Cottage Savings Regs. on the Way

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In *Cottage Savings v. U.S.*, 111 S.Ct. 1503 (1991), the Supreme Court considered whether the typical mortgage swap, fairly common in the thrift industry, involves a taxable exchange. The beleaguered thrift industry had hoped that the answer was yes, since the typical scenario involved losses that the exchanging institutions hoped to deduct on the exchange. Reversing the Sixth Circuit, the Supreme Court in *Cottage Savings* concluded that the exchanges were taxable, and thus, that deductions were appropriate. The Sixth Circuit had determined that Cottage Savings' true economic position had not changed as a result of the swap, and that therefore, no deduction should be allowed.

The Supreme Court fell short of concluding that similarity in the mortgage instruments was irrelevant, but still allowed the loss deductions. The Court concluded that the different mortgage interests were "materially different" within the meaning of Reg. 1.1001-1. According to the Court, what constitutes a material difference involves a low threshold. In fact, the Court found that Cottage Savings' new interests were different from its old ones based merely on the fact that the loans had different obligors and were secured by different homes.

Shortly after *Cottage Savings* was decided, it seemed that there would be enormous economic consequences from the decision. Indeed, Fannie Mae, which had deducted large losses on account of mortgage swaps that had been previously disallowed, reported that it would add more than $140 million to its second-quarter income as a result of the decision.

Is the Controversy Over?

Because the Supreme Court ruled on this matter, one might think the controversy was laid to rest. But two Justices in the case had dissented, arguing that the new mortgage interests were really the same as the old for all practical purposes. Naturally, the IRS agrees, and would like nothing more than to see a materiality standard that is somewhat narrower than the one loosely framed by the Court.

Proposed Regulations

The $64,000 question, therefore, is what constitutes a material modification that results in a new debt instrument being deemed to be issued. Regulations will shortly be proposed describing when a material modification has been made to a debt instrument. The proposed regulations are to apply across the board, superseding the Section 1274 proposed

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regulations to the extent they are inconsistent. However, the proposed regulations are not to apply to dispositions under Section 453.

In a recent speech, IRS Chief Counsel Abraham N.M. "Hap" Shashy described the forthcoming proposed regulations. Although they should not apply to the modification of tax-exempt obligations, according to Shashy, the IRS will carefully examine modifications to such obligations that would cause reissuance and thus obviate the tax exemption. Instruments that are convertible into the issuer's equity are not to be affected by the forthcoming proposed rules.

What is a Modification?

Before deciding what is a "material modification," one must decide what constitutes a modification. A modification is any alteration in the rights or terms of a debt instrument, unless the alteration took place pursuant to the instrument's terms or to a contingency that was uncontrollable by the parties. The reset of a Dutch auction rate debt instrument, for example, arguably would not be a modification.

In fact, all indications are that a unilateral alteration of a debt instrument would not be a modification under the proposed rules, nor would a unilateral right to switch from a variable interest rate to a fixed rate.

It is likely that the following four types of changes will be considered modifications:

- Changes in yield.
- Changes in timing of payments or the maturity of the obligation.
- Changes in the obligor.
- Changes in the collateral.

Any change in maturity may affect the yield of the obligation. According to Shashy, there will likely be a *de minimis* rule for changes in the yield of obligations, but it is not yet clear exactly where the level of that threshold exception will be set. Part of the difficulty will be simply how one determines the yield.

Defining Materiality

Assuming that a modification has been made, the next question is whether it is material. If the obligation is a recourse obligation, a change in the obligor will certainly be considered material. Yet, some changes of obligors on recourse debt, as where the obligor changes because there is a taxable sale of the property, may not be considered material. ■