Proposed Tax Regulations Affecting Debt-for-Debt Exchanges and Debt Restructurings

I. Overview

On January 6, 2011 the U.S. Treasury Department and the Internal Revenue Service (the "IRS") published proposed regulations interpreting the definition of "traded on an established securities market." That term is significant in determining the tax consequences of debt-for-debt exchanges, debt restructurings, and other transactions in which debt is issued or deemed issued in exchange for other property. Very generally, the proposed regulations will govern whether or not debt issued in such transactions has an issue price equal to its fair market value (or the fair market value of the property exchanged for it). Although applicable to all issuers, the proposed regulations have the indirect effect of significantly increasing the likelihood that a U.S. issuer of relatively illiquid outstanding bonds or loans that trade for less than par will recognize "cancellation of debt" income in an exchange or restructuring of that debt. The proposed regulations also diminish the risk that secondary market investors will recognize uneconomic gain in such transactions.

By way of background, the U.S. federal income tax treatment of a debt-for-debt exchange (or a modification of debt terms that is treated for U.S. federal income tax purposes as a deemed exchange of the old unmodified debt for the new modified debt) generally depends, for both the issuer and creditors, on whether the new or old debt is "traded on an established securities market" (generally referred to as "publicly traded"). Under current law, bonds are more likely to be considered publicly traded than loans.

For an issuer, the outstanding debt that is exchanged or modified is treated as retired for fair market value if either that debt or the new debt is "publicly traded." Otherwise, the old debt generally is treated as retired for par. Consequently, a broad definition of "publicly traded" increases the likelihood that outstanding debt trading for less than par will be treated as retired at a discount, giving rise to cancellation of debt income ("COD income"). In such a case, the new debt would be treated as issued at a similar discount, giving rise to original issue discount ("OID") deductions to the issuer over the term of the new debt.

As a result, if a U.S. issuer exchanges or restructures loans or other debt that is valued at less than par, but not treated as publicly traded under current law, a broadened "publicly traded" definition will make it more likely that the transaction will create current taxable income matched by a deferred deduction. If a large amount of OID is created, moreover, the "applicable high yield discount obligation" ("AHYDO") rules may apply, causing the OID deduction to be deferred until the OID is paid, and potentially disallowing a portion of the OID deduction altogether. Accordingly, a broad definition of "publicly traded" can be expected to increase the tax costs of debt-for-debt exchanges or debt restructurings for financially troubled U.S. issuers.[1] This may be particularly problematic for debt workouts by partnerships because many exclusions for COD income (*e.g.*, insolvency or bankruptcy) are determined at the level of the *partner* and not the partnership itself.

For a creditor, a broad definition of "publicly traded" may be preferable, because it allows the creditor's gain or loss on a debt-for-debt exchange or debt restructuring to be measured by reference to the fair market value of the debt and thus to correspond to the creditor's economic gain or loss from the transaction. By contrast, if neither the old nor the new debt is treated as publicly traded, the creditor generally would be treated as disposing of the old debt for the par amount of the new debt received, which would give rise to uneconomic gain if the creditor purchased the old debt at a discount. In practice, the aggregate benefits to U.S. investors of a broad definition of "publicly traded" may be less than the aggregate costs to U.S. issuers, because many investors in debt instruments are not subject to U.S. federal income tax on gain because they are tax-exempt or foreign investors or are otherwise tax-indifferent. Moreover, many bond exchanges or restructurings qualify as tax-free recapitalizations in any event.[2]

The proposed regulations would make the following changes to the tax law governing debt-for-debt exchanges, debt restructurings, and related transactions:

- *Definition of Public Trading*. Generally, the proposed regulations define publicly traded property to mean any property that is subject to more than *de minimis* trading if (i) it is listed on a domestic or foreign regulated securities

[1] If a corporate issuer has net operating losses or is in bankruptcy, it may not be required to pay tax on the COD income. In such a case, the COD income will, however, reduce favorable tax attributes such as the NOLs, and that may in turn reduce the deferred tax assets on the company's balance sheet. A special statutory rule that was in effect in 2009 and 2010 allowed COD income to be deferred, but it has not been extended.

[2] Whether or not a debt-for-debt exchange qualifies as a tax-free recapitalization, if the issue price of the new debt is measured by reference to its fair market value (or the fair market value of the old debt) and is significantly below its par value, market discount on the old debt will generally become OID on the new debt. Since market discount is typically not recognized until a debt instrument is sold or exchanged, while OID is included in income as it accrues, this would have the effect of accelerating income for creditors who purchased the old debt at a discount.

exchange, (ii) the price for an executed sale of the property is reasonably available, or (iii) there are firm or indicative price quotes available from brokers or dealers with respect to the property. This definition would remove many of the ambiguities of the current definition of "publicly traded," and in that regard is responsive to requests by taxpayers, who have found it increasingly difficult to apply the current rules.

- Trading in a debt instrument would be treated as *de minimis* if (i) there are no trades of the debt instrument during the 31 day period ending 15 days after the issue date (the applicable 31-day period) exceeding $1 million, and (ii) *total* trades during that period are $5 million or less.

- *Broadened Scope*. We understand that the broadening of the "publicly traded" definition is based on the government's understanding that liquidity in the fixed income market has increased greatly since the current regulations were adopted, and on the government's belief that the tax consequences of debt-for-debt exchanges and debt restructurings should be determined by reference to the fair market value of the debt as long as some credible evidence of that fair market value is available to market participants. As described in more detail below, however, in the form proposed, the new rules do not include a general requirement that available prices accurately reflect fair market value. Consequently, if not revised to conform more closely to what we understand is the intent of the rules, subject to the small issue exception described below, the proposed regulations effectively may generally treat virtually all bonds or loans as "publicly traded" as long as the *de minimis* trading standard is satisfied. Conversely, the *de minimis* trading rule may cause debt that trades infrequently but that can in fact readily be valued through dealer quotes to be treated as not publicly traded.

- *Lack of COD Income Relief.* No relief is provided for the additional COD income that would result from the broadening of the definition of publicly traded property. We understand that government officials consider that issue to be one that would need to be addressed under other provisions of the law. It is possible that the government will consider providing such relief in connection with another project under way to provide guidance on tax issues in connection with distressed debt.

- *Exception for Small Issues.* Regardless of how the rules described above would otherwise apply, debt instruments in an issue will not be considered to be publicly traded if the original stated principal amount of the issue was $50 million or less. In the case of a bond issuance or loan facility that includes multiple debt instruments with different terms, the test would apply separately to each group of identical debt instruments. It appears that this rule was intended to simplify the analysis for debt of a kind unlikely to be publicly traded in any event, and to prevent abuse in such cases. This rule may need to be modified, however, in order to avoid treating debt instruments that in fact trade regularly, but on a pooled basis, as *per se* non-publicly traded.

- *Valuation Presumption*. Unlike current law, the proposed regulations establish a presumption that the fair market value of publicly traded property is equal to the exchange-traded price, sales price, or quoted price, as the case may be. Special rules apply when indicative quotations constitute the basis for treating a debt instrument as publicly traded, in recognition of the fact that indicative quotations may vary considerably from the price at which a purchase or sale transaction would actually take place.

- *"Recent Sales Transaction" Rules.* The proposed regulations will prevent a debt instrument from being treated as publicly traded solely by reason of a purchase of debt shortly before a debt-for-debt exchange or debt restructuring, under the "recent sales transaction" rules.

- *"Qualified Reopening" Rules.* The proposed regulations also address an unrelated question relating to further issuances ("reopenings") of outstanding debt. If the reopening is a "qualified reopening," the new debt will be treated as identical for U.S. federal income tax purposes with the original debt, allowing the original and new debt to trade as a more liquid single issue with a greater outstanding principal amount. Under current law, the original debt must be publicly traded in order for the reopening to constitute a "qualified reopening." The proposed regulations would provide that a reopening where debt is issued for cash to unrelated persons also can qualify as a "qualified reopening."

- *Effective Date*. The new regulations are proposed to apply to debt issued on or after the date that final regulations are issued. Consequently, the new rules would apply to a restructuring or exchange of outstanding debt, if the new debt is issued or deemed issued on or after that date.

II. Definition of "Traded on an Established Securities Market"

Under current law, debt instruments generally are treated as publicly traded if, at any time during the 60-day period ending 30 days after the issue date, either (i) they are listed on a U.S. national securities exchange or a limited number of specified foreign exchanges, (ii) they are traded in the interbank market, (iii) they appear on a system of general circulation open to market participants that provides a reasonable basis to determine fair market value based on either recent price quotations of identified brokers or dealers or actual sales prices, or (iv) price quotations for the debt are readily available from brokers or dealers, subject to certain safe harbors. There is widespread confusion as to what constitutes an "interbank market" or a qualifying "system of general circulation" for this purpose, and as to the breadth of the broker quotation rule.[3]

Under the proposed regulations, property will generally be publicly traded if there is more than *de minimis* actual trading in the property within the applicable 31-day period and at any time within that period either (i) the property is listed on a regulated domestic or foreign exchange ("exchange listing" rule), (ii) the price for an executed purchase or sale of the property is reasonably available ("sales price" rule), (iii) a "firm quote" for the property is available, *i.e.*, a price at which an identified broker or dealer would be willing to buy or sell the property ("firm quotation" rule), or (iv) a price quote for the property is available from a broker, dealer or pricing service that is not a firm quotation ("indicative quotation" rule).[4] As described in more detail below, these criteria are so inclusive that the determination of whether a debt instrument is treated as publicly traded will in many cases hinge primarily on whether more than *de minimis* trading exists.

As a matter of statutory construction, these rules appear to take the position that, as long as there is sufficient trading in a debt instrument, only in very limited cases will the trading fail to be considered to be "on an established securities market." We understand that the government believes that its regulatory power to apply the statutory language in this manner may be founded in part on the statutory authority granted to it under section 1275(d), which grants broad powers to vary the specific rules of sections 1271-1275 to the extent appropriate to carry out the purposes of the OID rules, although section 1275(d) is not referred to in the proposed regulations or the preamble thereto.[5]

De Minimis Trading. As described above, trading in a debt instrument within the applicable 31-day period generally will be treated as *de minimis* if the quantity of each such

3 Two recent reports by the New York State Bar Association's Tax Section describe the difficulties of applying the current law standard. New York State Bar Association Tax Section, Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273 and Related Issues (2010); New York State Bar Association Tax Section, Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273 (2004). The proposed regulations appear to have drawn much of their inspiration from the recommendations of these reports, although the rules provided by the regulations are broader than those recommended by the bar association and do not include the COD relief recommended in the reports.

4 The proposed regulations retain the anti-abuse rule from the current regulations, which disregards any temporary restrictions imposed on the trading of property to prevent the property from being treated as publicly traded. The proposed regulations also add an anti-abuse rule that provides that a sales price or quote "may be disregarded" if a "principal purpose for the existence of any sale or price quotation is to materially misrepresent the value of property." Note that this new rule does not apply merely because the purpose of a price or quote is to allow debt to be treated as publicly traded.

5 Citations to sections are to sections of the Internal Revenue Code of 1986, as amended.

trade is $1 million or less, unless the aggregate amount of trades exceeds $5 million.[6] This rule applies solely with respect to debt instruments. Consequently, a small number of small trades will not satisfy the requirement that property be traded on an established securities market. In practice, this rule treats purchases and sales of a debt instrument by retail investors as insufficient to cause the debt to be treated as publicly traded, unless those transactions exceed the $5 million mark in the aggregate. A single trade of more than $1 million within the applicable 31-day period – typically, a trade by an institutional investor – will, however, be treated as non-*de minimis*.

The *de minimis* rule is phrased as an exception to the general rule, which is that property satisfying any of the exchange listing, sales price, firm quotation or indicative quotation rules is treated as publicly traded. It was presumably intended to narrow the expansiveness of the definition in order to exclude cases where no reliable information about the fair market value of the property is in fact available. For example, a debt instrument might be listed on an exchange that does not impose trading volume-related requirements, or a recent sales price might reflect a disposition of a minimal amount by an individual investor at a price not reflective of the price larger amounts of the property would sell for. Additionally, an indicative quote without any contemporaneous actual trading may not be a reliable indicator of value.

The 31-day period for testing whether *de minimis* trading has taken place, or more generally for testing whether the conditions for satisfying the public trading test are met, is more limited than the 60-day period provided by current law. The narrowing of the time period for testing public trading status presumably reflects a judgment that events taking place more than 15 days from the issue date do not provide a sufficiently reliable basis for making that determination. The shorter time period also makes determining the precise issue date in a debt-for-debt exchange more significant for its tax treatment.

One practical issue in applying the *de minimis* rule is that it requires accurate information about trading done through any kind of market mechanism (and in theory whether or not reported through some kind of medium available to a wide group). For example, even if a system of general circulation reports the price of actual sales, if the sizes of those trades are not reported, it is unclear how a taxpayer would determine whether the trading is *de minimis*.

Exchange Listing Rule. Property is listed on an exchange for purposes of the proposed regulations if it is listed on a national securities exchange, a board of trade

[6] The rule refers to "quantities" of trades, which would seem to mean the principal amounts, but that is not clear. The issue price of an issue of debt issued for non-traded property is based on the fair market value of the issued debt only if a "substantial amount" of the issue is publicly traded. It is not clear how this rule interacts with the new *de minimis* test.

designated as a contract market by the CFTC, or a foreign securities exchange that is "officially recognized, sanctioned, regulated or supervised" by a foreign governmental authority. Additionally, the Commissioner may identify in guidance additional exchanges, boards of trade, or other markets that will qualify for purposes of this rule.

Because property need only be "listed" and not "traded" on an exchange, this requirement may be met by exchanges that do not impose minimum requirements for the number of holders or other terms intended to ensure that there is active trading in the property. For example, a number of foreign exchanges on which debt is frequently listed have listing requirements that focus primarily on the adequacy of disclosure. Consequently, under the proposed regulations, debt may be treated as publicly traded if it is listed on such an exchange and there is more than *de minimis* trading on or, more likely, off of the exchange—for example, a single trade of more than $1 million—within the applicable 31-day period. In practice, this seems to reduce the publicly traded test to a requirement to satisfy the *de minimis* trading requirement.

Under current law, listing on certain specified foreign exchanges also is sufficient for property to qualify as publicly traded. The list of permitted foreign exchanges is very short, however. Because the proposed regulations include many more foreign exchanges, they would result in many more debt instruments meeting the requirements of the exchange listing rule. For example, the list of permitted foreign exchanges under current law does not include the Luxembourg Stock Exchange, which lists thousands of bonds that have been sold in the European markets.

Sales Price Rule. As described above, generally a sales price exists with respect to property if the price for an executed purchase or sale of the property is reasonably available. The proposed regulations contain a special rule for debt instruments that provides that a debt instrument's sales price will be "reasonably available" if it appears in a medium that is made available to brokers or persons who regularly buy and sell debt instruments. A subscription medium, or a medium provided only to certain customers, can meet this requirement.

The most obvious medium satisfying these requirements is the TRACE system operated by FINRA for SEC-registered debt. Under current law, TRACE constitutes a "system of general circulation" that causes debt to be treated as publicly traded, but only if the information available on TRACE provides a reasonable basis to determine fair market value. The proposed regulations drop the requirement that the available information provide a reasonable basis to determine value, but effectively replace it with a requirement of some substantial trading.

In some case, investors and issuers will not have equal access to information about sales, or even price quotations. Investors may subscribe to electronic data services that provide such information, for example, while issuers ordinarily would not. In cases where a debt instrument is relatively illiquid, therefore, there may be circumstances where an issuer may find it difficult to determine whether there has been a recent sale even if that information is reasonably available to other parties, within the meaning of the proposed regulations. The proposed regulations appear to contemplate that debt may be treated as publicly traded if pricing information is available to investors without regard to its availability to issuers. As a result, it is not clear under the proposed regulations when an issuer can rely upon available information and its lack of knowledge regarding recent sales to treat its debt as not being publicly traded. For example, a borrower under a loan may frequently be unaware that a lender has sold a participation in the loan that is treated as a sale of part of the loan for U.S. federal income tax purposes.

Firm Quotation Rule. A firm quote exists with respect to property if (i) a price quote is available from at least one broker, dealer, or pricing service (including a price quote available only to certain customers or subscribers), (ii) the quoted price is substantially the same as the price for which the property could be purchased, and (iii) the identity of the person making the quote is reasonably ascertainable.[7] Included are prices made available only to certain customers or subscribers. A quotation may be a firm quotation even if there is no legal obligation on the part of the person making the quote to transact at that price, if market participants typically in fact buy or sell at the quoted price.

This rule is broadly comparable to current law's rule that a debt instrument is publicly traded if quotations from brokers or dealers are readily available for the property, except that many market participants do not consider the current law rule applicable to most debt instruments because of additional "safe harbor" provisions.

Indicative Quotation Rule. An indicative quote is any price quote that is available from at least one broker, dealer or pricing service (even if it is available only to certain customers or subscribers) that is not a firm quote. Unlike a firm quote, therefore, an indicative quote may be one where the identity of the person making the quote is unknown, and there is no requirement that the indicative quote bear any specified relationship to the price at which the person making the quote would in fact buy or sell the property. For example, there is no requirement that an indicative quote be one that provides a reasonable basis for determining the fair market value of the property or that indicative quotes be "readily" available.[8] It is not clear how much of an issue this will be in practice, because if

[7] Presumably it is necessary that the identity be reasonably ascertainable only to those receiving the quotations and not the general public.

[8] In a 2010 report on the "publicly traded" rules (cited in note 3, above), the New York State Bar Association's Tax Section recommended that for indicative quotes to provide a basis to treat property as publicly traded, they should be "readily available" and provide a reasonable basis for the issuer to determine the fair market value of the debt instrument.

property passes the *de minimis* trading test, there is necessarily some actual trading in the property and indicative quotes will presumably generally reflect that trading. That said, in the case of illiquid debt of a distressed issuer, fire sales, or other special circumstances, quoted prices can diverge greatly from actual sales prices.

The reference to pricing services is significant, because there are dozens of electronic data services providing estimated prices or quotes for bonds (*e.g.*, "daily runs" sent by dealers through Bloomberg), most of which are indicative. The LSTA/LTC Mark-to-Market service and Markit pricing service provide pricing information (but not actual trading prices) with respect to loans.

The proposed regulations' inclusion of indicative quotes as a mechanism by which property may be publicly traded is the principal reason that the proposed redefinition of the term "traded on an established securities market" is so much broader than current law. It is telling in this regard that there is a special pricing rule, described in more detail below, which applies if a taxpayer determines that an indicative quotation materially misrepresents the fair market value of the property. It appears that a single indicative quotation from a broker, dealer or pricing service that bears only a distant relationship to the price at which anyone would in fact buy or sell the property is sufficient to cause a debt instrument to be publicly traded, as long as the *de minimis* trading test is satisfied. This seems again largely to reduce the proposed rules essentially to a single test, which is whether the *de minimis* trading test is satisfied.

III. Small Debt Issuance Exception

Notwithstanding the rules described above, a debt instrument is not treated as publicly traded under the proposed regulations if the "original stated principal amount" of the issue that includes the debt instrument is $50 million or less. This rule apparently reflects an expectation that smaller issues of debt instruments generally are illiquid and therefore should not be treated as publicly traded irrespective of whether, for example, a reported sale for more than the *de minimis* amount was made within the applicable 31 day period. The rule thus operates in part as a simplification of the publicly traded test, and in part as an anti-abuse rule.

There may be some limited cases, however, where the premise underlying the $50 million limitation is not correct. For example, we understand that in the residential mortgage market, pools of whole loans with similar economic terms are traded in a manner that would satisfy the publicly traded test if the $50 million threshold applied on a pooled basis. For debt instruments of that kind, it would appear to be more appropriate to apply the $50 million threshold to the pool rather than to each whole loan. In the absence of such a rule, an investor that buys a pool of whole residential mortgage loans at a discount and restructures them would realize uneconomic gain if the value of the restructured loans is still less than par.[9]

Some technical corrections may also be necessary for the small debt issuance exception to work as intended. The rule refers to the "original stated principal amount" of the debt. In the case of newly issued debt, that standard is appropriate. If the debt being tested is outstanding debt, however, it may be more appropriate to look to the outstanding principal of the debt at that time, giving effect to intervening redemptions of the debt that reduced its outstanding principal amount or reopenings that increased its outstanding principal amount.

IV. Valuation of Publicly Traded Property

The proposed regulations not only provide rules governing when property will be considered publicly traded, but also, unlike the current regulations, provide useful guidance for determining what the value of such property will be presumed to be. Under the proposed regulations, the fair market value of publicly traded property would be presumed to be equal to the trading price on the listing exchange or the relevant sales price or quote, depending on the rule under which the property qualified as publicly traded. If there is more than one such price available, the taxpayer can use "any reasonable method, consistently applied" to determine the price, and thus the presumed fair market value.[10] Presumably, such a reasonable method would have to reflect the available trading, sales, or quoted prices.

The proposed regulations provide a special rule for publicly traded property for which only prices from indicative quotes are available. If the quote (or average value of quotes) "materially misrepresents" the property's fair market value, the taxpayer may use another reasonable method, which the taxpayer must demonstrate more accurately reflects

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[9] In a transaction of this kind, the disparity between the knowledge available to the investor and to the issuer may be particularly acute. That is true under current law as well.

Another case where the premise underlying the $50 million limitation may not be correct is with respect to securitized debt. An offering of debt by a securitization vehicle may be quite large in the aggregate but divided into small tranches that would qualify as separate issues. Under current market conditions, we understand that there is a reasonably active market for such debt, and that, absent the small debt issuance exception, those tranches might be treated as publicly traded under the proposed regulations. Because debt of this kind is rarely restructured or the subject of an exchange offer, however, it appears that treating debt of this kind as per se not publicly traded is not likely to have a significant real-world effect.

[10] In the case of exchange-listed debt instruments, this valuation rule technically applies only to prices for debt traded *on* the exchange. It seems likely that prices for off-exchange trades were intended to be covered by the valuation rule as well.

its fair market value. In view of the fact that this rule applies only when a debt instrument is not listed on an exchange, does not have recent sales prices reasonably available, and there are no firm quotations for the debt, it is not clear what other types of information taxpayers will be permitted to rely upon and how a taxpayer could establish that its valuation is *more* accurate.

The proposed regulations do not address situations in which different taxpayers elect to use different reasonable methods to determine the price of property, either in the case where more than one trading, sales, or quoted price exists or when an indicative quote materially misrepresents the value of property. For example, there is no rule requiring investors to adopt the same valuation as an issuer, or to provide an explanation if they use a different valuation. In the case of a debt-for-debt exchange involving thinly traded debt that satisfies the expanded definition of publicly traded property, issuers may have an incentive to use a high value (to reduce COD income) while investors may have an incentive to use a low value (to minimize gain or maximize loss).

V. Application of "Recent Sales Transaction" Rule

Generally, in a debt-for-debt exchange where neither the new debt nor the old debt is publicly traded, the issue price of the new debt will be its stated principal amount, if it pays adequate stated interest, or an imputed principal amount determined by discounting its scheduled cash flows at a specified risk-free rate otherwise. However, in a "potentially abusive situation", the imputed principal amount of a debt instrument issued for property will be based on the fair market value of such property, and the imputed principal amount will be treated as the issue price if it is less than the stated principal amount. A potentially abusive situation includes a "recent sales transaction." As a result, the "recent sales transaction" rule provides an alternative mechanism by which debt can be issued for property with a fair market value issue price, even if neither the debt nor the property it is issued for is publicly traded.

Under current law, some taxpayers who acquire a non-publicly traded debt instrument at a discount and shortly thereafter significantly modify the debt instrument in a workout transaction (in a transaction treated as a debt-for-debt exchange) take the position that the "recent sales transaction" rule applies to treat the issue price of the new debt as the fair market value of the old debt rather than its face amount. The advantage to the taxpayer would be avoidance of uneconomic taxable gain equal to the excess of the face amount of the modified debt over its fair market value. The gap between face and fair market value can be particularly dramatic where the acquisition discount is due to the impaired creditworthiness of the borrower.

The proposed regulations, however, clarify that debt-for-debt exchanges, including debt modifications, are not subject to the rule governing "recent sales transactions." Specifically, the proposed regulations provide that a debt-for-debt exchange will *never* be subject to the "recent sales transaction" rule, regardless of whether the taxpayer (or apparently any other person) recently purchased the old debt. Where the debt does not qualify as publicly traded (either because it is not listed and no sales price or quote exists or because the *de minimis* rule applies), a holder would be left with no alternative but to treat the stated or imputed principal amount of the debt as the amount realized from the debt-for-debt exchange. This can be particularly significant for modifications of mortgages purchased as part of a pool of loans that individually can never be treated as publicly traded under the proposed regulations because of the small issue exception.

VI. Qualified Reopening Rules

Because debt with a higher outstanding principal amount is likely to be more liquid (and therefore less expensive to issue) than debt with a lower outstanding amount, an issuer may prefer to issue new debt with terms identical to one of its outstanding debt issuances rather than to issue debt with new, at-market terms. The proposed regulations contain a modification to the current law applicable to such reopenings that is intended to remove a potential tax obstacle.

In order to achieve the goal of increasing trading liquidity, the new debt is ordinarily issued under the same CUSIP number as the old debt, so that it is fungible for all relevant purposes. As a matter of market practice, U.S. tax advisors generally permit the new debt to be issued under the same CUSIP number only if the old and new debt have identical tax attributes in the hands of investors (*e.g.*, have the same amount of OID) or the new issuance otherwise does not pose a risk of tax avoidance.

The new and old debt will have identical tax attributes only if the new debt is part of a "qualified reopening" of the old debt. Very generally, current law treats a reopening as "qualified" only if the new debt is not issued with more than *de minimis* OID (or, if the reopening takes place within six months of the original issuance, the new debt does not have significantly more OID than the original debt), in order to ensure that investors are properly taxed on any economic discount resulting from reopening at a discount. Under current law, a qualified reopening can only occur with respect to outstanding debt that is publicly traded.

The proposed regulations would add a rule that provides that a reopening is a qualified reopening if the reopened debt instruments are issued for cash to unrelated persons and the other requirements of the qualified reopening rules are met, even if the original debt is not publicly traded. This proposed rule takes into account that while it is necessary to be able to determine the yield of the reopened debt at issuance in order to achieve the objectives of the "qualified reopening" rule, that yield can be determined by reference to the cash price of the new debt. In such a case, it does not matter whether the old debt is publicly traded.

The proposed regulations also clarify under the qualified reopening rules that, for purposes of applying the rules governing reopening within six months of original issuance and reopening with *de minimis* OID, whether the original debt instruments are publicly traded is tested as of the reopening date.

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Please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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