IRS Regulations Affecting Debt Restructurings, Debt-for-Debt Exchanges, Reopenings and Other Liability Management Transactions

I. Highlights

On September 13, 2012, the U.S. Treasury Department and the Internal Revenue Service (the "IRS") published final regulations that will affect the U.S. federal income tax treatment of debt restructurings, amend-and-extend agreements, debt exchange offers, further issuances of outstanding debt, and other liability management transactions.

- These "publicly traded" regulations will increase the tax cost to some U.S. issuers of restructuring or amending the terms of distressed debt, particularly **syndicated loans**, and may increase the tax cost of such transactions for U.S. investors in illiquid distressed debt, particularly **middle-market loans, whole loans, credit card and other receivables and ABS, MBS and CDO tranches** with outstanding amounts of *$100 million or less*.

- For issuers of **bonds**, however, the regulations provide increased flexibility for further issuances – in tax parlance, "reopenings" – of outstanding debt, particularly debt trading below par.

- The new rules apply to both U.S. and **foreign issuers** and to U.S. investors, including U.S. investors in funds that invest in debt instruments such as **hedge funds.**

These rules will have different effects in different markets, in part because of the different economic characteristics of those markets and in part because of historic tax positions taken in different markets. We summarize those effects below, and then discuss the effect of the regulations on loans, structured finance and whole loan transactions, and bonds in more detail.

- ***Syndicated loans***. The final regulations generally increase the likelihood that a U.S. borrower with loans trading below par will recognize *cancellation of indebtedness income ("COD income")* in an amendment or restructuring of its debt. As a result U.S. borrowers may be required to pay current tax, or may see a deferred tax asset ("DTA") disappear, as a result of a restructuring, even though they still owe the same principal amount and have not gained access to any new cash.

The COD income on the "old" debt generally will be offset by deductions for *original issue discount ("OID")* on the "new" debt if the par amount of the debt is not reduced, but the issuer will suffer a timing mismatch (income today, deductions tomorrow). If the yield on the "new debt" is high, the issuer's interest deductions for the OID may be deferred or disallowed, in which case there could be a permanent tax cost to the amendment or restructuring.

- ***Middle-market loans/"small issue" exception***. For loans or other debt instruments with an outstanding face amount of $100 million or less (a "small issue") that have a value of less than par, the final regulations generally do not treat an amendment or restructuring as giving rise to COD income. However, an investor that purchased the loan for less than par will recognize tax gain in an amount that may exceed – substantially, in the case of highly distressed debt – its economic gain. While that uneconomic tax gain would be offset by a tax loss on the sale of the modified loan, there may be timing mismatches or character differences (ordinary income, capital loss) between the gain and the loss.

- ***ABS, MBS, CDOs, whole loans and receivables***. The "small issue" exception just described may create uneconomic tax gains for investors in restructured or amended mezzanine or junior tranches of MBS, CDOs, and ABS, which often have less than $100 million in principal upon issuance. Investors in pools of whole loans or receivables with individual amounts below that threshold, such as residential mortgages or credit card receivables, similarly will recognize uneconomic gain as the individual loans are restructured. As with middle-market loans, while that uneconomic tax gain would be offset by a tax loss on the sale of the modified loan, there may be timing mismatches or character differences between the gain and the loss.

- ***Corporate and sovereign bonds/further issuances***. The final regulations will apply in the same manner to restructurings and exchange offers for corporate and sovereign bonds as described above, but are less likely to give rise to uneconomic gain to investors or to change the current tax treatment of those transactions if the bonds' outstanding principal amount exceeds $100 million. The regulations may increase the risk that restructurings or exchange offers involving relatively illiquid bonds will give rise to COD income to issuers of bonds trading at a discount, or conversely may permit current deductions for issuers of bonds trading at a premium. Of more general significance is that the regulations provide new opportunities to reopen bonds trading below par, which should allow some issuers more flexibility to increase the liquidity of outstanding bonds and thereby lower their cost of capital.

- ***Increased compliance burdens on debtors***. Borrowers and issuers must use "reasonable diligence" to discover sales and price quotations in order to determine whether debt with a principal amount exceeding $100 million that is the subject of a restructuring, exchange offer or similar transaction qualifies as "publicly traded," and to determine its fair market value. Issuers also must make this information available to investors. Ideally, the information would be provided, possibly through a third party service provider, in a manner readily accessible to market participants for as long as the debt is outstanding.

  Because issuers do not generally have full access to information of this kind, issuers may seek such information from the agent bank, underwriter or other financial institution managing the transaction, with potential liability issues for those institutions. These dynamics may affect liability management negotiations and standard documentation.

- ***Valuations.*** The regulations rely on sales prices and price quotations to establish the fair market value of an issuer's debt, based on the premise that market information, even if imperfect, is the soundest basis for valuation. An issuer generally may use any reasonable method, consistently applied, to determine the fair market value of its debt, which may prove useful where fire sales have occurred or where there is a wide bid-ask spread. If the sole pricing information available consists of indicative quotes, and the issuer believes that those quotes materially misrepresent the fair market value of the debt, the issuer may use another more accurate method to value the debt. If an issuer's reasonable diligence turns up only one sale price or firm price quote during the relevant period, however, that price is presumed correct.

- ***Foreign issuers and borrowers***. The compliance rules described above do not contain an exception for foreign issuers and borrowers, even when a restructuring or the like takes place primarily outside the United States. If an issuer does not provide the required information to investors, then investors must carry out the same diligence described above in order to make their own determination. Accordingly, either a foreign issuer or its U.S. investors will have increased compliance obligations.

- ***Effective dates.*** The final regulations affecting debt restructurings, exchange offers and similar transactions will take effect for transactions carried out *on or after November 13, 2012.*

  The final regulations establishing a more permissive regime for further issuances took effect on September 13, 2012.

As described in more detail below, the principal effect of the regulations is on transactions that amend or modify the terms of a bond or loan, for example by changing coupons or maturities, in such a way that for U.S. federal income tax purposes the debt instrument is treated as retired and a new debt instrument is treated as issued. In transactions of this kind, the issuer may recognize COD income if the "old" debt is treated as retired for its fair market value, which would generally be the case if either the old or new debt is treated as "publicly traded." Conversely, investors may recognize uneconomic gain if the "old" debt is instead treated as retired for its face amount, which would generally be the case if neither the old nor the new debt is treated as "publicly traded."[1]

The new "publicly traded" regulations generally expand the definition of "publicly traded" to include any debt instrument for which there are sales transactions, or for which firm or indicative price quotes are available, within a 31-day period beginning 15 days prior to the issue date for the new debt and ending 15 days thereafter. As a result, they make it more likely that debt, including distressed debt with limited trading, will be treated as retired for its fair market value in a debt restructuring, exchange offer or similar transaction. In the case of debt with an outstanding amount of $100 million or less, however, the regulations treat the "old" debt generally as not publicly traded, and therefore as retired for its par amount.

Part II of this memorandum discusses the effect of the regulations on the loan market, and Parts III and IV discuss their effect on structured finance and whole loan transactions, and on the bond market, respectively. Part V provides a more detailed description of the law.

II. The Loan Market

Market practice has historically tended not to treat loans as "publicly traded." The final regulations are likely to cause most syndicated loans to be treated as publicly traded, especially as a result of the fact that indicative quotes – a term that is very broadly defined – may cause a loan to be publicly traded. However, the small issue exception for loans with an outstanding principal amount of $100 million or less will likely mean that

[1] The discussion in this memorandum assumes that there is no increase or decrease to the principal amount of a debt instrument in a restructuring, exchange offer or the like; that the debt pays adequate stated interest and has a principal amount exceeding $250,000; and that transactions take place on arm's length terms.

many middle-market loans are by law deemed not to be publicly traded. This dichotomy results in a cliff effect, with very different tax treatment for issuers and investors on one side or the other side of the line. The final regulations also impose new compliance requirements that apply to both U.S. and foreign borrowers.

A. Syndicated Loans

1. Adverse Tax Consequences for U.S. Borrowers. Distressed U.S. borrowers restructuring a syndicated loan (or any other loan with an outstanding principal amount of more than $100 million) that has a value below par are likely to face higher tax costs under the final regulations. If the outstanding loan is treated as "publicly traded," ordinarily the issuer will have current COD income and will have OID deductions over the life of the new debt. If the debt is deeply distressed, the OID deductions may be deferred until repayment of principal, or denied, under the rules for "applicable high yield debt instruments" ("AHYDOs"). As a result:

- U.S. borrowers may be required to pay current tax as a result of a restructuring, even though they still owe the same principal amount and have not gained access to any new cash.
- If the borrower has net operating losses ("NOLs") that have given rise to a deferred tax asset, the COD income will absorb some or all of those NOLs and consequently reduce the DTA associated with the NOLs.
- The U.S. borrower will have a timing mismatch (income today, deductions tomorrow) and may suffer a permanent increase in tax if the AHYDO rules apply.

Distressed U.S. borrowers may want to model the net present value of the timing detriment before negotiating the terms of a restructuring in light of these consequences. On the margin, where the modified loan risks being treated as an AHYDO, a borrower may want to seek an adjustment to the terms that reduces the yield to maturity or the maturity of the debt (if commercially possible) in order to avoid the deferral or permanent denial of interest deductions.

The new rules could however be favorable to a borrower that has expiring NOLs. In that case, restructuring a "publicly traded" loan may present an opportunity to refresh those NOLs by trading current COD income that absorbs the NOLs for deferred OID deductions.

The final regulations do not clearly indicate whether they apply to loans held by a single lender, for example by a pension plan, insurance company, or related party, or to loans held by a small number of lenders, for example in a private equity "club" transaction. It appears that the regulations were not intended to apply to loans of that kind, as the regulations use terminology usually associated with traded loans (*e.g.*, firm quote). They are however very broadly drafted, and are based on the principle that market valuations should be used to determine the value of a debt instrument for tax purposes wherever possible.

2. Potential Tax Costs for Lenders Holding Illiquid Debt. Lenders to distressed borrowers will generally benefit from the extension of "publicly traded" status to syndicated loans, since it causes the lender's gain or loss on a debt restructuring or exchange to be measured by reference to the fair market value of the new or amended loan and thus to correspond to the lender's economic gain or loss from the transaction.

- If the loan is highly illiquid, however – for example, there is no trading of the loan and there are no price quotes for the loan because no bank makes a market in the loan – lenders may have fewer options to avoid uneconomic tax gain (that is, gain equal to *par* amount less the lender's basis in the debt) as a result of a debt restructuring or exchange than before.

- Some lenders took the position (prior to the final regulations) that their gain or loss should be measured by reference to fair market value if they caused a portion of the loan to be sold within a period before the restructuring.[2] The final regulations specifically deny the use of such a sale to establish fair market value.

- The final regulations also prevent a lender from accomplishing the same result by buying the loan during the 31-day testing period (or by offering to purchase it) starting 15 days prior to the transaction if the principal purpose for the purchase or offer was to cause the debt to be treated as "publicly traded."

- Consequently, lenders holding such debt may owe tax on an amount that substantially exceeds their economic gain. If the lender disposes of the restructured debt, it should have an offsetting loss, but if the sale is in a later year there will be a timing mismatch. In addition, as described in Section V.A, below in more detail, the lender may not be able to use the capital loss deduction to the extent that it has ordinary income (market discount) from the restructuring.

3. Increased Compliance Costs for Borrowers. Borrowers must use "reasonable diligence" to determine whether the loan is publicly traded and to establish its

[2] In a "potentially abusive situation," a taxpayer is required to use the new debt's fair market value to determine its gain or loss if that value is less than the stated principal amount. Prior to the final regulations, a potentially abusive situation included a "recent sales transaction" in the case of an actual or deemed debt-for-debt exchange.

fair market value, including by discovering whether purchases and sales occur during the 31-day testing period surrounding the issue date, the price at which the transactions occurred, the existence of firm or indicative quotes, and any other information relevant to setting a price.

If the borrower determines that the new or the old debt is publicly traded, it must disclose its determination and the issue price of the new debt (which will equal the deemed redemption price of the old debt) within 90 days of the issue date. This may be accomplished by posting the price on a website or by similar "electronic publication." Lenders will be bound by the borrower's public trading and price determinations under a consistency rule unless they report the reasons for their contrary position to the IRS.

These rules raise a number of issues for borrowers:

- Borrowers may not have ready access to the relevant pricing and trading information, for example whether a lender has sold a participation in a loan that was treated as a sale of the loan for tax purposes. Because the question of whether a loan is "publicly traded" affects the borrower's own tax position, borrowers may want to seek information from the agent bank, if any, at an early stage in restructuring negotiations.

- Borrowers must decide how to make the required information available to lenders, for example by creating space on the investor relations section of the borrower's website.[3] It is not clear how long that information must remain available, but it would be prudent to ensure that lenders can find the information for as long as the new debt is outstanding. Alternatively, borrowers may be able to satisfy the disclosure obligation by posting the issue price of the restructured debt on a separate platform such as a widely available bulletin board or other information source.

- Borrowers will need to consider whether they have legal liability to lenders for their "public trading" and fair market value determinations. This may be of particular concern where a loan is illiquid, as a result of some uncertainty about when an "indicative quote" exists – for example, whether a bank's response to an inquiry by the borrower about pricing could itself give rise to an indicative quote.

4. <u>Possible New Burdens on Agent Banks</u>. As described above, it seems likely that borrowers will seek information about pricing and trading of their loans from

[3] If a new or restructured loan has OID, the borrower also must put a legend into the credit agreement stating that fact and provide OID information or contact information for someone who can provide that information.

agent banks in the course of a restructuring, workout, amend-and-extend agreement or similar transaction. This could raise a number of issues for the bank:

- If the bank is willing to provide that information to borrowers, the bank should develop an internal process for collecting the information and conveying it to the borrower.

- The bank may be concerned about legal liability for providing information that borrowers and lenders will rely on to determine their tax obligations. If borrowers seek a legal commitment from the bank to provide that information, the bank should consider whether to seek indemnification from the borrower.

- If the bank considers pricing or trading information to be proprietary, or is reluctant to provide the information as a negotiating matter, there may be added complications to the restructuring process. If borrowers are willing to wait to obtain the information until more than 15 days after closing (because all prices and price quotes during that period may be relevant to their determinations), that may alleviate the concern.

5. <u>Compliance Burdens on Non-U.S. Borrowers and on Lenders to Such Borrowers.</u> There is no exception to the compliance rules described above for foreign borrowers or for transactions effected outside the United States. (By contrast, the disclosure requirements for OID provide an exception for debt issuances not offered for sale or resale in the United States in connection with their original issuance.)

If a borrower fails to provide the required "publicly traded" and valuation information, the final regulations shift the burden of obtaining the information to its lenders. U.S. lenders to a non-U.S. borrower therefore may either need to obtain assurances that the borrower will provide the information, or make separate arrangements to obtain it.

B. <u>Middle-Market Loans</u>

In recognition of the fact that smaller loans to smaller companies ("middle-market loans") are often held by the originator or an investor that acquired the loan in connection with its issuance, the final regulations provide a special rule for loans with an outstanding principal amount of $100 million or less. (Loans with a higher principal amount are subject to the rules described above for syndicated loans.) Under this special rule, if the loan is restructured or modified in a taxable transaction, the modified loan will be deemed by law to be retired and reissued for par, whatever its actual fair market value.

For *U.S. borrowers*, this rule generally is favorable, because it avoids the COD income and other issues described above for borrowers of syndicated loans.

- Because the final regulations automatically treat such loans as non-publicly traded, there is no need for the issuer to make, or disseminate information regarding, the treatment of the loan.

- Distressed borrowers that plan to restructure a loan with an outstanding face amount just over the $100 million threshold may wish to consider whether they can structure into this rule by repaying or buying up some of the loan in advance of the modification. Their ability to do so may depend on the terms of the credit agreement and possibly on the cooperation of the administrative agent, among other constraints.

For *U.S. lenders* (or U.S. investors in funds) that purchased the loan at a discount, this rule generally will give rise uneconomic tax gain (that is, gain equal to *par* amount less the lender's basis in the debt) as a result of a debt restructuring or exchange. As described above in the syndicated loan discussion, the final regulations foreclose some strategies that lenders might otherwise have used to avoid this problem.

- Consequently, U.S. lenders holding distressed loans with a principal amount of $100 million or less that are restructured or substantially modified may owe tax on an amount that substantially exceeds their economic gain. If the lender disposes of the restructured debt, it should have an offsetting loss, but if the sale is in a later year there will be a timing mismatch. In addition, as described in Section V.A, below in more detail, the lender may not be able to use the capital loss deduction to the extent that it has ordinary income (market discount) from the restructuring.

III. Structured Finance Obligations, Whole Loans and Receivables

U.S. investors (or U.S. investors in funds that invest) in pools of distressed debt – such as residential mortgage loans, many if not most commercial mortgage loans, and credit card and other receivables – and investors in mezzanine and junior tranches of securitized debt that acquire the debt in order to work it out are likely to be adversely affected by a special rule in the final regulations that applies to debt with an outstanding principal amount of $100 million or less. Under this special rule, if the debt is restructured or modified in a taxable transaction, the modified debt will be deemed by law to be retired and reissued for par, whatever its actual fair market value. The investor's gain or loss therefore will be determined by reference to the difference between its basis in the debt and the *par* amount of the debt.

- Consequently, U.S. holders of distressed debt instruments of this kind may owe tax as a result of a workout or restructuring of the debt on an amount that substantially exceeds their economic gain.

- If the lender disposes of the restructured debt, it should have an offsetting loss, but if the sale is in a later year there will be a timing mismatch. In addition, as described in Section V.A, below, in more detail, the lender may not be able to use the capital loss deduction to the extent that it has ordinary income (market discount) from the restructuring.

- The final regulations foreclose a strategy that was used by some investors to alleviate these problems. Previously, some lenders took the position that their gain or loss should be measured by reference to fair market value if they caused a portion of the loan to be sold within a certain period before the restructuring.[4] The final regulations specifically deny the use of such a sale to establish fair market value.

IV. The Bond Market

The final regulations will affect bond transactions in two different ways. First, they apply to exchange offers and consent solicitations that give rise to taxable transactions. Consequently, issuers of illiquid distressed debt may be more likely to recognize COD income (and issuers of illiquid debt trading at a premium may be more likely to take immediate deductions for the premium) if they engage in such transactions. Because bond issuers already often took the position that their bonds were "publicly traded" and provided tax disclosure to that effect, however, the actual change to existing market practice in that regard may be limited, except for debt with an outstanding amount of $100 million or less. Issuers, including non-U.S. issuers, also will have new compliance burdens.

Second, the final regulations provide a very welcome liberalization of the tax rules for further issuances ("reopenings") of outstanding debt. They will principally affect debt that was issued for tax purposes at a discount, including in an exchange offer.

A. Exchange Offers and Consent Solicitations

1. Limited Changes to Current Law. In our experience, indicative quotes are available even for highly distressed bonds. With the possible exception of bonds where nearly all of the issue has been purchased and is held by distressed-debt funds, therefore, under the final regulations it is likely that virtually all bonds with an outstanding amount of more than $100 million will be treated as "publicly traded." As described below, this will give rise to new compliance burdens for issuers.

---

[4] See note 2, *supra*. These issues are discussed in more detail in a comment letter to the proposed regulations submitted by a Cleary Gottlieb partner. *See* Letter from James M. Peaslee to the Internal Revenue Service dated June 27, 2011, re: *Income Distortions from Modifications of Discount Debt – Comment on Proposed Regulation § 1.1274-3(b)(4)(i)*, 2011 TNT 126-26 (June 27, 2011), available online at http://www.regulations.gov/#!documentDetail;D=IRS-2011-0002-0004 (visited September 27, 2012).

As under current law:

- If bonds trading or valued at a discount are the subject of an exchange offer or are significantly modified in a consent solicitation, the issuer ordinarily will have current COD income (or reduced deferred tax assets, if the COD income absorbs NOLs) and later OID deductions, resulting in potential current taxation, timing mismatches and potentially a permanent increase in tax if the OID deductions are disallowed under the AHYDO rules.[5]

- Conversely, if bonds trading or valued at a premium are the subject of an exchange offer or the like where the new bonds have a principal amount equal to their value, under the rules for "publicly traded" debt the issuer generally is entitled to deduct the premium immediately rather than amortizing it over the life of the new bond. (If instead the new bonds are issued at a premium, for example because they are a reopening of outstanding bonds, then the issuer's interest expense deduction on the new bonds will be reduced to take account of the accelerated premium deduction.)

- Investors often are not required or permitted to recognize gain or loss on such transactions, under the rules for tax-free recapitalizations. An investor that purchased a bond at a discount could, however, be required to accrue OID after an exchange offer or significant modification.

2. Bonds with $100 Million or Less Outstanding. A more significant change to the law is that under a special rule for debt with an outstanding principal amount of $100 million or less, if a bond is restructured or modified in a taxable transaction and the modified bond still has a principal amount no greater than $100 million, the original bond will be deemed by law to be retired and reissued for the stated principal amount of the modified bond, whatever its actual fair market value.

- For U.S. issuers, this rule generally is favorable, because it avoids the COD income and other issues described above. However, if the bond is exchanged for new bonds when it is trading at a premium, the issuer will be required to amortize the deduction for the premium over the life of the new bonds, rather than deducting it immediately.

- These rules apply only if both the old and new bonds have an outstanding principal amount of less than $100 million. Consequently, if an issuer has multiple below-$100 million bonds outstanding, an exchange offer for those

[5] These consequences are described in more detail in Section V.A, below.

bonds will have different tax consequences depending on whether they are exchanged for new bonds with below-$100 million principal, or for a single new bond with an above-$100 million principal.

- Because the rule applies as a matter of law, U.S. issuers of these bonds do not have new compliance or disclosure obligations of the nature described below for transactions of this kind.

- Distressed issuers that plan to carry out an exchange offer or a consent solicitation for a bond with an outstanding face amount just over the $100 million threshold may wish to consider whether they can structure into this rule by repaying or buying up some of the bond in advance of the modification, subject to applicable securities laws constraints.

3. Increased Compliance Costs for Issuers and Underwriters. Issuers must use "reasonable diligence" to determine whether a bond with an outstanding principal amount above $100 million is publicly traded and to establish its fair market value, including by discovering whether purchases and sales occur during the 31-day testing period surrounding the issue date, the price at which the transactions occurred, the existence of firm or indicative quotes, and any other information relevant to setting a price.

If the issuer determines that the bonds are publicly traded, it must disclose its determination and the issue price to investors within 90 days of the issue date, which may be accomplished by posting the price on a website or by similar "electronic publication." Investors will be bound by the issuer's public trading and price determinations under a consistency rule unless they report the reasons for their contrary position to the IRS.

These rules raise a number of issues:

- Issuers may not have ready access to the relevant pricing and trading information. Accordingly, issuers may want to seek information from the investment bank involved in the exchange offer or other transaction. If the bank is willing to provide that information, the bank should develop an internal process for collecting the information and conveying it to the issuer.

- Issuers must decide how to make the required information available to investors, for example by creating space on the investor relations section of their website.[6] Because the fair market value of newly issued debt must be determined taking into account information from the first 15 days

[6] If a new or restructured bond has OID, the issuer also must either provide that information to the IRS or put an OID legend on the form of debt obligation.

after its issuance, it does not appear to be possible to satisfy the disclosure obligation by including information in the offering document for the bonds.

It is not clear how long that information must remain available, but it would be prudent to ensure that investors can find the information for as long as the new debt is outstanding. Alternatively, issuers may be able to satisfy the disclosure obligation by posting the issue price of the restructured debt on a separate platform such as a widely available bulletin board or other information source.

- Issuers will need to consider whether they have legal liability to investors for their determinations. Similarly, investment banks that provide pricing and trading information to an issuer will need to consider whether they have legal liability to issuers or investors for providing information that issuers and lenders will rely on to determine their tax obligations. If issuers seek a legal commitment from the bank to provide that information, the bank should consider whether to seek indemnification from the issuer.

4. Foreign Issuers and U.S. Investors in Foreign Bonds. There is no exception to the compliance rules described above for foreign issuers or for transactions effected outside the United States. (By contrast, the disclosure requirements for OID provide an exception for debt issuances not offered for sale or resale in the United States in connection with their original issuance.)

If an issuer fails to provide the required "publicly traded" and valuation information, the final regulations shift the burden of obtaining the information to its investors. U.S. investors in bonds of a non-U.S. issuer therefore may either need to obtain assurances that the issuer will provide the information, or make separate arrangements to obtain it.

B. Further Issuances of Outstanding Bonds (Reopenings)

Corporate and sovereign issuers of bonds regularly consider whether to structure the issuance as a further issuance of outstanding bonds, in order to increase the liquidity of those bonds and thereby reduce the issuer's cost of capital. For bonds sold in the U.S. markets, the U.S. tax rules limit issuers' ability to reopen bonds in this manner if the bonds are trading below par. The final regulations liberalize those rules to some extent, for bonds treated for tax purposes as originally issued at a discount. Under the new rules:

- If a bond is originally issued at a discount for U.S. tax purposes, for example because it was issued with a below-par value in an exchange offer, and the bond trades up in value, a later reopening of the bond generally will be permitted.

- The rules do not change the tax restrictions on further issuances of bonds originally issued at or near par.

More technically, under the final regulations, a reopening under the same CUSIP is permitted if:

- the new bonds are issued at a premium or with no more than *de minimis* OID (as under prior law); or

- the new bonds are issued within six months of the original issuance and the yield on the bonds at the time of the further issuance is no more than 110% of the original yield (as under prior law); or

- the new bonds are issued to unrelated investors after the initial six-month period and the yield on the new bonds is no more than 100% of the original yield (new rule). We believe that this rule generally is intended to apply as long as bonds are issued to some unrelated investors at an arm's length price, even if other bonds in the same issuance are issued to a related party.

Under prior law, some market practitioners believed that a further issuance might be permissible if bonds originally issued at a discount traded up (the situation described in the last bullet point above), under certain circumstances where there was no risk of tax avoidance, but those circumstances were limited and different advisors had different views on that question. The final regulations remove the uncertainty about such transactions and provide a more flexible rule. This change is likely to be especially relevant to financially troubled issuers (sovereigns and corporates) because they are more likely to issue bonds originally treated as OID bonds for tax purposes.

The final regulations also make a number of helpful technical changes to the reopening rules:

- The yield on new bonds issued for cash generally can be calculated by reference to the cash price of the issuance. This eliminates ambiguities that used to exist about when during the trading day to measure the yield on the old bonds.

- Bonds do not need to be "publicly traded" if the further issuance is made in exchange for cash to unrelated persons and the other requirements for a qualified reopening are met. This change is not likely to be significant, except for highly illiquid bonds.

As described above, the new rules for further issuances are already in effect.

V. More Detailed Description of the New Rules for "Publicly Traded" Debt

A. Significance of "Public Trading"

As described above, whether or not a debt instrument is treated as "publicly traded" determines, and may radically change, the U.S. federal income tax consequences of debt restructurings or other transactions in which debt terms are modified or debt is exchanged, for both the issuer and the investor in the debt. These new regulations thus may affect the U.S. tax treatment of such transactions if either (or both) of the issuer or investor are U.S. taxpayers or owned in whole or part by U.S. taxpayers.

By way of background, the U.S. tax rules treat a transaction in which the payment terms or other material terms of a debt instrument are modified, such as a debt restructuring, and a transaction in which existing debt is exchanged for new debt, as a "deemed exchange" of old debt for new debt if the changes to the terms are sufficiently significant. In that case, the old debt is treated as retired, and the new debt is treated as issued, for fair market value if the debt is treated as "publicly traded." If neither the old debt nor the new debt is publicly traded, then the old debt is treated as retired, and the new debt is treated as issued, for an amount equal to the stated principal amount of the new debt.[7] While these rules by their terms determine the issue price of the new debt, they also determine the deemed redemption price of the old debt and therefore gain or loss on the retirement of the old debt, because those amounts generally must be the same. The final regulations significantly broaden the definition of "publicly traded" in some contexts while narrowing it somewhat in others.

For *U.S. issuers*, the new rules increase the likelihood that outstanding debt trading for less than par will be treated as retired at a discount, giving rise to COD income. In such a case, the new debt would be treated as issued at a similar discount, giving rise to OID deductions to the borrower over the term of the debt. If the new debt is treated as having a significant amount of OID, however, the applicable high-yield debt 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 deductions altogether. The new regulations consequently increase the likelihood that restructuring or exchanging debt with a below-par value will give rise to timing mismatches (COD income today, OID deductions tomorrow), and in the case of distressed debt may give rise to net taxable income that does not correspond to any economic income. Conversely, for an issuer with debt that had an

---

[7] Although the stated principal amount of the new debt is not generally a good proxy for fair market value, from a tax policy perspective it is considered to provide an objective and readily observable price that is not as speculative or subject to manipulation as available alternatives.

above-par value, the regulations may offer the opportunity for an accelerated deduction of that premium.

An issuer that has NOLs typically will have a deferred tax asset resulting from those NOLs, which will add to the strength of the issuer's balance sheet – and for regulated institutions may also be taken into account for regulatory capital purposes – to the extent there is no valuation allowance against it. If an issuer with NOLs earns COD income, the COD income generally will first be absorbed by the NOLs. Accordingly, while an issuer of this kind may not suffer a current tax cost as a result of COD income from a debt restructuring, exchange offer or similar transaction, it may instead lose the valuable balance sheet asset associated with the NOLs.

For *U.S. investors* in debt instruments, a broad definition of "publicly traded" is generally preferable, since it allows the creditor's gain or loss on a debt restructuring or debt-for-debt exchange 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. In the case of highly illiquid debt instruments not treated as publicly traded, by contrast, the creditor generally would be treated as disposing of the old debt for the stated principal amount of the new debt received. If the creditor purchased the old debt at a discount, the investor would recognize gain in excess of its economic income. Moreover, the creditor may be required to treat part of that gain as ordinary income, under the market discount rules. The new regulations consequently increase the likelihood that restructuring or exchanging highly illiquid debt with a below-par value will give rise to timing mismatches (gain today, loss on later sale of the new debt) or character mismatches (ordinary income, capital loss) that may result in a net tax cost to the investor.

These potential mismatches are most significant for distressed debt, because of the greater potential disparity between economic gain/loss and tax gain/loss, and because these transactions typically do not give rise to cash that can be used to pay taxes resulting from the transaction. The IRS and Treasury have stated that they are working on rules that could alleviate these inefficiencies, but it does not appear that such rules will be issued in the near to medium future.

B. The New Rules

1. General Rule. Under current law there is often uncertainty as to whether a particular debt instrument is publicly traded for tax purposes. Since issuers and investors have access to different information and make their own determination of that issue, it is possible for each side of the transaction to reach a different conclusion, particularly in the loan market where there is no tax disclosure discussing the issue.

The final regulations provide more certainty for most debt instruments in the capital markets, by treating most debt instruments of that kind as publicly traded. Under the final regulations, a debt instrument or other property will generally be publicly traded if at any time within the 31-day period ending 15 days after the issue date:

- there is an executed purchase or sale, and the sales price becomes reasonably available within a reasonable period of time after the sale (*e.g.*, through the TRACE system operated by FINRA for SEC-registered debt); or

- there is a "firm quote" available, *i.e.* a price at which at least one identified broker or dealer would be willing to buy or sell the property even if it is not legally bound to do so; or

- there is an "indicative quote" available from at least one broker, dealer or pricing service that is not a firm quotation (*e.g.*, "daily runs" sent by dealers through Bloomberg, pricing information available on the LSTA/LTC Mark-to-Market service or Markit services, or other reporting engines, whether or not a subscription is required to obtain the information). In view of the fact that brokers and banks generally are willing to provide an estimate of value to their customers upon request, it is possible that a quote would be treated as "available" in a wide range of circumstances.

An issuer generally may use any reasonable method, consistently applied, to determine the fair market value of its debt. The regulations provide a list of factors on which the issuer may reasonably rely, including the timing of each relevant sale or quote in relation to the issue date; whether the price derives from a sale, a firm quote, or an indicative quote; the size of each relevant sale or quote; or whether the sales price or quote corresponds to pricing information provided by an independent bond or loan pricing service.[8] If the sole pricing information available consists of indicative quotes, and the issuer believes that those quotes materially misrepresent the fair market value of the debt, the issuer may use another more accurate method to value the debt. If an issuer's reasonable diligence turns up only one sale price or firm price quote during the relevant period, however, that price is presumed correct.

2. Small Issues. A debt instrument is treated as *not* publicly traded as a matter of law if, at the time the determination is made, the issue including the debt instrument has an outstanding principal amount of $100 million or less. Debt instruments in this category are viewed as very likely to be illiquid, so this "small issue exception"

[8] A sales or price quotation is disregarded if a principal purpose for its existence is to cause the property to be publicly traded or to materially misrepresent the value of the property. Similarly, in the case of a debt-for-debt exchange, investors can no longer cause the old debt to be publicly traded by trading a small portion of the debt shortly before the exchange. Conversely, a debt instrument is treated as publicly traded notwithstanding the existence of a temporary restriction on trading if a purpose of the restriction is to avoid publicly traded status.

functions in part as a simplification of the publicly traded test and in part as an anti-abuse rule.

*   *   *

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.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Odaid Tower
Office 1105, 11th Floor
Airport Road; PO Box 128161
Abu Dhabi, United Arab Emirates
T: +971 2 414 6628
F: +971 2 414 6600