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WSGR ALERT

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PROPOSED TREASURY REGULATIONS EXPAND THE MEANING OF PUBLICLY TRADED DEBT FOR TAX PURPOSES

On January 6, 2011, the Internal Revenue Service (IRS) and U.S. Department of the Treasury issued proposed regulations expanding and clarifying the meaning of "traded on an established market," or "publicly traded," for purposes of determining the issue price of a debt instrument. Whether or not debt is publicly traded can have a significant impact on the tax treatment of debt exchanges and modifications, in particular whether the issuer is required to recognize discharge of indebtedness income. While the proposed regulations are not effective until final, clients contemplating debt restructurings should consider whether the debt would be treated as publicly traded under the current or proposed regulations.

Significance of Public Trading

When a debt instrument is issued in exchange for property, such as a debt-for-debt exchange in a workout, the issue price of the debt instrument under Section 1273(b)(3) is its fair market value if either the existing debt or the new debt is publicly traded. A debt-for-debt exchange also may be deemed to occur for U.S. federal income tax purposes as a result of a significant modification of existing debt. Given the declining fortunes of the issuer in the workout context, it often will be the case that the issue price of the new or modified debt instrument, if required to be determined based on public trading, will be less than the adjusted issue price of the existing debt. As a consequence, the issuer generally will recognize cancellation of debt income, and the new/modified debt will have original issue discount, which must be accounted for by both the issuer and the holder. These income tax consequences have been exacerbated by the recent turmoil in the capital markets, and temporary relief provided by the Internal Revenue Code expired on December 31, 2010.

Current Regulations and the Over-the-Counter Market

Issuers and their tax advisors have had difficulty determining whether a debt instrument or the property for which it was exchanged would be treated as publicly traded under the current regulations, particularly the portions of the regulations dealing with property appearing on a quotation medium or for which price quotations are readily available from dealers, brokers, or traders. The current regulations define a "quotation medium" as a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders, or actual prices (including rates, yields, or other pricing information) of recent sales transactions.

In the current debt markets, trades commonly are executed over the counter in negotiated transactions between customers and securities brokers or dealers. The over-the-counter markets are relatively informal: Price quotations provided by a broker or dealer may be firm or executable quotes, or instead may be soft or indicative quotes signaling the willingness of the broker or dealer to trade a particular debt instrument, and some indication of its value, but not a firm price. Subscription and online services compile a variety of data relevant to a debt instrument's value, including actual trades, firm and indicative price quotes, and other available information. Notwithstanding the wide availability of quotation information that currently exists, the current regulations have not been considered by issuers and tax practitioners to give sufficient guidance as to whether or not a debt instrument is publicly traded.

Broad Standard under Proposed Regulations

In the preamble to the proposed regulations, the Treasury and the Internal Revenue Service take the position that the "traded on an established market" standard of Section 1273(b) should be interpreted broadly, on the grounds that the improved depth and transparency of the debt markets have diminished concerns that the trading prices of debt instruments may not reflect their fair market value. Thus, the preamble states, "to the extent accurate pricing information exists, whether it derives from executed sales, reliable price quotations, or valuation estimates that are based on some combination of sales and quotes, the Treasury and the IRS believe that that information should be the basis for the issue price determined under Section 1273(b)(3)."

The proposed regulations identify four ways for property to be traded on an established market. In each case, the time period for determining whether the property is publicly traded is the 31-day period ending 15 days after the issue date of the debt instrument (the "window period"). To be publicly traded,

Continued on page 2...

during the window period (1) the property must be listed on an exchange, (2) a sales price for the property must be reasonably available, (3) there must be one or more firm quotes for the property, or (4) there must be one or more indicative quotes for the property. These four concepts are discussed more fully below. A debt instrument is not treated as traded on an established market solely because it is convertible into property that is so traded.

There are two exceptions to this expanded definition of publicly traded, for *de minimis* trading and small debt issuances, which also are discussed more fully below.

Exchange-Listed Property

First, exchange-listed property is publicly traded. Most debt instruments are not listed on exchanges, but it nevertheless could be the case that the property in exchange for which a debt instrument is issued is so listed, such as the stock in a stock-for-debt exchange. To be treated as exchange-listed property, the property must be listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934; a board of trade designated as a contract market by the Commodities Futures Trading Commission; a foreign securities exchange that is officially recognized, sanctioned, regulated, or supervised by a governmental authority of the foreign country in which the market is located; or any other exchange, board of trade, or other market that the Commissioner of Internal Revenue identifies in published guidance as an exchange.

Sales Price

Property is publicly traded if a price for an executed purchase or sale is reasonably available. For this purpose, the proposed regulations provide that the sales price of a debt instrument is considered reasonably available if the price (or information sufficient to calculate it) appears in a medium that is made available to persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers), or persons that broker purchases or sales of debt instruments. The preamble uses as an example of public trading under this rule a sale of a debt instrument that is reported electronically in the Trade Reporting and Compliance Engine (TRACE) database maintained by the Financial Industry Regulatory Authority. Other pricing services and trading platforms that report prices of executed trades (whether to subscribers or the general public) also would result in public trading if the reported trades were within the window period.

Firm Quote

Property is publicly traded if one or more price quotes for the property are available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers), and the quoted price is substantially the same as the price for which the property could be purchased or sold. A price quote will be considered a firm quote for this purpose if market participants typically purchase or sell at the quoted price, even if not legally obligated to do so. The identity of the person providing the quote must be reasonably ascertainable.

Indicative Quote

Property is also publicly traded if one or more price quotes for the property are available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers), even if the price quote is not a firm quote as described above. Although there is a presumption in the proposed regulations that the property's trading price, sales price, or quoted price is its fair market value (with multiple prices or quotes reconciled in a reasonable manner), if only indicative quotes are available, and the taxpayer determines that the indicative quote (or an average of the 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 property's fair market value. The taxpayer must establish that the chosen method more accurately reflects the property's fair market value than the indicative quote or quotes. A volume discount or control premium for an equity or debt instrument is not considered to create a material misrepresentation of value for this purpose.

Exceptions for *De Minimis* Trading and Small Debt Issuances

As noted above, there are two exceptions to the expanded definition of publicly traded under the proposed regulations. Under the first exception, property will not be treated as publicly traded if there is no more than *de minimis* trading of the property. A debt instrument will be treated as traded in *de minimis* quantities only if each trade during the window period is for quantities of US$1 million or less, and the aggregate of all such trades does not exceed US$5 million. Among other debt instruments, the *de minimis* trading exception may cover certain syndicated bank debt, such as revolving credit facilities, which trade infrequently.

Under the second exception, a debt instrument will not be treated as publicly traded if the original stated principal amount of the issue that includes the debt instrument does not exceed US$50 million.

If you have any questions regarding the tax consequences of a debt-for-debt exchange or any modification of a debt instrument under the current or proposed regulations, please contact Eileen Marshall, any other member of the firm's tax practice, or your regular Wilson Sonsini Goodrich & Rosati contact.

Continued on page 3...

Proposed Treasury Regulations . . .

Continued from page 2...

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