

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED TREASURY REGULATIONS  
UNDER SECTION 108(e)(8)(A)  
("NOMINAL OR TOKEN" STOCK)

July 18, 1991

**Table of Contents**

Cover Letter:.....	i
I. Introduction .....	1
II. General Comments and Summary of Recommendations .....	2
III. Background .....	5
1. Section 108 and the Stock-for-Debt Exception .....	5
2. Legislative History. ....	7
3. Other Authorities .....	8
IV. The Proposed Regulations .....	10
V. The Proposed Standards .....	12
VI. Discussion .....	12
1. Facts and Circumstances Approach .....	12
2. The Proposed Standards .....	16
3. New Safe Harbors .....	19
4. Retroactive Application of Proposed Regulations .....	21
5. Use of Parent Stock .....	22

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July 22, 1991

The Honorable Fred T. Goldberg, Jr.  
Commissioner of Internal Revenue  
1111 Constitution Avenue, N.W.  
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Dear Commissioner Goldberg:

I enclose our report on Proposed Treasury Regulations under Section 108(e)(8)(A) ("Nominal or Token Stock"). The report was prepared by Stephen R. Field, co-chair of the Committee on Bankruptcy.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Peaslee  
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION TAX SECTION  
COMMITTEE ON BANKRUPTCY\*

REPORT ON PROPOSED TREASURY REGULATIONS  
UNDER SECTION 108(e)(8)(A)  
("NOMINAL OR TOKEN" STOCK)

July 18, 1991

I. Introduction

On December 6, 1990, the Treasury Department issued proposed regulations (the "Proposed Regulations") providing rules for determining whether stock issued in exchange for indebtedness is "nominal or token" under section 108(e)(8)(A).<sup>1</sup> The preamble to the Proposed Regulations indicates that the Treasury is considering the issuance of "standards" (the "Proposed Standards") which, if satisfied, will establish conclusively that stock issued in discharge of indebtedness is not "nominal or token." This report comments on the Proposed Regulations and Proposed Standards.

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\* This report was prepared by Stephen R. Field, co-chair of the Committee of Bankruptcy. Significant contributions were made by Robert Jacobs, co-chair of the Committee, Peter C Canellos, John A. Corry, Patrick C. Gallagher, Stuart J. Goldring, Gordon Henderson, James A. Levitan, James M. Peaslee, Robert J. Preminger, Eileen Silvers, and Ralph O. Winger.

<sup>1</sup> Section references are to the Internal Revenue Code of 1986 (the "Code"), unless otherwise indicated.

## II. General Comments and Summary of Recommendations

As explained below, our principal concern with the Proposed Regulations and Proposed Standards is that they go too far in transforming the nominal or token test from an anti-abuse rule that was intended to apply only in extreme cases into a set of rigid numerical guidelines that restrict substantially the availability of the stock-for-debt exception.

The Proposed Regulations and Proposed Standards raise the basic policy question of whether it is desirable for the Internal Revenue Service (the "Service") to flesh out the meaning of "nominal or token" through general guidelines or tests (particularly numerical tests) or whether instead the statutory language - together with its scanty legislative history - should be left alone, to be interpreted through rulings and judicial decisions based on specific facts. Although the general bias of practitioner groups, including ours, is to seek more guidance rather than less, we believe the question is a legitimate one and that the answer in this case is not obvious.

Section 108(e)(8)(A) has been on the books for over a decade and has been applied during that time by practitioners and the Service as directed by Congress, i.e., by looking at all relevant facts and circumstances. Facts and circumstances tests are inherently imprecise so that results can be difficult to predict, particularly in close cases. Moreover, when dealing with the reorganization of a bankrupt or insolvent company, certainty as to tax consequences is most desirable. On the other hand, facts and circumstances tests also obviate the need to draw lines in advance, which can prove a major benefit.

With regard to the nominal or token test, establishing precise standards is a daunting task for several reasons. First, we believe the test was intended as an anti-abuse measure aimed at fairly extreme cases. Creating a safe harbor for an anti-abuse provision virtually guarantees that transactions will be structured to fall just over the right side of the line. This prospect will not be lost on government drafters, so that any precise test fashioned by the Treasury may tend to distort the statute by giving the nominal or token test more teeth than Congress intended. We believe the Proposed Standards illustrate this problem vividly. Furthermore, despite anything that is said, a safe harbor rule will likely be viewed by some, including tax auditors, as a limiting rule, which is a major concern where the safe harbor standard is unrealistically severe.

Second, there is a basic tension between the requirement that stock issued in exchange for debt not be "nominal or token" and the fact that the test is applied only to bankrupt or insolvent corporations. Stock of bankrupt or insolvent corporations - particularly those most in need of the "fresh start" implicit in the Bankruptcy Code and related tax rules -- often has only speculative value. Framing numerical tests brings to light the tension between the bankruptcy policy of rehabilitating financially distressed debtors and a tax policy disfavoring tax-motivated transactions.

Finally, contrary to the conventional wisdom, line drawing engenders complexity. Simple standards tend to produce results that seem in some settings inappropriate and in need of correction or refinement. Also, new tests must be interpreted and

applied and difficulties in construction always arise, no matter how skilled the drafters. Furthermore, a numerical test that requires measurement of the fair market value of the debtor's stock will in practice produce uncertain results in close cases.

Some members of the Tax Section's Executive Committee would resolve the conflict between uncertainty and even more rules by recommending that both the Proposed Regulations and Proposed Standards be abandoned and the Service's attention directed elsewhere. A majority of the members believe, however, that there should be at least one relatively simple, workable, and reasonable safe harbor that could be relied on in many reorganizations in addition to a true facts and circumstances test.

Although we are not wedded to a particular rule, an acceptable safe harbor would treat the nominal or token test as satisfied if the stock given to unsecured creditors, as a group, constitutes 10% (measured by fair market value) of the debtor's stock following the exchange. For this purpose, each share of stock of a class would be considered to have the same value, so that the rule would not require the fair market value of the debtor's stock to be determined except where the debtor has more than one class of stock. Furthermore, the rule would allow flexibility in allocating stock among different classes of unsecured creditors, subject to the proportionality test of section 108(e)(8)(B). We also believe the 10% threshold is high enough to fulfill the purposes of the nominal or token test. We would apply the rule to parent stock where subsidiary debt is exchanged for parent stock (assuming the stock-for-debt exception applies to such exchanges), but would count stock issued to all unsecured creditors pursuant to the reorganization plan (i.e., not only subsidiary creditors) in determining whether the 10% threshold is satisfied.

We also recommend that the Proposed Regulations be changed to remove their overall bias for numerical stock ratios so that, where the safe harbor does not apply, a true facts and circumstances test remains. This can be done by including in the regulations an expanded list of nonexclusive factors to be considered (some of which would not be numerical). The ratios and other factors should not be assigned relative weights.

Finally, we do not believe that the regulations, including the "underlying principles," should be applied retroactively.

These recommendations are discussed in part VI. We begin with a brief review of the stock-for-debt exception and the Proposed Regulations and Proposed Standards.

### III. Background

#### 1. Section 108 and the Stock-for-Debt Exception

Section 108(a) provides, in general, that income from the discharge of indebtedness is not included in the taxpayer's gross income if the discharge occurs in a title 11 case or when the taxpayer is insolvent. Instead, the taxpayer ordinarily is required to reduce certain of its tax attributes, including net operating losses, in the order specified in section 108(b), thereby postponing income recognition. Any discharge of indebtedness income remaining after the tax-attribute reduction is excluded from gross income.

Pursuant to a line of judicial decisions preceding the Bankruptcy Tax Act of 1980 (the "1980 Act"), a debtor corporation is excused from recognizing cancellation of indebtedness income in a stock-for-debt exchange.<sup>2</sup> Therefore, where the stock-for-debt exception applies, the debtor need not reduce its tax attributes. Although the exception has been limited by statute and rulings over the years, it continues to play a crucial role in restructuring and rehabilitating bankrupt and insolvent corporations.

Section 108(e) limits the pre-1980 stock-for-debt exception in four ways. First, section 108(e)(10) restricts application of the exception to bankrupt corporations and corporations that are insolvent (to the extent of the insolvency). Second, under section 108(e)(10) the stock-for-debt exception does not apply to the issuance of "disqualified stock" (generally redeemable preferred stock).<sup>3</sup> Third, section 108(e)(8)(B) provides that the stock-for-debt exception will not apply to stock issued to any unsecured creditor if the ratio of the value of the stock issued to the creditor to the discharged is less than 50% of the same ratio for all unsecured creditors as a group. s "proportionality" test ensures that the exception will

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<sup>2</sup> See, e.g., Commissioner v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946), acq. 1947-1 C.B. 3; Capento Securities Corp. v. Commissioner, 47 B.T.A. 691 (1942), aff'd, 140 F.2d 382 (1st Cir. 1944), nonacq. 1943 C.B. 28.

<sup>3</sup> The disqualified stock rule, which effectively limits the amount of debt discharged to the fair market value of the stock, was added by the Revenue Reconciliation Act of 1990 ("1990 Act"). The 1990 Act also amended section 108(e)(8) to treat disqualified stock as property other than stock for purposes of the nominal or token and proportionality tests of section 108(e)(8). Application of the stock-for debt exception to exchanges of preferred stock had been challenged earlier in 1990 by Revenue Ruling 90-87, 1990-2 CB. 32, which limits the amount of debt discharged in exchange for preferred stock to the redemption and liquidation preference of the shares.

not apply to unsecured creditors receiving a disproportionately small share of the stock issued to all unsecured creditors in the workout. Finally, section 108(e)(8)(A) bars application of the stock-for-debt exception to the issuance of "nominal or token" shares.

## 2. Legislative History.

The nominal or token and proportionality tests originated in the 1980 Act. In 1980, Congress decided to preserve the judicially created stock-for-debt exception.<sup>4</sup> The House of Representatives acted initially to create a statutory "stock-for-security" exception,<sup>5</sup> which was reworked by the Senate into the stock-for-debt exception included in the 1980 Act. As stated by the Senate Finance Committee:

The committee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.<sup>6</sup>

Both the House and Senate believed, however, that the stock-for-debt exception should not be available where a debtor uses only a small amount of stock in an effort to qualify a stock-for-debt swap for favorable tax treatment. According to the House Ways and Means Committee:

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<sup>4</sup> S. Rep. No. 1035, 96th Cong., 2d Sess. 11 (1980) (the "Senate Report"). In 1986, section 108(e)(10) was amended to repeal the stock-for-debt exception in "qualified workouts" involving solvent corporations, thereby limiting application of the rule to bankrupt and insolvent corporations.

<sup>5</sup> The House had moved to limit the equity-for-debt exception to exchanges of stock for "securities" (i.e., indebtedness other than short-term debt and trade debt). H.R. 5043, 96th Cong., 2d Sess §2(a) (1980). See H.R. Rep. No. 833, 96th Cong., 2d Sess. 13-14 (1980) (the "House Report"). The view of the Senate prevailed, however, and the stock-for-debt exception is available with respect to all outstanding indebtedness of a bankrupt corporation. See Senate Report at 11.

<sup>6</sup> Senate Report at 11.

[T]he value of the stock received may not be very small when compared to the total amount of the creditor's claim, so that the debt forgiveness rules will not be circumvented by the issuance of token shares to a creditor with no real equity interest in the corporation.<sup>7</sup>

The Senate Finance Committee adopted a similar approach, stating that the committee does not believe that [the stock-for-debt exception] should apply if only a de minimis amount of stock is issued for the outstanding debt, so that the general rules on debt forgiveness cannot thereby be circumvented.<sup>8</sup>

The 1980 Act introduced two de minimis tests to ensure that the stock-for-debt exception is not abused by the issuance of small amounts of stock for outstanding indebtedness: the nominal or token test of section 108(e)(8)(A) and the proportionality test of section 108(e)(8)(B). Congress offered little guidance with regard to the parameters of the nominal or token test other than to state that whether stock is "nominal or token" is

to be determined from all the facts and circumstances, so that the forgiveness rules may not be circumvented by the issuance of nominal or token shares to a creditor who had no real equity interest in the corporation.<sup>9</sup>

### 3. Other Authorities

Over the decade between enactment of the nominal or token test and publication of the Proposed Regulations, section 108(e)(8)(A) has not been construed in a published court decision

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<sup>7</sup> House Report at 14. Although the House bill did not contain an express de minimis test, the House Report states that the stock-for-securities rule was not intended to apply in de minimis cases. The nominal or token and proportionality tests included in the 1980 Act were introduced by the Senate.

<sup>8</sup> Senate Report at 11.

<sup>9</sup> Id. at 17.

and has been considered by the Service in only one close case, a 1988 technical advice memorandum.<sup>10</sup> In Technical Advice Memorandum 8837001, a chapter 11 debtor paid cash and issued convertible participating redeemable preferred stock in discharge of claims held by unsecured creditors. The shares were convertible into common stock by the holder after three years and redeemable by the debtor after five years.<sup>11</sup> In addition, the preferred stock transferred to the unsecured creditors, which constituted approximately 68% of the preferred stock issued and 3.4% of the voting power of the corporation, constituted about 15% of the consideration received by the unsecured creditors and was valued at approximately 10% of the amount by which the claims discharged exceeded the cash component of the consideration.

The Service began its analysis by stating that

[t]his memorandum will demonstrate that section 108(e)(8)(A) was intended to continue the general notions of the substitution of liability theory underlying the stock for debt rule and to limit the application of the rule in the case of a stock for debt exchange which was essentially a sham transaction.

The Service then reviewed the judicial history of the stock-for-debt exception and the legislative history of section 108(e)(8)(A) and stated that in determining whether stock issued in exchange for debt is "nominal or token"

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<sup>10</sup> In Private Letter Ruling 9019036, the Service ruled that common stock of a parent corporation issued to unsecured creditors receiving only common stock in the exchange was not "nominal or token." The common stock issued to such creditors, believed to be valued at as little as 1% of the face amount of the debt discharged, constituted at least 50% of the common stock of the parent issued in the workout. The Service did not rule on whether a package of common stock and preferred stock issued by the subsidiary to its creditors was "nominal or token," although the issue was presented.

<sup>11</sup> It is unclear whether the preferred stock would constitute "disqualified stock" under the 1990 Act. Furthermore, it is arguable whether the shares would be subject to the special nominal or token rules established by the Proposed Regulations for "preferred" stock.

consideration must be given to those factors which indicate arm's length bargaining, including such elements as the existence of sufficiently adverse economic interests on each side of the exchange, the value of the stock exchanged in comparison to the face amount of the debt cancelled, and the value of the stock received in comparison to the total consideration received in discharge of the debt.

It then concluded that the preferred stock was a "significant part" of the consideration used to discharge the debt and was not "nominal or token."<sup>12</sup>

#### IV. The Proposed Regulations

The Proposed Regulations adopt a "facts and circumstances" approach to the determination of whether stock exchanged for debt is "nominal or token" and set forth three nonexclusive factors to be considered in making this determination:

- (i) The ratio of the fair market value of the stock issued to a creditor to the allocable indebtedness discharged by the stock (the "Stock to Debt Ratio");
- (ii) The ratio of the fair market value of the stock issued to a creditor to the fair market value of the total consideration received by the creditor (the "Stock to Total Consideration Ratio"); and

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<sup>12</sup> Compare Henderson and Goldring, Failing and Failed Businesses (CCH Tax Transactions Library, Vol. A1 1990) f504.041 (noting Service position that arm's-length bargaining a factor in nominal or token determination), with Shakow, The Stock-for-Debt De Minimis Exception, Tax Notes (December 19, 1988) 1325 (criticizing Service position).

(iii)The ratio of the fair market value of the stock issued to all creditors to the total fair market value of the outstanding stock of the corporation after the bankruptcy reorganization or insolvency workout (the "Stock to Total Stock Ratio").

The Proposed Regulations state that the Stock to Debt Ratio is the most important factor, although any low ratio may indicate that the shares issued in exchange for debt are "nominal or token."

The Proposed Regulations provide comprehensive rules for determining the amount of indebtedness discharged with preferred stock (other than disqualified stock). In general, such preferred stock is deemed to discharge an amount of debt equal to the lesser of the redemption price and liquidation preference of the stock, but not less than the fair market value of the stock. The rules for preferred stock appear to be relevant primarily for shares issued prior to the effective date of the 1990 Act amendments to section 108(e)(8) because most preferred stock (including participating preferred stock) would fall within the definition of disqualified stock.<sup>13</sup> The allocation rules where common and preferred shares are issued together in a title 11 workout are illustrated by an example in the Proposed Regulations.<sup>14</sup>

The somewhat elaborate rules for determining the amount of debt discharged with different classes of stock make sense

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<sup>13</sup> The 1990 Act amendments are generally effective for stock transferred after October 9, 1990, but a number of transition rules, including one for stock issued in a bankruptcy case filed on or before that date, may apply. See Section 11325(c) of the 1990 Act.

<sup>14</sup> The example appears to be in error because it treats callable preferred stock as not disqualified stock.

only if great precision is required in determining the debt discharge amount. The Service's desire for precision becomes apparent from an examination of the Proposed Standards.

## V. The Proposed Standards

Under the Proposed Standards, stock exchanged for debt will not be "nominal or token" if any of the following tests is satisfied:

- (i) The Stock to Debt Ratio is at least 10% for each class of stock issued to a creditor for which a separate ratio is calculated and the Stock to Total Consideration Ratio for the creditor is at least 25%.
- (ii) The Stock to Total Consideration Ratio for the creditor is at least 25% and the Stock to Total Stock Ratio for the creditor is at least 25%.
- (iii) The Stock to Total Consideration Ratio for unsecured creditors as a group is 100% and the Stock to Total Stock Ratio for unsecured creditors as a group is 90%.

## VI. Discussion

### 1. Facts and Circumstances Approach

The Senate Report states that whether shares are "nominal or token" is to be determined from "all the facts and

circumstances.”<sup>15</sup> Although a facts and circumstances test is inherently imprecise, the nominal or token test has been applied by practitioners and apparently by the Service for a decade without great difficulty. One reason for this result is that the test has been understood to be a narrow anti-abuse rule. Indeed, it is likely that prudent tax lawyers would be concerned about the availability of the stock- for-debt exception where token shares are issued even if section 108(e)(8)(A) had never been enacted.<sup>16</sup>

Given the apparently limited role the nominal or token rule was intended to play, there is a legitimate question whether it is worthwhile issuing guidance that attempts to flesh out the test. We are fearful that any guidance will be skewed -- whether intentionally or not -- toward expanding the nominal or token exception in a way that was not intended by Congress, imposing substantive standards that are themselves difficult to apply.

The Proposed Regulations and Proposed Standards demonstrate that our fears are not misplaced. Although the Proposed Regulations acknowledge that the nominal or token test is based on all facts and circumstances, they direct attention to three specific ratios. That other factors are not mentioned and that the ratios are incorporated in the Proposed Standards<sup>17</sup> will tend, as a practical matter, to focus any application of the nominal or token rule on these ratios. This is particularly true in the context of an audit.

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<sup>15</sup> Senate Report at 17.

<sup>16</sup> Cf. Revenue Ruling 88-31, 1988-1 CB. 302 (cash settlement put option considered to lapse even though nominal amount received).

<sup>17</sup> The very explicit rules in the Proposed Regulations for determining the three ratios are difficult to understand except in the context of the Proposed Standards. What is the point of calculating the ratios if there is no formula for using them?

The prominence given the ratios in the Proposed Regulations may create the comforting impression that application of the nominal or token test can be transformed into a simple arithmetic exercise. This would be true, however, only if the Proposed Standards (or some version of them) are read as exclusive substantive rules and the value of stock can be determined precisely.

The problem of according undue weight to the stock ratios is exacerbated by the statement in the Proposed Regulations that the Stock to Debt Ratio is the most important of the three factors. The authority for this rule may be the statement in the House Report that the value of the stock received may not be very small when compared to the total amount of the creditor's claim.<sup>18</sup> This statement is not found in the Senate Report, however. Furthermore, the House Report must be read in context; it is qualified by the statement that the rule is needed "so that the debt forgiveness rules will not be circumvented by the issuance of token shares to a creditor with no real equity interest."<sup>19</sup> Thus, the statement as a whole adds very little to the statutory language because it uses, without defining, the terms "very small," "token," and "no real equity interest." We do not think the statement can fairly be read to elevate the Stock to Debt Ratio above other factors in applying the nominal or token test

Attaching too much weight to the Stock to Debt Ratio could lead to the stock-for-debt exception not applying where creditors end up with a significant block of stock, measured by reference to the total stock outstanding, even though the stock

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<sup>18</sup> See House Report at 14.

<sup>19</sup> House Report at 14.

has little or only speculative value because of the extremely poor financial condition of the debtor. This same concern exists in applying the Stock to Total Consideration Ratio where consideration in addition to common stock is given. If the debtor is in severe financial straits, the availability of tax benefits may be crucial to its survival, so that the bankruptcy policy favoring rehabilitation would argue for applying the stock-for-debt exception. To the extent ratios are applied, the "fresh start" policy may be best carried out by focusing on the Stock to Total Stock Ratio.

There is another reason for believing that the Stock to Total Consideration Ratio should not be given undue weight. Suppose, for example, that a corporation with liabilities of \$5,000,000 exchanges \$1,000,000 in common stock and no other consideration for the debt. The Stock to Total Consideration Ratio is 100%. On the other hand, if a corporation with \$20,000,000 in debt exchanges \$15,000,000 in cash or disqualified stock and \$1,000,000 in common stock for the liabilities, the Stock to Total Consideration Ratio is only 6.25%. In both cases, \$1,000,000 of common stock is issued in exchange for \$5,000,000 in debt. It is not clear to us that the cases should be treated differently.

We recommend that the Proposed Regulations be changed to adopt a true facts and circumstances approach. This can be accomplished by listing relevant factors in addition to the three stock ratios presented and by eliminating the preference accorded the Stock to Debt Ratio. Other relevant factors may include:

(a) The nature of consideration other than qualifying stock received by a creditor (the receipt of other stock or

securities rather than cash may suggest that the creditor intends to hold a meaningful continuing stake in the debtor);

(b) the voting power represented by the qualifying stock issued;

(c) other elements evidencing arm's-length bargaining;  
and

(d) the dollar value of the qualifying stock issued.

## 2. The Proposed Standards

We support the Service's recognition of the need for a safe harbor rule that can be relied on to ensure that stock is not deemed "nominal or token." We believe, however, that the Proposed Standards are far too restrictive and would have an in terrorem effect on many bankruptcy workouts, contrary to the congressional policy of fostering reorganization, rather than liquidation, of financially troubled corporations.<sup>20</sup>

The Proposed Standards depart substantially from prior legislative and administrative interpretations of "nominal" and "token." Under long-standing interpretations of applicable provisions of the Code, the words "nominal" and "de minimis"<sup>21</sup>

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<sup>20</sup> Senate Report at 10, 11.

<sup>21</sup> Although "de minimis" is not actually part of the section 108(e)(8)(A) standard, the "nominal or token" and section 108(e)(8)(B) proportionality tests have been recognized as de minimis requirements. See heading to I.R.C § 108(e)(8) ("Stock for debt exception not to apply in de minimis cases"); Senate Report at 11 ("the committee does not believe that [the stock-for-debt exception] should apply if only a de minimis amount of stock is issued for the outstanding debt"). Consequently, interpretations of de minimis provide a useful analogy in construing the parameters of the nominal or token test

typically have been construed to mean between 5% and 10%<sup>22</sup> and not 25% (to say nothing of 90% or 100%). Only a few days before issuance of the Proposed Regulations, the Treasury released proposed regulations under Sections 6038A and 6038C defining the value of related party transactions as "de minimis" if, in addition to an unrelated requirement, the value of certain payments is less than 10% of certain U.S. gross income.<sup>23</sup> The proposed separate line of business regulations issued in February of this year construe the "no more than a de minimis number of employees" language of section 414(r)(3)(B)(i) to allow a variance of 5%.<sup>24</sup>

Technical Advice Memorandum 8837001 represents the only reasoned interpretation of the Section 108(e)(8)(A) nominal or token test in the decade between enactment of the statute and issuance of the Proposed Regulations and Proposed Standards.<sup>25</sup> In the technical advice, the Service ruled that the exchange of participating redeemable convertible preferred stock with 3.4% of

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<sup>22</sup> See, e.g., Prop. Reg. §1.1274-6(d)(1)(ii), Example 2 (for purposes of original issue discount rules, payment of 5% of total price treated as "nominal" and, therefore, disregarded in fixing term of installment obligation); I.R.C 55142(b)(2)(B) and 144(a)(12)(C) (use of 5% or less of facility for office space financed with tax-exempt instruments regarded as de minimis and does not disqualify issue); LR.C §48(1)(6) (repealed) and Treas. Reg. §1.48-9(g)(5)(ii) (for investment tax credit purposes, equipment qualified as recycling equipment if no more than 10% of treated material virgin); LR.C 5318(a)(3)(B) (beneficiary's interest in trust is "remote contingent interest" which avoids attribution of stock ownership from beneficiary to trust if actuarial value of interest represents 5% or less of value of trust); LR.G 51273(a)(3) (original issue discount "de minimis" rule treats OED as zero where discount is less than 0.25% of stated redemption price at maturity ("SRPM") times number of complete years to maturity, which, in case of 30-year debt, for example, would be only 7.5% of SRPM).

<sup>23</sup> The test has since been incorporated in final regulations. See Reg. §1.6038A-1(i)(1). Regulation 51.6038C-1, which is still in proposed form, adopts Regulation S1.6038A-1 by reference.

<sup>24</sup> See Proposed Regulation 51.414(r)-5(b)(5)(ii).

<sup>25</sup> Although the nominal or token issue was presented in Private Letter Ruling 9019036, the Service reached its conclusion without analysis. See note 10.

the issuer's voting power, a Stock to Debt Ratio of 10%, and a Stock to Total Consideration Ratio of 15% satisfied the nominal or token test of Section 108(e)(8)(A).

That Congress declined to adopt 30% guidelines proposed in hearings on the 1980 Act suggests that mechanical tests at such significant threshold levels were not intended.<sup>26</sup>

We also believe the Proposed Standards are at odds with the ordinary meaning of "nominal" and "token."<sup>27</sup>

In addition to incorporating thresholds that are too high, the Proposed Standards suffer from a number of other technical flaws. These problems have been discussed by other commentators<sup>28</sup> and will not be revisited here.

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<sup>26</sup> During Senate Finance Committee consideration of the 1980 Act, one commentator testified that the stock-for-debt exception should not be available unless at least 30% of a corporation's debt is exchanged for stock or at least 30% of the total value of all classes of the debtor's stock is transferred to creditors. See Miscellaneous Tax Bills VII: Hearings on S.2484. S.2486. S2520. S.2503. S.2548. and H.R. 5043 before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance, 95th Cong., 2nd Sess. (May 30, 1980) at 393-96 (Statement of Robert A. Bergquist).

<sup>27</sup> See, e.g., Black's Law Dictionary (6th Ed. 1990) 1049 ("nominal" means "not real or substantial"); Webster's Ninth New Collegiate Dictionary (1988) 801, 1240 ("nominal" is "trifling, insignificant"; "token" means "minimal, perfunctory").

<sup>28</sup> See Association of the Bar of the City of New York, Committee on Taxation of Corporations, Report on the Proposed Rules for Determining Whether Stock Issued In Exchange for Indebtedness is Nominal or Token Under Section 108, Highlights and Documents (April 14, 1991) 179; American Bar Association, Section of Taxation, Comments Concerning Proposed Standards for Determining Whether Shares are "Nominal or Token" Under Section 108(e)(8)(A), Highlights and Documents (February 27, 1991) 1941.

### 3. New Safe Harbors

We believe there should be at least one workable and reasonable safe harbor. As one possible approach, we recommend that stock (excluding "disqualified stock") issued to all unsecured creditors, as a group, not be deemed "nominal or token" if the stock represents, in the aggregate, at least 10% of the value of the outstanding stock of the debtor after the exchange. There is a question whether the outstanding stock of the debtor for this purpose should include disqualified stock. On the one hand, including disqualified stock may lead to abuses. For example, noneconomic features incorporated in certain classes of the debtor's stock could "disqualify" the stock and cause the remaining stock of the debtor (which would be issued to creditors in a debt cancellation transaction) to represent a larger percentage of the debtor's stock for purposes of the 10% standard. On the other hand, it would be somewhat troublesome to disregard the receipt of disqualified stock in determining whether the exchanging creditor received a sufficient amount of stock while treating such stock as part of the debtor's capitalization. A middle ground may be to count disqualified stock in the denominator, except for straight preferred stock within the meaning of section 1504(a)(4).

For purposes of our proposed safe harbor, each share of a class of stock would be deemed to have the same value and secured creditors would be treated as unsecured to the extent their claims exceed the value of their collateral. The safe harbor would not apply to stock issued to secured creditors,

except to the extent the stock is issued in respect of a deficiency claim (i.e., the excess of a claim over the value of the security). Ten percent is neither "nominal" nor "token" under general tax concepts<sup>29</sup> and would ensure that exchanging creditors obtain a "real equity interest" in the debtor commensurate with congressional intent. Although a 10% equity interest rarely constitutes control, such an interest nevertheless typically represents a significant investment and voice in corporate affairs.

Moreover, our recommendation provides debtors necessary latitude in structuring bankruptcy reorganizations. Different classes of unsecured creditors can be treated differently under the reorganization plan as circumstances warrant. Nevertheless, the proportionality test of Section 108(e)(8)(B) will require that unsecured creditors be treated equitably vis-a-vis one another, within prescribed limits, if the stock-for-debt exception is to be available.

Our suggested safe harbor also permits determination of the Stock to Total Stock Ratio without knowing the value of the debtor's shares, at least where there is only a single class of stock.

It is unimportant to us whether the proposed safe harbor is incorporated in a regulation, revenue procedure, or some other form of published guidance, provided it is clear the standard can be relied on by taxpayers and represents only a safe harbor, i.e., does not set a floor on the amount of stock exchanged or suggest

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<sup>29</sup> See Section VI.2.

an audit guideline. To deter auditing agents from applying the safe harbor as a substantive rule, any regulations interpreting the nominal or token test should include one or two examples of transactions that do not satisfy the safe harbor but include other elements that support the conclusion that the stock issued is not "nominal or token" on a facts and circumstances basis.

#### 4. Retroactive Application of Proposed Regulations

The Proposed Regulations provide that they will apply to stock-for-debt exchanges occurring on or after December 6, 1990. As noted in the preamble to the Proposed Regulations, although no inference is intended concerning interpretation of the nominal or token limitation for exchanges prior to the effective date, the Service will apply the principles underlying the Proposed Regulations to pre-December 6, 1990, transactions.

We agree with the decision not to apply the Proposed Regulations to transactions occurring before their issuance. This approach is appropriate in view of the time that has elapsed since enactment of the 1980 Act and given that the proposed rules, when read in conjunction with the Proposed Standards, could effectively limit the stock-for-debt exception beyond what could fairly have been contemplated based on the language of the statute and the legislative history. For the same reasons, however, the "principles" of the new rules, whatever that might mean, should not apply to pre-December 6, 1990, transactions.

We recently criticized the effective date rules in the proposed regulations under section 108(e)(4),<sup>30</sup> which similarly adopt an ambiguous standard for applying the law to pre-issuance transactions. Although ambiguity may be necessary in diplomacy, it has no place in an effective date rule. We therefore suggest, as we did for purposes of section 108(e)(4), that transactions prior to issuance of the Proposed Regulations be tested only under the language of the statute, as explained in the legislative history, without regard to the "principles" of the Proposed Regulations.<sup>31</sup> Although technical advice memoranda cannot be cited as precedent, that the "principles" of the Proposed Regulations appear to conflict with TAM 8837001 is an additional reason for not applying the proposed rules retroactively.

If the final regulations differ materially from the Proposed Regulations (and certainly if they are in any respect more restrictive), they should apply as of the date of promulgation rather than December 6, 1990. Given the time that has passed since enactment of the 1980 Act without the benefit of regulations, there seems to be little to lose in extending the period in which the statute and legislative history stand alone.

## 5. Use of Parent Stock

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<sup>30</sup> See New York State Bar Association Tax Section Committee on Bankruptcy, Acquisitions of Discount Debt by Related Parties under the New Code §108(e)(4) Regulation, Tax Notes (July 8, 1991) 211 (the "Section 108(e)(4) Report").

<sup>31</sup> In the case of section 108(e)(4), this result can be achieved only by adopting a retroactive regulation because section 108(e)(4) applies only to the extent set forth in regulations. By contrast, section 108(e)(8) is self-executing, so that the same result can be accomplished simply by making the Proposed Regulations and Proposed Standards effective as of a specified prospective date.

The Tax Section has repeatedly taken the position that the stock-for-debt exception should apply to an exchange of parent stock for subsidiary debt.<sup>32</sup> If our view is accepted, an issue arises as to whether the Stock to Total Stock Ratio is calculated with respect to the outstanding stock of the parent or the subsidiary.

Under a facts and circumstances approach, the conclusion may not be critical because the Stock to Total Stock Ratio is only one of a number of hypothetically relevant factors. If a safe harbor is based on the Stock to Total Stock Ratio, however, the question could assume controlling importance.

Looking to the value of the subsidiary's stock would not always benefit the taxpayer. Although parent stock ordinarily is more valuable than subsidiary stock, this will not be the case if parent debt exceeds the value of the parent's assets other than its subsidiary's stock.

The proper approach to follow is not obvious. The purpose of the Stock to Total Stock Ratio is to determine whether creditors end up with a meaningful stake in the debtor. It can be argued that the significance of the stake depends on the outstanding stock of the issuer of the stock. An investment of a fixed dollar amount is more significant in terms of its ability to influence corporate affairs if it represents a higher

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<sup>32</sup> See, e.g., New York State Bar Association Tax Section Committee on Bankruptcy, *Report on Suggested Bankruptcy Tax Revenue Rulings, Tax Notes* (February 11, 1991) 631; Section 108(e)(4) Report at 221. The House version of the 1980 Act provided specifically that stock of a corporation in "control" of the debtor (within the meaning of section 368(c)) be treated as stock of the debtor for purposes of the equity-for-debt rules. H.R. 5043, 96th Cong., 2d Sess. §2(a)(1980); House Report at 15. This provision was deleted by the Senate.

percentage of the issuer's stock. On the other hand, we have suggested in the single corporation context that a 10% equity stake issued to all unsecured creditors as a group should always be considered sufficient to satisfy the nominal or token test. While 10% is substantial, it would not ordinarily carry control over corporate affairs, particularly if the stock is spread over a number of unrelated holders. Thus, the true significance of the 10% figure could be said to be that it represents a significant economic interest in the assets to which the creditors had a claim.

A rule that looked to the value of the subsidiary's stock on the ground that the subsidiary's creditors look only to the subsidiary's assets for repayment would raise other questions. For example, would a different result apply if the parent guarantees the subsidiary's debt? Would the asset theory require that the total outstanding stock of a debtor be limited to an amount of stock equal to the value of an item of property in calculating the ratio with respect to nonrecourse debt secured by that property? Furthermore, including only the subsidiary's stock in the ratio would require that the value of that stock be determined.

On balance, we would recommend that the Stock to Total Stock Ratio be measured based on the stock of the actual issuer (i.e., the parent where subsidiary debt is exchanged for parent stock). We would count toward the ratio all stock issued to unsecured creditors, however, whether those creditors had claims against the parent or the subsidiary, if the issuance of stock to the creditors is pursuant to a single plan to reorganize the debtors (whether or not the plan is a formal bankruptcy reorganization plan).