



Is your debt considered publicly traded?

Companies contemplating a debt restructuring should assess the potential tax implications

When a company restructures or modifies an existing debt instrument, one of the questions that must be answered in determining the consequent tax results is whether the debt instrument is “traded on an established market” (i.e., publicly traded). The determination for tax purposes that a debt is publicly traded can lead to detrimental tax consequences for the debtor company and debt holders. Further, the definition of publicly traded is much broader than most companies realize and is not limited to debt that most investors, dealers and brokers may consider publicly traded. Though the recent enactment of section 108(i)¹ allows electing debtor companies to alleviate much of the federal tax impact of such a determination, the potential state tax consequences to the debtor company and overall tax consequences to the debt holders remain significant. This bulletin will help you better understand and navigate the rules for determining whether your debt is publicly traded.

Background

If a modification of a debt instrument is significant, the debt (old debt) is deemed satisfied and reissued (new debt) by the company. In determining the impact on the company from the deemed exchange, the old debt is deemed satisfied by an amount equal to the new debt’s issue price. To the extent the issue price on the new debt is less than the principal amount of the old debt, cancellation of debt (COD) will occur. The determination of the issue price of the new debt hinges upon whether the debt is publicly traded. If the debt is not publicly traded, a safe harbor of convenience provides that the new debt’s issue price is generally equal to the principal amount of the debt.² As a result, COD is generally avoided on non-publicly traded debt. On the other hand, the issue price on debt that is considered publicly traded is equal to its fair market value (FMV). With most debt currently trading well below stated principal amounts, a company is likely to incur COD income on a deemed exchange of publicly traded debt.

As mentioned above, section 108(i) has alleviated much of the impact from a federal tax perspective by allowing electing taxpayers to defer the recognition of COD income and corresponding original issue discount deductions until 2014, at which time they are recognized ratably over a five-year period. Thus, the timing difference that would generally occur between the recognition of COD income and ordinary issue discount (OID) deductions is greatly diminished, if not completely eliminated. However, with so many states facing budget deficits that must be eliminated, the likelihood that states will adopt section 108(i) is unclear at best.

This determination is significant to the holder of a debt instrument as well. Unless the deemed exchange represents a recapitalization pursuant to section 368(a)(1)(E), a holder will generally recognize gain or loss on the deemed exchange. Under current market conditions, a loss is most likely to occur. Where the debt holder is a bank, the loss is generally considered an ordinary loss; however, where the holder is not a bank, such loss is capital in nature.

¹ All section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.

² See §§1273(b)(4) and 1274.



Traded on an established market = publicly traded

For purposes of deemed debt exchanges, a debt instrument is considered publicly traded if a substantial amount of the debt is traded on an established market.³ This is further defined as a debt instrument that at any time during the 60-day period that ends 30 days after the instrument's issue date is traded on an established market.⁴ A debt instrument is traded on an established market if it:

1. Is listed on certain security exchanges, interdealer quotations systems, or designated foreign exchanges or boards of trade;⁵
2. Is traded on a designated contract market or an interbank market;⁶
3. Appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine FMV by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium);⁷ or
4. Has a price quotation on the debt instrument readily available from dealers, brokers, or traders.⁸

Categories one and four are generally easily determinable. Categories two and three generally cause companies the most problems and are the focus of the remainder of this discussion. The problem with category two is that there is not a clear definition of what, in fact, is an interbank market. In a field service advice, the Service held that an "interbank market is not a formal market, but rather a group of banks holding themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions. The Service broadly interprets the interbank market to include all banks and investment banks (as the terms are generally used in the marketplace)."⁹ However, the ruling dealt with a foreign currency transaction and was applied in the context of section 1256. There is little, if any, guidance that would support such a broad definition with respect to the determination of issue price under section 1273.

Category three has two requirements. First, the quotations must appear on a system of general circulation (the quotation medium), and second, the quotation medium must provide a reasonable basis to determine the FMV of the debt instrument. As defined in the regulations, a quotation medium is much broader than the traditional investor definition of a public market for the debt. There is no requirement that the debt be open for trading to the general investor or that the debt be actually traded. It could be argued that this category encompasses what some would define as a private market for the debt, within the definition of traded on an established market. Quotation mediums falling within this category could include quotation

³ Reg. §1.1273-2(b).

⁴ Reg. §1.1273-2(f)(1).

⁵ See Reg. §1.1273-2(f)(2).

⁶ See Reg. §1.1273-2(f)(3).

⁷ See Reg. §1.1273-2(f)(4).

⁸ See Reg. §1.1273-2(f)(5)(i).

⁹ FSA 200025020 (March 17, 2000).



systems provided by the trading desk of the syndicating bank. Such a system might allow interested parties to call and receive quotations and indices such as Markit™ that provide pricing information for bonds and credit derivatives. As a result, it is much more likely that a debt instrument could fit within the definition of publicly traded than a company might think.

The second requirement, that the quotation medium provide a reasonable basis to determine FMV, is perhaps a more difficult one to establish, particularly during times when the debt markets may not be functioning appropriately. Practitioners have raised this issue in the context of current market conditions while urging action by the Service.¹⁰ Adding to the question of reasonableness of market traded prices under today's economic conditions is the issuance, by the Financial Accounting Standards Board, of two FASB Staff Positions (FSPs), FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (Oct. 10, 2008), and, most recently, FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (April 9, 2009). FAS 157-4 specifically addresses price quotations from pricing services or brokers, which as discussed above generally create category three quotation mediums. Without specifically using the term reasonable basis for determining fair value when discussing the quoted prices, FAS 157-4 is clear in that less weight is given to these markets and quoted prices when trading activity significantly decreases.¹¹

While not providing precedent for federal income tax purposes, the FSPs merit consideration when determining whether a market provides a reasonable basis for determining FMV. The case law on this issue is of precedential value, however, and supports, not unlike the FSP, that there are situations in which the traded price of a financial asset is not indicative of the asset's true FMV. In *Amerada Hess Corporation*, the court stated that where the market exhibits peculiarities that cast doubt on the market value, the market price should be either adjusted or discarded in favor of another valuation measure.¹² In *Hazeltine Corporation & Heiner*, the court looked to the issue of thin trading, writing that when the market reflects only "sales of small lots, forced sales, or sales in a restricted market, the market may not furnish the best

¹⁰ William R. Welke and Rachel L. Cantor, Attorneys Urge Further Relief in Guidance on Debt Instruments, 2008 TNT 225-16 (Nov. 15, 2008).

¹¹ See FSP FAS 157-4, ¶ 13. "If the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability (or similar assets or liabilities), transactions or quoted prices may not be determinative of fair value ... Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with Statement 157." See also FSP FAS 157-4, ¶ 19. "When estimating fair value, Statement 157 does not preclude the use of quoted prices provided by third parties, such as pricing services or brokers, when a reporting entity has determined that the quoted prices provided by those parties are determined in accordance with Statement 157. However, when there has been a significant decrease in the volume or level of activity for the asset or liability, a reporting entity should evaluate whether those quoted prices are based on current information that reflects orderly transactions or a valuation technique that reflects market participant assumptions (including assumptions about risks). In weighting a quoted price as an input to a fair value measurement, a reporting entity should place less weight (when compared with other indications of fair value that are based on transactions) on quotes that do not reflect the result of transactions. Furthermore, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighting the available evidence, with more weight given to quotes based on binding offers."

¹² *Amerada Hess Corporation v. Commissioner*, 517 F.2d 75 (3rd Cir. 1975).



evidence of FMV.”¹³ A similar analysis is found in *American Steel Foundries*, where the court stated that when the number of shares traded is small, the reliability of subsequent trades as a basis for measuring stock value is “dubious at best.”¹⁴

The following example illustrates the extreme difference in tax consequences that can occur depending upon the determination of whether a debt is publicly traded:

Company X has made all payments required under a \$700M debt facility that appears on a quotation medium (as defined in category three). X has determined that the debt does not fall within the other categories that would treat the debt as traded on an established market. As a result of X not meeting certain debt covenants, X’s debt is modified to increase the interest rate by 200 basis points. Assume the interest rate represents adequate stated interest. This is a significant modification and results in a deemed exchange. The current prices on the quotation medium would value the debt at \$140M (20 cents on the dollar). However, no trade on the debt has occurred for more than \$5M of debt at face value (\$1M trade), and the vast majority of holders would hold their interests rather than selling at this price. Further, only \$40M of the face value debt has traded in the last four weeks, so the debt is thinly traded. Finally, assume that for purposes of determining goodwill impairment under FAS 142, X’s auditor placed a value on the debt of \$630M (90 cents on the dollar).

Treatment to debtor Company X

If the last trade is used to determine gain under the facts of the example, the modification will result in the recognition of \$560M of COD income. On the other hand, if X were to establish that, due to current market conditions, the quotation medium does not provide a reasonable basis for determining FMV of the debt, X could argue that the debt is not publicly traded. X would then determine issue price under sections 1273(b)(4) or 1274, and no COD income would be recognized on the modification. Alternatively, X might conclude that the debt is publicly traded but, rather than use the last trading price, argue that the market value is inaccurate and requires downward adjustment to a value closer to the \$630M established by X’s auditor.

Treatment to creditors

If both the original and modified debts represent securities, the creditors would recognize no gain or loss on the exchange. To the extent the debt is not a security, the creditors would recognize gain or loss. Unless the creditor is a bank, such loss would represent a capital loss, which would only be allowed to offset capital gains. In addition, the creditors would recognize, over the remaining term of the debt, income on the estimated \$560M of OID created in the modification.

¹³ *Hazelline Corporation & Heiner v. Crosby*, 24 F.2d 191 (3rd Cir. 1928).

¹⁴ *American Steel Foundries v. United States*, 153 Ct. Cl. 234 (1961).



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Summary

As with so many difficult questions facing companies in these troubled times, the determination of whether debt is publicly traded is not an easy one. Furthering the problem is the potential significance of the tax ramifications to the company and debt holder. Therefore, it is essential for companies to carefully analyze whether debt is in fact publicly traded. We recommend you take steps to consult with your RSM McGladrey or other tax advisor to assess the specific tax implications to you and your business.

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