Clients&FriendsMemo

IRS Issues New Regulations Defining "Publicly Traded Property" for Purposes of Determining the Issue Price of Debt Instruments That Are Significantly Modified in a Restructuring or Issued for Property

September 26, 2012

I. Summary

On September 12, 2012, the IRS issued new regulations defining when property is "publicly traded" for purposes of determining the issue price of a debt instrument that is issued for property or treated as issued for property, as is the case when a debt instrument is "significantly modified" in a restructuring.[1] The new regulations largely follow proposed regulations issued on January 6, 2011, which significantly expanded the definition of publicly traded property.[2] As a result, the new regulations generally increase the situations in which issuers will realize "cancellation of debt" ("**COD**") income upon a debt restructuring.[3]

The new regulations make the following changes to the proposed regulations:

- Under the proposed regulations, publicly traded property included property that was listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, such as the NYSE, NASDAQ, the Chicago Board Options Exchange, the Chicago Stock Exchange, the National Stock Exchange, or the International Securities Exchange.[4] The

1 77 Federal Register 56533 (September 13, 2012). The new regulations are primarily in Treasury regulations sections 1.1273-2(f) and 1.1275-2(k). All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations proposed or promulgated thereunder.

Debt instruments that are "significantly modified" are treated as retired and reissued for the modified debt instrument. Regulations under section 1001 explain when a debt instrument is significantly modified.

2 We discussed the proposed regulations in a previous Clients & Friends Memo, available here.

3 COD income arises when a debt instrument is retired for less than its principal amount or adjusted issue price. COD is currently recognized as ordinary income unless an exception contained in section 108 applies. Section 108 includes exceptions for issuers that are in bankruptcy or insolvent.

4 Proposed Treasury regulations section 1.1273-2(f)(2)(i).

new regulations eliminate this category of publicly traded property because the small amount of debt that is listed on an exchange rarely trades on the exchange.[5]

- The proposed regulations provided that a debt instrument would not be treated as publicly traded if the stated principal amount of the issuance that includes the debt instrument does not exceed $50 million. The new regulations expand this exception for "small debt issuances" to $100 million.[6]
- The proposed regulations permitted issuers and holders of debt instruments to adopt different reasonable methods to determine the fair market value of a debt instrument, and thereby reach different issue prices. The new regulations require issuers to determine whether a debt instrument is publicly traded and, if it is publicly traded, determine its fair market value and make this information available to holders in a commercially reasonable fashion (including by electronic publication) within 90 days of the issue date of the relevant debt instrument. The issuer's determinations are binding on holders of the debt instrument unless the holder explicitly discloses on a timely filed income tax return that its determination is different from the issuer's and the basis for its different determination.
- The new regulations permit issuers to treat certain additional issuances of a debt instrument as part of the original issuance, and to treat the additional debt as having the same issue price as the original debt (and assign the same CUSIP number to the additional debt), even if the additional issuance is more than 6 months after the original issuance. These additional issuances are referred to as "qualified reopenings."

The new regulations apply to debt instruments issued or significantly modified on or after November 13, 2012, and to qualified reopenings that occur on or after September 13, 2012.

II. Background

Under current law, if a debt instrument is issued for property and is either (i) "traded on an established securities market" (which this memorandum refers to as "publicly traded") or (ii) issued for property that is publicly traded, the issue price of the debt instrument is its fair market value.

This rule is particularly relevant to distressed debtors and their creditors because a "significant modification" of existing debt is treated as the retirement of the pre-modified debt instrument in

---

[5] The proposed regulations also had provided a *de minimis* exception that prevented exchange-listed property that traded in *de minimis* amounts from being treated as publicly traded. Because the new regulations remove the exchange-listed property category of publicly traded property, the *de minimis* trading exception contained in the proposed regulations was not necessary and was removed.

[6] The new regulations also clarify that the exception for small debt issuances is based on the outstanding stated principal amount of the issuance that includes the debt instrument, as of the determination date.

exchange for the modified debt instrument, which is treated as newly issued for its issue price.[7] Since distressed debt almost always trades for less than its principal amount, if the pre- or post-modified debt is publicly traded, then, even if the principal amount of a significantly modified debt instrument remains the same, the debt instrument is likely to be deemed to be retired for less than its principal amount (or, if the debt instrument was initially issued for a price that was less than its principal amount, it is likely to be deemed to be retired for less than its "adjusted issue price").[8] An issuer that retires or is deemed to retire outstanding debt for less than its principal amount (or adjusted issue price) realizes COD income. Solvent debtors that are not in bankruptcy are generally taxable on this COD income, even though these distressed debtors usually do not have available cash to pay the tax.[9] If the principal amount of the debt remains unchanged, these debtors will also have an amount of "original issue discount" ("**OID**") deductions in future years, but may be unable to use the deductions or the deductions may be subject to limitation.[10]

Although a solvent issuer that significantly modifies its distressed debt is generally taxable on COD income if that debt is publicly traded and trades for less than its principal amount or adjusted issue price, a very different rule applies to debt that is not publicly traded. If a debt instrument is not publicly traded and bears interest at a rate at least equal to the "applicable federal rate" (the "**AFR**"),[11] then its principal amount (or adjusted issue price) is generally deemed to represent its fair market value, even if its value is, in fact, significantly less. Thus, upon a significant modification of a

---

7 Under Treasury regulations section 1.1001-3, a significant modification of a debt instrument can result if, for example, (i) the yield changes by more than 25 basis points, (ii) the maturity date is extended by more than the lesser of five years or 50% of the original term of the debt instrument, (iii) the obligor changes on a recourse obligation, or (iv) in certain circumstances when collateral changes or the debt instrument changes from recourse to nonrecourse (or vice versa).

8 The adjusted issue price of a debt instrument is equal to its issue price plus any "original issue discount" includible in the income of the holder less any payments (other than payments of "qualified stated interest") received by the holder on the debt instrument. Section 1272(a)(4).

9 COD income is generally not required to be recognized by debtors that are "insolvent" or in bankruptcy. Section 108(a). Debtors that are not insolvent or in bankruptcy and that have sufficient available net operating losses ("**NOLs**") or other losses may be able to use the losses or NOLs to offset the COD. Other limited exceptions from the recognition of COD include the discharge of (i) "qualified farm debt," (ii) "qualified real property business debt," and (iii) "qualified principal residence debt" discharged before January 1, 2013.

10 For example, the deductibility of the OID may be limited under the "applicable high yield debt obligation" ("**AHYDO**") rules under section 163(e). Also, debtors with insufficient future income may be unable to use the deductions.

In its *Report on Proposed Regulations on the Definition of Public Trading*, the New York State Bar Association Tax Section had requested that the regulations permit distressed debtors that significantly modify their debt to amortize their COD income and offset it against future OID deductions so that the debtors would not be subject to current tax liability upon the restructuring of their distressed debt. The new regulations do not adopt this recommendation, but the preamble to the new regulations states that there is a separate regulation project underway to address the potential distortions created in distressed debt situations.

11 The AFR is a rate published by the U.S. Treasury for indebtedness with a maturity of less than three years (the "short-term AFR"), between three and nine years (the "mid-term AFR"), and more than nine years (the "long-term AFR"), based on the interpolated market yield on outstanding U.S. Treasuries with equal maturities. Section 1274(d)(1); Treasury regulations section 1.1274-4(b).

nonpublicly traded debt instrument that bears interest at the AFR or higher, the pre-modified debt instrument is deemed to be retired for its principal amount (or adjusted issue price). If the principal amount is not reduced in the restructuring, no COD is realized, and no tax is payable.

For this reason, solvent U.S. issuers of distressed debt that significantly modify their debt generally prefer to take the position that their debt is not publicly traded, unless they have losses to shelter the COD income. On the other hand, secondary market U.S. holders of significantly modified distressed debt generally prefer that the debt be publicly traded to establish a low value and avoid the "phantom" taxable gain that would result if the modified debt was deemed to be issued at par.[12]

III. Discussion of the New Regulations

The new regulations generally will increase the situations where debt is treated as publicly traded, which will tend to increase the COD income realized by distressed debtors, but minimize the phantom income realized by distressed debt traders upon a significant modification of the distressed debt.

A. Definition of "Publicly Traded"

The new regulations eliminate the definition of "publicly traded" that was contained in the replaced regulations and treat a debt instrument (or other property for which the debt instrument is exchanged) as publicly traded if, at any time during the 31-day period ending 15 days after the issue date of the debt instrument, (i) there is a sales price, or one or more firm or indicative quotes, for the debt instrument (or other property) and (ii) the stated principal amount of the issuance that includes the debt instrument is more than $100 million.

The new regulations require an issuer to use reasonable diligence to determine whether a debt instrument is publicly traded and, if it is publicly traded, determine its fair market value and make this information available to holders in a commercially reasonable fashion. These determinations generally are binding on holders, unless a holder explicitly discloses on a timely filed income tax return that its determination is different from the issuer's and the

[12] If a distressed debt investor purchases a debt instrument with a principal amount of $100 for $60 and the term of the debt instrument is materially extended so that the unmodified debt instrument is deemed to be redeemed for the modified debt instrument and the debt is not publicly traded (so its principal amount is deemed to be equal to its fair market value), the investor will recognize taxable income of $40. On the other hand, if the debt was publicly traded for $60 at the time of the modification, the investor would not recognize any taxable income.

basis for its different determination.[13] Any temporary restriction on the trading of a debt instrument (whether imposed by the issuer or a third party) a purpose of which is to avoid characterization of the debt instrument as publicly traded will cause the debt instrument to be treated as publicly traded.

1. Sales Price Available to Issuers, Broker-Dealers and Other Persons Who Regularly Purchase or Sell Debt Instruments

Under the new regulations, a debt instrument is treated as publicly traded if the price for a purchase or sale of the debt instrument executed within the 31 day period ending 15 days after the issue date appears in a medium that is made available within a reasonable period of time after the sale to issuers, brokers, and other persons who regularly purchase or sell debt instruments. This rule treats debt instruments that are reported electronically on the Trade Reporting and Compliance Engine ("TRACE") as publicly traded.

The new regulations provide that the sales price of a debt instrument that appears on such a medium is presumed to equal its fair market value. However, a sale or quoted price (quoted prices are discussed below in Part III.A.2 and 3) may be disregarded if a principal purpose of the sale or quoted price is to cause the property to be treated as publicly traded or to materially misrepresent the value of the debt instrument. Moreover, if there is more than one sales price, or if there is both more than one sales price and quoted prices (as discussed below), the regulations provide that a taxpayer may use any reasonable method consistently applied to the same or substantially similar facts to determine the fair market value of the debt instrument. The new regulations provide that the factors which a taxpayer may consider in determining the fair market value of the debt instrument include (but are not limited to) the timing of relevant sales or quotes in relation to the issue date, whether the price is derived from a sale or quote, the size of the relevant sale or quote, or whether the sales price or quote corresponds to pricing information provided by an independent bond or loan pricing service.

2. Firm Price Quotes

Under the new regulations, a debt instrument is treated as publicly traded if a price quote is available from at least one identified broker, dealer, or pricing service for the debt instrument and the debt instrument could be purchased or sold at the

[13] The new regulations provide that the factors a taxpayer may consider in determining the fair market value of a debt instrument include (but are not limited to) the timing of relevant sales or quotes in relation to the issue date, whether the price is derived from a sale or quote, the size of the relevant sale or quote, and whether the sales price or quote corresponds to pricing information provided by an independent bond or loan pricing service.

quoted price by the person receiving the quoted price (i.e., the price quote is "firm"). A price quote is considered "available" regardless of whether the quote is initiated by the person providing the quote or provided at the request of the person receiving the quote. In addition, in order for a quote to be considered firm, the identity of the person providing the quote must be reasonably ascertainable. A price quote is treated as a firm quote even if the party providing the quote is not legally obligated to purchase or sell the debt instrument at the quoted price, so long as market participants typically purchase or sell at the quoted price or the quote is designated as a firm quote by the person providing the quote.

The new regulations provide that a firm price quote is presumed to be the fair market value of the debt instrument. If there is more than one quoted price, or if there is both more than one sales price and quoted price, the regulations provide that a taxpayer may use any reasonable method consistently applied to the same or substantially similar facts to determine the fair market value.[14]

3. Indicative Price Quotes

Under the new regulations, a debt instrument is treated as publicly traded if an "indicative" or "soft" price quote (*i.e.*, a quote other than a firm quote) is available from at least one broker, dealer, or pricing service for the debt instrument (even if the identity of the broker or dealer providing the quote is not ascertainable). As indicative or soft price quotes are available for almost all debt instruments, the new regulations treat almost all debt instruments as publicly traded (subject to the small debt issuance exception described below).[15]

The regulations provide that the indicative price quote is presumed to be the fair market value of the debt instrument. If there is more than one quoted price, or if there is both more than one sales price and quoted price, the regulations provide

[14] The regulations provide that the factors which a taxpayer may consider in determining the fair market value of a debt instrument include (but are not limited to) the timing of relevant sales or quotes in relation to the issue date, whether the price is derived from a sale or quote, the size of the relevant sale or quote, or whether the sales price or quote corresponds to pricing information provided by an independent bond or loan pricing service.

[15] In its *Report on Proposed Regulations on the Definition of Public Trading*, the New York State Bar Association Tax Section had requested that the regulations provide that "a price quote must be a bona fide price quote to a third party to buy and sell (or must be based on such bona fide quotes), must be available to the issuer or the holder who is determining the issue price of the debt instrument in question, and must exist independently of any inquiry relating to the issue price determination." This request was rejected. The new regulations provide that a firm or indicative quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the quoted price is substantially the same price at which the person receiving the quote could buy or sell the property.

that a taxpayer may use any reasonable method consistently applied to the same or substantially similar facts to determine the fair market value.

However, if a taxpayer determines that that the quoted price or average of quotes for a debt instrument for which there are only indicative quotes materially misrepresents the fair market value of the property, the taxpayer can use any method that provides a reasonable basis to determine the fair market value of the property, so long as the taxpayer's method more accurately reflects the value of the property than the quoted price. It is curious that the regulations permit taxpayers to determine that a quote materially misrepresents fair market value (and apparently give them discretion in making the determination) rather than requiring that the price quote in fact misrepresents fair market value.

B. Issuer-Holder Consistency Requirement

As mentioned above, the new regulations provide that an issuer's determination that a debt instrument is publicly traded and its fair market value must be made available to holders in a commercially reasonable fashion, including by electronic publication, within 90 days of the issuance date.[16] The new regulations provide that the issuer's determination of public trading and fair market value is binding on all holders of the debt instrument unless the holder explicitly discloses on a timely filed income tax return that its determination is different from the issuer's (for example, the holder determines that the debt instrument is not publicly traded or determines a different fair market value) and the basis for its different determination. If an issuer fails to make the fair market value or issue price of a debt instrument reasonably available to a holder, the holder must determine the fair market value and issue price of the debt instrument.

C. Exception for Small Debt Issuances

The new regulations provide an exception to the publicly traded debt rules for "small debt issuances." A debt instrument is treated as part of a small debt issuance if the stated principal amount of the issuance that includes the debt instrument does not exceed $100 million on the date of determination.[17] A debt instrument that is part of a small debt issue is not treated as publicly traded, even if it otherwise would be.

[16] For debt instruments that are co-issued, the issuers are required to designate one issuer to make the determination of whether the debt instruments are publicly traded and their fair market value and to make this information available to holders.

[17] Presumably the $100 million threshold includes only debt instruments that are included in a qualified reopening of the issuance. Qualified reopenings are discussed in the next section.

D. Qualified Reopenings

Debt instruments issued as part of the same issuance have the same issue price. Generally, two debt instruments must be issued within a 13-day period to be treated as part of the same issuance. Under the "qualified reopening rules," as revised under the new regulations, additional debt instruments issued more than 13 days after the original date of issuance may be deemed part of the same issuance as the original debt instruments and have the same issue price (and same CUSIP number) as the original debt instruments if the debt instruments are taxable (i.e., not tax exempt), are not "contingent payment debt instruments,"[18] and either:

- (i) the original debt instruments are publicly traded, (ii) the reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments, and (iii) on the date that the price of the additional debt instruments is established (or the announcement date, if earlier), the yield on the original debt instruments (based on their fair market value) is not more than 110% of the yield of the original debt instruments on their issue date,[19] or
- (i) the original debt instruments are publicly traded and (ii) the additional debt instruments are issued with no more than a *de minimis* amount of OID,[20] or
- (i) the additional debt instruments are issued for cash to persons unrelated to the issuer for an arm's length price and (ii) either (A) the reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments, and on the date that the price of the additional debt instruments is established (or the announcement date, if earlier), the yield on the additional debt instruments (based on their cash purchase price) is not more than 110% of the yield of the original debt instruments on their issue date, or (B) the additional debt instruments are issued with no more than a *de minimis* amount of OID,[21] or
- (i) the additional debt instruments are issued more than six months after the issue date of the original debt instruments and (ii) either (A) the original debt instruments are publicly traded and on the date that the price of the additional debt instruments is established (or the announcement date, if earlier), the yield of the additional debt

---

18 A "contingent payment debt instrument," very generally, is a debt instrument that provides for one or more contingent payments, other than payments that are contingent on the value of LIBOR or certain other common variable interest rates.

19 Treasury regulations section 1.1275-2(k)(3)(ii).

20 Treasury regulations section 1.1275-2(k)(3)(iii). A debt instrument is treated as issued with a *de minimis* amount of OID if the excess of its "stated price at maturity" over its issue price does not exceed an amount equal to .25% of its stated price at maturity multiplied by the number of whole years to its maturity based on its anticipated weighted average life.

21 Treasury regulations section 1.1275-2(k)(3)(iv).

instruments (based on their fair market value or cash purchase price, whichever is applicable) is not more than 100% of the yield of the original debt instruments on their issue date, or (B) the additional debt instruments are issued for cash to persons unrelated to the issuer for an arm's length price and on the date that the price of the additional debt instruments is established (or the announcement date, if earlier), the yield of the additional debt instruments (based on their fair market value or cash purchase price, whichever is applicable) is not more than 100% of the yield of the original debt instruments on their issue date.[22]

The proposed regulations had dramatically expanded the availability of the qualified reopening rules to cover non-publicly traded debt instruments issued for cash to persons unrelated to the issuer for an arm's length price, so long as the other qualified reopening requirements were satisfied. The new regulations adopt the changes that were included in the proposed regulations and further relax the qualified reopening rules to include issuances more than six months after the initial offering, provided the 100% yield test described above is satisfied.

Accordingly, under the new regulations, in order for debt instruments issued more than 13 days after the initial issuance to give rise to a qualified reopening, either the original debt instruments must have been publicly traded or, if the original debt instruments are not publicly traded, the additional instruments are issued for cash to persons that are unrelated to the issuer for an arm's length price, and the other qualified reopening requirements are satisfied.[23]

The new regulations significantly increase the availability of the qualified reopening rules and allow additional issuances of debt instruments to be fungible (and have the same CUSIP number) for previously issued debt instruments with identical terms. In addition, by expanding the definition of publicly traded debt instruments, even if the additional debt instruments are issued for property, or to related persons, the new regulations make it easier for issuers to satisfy the qualified reopening rules.

* * * *

If you have any questions regarding this memorandum, please contact any member of our Tax Department.

---

22 Treasury regulations section 1.1275-2(k)(3)(v).

23 The new regulations clarify that the original debt instruments are tested to determine whether they are publicly traded on the date on which the price of the additional debt instruments is established or, the announcement date, if earlier.