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A Cause for Distress? Allocation of Payments in Insolvency Workouts

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In this article, Chapman and Nichols examine the history of payment allocation in the context of distressed debt and explain why the payment ordering rules are best interpreted as inapplicable to a distressed debt satisfaction.

For those who practice in the distressed companies area, it is a common situation to encounter — an insolvent debtor satisfies its debt with an amount that is less than the principal owed on the debt (a "distressed debt satisfaction"[1]). However, although distressed debt satisfactions occur frequently, there remains uncertainty about whether payment in a distressed debt satisfaction is treated first as a payment of principal or interest for federal income tax purposes. When the debtor and creditor are both U.S. accrual basis taxpayers, it may make little difference whether the payment is treated as a payment of principal or of interest that has already been deducted by the debtor and included in income by the creditor. However, for withholding tax purposes, the distinction between a payment of principal versus interest can be significant. Further, even in the context of accrual method taxpayers, not all interest expense may have been taken into account by the debtor and creditor at the time of a distressed debt satisfaction, meaning that the allocation between interest and principal can have significant consequences to the debtor and creditor.[2]

To the extent a payment is treated as a payment of interest not previously deducted or taken into income, generally the creditor will have interest income (potentially subject to withholding)[3] and the debtor a deduction for interest expense (potentially deferred under section 163(j)). To the extent a payment is treated as a payment of principal, generally the creditor will not have income and the debtor will not receive a deduction. Furthermore, cancellation of principal generally gives rise to cancellation of indebtedness income (CODI), while cancellation of unpaid not yet deducted interest may be excludable under section 108(e)(2).[4] Consequently, an interest-first allocation in a distressed debt satisfaction can create additional CODI compared to a principal-first allocation. Before the enactment of Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act,[5] this effect was less significant for debtors because the additional CODI resulting from an interest-first allocation could be offset by the additional interest

[1]For this article, we focus on distressed debt satisfaction of recourse debt. There are different considerations in applying the payment ordering rules to nonrecourse debt, as noted hereinafter.

[2]For instance, an accrual method taxpayer generally is not required to include accrued interest in income if, at the time of the relevant accrual, it is "of doubtful collectibility or it is reasonably certain that it will not be collected." *See infra* note 22. Further, if it becomes certain during the year in which interest would otherwise accrue that the interest will not be paid, a deduction generally is not allowed. *See, e.g.*, *McConway & Torley Corp. v. Commissioner*, 2 T.C. 593 (1943). Moreover, section 267(a)(3) may also prevent interest expense accrual for loans between related parties.

[3]Allocation of a payment towards interest may cause incremental loss for a creditor to the extent less principal is repaid. However, this loss would likely be capital under section 1271 and, therefore, could not offset the ordinary interest income. *See* section 1211.

[4]In other words, to the extent not yet deducted, payment of such interest would have given rise to a deduction. Thus, section 108(e)(2) arguably is applicable.

[5]*See* H.R. 1, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," P.L. 115-97 (Dec. 22, 2017).

deduction that would likewise result. However, post-TCJA, an interest deduction may be (and in a distressed context, often will be) subject to limitation under section 163(j), so there may be additional CODI with no offset. Thus, as compared with an allocation to principal, the allocation to interest can create additional CODI and interest expense that may be limited under section 163(j)[6] for the debtor, and additional ordinary income (and capital loss) for the creditor.

As noted above, although distressed debt satisfactions are common, and the consequences of payment allocation can be significant, the proper federal income tax treatment of payments in distressed debt satisfactions remains unclear. Open any disclosure statement filed under title 11 of the U.S. Code (that is, the Bankruptcy Code), and you are likely to find an excerpt similar to the following: "Consideration will be allocated first to the principal amount of allowed claims, with any excess allocated to accrued unpaid interest; however, certain Treasury Regulations treat payments as allocated first to any accrued but unpaid interest. . . . Holders should consult their tax advisors." The "certain Treasury Regulations" are reg. sections 1.446-2(e)(1) and 1.1275-2(a)(1) (together, the "payment ordering rules"). The application of the payment ordering rules to distressed debt has vexed tax practitioners since the payment ordering rules were promulgated, and recent case law has only served to further confuse the issue.

This article considers the history of payment allocation in the context of distressed debt, along with Treasury's authority to promulgate regulations, and presents an argument for treating payments in retirement of distressed debt first as payments of principal (not interest), despite the apparent broad reach of the payment ordering rules.

Precedent Before the Payment Ordering Rules

Before the promulgation of the payment ordering rules, several courts had addressed the appropriate allocation of a payment by a debtor between unpaid interest and principal. In these decisions, courts generally respected agreements between the parties concerning the allocation of payments.[7] Absent an agreement between the parties, courts generally held that payments under a loan should be applied first toward unpaid interest, then principal.[8]

However, the cases also distinguished a voluntary partial payment on indebtedness, made in the ordinary course, from a situation in which a creditor foreclosed on the assets of an insolvent debtor and received one or more amounts that were less than the principal owed (that is, a distressed debt satisfaction). In the latter circumstance, courts concluded that the payment did not represent a payment of interest within the plain meaning of that term (the "distressed debt case law").[9] For example, in *John Hancock Mutual Life Insurance*, a creditor foreclosed on mortgaged property and purchased that property at a price less than the outstanding principal on the underlying obligation. The creditor retained the notes documenting the underlying indebtedness following the foreclosure (and continued to retain them as of the court decision) but never undertook any further action to collect. The Board of Tax Appeals held that no portion of the purchase price paid in the foreclosure was allocable to accrued interest. The court explained:

> The word "interest" would seem to have its usual and ordinary meaning. That meaning involves the idea of a profit to a lender as a charge for a loan. It implies that

[6] Further, any disallowed business interest expense carryforwards under section 163(j) are not an attribute subject to attribute reduction under section 108(b) as a result of the exclusion of CODI from gross income under section 108(a).

[7] *See, e.g.*, *O'Dell v. Commissioner*, 26 T.C. 592 (1956), *nonacq. withdrawn*, 1963-2 C.B. 5; *Huntington Redondo Co. v. Commissioner*, 36 B.T.A. 116 (1937), *acq.*, 1937-2 C.B. 14; Rev. Rul. 63-57, 1963-1 C.B. 103.

[8] *See, e.g.*, *Story v. Livingston*, 38 U.S. 359, 371 (1839) ("The correct rule in general is, that the creditor shall calculate interest whenever a payment is made. To this interest the payment is first to be applied; and if it exceeds the interest due, the balance is to be applied to diminish the principal."); *Motel Corp. v. Commissioner*, 54 T.C. 1433, 1440 (1970); *Estate of Bowen v. Commissioner*, 2 T.C. 1, 10 (1943).

[9] *See, e.g.*, *John Hancock Mutual Life Insurance Co. v. Commissioner*, 10 B.T.A. 736 (1928); *Helvering v. Missouri State Life Insurance Co.*, 78 F.2d 778, 780 (8th Cir. 1934); *Manufacturers Life Insurance Co. v. Commissioner*, 43 B.T.A. 867 (1941); *Newhouse v. Commissioner*, 59 T.C. 783 (1973); *Lackey v. Commissioner*, T.C. Memo. 1977-213.

> when the lender has recovered the money loaned with the compensation for the use and risk, he will have received a certain profit. See "Words and Phrases," 1st Series, vol. 4, p. 3706, and cases there cited.[10]
>
> In the present case the lender, the petitioner, has in reality suffered a loss of part of its principal as a result of its loan. If the entire net proceeds of the foreclosure were applied to the principal debt the amount would be insufficient to cancel that debt. The Commissioner does not contest this nor make any claim that any additional amount can ever be recovered. Under these circumstances we can not see that the petitioner has received from the foreclosure interest and therefore income and profit within the intendment of the taxing statute.[11]

In *Newhouse*,[12] the taxpayers were debtors who had defaulted on a bank loan for which they had pledged certain stock as collateral. Over the course of three years, the bank sold the pledged stock, receiving payments that aggregated to less than the principal amount due on the loan. The taxpayers claimed that the sale proceeds should be first allocated to accrued, unpaid interest (as had apparently been decreed by a judge in the context of the creditor's collection action), giving the taxpayers interest deductions. However, the Tax Court found that the sale of pledged assets in the context in which the creditor received less than the principal amount owed was governed by the decision in *John Hancock* and similar cases. The court said that:

> The significance of petitioner's insolvency cannot be minimized. What would be deductible by him as interest would similarly be includable in the bank's income as interest received. And we find it difficult to believe that a creditor who was [sic] foreclosed on the collateral of an insolvent debtor, and who will never get back the full amount of his principal, is required to report a fictitious amount of income designated as interest.[13]

Similarly, in *Lackey*,[14] the taxpayers were debtors claiming that the proceeds from a foreclosure sale should be allocated first to interest owed on their loan to a bank, resulting in interest deductions. The Tax Court said, "The line drawn by our decisions centers on the insolvency of the debtor. That is, if there is a 'strong indication' that the debtor is insolvent at the time of foreclosure or transfer in lieu of foreclosure, then the proceeds from foreclosure or the value of the property transferred will be applied first to principal and then to interest." Thus, the court held that the proceeds from the foreclosure would be allocated first to the unpaid principal balance of the indebtedness.

Overall, the distressed debt case law emphasizes the compelling economic point that, when the creditor does not recover even the full amount originally lent to the borrower and has an economic loss, it seems inappropriate to treat the creditor as being paid interest income in the transaction in which the creditor's economic loss is crystallized.

Promulgation of Payment Ordering Rules

After the decisions noted above, Treasury promulgated the payment ordering rules, which address the general allocation of payments between principal and interest. The payment ordering rules provide as follows.

Reg. section 1.446-2(e)(1):

> Each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c)

[10] This conception of interest is consistent with how the term has been defined by the Supreme Court, as "compensation for the use or forbearance of money." *Deputy v. du Pont*, 308 U.S. 488 (1940). *See also Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552 (1932) ("as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money").

[11] *John Hancock Mutual Life Insurance*, 10 B.T.A. 736, 739.

[12] *Newhouse*, 59 T.C. 783.

[13] *Id.* at 790.

[14] *Lackey*, T.C. Memo. 1977-213.

> of this section as of the date the payment becomes due.

Reg. section 1.1275-2(a)(1):

> Each payment under a debt instrument is treated first as a payment of [original issue discount] OID[[15]] to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest.

Thus, these rules provide that payments under a loan or debt instrument are allocated first to accrued, unpaid interest or OID, then to principal. While the payment ordering rules do contain some limited exceptions, there is no explicit exception for a distressed debt satisfaction. Consequently, the payment ordering rules could be read to override the distressed debt case law.

There is no indication that this result was intended. The predecessors to the current payment ordering rules were promulgated as part of a large package of Treasury regulations, which addressed the significant statutory changes to rules regarding debt instruments and interest, including a significant expansion of the rules addressing OID, in 1982 and 1984.[16] The preambles to the proposed and final Treasury regulations including the payment ordering rules do not provide any material discussion or clear indication of the intended scope or purpose of those rules.[17] However, the regulations in which they were included generally implemented statutory changes that provide for more consistent determinations of the amount of interest and the timing of its recognition for federal income tax purposes. It could be that the payment ordering rules were intended to overrule prior precedents allowing a debtor and creditor to agree regarding the allocation of payments between principal and interest in the ordinary course since allowing those agreements could thwart Congressional intent to require the ongoing accrual and inclusion in income of economic interest in a more consistent manner. The increasing prevalence of compound interest,[18] in which an allocation of a payment between principal and interest may have no commercial significance but solely affect the federal income tax consequences, also may have contributed to Treasury's desire to overrule the prior case law allowing agreed allocations between principal and interest in the ordinary course.[19]

Importantly, the policies discussed above would not necessitate the application of the payment ordering rules to a distressed debt satisfaction. A distressed debt satisfaction is the final payment (or one of a series of final payments) in a situation in which no economic interest is paid. In this situation, generally there is no opportunity to alter or manipulate the timing of interest or other payments, but rather the financial distress of the debtor has forced the creditor to take payment of less than the principal amount owed. Thus, there are sensible rationales for the general application of the payment ordering rules that would not apply in the specific context of a distressed debt satisfaction.

Post-Payment Ordering Rules Guidance

Even following the promulgation of the payment ordering rules, the IRS in certain instances has continued to apply distressed debt case law to allocate partial payment in a distressed debt satisfaction to unpaid principal,

[15] OID refers to original issue discount, which generally represents the difference between the issue price of a debt instrument and the stated redemption price at maturity, and is discussed in more detail below.

[16] *See generally* the preamble to the 1986 proposed regulations (51 F.R. 12022-01), which included the predecessors to the current payment ordering rules and noted the statutory enactments addressed by the regulations.

[17] *See* 51 F.R. 12022-01; 57 F.R. 60750-01; T.D. 8517.

[18] In general, simple interest accrues only on the outstanding principal, and therefore an allocation of a payment to principal on a debt instrument with simple interest reduces the amount of interest that accrues going forward, while a payment allocated to interest does not. In contrast, compound interest accrues both on the outstanding principal and the accrued, unpaid interest so that any payment, whether allocated to principal or interest, results in the same reduction of the amount of interest that accrues going forward.

[19] At least one commentator has argued that the general replacement of simple interest with compound interest for both commercial and federal income tax purposes, which limited the commercial relevance of allocations between principal and interest, motivated, at least in part, the promulgation of the payment order rules. *See* David C. Garlock, "How to Account for Distressed Debt," *Tax Notes*, May 31, 2010, p. 999.

rather than interest. For example, in *Catalano*,[20] the IRS challenged a taxpayer's deduction of interest for a distressed debt satisfaction on the grounds that the debtor could not be considered to have paid interest when the value received by the creditor in a foreclosure was less than the outstanding principal on the loan. The court noted, "because the proceeds from the sale were insufficient to pay off the entire amount of outstanding principal, there were no proceeds remaining with which interest could have been paid."

In LTR 200035008, the IRS addressed ongoing payments from a specified bond fund in which the issuer "reasonably believed" that the funds set aside for payments would be insufficient to pay the full principal and interest due on the bonds. The IRS ruled that the taxpayer could treat all payments in liquidation of the bonds as allocated first to outstanding principal and second to outstanding interest. The ruling cited *Newhouse*, *Lackey*, and other distressed debt case law, indicating that these cases were still relevant in the context of a distressed debt satisfaction.[21]

Moreover, the IRS has continued to apply the doubtful collectibility exception (DCE) to interest accruals, even though the DCE would be effectively irrelevant if the payment ordering rules applied to distressed debt satisfactions. Under the DCE, an accrual method taxpayer is not required to include accrued interest in income if, at the time of the relevant accrual, it is "of doubtful collectibility or it is reasonably certain that it will not be collected."[22] If the payment ordering rules apply to provide that all amounts paid for a debt, including in a distressed debt satisfaction, are first allocated to interest, accruing interest would be deemed collectible in almost every case. Stated differently, a creditor's receipt of accrued interest would only be in doubt if the expected total recovery on a debt (principal and interest) was less than the accrued, unpaid interest, since any payments made would be treated first as payments of interest. The IRS has continued to apply the DCE since the promulgation of the payment ordering rules[23] without any indication that the creditor must establish that its expected recovery must be less than the amount of accrued, unpaid interest for the DCE to apply.

However, in other instances, it appears that the government has contemplated the application of the payment ordering rules to a distressed debt satisfaction. Reg. section 1.721-1(d)(3) cross-references the payment ordering rules for purposes of "determining whether a partnership interest transferred to a creditor in a debt-for-equity exchange is treated as payment of interest or accrued original issue discount." This cross-reference seems to indicate that a payment of partnership debt with equity is subject to the payment ordering rules, with no exception for a distressed debt satisfaction.[24] Further, in a 1995 field service advice,[25] the IRS noted that "while some may believe that it is inappropriate to apply [reg.] section 1.446-2(b)[[26]] in the case of a workout, we understand that it is the view of CC:DOM:FI&P, the division with jurisdiction over the area, that it should apply."[27]

In *Milkovich*,[28] the Ninth Circuit cited reg. section 1.446-2(e)(1) (one of the payment ordering rules) in the context of the settlement of a

[20]*Catalano v. Commissioner*, 279 F.3d 682, 685 (9th Cir. 2002).

[21]*See* LTR 200035008 ("The general rule for allocating payments between principal and interest is that voluntary partial payments made by a debtor to a creditor are, in the absence of an arm's length agreement, applied first to interest, then, if the payment exceeds the interest due, to principal. . . . An exception to these general rules exists when there is an involuntary foreclosure of mortgaged property, and strong evidence indicates that the mortgagor is insolvent. In that case, a final payment in an amount less than the principal amount of the debt should be allocated to principal, in part because the total repayment of cash, or the value of the property, transferred in the foreclosure is less than the outstanding principal amount of the indebtedness.") (internal citations omitted).

[22]*Corn Exchange Bank v. United States*, 37 F.2d 34, 35 (2d Cir. 1930).

[23]For example, in Rev. Rul. 2007-32, 2007-1 C.B. 1278, issued well after the finalization of the payment ordering rules, the IRS analyzed whether in the facts at issue the DCE would warrant the nonaccrual of interest by the lender.

[24]Presumably, if the full amount of the partnership's debt was being paid with equity, the payment ordering rules would not be relevant, as all principal and accrued interest would be repaid.

[25]1995 WL 1918305 (Oct. 17, 1995).

[26]The predecessor to reg. section 1.446-2(e)(1), included in proposed regulations.

[27]*See also* FSA 200006004 (addressing a distressed debt satisfaction that, because of the issuance date of the debt, was not subject to the payment ordering rules, but stating that reg. section 1.1275-2(a) (one of the payment ordering rules) provided an appropriate method for allocating payments between principal and interest); FSA 1998 WL 1757760 (suggesting that the payment ordering rules apply to distressed debt satisfaction, although apparently addressing payments that were not subject to the payment ordering rules, based on the issuance date of the debt instruments being considered).

[28]*Milkovich v. United States*, 28 F.4th 1 (9th Cir. 2022).

nonrecourse debt. The taxpayers in *Milkovich* had borrowed money on a recourse basis to purchase a house. The taxpayers later filed for bankruptcy, and as part of the bankruptcy action, the taxpayers' recourse mortgage loan was modified to become a nonrecourse loan. Following this modification, the creditor agreed to a short sale, whereby the house securing the nonrecourse loan was sold to a third party, with the proceeds of the sale paid to the creditor and the creditor discharging the remaining unpaid balance of the debtor. The proceeds received by the creditor were less than the principal balance owed on the mortgage loan. However, the creditor issued a Form 1098, "Mortgage Interest Statement," to the taxpayers stating that the taxpayers had paid interest on the loan.

The IRS challenged the taxpayers' deduction of the interest on grounds that are not directly relevant here. What was relevant to the Ninth Circuit was the nonrecourse nature of the mortgage loan as of the short sale. Under federal income tax principles, when encumbered property is transferred in full satisfaction of nonrecourse debt (in contrast to recourse debt), the entire amount of the debt is treated as amount realized for purposes of determining gain or loss.[29] This is true even if the value of the property is less than the amount of the indebtedness.[30] Consistent with this general principle, the Ninth Circuit said that, because the mortgage loan was nonrecourse as of the short sale, the entire amount of principal and interest outstanding was required to be included in the taxpayers' amount realized, even though the liabilities exceeded the value of the collateral. Moreover, based on this treatment, the Ninth Circuit found it appropriate to deem the taxpayers to have paid both principal and interest to the creditor, entitling the taxpayers to an interest deduction. The Ninth Circuit said that "because . . . Plaintiffs are deemed at the short sale to have realized an amount that includes all of the discharged nonrecourse debt, including the accrued interest . . . they must for that further reason be deemed to have made the payment of interest that [the creditor] received."

The Ninth Circuit based this analysis largely on the reasoning of a prior Tax Court decision, *Catalano*, noted above.[31] In *Catalano*, the Tax Court had similarly concluded that, on the discharge of a nonrecourse debt on the sale of the underlying collateral, all of the accrued interest liability was included in the debtor's amount realized, and therefore, the debtor should be deemed to have paid the accrued interest, entitling the debtor to a deduction. In *Catalano*, the IRS specifically argued that *Lackey*, a distressed debt case law case, applied.[32] However, the Tax Court distinguished *Lackey* on the grounds that the case involved a recourse loan and thus was governed by "different principles of realization"[33] than the nonrecourse loan at issue in *Catalano*.

While its analysis is largely based on the nonrecourse nature of the debt at issue, the Ninth Circuit's decision in *Milkovich* also referred to reg. section 1.446-2(e)(1). Specifically, the Ninth Circuit noted that the creditor applied the proceeds of the short sale to interest, "consistent with Treasury Regulations section 1.446-2(e)(1)." The court continued: "Applying payments to interest first is the long-established default rule in federal and Washington law. . . . *See also* Treasury Regulations section 1.446-2(e)(1) (stating the general rule that, when a taxpayer makes a payment on a loan that consists of both accrued interest and principal, 'each payment under [the] loan . . . is treated as a payment of interest to the extent of the accrued and unpaid interest')."

Thus, the Ninth Circuit cites to the "general rule" of interest-first allocation provided by reg. section 1.446-2(e)(1). The description of an interest-first allocation as the general rule is consistent with the distressed debt case law,

[29] *See, e.g.*, reg. section 1.1001-2(a)(1), (b); *Commissioner v. Tufts*, 461 U.S. 300 (1983), *rev'g* 651 F.2d 1058 (5th Cir. 1981).

[30] *See id.* In contrast, a transfer of encumbered property in satisfaction of recourse debt, when the value of the property is less than the amount of the debt, generally is bifurcated into a sale transaction giving rise to gain or loss and a separate cancellation of the indebtedness giving rise to cancellation of indebtedness income. *See, e.g.*, reg. section 1.1001-2(a)(2), (c), Example 8; FSA 200135002; *Frazier v. Commissioner*, 111 T.C. 243 (1998).

[31] *Catalano v. Commissioner*, T.C. Memo. 2000-82, *rev'd on other grounds*, 279 F.3d 682 (9th Cir. 2002).

[32] The IRS made a similar argument in its appeal to the Ninth Circuit.

[33] *Id.* at 4. Although the Tax Court did not elaborate on the "different principles of realization" at issue, as noted above, in the context of recourse indebtedness, the excess of the amount owed over the value provided to the creditor generally results in CODI, rather than additional amount realized. This treatment differs from the inclusion of the entire indebtedness in amount realized on the discharge of nonrecourse debt in connection with the transfer of the collateral.

although the distressed debt case law also provides for an exception to this general rule for a distressed debt satisfaction. However, it is not clear why the general rule or any allocation of payments is relevant to the Ninth Circuit's analysis. As noted, the Ninth Circuit held that, because all of the unpaid interest and principal liability was included in the taxpayers' amount realized, the taxpayers should be deemed to have paid those liabilities in their entirety. Under this construct, the allocation of payments under reg. section 1.446-2(e)(1) would appear to be irrelevant, as in any other case in which the debt (including principal and interest) was paid in full. The Tax Court's decision in *Catalano*, which the Ninth Circuit used as the basis for its decision in *Milkovich*, makes no reference to reg. section 1.446-2(e)(1), presumably for this reason. Thus, the references to reg. section 1.446-2(e)(1) in *Milkovich* appear to be dicta. However, the citation serves to muddy already opaque waters.

A more recent case, *Howland*,[34] further clouds the water. In *Howland*, the taxpayers had a first mortgage on a home, as well as a second mortgage and credit agreement secured by the home. The junior creditor foreclosed on the home and, shortly thereafter, sold it to a third party for an amount apparently insufficient to pay the principal due to the junior creditor. The IRS argued, consistent with distressed debt case law and inconsistent with the application of the payment ordering rules to a distressed debt satisfaction, that the payment to the junior credit should be applied first to principal, meaning that the cash method taxpayers were not entitled to an interest deduction. The Tax Court, in its analysis, restated the general rule that voluntary partial payments made by a debtor to a creditor are, in the absence of any agreement between the parties, to be applied first to interest and then to principal, while noting, "an exception to this general rule exists in the case of an involuntary foreclosure of mortgaged property where the evidence 'strongly indicates' that the mortgagor is insolvent at the time of foreclosure." However, the Tax Court found the distressed debt case law was distinguishable from the case because there was no evidence that the taxpayers were insolvent at the time of the foreclosure. Further, the credit agreement explicitly indicated that repayments on the note were applied first to interest.[35] Still, the Tax Court concluded that the taxpayer had failed to meet its burden in proving it was entitled to a deduction for interest paid because there was not enough evidence showing how the junior creditor allocated the funds received between the taxpayers' principal and interest obligations. Therefore, the Tax Court sustained the IRS's determination to disallow the interest deduction claimed by the taxpayers. Neither the parties nor the Tax Court raised the payment ordering rules.

On appeal, apparently for the first time,[36] the taxpayers in *Howland* asserted that the payment ordering rules should apply to treat the amounts received as first applied to interest. In response, the Justice Department moved to vacate the Tax Court decision,[37] explaining, "although Appellants waived any argument based on the regulation by failing to raise it below, we believe that vacatur and remand is appropriate because the regulation controls the outcome in this case. See *Milkovich v. United States*, 28 F.4th 1 (9th Cir. 2022)." The Eleventh Circuit granted the Justice Department's consent motion for vacatur and remand.

Howland is noteworthy for several reasons. First, the Tax Court found the distressed debt case law was not applicable because there was no proof that the taxpayer was insolvent. The distressed debt case law generally articulates the exception for principal-first allocation as requiring a "strong indication" that the debtor is insolvent; however, the Tax Court in *Howland* appeared to be holding the taxpayer to a higher burden in actually proving insolvency. Further, the fact that a creditor could not recover the principal originally lent on a recourse debt would appear to constitute evidence of the debtor's

[34] *Howland v. Commissioner*, T.C. Memo. 2022-60, *vacated and remanded*, No. 22-13744 (11th Cir. 2023).

[35] As noted above, it is possible that the payment ordering rules were enacted for the specific purpose of overruling case law that allowed agreements to govern. However, given that the payment ordering rules appear to have been entirely overlooked, it is unsurprising that this point does not appear to have been raised.

[36] *See* Consent Motion for Vacatur and Remand, *Howland v. Commissioner*, No. 22-13744 ("In their opening brief on appeal, Appellants for the first time cited that regulation as a basis for their deduction.").

[37] *Id.*

insolvency (since otherwise why would a creditor accept the economic loss?). What's more, while insolvency clearly is referenced in the analyses in the distressed debt case law, the underlying logic of those cases would seem to extend to any situation in which debt is satisfied for an amount less than principal, because the creditor in those cases does not receive any compensation for the use or forbearance of money. However, the court in *Howland* does not appear willing to extend the precedent that far. Further, the Justice Department's motion cited *Milkovich* for the proposition that the payment ordering rules apply. As noted, the cite to the payment ordering rules in *Milkovich* appeared to be unnecessary based on the logic of that case. Therefore, the reliance on *Milkovich*'s reference to the payment ordering rules is perplexing. Finally, the fact that the government did an about face on its own position mid-proceeding seems to aptly illustrate the confused state of the law in this area.

Where Does This Leave Us?

For the reasons set forth in the distressed debt case law, it appears eminently sensible to exclude a distressed debt satisfaction from the payment ordering rules. However, it is not clear that this exclusion can be read into the language of the payment ordering rules.[38] Moreover, authorities that postdate the payment ordering rules have failed to set forth a clear and consistent test for whether and how the payment ordering rules apply in the context of a distressed debt satisfaction. Hence, practitioners are left flummoxed.

However, in interpreting Treasury regulations, there is another consideration: The government is limited in the scope of regulations that it may validly promulgate. Recently, in *Loper Bright*, the Supreme Court ruled that courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority.[39] However, even before *Loper Bright*, Treasury regulations could be found invalid if "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" under the Administrative Procedure Act[40] or "arbitrary, capricious, or manifestly contrary to the statute" under case law.[41] Treasury regulations could overrule existing judicial precedent, generally subject to the same "arbitrary, capricious, or manifestly contrary to the statute" standard as applicable to Treasury regulations more generally.[42] A regulation could be considered manifestly contrary to the statute if outside the scope of authority delegated under the statute or to the extent it is inconsistent with the statutory scheme.[43]

A strong argument can be made that the application of the payment ordering rules to distressed debt satisfactions would be beyond the scope of the authority provided to Treasury in promulgating those regulations. The following discussion will make this argument, considering each of the payment ordering rules in turn.

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[38] *But see* Garlock, *supra* note 19 (arguing that final payment in settlement of a debt arguably is not "under" the loan or debt instrument). Alternatively, in arguing the payment ordering rules should not apply to a distressed debt satisfaction that occurs under a bankruptcy reorganization, practitioners sometimes cite language in the legislative history to the Bankruptcy Tax Act of 1980, including: "If the plan of reorganization allocates the value of the stock or other property received by the creditor between the principal amount of the creditor's security and the accrued interest, both the corporate debtor and the creditor must utilize that allocation for Federal income tax purposes." H.R. Rep. No. 833, 33-34 (1980). This legislative history predates the payment ordering rules, and it is unclear if it intended to affirmatively adopt a legal principal or is just a recitation of existing law, which at that point generally respected agreements allocating interest and principal.

[39] *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024).

[40] 5 U.S.C. 706(2)(A).

[41] *See Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44 (2011) (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 844 (1984)).

[42] *See Mayo Foundation*, 562 U.S. at 55, in which, for purposes of determining the deference afforded to regulations, the Supreme Court stated that "we have found it immaterial to our analysis that a 'regulation was prompted by litigation.' Indeed, in *United Dominion Industries, Inc. v. United States*, we expressly invited the Treasury Department to 'amend its regulations' if troubled by the consequences of our resolution of the case" (citations omitted).

[43] *See, e.g.*, *Rowan Cos. Inc. v. United States*, 452 U.S. 247, 252-253 (1981) ("We consider Treasury Regulations valid if they 'implement the congressional mandate in some reasonable manner.'. . . 'In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.'" (internal citations omitted)); *Commissioner v. South Texas Lumber Co.*, 333 U.S. 498, 501 (1948) (same); *Scofield v. Lewis*, 251 F.2d 128, 132 (5th Cir. 1958) ("The Regulations must, by their terms and in their application, be in harmony with the statute. A Regulation which is in conflict with or restrictive of the statute is, to the extent of the conflict or restriction, invalid. . . . The only authority conferred, or which could be conferred, upon the Treasury Department is to make regulations to carry out the purposes of the statute.").

Reg. Section 1.446-2(e)(1)

Reg. section 1.446-2(e)(1) was promulgated under section 446,[44] which is titled, "General Rule for Methods of Accounting." Section 446(a) provides that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446(b) provides that "if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." Thus, section 446 establishes the authority of the IRS to require a taxpayer to use one or more methods of accounting that clearly reflect income. A method of accounting has been defined broadly to include "not only the overall method of accounting of the taxpayer but also the accounting treatment of any item."[45]

There is extensive case law addressing the IRS's authority to change the method of accounting of a taxpayer to one that clearly reflects income under section 446(b). Courts, including the Supreme Court, have recognized that the IRS has wide discretion in determining whether a method of accounting clearly reflects income.[46] However, that discretion is not unlimited, and a taxpayer may prevail when the IRS challenges the taxpayer's method of accounting by establishing "either that [the taxpayer's] method of accounting clearly reflects income or that the Commissioner's method does not clearly reflect income."[47] In general, to prevail in a challenge of the IRS's determination under section 446(b), the taxpayer must show that the IRS's determination represents an abuse of discretion, meaning the determination is "without sound basis in fact or law."[48]

The Tax Court decision in *Estate of Ratliff*[49] provides a particularly relevant example of the analysis of the clear reflection of income standard under section 446(b). In *Estate of Ratliff*, a taxpayer on the cash method of accounting held several outstanding loans. Each loan was documented by a promissory note stating that "all installments paid hereunder shall be applied to reduction of principal until all principal hereunder has been paid in full, and thereafter to interest." Some of the tax years at issue followed the promulgation of the proposed payment ordering rules, which, like the final payment ordering rules, provided for a general interest-first allocation of payments. The taxpayer had allocated the payments received to principal, consistent with the language in the promissory notes. The IRS initially challenged this allocation based on the language in the proposed payment ordering rules for the years following their promulgation. In addressing whether the proposed payment ordering rules supported their position, the Tax Court said:

> We find it unnecessary to take either version of the proposed Treasury Regulations into account. In the first place, proposed Treasury Regulations are accorded little, if any, value in terms of judicial deference. *Beyond this, we think that the resolution of the issue before us turns upon the extent to which the broad statutory discretion accorded respondent under section 446 applies irrespective of the agreement of the parties*.[50] [Emphasis added.]

In other words, the Tax Court indicated that the allocation of payments between principal and interest was a method of accounting issue subject to section 446, and therefore, despite the proposed payment ordering rules, the question was whether the IRS had exceeded the "broad

[44] Reg. section 1.446-2(e)(1) was promulgated under Treasury's general authority under section 7805 to, "prescribe all needful rules and regulations for the enforcement of [title 26]." However, the issuance of reg. section 1.446-2(e)(1) under section 446 seems to indicate Treasury's view that the regulation was an implementation of the statutory provisions of section 446.

[45] Reg. section 1.446-1(a)(1). *See also* Notice of Proposed Rulemaking FI-54-93 (stating that "the proposed regulations invoke the Commissioner's authority under sections 446(b), 451, and 461 to require that a taxpayer's method of accounting for hedging transactions clearly reflect income").

[46] *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979) ("It is obvious that on their face, sections 446 and 471, with their accompanying Regulations, vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income.").

[47] *See Dayton Hudson Corp. v. Commissioner*, T.C. Memo. 1997-260, at 10.

[48] *See, e.g.*, *Mingo v. Commissioner*, T.C. Memo. 2013-149, at 6.

[49] *Estate of Ratliff v. Commissioner*, 101 T.C. 276 (1993).

[50] *Id.* at 277 (citations omitted).

statutory discretion" granted in disregarding the agreement between the parties on the grounds that it did not "clearly reflect income." The Tax Court further said:

> We recognize that respondent does not have unbridled discretion under section 446 in that she cannot force a taxpayer to adopt another method of accounting if the taxpayer's method clearly reflects income. A variety of factors enter into a determination whether a method of accounting for an item of income is a clear reflection of income. Thus, in the context of discounted loans, we have upheld the application of payments to principal in the first instance. We have followed the same path in sustaining the allocation of payments received by the taxpayer-purchaser of notes of third parties at a discount entirely to recovery of cost, i.e., principal, as against allocating such payments between principal and interest. The foundation of our position was the speculative character of the notes based upon an evaluation of several factual elements.[51]

The line of discounted loan authorities cited by *Ratliff* apply analogous logic to that set forth in the distressed debt case law.[52] In the case of a distressed debt satisfaction, it is certain that the holder will recover less than the amount originally lent when the debt is extinguished. In the discounted loan cases, it is merely uncertain whether the acquirer will ever recover its cost. In either case, the logic is that it is appropriate to defer income inclusion in a case in which there is a significant (or definite) chance that, in an economic sense, an income return will never materialize.

The Tax Court dismissed the taxpayer's motion for summary judgment in *Ratliff*, stating that the evidence presented was insufficient to determine whether the taxpayer's principal-first allocation clearly reflected income. In a subsequent decision (*Ratliff II*),[53] the Tax Court held that the prior decisions applying a principal-first allocation were inapplicable to the facts since insufficient evidence had been introduced to support that the loans were speculative or risky.[54] Thus, the Tax Court found that the taxpayer failed to prove that the IRS's allocation of the payments received by the taxpayer to interest was arbitrary. The IRS's position was upheld as a valid exercise of its authority to require the taxpayer to use a method of accounting that clearly reflected income.[55]

The fact that the payment ordering rules were only proposed, and not finalized, clearly affected the weight the Tax Court afforded to them in *Ratliff* and *Ratliff II*. However, it is notable that the Tax Court based its decision on the clear reflection of income standard in section 446(b) and viewed principal-first-allocation case law as an expression of section 446(b) principles. Further, while in *Ratliff II*, the Tax Court ruled against the taxpayer, it did so on the grounds that the taxpayer failed to prove that the loans at issue were speculative and therefore within the holdings of the principal-first-allocation case law. By implication, it appears that if the taxpayer had presented facts consistent with principal-first-allocation case law, the Tax Court would have upheld the taxpayer's allocation of payments as a clear reflection of income.

As noted, under *Loper Bright*, courts must exercise their independent judgment in deciding whether an agency has acted within its statutory authority. Further, even under prior law, a Treasury regulation could be held invalid if arbitrary, capricious, or manifestly contrary to the statute. Thus, Treasury regulations cannot create rules that are inconsistent with their statutory

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[51] *Id.* at 281 (citations omitted).

[52] *See Underhill v. Commissioner*, 45 T.C. 489, 495 (1966) ("We hold that the ultimate test is whether, at the time of acquisition, the person acquiring the obligation (whether by purchase or otherwise) cannot be reasonably certain that he will recover his cost and a major portion of the discount."). *See also Liftin v. Commissioner*, 36 T.C. 909, 911 (1961) *aff'd*, 317 F.2d 234 (4th Cir. 1963) ("Where it is shown that the amount of realizable discount gain is uncertain or that there is 'doubt whether the contract (will) be completely carried out,' the payments should be considered as a return of cost until the full amount thereof has been recovered, and no allocation should be made as between such cost and discount income"); *Premji v. Commissioner*, T.C. Memo. 1996-304, *aff'd*, 139 F.3d 912 (10th Cir. 1998) ("Thus, the essence of the open transaction doctrine is uncertainty that the taxpayer will recover the full amount of his basis or cost.").

[53] *Estate of Ratliff v. Commissioner*, T.C. Memo. 1995-428.

[54] *Id.*

[55] *Id.*

authority. Fundamentally, applying reg. section 1.446-2(e)(1) to a distressed debt satisfaction represents a clear distortion of income for the reasons identified by the distressed debt case law. In a distressed debt satisfaction scenario, the debtor has received more capital from the creditor than the debtor repays; the creditor has not earned income or a return but rather has sustained a loss. This logic supporting the principal-first allocation of a distressed debt satisfaction has been recognized by the distressed debt case law. Thus, a strong argument can be made that it is beyond the scope of Treasury's authority to promulgate a regulation imposing a payment and receipt of phantom interest under the authority granted by Congress to require taxpayers to "clearly reflect income."

That argument is consistent with the Tax Court's analysis in *Ratliff* and *Ratliff II*, which suggest that a principal-first allocation of payments in a case in which interest economically does not accrue represents a clear reflection of income under section 446(b) that the IRS is not entitled to alter.

Reg. Section 1.1275-2(a)

Reg. section 1.1275-2(a) was promulgated under section 1275. The authority listed for reg. sections 1.1275-1 through 1.1275-5 includes both section 7805(a) and section 1275(d), the latter of which provides the IRS the general authority to issue Treasury regulations to the extent appropriate to facilitate the purposes of the statutory OID rules.[56] As for reg. section 1.446-2(e)(1), the relevant query is whether the application of reg. section 1.1275-2(a) to a distressed debt satisfaction is consistent with Treasury's authority to promulgate regulations.

As reg. section 1.1275-2(a)(2) applies only to the extent a payment is made on an instrument with accrued OID, it is helpful to assess the application of reg. section 1.1275-2(a)(2) in the context of the statutory rules governing OID. OID generally equals the difference between the issue price and the stated redemption price at maturity of a debt instrument.[57] Thus, OID generally reflects the difference between the amount paid for a debt instrument and the amount owed on maturity, that is, a return on the original capital used to acquire the debt instrument that is economically similar to interest. Consistent with this economic similarity, the legislative history provides that "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 current payment of interest."[58] Similarly, the IRS has noted that "in general, the OID provisions can be viewed as an accrual method of accounting designed to place holders of debt instruments having OID on par with holders of debt instruments that pay interest currently."[59] Given this intended equivalence between currently payable interest and OID, OID generally is treated as interest for federal income tax purposes.[60]

As both OID and stated interest generally represent a return on the original capital invested, for the same reasons it is inappropriate to treat a distressed debt satisfaction as a payment of currently payable interest under reg. section 1.446-2(e)(1), it is inappropriate to treat a distressed debt satisfaction as a payment of OID under reg. section 1.1275-2(a)(2). In either case, the distressed debt satisfaction does not represent a return provided on the original capital lent.

Reg. section 1.1275-2(a)(2) was not promulgated under section 446 and the "clear reflection of income" standard provided by

[56] Section 1275(d) states that:
The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart [*i.e.*, Subpart A — Original Issue Discount, sections 1271-1275] (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e)).

[57] Section 1273(a).

[58] H.R. Rep. No. 98-432, Part 2, 1241, n.2 (1984). *See also* S. Rep. No. 97-494, 212 (1982).

[59] TAM 9538007. In this technical advice memorandum, the IRS held that the DCE did not apply to OID inclusions even when collectibility of the OID was doubtful. Thus, contrary to the analysis above and the legislative history cited, this TAM asserts that OID is treated differently than stated interest requiring current payment (by arguing that the DCE does not apply to the former but does apply to the latter). The IRS's conclusion in this memorandum, which is not precedential, has been questioned by commentators. *See*, *e.g.*, David H. Schnabel, "Great Expectations: The Basic Tax Problem With Distressed Debt," 89 *Taxes* 173 (2011). Further, it addresses the accrual of interest income, which is distinct from the allocation of a payment between interest and principal at issue here and is thus distinguishable.

[60] *See*, *e.g.*, section 163(e).

section 446(b). However, reg. section 1.1275-2(a)(2) was promulgated to carry out the purposes of the statutory OID rules, and as noted, the general purposes of the statutory OID rules is to treat OID in a manner consistent with currently payable interest. This statutory scheme would be undercut by treating a distressed debt satisfaction as (1) a payment of principal consistent with the distressed debt case law when the debt bears currently payable interest but (2) as a payment of OID "interest," solely because OID (not currently payable interest) provides the return to the lender in the latter case. Rather, the statutory scheme of the OID rules is better achieved by treating a distressed debt satisfaction consistent with economic reality as a payment of principal, regardless of whether the lender's return was intended to be provided by currently payable interest or OID.

Thus, there is again a strong argument that the application of reg. section 1.1275-2(a)(2) to a distressed debt satisfaction would be beyond the scope of Treasury's authority in promulgating regulations.

Conclusion

In sum, the distressed debt case law sets forth compelling economic logic for why a payment in a distressed debt satisfaction should not be allocated first to interest. Essentially, a distressed debt satisfaction represents an economic loss to the creditor, and therefore it is not appropriate to require the creditor to report phantom interest income (and provide the debtor a corresponding interest deduction).

The application of the payment ordering rules to a distressed debt satisfaction appears inconsistent with (in fact, seemingly directly contrary to) a grant of authority to Treasury to promulgate needed rules and regulations under a statute concerned with clearly reflecting income. Preventing the application of the payment ordering rules to a distressed debt satisfaction on these grounds may help clarify at least some of the existing murkiness in this area.[61] ■

[61] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.