MEMO# 2585

March 6, 1991

PROPOSED REGULATIONS ON TREATMENT OF DEBT INSTRUMENTS WITH CONTINGENT PAYMENTS ISSUED WITH ORIGINAL ISSUE DISCOUNT

March 6, 1991 TO: TAX MEMBERS NO. 8-91 CLOSED-END FUND MEMBERS NO. 16-91 ACCOUNTING/TREASURERS MEMBERS NO. 8-91 RE: PROPOSED REGULATIONS ON TREATMENT OF DEBT INSTRUMENTS WITH CONTINGENT PAYMENTS ISSUED WITH ORIGINAL ISSUE DISCOUNT ____ The Internal Revenue Service ("IRS") has released the attached amendments to the proposed original issue discount ("OID") regulations under Internal Revenue Code section 1271-1276 regarding the proper tax treatment of debt instruments issued with original issue discount which provide for contingent pay- ments based on the value of publicly traded stock, securities, commodities or other publicly traded property. As you may know, the IRS only recently announced that these amendments would be made. (See Institute Memorandum to Tax Members No. 5-91 and Accounting/Treasurers Members No. 6-91, dated February 22, 1991.) The amendments would apply to any obligation that provides for contingent payments (a "contingent instrument") and that: (1) is issued for cash or publicly traded property; (2) provides for noncontingent payments equal to or greater than the instru- ment's issue price; and (3) provides for one or more contingent payments determined, in whole or in part, by reference to the value of publicly traded stock, securities, commodities or other publicly traded property. Under the amendments, one component of the instrument would be treated as a noncontingent debt obligation. A portion of the issue price of the contingent instrument would be allocated to the noncontingent debt obligation, which would be treated as a normal OID instrument under the general OID rules. The remainder of the contingent instrument would not be treated as debt, but as one or more options or other property rights, and would be taxed as if the property right had been issued separately. In the preamble to the regulations, the Service states that the principle of the amendments could be extended to all convert- ible debt instruments. Currently, the amendments explicitly pro- vide that an instrument will not be subject to the proposed regu- lations as amended solely because the instrument is convertible into the stock or another debt instrument of the issuer, nor if it is subject to a put or call option. The Service invites com- ments on whether these exclusions should be continued or eliminated. In general, the amendments do not apply to a bond denominated solely in a nonfunctional currency with no contin- gency, because the changes in value due to currency fluctuations are not considered contingencies. However, the Service states that it may amplify the contingent interest rules as they relate to currency gains and losses in regulations under Internal Reve- nue Code section 988. Consideration is also being given to extending the amend- ments to instruments on which some or all of the principal is contingent. The Service requests comments on whether contingent principal instruments should be separated into a debt component and components similar to futures or forward contracts. The Ser- vice also asks for comments on the merits of alternative approaches, such as marking to market or marking to the value of the index or property right underlying the contingency ("marking to index"). The amendments will be applicable to debt instruments issued on or after February 20, 1991. Written comments on the amendments to the proposed regulations are due May 3, 1991. Please let us know of any concerns you might have and whether the Institute should submit comments. We will keep you informed of developments. David J. Mangefrida, Jr. Assistant Counsel - Tax Attachments DJM:bmb

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