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Client Alert

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Determining the Issue Price of a Debt Instrument: Final Treasury Regulations Clarify When Property Is Publicly Traded

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On September 12, 2012, the US Internal Revenue Service (the "Service") released final regulations (the "Final Regulations") detailing when property is publicly traded for purposes of determining the issue price of a debt instrument. The issue price of a debt instrument has important income tax consequences and is relevant for determining, among other things, original issue discount ("OID") associated with the instrument, cancellation of indebtedness ("COD") income of the issuer and the gain or loss on the sale of the instrument by a holder. The new rules should be of particular interest to borrowers and lenders in a variety of bank finance and capital markets transactions, including consent solicitations, debt-for-debt exchanges, recapitalization transactions, workouts, reopenings and any transaction that involves amendments or modifications to an existing debt obligation (including a bank loan) that results in a deemed reissuance of the debt obligation for US federal income tax purposes. These rules do not change the determination of the issue price of debt issued for cash.

Background

In general, a debt instrument that is issued for property and is part of an issue, some or all of which is "publicly traded" for US tax purposes (i.e., is traded on an established securities market), has an issue price equal to the fair market value of the debt instrument. Similarly, if a non-publicly traded debt instrument is issued for property that is publicly traded (such as stock or securities), the issue price of the debt instrument is the fair market value of the stock, securities or other property. If a debt instrument issued for property is neither publicly traded nor issued for property that is publicly traded, the issue price of the debt instrument generally is equal to the stated principal amount of the debt instrument if such instrument provides for adequate stated interest.

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Relaxing the Criteria for Determining Whether Property Is Publicly Traded

Generally

The Final Regulations provide that property (including most debt instruments issued for property) is publicly traded for tax purposes if, at any time during the 31-day period ending 15 days after the issue date, any of the following are available:

- **A "sales price" for the property.** A sales price exists if the price for an executed purchase or sale of the property is "reasonably available" within a reasonable period of time after the sale (meaning that the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available to issuers of debt instruments, regular purchasers or sellers of debt instruments, or certain brokers).
- **One or more "firm quotes" for the property.** A firm quote is a price quote that is available from at least one broker, dealer or pricing service (including a price provided only to certain customers or subscribers) for property, and the quoted price is substantially the same as the price for which the person receiving the quoted price could purchase or sell the property. The identity of the person providing the quote must be reasonably ascertainable but such person does not have to be legally obligated to purchase or sell at that price.
- **One or more "indicative quotes" for the property.** An indicative quote is a price quote that is available from at least one broker, dealer or pricing service (including a price provided only to certain customers or subscribers) for property and the price quote is not a firm quote.

In such case, the fair market value of the property will be presumed to be the sales price or quoted price that is available. If more than one sales price or quoted price is available, a taxpayer may use any reasonable method to determine the fair market value (such as the timing of each relevant price or quote in relation to the issue date, whether the price is derived from a sale, a firm quote, or an indicative quote, or the size of each relevant sale or quote).

The rules outlined above relax the criteria for determining whether a debt instrument is publicly traded, and thus it is more likely under the Final Regulations that the issue price of a debt instrument issued for property will be the fair market value of such debt or property. The Service explained that the reason for the relaxation of these rules is due to the increased liquidity and transparency of the debt markets in recent years. Such liquidity and transparency largely eliminate concerns about reliable information on sales and pricing being unavailable. Accordingly, the Final Regulations provide that, to the extent that objective pricing information exists, such information can be used to determine the issue price for most debt instruments issued for property.

Special Rules

A debt instrument will not be treated as publicly traded if, at the time the determination is made, the outstanding stated principal amount of the issue that includes the debt instrument does not exceed US$100 million (or the equivalent in the currency in which the debt instrument is denominated). In addition, a debt instrument is not treated as publicly traded solely because it is convertible into property that is so traded.

If an issuer determines that property is publicly traded, the issuer is required to make that determination as well as the fair market value of the property (which can be stated as the issue price of the debt instrument) available to holders in a commercially reasonable fashion, including by electronic publication, within 90 days of the date that the debt instrument is issued. Each determination by an issuer is binding on a holder of the debt instrument unless the holder explicitly discloses the reasons for a different determination on its timely filed federal income tax return for the year that includes the acquisition date of the debt instrument.

Effective Date

The rules described above apply to a debt instrument issued on or after the date that is 60 days after the publication date of the Final Regulations.

Debt-for-Debt Exchanges

In general, the issue price of a non-publicly traded debt instrument is equal to the fair market value of the non-publicly traded property for which the debt was issued if such property was recently acquired prior to the exchange. The Final Regulations provide that a debt instrument issued in a debt-for-debt exchange, including a deemed exchange resulting from a significant modification of a debt instrument, will not be treated as subject to this so-called "recent sales transaction" rule even if the debt instrument that is exchanged for a newly issued debt instrument was recently acquired prior to the exchange. Thus, in the case of a debt-for-debt exchange of non-publicly traded debt instruments, the trading price of the instrument that is exchanged (or deemed to be exchanged) will no longer be relevant in the determination of the issue price of the newly issued debt.

The rules described above with respect to debt-for-debt exchanges apply to a debt instrument issued on or after the date that is 60 days after the publication date of the Final Regulations.

The Final Regulations Expand the "Qualified Reopening" Rules

If additional debt instruments are issued in a "qualified reopening," such additional debt instruments are treated as part of the same issue as the original debt instruments for US federal income tax purposes. The Final Regulations expand the definition of a qualified reopening in two important ways:

- **Non-publicly traded debt instruments are eligible for qualified reopening treatment.** Prior to the publication of the Final Regulations, the qualified reopening exception was limited to publicly traded debt instruments. Under the Final Regulations, a reopening of non-publicly traded debt instruments is eligible to be treated as a qualified reopening if the additional debt instruments are issued for cash to unrelated persons for an arm's length price and rules similar to the rules that apply to publicly traded debt instruments are met.*

- **Additional debt instruments may be eligible for qualified reopening treatment if issued after six months.** A reopening of debt instruments is now eligible for qualified reopening treatment if the additional debt instruments are issued more than six months after the issue date of the original debt instruments and (A) either the original debt instruments are publicly traded (as defined above) or the original debt instruments are non-publicly traded and are issued for cash to unrelated persons for an arm's length price, and (B) on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments is not more than 100 percent of the yield of the original debt instruments on their issue date.

These provisions expanding the qualified reopening rules apply to debt instruments that are part of a reopening if the reopening date is on or after the publication date of the Final Regulations.

* Either (A) the reopening date of the additional debt instruments is within six months of the original issue and the yield of the original debt instruments, on the date on which the additional debt instruments price (or, if earlier, the announcement date), is not more than 110 percent of the yield of the original debt instruments on their issue date, or (B) the additional debt instruments are issued without OID or with no more than a de minimis amount of