August 17, 2020

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re:  Comments on Workout-Related Relief in Response to COVID-19

Dear Commissioner Rettig:

Enclosed please find comments concerning relief related to workouts in response to the COVID-19 emergency. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Joan C. Arnold
Chair, Section of Taxation

Enclosure

cc:  Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
     Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
     Colin Campbell, Attorney-Advisor, Department of the Treasury
     Kimberly Koch, Attorney-Advisor, Department of the Treasury
     Natasha Goldvug, Attorney-Advisor, Department of the Treasury
     Jarrett Jacinto, Attorney-Advisor, Department of the Treasury
     Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
     Helen Hubbard, Associate Chief Counsel Financial Institutions and Products,
         Internal Revenue Service
     Robert Wellen, Associate Chief Counsel Corporate, Internal Revenue Service
     Kathryn Zuba, Associate Chief Counsel Procedure & Administration, Internal
         Revenue Service
     John Moriarty, Associate Chief Counsel Income Tax and Accounting, Internal
         Revenue Service
     Darren Guillot, Deputy Commissioner Collection and Operations Support,
         Small Business/Self-Employed Division, Internal Revenue Service
     Frederick Schindler, Director, Collection Policy, Small Business/Self Employed
         Division, Internal Revenue Service
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON WORKOUT-RELATED RELIEF
IN RESPONSE TO THE COVID-19 EMERGENCY

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Lawrence A. Sannicandro and Wm. Robert Pope, Jr.. Substantive contributions were made by Laura E. Krebs Al-Shathir, Amy K. Chapman, Pamela Lawrence Endreny, T. Keith Fogg, Mark R. Hoffenberg, Robert Liquerman, Sarah Lora, William R. Pauls, Nancy O. Ryan, Anthony V. Sexton, Janice Shih, Caleb B. Smith, Bela Unell, and Kenneth C. Weil. These Comments were reviewed by Lisa M. Zarlenga of the Section’s Committee on Government Submissions and by Kurt L. Lawson, the Section’s Vice Chair for Government Relations.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by the Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of, one or more specific issues addressed by the Comments has participated in the preparation of the portion (or portions) of the Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of the Comments.

Contact: Amy K. Chapman
akchapman@kpmg.com
(202) 533-4742

Wm. Robert Pope, Jr.
bobpope@whitereasor.com
(615) 383-9495

Bela Unell
bunell@kpmg.com
(202) 533-3064

Date: August 17, 2020
Executive Summary

During a telephone conference of the American College of Tax Counsel on May 1, 2020, Chief Counsel Michael J. Desmond requested input from the Section with respect to issues arising in workouts and restructurings for which tax-related guidance is appropriate. We understand that Chief Counsel Desmond requested the Section’s input to help the Internal Revenue Service (the “Service”) understand, and potentially issue appropriate guidance with respect to, the most pressing issues that are arising (or are likely to arise) in workouts and restructurings pursued in connection with the COVID-19 emergency. We appreciate the opportunity to provide our comments and identify several areas where guidance would be helpful. Given the number of bankruptcies and workouts expected as a result of the COVID-19 emergency, we request that guidance be issued as soon as possible.¹

Our Comments are based on the belief that tax policy should not preclude a workout or compel a company (or person) into bankruptcy. Part I provides recommendations with respect to traditional “workout” issues faced by financially distressed businesses (and their workouts partners). Part II provides recommendations with respect to ways in which individuals and businesses can resolve outstanding tax debts with the Service.

With respect to workout issues faced by financially distressed companies, including small businesses, and their workout partners, we recommend that the U.S. Department of the Treasury (“Treasury”) and the Service:

- Issue guidance providing that a responsible person who, in good faith, miscalculates an employee retention credit under the Coronavirus Aid, Relief and Economic Security (“CARES”) Act² or a paid family leave credit under the Families First Coronavirus Response Act (“FFCRA”)³ (each, an “Employment-Related Credit”) will not be held liable for the trust fund recovery penalty under section 6672⁴ with respect to the amount of any underpaid trust fund tax that is attributable to a good faith miscalculation of the credit;

¹ As the New York Times reports: “Edward I. Altman, the creator of the Z score, a widely used method of predicting business failures, estimated that this year will easily set a record for so-called mega bankruptcies—filings by companies with $1 billion or more in debt. And he expects the number of merely large bankruptcies—at least $100 million—to challenge the record set the year after the 2008 economic crisis.” Mary Williams Walsh, A Tidal Wave of Bankruptcies Is Coming, N.Y. TIMES (June 18, 2020), available at https://www.nytimes.com/2020/06/18/business/corporate-bankruptcy-coronavirus.html. And, it is widely expected that “a significant fraction of viable small businesses will be forced to liquidate, causing high and irreversible economic losses.” Id.


⁴ Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”) and all “Treas. Reg. §” references are to the Treasury Regulations.
• Adopt one or more safe harbors, described in more detail below, to help determine insolvency in workouts under section 108;

• Clarify the interaction between sections 163(j) and 108 by issuing guidance providing that the forgiveness of accrued interest for which a deduction was deferred under section 163(j) does not give rise to cancellation of indebtedness income (“CODI”), but instead reduces the excess business interest expense carryover under section 163(j);

• Clarify that certain deemed changes to debt instruments, caused solely by an elective change in entity status under the check-the-box regulations\(^5\) and described in more detail below, do not cause significant modifications under section 1001;

• Clarify that certain other actual changes to debt instruments, described in more detail below, also do not cause significant modifications under section 1001;

• Clarify the Payment Ordering Rule (as defined below) to apply only to interim payments and not to a payment in satisfaction of or termination of a debt, including a taxable exchange triggered by a significant modification within the meaning of Treas. Reg. § 1.1001-3 (or, alternatively, suspend the Payment Ordering Rule in the context of a distressed in- or out-of-court workout);

• Issue guidance concluding that a holder of an instrument with original issue discount (“OID”) need not accrue additional OID when the collectability of the OID is doubtful, and that a holder of an instrument with market discount need not accrue additional market discount under the same circumstances;

• Issue guidance clarifying, as described in more detail below, the application of the investment unit rules under section 1273 to situations in which some elements of the investment unit are publicly traded and other elements are not;

• Formally indicate that they do not intend to finalize the proposed Treasury Regulations under section 382(h), that were published in 2019, until at least 2021;

• Issue guidance, described in more detail below, clarifying that trading in distressed debt will not cause the debt to be treated as stock for purposes of section 382;

• Issue guidance describing the manner in which section 382(l)(5) and (l)(6) apply to a consolidated group;

promulgated under the Code, all as in effect (or, in the case of proposed regulations which remain outstanding, as proposed) as of the date of these Comments.

\(^5\) Treas. Reg. § 301.7701-3.
• Clarify that, for purposes of applying section 382(l)(5), where debt is satisfied for a combination of stock and debt, the debt is treated as having been satisfied by each form of consideration pro rata based on the relative fair market value of the consideration received; and

• Identify an experienced insolvency practitioner in each local insolvency office who can be available to answer questions and identify issues necessary for resolution relating to businesses making bankruptcy filings under the Small Business Reorganization Act of 2019 (the “SBRA”).

With respect to working out tax debts of financially distressed individuals and businesses, we recommend that the Service:

• Modify its offer in compromise (“OIC”) program in certain respects to offer certain taxpayers the benefits of bankruptcy through a streamlined OIC by:

  o Adopting a streamlined OIC program based on the Service’s OIC Pre-Qualifier tool (“Pre-Qualifier Tool”) that offers the same benefits of certainty and expediency that accompany a bankruptcy filing;

  o Applying federal exemption laws to OICs to offer the same benefit of asset protection as is available in a bankruptcy filing;

  o Changing or eliminating the five-year post-OIC compliance period and adopt a period within which successive OICs may not be filed, as in individual bankruptcies; and

  o Eliminating refund recoupments, especially of the earned income tax credit, the additional child tax credit, and the American Opportunity Tax Credit (collectively, “Income-Based Credits”); and

• Clarify that refunds will not be recouped to the extent they are attributable to EIPs, and that EIPs will not be treated as available assets for purposes of computing a taxpayer’s available individual equity in assets or, more generally, RCP (each as defined below).

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Recommendations

I. Workouts for Businesses

Our recommendations with respect to workout issues faced by financially distressed companies, including small businesses, and their workout partners are as follows:

A. Calculating Employment-Related Credits Under FFCRA and CARES Act

1. Recommendation

We recommend that Treasury and the Service issue guidance providing that a responsible person who miscalculates an Employment-Related Credit will not be held liable for the trust fund recovery penalty under section 6672 with respect to the amount of any underpaid trust fund tax that is attributable to a good faith miscalculation of the credit.

2. Explanation

The Employment-Related Credits are centerpieces of Congress’ COVID-19-related relief legislation. Treasury and the Service have released guidance with respect to each Employment-Related Credit, generally permitting taxpayers to claim refundable credits against the employer share of Social Security taxes, and use anticipated credits to reduce a number of of employment taxes, including payments of withheld income taxes and the withheld employee share of Social Security and Medicare taxes. The guidance issued thus far does not address an inadvertent miscalculation of the amount of an Employment-Related Credit.

More specifically, it is possible that some taxpayers, acting in good faith, will incorrectly calculate an Employment-Related Credit. In such a situation, those taxpayers might underfund the employee’s share of employment taxes (i.e., so-called “trust fund” taxes). And, when faced with an underfunded trust fund tax, the Service could assert the trust fund recovery penalty under section 6672 to recover the amount of that underfunded trust fund tax. Unfortunately, there is a very real possibility that some companies that take advantage of an Employment-Related Credit, whose responsible persons act in good faith but make (or rely upon) an inaccurate calculation of an Employment-Related Credit, might become distressed and unable to satisfy any subsequently determined under-

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withholding as a result of an over-claimed credit. In this circumstance, individuals at the companies in question could potentially be exposed to personal liability, depending upon whether they are “responsible persons” who “willfully” failed to collect, truthfully account for, and pay over any trust fund tax.  

Government employees have said repeatedly that it is a top priority of the Service and the Tax Division of the U.S. Department of Justice that employers properly collect and pay over to the Service taxes withheld from employees’ wages. Especially in light of the government’s focus on underpaid trust fund taxes, we recommend that Treasury and the Service issue guidance providing that a responsible person will not be treated as having acted willfully, and thus will not be held liable for the trust fund recovery penalty, to the extent the claimed liability for that penalty is attributable to a good faith miscalculation of an Employment-Related Credit.

Moreover, it would be helpful for Treasury and the Service to clarify whether “good faith” includes circumstances in which facts change such that an employer originally eligible for an Employment-Related Credit subsequently is no longer entitled to that credit. For example, an employer might purchase a company that received a Paycheck Protection Program (“PPP”) loan, and they might be treated as a single employer under the applicable aggregation rules. In such a situation, we understand that Treasury and the Service might take the position that the employer no longer would be eligible for an Employment-Related Credit and might have underfunded the employee’s share of employment taxes. Guidance would be helpful as to the extent of the liability the employer faces, if any, for underfunding the trust fund taxes.

In the absence of such guidance, financially distressed companies are put in the difficult situation of either (i) not taking advantage of the ability to claim an Employment-Related Credit against the employee’s share of employment taxes, which might exacerbate the financial distress of these companies, or (ii) exposing responsible persons who claim an Employment-Related Credit in good faith, but nevertheless underfunds a trust fund tax, may of course argue that the trust fund recovery penalty should not be imposed because he or she did not act willfully. However, courts have found willfulness to exist even though a responsible person did not have evil intent or bad motive in failing to collect and pay over the correct amount of trust fund taxes. For example, Finley v. United States, 123 F.3d 1342 (10th Cir. 1997), held that willfulness can be demonstrated by a failure to correct mismanagement, and Phillips v. United States, 73 F.3d 939, 942 (9th Cir. 1996), held that willfulness exists when the person was aware of the outstanding taxes and either deliberately chose not to pay the taxes or recklessly disregarded an obvious risk that the taxes would not be paid. Under these authorities, arguably, a responsible person of a financial troubled company who mismanaged that company or chose to pay creditors of the company to keep the business a going concern might be held to have acted willfully.

Cf. CARES Act § 2301(j).
persons to potential personal liability if the calculation of an Employment-Related Credit is wrong.

B. Determining Insolvency in Workouts

1. Recommendation

We recommend that Treasury and the Service adopt one or more safe harbors, described in more detail below, to help determine insolvency in workouts under section 108.

2. Explanation

A critical consideration for many companies considering an out-of-court workout, as opposed to bankruptcy, is the extent to which the company (or its owners) might be required to treat cancelled debt as income. Generally, when indebtedness is cancelled, the debtor must include CODI in gross income.12 There are, however, exceptions to this general rule. Under one exception, if a debt discharge occurs when a taxpayer-debtor is insolvent, the amount of the CODI does not exceed the amount by which the taxpayer-debtor is insolvent (the “Insolvency Exception”).13 Under another exception, gross income does not include any CODI at all if the debt discharge occurs in a case under title 11 of the United States Code (the “Bankruptcy Code” or “Title 11”).14 To the extent that either exception applies, the amount of CODI is excluded from gross income, and the amount of CODI excluded is applied to reduce certain tax attributes of the taxpayer-debtor.15

There is uncertainty around how to calculate the extent of insolvency for purposes of the Insolvency Exception. By way of background, if an issuer of a debt instrument restructures or renegotiates debt, the issuer is treated as issuing a new debt instrument to satisfy the original debt instrument, which generally is a taxable event.16 CODI is realized in an amount equal to (i) the adjusted issue price of the original debt (as determined under Treas. Reg. § 1.1275-1(b)), less (ii) the issue price of the new debt (as determined under sections 1273 and 1274).17

It is unclear whether the issue price rules that are determinative of the amount of CODI for purposes of the Insolvency Exception also can be relied upon in order to establish insolvency, which can lead to valuation uncertainty and disconnects between CODI and insolvency determinations. For example, if a company has nominal equity

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12 I.R.C. § 61(a)(11).
16 See Treas. Reg. § 1.61-12(c)(2)(ii).
17 I.R.C. § 108(e)(3); Treas. Reg. § 1.61-12(c)(2)(ii).
market capitalization and debt with a principal amount of $200 million that is “publicly traded” (within the meaning of the issue price rules) and quoted at $101 million, one might expect that the market believes the company is worth approximately $101 million and that the company is insolvent by approximately $99 million. If that debt is exchanged for the company’s equity and new debt that has a total value (and issue price, in the case of the new debt) of $101 million, the company will recognize approximately $99 million of CODI under section 108(e)(8) and (10). But there is no certainty that the company’s insolvency determination will properly align, even though it would appear that CODI should be equal to the amount of insolvency in this situation.

Indeed, if contingent liabilities with a less-than-50% chance of coming to pass are one reason the market has priced the company’s debt at $101 million, the company might be advised that, under the reasoning of Merkel v. Commissioner, it must not take contingent liabilities into account for purposes of determining the company’s insolvency, even though the market clearly is taking such liabilities into account and even though such liabilities will directly influence the amount of CODI that would be realized in a workout of the company’s debt. Even setting aside the results that can flow from Merkel, the company might have internal valuations that indicate that the debt markets have undervalued the company’s total enterprise value, and therefore face a disconnect between the CODI amount dictated by the issue price rules, on the one hand, and the less certain insolvency analysis, on the other hand. As a result, taxpayers might—and in fact occasionally do—choose to file for bankruptcy, rather than restructuring out-of-court, in part because of the risks associated with the application of the insolvency exclusion under section 108(a)(1)(B).

Other valuation concerns are common in workouts. For example, even if a company obtains a third-party valuation of its assets, taxpayers worry that if the company’s value increases over time, then the Service might be able to challenge the valuation. And, in any case, valuation always has a significant element of subjectivity to it.

Adopting one or more safe harbors would allow taxpayers (and the Service) to more easily navigate these issues. Specifically, we recommend a safe harbor in which the value of public debt is presumptively the value of the debt for purposes of the insolvency calculation. We also recommend a safe harbor in which a debtor will be presumed to be insolvent with respect to any workout in which the equity is completely eliminated and the creditors take all of the assets or equity of the company. In those cases, we think it

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18 192 F.3d 844, 850-851 (9th Cir. 1999), aff ’g 109 T.C. 463 (1997).

19 As discussed below in Part I.H, this uncertainty is compounded in many cases because of the application of the investment unit rules.

20 As compared to the 2008-2009 financial crisis, this problem has been significantly exacerbated by: (i) the lack of an analogue to section 108(i), which generally permits a taxpayer-debtor to defer the recognition of CODI from the purchase, exchange, or forgiveness of one of its debt instruments and retain its tax attributes for future use; and (ii) the new existence of section 163(j), which has limited the amount of net operating losses (“NOLs”) available to address taxable CODI.
would be appropriate to treat the debtor as insolvent by the full amount of the CODI, without having to prove an actual valuation of the assets, even if, in fact, the value of the equity and debt the creditors receive is in part depressed by the existence of contingent liabilities. Finally, we recommend that Treasury and the Service consider whether a similar safe harbor should be adopted where the pre-restructuring equity holders retain a much attenuated stake in the company after the restructuring; for example, if the old equity is eliminated and the old shareholders take back warrants for a small percent of the stock.

We recommend that these safe harbors be adopted via a Notice or Revenue Procedure to give critically needed certainty to companies trying to accomplish out-of-court restructurings. Without such guidance, it is likely that bankruptcies that otherwise might have been avoidable will be filed principally to avoid the potentially incongruous results under the Insolvency Exception.

C. Interaction Between Sections 163(j) and 108 with Respect to the Forgiveness of Accrued Interest

1. Recommendation

We recommend that Treasury and the Service clarify the interaction between sections 163(j) and 108 by issuing guidance providing that the forgiveness of accrued interest for which a deduction was deferred under section 163(j) does not give rise to CODI, but instead reduces the excess business interest expense carryover under section 163(j). We made the same recommendation in 2019, and reiterate it now.

2. Explanation

Section 163(j) limits a taxpayer’s deduction for business interest expense each taxable year, generally to a percentage of its adjusted taxable income (generally 30%; now temporarily 50% under the CARES Act), with certain adjustments. The amount of a taxpayer’s business interest expense that is limited by section 163(j) is carried forward and treated as business interest paid or accrued in the succeeding taxable year(s).

21 This would be a safe-harbor limited exception to Merkel.

22 We believe it would be appropriate to have more expansive safe harbors for less straightforward fact-patterns as well. Should Treasury and the Service be interested in pursuing this issue, we would be happy to follow up this letter with more detailed recommendations.


When accrued interest is forgiven, generally the cancellation gives rise to CODI. However, we believe it is inappropriate to create CODI with respect to interest for which a deduction has been deferred under section 163(j) because the taxpayer has not been, and might never be, allowed a deduction for that interest.

D. Treatment of Debt Instrument Changes Caused by Elective Changes in Entity Status

1. Recommendation

We recommend that Treasury and the Service clarify that certain deemed changes to debt instruments, caused solely by an elective change in entity status under the check-the-box regulations and described in more detail below, do not cause significant modifications under section 1001.

2. Explanation

Generally, any modification of a debt instrument will result in a taxable exchange under section 1001 if it is a “significant modification.”26 A change in obligor on a recourse debt instrument can be a significant modification, as can a change in the recourse or nonrecourse nature of a debt obligation.27

If the tax fiction behind the check-the-box regulations is respected, arguably an elective change in entity status could result in a deemed change in the obligor of a debt instrument or the nature of the debt as recourse or nonrecourse.28 Specifically, if a check-the-box election is made to disregard a previously regarded entity, that entity is not regarded for federal tax purposes even though it is respected for state law purposes. Thus, a tax fiction exists in that the tax law ignores an entity which, for state law purposes, undeniably exists. This tax fiction, in turn, arguably results in a deemed change of the obligor for federal tax purposes (i.e., the obligor is changed from the previously regarded entity to the owner of the now-disregarded entity). In addition, if the debt is recourse, the tax fiction arguably results in a deemed change in the nature of the debt obligation from recourse against the regarded entity to nonrecourse against the owner of the disregarded entity.

We do not believe the Treasury Regulations compel such results. They define a “modification” as any alteration of a “legal right or obligation of the issuer or a holder of a debt instrument.”29 In our view, a change in tax classification creates no change in a legal rights or obligation because an entity that is disregarded for federal tax purposes

26 Treas. Reg. § 1.1001-3(b).
28 For a detailed discussion of this issue, see New York State Bar Ass’n, Tax Section, Report No. 1383: Report on Debt Issued by Disregarded Entities and Treasury Regulations Section 1.1001-3 (Dec. 15, 2017).
29 Treas. Reg. § 1.1001-3(c)(1)(i).
continues to exist for state law purposes. The Service has issued private letter rulings agreeing with this result, albeit for seemingly varying reasons: Some rulings rely on the rationale that there is no modification, other rulings rely on the rationale that the modification is not significant, and other rulings rely on both rationales.30

Nevertheless, the lack of clear guidance results in uncertainty. This is particularly true in light of relatively recent rulings that treat recourse debt of a disregarded entity as nonrecourse debt for purposes of Treas. Reg. § 1.1001-2, thus suggesting that the nature of the debt does, in fact, change due to the tax fiction.31 Thus, we recommend that Treasury and the Service issue guidance confirming that an elective change in entity status will not be treated as a modification, and any change in obligor or the recourse nature of debt as a result of an elective change in entity status will not be taken into account in determining whether related modifications to a debt instrument are significant. Additionally, we recommend that Treasury and the Service issue guidance under Treas. Reg. § 1.1001-2 clarifying the treatment of recourse debt of a disregarded entity.

We appreciate that the significant modification issue is already on Treasury and the Service’s priority guidance plan and that it has been acknowledged as an issue that is under active study. But, the need for guidance in this area is pressing. Many out-of-court liability management transactions rely heavily on the ability to make modifications to a corporate structure and move assets among the legal entities in the group to comply with or utilize credit agreement provisions that permit incremental debt issuances and similar transactions. The uncertainty that now exists in this area substantially increases the uncertainty taxpayers face in evaluating the tax consequences of these transactions.32

E. Treatment of Other Debt Instrument Changes

1. Recommendation

We recommend that Treasury and the Service clarify that certain other actual changes to debt instruments, described in more detail below, also do not cause significant modifications under section 1001.

2. Explanation

As explained above in Part I.D, a modification of a debt instrument generally will result in a taxable exchange if it is a “significant modification.” Clarifying that certain specific changes to a debt instrument will not trigger the significant modification rules

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30 See PLR 200315001 (Sept. 19, 2002); PLR 200709013 (Nov. 22, 2006); PLR 200630002 (April 24, 2006); PLR 2010100015 (Nov. 5, 2009).

31 See PLR 201644018 (July 28, 2016) (concluding that debt of a disregarded entity is nonrecourse for purposes of computing gain or loss under Treas. Reg. § 1.1001-2); CCA 201525010 (March 6, 2015) (concluding that the characterization of a liability under section 752 is irrelevant to the determination of whether the liability is recourse or nonrecourse for purposes of section 1001).

32 If Treasury and the Service would like additional time to continue studying the issue, we suggest that a temporary Notice could be issued during the period of study (at least for workout situations).
will, we believe, facilitate debt workout. Although we believe the clarifications are particularly important in the current economic climate caused by the COVID-19 emergency, we believe that Treasury and the Service should consider making them permanent.

Specifically, we recommend that Treasury and the Service not treat as a significant modification an isolated fee payment done in conjunction with other modification(s) that would not itself be a significant modification or, at least, significantly expand the relevant yield safe harbor. It is true that fees paid in the context of consent solicitations and similar transactions increase the all-in yield of a debt instrument, but the current rules act as a foot-fault that are making many out-of-court liability management transactions impossible to execute and, therefore, they risk causing otherwise-avoidable bankruptcy filings. We also recommend that Treasury and the Service not treat as a significant modification a situation in which a taxpayer seeks an extension but does not otherwise change yield or other terms of the debt. Finally, we recommend that Treasury and the Service significantly shorten the five-year look-back rule in Treas. Reg. § 1.1001-3(f)(3): The fact that companies dealing with COVID-19-related financial distress must look back to fees paid to support covenant modifications in the middle of the bull market in our view does not make policy sense.

We refer the Service to our prior comments discussing these and other similar issues, though we respectfully request accelerated guidance, at least for workout situations. 33

F. Application of Payment Ordering Rule

1. Recommendation

We recommend that Treasury and the Service clarify the Payment Ordering Rule (as defined below) to apply only to interim payments and not to a payment in satisfaction of or termination of a debt, including a taxable exchange triggered by a significant modification within the meaning of Treas. Reg. § 1.1001-3. Alternatively, we recommend that the Payment Ordering Rule be suspended in the context of a distressed in- or out-of-court workout.

2. Explanation

More often than not in restructurings, the fair market value of consideration paid to creditors is not sufficient to fully satisfy all principal and interest on debts that are paid. Treasury Regulations generally provide for a payment ordering rule under which payments under a loan are classified first as interest to the extent there is interest accrued

(such Treasury Regulation, sometimes, the “Payment Ordering Rule”). Where a debt is distressed, allocating payment to interest first is almost always unfavorable for the holder, which results in ordinary interest income and capital loss on the debt under section 1271.

Bankruptcy plans often will indicate that the aggregate consideration with respect to any debt will be allocated first to the principal amount, with any excess allocated to accrued but unpaid interest. The legislative history of the Bankruptcy Tax Act of 1980\(^{35}\) indicates that an allocation of consideration as between principal and interest provided in a plan of reorganization is binding for federal income tax purposes.\(^{36}\)

The inconsistencies between the potentially different allocations allowed by the Payment Ordering Rule and the Bankruptcy Tax Act of 1980 have led taxpayers (or their advisors) to get comfortable applying consideration first to principal when so ordered pursuant to a chapter 11 plan, but not outside of that context. We do not believe there should be disparate results between chapter 11 plans and all other bankruptcy or workout plans. Furthermore, the policies underlying the Payment Ordering Rule, which was promulgated to prevent cash method taxpayers from delaying inclusion of interest income on interim payments on debt by characterizing interim payments as repayments of principal, generally are not implicated in the context of a final payment on debt.\(^{37}\)

G. Accrual of OID and Market Discount When Collectability Is Doubtful

1. Recommendation

We recommend that Treasury and the Service issue guidance concluding that a holder of an instrument with OID need not accrue additional OID when the collectability of the OID is doubtful, and that a holder of an instrument with market discount need not accrue additional market discount under the same circumstances.

2. Explanation

A taxpayer that uses the accrual method of accounting generally must include interest in income when the right to receive the interest becomes fixed, regardless of when the interest is actually is received.\(^{38}\) Congress has concluded that OID is akin to interest.\(^{39}\) Thus, section 1272 generally requires there to be included in the gross income

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\(^{34}\) Treas. Reg. § 1.446-2(e)(1).  
\(^{35}\) Pub. L. No. 96-589, 94 Stat. 3389.  
\(^{38}\) Treas. Reg. §§ 1.451-1(a), 1.451-2(a).  
\(^{39}\) S. Rep. No. 98-169, Vol. 1, at 249 n. 2 (1984) (“The purpose of the OID rules is to ensure that an OID obligation is treated for tax purposes in a manner similar to a nondiscount obligation requiring payment of interest”); Staff of the Joint Comm. on Tax’n, \textit{Description of the Tax Treatment of Imputed}
of a holder of any debt instrument having OID an amount equal to the sum of the daily portions of the OID for each day during the taxable year on which such holder held such debt instrument.\textsuperscript{40}

Courts and the Service have held that where there is a reasonable doubt as to the collectability of interest (\textit{e.g.}, because an issuer is distressed), the holder can stop accruing interest.\textsuperscript{41} However in Technical Advice Memorandum 9538007\textsuperscript{42} the Service concluded that a taxpayer was required to include OID that was doubtful to be collected. We believe this rule is not consistent with the theory of the OID accrual rules. We see no reason to treat accrual of OID with respect to distressed debt differently than interest.

For substantially the same reasons, we recommend that the same treatment be extended to the market discount rules that apply to purchases of distressed debt instruments.\textsuperscript{43}

The foregoing recommendations should facilitate workouts, and help businesses avoid bankruptcy, by providing guidance that allows taxpayers (and workout partners) to make informed decisions about the tax consequences of an out-of-court restructuring.

H. Application of the Investment Unit Rules Where Some Elements Are Publicly Traded and Others Are Not

1. Recommendation

We recommend that Treasury and the Service issue guidance clarifying, as described in more detail below, the application of the investment unit rules under section 1273 to situations in which some elements of the investment unit are publicly traded and other elements are not.

2. Explanation

In the case of any debt instrument and an option, security, or other property issued together as an investment unit, the issue price for the investment unit is determined under

\begin{quote}
\textit{Interest on Deferred Payment Sales of Property} 4 (1985) (\textquote{Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender’s money.
}).
\end{quote}

\textsuperscript{40} I.R.C. § 1272(a)(1).

\textsuperscript{41} \textit{See, e.g.}, Corn Exch. Bank \textit{v. United States}, 37 F.2d 34, 34-35 (2d Cir. 1930); Rev. Rul. 80-361, 1980-2 C.B. 164.

\textsuperscript{42} TAM 9538007 (Sept. 22, 1995).

\textsuperscript{43} Several commentators have argued over the years that the market discount rules improperly convert capital gain into ordinary income when distressed debt is purchased in the market and ultimately receives a recovery in excess of that purchase price that is wholly unrelated to any economic equivalent to interest. \textit{See, e.g.}, David H. Schnabel, \textit{Great Expectations: The Basic Tax Problem with Distressed Debt}, 89 TAXES 173, 188-189 (March 2011); David C. Garlock, \textit{How to Account for Distressed Debt}, 127 Tax Notes 999, 1002 (May 31, 2010); Andrew W. Needham, \textit{Do the Market Discount Rules Apply to Distressed Debt? Probably Not}, 8 J. TAX’N FIN. PROD. 19, 25 (2010).
section 1273 as if it were a debt instrument. The issue price of the investment unit is then allocated between the debt instrument and the property right (or rights) that comprise the unit based on their relative fair market values. If the investment unit is publicly traded, the issue price of the debt instrument will equal its initial trading price. If the investment unit is not publicly traded, but is received in exchange for property that was so traded, the issue price of the investment unit will equal the trading price of the property so exchanged.

Many restructurings involve an exchange of debt for a combination of debt and equity and other consideration (e.g., warrants). It often is the case that the debt in such situations is publicly traded, but the equity and/or other consideration is not. The investment unit rules described above, as currently in effect, could be read to require taxpayers to use the fair market value of the old debt to determine the issue price of the new debt in this situation, even if doing so leads to incorrect results. For example, if a $200 million debt instrument is trading at $101 million immediately prior to an exchange in which a creditor receives (solely) a new $150 million debt instrument that is trading for $110 million, then it is clear that the issue price of the new debt instrument is $110 million, and there is $90 million of CODI. By contrast, if that same $200 million debt instrument is exchanged for (i) a new debt instrument trading at $110 million, and (ii) non-traded equity in the company, then the investment unit rules could be read to require that the trading value of the old debt (i.e., $101 million) be used to establish the issue price of the investment unit, with a portion of that issue price being allocated to the new debt. This application will necessarily result in the new debt having an issue price that is less than the amount for which the new debt is in fact trading.

Similarly, there are circumstances where the overall trading value of the new debt is less than the trading value of the old debt, but any valuator would insist that the non-traded portion of the investment unit (e.g., the equity) more than makes up the difference. In such a situation, the investment unit rules could still force the use of the trading value of the old debt in a way that requires the new debt to be treated as issued with an issue price that is less than its actual trading value.

These kinds of disconnects are not uncommon. In fact, when junior debt is exchanged for debt of a higher priority level, the disconnects are quite common. Moreover, trading in distressed debt before a workout can be artificially depressed (or inflated), resulting in a mismatch between the trading price of the old debt and the value of the consideration received by the creditors. This mismatch is exacerbated by the very common practice of “restricting” lenders that are participating in an out-of-court workout by providing them with material non-public information—which is, of course, critical to

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44 I.R.C. § 1273(c)(2).
45 Treas. Reg. § 1.1273-2(h)(1).
46 Treas. Reg. § 1.1273-2(b)(1).
47 Treas. Reg. § 1.1273-2(c)(1).
their ability to make an investment decision—but leads to a dynamic whereby only comparatively uninformed holders of debt are engaged in trading.48

Fundamentally, these results illustrate a disconnect between the basic principle of the issue price rules, which is that the trading value of the consideration received in an exchange is the best indicator of its own value, and the unclear application of the investment unit rules to situations where the investment unit is composed of some elements that trade and some do not.

We recommend that this problem be fixed in one of the following ways: First, we recommend that the investment unit rules be clarified to provide that if a substantial portion of the consideration issued in the investment unit is publicly traded, then the investment unit itself should be treated as publicly traded, with the trading value of the publicly traded component being added to the value of the untraded components based on a reasonably supportable valuation methodology. Alternatively, if Treasury and the Service prefer not to change the investment unit rules so significantly without further study, we recommend that an “override” be created to provide that, in any situation involving an investment unit that includes debt, if the debt component is publicly traded, the trading value of the new debt will determine its issue price, even if a different issue price would be established by applying the investment unit rules.

I. Deferred Finalization of Proposed Regulations Under Section 382(h)

1. Recommendation

We recommend that Treasury and the Service formally indicate (e.g., in an FAQ or a press release) that they do not intend to finalize the proposed Treasury Regulations under section 382(h), that were published in 2019, until at least 2021. We previously made this recommendation in comments related to the COVID-19 emergency,49 and reiterate it now.

2. Explanation

Section 382(h) provides rules for the treatment of built-in gain or loss recognized during the five-year period beginning on the change date with respect to assets owned by the loss corporation immediately before the ownership change. In Notice 2003-65,50 Treasury and the Service provided interim guidance regarding the identification of built-

48 The mismatch also is exacerbated by the performance of “indicative quote” markets. Of course, taxpayers may be able to rebut the values resulting from mere indicative quotes, but this is a burdensome (and potentially expensive) factual standard to rebut.


in items for purposes of section 382(h), on which taxpayers may rely until the effective date of any final or temporary regulations issued under section 382(h).

On September 10, 2019, Treasury and the Service released proposed regulations under section 382(h)\(^{51}\) that would supplant Notice 2003-65 in providing guidance regarding the identification of built-in items for purposes of section 382(h). If finalized in their proposed form, these proposed regulations would change the landscape of current law in ways that have significantly adverse impacts for affected taxpayers, including certain taxpayers engaged in workouts and restructurings.\(^{52}\)

We believe that deferring the finalization of the proposed regulations would facilitate advising taxpayers in workouts and restructurings and thereby assist corporations undergoing significant distress as a result of the COVID-19 emergency.

J. Application of the Non-Stock Treated as Stock Rule to Trading in Distressed Debt

1. Recommendation

We recommend that Treasury and the Service issue guidance, described in more detail below, clarifying that trading in distressed debt will not cause the debt to be treated as stock for purposes of section 382.

2. Explanation

For purposes of section 382, certain non-stock instruments are treated as stock if, at the time the instrument is issued or transferred: (i) the interest offers a potentially significant participation in the growth of the corporation; (ii) treating the interest as stock would cause an ownership change; and (iii) the amount of pre-change losses exceeds a certain \textit{de minimis} threshold (the “\textbf{Non-Stock Treated as Stock Rule}”).\(^{53}\)

When a loss corporation is distressed, the value of the company (and the likelihood that debt would be repaid) could be so low that the debt could be viewed as significantly participating in corporate growth. If this discounted debt is then traded, a question arises as to whether that debt should be treated as subject to the Non-Stock Treated as Stock Rule. If the debt is subject to the Non-Stock Treated as Stock Rule, then trading of the debt could trigger ownership changes under section 382.


\(^{52}\) For additional discussion, see ABA Section of Taxation, \textit{Proposed Regulations Under Section 382(h)} (2019), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2019/111219comments.pdf.

In Private Letter Ruling 201345023 the Service ruled that notes of a distressed company did not constitute stock under the Non-Stock Treated as Stock Rule where: (i) neither the debtor nor any person related to the debtor (within the meaning of section 267(b) or 707(b)) was actively involved or engaged in placing the notes with, or transferring the notes to, any person; (ii) the notes were not issued or transferred to an acquiring person (or related persons) who became the owner of more than 50% of the notes; and (iii) there is no material change (in kind or extent) in the terms of the notes.

We recommend that Treasury and the Service issue guidance, consistent with the conclusion in Private Letter Ruling 201345023, clarifying that trading in distressed debt will not trigger application of the Non-Stock Treated as Stock Rule. We do not believe that an anti-abuse exception from this rule will be necessary. We note that acquisitions of debt in anticipation of such debt converting to equity in a transaction that qualifies under section 382(l)(5) (discussed below in Part I.K) already is policed by the requirement that non-ordinary course qualified indebtedness be held for at least 18 months before the date of the filing of a Title 11 or similar case.

K. Application of Section 382(l)(5) and (l)(6) to Consolidated Groups

1. Recommendation

We recommend that Treasury and the Service issue guidance describing the manner in which section 382(l)(5) and (l)(6) apply to a consolidated group.

2. Explanation

Section 382(l)(5) provides an exception to the general section 382 limitation for corporations in bankruptcy. Section 382(l)(5) applies where: (i) immediately before the ownership change, the loss corporation was under the jurisdiction of a court in a Title 11 or similar case, and such ownership change was pursuant to a plan approved by the court; and (ii) the pre-change shareholders and qualified creditors of the loss corporation own at least 50% of the voting power and value of the corporation’s stock (or stock of a controlling corporation, if also in bankruptcy) after such change as a result of their pre-change ownership.

If section 382(l)(5) is inapplicable, or if a taxpayer elects not to apply section 382(l)(5), section 382(l)(6) provides another exception to the general section 382 limitation for ownership changes that occur pursuant to a bankruptcy plan. For purposes of determining the section 382 limitation under section 382(l)(6), the value of the loss corporation generally is equal to the lesser of the fair market value of (i) the stock

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54 PLR 201345023 (Nov. 8, 2013).
56 I.R.C. § 382(l)(5)(A); Treas. Reg. § 1.382-9(a).
57 I.R.C. § 382(l)(6).
of the loss corporation immediately after the ownership change or (ii) the loss corporation’s pre-change assets.\(^5^8\)

Treas. Reg. § 1.1502-97 currently reserves on the application of section 382 to consolidated groups under the jurisdiction of a court in a Title 11 or similar case. Therefore, the Treasury Regulations do not currently address the manner in which section 382(l)(5) and (l)(6) apply to a consolidated group.

We recommend that Treasury and the Service issue guidance on this issue. The guidance could indicate, for example, that section 382(l)(5) and (l)(6) apply to an ownership change of a consolidated group if the common parent of the group would qualify under the respective provisions regardless of whether the other group members are insolvent or under the jurisdiction of a court in a Title 11 or similar case. The guidance also could adopt the approach in Treas. Reg. § 1.382-9 for purposes of applying section 382(l)(6) to the common parent of the consolidated group, using the lesser of the common parent’s pre-change gross asset value or post-change stock value, consistent with Treas. Reg. § 1.382-9.

L. Allocation of Consideration Where Debt is Satisfied for a Combination of Stock and Debt

1. Recommendation

We recommend that Treasury and the Service clarify that, for purposes of applying section 382(l)(5), where debt is satisfied for a combination of stock and debt, the debt is treated as having been satisfied by each form of consideration pro rata based on the relative fair market value of the consideration received.

2. Explanation

Although section 382(l)(5) allows a loss corporation to avoid the general limitation under section 382, it imposes a “toll charge.” Specifically, section 382(l)(5)(B) generally requires a loss corporation that applies section 382(l)(5) to recalculate its carryovers as if no deduction was allowable for interest paid or accrued on debt that was converted into stock during any taxable year ending during the three-year period preceding the taxable year in which the ownership change occurs.\(^5^9\)

Often, in workouts, creditors receive a combination of stock and new debt. Section 382(l)(5) requires interest to be haircut only with respect to the portion of the debt that was converted into stock. However, there is no guidance to determine what portion is allocated to debt converted to stock. We recommend that the allocation be

\(^{58}\) Treas. Reg. § 1.382-9(j).

\(^{59}\) In addition, if a second ownership change occurs within the two-year period following an ownership change to which section 382(l)(5) applied, a zero limitation will be placed on all NOL carryforwards for any post-change year ending after the change date of the second ownership change. I.R.C. § 382(l)(5)(D).
done *pro rata* based on the relative fair market value of the consideration received. For example, if a taxpayer satisfied $100 of debt with $20 of stock and $30 of new debt, the interest haircut would apply only to 40% (*i.e.*, $20 stock / $50 total consideration) of the old debt.

**M. Designation of Point-of-Contact in Each Local Insolvency Office**

1. **Recommendation**

We recommend that the Service identify an experienced insolvency practitioner in each local insolvency office who can be available to answer questions and identify issues necessary for resolution relating to businesses making bankruptcy filings under the SBRA.

2. **Explanation**

The SBRA added subchapter V to chapter 11 of the Bankruptcy Code effective February 19, 2020. The SBRA is designed to facilitate the use of chapter 11 reorganizations by smaller businesses. 60 One of the most attractive features of the SBRA is the elimination of the absolute priority rule, which requires creditors to be paid in full before an equity holder can retain equity. 61 In light of the economic turmoil caused by the COVID-19 emergency, as well as the increased debt-filing limit and the elimination of the absolute priority rule, we anticipate a surge in bankruptcy filings by small businesses under the SBRA.

Importantly, the SBRA requires any chapter 11 bankruptcy plan to be submitted within 90 days of filing. 62 Because the SBRA is a relatively new law, which practitioners will experience for the first time in the next few years, they are likely to have questions that will be challenging to answer within that time frame. To help address this, we recommend that the Service identify an experienced insolvency practitioner in each local insolvency office who can be available to answer questions and identify issues necessary for resolution so that a confirmable plan can be proposed under the SBRA.

**II. Recommendations Regarding the OIC Program**

In addition to recommendations we previously submitted to the Service concerning tax collection- and bankruptcy-specific issues in response to the COVID-19

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60 See Bankruptcy Code § 1182(1)(A) (increasing the debt-filing limit under the SBRA and the CARES Act to $7,500,000).

61 See Bankruptcy Code § 1191(b).

62 Bankruptcy Code § 1189(b).
emergency, our recommendations with respect to working out tax debts of financially distressed individuals and businesses through the OIC program are as follows:

A. Streamlined Process for Low-Income Taxpayers and Taxpayers with Low Balances

1. Recommendations

We recommend that the Service modify its existing OIC program in certain respects to offer certain taxpayers the benefits of bankruptcy through a streamlined OIC by:

- Adopting a streamlined OIC program based on the Service’s OIC Pre-Qualifier Tool that offers the same benefits of certainty and expediency that accompany a bankruptcy filing;
- Applying federal exemption laws to OICs to offer the same benefit of asset protection as is available in a bankruptcy filing;
- Changing or eliminating the five-year post-OIC compliance period and adopt a period within which successive OICs may not be filed, as in individual bankruptcies; and
- Eliminating refund recoupments, especially of Income-Based Credits.

2. Explanations

By making these systemic modifications to the existing OIC program, we believe the Service can help taxpayers resolve tax debts and avoid a bankruptcy filing. Before we discuss the details of our recommendations, we first provide relevant background so the Service can understand how many taxpayers evaluate whether to pursue a bankruptcy or an OIC.

a. Background

Although tax professionals typically associate workouts with the corporate world, there are alternatives for individual taxpayers that are similar in practice and scope to a corporate workout, though smaller in scale. As with corporate workouts, the primary

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goal of an individual workout is to avoid having to resort to filing a formal bankruptcy case. Similar to how many corporate workout partners approach at-risk debt, the Internal Revenue Manual (the “I.R.M.”) recognizes that it generally is in the government’s interest to collect what is potentially recoverable at the earliest possible time and at the least cost to the government. In this regard, the I.R.M. provides:

The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An offer in compromise is a legitimate alternative to declaring a case currently not collectible or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.64

Details about the current OIC program can be found in Form 656-B, Offer in Compromise Booklet, Publication 594, The IRS Collection Process, and on the Service’s website.65

There are three primary methods that individuals use to attempt to deal with debt issues outside of bankruptcy: credit consolidation services; debt settlement; and negotiation with individual creditors. Credit consolidation involves the person making a monthly payment to an independent third party who negotiates lower balances or reduced interest rates and then pays all of the creditors who agree to participate, pro rata, after extracting a fee. Debt settlement generally requires a debtor to allow his or her debts to go into default in the hope that creditors will settle for a lower payment once debt repayment is considered to be at risk. Negotiation with individual creditors can take many forms, but most typically debtors ask for hardship relief from individual creditors and hope the creditor agrees to defer or write-off at least a portion of the debt without taking legal action.

The foregoing actions require the debtor to have at least some disposable income left over to be paid towards debt after basic monthly living expenses are met, an unlikely scenario for most low-income taxpayers. And, in all of these situations, even when low-income taxpayers achieve some debt relief, they often are surprised when a Form 1099-C, Cancellation of Debt, arrives in the mail the following year (or several years after the debt is written-off), and even more surprised to find out that the cancelled debt, in most cases, is taxable.

Most low-income taxpayers (and many middle-income taxpayers) live paycheck-to-paycheck, with monthly “budgets” that are “underwater” (i.e., recurring expenses regularly exceed recurring family income). Sometimes a low-income taxpayer will use

64 I.R.M. 1.2.1.6.17(2) (Jan. 30, 1992) (formerly Policy Statement 5-100). For the reasons stated throughout these Comments, we suggest that the Service update former Policy Statement 5-100 to recognize that an OIC is also a legitimate alternative to bankruptcy.

65 See https://www.irs.gov/taxtopics/tc204.
desperately needed income required to meet their basic living expenses to attempt a “workout” with creditors, when doing so will certainly create severe financial hardship. For example, a low-income person might pay creditors when the landlord is threatening eviction, the lender is repossessing the car, the utility company is threatening a shut-off, or the Service is threatening to levy a bank account, wages, or 15% of the taxpayer’s Social Security benefits. So as not to become destitute and to find a lasting more productive solution, these individuals often will seek bankruptcy.

For taxpayers at every income level, and especially those principally with tax debts, an OIC can be a viable alternative to a bankruptcy filing. Stated simply, the best way the Service can assist taxpayers towards the goal of resolving tax debts and avoiding a bankruptcy filing is to offer taxpayers the benefits of bankruptcy with a streamlined OIC. As explained below, the benefits of a streamlined OIC as recommended herein include certainty, expediency, greater asset protection by utilizing already established federal exemption laws for bankruptcy, no post-bankruptcy monitoring, and no offset of current or future year refunds, including of Income-Based Credits.

b. Specific Recommendations

i. Adoption of Streamlined OIC

Bankruptcy is statutory and provides certainty not typically found in OICs. Before filing for bankruptcy, it is possible for a taxpayer to determine exactly what taxes will or will not be discharged by looking to the Bankruptcy Code.66 By contrast, an OIC is discretionary, decided on a case-by-case basis by a Service employee. Particularly if a taxpayer is making an OIC on the ground of special circumstances or effective tax administration, the taxpayer essentially is at the mercy of the individual deciding, or the manager reviewing, the OIC. It is not uncommon for taxpayers with virtually identical circumstances to achieve different results when pursuing an OIC.

Bankruptcy also usually is a much more expedient alternative than an OIC. The typical non-asset chapter 7 bankruptcy case takes no more than four months. An asset case takes longer, but the taxpayer-debtor generally receives a discharge within 75 days after the meeting of creditors,67 also less than four months after the case is initially filed. Chapter 13 proceedings typically can last for three to five years, but the chapter 13 plan generally is confirmed early on, again within three to four months of the bankruptcy petition being filed. Individual debtors can either turn over their non-exempt assets to a chapter 7 trustee or nail down the monthly payment they need to make going forward and how it will be applied to their tax liabilities within a very short period.

By contrast, only the simplest OICs, if any, are decided within 90 days of submission. Most OICs take at least six months before a Service employee begins working on them, and OICs can (and sometimes do) take up to two years before they are

67 See Bankruptcy Code § 341.
statutorily deemed accepted under section 7122(f). During that time, the financial information submitted with the OIC usually becomes stale. In the meantime, the taxpayer’s financial life is in limbo, with the taxpayer waiting to see, for example, whether the monthly payments being made while waiting for an OIC resolution will in fact resolve the tax debt(s) or whether, 23 months later, the OIC will be rejected and the taxpayer will be back at square one, with 23 months of additional interest added to the tax balance.\textsuperscript{68} Furthermore, during the COVID-19 emergency the OIC process has been set back dramatically with the closing of the OIC units, which we expect will further inhibit taxpayers’ resolution of tax debts.

Consequently, a streamlined OIC will be an attractive option for a taxpayer if it provides the same level of certainty and expediency of a bankruptcy. We believe that it will benefit the Service, as well. The Service’s processing of OICs already runs up against the TIPRA Statute Date in many cases. The extreme financial difficulties suffered by taxpayers at all income levels due to COVID-19 will, we expect, result in a significant uptick in the number of OICs filed by all taxpayers, especially low- and middle-income taxpayers, in the coming months. This is likely to result in a backlog of cases and a significant increase in the number of “deemed acceptances” under section 7122(f).

We believe that the Service already has tools available to it that could be adapted to adopt a streamlined OIC program. Specifically, its OIC Pre-Qualifier Tool\textsuperscript{69} already gathers all of the financial data needed to calculate a taxpayer’s “reasonable collection potential” ("RCP"),\textsuperscript{70} which determines a minimally acceptable OIC amount. Both the Service and taxpayers would benefit from using the Pre-Qualifier Tool to determine a taxpayer’s eligibility for a streamlined OIC because using that tool would inject certainty and expediency into the OIC process. In this regard, currently, after the taxpayer uses the Pre-Qualifier Tool, the taxpayer is directed to a 32-page paper form that is used to collect financial data that has already been provided in the Pre-Qualifier Tool. We believe that this time-consuming process could be streamlined considerably if the Service made greater use of the Pre-Qualifier Tool for taxpayers with income and assets that are easily verified and valued. Service employees could then focus their efforts on scrutinizing the income and assets of relatively higher-income taxpayers who have more realistic collection potential.

\textsuperscript{68} In our experience, the Service usually attempts to make a determination with respect to an OIC within two years from the date the OIC is submitted. The significance of this two-year period is that an OIC is generally deemed to be accepted within 24 months of its submission if the Service does not reject the OIC within that same 24-month period. See I.R.C. § 7122(f). We refer to the date on which this 24-month period expires with respect to a particular OIC as the “\textit{TIPRA Statute Date}” after the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345, which added section 7122(f).

\textsuperscript{69} Offer in Compromise Pre-Qualifier, available at https://irs.treasury.gov/oic_pre_qualifier/.

\textsuperscript{70} “Reasonable collection potential” is the sum of the taxpayer’s “available individual equity in assets” and net monthly household income. “Available individual equity in assets” is calculated on Form 433-A(OIC), \textit{Collection Information Statement for Wage Earners and Self-Employed Individuals}, p. 4, § 3, Box A.
A good example of a similar program is the Service’s current automated, streamlined installment agreement program, which offers an on-line application. In a relatively short period of time—minutes, not months—taxpayers now are able to set-up and access an account on the Service’s website, pick a payment option, set up a direct bank debit, and know their outstanding tax balance. Most importantly, perhaps, is the taxpayer’s tax problems are resolved (or the taxpayer now has a defined plan to resolve those problems).

As to the specific parameters under which a taxpayer might be eligible for a streamlined OIC, we recommend that they be discussed with stakeholders.

ii. Application of Federal Exemption Laws to OICs

The Bankruptcy Code provides that certain property belonging to a debtor can be claimed as exempt from the bankruptcy process.71 Bankruptcy is a federal law, but it looks to state law to determine property rights, including what property is exempt from bankruptcy.72 The Bankruptcy Code also includes federal exemptions which can be applied when a state opts to follow those exemptions or if, for some reason, the state exemptions are not appropriate for a debtor. Importantly, almost every state has a homestead law that protects at least a portion of the equity in a debtor’s primary residence from sale in a bankruptcy case. By contrast, the current OIC program generally requires a taxpayer to include 80% of the fair market value of the home minus any loan balance (known as “net realizable equity”) to determine the amount that must be included in the offer amount.73

The Bankruptcy Code also protects up to $1 million in retirement savings in a 401(k) savings plan, a 403(b) savings plan, an individual retirement account, or similar fund. By contrast, the current OIC program includes 80% of the value of these funds in the OIC calculation, no matter the amount, the taxpayer’s age, the taxpayer’s income level, or the tax consequences associated with withdrawing those funds to pay a past-due tax debt.

Unfortunately, for low-income taxpayers in financial distress who own their homes (typically seniors who purchased them and paid them off long ago) or whose only tangible asset is the 401(k) savings plan or similar fund they have contributed to for years to ensure a modicum of future financial security, the only logical choice under the current OIC program often is to file for bankruptcy, because to pursue an OIC means those assets are reachable by the Service. Against this background, we recommend that the Service redefine the OIC asset valuation criteria included in the calculation of RCP to carve out the value of assets that are protected by current federal exemption laws. We believe this

71 See Bankruptcy Code § 522.
73 See I.R.M. 5.8.5.4.1 (Sept. 30, 2013).
will benefit taxpayers and the Service by making the OIC process a more realistic alternative to bankruptcy.

We believe that the Service has the authority to make this change. The criteria for determining RCP currently includes assets in the calculation that the Service either cannot levy upon because of the exemptions on levy under section 6334, does not levy upon because of internal policy decisions such as the determination not to levy on Social Security disability benefits, or cannot easily levy upon because, for example, the assets are outside of the United States. Adopting the federal bankruptcy exemptions as part of the OIC program not only honors Congress’s intent, expressed in section 522 of the Bankruptcy Code, that certain assets and rights to property should be beyond the reach of creditors, even if the creditor is the federal government, but recognizes the reality that not doing so will drive more taxpayers into bankruptcy where the assets will be exempt from levy in any event.

### iii. Change to (or Elimination of) the Five-Year Compliance Period

When a debtor files a chapter 7 bankruptcy petition and receives a discharge, all dischargeable debt that existed as of the bankruptcy filing is discharged as a matter of law. Similarly, when a chapter 13 debtor completes all payments required to be made to the chapter 13 trustee, a discharge order is entered and the debtor emerges from bankruptcy debt-free. There is a clear line of demarcation between the debtor’s pre- and post-bankruptcy life. And, absent fraud, the debtor’s future actions, good or bad, do not have any impact on the discharged debt—it cannot be resurrected. Creditors’ future interests are protected, for example, by limiting individuals from being permitted to file subsequent bankruptcies for a period of eight years.

By contrast, the OIC program offers only a conditional acceptance of the OIC. Under the standard terms of an OIC, as set forth on Form 656, if a taxpayer fails to file any tax return or make any required tax payment on time for the five years after acceptance, the OIC agreement is generally rescinded and the entire compromised balance is once again owed, even if the taxpayer completed all required payments under the OIC.

Unfortunately, many taxpayers faced with the choice between a bankruptcy and an OIC favor the true “fresh start” of a bankruptcy. Against this background, we recommend that the Service close an OIC once it has been paid-in-full and cease monitoring during the five-year post-OIC-acceptance date. We believe that, like our recommendation in Section 2.b.ii, these changes will benefit taxpayers and the Service by making the OIC process a more realistic alternative to bankruptcy. To prevent taxpayers from taking advantage of the OIC program, we recommend that the Service adopt a

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74 See Bankruptcy Code § 524.

75 See Bankruptcy Code § 727(a)(8).
policy that allows taxpayers to apply for an OIC only after a certain time has elapsed after an OIC has been accepted and paid in full.

iv. Removal of Refund Recoupments

Under the existing OIC program, the Service may recoup all refunds due a taxpayer through the refund for the year in which an offer is accepted. This often leads to unfair results and can prevent taxpayers from accessing funds needed for basic living expenses, including the anti-poverty tax credits that have lifted millions of families out of poverty.76

Assume that two taxpayers submit an OIC on the same date and both are due refunds for all years after the OIC was submitted. The first taxpayer has his OIC accepted on December 30, 2020, which means the imminent refund generated by the 2020 tax return will be offset by the Service. The second taxpayer has her OIC accepted on January 2, 2021, which means the Service may offset the imminent refund generated by the 2020 tax return and the future refund generated by the 2021 tax return. The second taxpayer, due to no fault of her own, loses her 2020 and 2021 refunds to the Service’s offset. By contrast, and stroke of good luck, the first taxpayer loses only his 2020 refund to the offset. The preceding example results in the inconsistent, and potentially unfair, treatment of similarly situated taxpayers.

Moreover, the COVID-19 emergency is likely to cause many taxpayers seeking to resolve their tax debts with an OIC to fall into the category of the second taxpayer: by the time the Service processes the OICs submitted during and after the COVID-19 emergency, most OICs submitted in early-2020 will not be decided or processed until at least 2021, which means those taxpayers might lose the benefit of tax refunds for multiple years at a time when those refunds are most needed. This result is particularly devastating to recipients of Income-Based Credits, who receive these subsidies to supplement their already extremely low-income. These taxpayers stand to lose two years of federal financial assistance meant to help feed and care for them and their children, again at a time when those subsidies are most needed.

The Bankruptcy Code does not contain a federal exemption for tax refunds of any kind, including Income-Based Credits, but most states allow debtors in a bankruptcy case to exempt the Income-Based Credits portion of their annual tax refund from being part of the bankruptcy estate. Once the debtor files a bankruptcy petition, she can be guaranteed the receipt of her post-petition Income-Based Credits from that point forward, even if she owes prepetition tax liabilities. Faced with the option of possibly losing two sizeable refunds going forward, versus immediate relief from upcoming offsets, a low-income taxpayer is likely to choose bankruptcy over an OIC.

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Against this background, we recommend that the Service suspend the recoupments of refunds, including in particular Income-Based Credits, for pending and accepted OICs through at least the end of 2020, or permanently. We believe that, like our recommendation in Section 2.b.ii, this change will benefit taxpayers and the Service by making the OIC process a more realistic alternative to bankruptcy, and is particularly timely in light of the economic turmoil caused by the COVID-19 emergency.

We believe that the Service has the authority to make this change. Section 6402 does not require it to offset refunds due a taxpayer. (The statute uses the permissive “may,” not the mandatory “shall.”) Rather, the Service has made the policy decision to make these offsets.

B. Offset of EIPs Against Outstanding Tax Liabilities and Treatment of EIPs as Available Assets

1. Recommendations

We recommend that the Service clarify that refunds will not be recouped to the extent they are attributable to EIPs, and that EIPs will not be treated as available assets for purposes of computing a taxpayer’s available individual equity in assets or, more generally, RCP.

2. Explanation

Section 2201(d) of the CARES Act provides:

EXCEPTION FROM REDUCTION OR OFFSET.—Any credit or refund allowed or made to any individual by reason of section 6428 of the Internal Revenue Code of 1986 (as added by this section) or by reason of subsection (c) of this section shall not be—

* * *

(3) reduced or offset by other assessed Federal taxes that would otherwise be subject to levy or collection.

Thus, by its terms section 2201(d) prohibits any EIP, whether allowed or made, from being reduced or offset by other assessed taxes. Yet the standard terms in Form 656, Offer in Compromise, appear to allow the recoupment of refunds attributable to EIPs in the context of an OIC.77 Similarly, nothing in Form 433-A (OIC), Collection Information Statement for Wage Earners and Self-Employed Individuals, or elsewhere prohibits them from being counted as available assets or RCP. Consequently, if a

77 See Form 656, Offer in Compromise, p. 5, § 7(e) (“The IRS will keep any refund, including interest, that I might be due for tax periods extending through the calendar year in which the IRS accepts my offer.”), available at https://www.irs.gov/pub/irs-pdf/f656.pdf.
taxpayer is entitled to a refund generated, in-full or in-part, by an EIP, the Service could be entitled to the refund by contract if not by law.

We believe this is inconsistent with the intent of section 2201(d) of the CARES Act, and recommend that the Service revise Forms 656 and 433-A (OIC), and the accompanying instructions, as well as the I.R.M., to avoid this result.