criticized the whole transaction approach on grounds of impracticality, since it will often be impractical to attempt to trace the use of the borrowed proceeds. Deborah H. Schenk, *The Story of* Kirby Lumber*: The Many Faces of Discharge of Indebtedness Income*, *in* TAX STORIES 97, 106 (Paul Caron ed. 2003).

[62] Bittker & Thompson, *supra* note 17.

[63] *See, e.g.*, Schenk, *supra* note 61, at 107.

[64] *See, e.g.*, Deborah A. Geier, *Tufts and the Evolution of Debt Discharge Theory*, 1 FLA. TAX REV. 115, 145 (1993).

however, the circumstances in the year of the discharge, such as the debtor's insolvency, are irrelevant.[65]

The consensus among tax commentators is that the loan proceeds approach is the correct theoretical approach to debt discharge.[66] Commentators characterize the freeing of assets theory as "outmoded." [67]

In 1980, Congress adopted the loan proceeds approach when it overhauled the COD income rules.[68] As part of the 1980 Bankrupcy Tax Act,[69] Congress codified a number of judicial exceptions to COD income.[70] One of the issues that Congress had to consider was whether debt discharge by an insolvent debtor created income.[71] Under the case law freeing of assets approach, an insolvent debtor has no income from the debt discharge.[72] Under the loan proceeds approach to COD income, however, the debt discharge by an insolvent debtor creates income.

Congress followed the loan proceeds approach to debt discharges by insolvent debtors and did not codify the freeing of assets insolvency exception to *Kirby Lumber*. Consistent with the loan proceeds theory of COD income, debt discharge by an insolvent or bankrupt debtor was thought to create COD income. An insolvent or bankrupt debtor is not in a position to pay tax on COD income in the year of the discharge, however, so Congress allowed such debtors to defer the tax on COD income arising from discharge of their debts.[73]

Congress provided an exclusion for COD income, to the extent of a debtor's insolvency, or for any COD income arising in a bankruptcy proceeding.[74] In order to tax the debtor on the COD income when the debtor is better able to pay tax (*i.e.*, when the debtor starts earning income after it recovers), Congress also provided in § 108 that the debtor's tax attributes, beginning with the debtor's net operating losses,

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[65] *Id.* at n.8 and 144-56.

[66] *See, e.g.*, Schenk, *supra* note 61, at 104, 107 ("the freeing-of-assets theory has been subjected to withering criticism" and the loan proceeds approach is the "better approach").

[67] *See, e.g.*, Geier, *supra* note 64, at 144 (freeing of assets theory is "outmoded").

[68] Pub. L. No. 96-589, 94 Stat. 3389, 96th Cong., 2d Sess. (1980).

[69] *Id.*

[70] For an example of one of these statutory exceptions in the current Code, see I.R.C. § 108(e)(2) (2000) (no COD income on the discharge of debt to the extent that payment of the debt would have given rise to a deduction).

[71] *See, e.g.*, Geier, *supra* note 64, at n.8.

[72] *See supra* note 50.

[73] S. REP. NO. 1035, 96th Cong., 2d Sess. 10 (1980) (not permanently excluding the COD income of insolvent debtors, but permitting the debtor to defer the tax on the COD income).

[74] I.R.C. § 108(a) (2000).

are reduced by the amount of COD income excluded.[75] Tax attributes such as net operating losses offset the debtor's income in the years after the debt discharge (reducing the tax the debtor has to pay), so reducing the debtor's attributes increases the tax the debtor has to pay in the years after the debt discharge. The exclusion and attribute reduction rules were structured to defer the tax on COD income, instead of permanently excluding the COD income, as the case law insolvency exception had done.[76] Said another way, the loan proceeds approach is a type of timing rule:

> Loan proceeds must be taxed at some point in time. Current law chooses to place the tax event at the point of repayment of the principal by excluding the loan proceeds from gross income on receipt but taxing the income used to repay the principal amount. . . . Failure to repay the loan with after-tax dollars at the back end (which occurs on debt discharge) requires, in essence, retroactive taxation at the front end.[77]

There is, however, a stronger version of the loan proceeds approach, which is based on the idea that the loan proceeds approach is related in theory to the tax benefit rule.[78] Under this stronger application of the loan proceeds approach, cancellation of indebtedness results in COD income "if the taxpayer would have recognized income from the borrowing in the absence of an assumption that the debt would be repaid."[79] If, on the other hand, "the taxpayer would not have recognized income from the borrowing transaction even if it had been known from the outset that the debt would never be repaid," the discharge of the debt does not result in COD income.[80]

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[75] I.R.C. § 108(b) (2000).

[76] S. REP. NO. 1035, 96th Cong., 2d Sess. 10 (1980). Department of Treasury and Justice officials had argued that permitting an insolvent debtor to exclude COD income without attribute reduction would give the debtor "a head start rather than a fresh start." Paul H. Asofsky, *Towards a Bankruptcy Tax Act of 1993*, 51 N.Y.U. INSTITUTE ON FED. TAX'N 13-1, 13-8 (1993) (citations omitted).

[77] Geier, *supra*, note 64, at 146.

[78] *Id.* at 147. Professor Geier discusses the relationship between COD income and the tax benefit rule.

[79] Seto, *supra* note 28, at 219. Seto refers to the strong version of the Bittker and Thompson approach as the "deferred income approach."

[80] *Id.* Professor Seto illustrates this approach with two examples. The first example involves a purchase price adjustment. The second example involves the facts of *Commissioner v. Rail Joint*, 61 F.2d 751 (2d Cir. 1932). Recall that, in *Rail Joint*, the

E. COD income as a transactional error correction device.

Although most commentators agree that the loan proceeds approach is the theoretically correct approach to COD income,[81] individual commentators have advocated variations on the whole transaction approach to determine the tax consequences of debt discharge. For example, Professor Seto has advocated a form of transactional accounting for debt discharge. The starting point is our annual system of accounting.[82] Annual accounting trumps transactional accounting generally.[83] We do, however, keep track of certain tax attributes, such as basis[84] and net operating losses,[85] which are carried from year to year. These attributes affect a taxpayer's tax liability in other years. The Internal Revenue Code (the Code) also includes some specific rules that require a taxpayer to take into account events in other tax years in order to compute the current year's liability.[86] The thesis of Professor Seto's article is: "A taxpayer's reportable income for tax purposes, however measured, ultimately should equal her real income. . . . [T]he rules comprising the federal income tax system should, in the aggregate, be interpreted so as to account *completely* for every real item of income or loss."[87] If use of the annual accounting period results in an error, a transactional approach should be used to correct that error.

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debtor corporation issued debt as a dividend on its stock. The corporation later discharged the debt for less than the face amount of the debt. The court held that the discharge did not result in COD income. *Rail Joint* is often cited as an example of the freeing of assets approach to COD. Professor Seto argues that the result in *Rail Joint* is also consistent with the deferred income approach to COD, because there would have been no inclusion in the year in which the debt was issued if it had been known at that time that the full amount of the debt would not be repaid. *Id.* at 220. Professor Geier also cites *Rail Joint* as a case in which the debt discharge did not create COD because the borrowing did not result in the debtor receiving untaxed loan proceeds. Geier, *supra* note 64, at 148.

[81] *See, e.g.*, Schenk, *supra* note 61, at 104, 107. Professor Schenk calls the loan proceeds approach the "better approach," after noting the severe criticism leveled against the freeing of assets theory. *Id.*

[82] I.R.C. § 441 (2000).

[83] Burnet v. Sanford and Brooks, 282 U.S. 359 (1931).

[84] I.R.C. §§ 1012, 1011, 1016 (2000).

[85] I.R.C. § 172 (2000).

[86] *See, e.g.*, I.R.C. § 104(a) (2000), which requires taxpayers to consider medical expenses deducted under I.R.C. § 213 in prior years, in determining the excludability of personal injury recoveries.

[87] Seto, *supra* note 28, at 227. Professor Seto refers to this principle as "the principle of complete accounting."

Professor Seto acknowledges that the complete accounting principle ignores base-definition, timing, and valuation issues.[88] In addition, the Internal Revenue Code includes numerous rules that preclude precise application of the complete accounting principle in specific circumstances. For example, net operating losses expire if they are not utilized within the number of years specified in § 172.[89] Professor Seto argues, nonetheless, that the principle of complete accounting is "an interpretive rule of general applicability."[90]

The Bittker and Thompson loan proceeds approach is a particular type of error correction device. In the simplest form, the loan proceeds rule says that debt that is excluded in the year of the borrowing and is not repaid must be included in income in the year of the discharge. The stronger form of the loan proceeds approach would require inclusion in most, but not all cases. In the year in which the debt is discharged, it requires that we ask whether the loan proceeds would have been included in income, in the year in which the debt was incurred, if it had been known at that time that the loan would not be repaid. If the exclusion in the year of the borrowing is dependent on the assumption that the loan would be repaid, the discharge results in COD income. If the exclusion in the year of the borrowing is not dependent on the assumption that the loan would be repaid, the discharge does not result in COD income.

Under this approach to COD income, the error to be corrected is the erroneous exclusion of the loan proceeds in the year of the borrowing. This approach considers facts in another annual accounting period (the year of the borrowing), but it does not consider the transaction as a whole. Professor Seto argues that even the stronger form of the Bittker and Thompson approach can be inadequate precisely because it fails to take into account events that occurred while the loan was outstanding.[91]

Against this backdrop of the development of the general theories of debt discharge, the next part of this Article tracks the development of the specific tax rules that apply to the discharge of debt in a debt-for-debt or stock-for-debt exchange. Part III illustrates the application of the general COD income theories in debt-for-debt and stock-for-debt exchanges, and highlights the connection between the COD income rules and OID rules applicable in these transactions.

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[88] *Id.* at 228.

[89] Under current law, net operating losses may generally be carried back two years and forward twenty years. I.R.C. § 172(b)(1)(A) (2000).

[90] Seto, *supra* note 28, at 228.

[91] *Id.* at 221-22.

III. COD INCOME IN DEBT-FOR-DEBT AND STOCK-FOR-DEBT EXCHANGES.

A. Case law and the substitution of liabilities theory.

As noted earlier, our tax system draws various distinctions between debt and equity. A corporation can deduct interest paid or accrued on its debt but cannot deduct the dividends it pays on the its stock.[92] A corporation does not have to include in income the proceeds from its issuance of debt. If a corporation retires debt for less than the amount owed on the debt, however, the corporation has COD income in an amount equal to the difference between the amount owed on the debt and the amount paid to discharge the debt.[93] A corporation does not have income when it receives cash or other property in exchange for its stock.[94] If the corporation later repurchases the stock for less than the amount for which the stock was issued, the corporation has no income. [95]

Early case law established the stock-for-debt and debt-for-debt exceptions to COD income.[96] The theory articulated in these cases is generally a substitution of liabilities theory.

The converse of these debt discharge cases were cases in which the issue was whether a corporation could deduct unstated interest on corporate debt issued in exchange for the corporation's stock.[97] Until 1969, it was unclear whether a corporation could deduct unstated interest on debt issued in exchange for property.[98] The issue was thought to be particularly problematic where debt was issued in exchange for the corporation's stock.[99]

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[92] I.R.C. § 163(a)(2000).
[93] *See* I.R.C. § 61(a)(12) (2000).
[94] I.R.C. § 1032(a) (2000). For a discussion of I.R.C. § 1032, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS ¶ 3.12[1], page 3-67 to 65 (7th ed. 2000, with 2002 Supp.).
[95] See I.R.C. § 311(a) (2000). Section 1032(a) provides that a corporation does not recognize gain or loss on the issuance of stock in exchange from property. Treasury Regulations provide that § 1032 does not apply to a corporation's acquisition of its own shares unless the corporation acquires the shares in exchange for its own stock (although the regulation cross-references the § 311 regulations). *See* Treas. Reg. § 1.1032-1(b). Section 311(a) provides that a corporation does not recognize gain on the distribution of property with respect to its stock. See I.R.C § 311(a) (2000). Property includes cash under I.R.C. § 317(a). *See id.* § 317(a) (2000).
[96] *See infra* Part III.A.2. and 3.
[97] *See infra* in Part III.A.1.
[98] *Id.*
[99] *Id.*

1. The creation of deductible discount in debt-for-stock exchanges and debt-for-debt exchanges.

As early as 1934, the Supreme Court recognized that debt discount (what we refer to today as OID)[100] represents an additional cost of borrowing.[101] In the period before 1969, the issuer of a debt instrument with OID was allowed to deduct the interest on straight line basis over the life of the bonds.[102] However, cash basis bondholders were not required to include the OID in income until the bonds were sold or retired.[103] Neither the Code nor the regulations provided specific rules for determining the OID on debt issued in exchange for property.[104]

At that time, it was not clear whether a corporation could create deductible discount by issuing debt in exchange for its stock. The government had several concerns about allowing deductions for discount where the discount bonds were issued in exchange for property.[105] First, the government was concerned about the

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[100] *See supra* note 8.

[101] Helvering v. Union Pacific Railroad, 293 U.S. 282 (1934). The opinion in the case created some confusion regarding the rationale for the deductibility of debt discount. It was not clear from the opinion whether the Court thought the discount was deductible as unstated interest or as a loss. However, the Court, in *United States v. Midland Ross Corp.*, made it clear that the discount was viewed as unstated interest. The Supreme Court stated: "Earned original issue discount serves the same function as stated interest . . . . [I]t is simply 'compensation for the use or forbearance of money.'" 381 U.S. 54, 57 (1965) (*citing* Deputy v. du Pont, 308 U.S. 488 (1940)).

[102] *See* James S. Eustice, *The Tax Reform Act of 1969: Corporations and Corporate Investors*, 25 TAX L. REV. 509, 532 (1970) [hereinafter Eustice, *Tax Reform Act of 1969*]. Note that this typically allowed the issuer to overstate its OID deductions in the early years that the debt was outstanding. If OID accrues on a yield-to-maturity basis, the OID deductions in the early years should be less than straight line deductions would be and the OID deductions in the later years should be more than the straight line deductions would be. Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565, 568 (1983).

[103] In *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965), the Supreme Court held that OID realized by a bondholder on the sale or retirement of a bond was ordinary income, not capital gain. Eustice, *Tax Reform Act of 1969, supra*, note 102, at 532, notes that bondholders were prone to forget that all or a part of the gain on the sale or retirement of the bonds was ordinary income instead of capital gain.

[104] Section 1232(b)(1) (repealed). Treas. Reg. § 1.1232-3(b)(2) provided several specific Issue Price rules for debt issued in exchange for cash, but was silent regarding the Issue Price of debt issued for property.

[105] W.J. Rockler et al., *Status of Amortizable Bond Discount After* National Alfalfa *Case*,41 J. TAX'N 134 (1974).

asymmetrical treatment for issuers and bondholders described above.[106] Second, the government was concerned that the quantification of the discount would pose difficult valuation questions where the debt was issued for property.[107] The government feared it would be "whipsawed" if the bondholders either argued for a higher valuation (reducing the OID they would have to include) or failed to include the full amount of discount in income as ordinary income.[108]

The government had additional concerns where the debt was issued in a reorganization. If the new debt was issued in exchange for the issuing corporation's stock, allowing the corporation to deduct the unstated interest on the new debt would allow the corporation to convert its nondeductible cost of equity capital into deductible interest, at no tax cost to the corporation.[109] If the new debt was issued in exchange for debt that had declined in value since issuance, allowing the corporation to deduct the difference between the face amount of the new debt and the value of the old debt would allow the corporation to convert nondeductible market discount into deductible discount. The government therefore took the position in litigation that deductible discount did not arise where debt was issued in exchange for property, especially where the property was the stock of the issuer.[110] Issuers took the contrary position.[111]

Some courts held that discount could arise in a debt-for-property transaction.[112] In order to determine whether, in a specific transaction, the issuance of debt in exchange for property created discount, courts also had to determine the Issue Price of the debt issued for property.[113] This was controversial where the debt was issued in exchange for the issuer's stock. Courts

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[106] *Id.* at 134.
[107] *Id.*
[108] *Id.*
[109] This was a concern in *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 142 (1974).
[110] *See, e.g.*, Atchison, Topeka & Sante Fe Railroad, 443 F.2d 147 (10th Cir. 1971).
[111] *Id.*
[112] *Id.* The Tenth Circuit Court of Appeals held that discount could arise from debt-for-property transactions. The court noted that the regulations did not distinguish between bonds issued for cash and bonds issued for property, and concluded that the regulations acknowledged the economic possibility that discount could arise in exchanges of bonds for property. *See also* American Smelting and Refining Co. v. United States, 130 F.2d 883 (3d Cir. 1942) (issuer could deduct discount arising from the exchange of new debt for the preferred stock of its subsidiary).
[113] Original issue discount equals the stated redemption price at maturity of the debt instrument over the issue price of the instrument. I.R.C. § 1273(a)(1) (2000). Under current law, the issue price is determined under §§ 1273(b) and 1274. These rules did not exist at the time these cases were decided.

developed several different approaches for determining the Issue Price of debt issued for property. Some courts said that the Issue Price of the new debt was the consideration originally received for the stock.[114] Other courts said that the Issue Price of the new debt was the greater of the consideration originally received for the stock or the value of the stock at the time of the exchange.[115] Still another approach was to look only to the value of the stock at the time of the exchange.[116]

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[114] In *Erie Lackawanna Railroad Co. v. United States*, 422 F.2d 425 (1970), the Court of Claims held that no discount arose on the exchange of new $100 face debt for preferred stock, with a value of $81, for which the issuer had received $100 when it was issued. The court denied the issuer's discount deduction because it concluded that the amount to be used as the Issue Price of the new debt, for purposes of computing the discount on the new debt, was the $100 consideration the issuer originally received for the stock, not the $81 value of the stock on the date of the exchange. Therefore, the court concluded that there was no discount on the new debt. The court said that the value of the preferred on the date of the exchange was irrelevant. This decision left open the possibility that discount could arise where the face of the new debt exceeded the amount of consideration originally received for the stock.

The Court of Claims later modified its *Erie Lackawanna* original consideration Issue Price approach when it reconsidered *Missouri Pacific Railroad*, 433 F.2d 1324 (1970), *modifying* 427 F.2d 727 (1970). There, the Court of Claims adopted the "two-tier" Issue Price approach used by the district court in *Cities Service Co. v. United States*, 316 F. Supp. 61, 72 (S.D.N.Y. 1970), *supplemental opinions*, 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *aff'd*, 522 F.2d 1281 (2d Cir. 1974). Under that approach, the Issue Price of the new debt is the greater of (1) the consideration originally received for the stock, or (2) the value of the stock on the date of the exchange. *Id.* at 430. One group of commentators concluded the following, regarding the change in approach:

> The inference is almost irresistible that the Court of Claims began to realize the troublesome implications of its original position. Under the Erie decision, a corporation that issued a $50 bond for a share of preferred stock, originally issued for $30 per share but worth $50 per share at the time of the exchange, would be entitled to claim discount of $20 per bond, although there was no cost of borrowing other than the stated interest rate. In order to prevent such an unwarranted result, the Court of Claims simply combined its original rule with another altogether different rule.

Rockler et al, *supra* note 105, at 135.

[115] Cities Service Co. v. United States, 316 F. Supp. 61, 72 (S.D.N.Y. 1970), *supplemental opinions*, 330 F. Supp. 421 (S.D.N.Y. 1971), 362 F. Supp. 830 (S.D.N.Y. 1973), *aff'd*, 522 F.2d 1281 (2d Cir. 1974).

[116] Although the Tenth Circuit adopted this approach in *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 472 F.2d 796 (10th Cir. 1973), the Supreme Court rejected this

The issue eventually reached the Supreme Court, in *Commissioner v. National Alfalfa Dehydrating & Milling Co*.[117] In 1957, National Alfalfa had exchanged new $50 face 5% sinking fund debentures[118] for outstanding $50 par 5% cumulative sinking fund preferred stock. At the time of the exchange, the preferred shares were thinly traded in the over-the-counter market. The issuer had taken the position that the value of the preferred at the time of the exchange was $33, so the Issue Price of the new debt was also $33 and the issuer was entitled to deduct $17 of OID ($50 stated redemption price less $33 Issue Price) on the new debt. The Service disallowed the OID deduction. The Tax Court held for the Service,[119] but the Tenth Circuit reversed, holding that National Alfalfa was entitled to the OID deductions.[120]

The Supreme Court held that National Alfalfa was not entitled to deduct the discount. However, the precise rationale for the Court's holding is somewhat ambiguous. The Court seemed comfortable with the notion of a corporation deducting a discount arising from the issuance of debt for cash, but seemed troubled by the notion of a corporation exchanging new debt "for its own outstanding preferred stock."[121]

In part III of the opinion, the Court rejected the taxpayer's argument that the debt for stock exchange should be treated as though the debt had been issued for cash in an amount equal to the value of the preferred stock, and the hypothetical cash proceeds had been used to retire the preferred stock (the approach used by the Tenth Circuit). The Court said that it was rejecting the taxpayer's argument for two reasons. First, the Court said that the taxpayer should be bound by the actual form of the transaction. Second, the Court expressed concern that the value of the preferred stock had not been conclusively established.[122] In this part of the opinion,

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approach. 417 U.S. 134 (1974).

[117] 417 U.S. 134 (1974).

[118] A debenture is a type of debt security. It is typically an unsecured debt obligation. ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS: ESSENTIAL CONCEPTS AND APPLICATIONS 293 (2002).

[119] 57 T.C. 46 (1971).

[120] 472 F.2d 796 (1973).

[121] 417 U.S. at 142. The Court seemed disturbed by the idea that a company could "create" deductible discount by substituting a debt liability for an existing stock liability. This concern would of course be more pronounced if the Issue Price of the new debt is based on the fluctuating value of the stock, because under that rule the issuer could time the exchange to coincide with a low value for the stock, creating even more discount on the exchange.

[122] The Court said that it would not speculate as to the value of the preferred stock for three reasons. First, the Court said that there was nothing in the record to establish the cash price at which the debentures could have been sold, if they had been sold on the open market.

the Court seemed to indicate that discount on debt issued in debt-for-property exchanges could be deducted if the issuer established the value of the property exchanged for the debt.

In part IV of the Court's opinion, however, the Court said that discount can arise only where debt is issued in an exchange in which the issuer incurs "some cost or expense of acquiring the use of capital."[123] The Court concluded that the exchange did not cause the corporation to acquire any new capital (because it did not increase the corporate assets), or any additional cost to retain the old capital. The Court noted that the terms of the old preferred and the new debt were "highly equivalent"[124] and said that National Alfalfa's "cost of capital" "was the same whether represented by the preferred or by the debentures."[125] Therefore, the Court concluded that the "substitution" of the debt for the preferred stock "did not create an obligation to pay in excess of an amount previously committed, or establish a base upon which debt discount can arise."[126]

Tax commentators criticized the "cost of capital" analysis in Part IV of the *National Alfalfa* opinion because it treated debt and equity as equivalent for tax purposes.[127] Courts nonetheless continued to cite the *National Alfalfa* substitution of

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Second, The Court said that nothing in the record established that National Alfalfa would have been able to purchase all of its preferred stock on the open market, or at what price the stock could have been repurchased. Third, the Court said that when a corporation exchanges its newly issued debt for the preferred stock of its own shareholders, the claimed value of both securities is "somewhat artificial since the exchange is effectively insulated from market forces by the intracorporate and private nature of the transaction." *Id.* at 151.

[123] *Id.* at 147.

[124] *Id* at 155. The 5% interest on the debt equaled the 5% cumulative dividend on the preferred. The face amount of the debt equaled the par value of the stock, and the preferred stock and the debt had comparable sinking fund provisions.

[125] *Id.* at 155.

[126] *Id.* The Supreme Court, at note 11 of its opinion, said that National Alfalfa "incurred no additional obligation because of the substitution of its debentures for its preferred," although the Court acknowledged that, when National Alfalfa issued its debt, it "assumed a fixed obligation to pay at a date certain," unlike the obligation to pay dividends on the stock. The Court, at note 12, said that it, in the past, had noted that "the investment difference between preferred shares and unsecured debentures can be of slight degree, and it is further diminished when, as here, the debentures are subordinated."

[127] *See, e.g.*, Rockler et al, *supra* note 105, at 137 ("[W]hile the economic differences between debt and stock interests in a corporation may for some purposes be minor and while classification may be difficult, classification is essential and must be made under the tax laws because tax consequences differ in myriad areas depending on whether an instrument is

liabilities rationale.[128] On the other hand, some courts applying *National Alfalfa* interpreted part IV of the opinion narrowly. They did not read *National Alfalfa* as saying that discount could not arise on the issuance of debt in exchange for the issuer's stock.[129]

Conflicts arose in the case law regarding the possibility of discount arising on the issuance of new debt in exchange for the issuer's preferred stock, and the method to be used to determine the Issue Price of the new debt. In 1969, Congress "clarified" both issues as part of the 1969 Act.[130]

2. The creation of COD income in debt-for-debt exchanges.

Courts also adopted a substitution of liabilities approach for purposes of determining COD income in debt-for-debt exchanges.[131] If old debt was discharged in exchange for new debt with the same face amount payable at maturity, there was no COD income in the exchange. If, on the other hand, the face amount of the new debt was less than the face amount of the old debt, the debtor corporation had COD income in an amount equal to the reduction in the face amount of the debt.[132] Said another way, the new debt was treated as a continuation of the old debt to the extent of the face amount of the new debt. The value of the old debt at the time of the exchange was not thought to be relevant for purposes of determining the COD income on the exchange.

For example, in *Commissioner v. Coastwise Transportation Corp.*,[133] the debtor corporation issued $375,000 of new debt in exchange for old debt, with a face amount of $456,300. The Court of Appeals held that the debtor corporation had COD income from the exchange, in an amount equal to the reduction in the face amount of the debt.[134] Other courts followed this substitution of liabilities approach in debt-for-debt exchanges.[135]

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considered debt or equity for tax purposes."). *Id.*

[128] *See, e.g.*, United States Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988).

[129] *See, e.g.*, Cities Service Co. v. United States, 522 F.2d 1281 (10th Cir. 1975), *cert. denied*, 423 U.S. 827 (1975) (exchange of new debt for old stock did give rise to deductible discount, in spite of *National Alfalfa*).

[130] The 1969 Act changes in the OID rules are described *infra* at Part III.B.1.

[131] *See, e.g.*, Commissioner v. Coastwise Transportation Corp., 71 F.2d 104 (1st Cir.), cert. denied, 293 U.S. 595 (1934).

[132] *Id.*

[133] *Id.*

[134] 71 F.2d at 105-06.

[135] *See, e.g.*, United States v. Little War Creek Coal Co., 104 F.2d 483 (4th Cir. 1939); Commissioner v. Stanley Co., 185 F.2d 979 (2d Cir. 1951).

The Supreme Court later applied a slightly different substitution of liabilities approach to debt-for-debt exchanges in *Great Western Power Co. of California v. Commissioner*.[136] The issue in *Great Western Power* was whether the retirement of debt in a debt-for-debt exchange could create bond retirement premium, which is the opposite of COD income.[137] The new debt issued in the exchange had the same face amount as the old debt for which it was exchanged. The issuer also paid cash to the bondholders in the exchange. The issuer took the position that the cash premium was immediately deductible as bond retirement premium. The Supreme Court, applying the substitution of liabilities approach, held that retirement premium from the discharge of the old debt at a premium could not be deducted in the year of the exchange, but must instead be amortized over the life of the new debt issued in the exchange.[138] Before adopting the substitution of liabilities approach, the Court considered and rejected a hypothetical cash issuance model. Following the decision in *Great Western Power Co.*, some issuers took the position that they did not have COD income in a debt-for-debt exchange, even where the face amount of new debt issued was less than the face amount of the old debt discharged.[139]

In 1977, the Service issued Revenue Ruling 77-437,[140] which clarified its position on the potential conflict between the rules articulated in *Coastwise Transportation* and *Great Western Power Co.* The Service ruled that the decision in *Great Western Power Co.* did not prevent the creation of COD income in a debt-for-debt recapitalization if the face amount of the new debt was less than the face amount of the old debt. In such a case, the corporate issuer had COD income in an amount equal to the reduction in the face amount of the debt. The Service agreed with the substitution of liabilities approach, but treated the debt as retired to the extent of the reduction in the face amount of the debt.[141]

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[136] 297 U.S. 543 (1936).

[137] Bond retirement premium, which is deductible by the issuer, is the amount the issuer pays to retire debt less the amount owed on the debt retired. Treas. Reg. § 1.163-4(c)(1). If the old debt is retired for cash, the premium is deductible in the year the debt is retired. *Id.*

[138] 297 U.S. at 546-47.

[139] Gary B. Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructurings*, 10 VA. TAX REV. 357, 377 (1990)

[140] 1977-2 C.B. 28.

[141] See also GCM 36602 (March 1, 1976). In a subsequent technical advice memorandum, the Service articulated the theory behind its approach:

> Neither the Code [n]or the regulations nor case law provide for increasing income from a discharge of indebtedness resulting from an exchange of debt instruments because the fair

3. The creation of COD income in stock-for-debt exchanges.

Courts also adopted a substitution of liabilities approach to determine whether a corporate issuer had COD income on the issuance of its stock in exchange for its outstanding debt. For example, in *Capento Securities Corp. v. Commissioner*,[142] the court viewed stock as a form of "liability," and concluded that the discharge of debt in exchange for preferred stock did not create COD income.[143] In *Capento Securities Corp.*, Raytheon in 1935 issued 5,000 shares of $100 par value 6% noncumulative preferred stock to Capento in exchange for bonds with a face amount of $500,000.[144] At the time of the exchange, the new stock was worth only $50,000.[145] The Commissioner argued that Raytheon realized $450,000 of COD income from the discharge of the bonds.[146]

The Board of Tax Appeals (BTA)[147] rejected the Commissioner's argument. The BTA concluded that the substitution of the debtor's "capital stock liability" for its bond did not result in the realization of gain.[148] The court distinguished such a substitution of liabilities from the discharge of debt for cash.[149] The court also articulated an alternative rationale for its holding. The bonds were terminated, but the court said that the consideration originally received for the bonds could be thought of as the subscription price for the new stock.[150] Corporations do not have income on the receipt of the subscription price for stock,[151] so Raytheon realized no COD income on the exchange.[152]

> market value of the instruments is less than their face value. Rather, the courts, in the cases cited, look to the reduction of taxpayers' liabilities and the corresponding shrinkage of assets to determine income. The fact that the fair market value of debt instruments may be less than their face does not lessen the issuer's financial obligation. The issuer of the debt instruments remains obligated for the face value of the instrument upon the maturity date of the instrument regardless of the fair market value of the instrument.

TAM 7752002 (Sept. 2, 1977).

[142] 47 B.T.A. 691, *aff'd*, 140 F.2d 382 (1st Cir. 1942).

[143] 47 B.T.A. at 695.

[144] 47 B.T.A. at 694-95.

[145] *Id.* at 695.

[146] *Id.*

[147] The Board of Tax Appeals was the predecessor of the United States Tax Court.

[148] *Id.* The court cited the freeing of assets rationale in support of this conclusion. *Id.*

[149] *Id.*

[150] *Id.*

[151] I.R.C. § 1032 (2000).

In *Motor Mart Trust v. Commissioner*,[153] the court extended the substitution of liabilities rationale of *Capento Securities* to the issuance of a package of common and preferred stock in exchange for the debt of an insolvent company. In *Motor Mart Trust*, the court concluded that the exchange of new common and preferred stock for debt was not a "cancellation" of debt.[154] The court noted that, by the time of the exchange, the bondholders had become the de facto owners of the company. The exchange merely formalized the prior conversion of the bondholders into shareholders, so the court did not think that the exchange resulted in the realization of COD income.[155]

Tax commentators have criticized the substitution of liabilities rationale for the stock-for-debt exception to COD income, because debt and equity are, for many tax purposes, not treated as equivalent sources of capital.[156] Commentators

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[152] *Id.*

[153] 4 T.C. 931, *aff'd*, 156 F.2d 122 (1st Cir. 1946).

[154] 156 F. 2d at 127. At the time of the case, federal bankruptcy law required debtors to reduce their basis in property by the amount of debt cancelled in a bankruptcy proceeding, so courts also had to determine whether a stock-for-debt exchange was a "cancellation" that triggered such attribute reduction. Bankruptcy Act of 1938, § 270, as amended by the Chandler Act, 52 Stat. 904 (repealed).

[155] 156 F. 2d at 124:

> At the date of the reorganization the equity of the old shareholders had vanished, and in substance the bondholders were the owners of the company. This situation was merely given formal recognition under the plan of reorganization whereby the interests of the old shareholders were extinguished and the bondholders changed their status to that of shareholders in the reorganized company. It would be economic nonsense to say that the taxpayer thereby made a present realization of taxable gain when the bonds were retired.

Id.

[156] For example, Timothy Sherck observed:

> That this rationale is not entirely satisfactory is an understatement. . . . Even when preferred stock like that in *Capento Securities* is involved, the debtor's position after the exchange seems quite different from what it was before. While stock is not always easily distinguishable from debt, it is clear that the two concepts differ greatly for tax purposes. At a minimum, debt must consist of an obligation to pay an ascertainable sum at a definite time, enforceable against the [debtor] by a lawsuit to collect payments. If rights to dividend

have also criticized the alternative subscription price rationale for the stock-for-debt exception. For example, Ken Kies has argued that the subscription price theory "ignores the plain economics of the exchange:"[157]

> Only pre-existing creditors, and not new shareholders, would have to 'pay" that subscription premium for the debtor's stock, because of their status as creditors. . . . [M]ost creditors would indeed be surprised to learn that money they have advanced to a corporation in a nonconvertible loan transaction was a 'prepaid subscription price for stock to be issued at an undetermined time in the future.'[158]

Some commentators have argued that the subscription price rationale for the stock-for-debt exception is a stronger rationale than the substitution of liabilities rationale, especially where the debtor corporation is insolvent.[159] These commentators have noted that the subscription price rationale is consistent with what happens in a stock-for-debt exchange that is part of a bankruptcy restructuring.[160]

> payments or stock are defaulted, on the other hand, the equity holder may be accorded rights to elect directors, perhaps even take control of the corporation, but has no ability to sue to enforce payment or place the corporation into bankruptcy. A shift from status as a creditor to that of a preferred, to say nothing of a common, stockholder thus effects a real and substantial change in the relationship between the corporation and its former debtholder, and effects an immediate increase in corporate net worth.

Timothy C. Sherck, *Restructuring Today's Financially Troubled Corporation*, 68 TAXES 881, 895 (1990).

[157] Kenneth J. Kies, *Taking a Fresh Look at the Stock-for-Debt Exception*, 56 TAX NOTES 1619, 1622 (1992).

[158] *Id.* (citation omitted).

[159] *See, e.g.*, Sherck, *supra* note 156, at 896 (subscription price rationale is a more satisfactory rationale than the substitution of liabilities rationale and is especially applicable to restructurings of troubled companies).

[160] *Id.* Sherck notes that the subscription price rationale for the stock-for-debt exception to COD income:

> fits particularly well in the financially troubled company context. The principle is well established that where the debtor is insolvent, the creditors have become, in effect, involuntary equity holders, and should be treated as such for continuity of interest purposes. Similarly, it does not seem too much of a

B. The gradual adoption of a hypothetical cash issuance model in stock-for-debt and debt-for-debt exchanges.

Courts that adopted the substitution of liabilities or subscription price theory in debt-for-stock, debt-for-debt, and stock-for-debt exchanges rejected the argument that the tax consequences of the exchange should be governed by a hypothetical cash issuance approach.[161] Over time, however, Congress has replaced the substitution of liabilities approach with the hypothetical cash issuance approach.

As Congress reconsidered the tax treatment of debt discharge, it also considered the ways in which the COD income rules interacted with the OID rules, especially the rules that governed the amount of discount created on the issuance of debt in exchange for property. Prior to 1969, the rules governing the creation of OID on bonds issued in exchange for property, especially the debtor's debt or stock, were not clear.[162] In 1969, Congress overhauled the OID rules to "clarify" the tax treatment of such debt.[163] As Congress amended the OID rules, the interaction of the OID and COD income rules became more complex.

1. Reform of the OID rules and the determination of COD income in debt-for-debt exchanges.

Section 413 of the 1969 Act[164] amended Code § 1232 to provide express rules for determining the Issue Price of debt issued in exchange for property.[165] As amended, § 1232(b)(2) provided that the Issue Price of debt issued in a

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> logical stretch in such a case to treat the creditors, for purposes of determining COD income, as having acquired the equity interest in a Section 1032 exchange at some earlier undefined point in time. The 'formalization' of their equity position by the actual exchange of debt for stock thus would not require recognition of gain to the debtor.

Id. (citations omitted).

[161] *See, e.g.*, Capento Securities Corp. v. Commissioner, 140 F.2d 382, 386-87 (1st Cir. 1942).

[162] *See supra* Part III.A.1.

[163] Tax Reform Act of 1969, Pub. L. No. 91-172 § 413, 83 Stat. 487, 611 (1969) (applicable to bonds issued after May 27, 1969).

[164] *Id.*

[165] Section 413 also added Code section 1232(a)(3), which for the first time required bondholders to include OID ratably over the life of the debt instrument. This provision was enacted to stop the mismatching of OID deductions and inclusions. *See* Eustice, *Tax Reform Act of 1969*, *supra* note 102, at 533.

reorganization is its stated redemption price.[166] Under this rule, debt issued in a reorganization could never have OID, because the Issue Price of the debt would equal the stated redemption price at maturity of the debt.[167] This seemingly harsh provision was ameliorated by Treasury Regulation § 1.1232-3(b)(1)(iv), which provided for the carryover of unamortized OID on a debt instrument given up in exchange for the new debt. The OID carryover rule applied regardless of whether the stated redemption price at maturity of the new debt differed from that of the old debt, so the rule could produce anomalous results.[168]

The reason for this special reorganization rule can be gleaned from the legislative history of the 1969 Act.[169] The special reorganization Issue Price rule was not included in the first draft of the Issue Price provision that was adopted by the House and Senate Committees. The first draft of the Issue Price rule provided that the Issue Price of any debt issued in exchange for property would be the value of the property given up in the exchange if either the debt or the property was traded. However, the provision was amended, at the request of the Treasury Department, during the Senate debate of the Bill.[170] Once again the Treasury Department was concerned that it might be "whipsawed" on valuations of property exchanged for debt,[171] so the Issue Price rule was amended to include the special reorganization

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[166] Section 1232(b)(2) provided that the Issue Price of debt issued for property is:

> (1) the value of the property exchanged for the debt, if
>
> > (a) the debt issued is traded or if the debt is issued for stock or securities that are traded, and
> >
> > (b) the debt is not issued in a reorganization; or
>
> (2) the stated redemption price at maturity.

[167] OID equals the stated redemption price of the debt less the Issue Price of the debt. I.R.C. § 1273(a)(1) (2000).

[168] Haims, *Restructuring the Debt of the Sick Company*, unpublished paper delivered at The Tax Club (Jan. 16, 1990), at n.20 (copy on file with the author).

[169] For a discussion of the origin of this rule, see Charles L. Almond, Note, *The Original Issue Discount Deduction in Bonds-for-Noncash Property Exchanges*, 27 VAND. L. REV. 1179, 1207 (1974) (citing H.R. REP. NO. 413 (Part 2), 91st Cong., 1st Sess. 86 (1969); S. REP. NO. 552, 91st Cong., 1st Sess. 148 (1969)). *See also* David P. Hariton, *Recapitalizations: The Issuer's Treatment*, 40 TAX L. REV. 873 (1987).

[170] *Id.* (citing 115 Cong. Rec. 36730-31 (1969)).

[171] *Id.* at 1207, 1208 (citing 115 CONG. REC. 35730 (1969)). The Deputy Assistant Secretary of the Treasury described the problem in the following way:

> The issuing corporation will claim a low value for property received on issuance of its bonds in order to obtain a bond discount amortization deduction. The bondholder will claim that the property was worth the full face amount of the bonds so he has no 'original issue discount' income. It is not possible to bring these parties together in a lawsuit, or otherwise to insure that consistent

rule. In other words, the special reorganization rule was probably adopted for practical, not theoretical, reasons.

The special reorganization Issue Price rule eliminated the OID valuation whipsaw problem, but it created another problem. Under the special rule, the Issue Price of debt issued in reorganizations equaled the face of the debt. Although this eliminated OID on the debt, it arguably created amortizable bond retirement premium in some situations where the new debt was issued in exchange for old debt. Issuers took the position that they could deduct the difference between the face of the new debt (which was also the Issue Price of the debt) and the Adjusted Issue Price of old debt exchanged for the new debt, as bond retirement premium.[172] Holders of the new debt, on the other hand, argued that they there was no OID to include in income, so once again issuers and holders were taking asymmetrical positions. If the value of the new debt was less than the Adjusted Issue Price of the old debt, the retirement premium was artificial.[173]

Due to this disparate treatment, a market developed for exchanges of new deferred interest debentures for old debentures, much to the dismay of the government.[174] The Treasury Department reacted, and the Issue Price rules were

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> valuations are applied, so that if one party gets an ordinary deduction, the other has an equivalent amount of ordinary income. This would suggest that there should be no original issue discount where bonds are issued for property except where the bonds are traded on an established securities market or are issued for property which consists of property so traded.

Id.

[172] *See, e.g.*, Canellos & Kleinbard, *supra* note 102, at 601-09, (discussing the issuer's arguments for the deduction, with examples of these transactions, such as the Exxon Shipping debt-for-debt exchange).

[173] Here is an example of how this problem could arise: An issuer exchanges a new deferred interest note, with low stated interest, for old debt with a higher stated interest. The old debt was originally issued for $1,000 and has a value of $900 at the time of the exchange. The new debt has a face and Issue Price of $1,200. The value of the new debt at the time of the exchange is $900. The holder took the position that there was no OID on the new debt, so would not include the deferred interest on the debt. On the other hand, the issuer took the position it could deduct $200 (the $1,200 Issue Price of the new debt less the $1,000 Adjusted Issue Price of the old debt) ratably over the life of the new debt. The retirement premium, created by inflating the Issue Price of the new debt to equal the face of the debt, is artificial because the value of the new debt is less than the Adjusted Issue Price of the old debt. Example from Haims, *supra* note 168, at n.22.

[174] Almond, *supra* note 169, at 1208. *See also* Canellos & Kleinbard, *supra* note 102, at

again changed in 1982 to eliminate this perceived abuse. The 1982 Act[175] deleted the special reorganization rule from § 1232(b)(2), but added new § 1232(b)(4), which provided that the Issue Price of debt issued for debt in a reorganization (where either the debt or the property for which it was issued was publicly traded) was the greater of the fair market value of the old debt or the Adjusted Issue Price of the old debt.[176]

The legislative history of this provision indicates that § 1232(b)(4) was enacted to eliminate the artificial bond retirement premium that issuers were deducting ratably (but holders were not including) under pre-1982 Act law. Section 1232(b)(4), by changing the reorganization Issue Price rule, allowed the creation of OID on the debt issued in the reorganization. The issuer's OID deductions would accrue on a yield-to-maturity basis, instead of ratably.[177] Holders would have to include the OID in income, under the OID accrual rules.

One commentator took the view that this change in the reorganization Issue Price rule was "an apparent attempt to ensure that [the new bond's Issue Price] would be measured in accordance with *National Alfalfa* principles."[178] However, it is not clear from the legislative history whether Congress had the principles of *National Alfalfa* in mind at all, or whether Congress was simply trying to find a way to end the perceived abuse associated with the popular pre-1982 deferred debt transactions described above.

609.

[175] 1982 Act § 306(a)(9)(C). The 1982 Act changes applied to debt issued after December 13, 1982.

[176] Consider how the change in 1982 affected the tax consequences of the example in note 173 *supra*. Under the 1982 Act, the Issue Price of the new note would be $1,000, so the holder would include $200 of OID and the issuer would deduct $200 of OID over the life of the instrument.[176] The issuer would not realize any bond retirement premium on the exchange because the $1,000 Issue Price of the new debt equals the $1,000 Adjusted Issue Price of the old debt.

The repeal of the special reorganization Issue Price rule, and the enactment of § 1232(b)(4), created difficult interpretive problems that commentators quickly noted. *See, e.g.*, Canellos & Kleinbard, *supra* note 102 at 613-17, noting the following problems: (1) creation of OID under the rule where it would not exist as an economic matter; (2) distortion of COD income; and (3) difficulty in applying the rule to a package of consideration. These interpretation problems continued when § 1232(b)(4) was later redesignated § 1275(a)(4).

[177] H.R. REP. NO. 986, 97th Cong., 2d Sess. 21 (1982). For a thorough discussion of the legislative history of this provision, see Canellos & Kleinbard, *supra* note 102, at 609-12.

[178] Emanuel S. Burstein,*Federal Income Taxation of Debt Swaps and Modifications* , 17 J. CORP. TAX'N. 3, n.92 (1990).

Congress changed the Issue Price rules again in 1984. Section 42 of the 1984 Act[179] repealed §§ 1232 and 1232A, and added new §§ 1271 to 1275 to deal with OID. Section 1273(b)(1) through (4) and § 1274 set forth various rules for determining the Issue Price of debt instruments generally. However, where debt was issued in exchange for debt in a reorganization, § 1275(a)(4)[180] provided that the Issue Price of the new debt was the greater of (1) the Issue Price determined under §§ 1273(b) and 1274, or (2) the Adjusted Issue Price of the old debt.

Section 1273(b)(3) applies if (1) debt is issued for property, including the outstanding stock or debt of the issuer, and, (2) either the debt or the property received by the issuer in the exchange is traded on an established securities market. The Issue Price of such debt is the fair market value of the property received in exchange for the debt.[181]

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[179] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

[180] I.R.C. § 1275(a)(4) was the successor to the carryover Issue Price rule of § 1232(b)(4), which applied in reorganizations. Section 41(a) of the Deficit Reduction Act of 1984 modified § 1232(b)(4) and redesignated it as § 1275(a)(4). Pub. L. No. 98-369, 98 Stat. 494.

[181] I.R.C. § 1273(b)(3) (2000). The various Issue Price rules of §§ 1273(b) and 1274 distinguish between (1) instruments that are publicly traded and those that are not, and (2) instruments that are issued for money and instruments that are issued for "property." "Property" does not include money. I.R.C. § 1273(b)(5) (2000). Section 1273(b)(1) applies to debt instruments that are publicly offered and are issued for money. Debt is "publicly offered" if it is registered with the Securities and Exchange Commission, would be required to be registered but for the identity of the issuer, or is exempt from registration under section 3 of the Securities Act of 1933. Treas. Reg. section 1.1273-2(a)(2). The Issue Price of such debt is the initial offering price to the public at which price a substantial amount of such debt instruments was sold. I.R.C. § 1273(b)(1) (2000). Section 1273(b)(2), which applies to debt that is not publicly offered and which is issued for money, provides that that the Issue Price of such debt is the price paid for the debt by the first buyer of the debt. I.R.C. § 1273(b)(2) (2000).

Section 1273(b)(4) applies if nonpublicly traded debt is issued in exchange for nonpublicly traded property, including the stock or debt of the issuer, and § 1274 does not apply to the exchange. If § 1274 applies to the exchange, § 1274 will determine the Issue Price of the debt issued in the exchange. If § 1273(b)(4) applies, the Issue Price of the debt is deemed to be the stated redemption price at maturity of the debt. Section 1274(c)(1) provides that § 1274 applies to any debt instrument issued for property if the stated redemption price at maturity of the debt instrument exceeds (1) the "stated principal amount" of the debt, where there is "adequate stated interest" on the debt, or (2) the "imputed principal amount" where the debt does not bear "adequate stated interest." The debt has "adequate stated interest" if the stated interest rate on the debt instrument exceeds the applicable federal rate (published monthly by the Service), or if the "stated

As mentioned above, the special reorganization rule of § 1275(a)(4) provided that, if debt was exchanged for debt in a reorganization, and the Adjusted Issue Price of the old debt was greater that the Issue Price of the new debt, as determined under §§ 1273(b), then the Issue Price of the new debt was the Adjusted Issue Price of the old debt. In effect, § 1275(a)(4) precluded a debtor corporation from converting market discount (the decline in the value of the debt since issuance), which is not deductible, into deductible OID, by exchanging new debt for the old debt.

The § 1275(a)(4) issue price rule was also thought to preclude the creation of COD income in a debt-for-debt exchange. Before 1990, it was often assumed that the OID issue price of the new debt (which, for OID purposes, is the amount borrowed) should be treated as the amount paid to discharge the old debt, although the link between the OID and COD income rules was not explicit in the Code.[182] If, in a debt-for-debt exchange, § 1275(a)(4) applied to determine the amount for which the old debt had been discharged, the Issue Price of the new debt could not be less than the Adjusted Issue Price of the old debt, so there could never be COD income in a debt-for-debt exchange.

Section 1275(a)(4) raised a number of difficult interpretation issues. For purposes of § 1275, § 1275(a)(4)(B)(ii) provided that "Adjusted Issue Price" was the Issue Price of the debt plus the previously included OID on the debt. This definition, which failed to take into account unamortized bond issuance premium, could cause distortions where the old debt had bond issuance premium.[183] Section 1275(a)(4) could also cause distortions where the stated redemption price at maturity of the new debt differed from the stated redemption price at maturity of the old debt.[184]

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principal amount" (the sum of all payments due under the instrument, less payments designated as interest) is less than or equal to the "imputed principal amount" (the sum of the discounted present values of all payments due under the instrument, discounted at the applicable federal rate). Treas. Reg. § 1.1274-3(a) and (b). If § 1274 applies and the debt has adequate stated interest, the Issue Price of the debt is the "stated principal amount" of the debt. If § 1274 applies and the debt does not bear adequate stated interest, the Issue Price is the imputed principal amount.

[182] The link between the OID and COD rules was clear with respect to debt that was issued in exchange for cash and retired for cash. *See, e.g.*, Reg. 65 Art. 545(c) under the 1924 Act: "If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted . . . over the purchase price is gain or income for the taxable year." It was unclear, however, how this rule applied to debt that was issued in exchange for property, or to debt that was retired in exchange for property.

[183] Hariton, *supra* note 169, at 885.

[184] *Id.*

Another problem with § 1275(a)(4) was that its application was unclear where a package of new debt plus cash, or an investment unit, was exchanged for the old debt.[185]

The government became concerned that the various plausible approaches for applying § 1275(a)(4) permitted taxpayers to "cherry pick" results.[186] Instead of resolving the various interpretation questions regarding § 1275(a)(4), Treasury instead rejected the entire substitution of liabilities approach (also known as the "carryover issue price model") of § 1275(a)(4), in favor of a hypothetical cash issuance approach.[187] Under this new approach, a debt-for-debt exchange would be treated like any other issuance of new debt in exchange for property and the general OID issue price rules would determine the issue price of the debt issued in a debt-for-debt exchange.[188]

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[185] Wilcox, *supra* note 139, at 403-04. The OID rules in the Code and regulations provide specific operating rules to deal with debt instruments with certain features. Section 1273(c) and regulation section 1.1273-2(d)(1) provide special operating rules for determining the section 1273(b) Issue Price of debt issued in an "investment unit" with an option, stock or other property. Section 1273(c) requires that the Issue Price for the investment unit be allocated between the debt and other property based on relative fair market value of the two pieces. The regulation says that if the debt is publicly traded, the Issue Price of the debt is the initial trading price of the debt instrument. If the property right is publicly traded and the debt is not publicly traded, the Issue Price of the debt instrument is the price paid for the investment unit less the initial trading price of the debt instrument. If neither piece is traded, the Issue Price is the present value of the payments due under the instrument, discounted at a rate agreed to by the issuer and the holder, and based on comparable debt instruments, but such rate cannot be less than the applicable federal rate. Where an investment unit was issued in exchange for old debt and section 1275(a)(4) applied to determine the Issue Price of the new debt (because the Adjusted Issue Price of the old debt exceeds the section 1273 or 1274 Issue Price), it was not clear how section 1275(a)(4) allocated the Adjusted Issue Price of the old debt to the new debt.

[186] *See* H.R. REP. NO. 881, 101st Cong., 2d Sess. 353, 354 (1990); Sen. Fin. Comm., 101st Cong., 2d Sess., *Explanation of Revenue Reconciliation Bill of 1990,* 136 CONG. REC. S15667, S15708 (daily ed., Oct. 18, 1990). For a detailed account of the repeal of I.R.C. § 1275(a)(4), see Benjamin Cohen & Gary Henningsen, Jr., *The Repeal of Section § 1275(a)(4),* 44 Tax Law. 697, 720-22 (1990).

[187] Jayne Levin, *IRS Studies Tax Change Aimed at Exchange Offers: Fair Market Valuation is Key,* INVESTMENT DEALER'S DIGEST, May 14, 1990.

[188] James Eichen et al., *Reasons for Reenacting Code Section 1275(a)(4): Analysis and Recommendations on H.R. 5655,* 55 TAX NOTES 1461 (1992).

In 1990, Congress repealed § 1275(a)(4).[189] The provision repealing § 1275(a)(4) was added to the bill late in the legislative process.[190] The tax and bankruptcy bar quickly mobilized to try to prevent the repeal of § 1275(a)(4),[191] but the repeal provision was included in the bill and became law. Following the repeal, commentators argued, unsuccessfully, for reinstatement of § 1275(a)(4).[192]

Congress, in 1990, also enacted new § 108(e)(11),[193] which provided that, for purposes of determining COD income in a debt-for-debt exchange, the debtor corporation would be treated as though it had discharged the old debt for "an amount of money equal to the issue price" of the new debt. Where the old or new debt is publicly traded, this means that the new debt has an Issue Price equal to the fair market value of the debt. Said another way, this section adopted the hypothetical cash issuance model for calculating COD income. It also explicitly linked the OID and COD income rules in debt-for-debt exchanges.

In addition, the *Cottage Savings* case,[194] decided in 1991, and subsequent treasury regulations[195] impose a "hair trigger" for realization in debt modifications. Under these rules, many modifications of outstanding debt are treated as debt-for-debt exchanges. [196]

2. The narrowing and repeal of the stock-for-debt exception to COD income.

Congress also gradually narrowed and eventually repealed the stock-for-debt exception to COD income. In 1970, Congress created a special commission to consider the reform of U.S bankruptcy law.[197] The commission's report included recommendations about reform of the Internal Revenue Code. For several years, members of Congress, Treasury Department and Justice Department officials, representatives of the Service, and lawyers and accountants from private practice

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[189] Section 11325(a)(2) of the Revenue Reconciliation Act of 1990. Pub. L. No. 101-508, 104 Stat. 1388 (1990).
[190] Cohen & Henningsen, *supra* note 186, at 720.
[191] *Id.* at 720 and n.127.
[192] *See, e.g., id.* at 734 (the repeal of § 1275(a)(4) "imposes tax liability based on what will be regarded as a subtle and theoretical, if not wholly artificial, view of the transaction").
[193] *Id.*, § 11325(a)(1). Today, this provision is in I.R.C. § 108(e)(10) (2000).
[194] Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 (1991).
[195] Treas. Reg. § 1.1001-3.
[196] *Id.*
[197] This summary of the passage of the Bankruptcy Tax Act of 1980 is based on the detailed discussion in Asofsky, *supra* note 76, at 13-1 to 13-11.

debated these proposals. The debates culminated in the passage of the Bankruptcy Tax Act of 1980.[198]

During the debate of the proposed legislation, government and private witnesses strongly disagreed about two specific issues, one of which was the stock-for-debt-exception to COD income. [199] In particular, the parties disagreed about whether a stock-for-debt exchange should result in reduction of the debtor corporation's tax attributes.[200] Tax lawyers from the Treasury Department and Justice Department testified that stock-for-debt exchanges should result in attribute reduction, notwithstanding *Motor Mart Trust*, but private practice lawyers and accountants argued against that change in the law.[201] The House version of the bill would have retained the stock-for-debt exception in tax-free reorganizations and precluded attribute reduction in such cases. Stock-for-debt exchanges that did not qualify as tax-free reorganizations, on the other hand, would have resulted in COD income and attribute reduction. The Senate eliminated these provisions from the bill, and the Senate Report specified that the bill would not alter the case law on COD income and attribute reduction in stock-for-debt exchanges.[202] The Senate version of the bill became the Bankruptcy Tax Act of 1980.[203]

The Bankruptcy Tax Act of 1980 included two specific limitations on the stock-for-debt exception, in order to curb perceived abuses of the exception.[204] First, the stock-for-debt exception did not apply to the issuance of "nominal or token shares."[205] Second, the stock-for-debt exception did not apply where the

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[198] Pub. L. No. 96-589, 94 Stat. 3389, 96th Cong., 2d Sess. (1980).

[199] Asofsky, *supra* note 76, at 13-8 and 13-9.

[200] *Id.* at 13-9.

[201] *Id.* at 13-10. (The Justice and Treasury Department witnesses included Carr Ferguson, Daniel Halperin, and David Shakow, all of whom became law professors.)

[202] S. REP. NO. 1035, 96th Cong., 2d Sess. 17 (1980):

> The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt.

Id.

[203] Asofsky, *supra* note 76, at 13-11.

[204] Pub. L. No. 96-589, 94 Stat. 3389, 96th Cong., 2d Sess. (1980) (hereinafter the Bankruptcy Tax Act of 1980).

[205] Section 108(e)(8)(A) (repealed). This limitation was known as the "de minimis"

ratio of the value of the stock received by an unsecured creditor to the value of the indebtedness canceled or exchanged for the stock was less than 50% of a similar ratio computed for all unsecured creditors.[206]

In the early 1980s, "debt-equity swaps" became popular. Interest rates rose significantly at that time, which caused the value of outstanding corporate debt to decline. Corporate debtors could not retire outstanding debt at a discount for cash without triggering COD income. If the debtor retired the debt for stock instead of cash, on the other hand, the exchange qualified for the stock-for-debt exception to COD income and did not result in COD income or attribute reduction.[207] In 1984, Congress limited use of the stock-for-debt exception to financially troubled debtors.[208] Section 108(e)(10) provided that a debtor corporation could only qualify for the stock-for-debt exception (1) to the extent of its insolvency, or (2) if the debtor had filed a bankruptcy petition.[209]

In 1990, Congress amended § 108 to provide that the stock-for-debt exception would not apply to the issuance of callable or putable preferred stock, which Congress considered to be economically similar to debt.[210] Treasury also issued controversial regulations under § 108(e)(8) that made it even more difficult for debtors to rely on the stock-for-debt exception.[211]

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limitation.

[206] Section 108(e)(8)(B) (repealed). This limitation, known as the "proportionality limitation," could create problems in the restructuring of troubled companies with subordinated debt, because junior creditors often received a substantially lower percentage recovery than senior creditors.

[207] For a description of the debt-equity swap fad and the enactment of § 108(e)(10), see Bryan, *supra* note 46, at 89.

[208] The Deficit Reduction Act of 1984, Pub. L. No. 98-369, 1984 U.S.C.C.A.N. (98 Stat.) 494 [hereinafter the 1984 Act].

[209] This is the same test used to determine qualification for the § 108(a) COD exclusion. This test creates an incentive for debtors to file a bankruptcy petition, since there is often uncertainty about the degree of the debtor's insolvency. Katherine Pratt, *Shifting Biases: Troubled Company Debt Restructurings After the 1993 Tax Act,* 68 AM. BANKR. L.J. 23, n.31 (1994) [hereinafter, Pratt, *Shifting Biases*].

[210] Omnibus Revenue Reconciliation Act of 1990 § 11325(a), Pub. L. No. 101-508, 1990 U.S.C.C.A.N. (104 Stat.) 1388. On noted earlier, the 1990 Act also repealed § 1275(a)(4) with respect to debt-for-debt exchanges.

[211] Prop. Treas. Reg. § 1.108-1, 55 Fed. Reg. 50568 (1990). The safe harbor standards in the 1990 proposed regulations were so onerous that commentators accused Treasury of converting the statutory de minimis requirement into a regulatory "de maximis" requirement. *See* Lee Sheppard, *IRS Gets Educated at Hearing on Stock-for-debt Exception,* 50 TAX NOTES 1204 (1991). The 1990 proposed regulations were

In 1992, a provision repealing the stock-for-debt exception was included in a bill that passed but was vetoed by President Bush.[212] The next year, the repeal became law,[213] over the strenuous objection of the bankruptcy tax bar.[214]

The repeal of § 1275(a)(4) and the stock-for-debt exception changed the tax incentives in bankruptcy workouts and restructurings. Under the old substitution of liabilities approach to debt-for-debt and stock-for-debt exchanges, a debtor corporation could do a debt-for-debt or stock-for-debt exchange offer in an out of court workout without triggering COD income. Under the hypothetical cash issuance model, such exchanges trigger COD income. Debtor corporations are wary of relying on the insolvency exclusion for COD income, so the hypothetical cash issuance model increases the incentive in favor of filing a bankruptcy petition in order to qualify for the blanket COD income exclusion.[215]

In addition, the adoption of the hypothetical cash issuance model has increased the incentive to issue debt instead of stock in bankruptcy restructurings. The exclusion of COD income, under § 108(a), results in the reduction of tax

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withdrawn in November 1992 and Treasury subsequently issued more permissive regulations under § 108(e)(8). 57 Fed. Reg. 52601 (1992).

[212] 42 H.R. 5674, 102d Cong., 2d Sess. § 203 (1992) (incorporated into H.R. 11, 102d Cong., 2d Sess. (1992).

[213] Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 13226 (a)(1), 107 Stat. 312, 487 (1993).

[214] *See, e.g.*, letter from Peter Canellos, of the New York State Bar Association Tax Section, to Senate Finance Committee Chair Daniel Moynihan (June 23, 1993), *reprinted in* TAX NOTES TODAY (June 29, 1993) (expressing concern about the repeal).

[215] Insolvency is the excess of the debtor's liabilities over the value of the debtor's assets. § 108(d)(3). There are a number of open questions about how this formula is to be applied. For example, there is uncertainty about how the debtor's liabilities are to be measured and how the debtor's assets are to be valued. *See, e.g.,* Fred Witt & William Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness,* 10 VA. TAX REV. 1, 56-57 (1990) (arguing that contingent liabilities should not be taken into account for purposes of determining insolvency). In addition, the insolvency test requires valuation of all of the debtor's assets, which is both difficult and fraught with uncertainty. Chaim Fortgang & Thomas Mayer, *Valuations in Bankruptcy,* 32 UCLA L. REV. 1061 (1985). A debtor relying on the insolvency exclusion runs the risk that the Internal Revenue Service ("IRS") will later challenge the valuation that was the basis for concluding that the exclusion applied to the debt discharge. An insolvent debtor can avoid having to establish its degree of insolvency by filing a bankruptcy petition and qualifying for the blanket exclusion of I.R.C. § 108(a)(1)(A) (2000).

attributes, including net operating losses.[216] On the other hand, the issuance of new discount debt in a bankruptcy restructuring can create new OID deductions under the hypothetical cash issuance model.[217] New OID debt issued in a restructuring can shelter post-restructuring income in a manner similar to net operating losses. Where the restructuring creates COD income that reduces the debtor corporation's net operating losses, the debtor corporation has a tax incentive to issue new discount debt in the restructuring in order to shelter post restructuring income.[218]

We have replaced the substitution of liabilities or subscription price approach to debt-for-debt exchanges and stock-for-debt exchanges with a hypothetical cash issuance approach to such exchanges. We have done so, in part, based on certain theoretical tax principles.

Consider the normative justifications for our current approach to COD income in debt-for-debt and stock-for-debt exchanges. First, the hypothetical cash issuance approach has been justified by the comprehensive tax base principle. Said another way, the goal is accurate measurement of income.[219] Income is determined annually, not on a transactional basis.[220] The idea is that, where a debtor corporation discharges debt, which has declined in value, by exchanging it for new debt or stock, the corporation has income in an amount equal to the amount owed on the discharged debt less the value of the new debt or stock.[221] What has happened in previous years is irrelevant, and what will happen in future years is irrelevant.[222] We view the OID rules as correctly reflecting the annual determination of accrued interest on debt, so we use the OID rules to determine the amount of the old debt discharged and, in a debt-for-debt exchange, the hypothetical amount paid to discharge the old debt.[223] The OID rules adopt a

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[216] I.R.C. § 108(b).

[217] These interest deductions may, however, be limited by I.R.C. § 163(e)(5) (2000).

[218] Miller, *supra* note 1, at 21.

[219] *See, e.g.*, Cohen & Henningsen, *supra* note 186, at 732 ("one of the stated reasons for the repeal of section 1275(a)(4) was to ensure the proper measurement of income from discharge of indebtedness.").

[220] I.R.C. § 441; Burnet v. Sanford and Brooks, 282 U.S. 359 (1931); Vukasovich, Inc. v. Commissioner, 790 F.2d 1409 (9th Cir. 1986) (the decision in *Burnet v. Sanford & Brooks* precludes application of the transactional accounting approach used in the earlier *Kerbaugh-Empire* case).

[221] Kies, *supra* note 157, at 1624 (1992).

[222] The hypothetical cash issuance approach replaced the earlier substitution of liabilities or subscription price approach to debt-for-debt and stock-for-debt exchanges.

[223] H.R. REP. NO. 881, 101st Cong., 2d Sess. 353, 354 (1990); Sen. Fin. Comm., 101st Cong., 2d Sess., *Explanation of Revenue Reconciliation Bill of 1990*, 136 CONG. REC.

hypothetical cash issuance approach to the issuance of debt in exchange for property.[224]

Second, the hypothetical cash issuance approach has been justified by the principle of horizontal equity, which is invoked in two ways. First, the horizontal equity principle is invoked to support arguments that economically comparable transactions should be treated the same.[225] This argument is an argument in favor of consistency: if the discharge of corporate debt for cash creates COD income, the discharge of corporate debt for debt or stock of comparable value should also create COD income. Second, the horizontal equity principle is cited to support the argument that the hypothetical cash issuance approach should be applied to all debtor corporations, regardless of whether the debtor corporation is financially troubled; if thriving corporations have COD income from a stock-for-debt or debt-for-debt exchange, troubled corporations should also have COD income from a stock-for-debt or debt-for-debt exchange.[226]

These principles do not provide a compelling justification for the current treatment of stock-for-debt exchanges and debt-for-debt exchanges. The next Part critiques the theoretical justifications for the current COD income rules applicable in debt-for-debt and stock-for-debt exchanges.

IV. A NORMATIVE EVALUATION OF OUR APPROACH TO COD INCOME IN DEBT-FOR-DEBT AND STOCK-FOR-DEBT EXCHANGES.

This Part evaluates the current tax treatment of corporate debt discharge in debt-for-debt and stock-for-debt exchanges under two alternative normative approaches. The first approach is a comprehensive tax base or horizontal equity approach. Under this approach, we apply a general theory of COD income to determine the proper tax treatment of corporate debt discharge in debt-for-debt and stock-for-debt exchanges. The alternative normative approach is to determine the proper tax treatment of such transactions by applying principles of economic efficiency.

A. The comprehensive tax base or horizontal equity approach.

S15667, S15708 (daily ed., Oct. 18, 1990).

[224] Kies, *supra* note 157, at 1624.

[225] H.R. REP. No. 881, 101st Cong., 2d Sess. 353, 354 (1990); Sen. Fin. Comm., 101st Cong., 2d Sess., *Explanation of Revenue Reconciliation Bill of 1990*, 136 CONG. REC. S15667, S15708 (daily ed., Oct. 18, 1990).

[226] Kies, *supra* note 157, at 1623-24.

Tax commentators have consistently applied a comprehensive tax base or horizontal equity norm to determine the appropriate tax treatment of COD income. They have stressed the desirability of applying the same debt discharge approach to all taxpayers, regardless of the type of transaction in which the debt is discharged (*i.e.*, whether the outstanding debt is discharged in exchange for cash, new debt, or new stock), and regardless of the taxpayer's financial circumstances (*i.e.*, solvent or insolvent). Said another way, proponents of this approach have tried to provide a consistent, comprehensive COD income rule for debt discharge.[227]

The COD income consequences of debt-for-debt and stock-for-debt exchanges depend on which general COD theory we apply to these exchanges. If we applied the Kerbaugh-Empire "whole transaction" approach to COD income, we would have to trace the loan proceeds to determine whether the loan transaction as a whole produced a gain or loss. As commentators and courts have observed, however, this particular approach is surely no longer good law.[228]

If we applied the Kirby Lumber "freeing of assets" approach, the consequences of the debt discharge would depend on the circumstances in the year of the debt discharge, in particular, the solvency or insolvency of the debtor corporation. (Circumstances in the year in which the debt was incurred would be irrelevant.) Under this approach, the exchange would create COD income if it increased the shareholders' balance sheet net worth, regardless of the manner in which the debt is discharged (*i.e.*, for cash, new debt or stock). Debt discharge would not produce COD income, however, if the discharge did not make the corporation solvent. Although tax commentators have consistently rejected this approach, as "outmoded,"[229] the freeing of assets language in the *Kirby Lumber* opinion continues to create tension between the freeing of assets theory and other COD income theories.[230]

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[227] *See, e.g.*, Bittker & Thompson, *supra* note 17 (articulating the "loan proceeds" or "symmetry" theory of COD income).

[228] *See, e.g.*, Dodge, *supra* note 61 , at 678 and text at n.8; Seto, *supra* note 28, at 211; Schenk, *supra* note 61, at 106 (noting that it is often not possible to trace the use of the loan proceeds). See also *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986) (holding that *Burnet v. Sanford & Brooks* precluded application of the earlier transactional approach in *Kerbaugh-Empire*.)

[229] *See, e.g.*, Geier, *supra* note 64, at 144 (describing the freeing of assets theory as "outmoded").

[230] *See, e.g.*, United States v. Centennial Savings Bank, 499 U.S. 573, 583 (1991) (in which the Supreme Court seems to be applying both the freeing of assets approach and the loan proceeds approach).

If we applied the simpler form of the Bittker and Thompson loan proceeds approach, we would require the corporation to include in income any untaxed loan proceeds that will not be repaid. This rule is simply a timing rule that requires the corporation to include, in the year of the discharge, the previously untaxed loan proceeds that will not be repaid. This approach focuses exclusively on the exclusion of the loan proceeds in the year in which the debt was incurred. Other circumstances in the year in which the debt was incurred are irrelevant.

Applying the stronger form of the Bittker and Thompson loan proceeds theory, however, other circumstances in the year in which the loan was made could affect the amount of the COD income inclusion. Under this approach, we would look back to the year in which the debt was incurred and ask whether the debtor would have been able to exclude the loan proceeds in the year in which the debt was incurred if we had known at the time what was going to happen in the later year of the discharge.

If, in the later year, the debt is exchanged for new debt, with a face amount at least equal to the face amount of the debt discharged, it may be that nothing has happened that is inconsistent with the earlier exclusion. In such a case, there truly has been a substitution of liabilities. If, on the other hand, the new debt has a face amount that is less than the face amount of the old debt, we know that the difference between the face of the old debt and the face of the new debt will never be repaid, which could, under this theory, support the creation of COD income in an amount equal to the difference between the old and new face amount. This is the rule that we had in place for debt-for-debt exchanges until we abandoned the substitution of liabilities approach in favor of the hypothetical cash issuance model.[231]

The stronger form of the loans proceeds approach could also justify the stock-for-debt exception. If, in the year in which the loan was incurred, we had known that the loan would be converted into stock in a later year, that information does not necessarily lead to the conclusion that the loan proceeds would have been included in income. The "error" in such a case would have been the characterization of the loan as debt; if, in the year of the borrowing, we had characterized the loan proceeds as a capital contribution, the corporate taxpayer could have excluded the proceeds nonetheless.[232]

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[231] *See, e.g.*, Rev. Rul. 77-437, 1977-2 C.B. 28.

[232] I.R.C. § 1032. A corporate taxpayer is also not taxed on the discharge of stock for less

Courts applying the stock-for-debt exception to COD income often spoke in terms of a substitution of liabilities.[233] The problem with this approach is that tax commentators have stressed time and again that the taxpayer's choice of form matters, for purposes of the corporate tax.[234] The corporate tax permits corporation to deduct interest on debt but does not permit corporations to deduct dividends on stock, so debt and equity are not equivalent sources of capital for purposes of the corporate tax.[235]

The subscription price theory is a stronger rationale for the stock-for-debt exception to COD income.[236] Commentators have dismissed the subscription price theory on the grounds that the creditor did not buy stock, but instead made a loan.[237] This is no doubt true in the year of the loan, but the question is what type of error correction is required when, in a later year, a creditor exchanges that debt for stock.

Tax commentators who favor applying a hypothetical cash issuance model to a stock-for-debt exchange are implicitly arguing that the fictional corporate taxpayer must pay the price for converting debt into equity. They are saying that there is income when the debtor corporation "closes out" the loan transaction and converts debt into stock. On the other hand, the problem is not so much that the

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than the amount received on the issuance of the stock. I.R.C. § 311.

[233] *See, e.g.*, Capento Sec. Corp. v. Commissioner, 47 B.T.A. 691, 695, *aff'd*, 140 F.2d 382 (1st Cir. 1942).

[234] *See, e.g.*, Rockler, *supra* note 105, at 137-38.

[235] I.R.C. § 163(a) (2000).

[236] I.R.C. § 118 provides that contributions to the capital of a corporation are not income to the corporation. Until recently, cancellation of corporate debt held by shareholders was treated entirely as a contribution to capital, not as COD. Treas. Reg. § 1.61-12(a) (debt cancellation by a shareholder is treated as a § 118 contribution to capital); Putoma Corp. v. Commissioner, 66 T.C. 652, *aff'd* 601 F.2d 734 (5th Cir. 1979) (section 118 trumps COD rules). Section 108(e)(6) now overrides § 118 and provides that debt cancellation by a shareholder is treated as though the shareholder discharged the debt for an amount of money equal to the shareholder's basis in the debt. This rule does not typically create COD because the shareholder's basis usually equals the amount owed on the debt. For examples of situations in which the shareholder's basis would not equal the amount owed on the debt, see Schenk, *supra* note 61, at 120, n.74, and DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 15-84.41, n.254 (4th ed. 2000, with 2003 Supp.).

[237] *See, e.g.*, Kies, *supra* note 157, at 1622 ("most creditors would indeed be surprised to learn that money they have advanced to a corporation in a nonconvertible loan transaction was a 'prepaid subscription price for stock to be issued at an undetermined time in the future.'") (citation omitted).

loan proceeds were excluded in the year in which the debt is incurred; the real problem is that the corporate taxpayer took interest deductions on the debt while the debt was outstanding.

Professor Seto has criticized even the stronger form of the loan proceeds approach precisely because it fails to take into account events that occurred while the loan was outstanding. If we applied a broader transactional approach, looking at the years during which the loan was outstanding, not just at the year of the borrowing and the year of the discharge,[238] we could permit a corporation to convert debt into stock without COD income on the debt discharge, but require recapture of all or a part of the interest deductions taken on the debt converted into stock.[239]

Consider a thought experiment. How would we tax the discharge of corporate debt for less than the amount owed if we did not allow a corporation to deduct interest, or if we allowed corporations to deduct only a cost of capital allowance, without regard to capital structure? Under current law, a corporation's retirement of stock for less than the subscription price of the stock does not create income,[240] but the discharge of debt for less than the amount owed creates COD income.[241] If we equated the tax treatment of interest and dividends, but left in place other distinctions between debt and equity (such as the distinction between accrual taxation and realization taxation), would we still distinguish between the equity approach, of § 1032 and § 311, and the COD income approach of § 61(a)(12)?

Disallowing the corporate interest deduction or adopting a cost of capital allowance system is consistent with the notion that all public security holders, not just shareholders, are the "owners" of the corporation.[242] Under this approach, the

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[238] This transactional approach would not require the impractical sort of tracing of loan proceeds that the Kerbaugh-Empire "whole transaction" approach requires.

[239] There are many other differences between the tax treatment of debt and equity, but the difference between the treatment of interest and dividends is arguably the most important.

[240] I.R.C. § 311 (2000).

[241] I.R.C. § 61(a)(12) (2000).

[242] Edwin Seligman argued in 1909 that corporate income is the earnings on the combined debt and equity capital invested in the corporation. (Consistent with this view, he argued that corporations should not be allowed an interest deduction.) Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L. J. 1585, 1597 (1974) (quoting EDWIN R.A. SELIGMAN, ESSAYS IN TAXATION 246 (9th ed. 1921)). Congress rejected Seligman's proposal, in keeping with the traditional theory of the firm,

retirement of corporate debt and equity at a discount arguably should be treated the same way for tax purposes. It would be consistent with this approach to completely repeal § 61(a)(12) for a corporation's retirement of its own debt securities.[243]

The conceptual distinction between corporate debt and equity securities has always been questionable, but it is even more questionable today.[244] This is, in part, because the corporate tax has been effectively converted into a tax on public companies and public company stock and debt securities are in many ways qualitatively similar.[245] In addition, there has been a proliferation of hybrid securities that are difficult to classify.[246] The cubbyhole approach to debt and equity, with its sharp discontinuity between the tax treatment of debt and equity, also creates opportunities for tax-motivated behavior.[247]

Professor Rudnick has argued that we should tax corporations on their "pure" profits on invested capital and let corporations deduct the "normal" profits on invested capital.[248] This approach is consistent with permitting corporations to deduct a cost of capital allowance equal to the time value of money.[249] Another possibility is a complete disallowance of interest deductions for corporate taxpayers.[250] If we equated the corporate treatment of interest and dividends,

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which viewed the shareholders but not the bondholders as owners of the firm. Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1067, (2000) [hereinafter Pratt, *Debt-Equity Distinction*]. In today's environment, with the dispersion of corporate ownership and the conversion of the corporate tax into a tax on public companies, bondholders and shareholders are even more similar qualitatively.

[243] No legal commentators have suggested such a radical change in the tax law, but noted economist Merton Miller argued for the repeal of I.R.C. § 61(a)(12) in a 1991 corporate finance article. Miller, *supra* note 1, at 22**.** Miller's proposal is discussed *infra* at Part IV.B.

[244] *See* Pratt, *Debt-Equity Distinction*, *supra* note 243, at 1072-94.

[245] *Id.* at 1075, 1113.

[246] *Id.* at 1075-88.

[247] *See* Strnad, *supra* note 26, at 571.

[248] Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1172 (1988-89). *See also* Pratt, *Debt-Equity Distinction*, *supra* note 243, at 1157.

[249] *See* Edward D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943 (1989) for an argument in favor of adopting a cost of capital allowance proposal. *See also* Pratt, *Debt-Equity Distinction, supra* note 243, at 1139-45, 1156-57.

[250] *See, e.g.*, Herwig Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99 MICH. L. REV. 410, 411 (2000) (arguing for the elimination of the corporate interest

perhaps we should also equate the treatment of corporate retirements of debt and equity.

Even if we do not equate the corporate treatment of interest and dividends, we still have to decide which of several competing defensible approaches to COD income is appropriate in debt-for-debt and stock-for-debt exchanges. The goal of accurate measurement of income does not preclude the use of transactional accounting.[251] In fact, in some circumstances, accurate measurement of income may require the use of transactional accounting. As Professor Seto has noted in his article on complete accounting, the Code frequently permits the use of transactional accounting to facilitate more accurate measurement of income.[252] For example, after the court held, in *Burnet v. Sanford and Brooks*,[253] that income is determined on an annual, not a transactional basis, Congress amended the Code

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deduction). *See also*, David A. Weisbach, *Reconsidering the Accrual of Interest Income*, 78 TAXES 36, 47 (2000) [hereinafter Weisbach, *Interest Accrual*]. Professor Weisbach, in his assessment of the OID rules, observed that "any method of taxing interest that is indifferent to form is promising, or said more accurately, is like[ly] to have a low distortion per dollar of revenue. Perhaps the most promising is to simply deny all interest deductions." *Id.* Weisbach adds that we would increase revenue collection if we denied corporations an interest deduction and allowed bondholders to exclude interest income. This is because a great deal of interest income, which in theory is includible by bondholders, is functionally tax exempt because the bondholders are foreign or tax exempt entities. *Id.* at 43-44. Even if the bondholder is taxable, the bondholder can engage in tax trading to reduce the tax on the OID. *Id.* at 44. Said another way, clientele effects and tax trading reduce the amount of revenue collected on bondholders' interest income.

[251] The default rule in our system is an annual accounting approach. I.R.C. § 441 (2000). Courts have nonetheless consistently cited *Bowers v. Kerbaugh-Empire* in support of a transactional accounting approach to COD income. Recall that the court in *Kerbaugh-Empire* held that the consequences of the debt discharge depended on whether the transaction as a whole resulted in gain or loss. This approach requires that a corporate debtor trace the loan proceeds to determine whether the entire transaction produced a gain or loss. As many commentators have observed, surely this is no longer good law. *See supra* note 61. On the other hand, that does not necessarily mean that there is no support for another form of transactional approach to debt discharge. *Kerbaugh-Empire* is, in a way, a "red herring" because of the idiosyncratic transactional approach the court used in that case. Although *Kerbaugh-Empire* is no longer good law, another form of transactional approach to COD income may still be the better approach in stock-for-debt and debt-for-debt exchanges.

[252] Seto, *supra* note 28, at 225-27.

[253] 282 U.S. 359 (1931).

to permit taxpayers to carry a net operating loss back and forward to offset income from other years.[254] The default rule of annual accounting is justified by its administrative convenience; where transactional concepts are required to accurately reflect the taxpayer's income, the transactional approach can trump the annual accounting approach.

We have rejected the substitution of liabilities model in favor of the hypothetical cash issuance model[255] in part because the consensus is that the OID rules, which employ a hypothetical cash issuance model, correctly reflect economic reality. Professor Weisbach has argued that we should not regard the OID rules as "right," however, just because economic accrual of interest is typically closer to economic reality than ratable accrual of interest.[256] In his view, the economic accrual of interest provided for in the OID rules is just one of several controversial approaches to the accrual of income.[257]

Professor Weisbach argues that developments in financial theory, such as the put-call parity theorem,[258] call into question the risk-based distinction between accrual taxation and realization-based taxation.[259] In addition, he argues that the OID rules do not necessarily reflect Haig-Simons income[260] because the OID

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[254] I.R.C. § 172.

[255] Recall that, at one time, it was unclear whether a corporation could create OID by issuing new debt in exchange for stock or debt. *See supra* part III.A.1. The current OID rules are clear that new debt issued in exchange for property, including debt or stock of the corporate issuer, can bear OID. OID equals the stated redemption price of the debt less the Issue Price of the debt. I.R.C. § 1273(a)(1) (2000). The stated redemption price of the new debt is the amount payable at maturity plus certain stated interest. I.R.C. § 1273(a)(2) (2000). The Issue Price of the new debt is determined under I.R.C. § 1273(b) (2000). The Issue Price of the debt is its value or the value of the property for which it is traded (including the outstanding debt or stock of the issuer) if the debt or the property is publicly traded or the debt is issued for cash. I.R.C. § 1273(b) (2000).

[256] Weisbach, *Interest Accrual*, *supra* note 250.

[257] *Id.* at 39.

[258] For an explanation of the put-call parity theorem, see Pratt, *Debt-Equity Distinction*, *supra* note 243, at 1077-78.

[259] *Id.* at 41. "Any distinction between fixed and contingent returns on assets is undermined by modern financial theory." *Id.*

[260] The Haig-Simons formula is one expression of a comprehensive income tax base. Under the Haig-Simons formula, income equals the sum of (1) the taxpayer's consumption during the period and (2) the taxpayer's change in wealth during the period. See Robert M. Haig, *The Concept of Income--Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 7 (Robert M. Haig ed., 1921), *reprinted in* AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl Shoup

rules do not take into account events that occur after issuance, such as interest rate fluctuations and changes in the creditworthiness of the corporate issuer.[261] The OID rules are more likely to reflect reality than the ratable interest accrual rules they replaced,[262] but clientele effects and tax trading may prevent the OID rules from collecting revenue consistent with this reality.[263] The OID rules also include discontinuities that provide taxpayers with opportunities to engage in tax-motivated transactions.[264] They are also incredibly complex and may result in a loss of tax revenue.[265]

Professors Bankman and Klein have also argued that the ex ante method used to calculate OID deductions is inaccurate.[266] The OID approach accrues interest at a constant yield-to-maturity.[267] Bankman and Klein demonstrate that this ex ante approach to accruing interest does not take into account the term structure of interest.[268] If short term interest rates and long term interest rates differ, using the constant-rate yield-to-maturity method mismeasures the annual interest accruals. For example, if long-term rates are higher than short-term rates, the OID accrual method understates the accrual of interest on the front end of the

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eds., 1959); HENRY SIMONS, PERSONAL INCOME TAXATION 50 (1938). Expenditures incurred to produce income are not classified as consumption and are excluded from the base. Personal expenditures, which are characterized as "consumption," are included in the base. *See, e.g.*, Alvin C. Warren, Jr., *The Corporate Interest Deduction: A Policy Evaluation*, 83 YALE L.J. 1585,1591 (1974) (defining consumption as "the use of wealth for personal gratification" or "the destruction of economic resources") (citing George F. Break, *Capital Maintenance and the Concept of Income*, 62 J. POL. ECON. 48, 52 (1954)).

[261] *Id*. at 41.

[262] *See* Canellos & Kleinbard, *supra* note 102, at 565.

[263] Weisbach, *Interest Accrual*, *supra* note 250, at 42-43.

[264] *Id*. at 43.

[265] *Id.*

[266] Joseph Bankman & William A. Klein, *Accurate Taxation of Long-Term Debt: Taking Into Account the Term Structure of Interest*, 44 TAX L. REV. 335 (1989).

[267] I.R.C. § 1272(a)(3) (OID for each period is computed by multiplying the Adjusted Issue Price of the debt by the yield-to-maturity of the debt). Treas. Reg. § 1.1272-1(b)(1)(i) provides that a debt instrument's yield to maturity is "the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument." The rate is a constant rate. *Id.*

[268] Bankman & Klein, *supra* note 266, at 335.

loan and overstates the accrual of interest on the back end of the loan.[269] If short-term rates are higher than long-term rates, the OID accrual method overstates the accrual of interest on the front end of the loan and understates the accrual of interest on the back end of the loan.[270] The mismeasurement of the interest increases as the term of the loan increases and the differential between short and long term rates increases.[271]

Although the OID rules might seem, in theory, to more accurately measure income than the ratable allocation of interest method the OID rules replaced, Bankman and Klein argue that no ex ante method can, in all circumstances, measure interest accrual accurately. Only an ex post system, such as a mark-to-market system, can measure interest accrual accurately.[272]

Consider how corporate debt discharge would be treated in a mark-to-market system.[273] Corporate debt discharge at a discount increases the balance sheet net worth of the corporation's shareholders, so it might seem at first that such a debt discharge would increase the value of the corporation's outstanding stock and result in income. The overall effect of the debt discharge, however, depends on the context within which the discharge occurs. Consider the following example:[274] Assume that Corporation Y, in an earlier year, issued $10x

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[269] *Id.* at 338.
[270] *Id.* at 341.
[271] *Id.* at 339.
[272] *Id.* at 348.
[273] *See e.g.*, Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration Proposal*, 50 TAX L. REV. 265 (1995) (proposing a mark-to-market system to replace the corporate tax). Note that, under a mark-to-market system, such as the system proposed by Professor Dodge, "[t]he distinction between debt and equity would disappear for stock subject to the mark-to-market regime, because neither dividends nor interest would be deductible. . . ." *Id.*
[274] This example is loosely based on an example in Miller, *supra* note 1, at 22. Miller's example assumes that the bonds in the example are perpetuities, in order to simply the present value calculations. Miller uses this example to explain why he thinks that *Kirby Lumber* was wrongly decided:

> The Internal Revenue Service . . . and the Supreme Court both seem to have been mesmerized in *Kirby* by the rise in book net worth that must occur under the conventions of double-entry bookkeeping whenever securities are retired at prices less than those at which they originally entered the company's books. Those gains must get to the net worth account somehow; otherwise the books won't balance. Unhappily, the only route to net worth the Bureau and the Court could seem to find at the time led through the income account. Nowadays accountants just

of bonds bearing 5% interest. Interest rates later increase to 10%. The managers of Corporation Y decide to discharge the old bonds in exchange for $5x of new bonds bearing 10% interest. Although the discharge of the old debt reduces the liabilities on the corporation's balance sheet by $5x, the corporation's annual interest obligation has not changed.[275]

The reduction in debt liabilities from $10x to $5x increases the shareholders' balance sheet net worth by $5x, but that does not necessarily translate into an overall increase in the value of the stock because of the context within which the debt discharge occurs. In the example, the old debt declines in value because interest rates have increased from 5% to 10%. In other words, the corporation's cost of capital has increased. The increase in interest rates means that, other things being equal, the value of the stock declines as well, since the value of the stock is, in theory, the sum of the present values of the future cash flows of the corporation. An increase in interest rates means that the discount rate used to compute those present values is higher and the stock is therefore worth less.[276] This decline in the value of the stock from the interest rate increase offsets the increase in the value of the stock attributable to the debt discharge. A mark-to-market system would take into account the multiple effects of the interest rate increase, not just the balance sheet increase in shareholder net worth that results from the debt discharge.

The conventional wisdom is that a substitution of liabilities approach is wrong and the hypothetical cash issuance approach is correct, but this argument boils down to an argument for a comprehensive, consistently applied theory of

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> treat the net worth write-ups following debt retirements as "extraordinary items," which is to say, they just post them to net worth directly.

Id. at 23. Miller argues that the debt discharge in *Kirby Lumber* should have resulted in no income, just as a corporate repurchase of stock for less than the issue price of the stock results in no income. In other words, he argues that the tax treatment of debt retirements should be the same as the tax treatment of stock repurchases. Miller concluded that the court in *Kirby Lumber* "blew it because our corporate law then, as now, regards debt and equity as fundamentally distinct species (in contrast to modern finance theory, which treats them as basically equivalent sources of 'capital' for most, though certainly not all, purposes)."

[275] If the bonds have a fixed maturity, the annual interest payments the corporation owes could vary after the discharge of the old debt. *Id.* at 23.

[276] For a discussion of valuation and the calculation of present value, see WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION & FINANCE: LEGAL AND ECONOMIC PRINCIPLES 305-07 (2000).

COD income. We may, however, not want to apply a single COD income approach to all debt discharge transactions, regardless of the circumstances in which the debt is discharged. We might, instead want to determine the tax consequences of various types of debt discharge by applying an economic efficiency norm.

B. The economic efficiency approach.

When tax commentators argue that economically similar transactions should be taxed in a similar fashion, they are expressing the idea that our tax system should have the property of "consistency."[277] As Professor Strnad has observed, a tax system has the property of consistency only if the system provides a unique tax treatment for any possible cash flow pattern.[278] Our corporate tax system includes a distinction between debt and equity, which creates a discontinuity. Given this debt-equity distinction, how should we treat the exchange of new debt or stock for old debt? Should it be subject to a substitution of liabilities/subscription price model or to a hypothetical cash issuance model? And should the answer depend on the circumstances of the particular transaction?

Professor Weisbach argues that we should not resolve these sorts of questions by reference to the heuristics of the comprehensive tax base or horizontal equity.[279] He argues that we should determine the tax treatment of the transaction in question by attempting to minimize efficiency losses[280] keeping in mind the second-best setting in which the issue arises.[281] For example, Weisbach

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[277] Strnad, *supra* note 26. Professor Strnad has observed that a good tax system displays the properties of "universality," "consistency," "linearity" and "continuity." *Id.* at 572, 573 and 576. A tax system has the property of universality only if the system specifies the particular treatment for any possible transaction. *Id.* at 572. A tax system has the property of consistency only if the system provides a unique tax treatment for any possible cash flow pattern. *Id.* at 573. A tax system has the property of linearity if "the tax on any transaction equals the sum of the taxes on any collection of subtransactions that comprise that transaction." *Id.* at 576. A tax system has the property of continuity if nearly identical portfolios have nearly identical tax consequences. *Id.*

[278] *Id.* at 573. If a tax system has the property of consistency, "it is not possible to manipulate tax outcomes by repackaging cash flows into different financial vehicles." In a second-best world, a tax proposal has to be considered in light of discontinuities that the policymaker cannot eliminate. *Id.* at 553.

[279] Weisbach, *Interest Accrual*, *supra* note 250, at 44.

[280] *Id.* at 45.

[281] The theory of the second best posits that, in a world with multiple distortions, eliminating an economic distortion does not necessarily increase efficiency because of the effects of other remaining distortions. Lipsey & Lancaster, *supra* note 25.

advocates use of this approach to characterize hybrid securities as either debt or equity for tax purposes.[282]

Since the corporate tax creates known distortions and use of debt in a corporation's capital structure operates as a form of do-it-yourself integration, we might at first think that debt-equity line drawing questions should favor debt classification.[283] Weisbach cautions, however, that we must also consider the effects of the debt-equity classification on the costs of financial distress and related costs.[284] Gergen and Schmitz, in their analysis of the classification of hybrid securities as debt or equity, consider the effects of the debt-equity distinction on capital structure decisions.[285] In particular, they consider the tradeoff between the tax shield provided by debt and the increase in expected costs of financial distress that results from the use of debt in the capital structure.[286]

The current approach for determining COD income in debt-for-debt and stock-for-debt exchanges fails to take into account the economic effects of such rules on capital structure decisions. In particular, the current approach fails to take into account the costs of financial distress when corporations choose to use debt instead of equity in their financial structure. This oversight is more problematic where the corporation exchanging new stock or debt for outstanding debt is financially troubled.

Numerous studies have estimated the costs of financial distress generally. The estimates in these studies vary greatly. Some studies consider only the direct costs of bankruptcy, including legal and administrative fees and professional fees for lawyers, accountants and other professionals involved in the bankruptcy.[287]

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[282] Weisbach, *Efficiency Analysis*, *supra* note 23, at 80.
[283] *Id.*
[284] *Id.*
[285] Gergen & Schmitz, *supra* note 24, at 189-91.
[286] *Id.* Weisbach later argued that the approach used by Gergen & Schmitz should be refined. Weisbach, *Efficiency Analysis*, *supra* note 23, at 81. Specifically, Weisbach argued that: (1) Gergen & Schmitz looked to the elasticities of the underlying economic arrangements, but should have considered the elasticities of the MIPS themselves; (2) Gergen & Schmitz used uncompensated elasticities in their model, but should have used uncompensated elasticities; and (3) Gergen & Schmitz considered bankruptcy costs but should also have considered related issues such as the effect of debt on the monitoring of corporate managers. *Id.* at 81.
[287] *See, e.g.*, Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285-86 (1990) (estimating direct costs of

Other studies include indirect costs, which include various opportunity costs, such as lost sales, lost profits, or the increased cost of obtaining credit.[288]

Some economists have argued that the costs of financial distress are generally insignificant when compared to the tax savings achieved from the interest deduction,[289] but other economists have concluded that the costs of financial distress are quite significant.[290] Andrade and Kaplan conclude that, even if the costs of financial distress are 10 to 25 percent of firm value, the ex ante expected costs of financial distress are small for most public companies because the probability of financial distress is small for such companies.[291] The expected costs of distress are therefore generally trivial when compared with the tax and incentive benefits of debt.[292]

On the other hand, the expected costs of financial distress are higher for distressed companies that are restructuring. The managers of a company that is restructuring due to financial distress must make new capital structure decisions. For such a distressed company, the expected costs of financial distress are much higher because the probability of future, post-reorganization distress is much higher than it is for companies generally. Companies that emerge from a bankruptcy restructuring with high leverage ratios run an increased risk of a

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bankruptcy based on a study of 37 firms).

[288] *See, e.g.*, Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1087 (1984) (indirect bankruptcy costs are significant and must be considered, despite the fact that indirect costs are difficult to measure).

[289] *See* Robert A. Haugen & Lemma W. Senbet, *The Insignificance of Bankruptcy Costs to the Theory of Optimal Capital Structure*, 33 J. FIN. 383, 384 (1978) (arguing that the costs of financial distress are insignificant when compared to the value of the tax shield). *See also* Lawrence A. Weiss, *Bankruptcy Resolution*, 27 J. FIN. ECON. 285, 286 (1990) (direct bankruptcy costs average 3.1% of the firm's book value of debt plus the market value of equity and have no significant effect on capital structure decisions).

[290] *See, e.g.*, Altman, *supra* note 288, at 1087 (combined direct and indirect bankruptcy costs of firms in the study averaged between 11% and 17% of firm value prior to bankruptcy, with the costs exceeding 20% of the value of the firm in many cases).

[291] Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443, 1488-89 (1998).

[292] *Id.* Debt in a firm's capital structure can provide benefits in addition to the interest deduction. For example, debt may help to monitor and discipline managers and may provide valuable information to investors. *See* Milton Harris & Artur Raviv, *Capital Structure and the Informational Role of Debt*, 45 J. FIN. 321 (1990). These benefits of debt also should be considered, in addition to the costs of financial distress.

repeat failure.[293] In addition, complex financial structures increase both the risk and costs of financial distress.[294]

We could adopt specific COD income rules for distressed corporations that take into account the higher costs of financial distress for such firms. For example, we could adopt rules that encourage the issuance of new stock and discourage the issuance of new debt in bankruptcy restructurings.[295] Said another way, we could create COD income rules that treat stock-for-debt exchanges more favorably than debt-for-debt exchanges.[296]

Mark Roe and Lucian Bebchuk, among others, have argued that bankruptcy law should encourage or require distressed debtor corporations to adopt capital structures with little or no debt.[297] It is costly and difficult for firms to reduce their debt in a restructuring, for a variety of reasons:[298]

> To get their debt levels down, financially distressed firms must either persuade creditors to write down their claims, or retire the debt by selling assets and/or new securities. However, for a number of reasons these options may be quite costly: firms cannot unilaterally force a

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[293] Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. OF FIN. 161, 166-67 (1997). *Compare* Lynn M. LoPucki & Joseph W. Doherty, *Why are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933, 1969 (2002) (firms that re-filed for bankruptcy protection, after a bankruptcy reorganization, had higher leverage than reorganized firms that did not fail, but the difference was not statistically significant).

[294] LoPucki & Doherty, *supra* note 293, at 1953. *See also* David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309, 319 (2001) (complexity of capital structure may account for higher failure rates in Delaware). The tax law debt-equity distinction and the "designer" hybrid securities it has spawned (such as MIPS), have increased complexity in corporate capital structures.

[295] In addition, we might want to encourage voluntary out-of-court workouts, so that corporate debtors can reduce the transaction costs of their restructuring.

[296] In the early 1990s, after the repeal of I.R.C. § 1275(a)(4) but before the repeal of the stock-for-debt exception to COD income, we had a set of COD income rules that favored stock-for-debt exchanges over debt-for-debt exchanges.

[297] Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 559 (1983) (advocating an all equity structure for corporate debtors emerging from chapter 11); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

[298] Gilson, *supra* note 293, at 162.

> financial settlement on all creditors, giving individual creditors an incentive to hold out; various regulations discourage institutional lenders from writing down their principal or exchanging debt for equity; income from debt forgiveness is taxed; managers have much better information than outsiders about the firm's business prospects; and financially distressed firms may be forced to sell assets at fire sale prices (or be unable to find buyers at any price, e.g., because their whole industry is depressed).[299]

Under the current tax approach to COD income, attribute reduction, and OID, corporations have an incentive to issue debt in a bankruptcy restructuring.[300] In addition, the debt may be in the form of a hybrid debt instrument that results in a more complex capital structure.[301] The § 108 rules that permit corporations to exclude COD income also create an incentive for a debtor corporation to reorganize in a bankruptcy proceeding instead of out of court.[302] (The fact that a modification of outstanding debt is treated like a debt-for-debt exchange adds to

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[299] *Id.*

[300] Firms can reduce the COD income generated in the restructuring by leaving the high level of pre-restructuring leverage in place. Gilson notes that firms "have an incentive to keep their debt high to avoid creating COD income. Anecdotal evidence suggests that many reorganizations are structured to minimize the amount of taxable COD income that is generated." Gilson, *supra* note 293, at 171. Where the restructuring creates COD income that reduces the debtor corporation's NOLs, there is a tax incentive to issue debt in the restructuring, in order to create deductions that can shield post-restructuring income from tax.

[301] For example, various particular types of hybrid instruments, such as MIPS, are designed to be characterized as debt for tax purposes, but to be treated as equity for other purposes, including certain regulatory purposes.

[302] Debtors have an incentive to file a bankruptcy petition in order to qualify for the blanket exclusion of COD income in § 108(a)(1)(A), instead of relying the § 108(a)(1)(B) insolvency exception, which requires a valuation and creates uncertainty. I.R.C. § 108(a)(1)(A) and (B). The conventional wisdom is that we should encourage out-of-court workouts instead of Chapter 11 bankruptcy restructurings. *See, e.g.*, Miller, *supra* note 1, at 22. Bankruptcy commentators agree that distressed firms wait too long before filing a bankruptcy petition. Barry E. Adler, *The Law of Last Resort*, 55 VAND. L. REV. 1661, 1694-95 (2002). By the time the debtor corporation files the petition, it has already lost much of its value. *Id.* On the other hand, Stuart Gilson has argued that transaction costs are lower in bankruptcy restructurings than in out-of-court workouts. Gilson, *supra* note 293, at 163 (listing five reasons why transaction costs are lower in Chapter 11). In addition, companies that restructure out of court reduce their leverage ratios less than companies that restructure in a bankruptcy proceeding. *Id.* at 162.

the incentive to file a bankruptcy petition.) Also, § 382 generally limits a corporation's utilization of its net operating losses after an ownership change (a 50% shift in equity ownership),[303] but special rules apply where the corporation is reorganized in a bankruptcy proceeding.[304] The § 382 rules discourage debtor corporations from issuing stock thatwould trigger an ownership change.

Merton Miller, a Nobel Laureate economist, argues that tax commentators have gotten the corporate COD income rules wrong.[305] In Miller's view, the current tax incentives do not make sense from an economic perspective because they create obstacles to voluntary restructurings.[306] Miller concludes that "if the parties can reach a voluntary agreement (achieving thereby what economists dub a 'pareto-improving solution'), surely wise social policy should smile, not frown, on their efforts."[307]

How could we alter the current COD income rules to promote economic efficiency?[308] We could encourage distressed corporations to emerge from bankruptcy with more stock and less debt in their capital structures by favoring stock-for-debt exchanges over debt-for-debt exchanges. For example, we could reinstate the set of COD rules that were in effect after the 1990 repeal of § 1275(a)(4) but before the repeal of the stock-for-debt exception. Perhaps we should also encourage voluntary out-of-court workouts by providing that debt modifications will not generally be treated as a debt-for-debt exchange. If we were prepared to be more radical, we could equate the corporate treatment of

[303] I.R.C. § 382(a), (d), and (g)(1) (2000).
[304] I.R.C. § 382(l)(5) and (6) (2000).
[305] Miller, *supra* note 1, at 22.
[306] *Id.* at 20.
[307] *Id.* (emphasis omitted).
[308] As Professor Weisbach has observed, the calculation of efficiency losses is more precisely the work of economists than of legal academics. Weisbach, *Interest Accrual*, *supra* note 250, at 48. On the other hand, the tax law should probably: (1) distinguish, for purposes of the creation of COD income, between debt discharge by solvent and insolvent debtors; (2) encourage early resolution of financial distress by minimizing the tax cost of restructuring in such cases; and (3) encourage distressed corporations to reduce the amount of debt in their capital structure during the restructuring. Using the hypothetical cash issuance model to determine COD income in stock-for-debt and debt-for-debt exchanges, and failing to distinguish between solvent and insolvent debtors, likely does more harm than good.

interest and dividends and repeal § 61(a)(12) for a corporation's dealings in its own debt securities, as Merton Miller has suggested.[309]

More generally, this Article illustrates the danger of tax commentators creating tax rules in isolation, based on theoretical norms such as the comprehensive tax base norm or horizontal equity norm, without sufficient concern for the economic effects of those tax rules. The repeal of the debt-for-debt exception and stock-for-debt exception made sense to tax commentators and the Treasury Department because the repeal was consistent with the horizontal equity norm. On the other hand, the repeal baffled economists[310] and the bankruptcy and bankruptcy tax bar[311] and occurred without their participation.[312]

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[309] Miller, *supra* note 1, at 22.

[310] *Id.*

[311] Lee A. Sheppard, *Cold Comfort: Determining Tax Liability In Bankruptcy*, 91 TAX NOTES TODAY 162-6 (August 2, 1991):

> [O]ne telling exchange concerned the recent repeal of section 1275(a)(4), a subject that frustrates and baffles bankruptcy lawyers. Andrew Dubroff, an attorney-advisor in Treasury's Office of Tax Legislative Counsel, sought to justify repeal on the grounds of proper income measurement and the notion that the section 108 exclusions from cancellation of indebtedness income constitute a subsidy. "Subsidy? How do you think a creditor feels?" Alan Miller of Weil, Gotshal & Manges reacted. "The tax hit comes to the creditor on top of having to write down the debt. It is the creditors who are subsidizing the government," said Miller, who handled the Drexel Burnham Lambert bankruptcy. Dubroff replied that the government is an involuntary creditor; moreover, the creditor is allowed to recognize a tax loss for writing down the debt.

[312] Paul Asofsky and others have drawn attention to the defects in the process used to enact the repeal. *See, e.g.*, Asofsky, *supra* note 76. The repeal was, at least in part, the result of last-minute political horse trading that was designed to fund special interest legislation. *Id.* at 13-32. For example, the provision repealing the stock-for-debt exception was added to fund an investment tax credit for intermodal cargo containers. Asofsky calls this provision "a rancid piece of political pork." *Id.* Asofsky compares the recent process to the process used to enact the Bankruptcy Tax Act of 1980. In the late 1970s, tax and bankruptcy experts worked together to fashion those changes in the tax law. The process used to enact the Bankruptcy Tax Act of 1980 stands as an example of good tax legislation, because of the full participation of all interested parties. *Id.* at 13-14. "The Bankruptcy Tax Act was not a perfect statute, but it is a model piece of legislation. It was the product of extended study and debate, and it represented a rational compromise of competing views and interests." *Id.* Asofsky has argued that the process that has been used to change the tax treatment of COD income since 1980 has been

V. CONCLUSION.

Early case law adopted a substitution of liabilities approach to COD income in debt-for-debt and stock-for-debt exchanges.[313] Over time we replaced the substitution of liabilities approach with a hypothetical cash issuance approach.[314] The conventional wisdom among tax commentators is that this change in the COD income rules was justified by a comprehensive tax base norm or horizontal equity norm.[315]

Other approaches are, however, also defensible under the comprehensive tax base or horizontal equity norm. This Article highlights the connection between COD income rules and OID rules and considers the implications of the error correction function of the COD income rules. The earlier substitution of liabilities approach to COD, or a variation known as subscription price theory, can be reconciled with the theory underlying existing COD income doctrine, although it may require a different sort of error correction device than we currently employ.

If we equated the interest and dividend treatment of corporate issuers, corporations arguably should not have income from debt discharge, just as they currently have no income from dealings in the corporation's own stock. Even if we retain the corporate interest deduction in its current form, we could fashion a different error correction device that requires interest deduction recapture in stock-for-debt exchanges. In debt-for-debt exchanges, we could reinstate the carryover issue price rule that precludes COD income where the face of the new debt at least equals the face of the old debt. The notion of a comprehensive tax base does not preclude a transactional approach to COD income in debt-for-debt and stock-for-debt exchanges.

In addition, it may be preferable, from a normative perspective, to apply principles of economic efficiency to determine the tax rules for calculating COD income in debt-for-debt and stock-for-debt transactions.[316] Professor Weisbach has argued that we should determine the tax consequences of various types of

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seriously flawed. He takes the position that, since that time, Congress has, with little debate, consideration, or public comment, gradually eviscerated the provisions of the Bankruptcy Tax Act. *Id.* at § 13.01.

[313] *See infra* Part III.

[314] *Id.*

[315] *See, e.g.*, Kies, *supra* note 157.

[316] *See infra* Part IV.B. 1. and 2.

transactions by attempting to minimize deadweight losses.[317] The issue is complicated because of the second-best setting in which the issue arises. The hypothetical cash issuance model is designed to produce consistency in the treatment of debt discharge, but this model may increase economic distortions caused by the debt-equity distinction. For example, using the hypothetical cash issuance model to determine COD income in debt-for-debt and stock-for-debt exchanges may increase the costs of financial distress, especially where the corporate issuer is financially troubled[318] Congress adopted the hypothetical cash issuance model without sufficiently considering the economic effects of the new tax rules on workouts and bankruptcy restructurings.

[317] Weisbach, *Line Drawing*, *supra* note 23; Weisbach, *Efficiency Analysis*, *supra* note 23.
[318] *See infra* Part IV.B.2.