

**INTERNAL REVENUE SERVICE**  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 27, 2005

Third Party Communication: None  
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-114303-05/CC:FIP:B02

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Year(s) Involved:  
Date of Conference:

**LEGEND:**

Taxpayer =  
Trust =  
a =  
b =  
c =  
d =  
State X =  
Date 1 =  
Date 2 =  
Date 3 =  
Tax Year 1 =  
Tax Year 2 =

## ISSUE:

Whether, under the circumstances described below, the conversion of certain convertible preferred securities (by the holders of such securities) into Taxpayer's common stock gives rise to discharge of indebtedness income for purposes of sections 61(a)(12) and 108 of the Internal Revenue Code and section 1.61-12(c)(2)(ii) of the Income Tax Regulations.

## CONCLUSION:

The conversion of the convertible preferred securities into Taxpayer's common stock at a time when the fair market value of Taxpayer's common stock was less than the adjusted issue price of the convertible preferred securities resulted in discharge of indebtedness income for purposes of sections 61(a)(12), 108 and 1.61-12(c)(2)(ii).

## FACTS:

Taxpayer established Trust for the purpose of issuing convertible preferred securities (CPSs collectively and CPS individually). Trust is a special purpose statutory trust created under the laws of State X. Taxpayer is the sole holder of Trust's common securities. Taxpayer represents that Trust is a grantor trust for federal income tax purposes.

The CPSs issued by Trust were convertible into shares of Taxpayer's no par value common stock. In accordance with an offering memorandum dated Date 1, with some exceptions, each CPS was convertible at any time, at the option of the holder, into shares of Taxpayer's common stock beginning a days following the latest date of original issuance of the CPS through the close of business on the business day prior to the maturity date of the CPS.

Trust used the proceeds from the issuance of its common securities and the CPSs to purchase Taxpayer's convertible junior subordinated debentures. Taxpayer's convertible junior subordinated debentures were the sole assets of Trust. In general, the CPSs were guaranteed by Taxpayer with respect to distributions and amounts payable upon liquidation or redemption.

On Date 2 (a date in Tax Year 1), Taxpayer's board of directors established a committee to evaluate the possibility of issuing shares of Taxpayer's common stock in exchange for the retirement of either Taxpayer's publicly traded debt or the CPSs. The committee was authorized to approach debt holders with the offer of the exchange of Taxpayer's common stock for outstanding debt. On Date 3 (a date in Tax Year 1), Taxpayer petitioned for Chapter 11 Bankruptcy, and stopped all payments to Trust.

In Tax Year 1, some holders of the CPSs converted their CPSs into shares of Taxpayer's common stock in accordance with their conversion right (under the original terms of the CPSs) at a time when the fair market value of Taxpayer's common stock was less than the adjusted issue price of the CPSs. No offer was made in connection with conversion of the CPSs on any terms other than the original terms of the CPSs. As a result of the conversions, Taxpayer reported b dollars of other income on its Tax Year 1 federal income tax return. Taxpayer is filing a claim for refund for Tax Year 1 claiming that the b dollars should not have been included in income.

In Tax Year 2, c CPSs were converted into Taxpayer's common stock under the original terms of the CPSs. At the time of the conversion, the fair market value of Taxpayer's common stock was less than the adjusted issue price of the CPSs in the amount of d dollars. Taxpayer did not report the d dollars as income on its Tax Year 2 federal income tax return.

#### LAW AND ANALYSIS:

Under section 61(a)(12), gross income includes income from discharge of indebtedness.

Under section 1.61-12(c)(2)(i), an issuer generally does not realize gain or loss upon the repurchase of a debt instrument. For purposes of section 1.61-12(c)(2), the term "repurchase" includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.

Under section 1.61-12(c)(2)(ii), an issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of § 1.1275-1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. Section 1.61-12(c)(2)(ii) does not distinguish between a conversion at the request of the holder of a convertible debt versus a redemption by the issuing corporation. Section 1.61-12(c)(2)(ii) refers to section 108 and the regulations thereunder for additional rules relating to income from discharge of indebtedness.

Under section 108(e)(8), for purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

The legislative history to section 108(e)(8) (formerly section 108(e)(10)) provides:

The House bill provides that a debtor corporation realizes income from discharge of indebtedness when it satisfies its debt with stock having a fair market value

less than the principal of the debt. This rule applies where the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt....(Section 1032 does not prevent the recognition of this income from the discharge of indebtedness.)

H.R. Rep. No. 98-861 (Conf. Rep.), 98<sup>th</sup> Cong., 2d Sess. 829 (1984), 1984-3 C.B. (Vol. 2) 83.

Section 108(e)(8) (formerly section 108(e)(10)) included transition rules regarding the application of its provisions. The transition rules provided an exception from the recognition of discharge of indebtedness income on the transfer by a corporation of its stock in exchange for its debt if such transfer was pursuant to certain binding written contracts in effect on June 7, 1984, requiring such transfer or pursuant to the exercise of certain options in effect on June 7, 1984, to exchange debt for stock. P.L. 98-369, § 59(b)(2), 1984-3 C.B. (Vol 1) 85.

The legislative history to section 108(e)(8) (formerly section 108(e)(10)) further provides that:

Under the first transitional rule, the provision in the bill will not apply to any transfer pursuant to a written binding contract or option (including a convertible debenture) which was in effect at all times on the day of June 7, 1984, and which remains in effect at all times thereafter....The conversion of debt pursuant to an option or conversion right outstanding at all times on June 7, 1984, and thereafter will be covered by the transitional rule regardless of whether conversion is after 1984.

H.R. Rep. No. 98-861 (Conf. Rep.), 98<sup>th</sup> Cong., 2d Sess. 830 (1984), 1984-3 C.B. (Vol. 2) 84.

In United States v. Centennial Savings Bank FSB, 499 U.S. 573 (1991), the United States Supreme Court addressed a bank's income tax treatment of early withdrawal penalties due the bank on holders' premature redemption of certificates of deposit. The bank conceded that the early withdrawal penalties were income under section 61. However, the bank argued that the prepayment penalties, which were offset against the amount payable to holders on redemption of certificates of deposit, represented discharge of indebtedness income excludible from gross income under section 108. The Supreme Court found that, because the penalties were paid pursuant to the terms of the original contracts, the penalties did not result in discharge of indebtedness income. Accordingly, the early withdrawal penalties were not excludable from the bank's gross income pursuant to section 108(a) as discharge of indebtedness income.

Based on Centennial, Taxpayer argues that there can be no discharge of indebtedness income when debt is converted into common stock in accordance with the terms of the original debt instrument. Accordingly, because the conversion of the CPSs into

Taxpayer's stock in this case was pursuant to the original terms of the CPSs, Taxpayer argues there is no discharge of indebtedness income in this case. Taxpayer specifically relies on the Court's statement in Centennial that "as used in section 108, the term 'discharge...of indebtedness' conveys forgiveness of, or release from, an obligation to repay." 499 U.S. at 580.

Taxpayer relies on Philip Morris, Inc. v. Commissioner, 104 T.C. 61 (1995), *aff'd*, 71 F.3d 1040 (2<sup>nd</sup> Cir. 1995), *cert. denied*, 517 U.S. 1220 (1996), in arguing that the Court's decision in Centennial should be read broadly regardless of the nature of the obligation at issue. In Philip Morris, the Tax Court and the Second Circuit, relying on Centennial, found that no discharge of indebtedness income resulted when foreign currency loans were repaid in accordance with the original loan agreement in depreciated foreign currency.

Taxpayer further argues that the Court's interpretation of "discharge of indebtedness" in Centennial is *stare decisis* and controls over any subsequent regulation's interpretation of that term. Taxpayer cites the Supreme Court decision in Neal v. United States, 516 U.S. 284 (1996), in asserting this position. The Court in Neal stated that:

[o]nce we have determined a statute's meaning, we adhere to our ruling under the doctrine of *stare decisis*, and we assess an agency's later interpretation of the statute against that settled law. Lechmere, Inc. v. NLRB, 502 U.S. 527, 536-537 (1992); Maislin Industries, U.S., Inc. v. Primary Steel, Inc., 497 U.S. 116, 131 (1990).

Our reluctance to overturn precedents derives in part from institutional concerns about the relationship of the Judiciary to Congress. One reason that we give great weight to *stare decisis* in the area of statutory construction is that "Congress is free to change this Court's interpretation of its legislation." Illinois Brick Co. v. Illinois, 431 U.S. 720, 736 (1977). We have overruled our precedents when the intervening development of the law has "removed or weakened the conceptual underpinnings from the prior decision, or where the later law has rendered the decision irreconcilable with competing legal doctrines or policies." Patterson v. McLean Credit Union, 491 U.S. 164, 173 (1989) (citations omitted). Absent those changes or compelling evidence bearing on Congress' original intent, NLRB v. Longshorem, 473 U.S. 61, 84 (1985), our system demands that we adhere to our prior interpretations of statutes.

Id. at 295.

The Service does not believe Centennial is controlling in this case. While Centennial did address the meaning of "discharge of indebtedness," Centennial did not address the term in the context of section 108(e)(8). The case did not involve convertible debt and, therefore, the Court had no need to focus on whether there was "compelling evidence bearing on Congress' original intent" regarding the meaning of "discharge" in the context

of section 108(e)(8). In this case, the transition rules and the legislative history to section 108(e)(8) (formerly section 108(e)(10)) provide “compelling evidence bearing on Congress’ original intent.” Accordingly, based on Neal, Centennial’s interpretation of “discharge of indebtedness” would not be *stare decisis* in this case in view of the compelling evidence of Congressional intent that the exercise of a conversion right by the holder of convertible debt results in discharge of indebtedness income for purposes of section 108(e)(8) (formerly section 108(e)(10)).

Taxpayer argues that the language in the legislative history to section 108(e)(8) (formerly section 108(e)(10)) merely adds “conversions” to the general rule for discharge of indebtedness and does not provide a special definition of “discharge” for conversions. Taxpayer argues that, in Centennial, the Court provided the definition of “discharge” and there is nothing in the legislative history to section 108(e)(8) (formerly section 108(e)(10)) that makes the exercise of a conversion right an exception to the requirements for a “discharge” as set forth in Centennial.

Contrary to Taxpayer’s assertion, the legislative history to section 108(e)(8) (formerly section 108(e)(10)) does provide that the conversion of a convertible debenture is a “discharge” that gives rise to discharge of indebtedness income. By stating that “[t]his rule applies where the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt...”, Congress clearly indicated that it intended for a conversion of a debt instrument by a debt holder to result in a “discharge” giving rise to discharge of indebtedness income, provided that the fair market value of the stock transferred is less than the adjusted issue price of the debt instrument converted. Further, by providing a transition rule to exempt certain conversions from the statutory provisions, it is clear that Congress intended that a conversion of convertible debt could give rise to discharge of indebtedness income absent the transition rule.

Since Centennial’s interpretation of “discharge of indebtedness” is not controlling in this case, Taxpayer’s argument that a later enacted regulation (i.e., section 1.61-12(c)(2)(ii)) cannot alter the Court’s decision is misplaced.

Based on the foregoing, we conclude that the operation of sections 61(a)(12), 108(e)(8) and 1.61-12(c)(2)(ii) in this case results in discharge of indebtedness income on the conversion of the CPSs into Taxpayer’s common stock at a time when the fair market value of Taxpayer’s common stock was less than the adjusted issue price of the CPSs.

#### CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with section 6110(c), names, addresses, and other identifying numbers have been deleted.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequence of any aspect of any transaction or item discussed or referenced by this technical advice memorandum.