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Proposed Treasury Regulations Significantly Clarify and Expand Scope of “Publicly Traded” for Purposes of Determining the Issue Price of Debt Instruments

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The Internal Revenue Service (the “IRS”), in proposed Treasury Regulations (REG-131947-10) (the “Proposed Regulations”) released on January 6, 2011, clarifies and expands the circumstances that cause property to be “publicly traded” for purposes of determining the issue price of a debt instrument. The Proposed Regulations have been issued in response to commentary from practitioners regarding the meaning of such term in the current Treasury Regulations. The Proposed Regulations, if enacted in a form substantially similar to the proposed form, would result in debt instruments purchased and sold in current financial markets to be more easily characterized as “publicly traded.” This characterization could have significant consequences for creditors and debtors that engage in debt modifications that result in a deemed exchange of the old debt obligation for a new modified obligation.

BACKGROUND

The issue price of a debt instrument that is issued in exchange for property that is traded on an established market, or publicly traded, is equal to the fair market value of the publicly traded property. Treasury Regulations issued in 1994 address when property is considered to be “traded on an established market” at any time during the 60-day period ending 30 days after the issue date. Property is considered to be traded on an established market for this purpose if it is listed on (1) a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (the “Act”), (2) an “interdealer quotation system sponsored by a national securities association registered” under Section 15A of the Act (e.g., NASDAQ), or (3) a foreign exchange or board of trade recognized by the Treasury Regulations or the IRS.¹ Property also qualifies if it is traded on an interbank market or on a board of trade designated as a contract market by the Commodities Futures Trading Commission.² Property is traded on an established market if it appears on a “quotation medium,” which is defined as “a system of general circulation . . . that provides a reasonable basis to determine fair market value by disseminating either recent price quotations . . . of one or more identified brokers, dealers, or traders or actual prices . . . of recent sales transactions.”³ In addition, property is traded on an established market if price quotations are “readily available” from brokers, dealers, or traders.⁴ However, this category is subject to a number of limitations.

Practitioners have criticized the definition of an established market under the current Treasury Regulations, asserting that comparatively little debt is listed on an exchange described in the Regulations. Practitioners also have raised issues

¹ Treas. Reg. § 1.1273-2(f)(2).

² Treas. Reg. § 1.1273-2(f)(3).

³ Treas. Reg. § 1.1273-2(f)(4).

⁴ Treas. Reg. § 1.1273-2(f)(5).

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regarding the meaning of what constitutes a “quotation medium.” The vast majority of debt instruments are currently purchased and sold over-the-counter for a price negotiated between a financial entity (such as a securities dealer or broker) and a customer. Almost all pricing services provide quotes or valuations rather than actual trading prices. Practitioners have struggled to characterize the debt instruments exchanged in such transactions as appearing on a quotation medium. Moreover, practitioners have found too restrictive the exclusions to the general rule that treats a debt instrument as publicly traded if price quotations are readily available from dealers, brokers, or traders. Thus, it has been unclear whether debt instruments sold in financial markets through current trading mechanisms would be considered publicly traded for purposes of determining the issue price.

PROPOSED TREASURY REGULATIONS

According to the preamble, the Treasury and the IRS generally believe that the “traded on an established market” standard under Section⁵ 1273(b)(3) should be interpreted broadly, and that accurate pricing information, to the extent it exists, should be the basis for the issue price determination under Section 1273(b)(3). To address concerns with the current rules, the Proposed Regulations simplify and clarify the determination of when property is traded on an established market, identifying four situations in which property is considered to be so traded: (1) the property is listed on an exchange; (2) the sales price for property is reasonably available; (3) a “firm” price quote to buy or sell the property is available; or (4) a price quote (i.e. an indicative quote) is provided by a dealer, broker, or pricing service. The Proposed Regulations provide that the fair market value of such property will be presumed to be equal to its trading price, sales price, or quoted price, whichever is applicable. If more than one price quote exists, taxpayers can reconcile the competing prices in a “reasonable manner.” In the case of an indicative quote, however, if the taxpayer determines that the quote materially misrepresents fair market value, then the taxpayer is entitled to use a reasonable method to determine fair market value.

The Proposed Regulations will be effective for debt issued on or after the date that the regulations are finalized.

The Proposed Regulations provide significantly greater clarity than the current Regulations with respect to when a debt instrument is publicly traded. Since price quotes, either firm or soft, are available for a substantial amount of debt obligations, the Proposed Regulations would have the effect of significantly increasing the number of debt obligations that are publicly traded. Thus, the issue price of such instruments will generally be the fair market value (presumed equal to its trading, sales, or quoted price) as opposed to the face value. However, further guidance would be helpful. The Proposed Regulations, for example, do not clarify whether debt obligations purchased in a government-sponsored auction would be considered to be “publicly traded” under the Proposed Regulations.

CONSEQUENCES FOR PURCHASERS AND ISSUERS OF DEBT OBLIGATIONS

The Proposed Regulations, if enacted, could have significant consequences for creditors and debtors that engage in modifications of distressed debt obligations, resulting in a deemed exchange of the old debt obligation for a new modified obligation. Purchasers of debt obligations that are considered “publicly traded” under the Proposed Regulations would be able to avoid recognition of phantom income in the case of a modification of a debt obligation purchased at a discount. However, for some issuers, the changes in the Proposed Regulations could increase the amount of cancellation of debt (“COD”) income on a restructuring.

Many investors have purchased distressed debt obligations at a discount with the intent of modifying the terms in order to

⁵ References to “Section” herein generally refer to sections of the Internal Revenue Code of 1986, as amended.

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enable the debtor to more readily make payments. The modifications negotiated with the debtors generally constitute significant modifications under Treasury Regulations Section 1.1001-3 and are treated as taxable exchanges. The treatment of the creditor and debtor in these situations depends on the difference between the issue price for the purchased debt instrument and the issue price for the “new” modified debt instrument.

Under the Proposed Regulations, classes of debt instruments that are considered to be traded on an established securities market would be significantly expanded. Moreover, the proposed new definition could more easily apply to the types of exchanges of debt instruments that currently occur in financial markets. For example, it would be clear that a debt instrument acquired from a dealer that offered a “soft quote” for the purchase price of the debt would be “publicly traded.”

Example: A debt obligation with an outstanding principal amount equal to its issue price of \$100 is purchased for \$30 in an over-the-counter transaction for a price negotiated between a securities dealer and the purchaser. The purchaser and issuer subsequently agree to lengthen the maturity and reduce the interest rate on the debt instrument. The debt obligation after the modification is quoted at a purchase price of \$35.

Under the Proposed Regulations, the issuer of a debt obligation that was purchased would recognize COD income at the time that such obligation is modified in an amount equal to \$65 (\$100 adjusted issue price less \$35 quoted purchase price). In contrast, if the debt obligation was not considered to be publicly traded and no change was made to the outstanding principal amount, the issuer would not recognize COD income on the deemed exchange.

On the other hand, purchasers of distressed debt obligations at a discount would be able to modify the obligations with little or no recognition of phantom income on any deemed exchange attributable to a significant modification under Treasury Regulations Section 1.1001-3. In the example above, the purchaser would recognize \$5 of gain on the deemed exchange (\$35 fair market value less \$30 of tax basis equal to the purchase price) if the debt instrument were considered to be publicly traded. In contrast, if the debt instrument is not publicly traded, the purchaser would recognize \$70 (\$100 issue price equal to the outstanding principal amount less \$30 basis) of gain on the deemed exchange in an amount equal to the difference between the purchase price and the outstanding principal amount.

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