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NOTES

The Original Issue Discount Deduction In Bonds-for-Noncash Property Exchanges

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I. Introduction

Section 163(a) of the Internal Revenue Code provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[1] A corporate taxpayer's deduction for "interest paid," normally brings to mind a deduction equal to a stated percentage of an outstanding debt obligation—an amount that the obligor has agreed contractually to pay as compensation for the use of money loaned.[2] Treasury Regulations, however, have recognized that deductible interest can arise in situations other than payment of a stated interest rate on a debt. Deductible "interest" has been found to arise when a corporation issues a bond in exchange for an amount less than the stated maturity value of the bond.[3] The amount by which the maturity value[4] of the bond exceeds the value received by the corporation upon the issuance of the bonds is commonly known as "original issue discount;" it is deductible as interest and is amortizable over the life of the obligations.[5] Although in most instances in which corporations issue debt obligations the presence or absence of deductible original issue discount is easily ascertainable,[6] the variety of characteristics bonds may possess[7] and the variety of uses to which bonds may be put in corporate reorganizations and recapitalizations[8] have engendered

1. INT. REV. CODE OF 1954, § 163(a).

2. "Interest is the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." BLACK'S LAW DICTIONARY 950 (4th ed. rev. 1968).

3. *See* Treas. Reg. § 1.163-3 (1968); Treas. Reg. § 1.163-4 (1972).

4. The maturity value of the bond is the amount that the corporation is obligated to pay upon redemption or retirement of the bond.

5. Treas. Reg. § 1.163-3, -4 (1972).

6. Probably the most easily understood illustration of original issue discount is the following: X Corporation issues a $1,000 face-amount, 10 year bond with a stated interest rate of 5% in exchange for cash of $990. The maturity value of the bond ($1,000) exceeds the amount received for the bond ($990) by $10. This $10 is original issue discount; in addition to the $50 stated annual interest, the corporation annually deducts $1 of the discount over the life of the bond even though this discount interest of $10 will not actually be paid until retirement of the obligation. Original issue discount most commonly arises when bonds are offered to a public market and the stated interest rate is less than the market rate for money. The issuing corporation will adjust the price of the bond downward to align the bond's effective rate of interest with the market rate; this downward adjustment of the price by the issuer creates discount and makes the offer more attractive to the public. The forces behind the creation of discount explain why it is treated as interest; it is an adjustment for the price of obtaining money or property. *See generally* J. BOGEN, FINANCIAL HANDBOOK, 27.45 (4th ed. 1968).

7. For an excellent discussion of the characteristics of bonds and their utility in a corporation's capital structure, see J. BOGEN, FINANCIAL HANDBOOK, ch. 14 (4th ed. 1968).

8. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶¶ 4.20-.22, 14.17 (abr. stud. ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

litigious questions on the existence of deductible original issue discount in certain circumstances. The purpose of this Note is to examine the problems concerning the creation of deductible discount when a corporation issues bonds for property other than cash—securities or tangible property, for example. Consideration of this problem requires an examination and analysis of pre-1969 statutory, regulatory, and judicial authority and an examination and analysis of the 1969 Tax Reform Act's legislative response to the problem. The Note considers primarily the existence of original issue discount as an item deductible from income by the corporation that issues bonds and discusses the treatment of the creditor-bondholder only tangentially.

II. Business Purposes Underlying the Issuance of Bonds for Noncash Property

Initially it may be helpful to consider some of the business purposes and policies that influence a corporation's decision to issue bonds in exchange for noncash property. Such an exchange generally occurs in one of three different contexts—an organization of a corporation, a debt-financed acquisition of another business or property to be used in the corporation's trade or business, or a corporate recapitalization.

A. *Corporate Organizations*

When a person, or persons, decide to incorporate an enterprise, one of their most basic decisions is the extent to which debt should be used in the capital structure of the corporation—a decision that entails consideration of both tax and financial planning concepts.[9] The corporation's tax considerations include primarily the deductibility of interest paid,[10] perhaps a deduction for discount if the face value of the bonds exceeds the value of the property received, and use of the debt's existence as a justification for accumulating earnings and profits.[11] An important nontax question is the corporation's willingness to risk the use of leverage[12] to increase the return on

9. For a general discussion of some of the tax considerations, *see* Bittker & Eustice, *supra* note 8, at ¶ 4.01; financial planning concepts are discussed in J. Weston & E. Brigham, Essentials of Managerial Finance, 434-39 (3d ed. 1974) [hereinafter cited as Weston & Brigham].

10. Int. Rev. Code of 1954, § 163(a).

11. *See id.* § 533(a).

12. Simply stated, leverage is the use of debt to finance a business and is accompanied by the expectation that the business can use the borrowed funds to produce a return in excess of the cost of horrowing. This excess inures to the benefit of equity security holders by

equity. Debt may also be issued to a member of the organizing group who has misgivings about the corporation's growth prospects but who nevertheless is willing to contribute noncash property to the corporation in return for the corporation's bond, which gives him a stated rate of return, the promise of receiving a fixed sum at a future definite date, and a liquidation preference.

At least one reason can be advanced to explain why a corporation might issue a bond with a face value in excess of the value of the noncash property it receives. Assume that Smith is willing to transfer to the corporation a machine worth 100,000 dollars if the corporation issues a bond in exchange for the machine. The corporation expects that for the first few years the machine and its other assets will produce a cash flow that would enable the corporation to pay only approximately five percent annual interest on the 100,000-dollar bond. If the "going rate" for money is 6.5 percent, Smith will probably be unwilling to transfer his machine in exchange for a 100,000-dollar face-amount, ten year bond with a stated interest rate of only five percent. The transaction might be accomplished to the satisfaction of all parties, however, if the corporation issued bonds with a total maturity value of 110,000 dollars. This 10,000-dollar excess of face value over the machine's fair market value would effectively increase the cost *of financing* the purchase and bring that cost more in line with current interest rates; but, the transaction would be structured to postpone the payment of part of that cost for ten years, at which time the corporation expects its cash flow position to be improved. If the bondholder is required to recognize gain on the transfer, the corporation will get a stepped-up basis for the machine.[13]

increasing the return on their investment. Of course, if the borrowed funds produce a return less than the cost of borrowing, the leverage works in reverse and the equity security holders suffer the consequences. *See* WESTON & BRIGHAM, *supra* note 9, at 420-28.

13. Whether the bondholder is taxed on this exchange will depend on § 351 of the Code. That section provides for nonrecognition if the transferor is in control (80% of voting stock) of the corporation immediately after the transfer. If the transferor receives only bonds and no stock, he will not qualify. In Smith's case, the bond was issued at a $10,000 discount. Deferring a detailed analysis of the tax effect of discount until later in the paper, for the present suffice it to say that, *if* for purposes of tax law this $10,000 is original issue discount, it seems that it should not be considered as part of the amount realized by Smith on his transfer of the machine; rather it should be taxed to him as ordinary income—just like interest income—either when he disposes of the bond by sale or retirement (pre-1969 law, *see* Reg. §§ 1.1232-1-3, T.D. 6253) or ratably over the life of the bond (post-1969 law, *see* INT. REV. CODE OF 1954, § 1232(a)(3) and Treasury Regulation promulgated thereunder). Such treatment of the discount would result in his treating $100,000 as the amount realized on the transfer. If his § 1012 cost basis for the machine if $80,000 dollars he will recognize a $20,000 capital gain on the exchange. Pursuant to § 362(a)(2) the corporation would take a basis of

B. *Debt-Financed Acquisitions*

Purchases by corporations of other incorporated businesses utilizing debt securities have not been uncommon.[14] Although most of these purchases have been taxable transactions,[15] this form has offered significant tax advantages. The use of debt to purchase the stock of another corporation enables the purchasing corporation to deduct the interest on the debt.[16] The earnings of the acquired corporation can be paid out in dividends to the acquiring company, which can exclude from its income eighty-five percent of those dividends.[17] As one commentary has noted, "the bootstrapping possibilities of this technique soon become obvious."[18] Furthermore, the acquiring corporation obtains a stepped-up cost basis for the stock,[19] and can, by liquidating the acquired corporation, obtain a stepped-up basis for the assets.[20] A debt purchase-liquidation plan can cleanse the acquired corporation of unfavorable tax attributes, since the transaction does not come within section 381(a).[21] The corporation may also attempt to take the discount deduction that is the subject of this paper, if the value of the acquired stock is less than the face value of the debt. The primary advantage to the seller of acquired company stock, prior to the 1969 Tax Reform Act, was the opportunity to report gain under the installment gain provisions of section 453.[22] The acquiring corporation can also achieve substan-

$10,000 for the machine: $80,000 (basis in Smith's hands) + $20,000 (gain recognized by Smith). The corporation would, of course, attempt to deduct the $10,000 of discount ratably over the life of the bonds, pursuant to § 163(a) and the regulations thereunder.

14. BITTKER & EUSTICE, *supra* note 8, at ¶ 4.20.

15. Acquisitive-type, tax-free reorganizations generally require a substantial amount of the consideration to be voting stock of the acquiring corporation. *See* INT. REV. CODE OF 1954, § 368(a)(1) and regulations pursuant thereto.

16. INT. REV. CODE OF 1954, § 163(a). *But cf.* INT. REV. CODE OF 1954, § 279, discussed at note 164 *infra.*

17. INT. REV. CODE OF 1954, § 243. Moreover, if the acquiring corporation gets at least 80% control of the corporation, these intercorporate dividends are received tax-free. INT. REV. CODE OF 1954, § 1501-04.

18. BITTKER & EUSTICE, *supra* note 8, at ¶ 4.20. It should be mentioned at this point that 1969 tax legislation, to be discussed later, has placed some constraints on the use of debt to finance acquisition.

19. INT. REV. CODE OF 1954, § 1012 ("The basis of property shall be the cost of such property . . .").

20. INT. REV. CODE OF 1954, § 334(a) (if the corporation has acquired less than 80% of the acquired company's voting stock); and § 334(b)(2) (if the corporation has acquired 80% or more of the acquired company's voting stock and liquidates it within 2 years or comes witbin the judicial "Kimball-Diamond" doctrine).

21. INT. REV. CODE OF 1954, § 381(a).

22. INT. REV. CODE OF 1954, § 453. In 1969, however, Pub. L. No. 91-172, § 412(a) added

tially the same results and attendant advantages present in a bonds-for-stock exchange by using debt obligations to purchase directly the *assets* of the acquired corporation.

Limited use of bonds in an acquisitive section 368 tax-free reorganization is also a possibility.[23] In a type "A" reorganization—statutory merger—up to fifty percent of the consideration to the acquired company's shareholders may be other than voting stock.[24] The type "B" reorganization, however, is limited to the exclusive use of common stock as consideration.[25] A type "C" reorganization will permit the use of bonds in an amount up to twenty percent of the fair market value of the assets being acquired.[26] The use of some debt obligations in a type "D" reorganization may be possible, but type "D" reorganizations in a "normal" acquisitive context are rare.[27] Among the reasons for using some debt obligations in a tax-free reorganization are the following: some acquired-

§ 453(b)(3) to tbe Code, which disallows installment reporting for corporate bonds in registered form or with interest coupon attached, or "in any other form designed to render such bond . . . readily tradable in an established securities market."

23. INT. REV. CODE OF 1954, § 368.

24. INT. REV. CODE OF 1954, § 368(a)(1)(A); Rev. Proc. 66-34, § 3.02, 1966-2 CUM. BULL. 1233 ("continuity of interest" requirement, implicit in § 368(a)(1)(A), met if 50% of consideration is voting stock).

25. INT. REV. CODE OF 1954, § 368(a)(1)(B).

26. *Id.* § 368(a)(1)(C),(a)(2)(B). The 20% maximum use will be diminished if the acquiring corporation assumes liabilities of the acquired corporation. *Id.*

27. INT. REV. CODE OF 1954, § 368(a)(1)(D). If (1) a corporation, in acquiring the assets of another corporation, gives up 80% of its voting stock as consideration for the purchase and (2) acquires *substantially all* of the assets of the transferor, and (3) the transferor corporation distributes the stock and securities received from the acquiring corporation *and* any other property it owns pursuant to the plan of reorganization, then the transaction will be a type "D" reorganization. INT. REV. CODE OF 1954, §§ 368 (a)(1)(D) (definition of type "D"), 354(b)(1) (distribution requirement with which transferor must comply to qualify for "D"), 368(a)(2)(A) (when type "C" and type "D" overlap, type "D" controls). In the normal acquisitive context—an arm's length purchase of assets—this situation would probably be rare because shareholders of the acquiring company probably would not want to give up control of the acquiring company to obtain the assets. Assuming that such a transaction does take place, few constraints would be imposed on the amount of debt that could be used in this transaction, since there is no maximum percentage of the consideration's value that must be represented by the stock; the requirement is merely that the transferee receives 80% (control) of the transferor's stock. The most common context, however, in which a type "D" reorganization occurs is a situation in which a corporation creates a subsidiary and transfers to it only part of its assets and then distributes the stock of the subsidiary to some or all of its shareholders pursuant to § 355 in a valid "spin-off" or "split-up." Even in this context, the subsidiary might issue bonds to the parent in amounts not subject to any requirement that their value be below a certain percentage of the value of the transferred property. These bonds then would wind up in the hands of the distributees. This is not the "normal" acquisitive context; even though a "new" corporation has acquired property, the security holders of the "new" corporation had previously owned the same property in the corporate form.

company shareholders may wish to divest themselves, totally or partially, of the indirect equity interest in the transferred assets; the acquiring company can deduct the bond interest from its taxable income;[28] until 1969,[29] the acquiring company could attempt to deduct, as amortizable bond discount, the excess of the bond's maturity value over the fair market value of the property acquired; and, at least in a "C" reorganization, the corporation *might* increase its basis for the property acquired, to the extent that the transferor corporation is required to recognize any gain on its receipt of the bonds.[30]

In addition to purchasing the assets or outstanding stock of whole enterprises by using bonds as a part or all of the consideration, a corporation apparently could use bonds as the consideration for purchases of individual items of property. Again, the interest deduction, a cost basis for the acquired property, and possibly a discount deduction would be available to the corporation.[31]

The same explanation for a newly organized corporation's issuance of bonds at a discount in exchange for noncash property applies to this acquisition-by-bonds discussion: the corporation may want to "defer interest" until it can build up a more sufficient cash flow. The discount would be necessary to entice the property holder to make the exchange for bonds at a lower stated rate of interest.

C. *Recapitalizations*

The other common instance in which bonds might be exchanged for noncash property arises when a corporation decides to change its capital structure by exchanging the bonds for its outstanding securities. A number of factors might require or entice a corporation to undertake such a recapitalization. The corporation might be required, under law, to simplify its capital structure.[32] The

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28. INT. REV. CODE OF 1954, § 163(a).

29. For an analysis of the 1969 Tax Reform Act's denial of the discount deduction in reorganization, see note 163-68 *infra* and accompanying text.

30. INT. REV. CODE OF 1954, § 362(b). Section 362(b) requires that property acquired in a reorganization have a carryover basis (same basis as in the hands of the corporate transferor), but provides that the basis will be increased in the amount of gain recognized by the transferor on such transfer. The "transferor" means the transferor corporation; the only time that the transferor would recognize gain in one of these acquisitive reorganizations would be in a type "C" in which the corporation does not distribute "boot" pursuant to the plan of reorganization. *See* INT. REV. CODE OF 1954, § 361(b)(1)(B). Even in this situation, it is unclear whether bonds are "boot" for purpose of § 361.

31. *See* notes 16-21 *supra* and accompanying text.

32. *See, e.g.,* 15 U.S.C. § 79K (1970); Cities Serv. Co. v. United States, 316 F. Supp. 61, 63 (S.D.N.Y. 1970).

bonds may be issued in order to retire outstanding securities that give their holders rights that hinder management in running the business. For instance, outstanding shares of preferred stock may contain a cumulative dividend provision, which prevents the management from paying dividends on the common stock until any accumulated dividends are paid to the preferred shareholders.[33] Another important consideration is the deductibility of the interest paid to the bondholders.[34] A corporation that has been paying dividends to preferred shareholders steadily over a period of years, receiving no deduction for these payments, may realize that paying the same amount as interest on bonds and the concommitant deduction of that amount from taxable income will produce more after-tax dollars to pay dividends on common stock or to reinvest in the business. Also, the shareholder may desire to divest himself of his equity interest in the corporation, particularly if his preferred shares are not producing dividends with any regularity; he might prefer to own a security under which the corporation would be obliged to pay annually a stated amount and obliged to pay a principal amount at the end of the obligation's life.

A corporation in a recapitalization could have several reasons for issuing bonds with a face value greater than the fair market value of the securities being retired and thereby create a discount. As mentioned previously in the organization discussion, the corporation might fear that its present cash flow would not permit the use of a stated interest rate high enough to entice the preferred shareholders to make the exchange. Therefore, the corporation might issue bonds at the lower interest rate with a higher face value to make the exchange attractive enough to ensure its acceptance. Also, consider a situation in which preferred stock has a cumulative dividend provision and substantial arrearages have resulted from the corporation's failure to pay the dividends over a period of years. These dividend arrearages, coupled with little expectation of payment in the near future, are likely to have caused a decline in the market value of the stock below the amount that the shareholder originally paid for it. Nonetheless, the shareholders, pursuant to the terms of the preferred shares, may have rights with respect to the payment of the arrearages and probably have preferred status in the event of a liquidation. Possession of these rights—bargaining tools—might make the shareholders reluctant to accept bonds with

33. *See* Cities Serv. Co. v. United States, 316 F. Supp. 61, 70 (S.D.N.Y. 1970); 12 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 5451 (perm. ed. 1971).

34. INT. REV. CODE OF 1954, § 163(a).

a face value equal only to the depressed market value of the stock. Thus, to retire this preferred stock, the corporation might find it necessary to issue bonds with a face value greater than the stock's market value.

Most of the above discussion has centered on recapitalizations effected by the corporation's issuance of bonds in exchange for outstanding *preferred* stock. Of course, a recapitalization may take the form of an exchange of bonds for outstanding common stock. Bonds-for-common stock exchanges, however, have potential bail out effects, especially if the shareholders retain part of their equity interests. The 1947 case of *Bazley v. Commissioner*[35] held that the full principal amount of all bonds received in an apparent recapitalization was dividend income. Although *Bazley*'s scope and present viability are uncertain in light of the 1954 reorganization provisions, its specter has caused a decline in bonds-for-common stock recapitalizations.[36]

III. PRE-1969 STATUTES AND TREASURY REGULATIONS

The first codification of the United States Internal Revenue laws gave a corporation a deduction from income of "[a]ll interest paid or accrued within the taxable year on its indebtedness . . . ."[37] This same language is presently in force in the Internal Revenue Code of 1954.[38] The statutory language authorizing the interest deduction has never dealt explicitly with the deductibility of discount arising upon a corporation's original issuance of bonds. Treasury Regulations promulgated pursuant to the interest deduction sections, however, have recognized continually that the statutory language embodies a deduction for original issue discount.[39] The latest pre-1969 regulation, which limits itself to bonds issued on or before May 27, 1969 states: "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity . . . over the issue price of the bond

35. Bazley v. Commissioner, 331 U.S. 737 (1947).

36. *See*, BITTKER & EUSTICE, *supra* note 8, at ¶ 14.17.4, at 67. It should also be noted that recapitalization can take place in bankruptcy proceedings. The issuance of new bonds in exchange for old claims or preferred stock is not rare in the bankruptcy context and it is easy to see how discount could arise in that situation. *See* INT. REV. CODE OF 1954, §§ 371-72.

37. INT. REV. CODE OF 1924, ch. 234, § 234, 43 Stat. 283.

38. INT. REV. CODE OF 1954, § 163(a). *See* text accompanying note 1 *supra*.

39. For a capsule summary of the earliest history of such regulations see American Smelting & Ref. Co. v. United States, 130 F.2d 883, 884 & n.3 (3d Cir. 1942).

(as defined in paragraph (b)(2) of § 1.1232-3)."[40] The definition of issue price is generally that price at which the bonds were first sold by the corporation.[41] The pre-1969 regulations, however, did not explicitly single out for different treatment those situations in which a corporation issues a bond in exchange for noncash property. This absence of specific regulatory authority did not impede the attempted taking of discount deductions by corporations that had issued bonds in exchange for some of their own outstanding equity securities in recapitalizations or by corporations that had utilized bonds directly to acquire tangible property for use in their business. In these instances corporations have claimed that amortizable bond discount was present when the maturity value of the issued bonds exceeded the value of the noncash property received. The same absence of specificity in the statute and regulation has allowed the Commissioner of Internal Revenue to argue that amortizable bond discount could not arise in such instances. The most siguificant forum for these conflicting arguments has been the federal judiciary, and this Note devotes substantial space to a consideration of the judiciary's handling of this problem. Inasmuch as one of the primary goals of this Note is to evaluate the appropriateness of the 1969 legislative response to the bonds-for-noncash property question, a study of the pre-1969 cases provides the background and a framework necessary for such an evaluation. Furthermore, the pre-1969 case law is still timely because it should govern the question for bonds issued prior to May 27, 1969.[42]

IV. AN ANALYSIS OF CASES DEALING WITH THE PRE-1969 LAW

Although the courts have not always drawn distinctions between organization purposes, acquisition purposes, and recapitalization purposes for issuing bonds for noncash property, such distinctions do not seem artificial, especially when the different business

40. Treas. Reg. § 1.163-3(a) (1968). Curiously, the previous discount regulation, Treas. Reg. § 1.61-12(c)(3), T.D. 6272, 1957-2 CUM. BULL 32, had appeared under § 61(a)(12) of the Code— the section including income from discharge of indebtedness within the definition of gross income. That regulation did not even define amortizable bond discount, but presumably it implicitly meant the excess of the maturity value of the bond over the amount paid for it. The regulation did not specifically mention bonds issued for noncash property.

41. Treas. Reg. § 1.1232-3(b)(2). The regulation provides for different tests to determine the "issue price" depending on whether the obligations were offered publicly or were placed privately. In the case of a public offering the issue price is the "initial offering price to the public at which price a substantial amount of such obligations were sold." *Id.* In private placements, the issue price is "the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue." *Id.*

42. *See* note 40 *supra* and accompanying text.

reasons underlying the three types of transactions are considered. For purposes of analysis, the following discussion of case law is divided into three sections on the basis of these distinctions.

A. Corporation Organizations

In the case of *Dodge Brothers, Inc. v. United States*[43] an underwriting syndicate purchased for cash an automobile manufacturer's assets and then transferred them to a newly organized corporation in exchange for the new corporation's debentures and stock. The syndicate quickly disposed of a substantial amount of these securities by selling them to the public. The taxpayer-corporation and the government agreed that the fair market value of the acquired assets was 132,000,000 dollars. The corporation contended that the fair market value of the securities issued in exchange for the assets exceeded the value of the assets, and that part of this excess was attributable to the bonds and was deductible as original issue discount.

The Fourth Circuit disallowed the discount deduction, but refused "to lay down any universal proposition that where bonds are issued for [noncash] property, a reasonably estimated discount may never be taken as an amortized deduction."[44] The court emphasized the character of discount as "deferred interest" that arises as an adjustment of the bond's stated interest rate to bring it in line with the going market rate.[45] The court then found that the circumstances under which taxpayer's securities were originally issued were not "typical of the circumstances that might compel a corporation to discount its securities in the effort to secure for them a ready market."[46] Pointing out the ease with which the syndicate sold the securities to the public, the court found that the sale prices were not indicative of the true value of taxpayer's securities on the date of their issuance to the syndicate. The court analogized to a situation in which a taxpayer has made a "bad bargain" by paying a value greater than that of the property received.[47] The taxpayer must wait until the disposition of the property to deduct the cost of the property, and not until that time can the taxpayer have a deduction for the bad bargain.

43. 118 F.2d 95 (4th Cir. 1941).
44. *Id.* at 103.
45. *Id. See* United States v. Midland-Ross Corp., 381 U.S. 54 (1965); Helvering v. Union P. R.R., 293 U.S. 282 (1934).
46. 118 F.2d at 103.
47. *Id.* at 104.

The Second Circuit examined the bonds-for-noncash property question in *Nassau Lens Co. v. Commissioner*,[48] in which a sole proprietor organized a new corporation to which he transferred assets in exchange for the corporation's stock and bonds. The taxpayer-corporation issued noninterest-bearing bonds with a ten-year maturity value of 150,000 dollars in exchange for inventory valued at 100,000 dollars.[49] The taxpayer contended that the 50,000-dollar excess of maturity value over inventory value was amortizable bond discount. In disallowing a discount deduction, the Tax Court stressed that the proprietor and the taxpayer had not dealt at arm's length in the inventory-bond exchange and questioned the 100,000-dollar valuation of the inventory.[50] The Second Circuit, nonetheless, rejected the government's broad contention that discount could never arise "when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property."[51]

In *Southern Natural Gas Co. v. United States*,[52] a newly organized corporation in the process of acquiring assets, assumed those bonds of its bankrupt transferor that were not in default and issued new one hundred-dollar six-percent, twenty-five year bonds and some stock to other security holders and unsecured creditors of the bankrupt transferor.[53] The taxpayer calculated the fair market value of each one hundred-dollar bond to be 71.50 dollars on the date of issuance; that figure was used by the taxpayer to determine the cost basis of the property acquired by issuing the bonds, since the transaction was taxable.[54] Arguing that the face value of the bonds—one hundred dollars per bond—was 1,647,749 dollars greater than the fair market value of the property acquired, the taxpayer maintained that this amount was amortizable discount. The taxpayer further contended that, if one hundred-dollar bonds were issued to the public for 71.50 dollars cash and the cash used to purchase the assets, amortizable discount would certainly arise, and it should make no

48. 308 F.2d 39 (2d Cir. 1962), *reviewing* 35 T.C. 268.

49. *Id.* at 40-42. The sole proprietor had made a formal written offer to the new corporation, of which he was the sole stockholder. In the offer he specified that the issuance of the bonds was in exchange for the inventory. The bonds provided for an optional redemption schedule pursuant to which the corporation could redeem the bonds at prices ranging from $1,040 per $1,000 bond in the first year to $1,500 in the tenth year.

50. 35 T.C. at 272-73.

51. 308 F.2d at 44.

52. 412 F.2d 1222 (Ct. Cl. 1969).

53. *Id.* at 1235.

54. *Id.* at 1236, 1238.

difference that the instant transaction was accomplished in one step rather than two.[55] The Court of Claims rejected taxpayer's arguments and disallowed a bond discount deduction. The court based its holding on the theory that the taxpayer had suffered a "loss" by making a "bad bargain" in acquiring the property and such a loss could not have tax consequences until it was "realized" by a disposition of the property.[56] The court, however, did allow the corporation to increase the basis of its assets by an amount equal to the alleged discounts.[57]

To summarize the results, none of these three organization cases found amortizable original issue discounts. Nonetheless, in only one of the cases—*Southern Natural Gas*—did the court set forth a seemingly "universal proposition" disallowing discount on a bonds-for-property exchange. The other two cases held against a deduction essentially on the grounds of lack of proof—in *Dodge Brothers,* taxpayer failed to prove the value of the property acquired, and in *Nassau Lens,* taxpayer failed to prove a valid arm's-length debt obligation. The primary theory against allowing deductions in this species of cases was the "deferred deductibility of loss on a bad bargain" theory,[58] which was buttressed with an assertion that arm's-length dealing was absent in certain circumstances. The primary theory advanced in support of the discount deduction was that a seller of property can also act as a financing medium and choose to take bonds at a discount in exchange for his property.

B. Debt-Financed Acquisitions

Research has failed to uncover any litigation concerning discount deductions in the context of a "going" corporation's debt-financed acquisition of another business or assets to be used in its own trade or business. It is reasonable to surmise that the competing theories for and against allowing a deduction would be virtually identical to those discussed above in the section on corporate organizations.

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55. *Id.* at 1237.

56. *Id.* at 1237-38.

57. *Id.* at 1238-39. It should be noted that if the property was depreciable, the straight-line method would produce tax consequences similar to the deduction of the amount as discount—the similarity depending on the useful life of the property. If, however, the property was not depreciable, the taxpayer would have to sell the property to realize a deductible loss.

58. *See also* Sacramento Medico Dental Bldg. Co., 47 B.T.A. 315 (1942); Southern Ry., 27 B.T.A. 673 (1933).

C. *Recapitalizations*

Most of the litigation over deductible original issue discount in bonds-for-noncash property exchanges has arisen in the context of corporation recapitalizations. Not all of the cases discussed below fit neatly into a single recapitalization category; some deal with recapitalizations of bankrupt corporations pursuant to debtor rehabilitation provisions of the Bankruptcy Act[59] and others concern readjustments of property holdings and outstanding securities among parent-subsidiary or brother-sister affiliated groups. A third subcategory of cases involves the typical recapitalization transacted by a single profitable corporation. Despite these differences, treatment of these cases under the general heading "recapitalization" seems appropriate because they all involve a readjustment of the claims against the assets[60] of a corporate enterprise, which is effected by an issue of new bonds in exchange for outstanding securities.

To achieve a more lucid presentation, the cases have been divided into two groups, depending on whether their result was an allowance or disallowance of the claimed discount. Also, separate treatment is given to the case of *Commissioner v. National Alfalfa Dehydrating & Milling Co.*,[61] a 1974 Supreme Court decision holding that no deductible original issue discount could be created in a pre-1969 issuance of bonds in exchange for the issuer's outstanding preferred stock.

1. Taxpayers' Victories

In 1942, the Court of Appeals for the Third Circuit, in the case of *American Smelting & Refining Co. v. United States*,[62] allowed a discount deduction after taxpayer had issued bonds in exchange for outstanding preferred shares of its wholly owned subsidiary.[63] The thirty-year bonds had a face value of one hundred dollars and bore

59. *See generally* 11 U.S.C. §§ 205 (railroad reorganization), 616 (corporate reorganization), 756-57 (business arrangement). The debtor rehabilitation provision generally allows the bankrupt corporation to continue in business rather than force a liquidation. Creditors and security holders usually accept some modification of their claims on the company.

60. All creditors and security holders have some claim on the corporation's assets. Generally, creditors' claims have highest priority, followed by preferred stockholders and then common shareholders. Also, the claims of creditors and preferred shareholders are usually for a fixed amount.

61. 94 S. Ct. 2129 (1974), *rev'g*, 472 F.2d 796 (10th Cir. 1973), *rev'g*, 57 T.C. 46 (1971).

62. 130 F.2d 883 (3d. Cir. 1942).

63. By "wholly-owned subsidiary" it is meant that taxpayer owned all of the *common* stock of the subsidiary.

five percent stated interest; during the time of the exchange, the average fair market value of the preferred shares fluctuated between 100 ¼ and 82 ½. Taxpayer claimed that the difference between the bond's face value and the stock's fair market value at the time of the exchange was amortizable discount. The court reasoned that since a deductible discount certainly would have arisen had the taxpayer issued one hundred-dollar face-amount bonds for ninety dollars each and then taken the cash and bought the outstanding preferred shares,[64] no reason existed to disallow a transaction having the same result merely because it was accomplished in one step. The Government contended that because taxpayer might sell the preferred shares at a price *higher* than the fair market value, loss might not result to it. The court found that the rationale implicit in this analysis was incongruous when discussing original issue discount because, in the words of the court, original issue discount is "in the nature of additional interest which accrues over the life of the bond and is payable at the maturity of the principal obligation."[65]

More than twenty years after the *American Smelting* decision, two district courts allowed original issue discount deductions in recapitalization cases.[66] Although the analyses in these two opinions are not particularly revealing,[67] their facts merit mention. In one case, the taxpayer issued a 140-dollar five-percent debenture and ten dollars cash in exchange for each one hundred-dollar par, seven percent voting preferred share with substantial arrearages. Finding that at the time of exchange the fair market value of the preferred was 106 dollars per share, and that the fair market value of each bond was ninety-six dollars, the court allowed a discount deduction of forty-four dollars per bond issued in exchange for the preferred—an amount equal to the excess of the bond's face over the preferred's fair market value, *plus* the ten-dollar cash payment.[68] On the authority of a ruling by the Commissioner, the preferred shareholders' gain was limited to the amount of cash received—a circumstance that the court said made no difference in the availability of the discount deduction.[69] The court recognized *inter alia* a

64. 130 F.2d at 884.

65. *Id.* at 885.

66. Industrial Dev. Corp. v. United States, 51 Am. Fed. Tax R. 1514 (E.D. Ill. 1956); Southern Fertilizer & Chem. Co. v. United States, 167 F. Supp. 879 (M.D. Ga. 1955).

67. The opinions merely state findings of fact and conclusions of law, and do not discuss prior case law.

68. 51 Am. Fed. Tax R. at 1518. The court gave no reason for its treatment of the $10 cash payment as discount.

69. *Id.*

"feeling" on the part of taxpayer's board of directors that the five percent rate on the bonds was not sufficient to exchange the bonds at par and found that the plan was not more favorable than necessary to induce the preferred shareholder to make the exchange.[70] In the second district court case, the taxpayer exchanged cash, noncumulative preferred shares, script-warrants, and bonds for cumulative preferred shares with substantial arrearages.[71] The court found that the corporation had received outstanding preferred stock worth seventy-five dollars in exchange for its one hundred-dollar face-amount bonds; the twenty-five-dollar per bond excess was allowed as amortizable discount.[72] The court made no mention of the stated interest rate on the bond or the overall tax effects of the exchange, but it did note that the parties had negotiated at arm's length.[73]

The Southern District of New York has provided perhaps the most exhaustive analysis of the bonds-for-noncash property problem in its 1970 and 1973 decisions in *Cities Service Co. v. United States.*[74] In 1947, taxpayer utility, pursuant to the SEC's order to simplify its capital structure,[75] issued three precent debentures in exchange for its outstanding no-par voting cumulative preferred and preference stock. The total face amount of the bonds issued was 115,246,950 dollars—an amount greater than the fair market value of the bonds equalled exactly the sum of the amount originally received by taxpayer upon its issue of the preferred stock, *plus* undeclared cumulative accrued dividends, *plus* a call premium feature of the shares. The taxpayer contended alternatively that the amount by which the bonds' face value (115,246,950 dollars) exceeded either the preferred shares' fair market value (86,313,600 dollars) or the amount originally received for the preferred shares (45,323,846 dollars) was amortizable discount.

The government's first argument in its motion for summary judgment was that the transaction was a *redemption* of the preferred shares. The court, however, characterized the transaction as an *exchange*, pointing out that the constraining circumstances—the SEC's requirements—under which this transaction was conceived

70. *Id.* at 1516.

71. 167 F. Supp. at 881.

72. *Id.* The parties stipulated that the bonds were worth $75 each therefore the exchange was one of equivalents in term of fair market value.

73. *Id.*

74. 316 F. Supp. 61 (S.D.N.Y. 1970) (denial of motion for summary judgment), *reheard on second motion for summary judgment,* 330 F. Supp. 421 (1971), *tried pursuant to prior order,* 362 F. Supp. 830 (1973), *appeal pending.*

75. *See* 15 U.S.C. § 79K (1970).

precluded a finding of the voluntary and unilateral action characteristic of a redemption.[76] The court stated: "[This] was a transaction whereby shareholders (whose dividends and preferential rights had long been 'of little practical moment to them') became creditors owning long term debentures instead of stock."[77] The court found that regardless of whether the value of the stock given up was measured by the fair market value or original cost of the preferred, the shareholders had given up value substantially less than the face amount of the bonds received.[78]

Finding an undetermined excess of the bonds' face amount over the consideration received by the corporation, the court considered the deductibility of that excess as amortizable original issue discount. The government argued that for the face-amount excess to be deductible as discount, the taxpayer must prove that such excess is "traceable to market demand for a higher effective interest rate than the stated yield of the bonds."[79] Recognizing the variance in emphasis placed on the interest nature of discount by other courts, the court termed the debt-discount concept an "arbitrary creation" that should not be construed so technically as to deny taxpayer a deduction.[80] It further pointed out that the taxpayer had assumed enlarged and unconditional obligations as a result of the transaction—whereas, before the exchange, taxpayer had only a conditional obligation to pay dividends on the preferred, after the exchange it had the unconditional obligation to pay three percent annual interest plus the face amount of the bonds.[81]

Finally, the court turned to the means by which the *amount* of allowable discount should be determined. It reasoned that in ascribing a value to the preferred shares,[82] the amount of original consideration received when the shares were issued was the *minimum* amount that taxpayer could claim as the value; if the fair market value of the preferred had declined below its original issue price, the corporation could not claim that amount of decline as loss, since it would have had the use of the greater amount of money or property received upon issuance.[83] Although original receipt or issue value

76. 316 F. Supp. at 66-69.

77. *Id.* at 69.

78. *Id.*

79. *Id.*

80. *Id.* at 70.

81. *Id.* at 71-72 The court said that the assumption of these enlarged obligations produced "deductible losses."

82. The value of the consideration received—the "issue price"—is subtracted from the face amount of the bonds to determine discount.

83. 316 F. Supp. at 72.

was the floor on the preferred stock's value for purposes of computing the discount, the court recognized that the outstanding shares might have a value to the corporate taxpayer that was greater than that floor, and which would be the appropriate figure to use in the computation. As an example, the court pointed to the constraints on taxpayer's common-stock dividend policy imposed by the outstanding preferred shares.[84] Since retiring the stock would remove those constraints, the stock could have increased value in the hands of the taxpayer.[85] Accordingly, the court decided that the amount of taxpayer's amortizable original issue discount was the amount by which the face amount of the bonds exceeded the higher of (1) the amount originally received by the corporate taxpayer in consideration of its issuance of the preferred stock or (2) the value of the preferred stock to the taxpayer at the time of the exchange. For purposes of determining the actual value of the shares to the taxpayer, consideration should be given to "all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion."[86] Market value was said to be relevant but not conclusive.

At the trial of the case, both the government and the taxpayer produced expert testimony to support their positions regarding the value of the preferred stock to the taxpayer.[87] Despite the court's previous statement that fair market value was not controlling, the court found that the value of the preferred shares to the taxpayer was their fair market value at the time of the exchange; amortizable bond discount was allowed in an amount equal to the excess of the bond's face value over the preferred shares' fair market value.[88]

84. See note 33 *supra* and accompanying text.

85. 316 F. Supp. at 72.

86. *Id.* at 73.

87. Cities Serv. Co. v. United States, 362 F. Supp. 830 (S.D.N.Y. 1973).

88. *Id.* The experts at the trial testified from three different viewpoints: (1) an analysis of the economic and financial benefits and burdens resulting to the taxpayer from the exchange; (2) an analysis of what value, if any, accrued to the taxpayer on account of the exchange; and (3) an analysis of the exchange's effect on taxpayer's financial and economic structure. Taxpayer's witnesses concluded that the exchange had deteriorated the corporation's financial structure. *Id.* at 834. The government's experts testified "that the value [of the preferred shares] to the taxpayer by way of value to the [taxpayer's] common stockholders was in excess of the face amount of the debentures . . . ." *Id.*, at 835. Another government expert testified that in his opinion the taxpayer would have cleared up arrearages on the preferred shares within 10 years and that the preferred stock had a value equal to the face of the bonds. *Id.* The government experts were criticized for not directing themselves to the issue of the value of the preferred shares *to the taxpayer.* The opinion's discussion of the value issue and the result in the case—choice of fair market value—point up the difficulty of the valuation theory that the Southern District has chosen.

2. Taxpayers' Defeats

Fourteen years after its *American Smelting* decision, the Third Circuit apparently assumed a different approach to the bonds-for-noncash property discount issue.[89] Although the court's basis for disallowing a discount deduction was the taxpayer's failure to prove the fair market value of the property received, Judges Kalodner and Staley contended, in dictum, that discount can never be present in a bonds-for-noncash property exchange. Deductible bond discount, the judges said, arises only if "a 'sale' of bonds to 'procure capital' in the usual and customary course of a 'funding operation' " occurs;[90] the issuance of bonds to purchase noncash property is not such a transaction, and accordingly, they reasoned, no deductible discount results.[91]

The Court of Claims heard the case of *Montana Power Co. v. United States,*[92] in a slightly different context, and in holding against the taxpayer, stressed that "loss" in a bonds-for-noncash property exchange could not be realized until a disposition of the acquired property occurred. The *Montana Power* situation, however, involved a tax-free reorganization in which taxpayer was required to carry over the transferee's basis for the property. Since this artificial, carryover basis was much lower than the property's fair market value, the taxpayer could not look forward to recovering, through depreciation or by sale of the property, a deduction for the amount by which the bonds' face value exceeded the fair market value of the property. The Court of Claims seemed to recognize the "emptiness" of its postponed loss-realization rationale as applied to this set of facts, and it simply stated that any burdens incident to a reorganization transaction are "adequately compensated by corresponding advantages."[93]

In a more recent line of cases, the Court of Claims rendered a series of decisions evidencing its ultimate agreement with the *Cities Service* approach[94] discussed earlier. In the 1970 *Erie Lackawanna R.R. v. United States* case,[95] the Court of Claims first enunciated the equivalency-of-exchange test: discount never arises in any situa-

89. Montana Power Co. v. United States, 232 F.2d 541 (3d Cir. 1956).
90. *Id.* at 548.
91. *Id.*
92. 159 F. Supp. 593 (Ct. Cl. 1958). This case dealt with the discount deduction upon taxpayer's redemption of bonds at their face value before the end of the bonds' 30-year life.
93. *Id.* at 596.
94. See notes 74-80 *supra* and accompanying text.
95. 422 F.2d 425 (Ct. Cl. 1970).

tion in which bonds are issued in a face amount less than or equal to the amount originally received by the corporation upon the issuance of its other securities for which the bonds are being exchanged. The *Erie* decision, however, left open the question of discount when the amount originally received for the outstanding securities was less than the face value of the bonds. But in *Missouri Pacific R.R. v. United States,*[96] decided the same year, the court answered that question by holding that amortizable original issue discount can arise if the face value of the bond exceeds the original value of the outstanding securities for which they were traded. Although its first opinion rejected entirely the relevance of the outstanding securities' fair market value in computing the amount of discount,[97] the Court of Claims modified its original *Missouri Pacific* decision and adopted the rationale of the first *Cities Service* case, which had been decided in the interim. Thus, the court held that discount will arise in bonds-for-stock recapitalizations if the face amount of the bonds exceeds the higher of the stock's original value or fair market value at the time of exchange.[98] Although the taxpayer in *Missouri Pacific* was able to persuade the court to recognize the possible existence of deductible discount in a bond-preferred stock exchange, the taxpayer was not able to obtain the deduction because of its inability to prove the excess of the bond's face value over the surrendered securities' fair market value.

In *Claussen's Inc. v. United States,*[99] unlike the cases discussed previously, a taxpayer issued bonds in exchange for some of its outstanding *common* stock. The Fifth Circuit disallowed a discount deduction because in addition to the bonds that were issued to the exchanging common shareholders, the exchanging shareholders received *new* stock in direct proportion to their original equity in the corporation.[100] The substance of the transaction, according to the court, dictated the conclusion that the shareholders gave up nothing

96. 427 F.2d 727 (Ct. Cl.), *modified,* 433 F.2d 1324 (Ct. Cl. 1970) (recapitalization under § 77 of the Bankruptcy Act).

97. 427 F.2d at 734.

98. 433 F.2d at 1326. The court found that the fair market value of the securities received by taxpayer was in excess of the face amount of the bonds and, therefore, disallowed the claimed discount deduction.

99. 469 F.2d 340 (5th Cir. 1972). Other cases that also should be examined are St. L. & S.F. Ry. v. United States, 444 F.2d 1102 (Ct. Cl. 1971) (applying the *Cities Service* rationale to deny a deduction), and Atchison, T. & S.F.R.R. v. United States, 443 F.2d 147 (10th Cir. 1971) (allowing discount in a § 77 Railroad reorganization). *See* Rev. Rul. 387, 1959-2 CUM. BULL. 56.

100. 469 F.2d at 343-44.

of value to the corporation and for that reason, there was "no 'borrowing' sufficient to give rise to bond discount."[101]

3. National Alfalfa Dehydrating & Milling Co. v. Commissioner[102]

In *National Alfalfa,* the taxpayer corporation recapitalized by issuing debentures in exchange for its outstanding preferred stock, for which it had received fifty dollars per share upon issuance. At the time of the bonds-stock exchange, the preferred shares had a fair market value of thirty-three dollars per share; the shares were exchanged for debentures with face amounts of fifty dollars. On the basis of these facts, the corporation claimed that it was entitled to amortize as original issue discount, an amount equal to the excess of the bonds' face value over the preferred's market value—seventeen dollars for each bond and share exchanged.

Throughout the litigation, the government argued that no discount deduction should be allowed because there had been an equivalency of exchange. In other words, since the taxpayer already had received fifty dollars for each share of preferred stock, its issuance of fifty-dollar debentures in a one-for-one exchange for the stock resulted in no deductible loss. The government took the position that the result had been a reshuffiing of taxpayer's balance sheet—paid-in capital attributable to the preferred stock had been moved to the liability section of the balance sheet, producing no amount that could be deducted.

Relying primarily on the Court of Claims' decisions in *Missouri Pacific* and *Erie,* the Tax Court held for the government.[103] The Tenth Circuit reversed and allowed a discount deduction in the full seventeen dollar per unit-of-exchange amount. The Tenth Circuit agreed with the taxpayer's argument that what is allowed in one step should also be allowed in two steps. If taxpayer had issued fifty-dollar bonds and received thirty-three dollars cash for each bond and had then used that cash to purchase the outstanding preferred shares, amortizable discount undoubtedly would have been present; therefore, the accomplishment of the same end result in a one-step exchange should not be treated differently.[104] The court went on to

101. *Id.* at 344. The court found that the facts of the cases allowing bond discount in recapitalizations involved "radical" changes in the form of participation of the exchanging shareholders—a factor which was not present in *Claussen's. Id.* at 343 n.9. The court also pointed out that this case was close to the *Bazley* situation in which the bonds issued are treated, in their full amounts, as dividend income to the recipients. *Id.* at 344 nn.9 & 10.

102. 94 S. Ct. 2129 (1974), *rev'g* 472 F.2d 796 (10th Cir. 1973), *rev'g* 57 T.C. 46 (1971).

103. 57 T.C. at 54-58. *See* notes 95-98 *supra* and accompanying text.

104. 472 F.2d at 802.

state that the government's attempted treatment of this set of facts was not economically realistic because it incorrectly characterized amortizable bond discount as loss. The proper interest characterization of discount, said the court, renders the preferred stock's original issue price irrelevant in the ascertainment of presence and amount of discount.[105]

The Supreme Court reversed the Tenth Circuit and disallowed the taxpayer's discount deduction.[106] The Court's opinion stressed two primary bases for its decision. First, since the transaction was "insulated from the market processes," there was no showing that the bond-stock value differential was attributed to original issue discount. Secondly, according to the Court, the transaction resulted in no new capital being acquired and no additional cost being incurred.[107]

The first point, insulation from market forces, was the basis for the Court's rejection of the Tenth Circuit's "one-step, two-step" approach.[108] The Court stated that it found nothing in the record establishing a probable open market price for the five-percent debentures or the preferred shares. In the absence of proof of accurate open market prices, the Court refused to speculate whether original issue discount existed.[109]

In its second point, absence of "new" capital or additional cost of capital, the Court recognized that the corporation's substitution of bonds for preferred stock was perhaps more than a mere reshuffling of the capital structure.[110] The corporation had assumed a fiscal obligation to pay principal and interest. The Court, however, found no capital that could be said to have been acquired by the taxpayer and since "[t]he fixed interest on the debenture was equal to the cumulative dividend on the preferred, and both the preferred and the debenture worked equal diminutions in the earnings otherwise available for the common shareholder,"[111] the Court

105. *Id.* at 804-06. The court cited 2 United States Supreme Court decisions to establish the correctness of treating bond discount as interest paid. Those decisions are Helvering v. Union Pac. R.R., 293 U.S. 282 (1934) (discount serves "the same function as stated interest") and United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (discount represents a part of the cost of borrowed capital).

106. 94 S. Ct. at 2136-38.

107. *Id.* at 2138-40.

108. *See* note 104 *supra* and accompanying text.

109. The Court stated that the "one-step", "two-step" approach violated "the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred." 94 S. Ct. at 2137.

110. *Id.* at 2139.

111. *Id.*

found that the cost of capital had not increased as a result of the exchange. The "interest of the preferred shareholders 'was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred was converted.' "[112]

The Supreme Court expressly limited its holding to the "narrow issue whether debt discount arises where a corporate taxpayer [has issued] an obligation [prior to May 27, 1969] in exchange for its own outstanding preferred shares,"[113] and expressly did not decide the "broader" question whether discount arises upon an exchange of bonds for other types of noncash property.[114] The Court's comments on the nature of discount, however, will certainly be reference points for future courts faced with one of these broader questions. Refusing to commit itself to an exclusive characterization of discount as "interest paid for the use of capital" or "loss resulting from the funding operation,"[115] the Court stated that regardless of the characterization, "the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital."[116] This language will probably be quoted frequently in future original issue discount cases.

D. *Summary Analysis of Cases Dealing with the Pre-1969 Issue*

The foregoing discussion illustrates the differences in theory appearing in the cases considering the bond discount question in noncash property exchanges. The next section of this Note discusses and analyzes the 1969 legislation designed to clarify this confused area. Before turning to that section, however, the basic, underlying premises of the different theories of debt discount in these cases should be discussed, and the probable ramifications of *National Alfalfa* should be analyzed.

Readily identifiable are two competing characterizations of "original issue discount" that appear in some of the lower court decisions discussed above. The first characterization is that discount is in the nature of a loss incurred by the corporation; the second characterization is that discount is deferred interest—an expense that the corporation incurs for the use of another's money.

The loss characterization has been manifested in the theory

112. *Id.* at 2139-40.
113. *Id.* at 2136.
114. *Id.*
115. *Id.*
116. *Id.*

that the corporation should be denied discount amortization because it must dispose of the property acquired with the bonds before it can realize any loss—the loss being inherent in the payment for the property with bonds that have a face amount greater than the fair market value of the property. In taxable purchases of property with bonds, this theory would seemingly give the property a cost basis equal to the face amount of the bonds. Then, if the property is depreciable, the taxpayer will recover through depreciation the amount the corporation contends is discount.[117] If the property is not depreciable, the taxpayer might still recover an amount that includes this claimed discount by selling the property and subtracting his cost basis to compute his gain.

In a tax-free purchase transaction, however, the loss theory does not work so neatly. Since most tax-free transactions necessitate a carryover basis, the face amount of the bonds is not relevant in computing the basis of the acquired property; the amount of claimed discount is not a part of the basis and cannot be deducted as depreciation or as part of the cost basis on a sale of the property. At least one loss-theory court has recognized this anomaly, and justified it by saying merely that it is a burden accompanying tax-free treatment that must be suffered by a corporation structuring its transaction in this manner.[118]

The postponement-of-loss-until-disposition theory is inapplicable to most recapitalization cases because the property acquired consists of securities that ordinarily will be retired immediately after the exchange. Therefore, since no depreciation and no subtraction of cost basis on later disposition can be had, the claimed discount amount cannot be deducted. The loss characterization of discount is, however, manifested in some of these cases by means of what might be called the "original value" theory. That theory, set forth in the *Cities Service* case and the latest Court of Claims cases, states that it is impossible for deductible discount to arise in an exchange of a corporation's bonds for its own outstanding securities unless the bonds' face amount is in excess of the securities' original value. Advocates of this theory argue that "when a corporation exchange[s] $100 face value bonds for its own stock for which it had received $100, then it ha[s] really *lost* nothing as a result of the transaction" (emphasis added).[119] It is only when the face value of the bonds exceeds the higher of the amount originally received for

117. Southern Natural Gas Co. v. United States, 412 F.2d 1222, 1238-39 (Ct. Cl. 1969).

118. Montana Power Co. v. United States, 159 F. Supp. 593, 596 (Ct. Cl. 1958).

119. Missouri P. R.R. v. United States, 427 F.2d 727, 730 (Ct. Cl. 1970).

the stock or the value of the outstanding stock to the taxpayer that the corporation has suffered a loss deductible as discount.

In contrast to the loss-characterization courts, most of the courts that consistently have allowed original issue discount amortization in bond-for-noncash property exchanges have characterized the discount as interest. This characterization frequently appears in the "one step-two step" theory, which concedes that a discount deduction would be allowed if taxpayer issued bonds to the public for an amount of cash less than the face value of the bonds and then used that amount of cash to purchase property. According to this theory, a denial of the deduction should not occur when the same end result is accomplished in a one-step bond-property exchange.[120] Often mentioned is the use of the discount to induce the property owners to make the exchange for bonds with a lower stated interest rate.[121]

As previously mentioned, the Supreme Court in *National Alfalfa* refused to adopt exclusively either the loss characterization or the interest characterization of bond discount. Nonetheless, the Court's statement of the "relevant inquiry" in bond discount cases—"whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital"[122]—resembles an interest characterization much more than a loss description.

Putting aside recapitalization cases for a moment, a corporation that uses bonds to acquire noncash property, the face amount of which exceeds the value of the property, should be said to have incurred a cost or expense of acquiring the use of the property by virtue of the necessity of issuing the bonds in this excess amount. Therefore, to the extent that courts have used the loss theory to deny the existence of discount in corporate organization and acquisition cases, *National Alfalfa* seems to require at least a different approach, although perhaps not different results in all cases.

Reading *National Alfalfa* as supportive of an interest characterization should not be taken as a blanket endorsement of the results of those cases in which courts used the interest characterization to allow a discount deduction. Although the interest approach of lower

120. National Alfalfa Dehydrating & Milling Co. v. United States, 472 F.2d 796, 806 (10th Cir. 1973), *rev'd*, 94 S. Ct. 2129 (1974); Atchison, T. & S.F.R.R. v. United States, 443 F.2d 147, 151-52 (10th Cir. 1971); American Smelting & Ref. Co. v. United States, 130 F.2d 883, 885 (3d Cir. 1942).

121. *See* cases cited in note 120 *supra*.

122. 94 S. Ct. at 2136.

courts may have recognized correctly that a corporation incurred some additional cost in issuing bonds with a face value in excess of the value of property received, "interest" courts prior to *National Alfalfa* did not apply that case's second element—a strict standard of proof that market forces were the causative agents in producing the amount claimed as discount. These courts merely have used the "one-step, two-step" approach, which *National Alfalfa* explicitly rejects as too hypothetical and speculative.

The effect of *National Alfalfa* on a pre-1969 organizational or acquisitive issuance of bonds for noncash property seems twofold. First, the corporate taxpayer should be able to overcome the argument that the claimed discount is loss, the recognition of which must be postponed or which in appropriate instances may be deducted as depreciation.[123] The taxpayer can point to the *National Alfalfa* statement of the relevant inquiry. This taxpayer advantage, however, is counterbalanced by the likelihood that courts will require substantial proof that the claimed discount was necessitated by, and was a result of, market forces. The *National Alfalfa* Court's list of deficiencies in the taxpayer's proof included a lack of evidence of the cash price the bonds would have brought in open market sales and of proof of the price the taxpayers would have had to pay in order to purchase its outstanding preferred shares on the open market.[124]

Still considering only organizational or acquisitive issuances of bonds, a taxpayer that meets the *National Alfalfa* proof requirements should get a discount deduction. The degree of proof that will be required is an open question. A likely guess is that a court might refer to the statutory law for post-1969 bond-property exchanges, discussed in the next section, and require that at least one element of the exchange—the bond or the property acquired—be of a nature that would allow an accurate assessment of its value on an open, actively trading market.[125] The taxpayer could argue that the post-1969 requirement cannot be applied validly to a pre-1969 bond issue, but the court could always read *National Alfalfa* as implicitly treating such a requirement as always having been the law.

Having concluded that *National Alfalfa* should not absolutely preclude a court's finding amortizable discount in a pre-1969 organizational or acquisitive bond-noncash property exchange, the effect

123. *See* notes 57 & 58 *supra* and accompanying text.

124. 94 S. Ct. at 2137-38.

125. *See* notes 142-44 *infra* and accompanying text.

of that case on pre-1969 recapitalizations must be considered. At first glance the effect appears obvious—no original issue discount arises when a corporation issues bonds in exchange for its own outstanding preferred stock. A careful examination of the decision, however, indicates that in a different case, a recapitalized taxpayer might argue successfully that *National Alfalfa* should be limited to its facts despite the broad phraseology in which its issue was stated.[126] The taxpayer would argue that *National Alfalfa* should be limited to cases in which the face value of the bonds did not exceed the greater of the original issue price or the fair market value of the exchanged shares. In essence, this taxpayer would be contending that the Southern District of New York's *Cities Service* decision is not inconsistent with *National Alfalfa*.[127]

The merit of this argument limiting *National Alfalfa* is arguable. It is directed primarily to that section of the Court's opinion holding that the taxpayer had incurred no additional cost for the use of capital. The Court based this particular part of the decision on two assessments: (1) no *new* capital had been injected into the corporation and (2) "the substitution . . . of . . . debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed . . . ."[128] A recapitalization rarely, if ever, results in an injection of new capital into the corporation. The second assessment that no increase in the corporation's obligation resulted, is arguable, however, even considering the Court's finding that the fixed interest on the debenture was equal to the cumulative dividend on the preferred. The taxpayer's argument that the obligations to pay interest and the obligation to pay a principal sum at a certain date are greater and more rigid obligations than those that exist with respect to cumulative preferred stock appears convincing despite its dismissal by the Court.[129] Imagine circumstances in which the issued bonds carried a face amount in excess of the preferred's original issue price and redemption value, and in which the preferred was noncumulative. It would be even more difficult, in that case, to dismiss an argument that the corporation actually had assumed

126. The Court stated: "We are concerned . . . only with the narrow issue whether debt discount arises where a corporate taxpayer issues an obligation in exchange for its own outstanding preferred shares." 94 S. Ct. at 2136.

127. *See* notes 82-88 *supra* and accompanying text.

128. 94 S. Ct. at 2140.

129. The Court seemed to find equivalence of obligation by looking at the fact that "both the preferred and the debentures worked equal diminutions in the earnings otherwise available for the common shareholders." 94 S. Ct. at 2139.

greater obligations resulting in additional costs that satisfy the "relevant inquiry."[130]

Assuming that a recapitalized taxpayer, whose situation differed from *National Alfalfa,* could establish the incurrence of additional cost in the recapitalization, the taxpayer would still face the stricter proof requirements. These requirements may be even more difficult to meet in recapitalizations than in organizational and acquisitive exchanges because a recapitalization necessarily involves a transaction between related parties—the corporation and its shareholders. Therefore, courts may always consider recapitalizations to be insulated from market forces and deny a discount deduction on that factor alone. In short, *National Alfalfa* has made it extremely difficult, if not impossible, to obtain a discount deduction in recapitalization exchanges.

V. Legislative Response to the Problem: Section 413(b) of the 1969 Tax Reform Act

A. *The New Law—History and Operation*

The computation of original issue discount necessitates a determination of the amount by which the bond's face value exceeds its issue price.[131] In the bonds-for-noncash property cases allowing a discount deduction, the "issue price" was the value assigned to the property acquired by the corporation in exchange for its bond. Section 413(b) of the 1969 Tax Reform Act,[132] in an attempt to lay to rest the problems in the noncash property area, added to section 1232(b)(2) of the Internal Revenue Code the following:

> In the case of a bond or other evidence of indebtedness, or an investment unit as described in tbis paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371, 373, or 374), which is issued for property and which—
>
> (A) is part of an issue a portion of which is traded on an established securities market, or
>
> (B) is issued for stock or securities which are traded on an established securities market, the issue price of such bond or other evidence of indebtedness or investment unit, as the case may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.[133]

130. *See* note 122 *supra* and accompanying text.
131. Treas. Reg. § 1.1232-3(b)(1) (1967).
132. Pub. L. No. 91-172, § 413, 83 Stat. 611.
133. Int. Rev. Code of 1954, § 1232(b)(2).

This provision is applicable to bonds issued after May 27, 1969.[134]

The legislative history of this provision is interesting. The first draft of the provision apparently adopted the principle that original issue discount could arise in *any* bonds-for-property exchange, and contained no restrictions with respect to an "established securities market" or "reorganization[s] within the meaning of section 368(a)(1)."[135] Both the House and Senate Committees approved this first draft,[136] but during debate of the Bill in the Senate the provision was amended at the request of the Department of the Treasury to include the restrictive language.[137] The amendment was accepted by the conference committee,[138] and the provision was enacted in the form quoted above.[139]

The new law allows amortizable original issue discount to arise in a bonds-for-noncash property exchange only when the bond itself "(A) is part of an issue a portion of which is traded on an established securities market, *or* (B) is issued for stock or securities which are traded on an established securities market".[140] Note that this is an "either-or" situation—only one element of the exchange, not both, must be traded on an established securities market. The rationale behind this "established securities market" requirement is the government's fear of being "whipsawed"—a fear that is expressed most completely in a letter from the Deputy Assistant Secretary of the Treasury to Senator Williams of Delaware:

> The whipsaw problem arises because of the severe difficulty of valuing property not traded on some recognized exchange. 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 that he has no "original issue discount" income. It is not possible to bring these parties together in the same lawsuit, or otherwise to insure that consistent valuations are applied, so that if one party gets an ordinary deduction, the other has an

134. Treas. Reg. § 1.1232-3(b)(2)(iii) (1967). Although the statutory provision was added to § 1232, which deals primarily with the income aspects of bonds to bondholders, it is apparent from the provision's legislative history that it is intended to apply to the deductibility of discount to the issuing corporation. A 1971 Treasury Regulation, § 1.163-4, promulgated under § 163 (tbe deduction for interest paid) refers to Treas. Reg. § 1.1232-3(b)(2) (iii) for determining the existence and amount of deductible original issue discount and bonds-for-noncash property exchange.

135. *See* H.R. REP. No. 413 (Part 2), 91st Cong., 1st Sess. 86 (1969); BITTKER & EUSTICE, *supra* note 8, at ¶ 4.22.

136. H.R. REP. No. 413 (Part 2), 91st Cong., 1st Sess. 86 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 148 (1969).

137. 115 CONG. REC. 36730-31 (1969).

138. H. CONF. REP. 782, 91st Cong., 1st Sess. 135-36, 307-08 (1969).

139. *See* note 132 *supra* and accompanying text.

140. INT. REV. CODE OF 1954, § 1232(b)(2) (emphasis added).

equivalent amount of ordinary income. This would suggest 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 securities so traded. In these latter cases, the valuation problem (and thus the whipsaw danger) does not exist.[141]

Treasury Regulations further explain the computation of original issue discount in the noncash property exchanges. If the bond itself is part of an issue traded on an established securities market, the fair market value of the noncash property exchanged is determined by reference to the fair market value of the bond.[142] The fair market value of the bond is determined "as of the first date after the date of issue (within the meaning of section 1232(b)(3)) that [the bond] is traded on an established securities market."[143] In essence, this allows the bonds issued for noncash property to discount themselves with reference to the fair market value of the property. Apparently, the Treasury Department is of the opinion that if a one hundred-dollar, five percent bond issue is trading at ninety-seven dollars immediately after the exchange for property, a three dollar discount deduction should not be denied simply because the bond was issued for noncash property. If the bond is not part of an issue traded in an established market, original issue discount will not exist unless the property in exchange for which the bond is issued is stock or securities that are so traded. If the noncash property is traded-stock or securities, its fair market value is established as of the date that the exchange was made,[144] and discount is computed by subtracting that amount from the face value of the bond.

The definition of an "established securities market" is found by reference to Treasury Regulation section 1.453-3(d)(4), which includes exchanges registered under section 6 of the Securities and Exchange Act of 1934[145] or exempted from registration under Section 5 of that Act.[146] The definition also includes over-the-counter markets that utilize an interdealer quotation system.

As will be discussed below, the statute and regulations provide that even if the bond or property is traded on an established market,

141. 115 CONG. REC. 36730 (1969).

142. Treas. Reg. § 1.1232-3(b)(2)(iii)(*c*).

143. *Id.* The bond is "traded" if on or within 10 days after the date of its issuance it is being traded.

144. *Id.* The regulation refers to Treas. Reg. § 20-2031.2 for determining fair market value of traded securities.

145. 15 U.S.C. § 78f (1970).

146. 15 U.S.C. § 78e (1970).

no original issue discount results in exchanges pursuant to a plan of reorganization within the meaning of Code section 368(a)(1),[147] nor in insolvency reorganizations.[148] Again, reference to the Treasury Department letter is enlightening.

> The reorganization problem arises because in a taxfree reorganization, no gain or loss is recognized to the the corporations involved and the basis of the assets of the transferor corporation carries over, that is, such assets have the same basis in the hands of the transferee corporation. Under these circumstances, original issue discount ought not be taken into account so as to give the transferee corporation an amortization deduction as a result of the issuance of its bonds in the reorganization. In other situations, the issuing corporation pays a price where there is original issue discount because the basis of the assets is their lower value at the time the bonds are issued rather than the face amount of the bonds. In a reorganization, however, where the basis of the assets carries over, this "leveling" factor does not exist and there is every reason for the issuing corporation to claim a low value for the assets to increase its amortization deduction for bond discount if such a deduction is allowed. Thus, the danger of the Government being whipsawed is even greater.[149]

The new statute seems to have had judicial and administrative convenience as its primary aim. It is true that the valuation of property often plants the seeds of dispute that ripen into litigation particularly in instances where the fair market value is determinable only by reference to isolated transactions between parties that may or may not be dealing at arm's length. Although it may discriminate against smaller, closely held businesses, the traded-on-an-established-market requirement of the new law is justifiable as a necessary means of injecting some certainty into the administrative and judicial treatment of the discount deduction, and apparently this requirement will solve the market insulation problem that was forecefully raised in *National Alfalfa*.[150] Not as logically justifiable, however, is the specific exemption of reorganization transactions from the discount treatment—a problem that is discussed below.

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147. INT. REV. CODE OF 1954, § 368(a)(1).

148. *Id.* §§ 371, 374.

149. 115 CONG. REC. 36730 (1969).

150. *See* notes 108-09 *supra* and accompanying text. The amendments made by section 413 of the 1969 Tax Reform Act also changed the treatment of discount by bondholders. Whereas the prior law taxed hondholders' discount income only upon the bondholder's sale or redemption of the bond, the 1969 provision requires ratable inclusion of discount income over the life of the bond. The new provision does not state explicitly whether the character of the income is true interest or just ordinary gain. Nonetheless, the ordinary income nature of discount to the bondbolder and the requirement that it be ratably included over the life of the bond should be kept in mind when examining a discount problem. INT. REV. CODE OF 1954, § 1232(a)(3)(A); *see* BITTKER & EUSTICE, *supra* note 8, at ¶ 4.22; 9 CCH 1974 STAND. FED. TAX REP. ¶ 8146, at 75,333.

B. *Analysis of the Effect of Section 1232(b)(2) on Specific Transactions*

1. Corporate Organizations

Under the Tax Reform Act's addition to section 1232(b), deductible bond discount can arise in corporate organizations.[151] Its existence in such transactions will be limited to those situations in which the traded-on-an-established-market requirements are met. In the absence of public trading of its bonds, will the corporation lose a deduction for the amount by which its bonds' face value exceeds the fair market value of the property acquired? At least one government attorney[152] surmises that if the established market requirement is not met, section 1232(b)(2) adopts the theory of the Court of Claims' *Southern Natural Gas* decision[153] that the cost basis of the acquired property is the full face-amount of the debt when the discount deduction is denied. If this theory is applicable, then the corporation might get its claimed discount deduction in a different form—depreciation or subtraction of cost basis on resale of the property. Deductions in these forms, however, are much more contingent than a discount deduction; if the property is nondepreciable or unlikely to be resold, a deduction of the claimed amount may be lost. It is also doubtful whether this cost-basis theory would enable the corporation to deduct discount when the bond-property exchange occurs in a corporate organization that qualifies under section 351.[154] Assuming that the bond is a "security" and that its recipients control the corporation, section 362(a) requires the corporation to take a carryover basis which would foreclose *any* later deduction of the amount. Therefore, the possibility of a deduction of the discount amount in some form depends on whether the exchange is a sale or a section 351 transfer, whether the property is depreciable or likely to be sold by the corporation at a later date, or whether the bond issued is part of an issue traded on an established securities market.[155] Apparently Congress and the

151. "The application of section 351 shall not preclude the creation of original issue discount." Treas. Reg. § 1.1232-3(b)(2)(iii)(*d*) (1973).

152. Reply Brief for Petitioners at 6, Commissioner v. National Alfalfa Dehydrating & Milling Co. 94 S. Ct. 2129 (1974).

153. *See* notes 52-57 *supra* and accompanying text.

154. INT. REV. CODE OF 1954, § 351 (providing for nonrecognition of gain in certain transfers to controlled corporations). It is still assumed tbat the "trade-on-an-estahlished market" requirement is not met.

155. The denial of original issue discount in transactions in which it argnably exists in an economic sense apparently gives the bondholders a "break" with respect to the discount

Treasury justify this circumstantial disparity of treatment by pointing to the administrative convenience of allowing a discount deduction per se only when the circumstances facilitate specific computation of the amount of discount and ensure its arm's-length creation.

2. Recapitalizations

The foremost problem in analyzing the availability of an original issue discount deduction in recapitalizations is the inclusion by Code section 368(a)(1)(E) of the recapitalization within the meaning of the "reorganization." The new addition to section 1232(b)(2) operates to preclude the existence of discount with respect to bonds "issued pursuant to a plan of reorganization within the meaning of section 368(a)(1)."[156] It is entirely possible, however, to make a strong argument that the normal recapitalization context in which discount arguably arises—an issuance of debt securities in exchange for outstanding equity securities—is not a reorganization within the meaning of section 368(a)(1).[157]

A reorganization within the meaning of section 368(a)(1) connotes tax-free treatment of the transaction. A recapitalization in which the corporation issues bonds for equity securities, however, is by no means tax-free; section 356(d)(2)(B) would operate to make the exchange taxable to the extent of gain.[158] Such a transaction might be characterized more accurately as a redemption of the outstanding securities.[159] An example in a Treasury Regulation under section 354, which governs exchanges of stock in reorganization, lends authority to the above theory:

> C, a shareholder in Corporation Z (which is not a railroad corporation) surrenders all his stock in Corporation Z in exchange for securities [presumably debt] in Corporation Z. Whether or not this exchange is in

amount. If the bond-property exchange is treated as a "sale," the bondholder will be required to recognize gain determined pursuant to INT. REV. CODE OF 1954, § 1001, which provides that the adjusted basis of the disposed property shall be subtracted from the amount realized on the disposition. "Amount realized" is the fair market value of the bond. Suppose the bondholder successfully establishes that his $100, 4% bond has a fair market value of $95; assume bis adjusted basis for the transferred property (fair market value = $95) was $70; his recognized gain is $25 and his hasis for the bond becomes $95. When he receives $100 in retirement of the bond, that amount will be treated as capital gain pursuant to Treas. Reg. § 1.1232-2 (1974). The $5 amount looks very much like "deferred interest" which might warrant ordinary income treatment. The statute, however, says that this is not the case.

156. INT. REV. CODE OF 1954, § 1232(b)(2).

157. Brief for Respondent at 20-22, Commissioner v. National Alfalfa Dehydrating & Milling Co., 94 S. Ct. 2129 (1974), CCH 1974 STAND. FED. TAX REP. ¶¶ 2551.459, 8146.

158. *See id.;* BITTKER & EUSTICE, *supra* note 8, at ¶ 14.34.1.

159. Brief for Respondent, *supra* note 157.

connection with a recapitalization under section 368(a)(1)(E), section 354 does not apply. See, however, section 302 [redemptions].[160]

If these bond-equity exchanges are redemptions to which section 302 applies, the exchanging shareholder looks to that section to determine whether his gain receives dividend treatment or sale or exchange treatment.[161] As to the corporation, characterization of the exchange as a redemption rather than a section 368 reorganization leaves the corporation free to argue that the clause of section 1232(b)(2) excluding discount in "reorganizations" is inapplicable to the transaction. Then if the established market requirement is met, a discount deduction arguably could be taken. This argument would be strongest when the recapitalization consisted exclusively of the corporation's issuance of bonds in exchange for equity securities. If other property is exchanged for bonds in the recapitalization and *part* of the exchange is tax-free, the government might argue that the debt was "issued *pursuant* to a plan of reorganization within the meaning of section 368(a)(1)."[162]

The above discussion has pointed out the arguments that might be made to allow the taking of a discount deduction when publicly-traded securities change hands in what is commonly called a "recapitalization."[163] Even if the taxpayer could convince a court to characterize the transaction as coming outside of section 368, it is likely that the court conveniently could use the *National Alfalfa* case to deny a discount deduction. In fact, this would probably be the primary, if not sole, utility of *National Alfalfa* in considering cases involving post-1969 bond-property exchanges.

3. Debt-financed Acquisitions

Much of the above discussion on corporate reorganizations is applicable to debt-financed acquisitions. If a corporation uses bonds to purchase property in a taxable transaction, and the established market requirement is met, then deductible discount can arise in

160. Treas. Reg. § 1.354-1(d) Example (3). *See* INT. REV. CODE OF 1954, § 317(b), which states: "For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property [defined in § 317(a) to include securities], whether or not the stock so acquired is cancelled, retired or held as treasury stock."

161. INT. REV. CODE Of 1954, § 302.

162. *Id.* § 1232(b)(2) (emphasis added).

163. *See* CCH 1974 STAND. FED. TAX REP. ¶ 8146 at 75,333. The *National Alfalfa* Court was presented with this very argument by the taxpayer's counsel, apparently in anticipation that the Court migbt implicitly make a retroactive application of the post-1969 statute. Brief for Respondent at 20-22. The Court, however, did not mention the question.

the transaction. If, however, the established market requirement is not met, the corporation probably will lose its deduction for the discount amount unless the cost-basis theory works to provide a deduction in the form of depreciation or subtraction of basis on resale of the property. The administrative convenience justification discussed in the organization section is applicable to this treatment of acquisitions. In addition, the new law may have embodied some economic, fiscal policy designed to curb the popularity of debt-financed acquisitions.[164]

At the outset of the Note, mention was made of the permissible use of a limited amount of debt obligations in acquisitive-type, tax-free reorganizations—primarily Types "A" and "C". The new law provides that deductible discount shall not be created as a result of the issuance of bonds pursuant to those plans of reorganization. It is difficult to understand this aspect of the law. The Treasury Department letter previously mentioned[165] emphasized the "whipsaw" problem of competing valuations of property that make the discount question a stumblingblock in the efficient collection of revenue. The new law seeks to remedy the whipsaw problem, however, by providing the established market requirement. It is difficult to understand why an acquisitive reorganization that utilizes traded bonds or involves the acquisition of traded securities should be denied a discount deduction. Moreover, since acquisitive reorganizations require the acquiring corporation to take a carryover basis for the assets acquired increased by the amount of gain recognized by the transferor *corporation*,[166] the cost-basis theory generally will not work to provide a deduction of the discount amount in some other form. No good reason is available to explain why discount cannot exist in a section 368 reorganization but can exist in a section 351 transfer, assuming the established market requirement is met; the treatment of transactions qualifying under either of these sections is quite analogous. Referring again to the *National Alfalfa* decision,

164. The addition to § 1232(b)(2) was part of a larger scheme of legislation that had the effect of curbing some of the advantages of debt-financed acquisitions. *See* INT. REV. CODE OF 1954, §§ 453(b)(3) (treating receipt of readily marketable securities as the receipt of cash for purposes of determining eligibility for installment reporting), 279 (denying corporations an interest deduction for acquisitive debt with certain characteristics), 249 (allowing deduction of premium paid to redeem convertible debt only to the extent that the premium is not attributable to the conversion feature). *See* BITTKER & EUSTICE, *supra* note 8, at ¶¶ 4.21-.22.

165. *See* note 149 *supra* and accompanying text.

166. INT. REV. CODE OF 1954, § 362(b). In an "A" reorganization, the transferor corporation will never recognize gain. In a "C" reorganization, the transferor corporation recognizes gain only if it does not distribute boot. *Id.* § 361.

the market insulation problem should be satisfied by the statute's established market requirement making that case's "relevant" inquiry—whether additional cost for the use of capital is incurred —result in a response that such additional cost can exist and can be identified in these acquisitive reorganization transactions. A different explanation can perhaps be advanced for the denial of discount in reorganizations. Courts often argue that the burdens attendant to tax-free reorganizations must be accepted if the taxpayer chooses to structure its transaction to reap the available benefits. The Court of Claims in its *Montana Power Co.* decision made a similar statement to justify its denial of a discount deduction.[167] Congress may have designed the denial of discount in reorganizations as a burden to offset the attractive benefits of reorganization treatment.[168]

VI. CONCLUSION

The traditionally troublesome concept of original issue discount in federal tax law is compounded when bonds are issued in exchange for noncash property. Courts have been in disagreement over whether the discount should be treated as deferred interest or loss and the disparity of results in the case law reflects this confusion of characterization. In most bond-property transactions, a good argument can be made that the excess of the bond's fair value over the fair market value of the property represents deferred interest, as opposed to a bad bargain. In terms of economic reality, the deferred interest characterization seems superior and the treatment resulting from that characterization seems to produce theoretically correct results.

The *National Alfalfa* case may have put to rest the contention that discount can arise in corporate recapitalizations. That case did not adopt either of the characterizations discussed, but found that no additional cost for the use of capital is incurred in recapitalizations. In addition, it set forth a strict standard of proof, which seemingly applies to all pre-1969 bond-noncash property exchanges regardless of the context in which they are transacted. *National Alfalfa* did not decide the question of discount in acquisitive or organizational exchanges, but its reasoning on discount generally indicates that a deduction might be obtainable in those transactions.

167. Montana Power Co. v. United States, 159 F. Supp. 593, 596 (Ct. Cl. 1958).

168. *See* note 164 *supra* and accompanying text; Reply Brief for Petitioners, *supra* note 152, at 6.

Legislation has attempted to clarify the discount question with respect to bond-property exchanges occurring after May 27, 1969. Broadly speaking, that legislation permits discount to arise in bond-property exchanges if either the bond is traded on an established market or the property received is stock or securities traded on an established market. Significantly, discount cannot arise if bonds are issued for noncash property pursuant to a plan of reorganization within the meaning of section 368(a)(1) or pursuant to an insolvency reorganization.

The post-1969 law may be viewed as adopting the interest characterization of discount with an established market requirement superimposed to ensure ease in determination of its existence and computation of its amount. If the established market requirement is not met, perhaps the claimed discount amount will find another route to deductibility pursuant to the cost-basis theory.

The provision of the new law that is most difficult to explain is the denial of discount in reorganization transactions. It is possible that bond-equity exchanges, which are commonly referred to as recapitalizations, are not recapitalizations in the sense of a section 368(a)(1)(E) reorganization, but are actually redemptions in which a discount arguably could arise under the new law. Even if the post-1969 statute does not technically apply to such transactions, they will still be subject to the analysis of *National Alfalfa,* which likely will cause denial of a discount deduction. As to the acquisitive-type reorganizations, there appears to be no justifiable reason—other than curbing their popularity—for denying the existence of discount. In some ways, the new statute may have clarified the discount area, but in other very important respects it has created new questions and prolonged old ones.

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