A Washington National Tax Services (WNTS) Publication

WNTS Insight

Proposed regulations would provide updated guidance on debt restructuring issue

February 14, 2011

In a debt-for-debt exchange, the tax consequences to the borrower and holder depend on the "issue price" of the new debt, which in turn depends on whether the old or new debt is "publicly traded," i.e., traded on an established market. The IRS recently released proposed regulations addressing when property is treated as publicly traded for purposes of determining the issue price of a debt instrument. If finalized as proposed, the regulations would significantly expand the current definition of "publicly traded." When finalized, the proposed regulations will apply to debt instruments issued on or after the date the final regulations are published in the Federal Register.

Observations: The existing 1.1273-2 regulations, issued in 1994, are difficult to apply to modern financial markets. The proposed regulations would provide welcome guidance on one debt restructuring issue needing clarification. However, they would not resolve the cancellation of indebtedness (COD) income and "AHYDO" interest limitation issues that borrowers now face in distressed debt restructurings in light of the expiration of the relief granted by sections 108(i) and 163(e)(5)(F).

Background: What's at stake?

Debt restructurings often involve an actual exchange of new debt for old debt, or a deemed exchange that occurs when the terms of the debt are modified to an economically significant degree. For the borrower, the tax consequences of the exchange are measured based on the difference between the "adjusted issue price" of the old debt and the issue price of the new debt. If the issue price of the new debt is less than the adjusted issue price of the old, a borrower realizes COD income in the year of the exchange. If the issue price of the new debt exceeds the adjusted issue price of the old, a borrower realizes a repurchase premium that is deductible in the year of the exchange if the debt is publicly traded (or spread over the term of the new debt if it is not).

A borrower also accounts for the new debt by reference to its issue price. If the issue price is less than the new debt's "stated redemption price at maturity," the difference is taken into account in the form of original issue discount (OID) deductions over the new debt's term. These OID deductions may be limited under sections 163(e)(5) and 163(i) in some cases (the so-called "AHYDO rules").

The same construct is used to determine a lender's tax consequences. However, a lender's gain or loss realized is generally capital, and may not be recognized if the exchange qualifies as a reorganization. Thus, in situations in which lenders are restructuring publicly traded distressed debt, the potential for whipsaw exists -- capital loss on the old debt and ordinary OID income over the term of the new debt. In practice, however, lenders are less likely to be affected because they often are subject to mark-to-market accounting (dealers or traders), are tax exempt (pension funds), or are not subject to U.S. tax (foreign investment funds).

The bottom line is that in a debt-for-debt exchange (whether actual or deemed), the tax consequences to the borrower and lender hinge on the issue price of the new debt. The issue price, in turn, depends on whether the old or new debt is publicly traded. Not surprisingly, the fair market value of debt issued by a distressed borrower is usually less than its adjusted issue price. Thus, if a distressed borrower's debt is publicly traded, the exchange generates COD income and potentially limited OID deductions. (Relief was previously available for these consequences under sections 108(i) and 163(e)(5)(F), resulting in less pressure to resolve whether the debt in question was publicly traded or the amount that should represent fair market value.)

Ambiguity under existing regulations

The term "publicly traded" may suggest a security traded on an exchange. And, as expected, the existing definition of publicly traded includes SEC-registered debt that is listed on an exchange. However, most debt instrument trades are executed over-the-counter by investment banks making markets for specific issues.

In these privately negotiated transactions, a purchase or sale typically occurs on the basis of a quote. Quotes may be "firm" -- an offer at a specific price that can be accepted by the other party -- or "soft / indicative" -- a price at which the buyer or seller may be willing to pay, but conditioned on the specific terms. In addition, pricing models and data compiled by third-party service providers (available by subscription or on-line) have played an increased role in recent years in facilitating trades in the over-the-counter debt markets. The 1994 regulations have been criticized as being outdated and unclear in light of developments in the over-the-counter market.

Specifically, the current regulations (Reg. sec. 1.1273-2(f)(4) or Reg. sec. 1.1273-2(f)(5)) provide that a debt instrument is publicly traded if:

- It appears on a quotation medium 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, *or*

- A price quotation is readily available from dealers, brokers, or traders, the debt is part of an issue that exceeds $25 million, and the borrower has other debt that is considered publicly traded and does not have materially more restrictive covenants or a maturity date more than three years earlier.

Observation: In practice, these current rules are difficult to apply to modern financial markets. For example, Markit (or other data providers) may provide the date, volume, and parties to a trade -- but without an actual price. Likewise, quotes may be available but may not identify the broker or dealer providing them. The proposed regulations would (if finally adopted) expand and clarify the definition of publicly traded.

"Publicly traded" under the proposed regulations

The revised definition of publicly traded is based on four new categories that are subject to two new safe harbors (and a largely unchanged anti-abuse rule). Under the proposed regulations, unless the debt instrument meets one or more of the two safe harbors discussed below, it will be publicly traded if at any time during a period of 31 days ending 15 days after the issue date (the "testing period"):

- It is listed on a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (e.g., NYSE, NASDAQ, CBOE, CSE, the National Stock Exchange, or the International Securities Exchange), on a board of trade designated as a "contract market" by the Commodities Futures Trading Commission (e.g., CBOT, NYME, or CME), or on any foreign securities market that is officially recognized, sanctioned, regulated, or supervised by a governmental authority of the foreign country in which the market is located, or on any other exchange, board of trade, or other market identified by the IRS in published guidance;

- The sales price for an executed purchase or sale appears in a medium that is made available to brokers or persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers);

- One or more "firm" price quotes are available from at least one identified broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers), and the price is substantially the same as the price for which the property could be purchased or sold; *or*

- One or more "indicative" price quotes are available for the debt instrument from at least one broker, dealer, or pricing service.

A debt instrument meeting one or more of the tests above will *not* be publicly traded if it meets either of the following conditions (translated into the relevant foreign currency if the debt is not U.S. dollar-denominated):

- During the testing period, each trade of the debt instrument is for $1 million or less and the aggregate amount of all trades is $5 million or less; *or*

- The stated principal amount of the issue that includes the debt instrument does not exceed $50 million

Observations

There are several points worth noting about the revised definition. First, the preamble to the proposed regulations provides that the publicly traded standard should be interpreted broadly because the improved depth and transparency of the debt markets has diminished concerns that the trading price of debt instruments may not reflect their fair market value. It is unclear whether the IRS will apply this standard in resolving ambiguities under the existing regulations.

The *exchange-listed category* does not represent a significant departure from the existing regulations -- it essentially eliminates obsolete references and consolidates into one category what was previously listed under two categories. The *executed sales price category* (like its predecessor under Reg. sec. 1.1273-2(f)(4)) does not address the question of what constitutes a "medium." The preamble includes the TRACE system as the only example, but arguably Markit, Bloomberg, SMi, LSTA, and the "daily runs" produced by the trading desk of a syndicating bank should qualify as well. However, this may be irrelevant because it is reasonable to infer that if an actual sales price is reasonably available, so too will be "firm" or "indicative quotes" (resulting in a publicly traded characterization under one of those categories).

Establishing fair market value under the proposed regulations

The proposed regulations presume that the trading price, sales price, quoted price, or indicative price represents the debt's fair market value (FMV) and is therefore used to determine its issue price. However, if there is more than one price, taxpayers could use any consistently applied reasonable method to determine the price. Similarly, if only an indicative quote (or average of quotes) is available which the taxpayer determines materially misrepresents the FMV, any method that provides a reasonable basis to determine the FMV could be used.

Observations: While volume discounts and control premiums are deemed not to materially misrepresent FMV under the proposed regulations, it is unclear when the standard should apply. For financial reporting purposes, guidance in this area suggests quotations should be given less weight during periods of thin trading. (FSP FAS 157-3, 157-4).

For more information on this WNTS Insight, please contact Brian Ciszczon at (202) 414-4656 or brian.j.ciszczon@us.pwc.com, Rebecca Lee at (415) 498-6271 or rebecca.e.lee@us.pwc.com, Jeff Maddrey at (202) 414-4350 or jeffrey.maddrey@us.pwc.com, David Shapiro at (202) 414-1636 or david.h.shapiro@us.pwc.com, or Michael Yaghmour at (202) 414-1317 or Michael.yaghmour@us.pwc.com.

Link to WNTS Insight archive: http://www.pwc.com/us/en/washington-national-tax/newsletters/washington-national-tax-services-insight-archives.jhtml

pwc.com/wnts