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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ELIZABETH CHIRICH, LMSB ASSOCIATE AREA COUNSEL (HOUSTON) CC:LM:NR:HOU:2
Attn: Carol Bingham McClure, Special Litigation Assistant

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL CC:FIP

SUBJECT: Payment Made to a Related Entity for Assumption of Debt

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LEGEND

Parent	=
Subsidiary A	=
Subsidiary B	=
Subsidiary C	=
Bank	=
Year 1	=
a	=
b	=

ISSUES

1. Whether Treas. Reg. § 1.61-12(c), as applicable in Year 1, permits Subsidiary C to amortize as bond "premium," within the meaning of Treas. Reg. § 1.61-12(c)(4), a portion of the payment it received in Year 1 from Subsidiary A, a related party, as partial consideration for assuming certain of Subsidiary A's debt obligations.

2. If Subsidiary C were permitted to amortize the portion of the payment representing the bond "premium," whether I.R.C. § 267(a)(2) requires that Subsidiary A must defer its deduction of the payment until Subsidiary C reports the amortized amounts in income.

CONCLUSIONS

1. Based upon the facts provided in the request for Field Service Advice, the payment in issue does not fall within the definition of "premium" as described in Treas. Reg. § 1.61-12(c), as then in effect. Accordingly, Subsidiary C may not rely upon Treas. Reg. § 1.61-12(c) to avoid including in Year 1 that portion (the bond "premium") of the total consideration it received from Subsidiary A in Year 1 for assuming certain of its debt obligations.[1]

[1] We note, however, that depending on the outcome of the additional factual development recommended herein, there may be alternative legal theories the taxpayer (continued...)

2. If Subsidiary C is not required to include the "premium" in gross income in Year 1, we conclude that I.R.C. § 267(a)(2) does not require Subsidiary A to defer its deduction for the "premium" payment.

FACTS

The facts, as set forth in your request for Field Service Advice ("FSA"), are as follows. Parent is a United States corporation with numerous subsidiaries, both domestic and foreign. One of these subsidiaries is Subsidiary A, of which Parent is the sole shareholder. Subsidiary A secures all financing for Parent's U.S. investments, including issuing its own debt securities. Parent guarantees all Subsidiary A debt.

Parent also owns a% of the outstanding shares of Subsidiary B. Bank owns the remaining b%. Subsidiary B is the sole shareholder of Subsidiary C. Subsidiary C's principal business activity is holding and maintaining trust instruments on behalf of Parent's affiliates. All the entities involved herein are domestic corporations. Subsidiary A and Subsidiary C are accrual basis taxpayers. Subsidiary B and Subsidiary C are not part of the consolidated group with Parent.

Subsidiary A during the examination period had outstanding certain publicly held bonds, which it previously had issued at par. These bonds carried a higher coupon rate than the market interest rates prevailing during the years under examination. Interest rates had fallen since issuance of the bonds, causing the value of the bonds to be less to Subsidiary A but more to the bondholders than at the time originally issued. Subsidiary A wanted to eliminate these bonds from its balance sheet, but the bond indenture did not have a call provision. During Year 1, Subsidiary A transferred the bonds to Subsidiary C, along with amounts equaling the bonds' face amount, accrued interest, and a "premium" over face. Subsidiary C thus became liable for payments on the bonds, in the place of Subsidiary A, the original issuer of the bonds. The bondholders did not change.[2]

The "premium" over face is an amount, over and above the face amount of the bonds, equal to the difference between the present value of the bonds at the then prevailing interest rate and the face value of the bonds. The liabilities were originally issued at par; since the interest rates had fallen since then, the bonds were worth more to the bondholders and less to Subsidiary A. The so-called

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[1](...continued)
will assert in support of its position.

[2] For purposes of this memorandum, we assume that this transaction qualifies as an "assumption" of the bonds by Subsidiary C for federal income tax purposes.

"premium" was paid to compensate Subsidiary C for the interest differential in assuming Subsidiary A's bond liabilities.

Subsidiary C used the payment received from Subsidiary A to purchase Treasury securities, which were dedicated to defease (through a trust) the liabilities assumed from Subsidiary A.

For tax purposes, Subsidiary A deducted the entire "premium" amount paid as interest expense in Year 1, the year Subsidiary C assumed the bonds. Subsidiary C, on the other hand, rather than including the "premium" in income upon receipt in Year 1, amortized pro-rata amounts of the "premium" into income over subsequent years.

LAW AND ANALYSIS

Issue 1. Whether Treas. Reg. § 1.61-12(c), as applicable in Year 1, permits Subsidiary C to amortize as bond "premium," within the meaning of Treas. Reg. § 1.61-12(c)(4), a portion of the payment it received in Year 1 from Subsidiary A, a related party, as partial consideration for assuming certain of Subsidiary A's debt obligations.

Section 61(a) provides that, except as otherwise provided in subtitle A, gross income means all income from whatever source derived, including income from discharge of indebtedness. Section 451 provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

In your FSA request, you state that the taxpayer does not contend that I.R.C. § 451 authorizes amortization of the "premium," but rather the taxpayer appears to rely on Treas. Reg. § 1.61-12(c) as authority for deferring the income inclusion.

Treas. Reg. § 1.61-12(c), as in effect for the years in issue

Treas. Reg. § 1.61-12(c)(1) provides that if bonds are issued by a corporation at their face value, the corporation realizes no gain or loss.

Treas. Reg. § 1.61-12(c)(2) provides:

> If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium (as defined in subparagraph (4) of this paragraph), the net amount of such premium,

> excluding any portion thereof which is attributable to a conversion feature of the bond under paragraph (c) of § 1.171-2, is income which should be prorated or amortized over the life of the bonds. If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds.

Treas. Reg. § 1.61-12(c)(4) provides that for purposes of Treas. Reg. § 1.61-12(c), bond "premium equals the excess of the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3) over the amount payable at maturity (or in the case of a callable bond, at the earlier call date)."

The provisions of Treas. Reg. §1.61-12(c) are illustrated by an example set forth in Treas. Reg. §1.61-12(c)(5):

> (i) M Corporation, on January 1, 1946, the beginning of its taxable year, issued for $115,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The bonds were convertible into common stock at the option of the holder. The value of the conversion feature of the bonds, as determined under paragraph (c) of § 1.171-2, is $11,500. The net amount, or amortizable portion, of bond premium which is included in income over the 10-year life of the bonds is $3,500, computed as follows:

Issue price …………………………………………	$115,000
Less: Redemption price…………………………..	100,000
Premium……………………………………………....	15,000
Value of Conversion Feature…………………….....	11,500
Amortizable amount……………………….……….	$ 3,500

> (ii) On January 1, 1950, M Corporation repurchased all of the bonds for a total price of $110,000. M Corporation thereby realized income for the taxable year 1950 in the amount of $3,600, computed as follows:

Issue price	$115,000
Less: Portion of original premium Previously amortized, 1946-1949 (4/10 X $3,500)	1,400
	113,600
Repurchase price	100,000
Income	3,600

Treas. Reg. § 1.61-12(c)(6) provides: "For purposes of this paragraph, a debenture, note, or certificate or other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond."

Treas. Reg. § 1.61-12(c)(7) provides: "For rules relating to amortization of bond discount and the deduction upon repurchase of bonds at an amount in excess of their issue price, see § 1.163-3."[3]

Applying the above law to the facts of the instant case, Treas. Reg. § 1.61-12(c)(1) provides that if bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. The facts set forth in the FSA request state that Subsidiary A during the examination period had outstanding certain publicly held bonds (the bonds in issue), which it previously had issued at par. Accordingly, since the subject bonds were issued at par (that is, at face value[4]), Subsidiary A realized no gain or loss upon their issuance.

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[3] Although not applicable to the years in issue, final regulations were published concerning amortizable bond premium, which harmonize I.R.C. § 171 with the original issue discount (OID) regime. Under the new rules, bond premium generally arises when a holder acquires a bond for more than the principal amount of the bond. Similarly, bond issuance premium generally arises when an issuer issues a bond for more than the principal amount of the bond. Under the final regulations, the holder's treatment of bond premium is addressed in Treas. Regs. §§ 1.171-1 through 1.171-5. The issuer's treatment of bond issuance premium is addressed in Treas. Reg. § 1.163-13. In each case, the amortization of premium is based on constant yield principles. See TD 8746, 62 FR 68173 (December 31, 1997), 1998-1 C.B. 521.

[4] Neither I.R.C. § 61 nor Treas. Reg. § 1.61-12(c) use or define the term "par." However, "par" and "face value" are used synonymously in reference to both bonds and stock in other parts of the Code and in numerous revenue rulings. See, for example, I.R.C. § 247(b)(2) (B). See also Rev. Rul. 84-38, 1984-1 C.B. 250; Rev. Rul. 59-271, 1959-2 C.B. 70.

Under Treas. Reg. § 1.61-12(c)(2), if a corporation issues non-convertible bonds at a "premium" (as defined in Treas. Reg. §1.61-12(c)(4)), the entire premium "is treated as income which should be prorated or amortized over the life of the bonds." Treas. Reg. § 1.61-12(c)(2). According to the facts set forth in the FSA request, the bonds in issue were non-convertible. Therefore, if the bonds were issued at a "premium" (as defined in Treas. Reg. §1.61-12(c)(4)), the entire premium "is treated as income which should be prorated or amortized over the life of the bonds." Treas. Reg. § 1.61-12(c)(2).

Treas. Reg. § 1.61-12(c)(4) provides that for purposes of Treas. Reg. § 1.61-12(c), bond "premium equals the excess of the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232-3) over the amount payable at maturity (or in the case of a callable bond, at the earlier call date)." Since the facts provide that the bonds in issue are not callable, for purposes of Treas. Reg. § 1.61-12(c)(4), any bond "premium" would equal the excess of the "issue price" of the bond over the amount payable at maturity. The facts set forth in the FSA request indicate that the "issue price of the bonds" and "the amount payable at maturity" are the same for purposes of Treas. Reg. § 1.61-12(c). Therefore, the bonds were not issued at a premium for purposes of Treas. Reg. § 1.61-12(c). Moreover, absent further factual development, as discussed below, no part of the payment made by Subsidiary A to Subsidiary C upon the assumption of the bonds in Year 1 falls within the definition of "premium" for purposes of Treas. Reg. § 1.61-12(c).

Thus, we concur with your conclusion that Treas. Reg. § 1.61-12(c), as in effect for the applicable period, does not provide the authority for Subsidiary C to amortize the "premium" it received from Subsidiary A as partial consideration for its (that is, Subsidiary C's) assumption of Subsidiary A's payment obligations under the outstanding bonds.[5]

Issue 2. If Subsidiary C were permitted to amortize the portion of the payment representing the bond "premium," whether I.R.C. § 267(a)(2) requires that Subsidiary A must defer its deduction of the payment until Subsidiary C reports the amortized amounts in income.

In the FSA, you conclude that Subsidiary A properly deducted the amount paid as a "premium" in the year paid as an interest expense and Subsidiary C should include the entire premium in income in the year of receipt. However, if it is determined that Subsidiary C is allowed to amortize the premium, you would like our views on whether I.R.C. § 267(a)(2) requires that Subsidiary A must defer its

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[5] Again, we note that depending on the outcome of the additional factual development recommended herein, the taxpayer may assert alternative legal theories.

deduction of the payment until Subsidiary C reports the amortized amounts in income.

Section 267(a)(2) provides in relevant part as follows:

> If...by reason of the method of accounting of the person to whom payment is made, the amount thereof is not (unless paid) includible in the gross income of such person, and...at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom payment is to be made are persons specified in any of the paragraphs of subsection (b), then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom payment is made....

Among the persons specified in subsection (b) of I.R.C. § 267 is another member of the same controlled group, as defined in I.R.C. § 267(f). I.R.C. § 267(b)(3). Subsidiary A and Subsidiary C are members of the same controlled group for purposes of I.R.C. § 267(f) and thus, are related parties. However, a determination must be made as to whether the “premium” payment itself is a payment to which I.R.C. § 267(a)(2) applies.

Section 267(a)(2) defers an otherwise allowable deduction for amounts that, by reason of the payee’s method of accounting, are not (unless paid) includible in the payee’s gross income. The “unless paid” language of this provision describes the payee’s method of accounting with respect to the item for which the related payor is claiming a deduction. The payee’s method of accounting being described is the cash receipts and disbursements method. This statutory language suggests that I.R.C. § 267(a)(2) only applies to amounts that the related payee has not yet included in gross income under the cash method. If I.R.C. § 267(a)(2) does apply, the payor may not take its deduction until the item is included in the payee’s income under the cash method. In essence, I.R.C. § 267(a)(2) places the payor on the cash method with respect to such amounts. This interpretation is supported by the legislative history of the Tax Reform Act of 1984 (TRA 84), which amended I.R.C. § 267(a)(2) to read as it does currently. The pertinent part of the House and Senate Committee Reports to TRA 84 provides:

> Under the bill, an accrual-basis taxpayer will be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related

> cash-basis taxpayer. Thus, the accrual-basis taxpayer will be allowed to deduct business expenses and interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2 ½ months after the close of the taxable year); in other words, the deduction will be allowed no earlier than when the corresponding income is recognized by the payee. H. Rep. 98-432, 98th Cong., 2d Sess. 1579 (1984); S. Rep. 98-169, 98th Cong., 2d Sess. 495 (1984).

Based on the statutory language, as supported by the relevant legislative history, we conclude that I.R.C. § 267(a)(2) does not apply to the "premium" payment by Subsidiary A to Subsidiary C. The facts set forth in the FSA provide that the "premium" was actually paid by Subsidiary A to Subsidiary C in Year 1, the year that Subsidiary A is claiming a deduction for the premium. Under the cash receipts and disbursements method of accounting, Subsidiary C would include this amount in gross income for that year. However, if it is determined that Subsidiary C is allowed to include the "premium" in income on a pro-rata basis in subsequent years, then Subsidiary C's method of accounting with respect to this item would not be the cash method. Thus, the "premium" payment would not meet the first condition for applying I.R.C. § 267(a)(2) that by reason of the payee's method of accounting, the amount thereof is not (unless paid) includible in the gross income of the payee.

In addition, the legislative history to the amendments to I.R.C. § 267(a)(2) made in TRA 84 states that the provision, as amended, places an accrual-basis taxpayer on the cash method with respect to amounts owed to related payees. Under the cash method, Subsidiary A would be allowed a deduction for the premium in Year 1, the year it was actually paid to Subsidiary C. Thus, placing Subsidiary A on the cash method with respect to the "premium" would not change the timing of its deduction.

For these reasons, if it is determined that Subsidiary C is not required to include the "premium" in gross income in Year 1, we conclude that § 267(a)(2) does not require Subsidiary A to defer its deduction for the "premium" payment.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Inasmuch as the facts state that the bonds were issued at par (face value) and remain outstanding, for purposes of this memorandum, we conclude that the bonds in issue do not have bond "premium" as described in Treas. Reg. § 1.61-12(c). Therefore, [redacted] However, depending on the outcome of the additional factual development, based on one or more of the theories below, it appears that the taxpayer's position in this case may be the legally correct position.

Although you did not specifically request our views on alternative legal theories the taxpayer may assert in support of its position that amortization of the "premium" payment is proper, below we have outlined arguments the taxpayer may make.

Treas. Reg. § 1.1001-3

In general, Treas. Reg. § 1.1001-3 provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Treas. Reg. § 1.1001-1(a). Treas. Reg. § 1.1001-3 applies to any modification of the terms of a debt instrument, regardless of the form of the modification.

Treas. Reg. § 1.1001-3 applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on the regulations for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996. Treas. Reg. § 1.1001-3(h).

As a general rule, for purposes of Treas. Reg. § 1.1001-1(a), a significant modification of a debt instrument, within the meaning of Treas. Reg. § 1.1001-3, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of Treas. Reg. § 1.1001-1(a).

Paragraphs (c) and (d) of Treas. Reg. § 1.1001-3 define the term "modification" and provide examples illustrating the application of the rule. We recommend that you focus on paragraphs (e) and (f) of Treas. Reg. § 1.1001-3; these paragraphs provide rules for determining when a "modification" is a "significant modification." These paragraphs, in particular, should be helpful in developing the facts with respect to this issue.

[redacted]

If it were determined that the assumption of the bonds results in a "significant modification" under Treas. Reg. § 1.1001-3, the transaction is treated as if "old" bonds are exchanged for "new" bonds. To ascertain whether Treas. Reg. § 1.61-12(c) applies to the "new" bonds, a determination would need to be made whether the "new" bonds were issued at a premium.

If so, Subsidiary C would be required to comply with Treas. Reg. § 1.61-12(c)(2), which provides, in part, that the net amount of the premium "is income **which should be prorated or amortized over the life of the bonds**." (Emphasis added.) If the "new" bonds were issued at a premium, then Subsidiary C's treatment of the premium, in effect, was correct. As the facts are developed, we would be pleased to provide additional assistance on this issue.

I.R.C. § 446–Clear Reflection

There also may be an argument under I.R.C. § 446 that the "premium" should be included in income when Subsidiary C deducts the interest payments on the bonds–this treatment would clearly reflect Subsidiary C's income, especially because the "premium" relates to the above-market interest payments that Subsidiary C would make over the remaining term of the bonds.

[redacted] If the taxpayer were to raise an argument under I.R.C. § 446, we would be pleased to provide additional assistance on this issue.

Please call if you have any further questions.

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