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New Regulations on Debt Instruments – They Give a Little and Take a Little

Recently, the issue price of debt deemed issued as a result of a material modification of a debt instrument has become a problem for both issuers and purchasers of debt. In addition, the characterization of a modified debt instrument as equity rather than debt has become more problematic given the recent recession. In early January, Treasury issued proposed regulations for determining the issue price of debt (REG-131947-10) and final regulations regarding the characterization of modified debt instruments (T.D. 9513) that provide valuable guidance on these issues, with the guidance, we believe, favoring the investor rather than the issuer in the first instance and debt classification in the second instance.

Why do we care? Issuers and investors care a lot, because the issue price of an instrument is determined not only when the instrument is issued or an old instrument is exchanged for a new instrument, but also when there is a material modification of that same instrument. Given the recent recession, many issuers have been forced to restructure their outstanding debt instruments. This frequently gives rise to the deemed issuance of a new debt instrument. Depending upon the issue price of that newly deemed issued instrument, the issuer may have to recognize cancellation of debt income (COD), original issue discount (OID) may have been created, the AHYDO rules may apply, and the most recent purchaser of the instrument may have to recognize a short-term capital gain - important stuff which has real economic implications for the parties concerned.

Publicly Traded Debt

When a debt instrument is issued, the issuer needs to determine the issue price of the instrument. Generally, that determination is made under Section 1273 of the Internal Revenue Code of 1986, as amended (IRC), unless the instrument is issued for property, in which case the determination is made under IRC Section 1274. Under IRC Section 1273, the issue price of an instrument, part or all of which is issued in exchange for property which is traded on an established securities market ("publicly traded"), is equal to the fair market value of the instrument. Under existing Treasury Regulation 1.1273-2(f) (-2(f) regulations), an instrument is considered publicly traded if (i) it is traded on a specified exchange, (ii) it is traded on a contract market designated by the CFTC, (iii) it appears on a system of general circulation that disseminates price quotations or recent trading prices, or (iv) price quotations are readily available from dealers, brokers or traders.

Sounds simple – unfortunately as market quotation systems have changed greatly since the -2(f) regulations were finalized, it is frequently very difficult to determine whether an instrument is publicly traded under these tests. In practice, issuers have often taken the position that the deemed new instrument was NOT publicly traded, so that the issuer did not have to recognize any COD income or OID, and latest purchasers of that debt, typically acquiring such debt at a significant discount, have often taken the position that the deemed new debt instrument WAS publicly traded, so that it did not have to recognize a short-term capital gain. We note that the purchaser might have to re-characterize a portion of that gain as market discount, which would be characterized as ordinary income. Importantly, there was and is no requirement that the issuer and the debt holder take consistent positions on whether a debt instrument is publicly traded.

New Tests for Publicly Traded Instruments

Under the Proposed Regulations, new rules would apply to both the issuer and purchaser when determining whether or not a modified debt instrument was publicly traded. We believe that the new tests will increase the instances in which an instrument will be characterized as publicly traded and thus favor the holder of the debt instrument over the issuer, but better reflect the fair market value of the instrument. Under the Proposed Regulations, an instrument will now be considered to be publicly traded if it satisfies one of four tests.

- **Test 1: Is it traded on an exchange?**

The Proposed Regulations expand the definition of an exchange to include any foreign securities exchange that is officially recognized, sanctioned, regulated or supervised by a government authority. This revision greatly expands the reach of the provision, since many debt instruments are listed on a foreign exchange for securities law and other purposes.

- **Test 2: Is a sales price reasonably available?**

For this purpose, the sales price of an instrument is considered reasonably available if the sale price appears in a medium that is made available to persons who regularly buy or sell debt instruments, or to persons who regularly broker purchases or sales of debt instruments. With respect to debt instruments, this would be satisfied if prices of such instruments appear on the TRACE database maintained by the Financial Industry Regulatory Authority or on other pricing services and trading platforms that report prices on completed sales either on a general basis or to subscribers.

- **Test 3: Is a firm price quote to buy or sell the instrument available?**

The Proposed Regulations make it clear that this test can be satisfied if the firm price quote is labeled as such, or if the price quote is considered firm as a matter of law or industry practice.

- **Test 4: Is a soft quote available?**

An instrument will be considered publicly traded if a soft quote (rather than the firm quote referred to in Test 3) is provided by at least one dealer, broker or pricing service.

If pricing is obtained from more than one source described in the above-discussed tests, then an issuer and a holder may use any reasonable method to determine the issue price. In addition, if the pricing is based upon a "soft price," and the taxpayer determines that the soft price quote materially misstates the fair market value of the instrument, then the taxpayer can use a method which he or she believes more accurately reflects the value of the instrument.

Under a significant limitation, the new tests in the Proposed Regulations will not be applied if there is no more than *de minimis* trading of the instrument. For these purposes, *de minimis* trading will occur if during the 31-day period ending 15 days after the issue date the trading involves \$1 million or less and the aggregate of all trades does not exceed \$5 million. In addition, an instrument will not be considered publicly traded if the original principal amount of the instrument does not exceed \$50 million.

Retesting the Character of an Instrument

It is clear under current law that a material modification of a debt instrument results in the deemed issuance of a new instrument. In such case, the new instrument must be tested to determine whether it should continue to be characterized as a debt instrument or re-characterized as a new equity instrument. If the new debt instrument is re-characterized as an equity instrument, the interest payments should be recharacterized as non-deductible dividend payments. During the recent recession, the need for issuers to restructure their debt instruments was caused often by market forces rather than the individual results of operations of the issuer.

The recent final Regulations, which largely adopt the June 2010 Proposed Regulations, make it clear that in making the determination of the character of a newly deemed issued instrument, any deterioration in the financial condition of the issuer between the issue date of the original debt instrument and the date of the alteration and modification is not to be taken into account. This is a very favorable change that we believe greatly reduces the likelihood that a debt instrument will be recharacterized as an equity instrument. Importantly, however, this new rule would not apply where a new obligor is substituted for the original obligor, or where a co-obligor is either deleted or removed.

For additional information, please contact the authors or any member of the [Venable Tax Group](#).

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