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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:FIP:2-PLR-110493-00
Date:
August 30, 2000

Legend

X =

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Z =

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Dear

This is in response to a letter dated May 16, 2000, and subsequent correspondence, requesting a ruling that Y's removal as co-obligor on various debt instruments and on other debt instruments' collateral would not be considered a significant modification under section 1.1001-3 of the Income Tax Regulations, and therefore, would not be treated as a taxable exchange under section 1001 of the Internal Revenue Code.

FACTS

X is the holding company for Y and other subsidiaries. Y is the principal operating company of the X group. X issued several debt instruments with Y as co-obligor. X has outstanding long-term and medium-term debt instruments (Debentures) that were issued under three indentures (Indentures) dated Date 1, Date 2, and Date 3. X also has outstanding short-term commercial paper (Commercial Paper).

Furthermore, X has outstanding loan agreements and financing leases (Conduit Loans) that secure Industrial Revenue Bonds (IRBs). Finally, X provides a guarantee (Guarantee) on a non-recourse loan issued by the X Employee Stock Ownership Plan (ESOP), and is the obligor on an installment obligation (Obligation) securing a Taxable Industrial Revenue Bond (TIRB). The Debentures, Commercial Paper, Conduit Loans, Guarantee, and Obligation are collectively referred to as the co-obligated debt.

Under proposed Securities and Exchange Commission (SEC) rules, a company's annual report (Form 10-K) filed with the SEC will be required to include expanded financial information for any subsidiary that is a co-obligor on a debt instrument. Thus, if Y continues as co-obligor on the co-obligated debt, X will need to include for the first time this expanded financial information in the first Form 10-K filed after the proposed SEC rules become effective. To avoid investor confusion and reduce administrative burdens, X has proposed to remove Y as co-obligor on the entire co-obligated debt. Each instrument includes terms that permit X, under certain conditions, to remove Y as co-obligor on the instrument. One condition is that X must remove Y as co-obligor from all the debt instruments at approximately the same time.

The Indentures specify the legal obligations of X and Y, and the legal rights of the debt holders. As co-obligor, Y is jointly and severally liable with X for all payments due under the Debentures. Furthermore, the Indentures restrict the amount of debt Y may incur with a maturity of more than a months. Y may not issue debt in an amount over b% of X's net tangible assets. The restrictions will continue in force against Y, even after the proposed removal.

The Commercial Paper issued by X has maturities of less than c days. Under the Commercial Paper currently outstanding, X cannot remove Y as the co-obligor. As the short-term debt is retired, X intends to change its commercial paper documentation to allow X to remove Y as co-obligor. X intends to issue commercial paper in this revised form so it can remove Y as co-obligor on all debt instruments at approximately the same time. Thus, the commercial paper that will be outstanding at the time of the proposed transaction will permit X to remove Y as co-obligor.

Certain projects of X are financed by tax-exempt IRBs. The IRBs are obligations of state or local governments or agencies that satisfy the requirements of section 103(a) and are tax-exempt obligations. None of the IRBs are qualified tender bonds as defined in Notice 88-130, 1988-2 C.B. 543. Each IRB is secured by a separate Conduit Loan between X, with Y as a co-conduit borrower, and the government entity that issued the IRB. The IRBs that are the subject of this ruling are identical in all material terms, except that in some cases the Conduit Loan takes the form of a loan agreement and in other cases it takes the form of an installment sale. The obligations of X and Y under the Conduit Loans are recourse in nature. The terms of each Conduit Loan allow the removal of Y as co-conduit borrower provided Y is concurrently removed from all other co-obligated debt at approximately the same time. No consent of the issuers or holders of the IRBs is necessary to remove Y as a co-conduit borrower under the Conduit Loans.

The ESOP loan is guaranteed by X, with Y as co-guarantor. The obligations of X and Y under the ESOP loan are materially identical to the obligations under the Debentures. X and Y are also co-obligors on the Obligation. The TIRB is a non-recourse bond issued in 1999 by Z. Under certain conditions materially identical to those in the Indentures, X may remove Y as co-guarantor and co-obligor on the Guarantee and the Obligation, respectively.

As the holding company for Y, X controls 100% of Y's stock. The capacity of X to meet its debt obligations currently includes the earnings and assets of Y. After the removal of Y as co-obligor, Y's earnings and assets will continue to provide X with payment capacity.

LAW AND ANALYSIS

Section 1001 provides for the recognition of gain or loss on the sale or exchange of property. Section 1.1001-1(a) provides that gain or loss is realized from the exchange of property for other property differing materially either in kind or in extent.

Section 1.1001-3(b) provides that a debt instrument differs materially in kind or in extent if it has undergone a "significant modification".

Section 1.1001-3(c) provides rules for determining whether a change in the legal rights or obligations of a debt instrument is a "modification." Under § 1.1001-3(c)(1)(i), a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

Section 1.1001-3(c)(1)(ii) provides that, except as provided in paragraph (c)(2), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification.

Section 1.1001-3(c)(2)(i) provides that an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification, even if the alteration occurs by operation of the terms of a debt instrument.

Section 1.1001-3(c)(2)(iii) provides that an alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless the option is unilateral (as defined in paragraph (c)(3)). In general, an option is unilateral if its exercise does not (1) give the other party the right to alter, terminate, or put the debt instrument, (2) require the consent of the other party, or (3) require consideration.

Section 1.1001-3(e) provides rules for determining whether a modification is "significant." Section 1.1001-3(e)(4)(iii) provides that the addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations.

Section 1.1001-3(e)(4)(vi) provides that a change in payment expectations occurs if, as a result of a transaction, there is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

Section 1.1001-3(e)(4)(iv)(B) provides that a modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification.

Section 1.1001-3(f)(6)(i) provides that the obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds.

In the case of the Debentures and the Commercial Paper, Y will be obligated to follow the same restrictions regarding the issuance of debt as before its removal as co-obligor. Therefore, Y will not be allowed to increase the amount of its outstanding debt beyond the levels allowed previously. Furthermore, Y's earnings and assets will continue to provide X with payment capacity, just as before the proposed action. Thus, there will not be a substantial impairment of X's capacity to meet the payment obligations under the Debentures and the Commercial Paper and consequently no change in payment expectations.

In the case of the Conduit Loans, the removal of Y as a co-conduit borrower on the Conduit Loans occurs by operation of the terms of the IRBs within the meaning of section 1.1001-3(c)(1)(ii). X and Y are the co-conduit borrowers under the IRBs and, under section 1.1001-3(f)(6)(i), are not the obligors on the IRBs for purposes of section 1.1001-3. Therefore, the exception contained in section 1.1001-3(c)(2)(i) is inapplicable. Moreover, the exception contained in section 1.1001-3(c)(2)(iii) is inapplicable because the removal of Y as co-conduit borrower does not give rise to a right to alter, terminate, or put the IRBs nor does it require consent or consideration. Accordingly, the proposed alterations are not modifications to the IRBs and do not result in a reissuance under section 1.1001-3.

In the case of the ESOP loan and the TIRB, Y's earnings and assets will continue to provide payment capacity, even after Y's removal as co-obligor. The restrictions on Y's future debt issuance will ensure that the current co-obligations of X and Y will not be subordinated following the proposed removal of Y as co-obligor. Consequently, there would be no substantial alteration of the Guarantee or the Obligation and thus no "significant modification" of the debt instruments.

CONCLUSION

We conclude that the removal of Y as co-obligor on the Debentures, Commercial Paper, Conduit Loans, Guarantee, and Obligation would not be considered a significant modification under section 1.1001-3 of the regulations and, therefore, would not be treated as a taxable exchange under section 1001 of the Code.

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Acting Associate Chief Counsel
(Financial Institutions and Products)

By: ______________________________
William E. Coppersmith
Chief, Branch 2

Enclosures:
Copy of this letter
Copy for section 6110 purposes