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## ***Ways and Means "Discussion Draft" proposes major changes to taxation of financial products***

*February 12, 2013*

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### ***In brief***

The House Ways and Means Committee on January 24 released a "Discussion Draft" of a bill to reform the taxation of financial products. Following a comment period (for which no deadline has been set), a revised version of the Discussion Draft is expected to be considered later this year by the Ways and Means Committee as part of a comprehensive tax reform bill, addressing individual, corporate, and international tax provisions.

The Discussion Draft proposals would most significantly impact taxpayers that execute financial transactions as part of a trading or investment strategy, such as hedge funds, mutual funds, and individual investors/traders. Specifically:

- An investor/trader would be required to mark-to-market on an annual basis all "derivatives" (broadly defined) in the taxpayer's portfolio. The resulting income or loss would be ordinary.
- A taxpayer no longer could specifically identify by "lot" the security that it sells for purposes of determining cost basis. Instead, the proposal requires that cost basis be computed under an "average cost" methodology.
- Taxpayers would be required to accrue market discount into income on a current basis.

The mark-to-market proposal for derivatives also would impact businesses that use financial products to manage currency, interest rate, and price risk. However, the proposal provides an exception to the mark-to-market regime for transactions that qualify as tax hedges. In defining this hedging exception, the proposal provides relief from the current-law requirements for making tax-specific identifications of hedges. Specifically:

- The proposal effectively deems a tax hedge identification to have been made in situations where the transaction is properly treated as a hedging transaction in a taxpayer's audited GAAP financial statements.

The Discussion Draft also contains a proposal applicable to publicly traded debt that is modified. This proposal lessens the likelihood that an issuer would recognize 'phantom income' when the debt is modified, but it also has the potential of applying to an investor/trader that holds the debt.

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The Discussion Draft is of limited significance to the derivative dealer community that already marks-to-market derivatives and generates ordinary income/loss. However, financial intermediaries could be impacted significantly if the legislation is accompanied by increased reporting obligations (e.g., reporting of values for the derivative mark-to-market proposal and/or average cost basis).

Note that the Discussion Draft does not address the international sourcing of income from financial instruments. Presumably, the current residence-based sourcing for derivatives would be the starting point for any future discussion of sourcing, informed by the Section 871(m) legislative changes for dividend equivalents.

Ways and Means Chairman Dave Camp (R-MI) has indicated that he intends the forthcoming comprehensive tax reform bill to be revenue-neutral. Thus, specific provisions of the financial product Discussion Draft ultimately could be included (or dropped) as necessary to achieve revenue neutrality within this larger bill. Also, because each proposal in the Discussion Draft is fairly discrete and could be enacted separately without impacting the other proposals, some pieces of the Discussion Draft might be proposed to be included in other tax bills as revenue raisers.

As the name suggests, the Discussion Draft is designed to begin a conversation regarding the proposals. Interested taxpayers are encouraged to familiarize themselves with the proposals so that they can engage in the policy discussion. To that end, we have summarized the most important aspects of the proposals below and offer some preliminary observations.

We have arranged our discussion of these proposals according to the type of taxpayer affected: (1) investors/traders, (2) business hedgers, and (3) borrowers/lenders in debt work-out settings.

Please feel free to reach out to your PwC contact (or any of the professionals listed at the end of this piece) to discuss any aspects of the Discussion Draft in more detail.

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## ***In detail***

### ***1. Provisions applicable to investors/traders***

The Discussion Draft most heavily impacts taxpayers that execute financial transactions as part of a trading or investment strategy. Specifically, the Discussion Draft contains: (a) a Derivative Mark-to-Market Proposal, (b) an Average Cost Basis Proposal, (c) a Market Discount Proposal, and (d) a variety of miscellaneous proposals addressing wash sales, bond premium, and short-term government obligations. Each proposal is discussed below.

### ***a. The Derivative Mark-to-Market and Mixed Straddle Proposals***

#### **Summary of Proposals**

Investors/traders would be required to mark-to-market all "derivatives" (broadly defined) in their portfolio on an annual basis, effective for derivatives entered into after December 31, 2013. Any income resulting from the deemed disposition would be ordinary (not capital gain). Likewise, any losses would be ordinary, and generally deductible without restriction. (Thus, the proposal would repeal the 60% long term/40% short term capital gain treatment generally afforded to futures contracts and other Section 1256 contracts.)

Furthermore, if a derivative substantially diminishes risk with

respect to a publicly traded nonderivative position that is held by the taxpayer (i.e., if a derivative "straddles" an actively traded nonderivative), built-in gain on the nonderivative would be recognized immediately. This gain on the nonderivative would be capital gain. (Built-in loss, however, would not be recognized by reason of the mark-to-market regime, but would be suspended until the position is disposed of, retaining its capital loss character.)

Thereafter, for so long as the derivative and nonderivative are held together as a so-called "mixed straddle," both positions (including the nonderivative) would be marked-to-market on an annual basis, each generating ordinary income/loss. As under current law, the holding period

of the nonderivative would be suspended while it is part of a mixed straddle.

### **Commentary/Observations**

**Eliminates distinctions, but retains fundamental choice of law.** Currently, the taxation of financial products depends on a number of variables — the instrument (e.g., swap vs. futures contract vs. forward vs. option); the taxpayer's role in the marketplace (e.g., dealer vs. trader vs. investor vs. hedger); the underlying asset (e.g., foreign currency vs. commodities vs. equities); and the tax environment (e.g., controlled foreign corporation vs. domestic corporation). The Derivative Mark-to-Market Proposal eliminates many of these longstanding distinctions under current law. It generally would eliminate the current tax distinctions between most derivative financial instruments, and would tax derivative dealers, traders, and investors in the same manner.

In this regard, the proposal can fairly be described as reducing the legal complexity surrounding the taxation of a large number of financial instruments. Taxpayers would be offered a simple choice, based on two different transactional patterns with meaningful legal and economic distinctions: (a) to achieve realization-based capital gain/loss, taxpayers can purchase the security directly, or (b) to achieve mark-to-market ordinary income/loss, taxpayers should obtain their economic exposure via a derivative.

**Taxation without cash.** Obviously, a mark-to-market regime can operate to impose a tax on economic gains before a taxpayer has the cash to pay the tax. Presumably, this departure from longstanding realization principles is deemed justified as necessary to simplify the tax code while simultaneously "reflecting economics." However, this approach

would impose burdens on taxpayers who may be forced to liquidate positions to pay tax.

This burden would be most acute where a derivative relates to non-publicly traded property (such that it is difficult to exit), and in situations in which a taxpayer is unable to implement its desired investment strategy without derivatives but nonetheless is forced to exit a position before a strategy has fully run its course. It is also possible that seasonal tax-based selling (i.e., terminating derivative positions to generate cash to pay tax) could create increased volatility in the financial markets and thereby impose externalities on other market participants.

**Valuation issues.** The proposal introduces a new set of practical and administrative complexities, particularly around valuations. Over the years, the IRS and taxpayers have struggled with valuation issues -- from the ill-fated "Los Alamos project" (in which the IRS hired nuclear physicists in the Los Alamos laboratory to develop a model for valuing derivatives), through the lengthy First Chicago/Bank One litigation, and through the recent liquidity crisis (where markets froze, and valuations were tough to come by).

**Non-publicly traded or illiquid property.** Because the proposal's definition of "derivative" includes positions in non-publicly traded property, the proposal can be expected to increase further the administrative difficulties that the IRS and taxpayers face around valuations. For example, a taxpayer that executes a contract to sell stock in its wholly owned business would be deemed to have executed a derivative (a forward contract) on stock. If the contract is open at year-end, the seller (and the

buyer) would be required to mark-to-market the open contract.

Valuing such a derivative on non-publicly traded property can be extremely difficult, and such information may not always be needed for non-tax business reasons (including financial statement reporting). Disputes may arise with the IRS, as sellers (and buyers) mark-to-market their private contracts at year-end and recognize an ordinary tax loss (albeit a temporary one).

**Publicly traded property.** Valuing derivatives on publicly traded property is not easy. Consider that a swap on 100 shares of stock is priced/valued more easily than a swap on one-million shares -- i.e., a taxpayer unwinding a one million share long position would receive less per share than a taxpayer unwinding a 100 share long position. The proposal seems to indicate that the IRS should issue regulations providing that volume is to be disregarded when determining valuation. Perhaps this rule is intended to make the valuation exercise simpler, but it might cause a taxpayer to recognize gain on income it may never earn/receive simply because of the size of its position.

**Potential use of financial statements.** The proposal also allows the IRS to issue regulations that would determine fair market value by reference to the valuations a taxpayer uses in reports or financial statements provided to partners, shareholders, or lenders. However, the IRS historically has been hesitant to adopt such an approach in other mark-to-market regimes (e.g., Section 475), and so it is not clear whether such regulations would be forthcoming if not required by statute.

**Reporting/consistency issues.** The importance of valuations raises a series of other administrative questions that would need to be

addressed (in regulations or by statute). For example, would brokers be required to report valuations to customers on a Form 1099? (Systems would need to be adjusted to accommodate this practice.) Can (or must) customers rely on the valuations provided in their brokerage statements? What if the customer disagrees with that valuation? It is a fair policy issue to ask whether it is "worth it" to create these predictable administrative burdens to achieve legal simplicity.

**Convertible bonds and contingent debt.** The Derivative Mark-to-Market Proposal requires that the "embedded derivative component" of a debt instrument (including the embedded call option in a convertible bond) be bifurcated from the debt, and marked-to-market by the holder of the instrument. This bifurcation rule would not apply "merely because" the debt instrument is denominated in a foreign currency (FX) or subject to the contingent payment debt instrument (CPDI) rules. However, it could apply to FX debt or CPDIs, and in those situations it is not clear how the rule would impact the holder's interest accruals. For example, under the draft bill, it appears that the holder would accrue interest under the CPDI rules and mark-to-market gain/loss on the embedded derivative component. This result (effectively double counting) should be corrected in subsequent drafts.

**The Mixed Straddle Proposal.** The proposal raises several key issues.

*One-way revenue impact.* First, the proposal undoubtedly would raise tax revenue — when a taxpayer offsets risk of loss in a position in publicly traded property with a derivative, the taxpayer must immediately recognize built-in capital gains (but not losses) in the position. This is a one-way street that favors the government.

*Fairness.* Second, beyond the asymmetry noted above, an issue of fairness may arise. The rule requires taxpayers to immediately recognize built-in gains simply because they have temporarily protected themselves from loss.

For example, consider a taxpayer owning appreciated ABC stock, who, in an effort to protect herself from anticipated short-term volatility in the stock price, buys a one-month put option with a strike price equal to 95% of the current value of the ABC stock. The Mixed Straddle proposal would require her to immediately recognize the built-in gain in the ABC stock -- even if she sold the put option later that same day. Furthermore, the provision would require her to recognize currently (as ordinary income) any appreciation in the stock that occurs while she holds the put option (even if/as this appreciation exceeds the cost of the put option). Thus, the taxpayer would be required to pay tax in advance of receiving cash from a sale, simply because she temporarily reduced her downside exposure.

While taxpayers' sense of fairness ultimately may accept a mark-to-market regime for complex financial derivatives that are held by themselves the Mixed Straddle provision goes further than some may believe appropriate (especially if the transaction does not eliminate all of a taxpayer's economic exposure to a security).

*Complications resulting from dependence on straddle regime.* Third, the proposal is quite complicated, because it hinges on whether there is a "straddle." This depends on whether the derivative "substantially diminishes risk of loss" with respect to the non-derivative. This "substantial diminution" standard has been difficult to apply.

For example, does an interest rate swap substantially diminish risk of loss with respect to a corporate bond? What if one position is bigger than the other? Under the proposal, this determination becomes even more important.

*Too much choice?* Fourth, the proposal provides an interesting (and unprecedented) device for taxpayers with physical, nonderivative positions to seamlessly "toggle" back and forth between two tax regimes (realization-based capital gain/loss vs. mark-to-market ordinary), and the toggle switch depends on the straddle determination.

For example, consider a taxpayer with ABC stock who expects the stock to dip sharply in the coming week, before rebounding. The taxpayer might consider purchasing a one-month put option with a strike price equal to 50% of the current value of the ABC stock. The taxpayer may assert that this is a straddle, so that any depreciation in the stock during the period the option is in place would be currently realized by the taxpayer as ordinary loss (and any subsequent gain would be capital gain).

#### *b. The Average Cost Basis Proposal*

##### **Summary of Proposal**

A taxpayer no longer could specifically identify the specific "lots" of securities that it sells for purposes of determining its cost basis. Instead, the proposal would require that the cost basis of any security sold after December 31, 2013, be computed under an "average cost" methodology. This rule would be applied on an account-by-account basis, such that the basis of securities held in one account would not be averaged with securities held in a separate account. (Any security purchased before the effective date would be treated as held in a separate account.)



Under present law, brokers reporting certain security sales on Form 1099-B also must report the customer's adjusted basis in the security sold and whether gain/loss is long-term or short-term. The seller is not required to use an average cost methodology in computing cost basis.

### **Commentary/Observations**

Currently, if a taxpayer has acquired securities on different dates and at different prices and sells some (but not all) of the securities, the taxpayer can choose to identify which security it has sold when computing gain/loss from the sale. In this way, taxpayers can reduce their income by choosing to identify the security with the highest cost basis. The Average Cost Basis Proposal is designed to remove this electivity. Instead, taxpayers must determine their cost basis in the security sold by means of an average cost methodology.

Under the proposal, average cost basis would be determined on an account-by-account basis. Consequently, if a taxpayer owns securities in more than one account, basis computations would be made separately for securities in each account. One result could be that taxpayers would acquire different blocks of securities in different accounts, or would move securities among accounts or entities to blend the basis in an optimal fashion.

In addition, implementing this new regime could be quite difficult by the proposed effective date. Establishing an average cost approach within the fundamental logic of an information system that currently allows for a specific identification could take more time than may be envisioned.

Presumably, a taxpayer could specifically identify which securities it sells for purposes of determining the holding period of the securities that

are sold. If this is the case, other difficulties could arise, because, in effect, two systems would be needed to track a taxpayer's tax attributes -- one that accommodates specific identifications for purposes of holding period determinations, and one that computes average cost basis.

### *c. The Market Discount Proposal*

#### **Summary of Proposal**

Taxpayers that acquire a market discount bond after December 31, 2013, would be required to accrue market discount into income on a current basis. In situations in which the issuer of the bond is distressed, this accrual would be limited. The proposal provides a precise numerical test to determine when this limitation applies.

#### **Commentary/Observations**

The Discussion Draft generally equalizes the treatment of market discount with original issue discount (OID). Thus, the holder of a market discount bond would be required to apply the constant yield and current accrual rules provided under the statutory OID rules by substituting the holder's acquisition price for the adjusted issue price and the acquisition date for the issue date. The Discussion Draft proposal maintains the status of market discount as gain for certain purposes, such as withholding taxes.

In our view, the policy rationale for differences in treatment between OID and market discount has been difficult to justify. The Discussion Draft generally eliminates the disparate treatment.

The Discussion Draft also provides rules limiting the accrual of income (including interest, OID, and market discount) on distressed debt to certain yield thresholds. This limitation is accomplished by first discounting the

required cash flows under the debt instrument by the greater of (i) the debt's original yield plus 5% or (ii) the AFR as of the date of acquisition plus 10% (the greater of (i) or (ii), the "Distressed Yield") in order to determine an imputed principal amount, and then by applying the Distressed Yield to such imputed principal amount to determine the yield/income limitation.

The proposal appropriately recognizes that the current statutory framework for market discount ought not apply to distressed debt — at least not without modification. Thus, the Discussion Draft is a good first step in progressing toward a more appropriate income regime for distressed debt. At the same time, the methodology in the Discussion Draft likely would need to be modified as follows:

- First, accruing the Distressed Yield on an amount initially equal to the imputed principal amount still may severely distort income if the debt instrument is purchased at an amount well below the imputed principal amount.

For example, assume the holder acquired the instrument for \$20, the Distressed Yield is 15%, and the imputed principal amount is \$70. Assuming no principal payments, the income limitation for the first year would be \$10.50 ( $\$70 \times 15\%$ ). The \$10.50, when compared to the purchase price of \$20, represents a yield of over 50%. In our view, this result was not within the intent of the proposal, and there would be more opportunity for the Distressed Yield to be applied to the actual purchase price of the instrument.

- Second, the formulation in the Discussion Draft does not appear

to be workable for debt instruments that are past due or debt instruments that are in default and can be accelerated. In such cases, the imputed principal amount cannot be determined because all such payments are currently due. This provides an additional reason to apply the Distressed Yield to the actual purchase price of the instrument, which is feasible even where the payments on the debt instrument are currently due.

- Third, in determining the bond's original yield, the rules should provide the manner of measurement for debt instruments that bear interest at a floating rate. Presumably, the bond's original yield for purpose of the calculation should be based on the value of the floating rate at the time of the taxpayer's acquisition and not the value at original issuance.
- Finally, the Discussion Draft does not address the manner to apply the methodology to instruments that are governed by Section 1272(a)(6), such as asset-backed securities. In particular, the determination of the debt instrument's original yield often is problematic because the yields on asset-backed securities can be determined only by utilizing a prepayment assumption. Moreover, the calculation of an imputed principal amount similarly would be difficult as it would require an additional projection of cash flows that are affected by prepayments, and would require adjustments to any accrual schedule used by the holder for non-tax business purposes

(such as financial statement reporting).

Although we believe adjustments are warranted, the Discussion Draft takes an important step in achieving a balanced approach toward the taxation of distressed debt.

#### *d. Miscellaneous proposals*

##### **Summary of Proposals**

The Discussion Draft proposes to expand the wash sale rule by making it applicable to situations in which a taxpayer sells a security at a loss and the security is reacquired by a related party. The Discussion Draft also contains proposals dealing with bond premium and short-term government obligations.

##### **2. Proposals applicable to business hedgers**

The Discussion Draft contains a proposal applicable to businesses that use financial products to hedge their ordinary business operations. Furthermore, the Derivative Mark-to-Market proposal — although clearly designed to impact investors/traders (as discussed above) — also could impact businesses that use derivatives to manage currency, interest rate, or price risk. Each of these aspects of the Discussion Draft is discussed below.

#### *a. The Hedging Proposal*

##### **Summary of Proposal**

In an effort to simplify the tax hedge identification requirement, the proposal deems a tax hedge identification to have been made in situations in which the transaction is properly treated as a hedging transaction in a taxpayer's audited GAAP financial statements. This provision would apply for hedging transactions entered into after December 31, 2013.

#### **Commentary/Observations**

At the outset, it is important to note that the Derivative Mark-to-Market Proposal (described above) would treat all income and loss from derivatives as ordinary. Thus, that proposal would remove some of the practical pressure that is involved in the tax hedge identification process, because a failure to identify a derivative as a tax hedge would not result in a capital loss. (Regardless, taxpayers would still need to monitor compliance with the tax hedge identification requirement so that they do not run afoul of the "Mixed Straddle" proposals.) Thus, the Hedging Proposal is more significant in a scenario in which the Derivative Mark-to-Market Proposal did not become law.

As noted in the overview press release that accompanied the Discussion Draft, the Hedging Proposal is a "taxpayer-favorable proposal [that] would minimize inadvertent failures to identify a transaction as a hedge for tax purposes." Under current rules, it should be noted, an inadvertent failure to identify a tax hedge does not disqualify a transaction from being treated as a tax hedge. If the failure is truly inadvertent, the IRS is required to grant tax hedge status to a transaction.<sup>1</sup>

The proposal also makes the identification regime more administratively manageable. However, the proposal does not fully

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<sup>1</sup> For a fuller discussion of the IRS's recent approach to the inadvertent error exception, see Shapiro & Mou, "Does Section 1256 Incorporate an Inadvertent Error Exception," 128 Tax Notes 1159 (September 13, 2010), 2010 TNT 178-8, Doc. 2010-19516.

adopt a book/tax conformity regime. For example, a US corporation might execute a transaction to manage the foreign currency exchange risk attributable to the net equity of its foreign subsidiary. Although this transaction may be identified (and treated) as a hedge for GAAP purposes, it is not a hedge for tax purposes. The proposal would not change this result.

In addition, taxpayers still would need to be mindful that not all transactions that qualify for tax hedge treatment also would qualify for hedge treatment for book purposes. For example, a transaction may not be an "effective" hedge for GAAP purposes, but still could be viewed as a valid tax hedge. Under the proposal, the absence of a book identification would not preclude the corporation from identifying the transaction as a tax hedge (and in fact, the corporation may be required to do so). To be certain to obtain tax hedge treatment in this case, the taxpayer still would need to make a tax-specific identification. Taxpayers also may want to make a specific tax identification to frame the analysis by which a transaction qualifies as a tax hedge — e.g., transactions involving exposures in disregarded entities.

Thus, although the proposal would eliminate the need for many tax-specific identifications, it would not eliminate the need entirely. Indeed, the infrequent need for tax identifications might have the unintended consequence of increasing the frequency of inadvertent failures to make a valid tax identification.

Under the Discussion Draft, taxpayers that miss tax identifications presumably would receive mark-to-market/ordinary treatment for their derivatives (pursuant to the Derivative Mark-to-Market Proposal) unless they can establish that their failures to

identify were due to inadvertent error. If the derivative is marked-to-market, the position that it offsets also may be marked-to-market under the Mixed Straddle Proposal. Although this may provide a level of symmetry if the hedged item also is a security (such as a foreign currency denominated debt instrument), there still would be risk of substantial timing differences if the underlying is a forecasted exposure.

### *b. The Derivative Mark-to-Market Proposal (as relevant to businesses)*

#### **Summary of Proposal**

As noted above, pursuant to the Derivative Mark-to-Market Proposal, investors/traders would be required to mark-to-market all "derivatives" (broadly defined) in their portfolio on an annual basis. (For a fuller discussion of the proposal, see above.)

#### **Commentary/Observations**

**Potential impact on ordinary transactions.** Importantly, the term "derivative" would include positions in non-publicly traded property. Businesses will want to be mindful of this rule. For example, a contract to sell or purchase the stock of a wholly owned subsidiary would be treated as a derivative and would need to be marked-to-market. This could impact typical business combination and restructuring transactions.

The proposal, if enacted, also could impact other typical business transactions in an unintended fashion. For example, compensatory stock options might need to be marked in situations where an election under Section 83(b) has been made.

**Potential impact on certain debt issuances.** The Derivative Mark-to-Market Proposal requires that the "embedded derivative component" of a debt instrument (including the embedded call option in a convertible bond) be bifurcated from the debt. It

is not clear whether (and if so, how) this proposal applies to the issuer of a debt instrument. (It should be noted that a similar rule applies to issuers for financial statement purposes.) If the rule were to apply to debt issuers, presumably it would operate to create additional deductible interest expense (in the form of OID) for the issuer. It is not clear whether the embedded derivative then would be marked-to-market by the issuer for tax purposes, or how this would interact with the current rules for contingent payment debt instruments.

### **3. Proposals applicable to borrowers and lenders in work-out scenarios**

The Discussion Draft contains a proposal applicable to publicly traded debt that is modified. This proposal has the potential of applying both to the debtor/borrower and to the investor/trader that holds the debt.

#### *a. The Debt Modification Proposal*

#### **Summary of Proposal**

The proposal would amend some highly technical rules to ensure that the debt issuer does not have "cancellation of indebtedness" income if no principal is forgiven in debt modifications occurring after December 31, 2013. However, the amendment also would cause some investors/traders who previously purchased such debt at a discount to recognize 'phantom' income in certain circumstances.

#### **Commentary/Observations**

Under current law, when the terms of a debt instrument are significantly modified (as defined by Treas. Reg. sec. 1.1001-3), the original debt instrument is deemed to be retired for an amount equal to the issue price of the modified debt instrument. The issue price of a debt instrument is dependent on whether it is publicly traded. If it is publicly traded, the

issue price of the debt instrument is its fair market value; if not, the issue price of the debt instrument generally is its face amount.

Consequently, if a publicly traded debt instrument is modified, the deemed retirement price is wholly dependent on the debt's fair market value. Accordingly, even if the lender has not forgiven any actual principal owed by the borrower, the issue price of the modified publicly traded debt instrument will be lower than the issue price of the original debt instrument if the debt instrument has lost value since the loan was originally made (for example, as a result of an increase in interest rates or a decline in the borrower's credit quality).

If the issue price of the modified debt instrument is less than the adjusted issue price of the debt instrument prior to modification, the issuer will have cancellation of indebtedness income even though the borrower still owes the same amount of principal that was owed prior to the modification. The summary description accompanying the Discussion Draft states that this 'phantom' tax "has prolonged and intensified the past several economic downturns, including the recent financial crisis."

As a result, the Discussion Draft eliminates taxable cancellation of indebtedness income for borrowers

(in situations as described above) by providing that the issue price of the modified debt instrument cannot be less than the adjusted issue price of the original debt instrument. This represents a favorable change for many issuers that find themselves in the position of needing to change the terms of their debt when they are in financial distress.

On the other hand, the changes to the modification rules proposed in the Discussion Draft would be unfavorable to certain holders that purchase publicly traded debt in the secondary market when such debt is distressed. In those circumstances, a holder could recognize 'phantom' gain upon a subsequent restructuring of the debt instrument.

For example, assume that a holder acquires a debt instrument for \$35 that initially was issued at par for \$100. The holder and borrower agree to significantly modify the terms of the debt instrument, resulting in a debt-for-debt exchange under Treas. Reg. sec. 1.1001-3 that does not qualify as a tax-free recapitalization under Section 368(a). Under the proposal, even assuming that the fair market value of the debt remains \$35, the issue price of the modified debt would be \$100; there would be no cancellation of indebtedness income to the borrower, but \$65 of 'phantom' gain to the holder.

This 'phantom' gain could cause holders to hesitate to modify such debts, thereby hindering restructuring of troubled businesses. (It should be noted that if the debt instrument in this example were a "security," the holder would not recognize \$65 of income, pursuant to the corporate reorganization provisions of the Code.)

In addition, because the Discussion Draft limits the amount deemed paid on the retirement to no greater than the adjusted issued price of a debt instrument prior to the modification, the proposal would limit loss on restructuring of an above-the-market debt instrument.

***For more information:***

[Click here](#) for a copy of the Discussion Draft -- i.e., the proposed statutory language.

[Click here](#) for a copy of the technical explanation of the Discussion Draft, prepared by the staff of the Ways and Means Committee.

[Click here](#) for a copy of an overview of the Discussion Draft, prepared by the staff of the Ways and Means Committee.

[Click here](#) for a copy of a summary of the Discussion Draft, prepared by the staff of the Ways and Means Committee.



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For a deeper discussion of how the Discussion Draft issue might affect your business, please contact:

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