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A legal update from Dechert's International and Domestic Tax Group

Final U.S. Regulations Clarify When Property Is Deemed Publicly Traded for Purposes of Determining the Issue Price of a Debt Instrument

The Internal Revenue Service (IRS) has issued final regulations clarifying when property will be considered publicly traded for purposes of determining the issue price of a debt instrument. The determination of the issue price of a debt instrument can have significant effects on both the issuer and the holder of a debt instrument. In particular, in the case of a debt-for-debt exchange (including a significant modification of a debt instrument), the amount of the issue price of the "new" (or modified) debt instrument is of critical importance because (1) the amount of original issue discount (OID) associated with the "new" (or modified) debt instrument is determined based on the difference between the issue price of a debt instrument and its stated redemption price at maturity, (2) the issue price is used to determine whether an issuer has (and the amount of, if any) cancellation of indebtedness income resulting from this exchange, and (3) the determination of a holder's gain or loss from this exchange depends on whether the holder's basis in the "old" debt instrument is greater or less than the issue price of the "new" debt instrument. As described below, the expanded definition of publicly traded property under the final regulations increases the likelihood that a debt-for-debt exchange, including a significant amendment to an existing debt instrument, will result in a reduced issue price for the new debt.

The new regulations, effective November 13, 2012, closely follow the framework of the proposed regulations issued in January 2011, but include several significant changes made in response to comments received on the proposed regulations.

Background

The issue price of a debt instrument that is either publicly traded or issued for publicly traded property is the fair market value of such property. If a debt instrument issued for property is not publicly traded and is not issued for publicly traded property, the issue price is equal to the stated principal amount of the debt instrument (assuming the interest rate on the new debt instrument is at least equal to the applicable federal rate published by the IRS). Treasury Regulations issued in 1994 provide the rules for determining when property is publicly traded. Under these rules, property was deemed publicly traded if the property was exchange listed property, market traded property, property appearing on a quotation medium or readily quotable. The application of these rules in the context of modern information systems has been the subject of much discussion and uncertainty.

Due to the increasing liquidity and transparency of the debt markets, the IRS issued proposed regulations in January 2011 which materially expanded the definition of publicly traded property. Under the proposed regulations, publicly traded property included property listed on an exchange, property for which a sales price is reasonably available, and property

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for which there is one or more firm or indicative quotes. This change substantially increases the likelihood that many debt instruments can be considered publicly traded, with all the attendant tax consequences.

Final Regulations

The final regulations mirror the proposed regulations considerably, but several taxpayer favorable changes were made in response to comments on the proposed regulations. Significant changes include:

- The final regulations eliminate the category of exchange listed property from the definition of publicly traded property. The elimination of exchange listed property also eliminated the need for the de minimis trading exception in the proposed regulations.

- The $50 million exception for small debt issues in the proposed regulations has been expanded to $100 million. The final regulations clarify that the exception applies based on the outstanding stated principal amount of the debt instrument at the time the determination is made.

- The final regulations require issue price to be reported consistently by issuers and holders. The issuer must determine the fair market value of publicly traded property and provide such information to holders within 90 days of the issuance of the new debt instrument. If a holder makes a contrary determination, it must file a statement with its income tax return stating the reasons for its position.

- The proposed regulations provided that if more than one sales price or quoted price existed for property, a taxpayer could use any reasonable method, consistently applied, to determine the fair market value of the property. The final regulations add a list of nonexclusive factors a taxpayer may consider in establishing fair market value. The method used must be consistently applied to the same or substantially similar facts.

- The final regulations add a second anti-abuse rule providing that if the principal purpose of a sale or price quote is to cause the property to be traded on an established market or to materially misrepresent the value of property, then the sale or price quote is disregarded.

The final regulations apply to debt instruments issued on or after November 13, 2012.

While the final regulations improve and eliminate some of the adverse nature of the proposed rules, these rules still may result in debt being classified as publicly traded debt due to modern electronic media, widely available pricing data or other situations that fall far short of classic views of when property is publicly traded. Thus, future debt issuances and restructurings must be carefully reviewed to determine their tax treatment.

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