LATHAM & WATKINS

Number 1417 February 22, 2013

Client Alert

Latham & Watkins Corporate & Tax Departments

New Treasury Regulations Make it Easier to Issue Tack-On Bonds or Loans

But New FATCA Regulations Add Complexity

"The revised definitions of the terms 'qualified reopening' and 'publicly traded' under the Final Regulations provide greater flexibility to create fungible tack-on debt instruments in situations where either the original debt or the additional debt is issued with OID and in situations where the additional debt is issued more than six months after the original issuance."

On September 12, 2012, the Internal Revenue Service (IRS) issued final regulations (the Final Regulations) which make it easier to issue fungible tack-on debt instruments in situations where either the original debt instruments or the tack-on debt instruments are issued with original issue discount (OID) for tax purposes. The Final Regulations achieve this result by expanding the definitions of "qualified reopening" and "publicly traded," both of which are central to the analysis of whether a tack-on debt issuance will be treated as fungible with an outstanding series of debt instruments for tax purposes. The revised definition of "qualified reopening" applies to reopenings on or after September 13, 2012, while the revised definition of "publicly traded" applies to debt instruments issued on or after November 13, 2012.

Background

If an issuer of outstanding debt instruments plans to issue additional debt instruments with terms that are identical to those of an outstanding series of debt instruments, the issuer typically prefers that the additional debt have the same CUSIP number as the outstanding debt so that the original and the additional debt instruments can trade together.[1] If the tack-on debt can trade with the outstanding debt on a fungible basis, it will enjoy better after-market liquidity and, typically, will benefit from better pricing terms. For corporate law purposes, so long as the additional debt instruments are issued under the same indenture or other agreement with terms identical to the terms of the existing debt instruments, the same CUSIP number can generally be used. However, even if the additional debt instruments and the existing debt instruments are issued under the same agreement with identical terms, separate CUSIP numbers will nevertheless be required if they are not "fungible" for tax purposes, as the issuer will need to distinguish between the original debt and the additional debt for reporting purposes.

Two debt instruments with identical terms will be treated differently for tax purposes if, subject to the limited exceptions described below, one instrument is issued with OID but the other instrument is not, or if they are issued with different amounts of OID. A debt instrument is issued with OID if its issue price is less than its stated redemption price at maturity (generally, its stated principal amount) by more than a *de minimis* amount.[2] Holders of debt instruments issued with OID are

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required to accrue OID on a constant yield basis over the term of the instrument, whether they buy the debt instrument at or after the original issue date. In such case, the issuer is required to provide the holders with information relating to the accrual of OID periodically during the term of the debt instrument. As a result, when two debt instruments have identical terms but different amounts of OID, they would not be fungible for tax purposes, and it would be necessary to distinguish between the two instruments by assigning them different CUSIP numbers because the OID reporting and accrual on the two instruments would be different.

The "qualified reopening" rules under the previous Treasury regulations provided a limited opportunity to issue fungible tack-on debt instruments in situations where either the original debt instruments or the additional debt instruments were issued with OID. Under those regulations, unless tack-on debt instruments were issued within 12 days of the original debt instruments, the original debt instruments generally had to be "publicly traded" in order to meet the qualified reopening requirements. This often made it difficult to issue fungible tack-on instruments because the definition of the term "publicly traded" was narrow and ambiguous in many respects. In addition, under the old rules, additional debt instruments issued more than six months after the issuance of the original debt instruments had to be issued without OID (or with less than a *de minimis* amount of OID).

The Final Regulations expanded the definition of "qualified reopening," making it easier for additional debt instrument to be treated as fungible with an original debt instrument for tax purposes. Under the Final Regulations, the "publicly traded" requirement does not apply if the tack-on debt instrument is issued for cash to unrelated parties at an arm's-length price. In addition, a qualified reopening with OID will be allowed to occur more than six months after the issuance of the original debt if the yield test described below is satisfied.

The Final Regulations also expand and simplify the term "publicly traded." Under the new definition, a debt instrument is generally treated as publicly traded if a price quote, including an indicative quote, is available from at least one broker, dealer or pricing service during the 31-day period ending 15 days after the issue date (unless, at the time of the determination, the outstanding stated principal amount does not exceed $100 million, in which case, such debt instrument is considered not to be "publicly traded"). This portion of the Final Regulations is described in our *Alert* dated September 20, 2012.

Achieving Fungibility When Either Original or Additional Debt Is Issued with OID

"Same Issue" Within 12 Days

The Final Regulations preserve the 12-day safe harbor found in the old rules, which provides that the additional debt instruments will be part of the "same issue" as the original debt instruments for tax purposes and, therefore, have the same issue price and issue date as the original debt instrument, if:

- they have the same credit and payment terms,
- they are sold "either pursuant to a common plan or as a part of a single transaction or a series of related transactions," *and*
- the additional debt instruments are issued within a period of thirteen (13) days beginning with the issue date of the original debt instruments (*i.e.*, during the 12-day period following the date of issuance of the original debt instruments).

The advantage of the 12-day safe harbor is that it applies regardless of the yield or the price of the original or additional debt instruments.

"Qualified Reopening"

Even if the additional debt issuance does not qualify for the 12-day safe harbor, the additional debt can still be treated as part of the same issue as, and can be treated as having the same issue price and the same issue date as, the original debt for tax purposes, if the additional debt is issued in a "qualified reopening."

Previous Regulations. Under the previous regulations, an additional debt instrument issued with the same terms as an original debt instrument was treated as issued in a qualified reopening if the original debt was publicly traded for tax purposes *and either*:

(1) the additional debt was issued without OID (or with less than *de minimis* OID), *or*

(2) the additional debt was issued within six months of the issue date of the original debt, *and* the yield *on the original debt* (based on its fair market value) did not exceed 110 percent of the yield *on the original debt* on the issue date of the original debt (or coupon rate, if it was issued without OID).

Final Regulations. Under the Final Regulations, an additional debt instrument issued with the same terms as an original debt instrument will generally be treated as a "qualified reopening" of the original debt if any of the following three tests is satisfied:

(1) The additional debt is issued without OID (or with less than *de minimis* OID), *and either*:

- the original debt is publicly traded for tax purposes *or*
- the additional debt is issued for cash to unrelated parties for an arm's-length price.

(2) The additional debt is issued within six months of the issue date of the original debt, *and either*:

- the original debt is publicly traded for tax purposes and the yield *on the original debt* (based on its fair market value) does not exceed 110 percent of the yield *on the original debt* on the issue date of the original debt (or coupon rate, if it was issued without OID) *or*
- the additional debt is issued for cash to unrelated parties for an arm's-length price and the yield *on the additional debt* (based on its cash purchase price) does not exceed 110 percent of the yield *on the original debt* on the issue date of the original debt (or coupon rate, if it was issued without OID).

(3) The additional debt is issued more than six months after the issue date of the original debt, and either

- the original debt is publicly traded for tax purposes and the yield *on the additional debt*[3] (based on its fair market value) does not exceed 100 percent of the yield *on the original debt* on the issue date of the original debt (or coupon rate, if it was issued without OID) *or*
- the additional debt is issued for cash to unrelated parties for an arm's-length price and the yield *on the additional debt* (based on its cash purchase price) does not exceed 100 percent of the yield *on the original debt* on the issue date of the original debt (or coupon rate, if it was issued without OID).

For this purpose, the "publicly traded" status of the original debt, as well as the 110 percent yield test and the 100 percent yield test, are determined as of the date on which the price of the new debt is established (or, if earlier, as of the "announcement date"), not the closing date. The announcement date is the later of seven days prior to the date on which the price is established or the date on which the issuer publicly announces its intention to reopen the original debt. The ability to use the "announcement date" as the measurement date for this purpose (rather than the pricing date of the tack-on offering) provides an important practical benefit to issuers whose original debt is publicly traded. Since the 110 percent and 100 percent yield caps discussed above are based on the comparative yield *on the original debt* on its issue date versus the yield on the original debt on the measurement date, the actual yield *on the additional debt* issued in the tack-on offering is not taken into account. Therefore, an issuer that observes trading prices for the original debt within the prescribed range (*i.e.*, satisfying the 110 percent or 100 percent yield cap, as applicable), can announce a tack-on offering and thereby keep the window open for the tack-on transaction for the next seven days, even if market conditions deteriorate during that period such that the additional debt has to be issued at a yield that is in excess of 110 percent (or 100 percent, as the case may be) of the original yield on the original debt. Given this practical benefit, we advise issuers to be thoughtful about announcing a tack-on offering with due regard to the calculation of these yield caps.

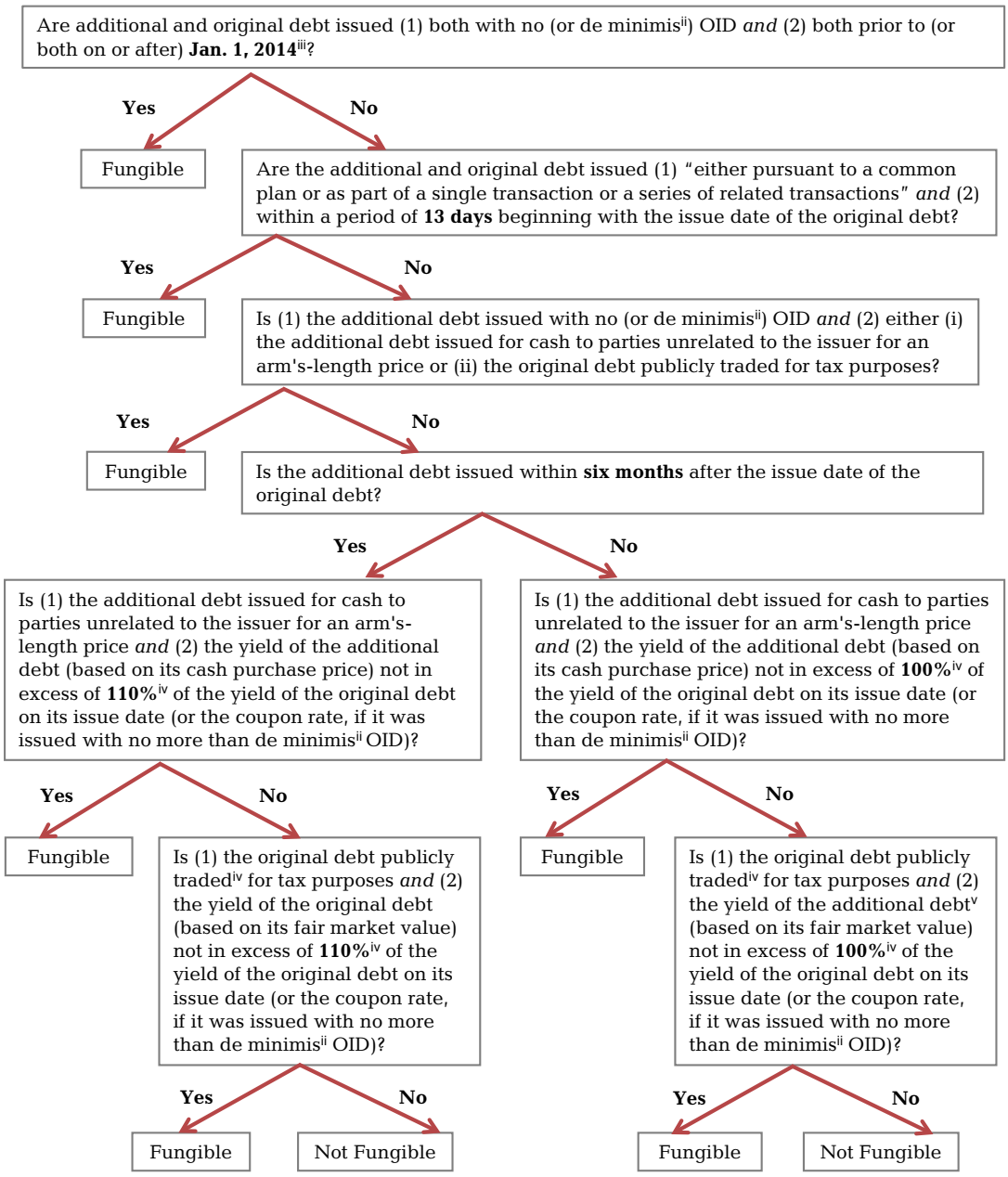
The definition of the term "publicly traded" has been expanded significantly in the Final Regulations. Under the new definition, a debt instrument is generally treated as "publicly traded" if there is a price quote, including an indicative quote, from at least one broker, dealer or pricing service during the 31-day period ending 15 days after the measurement date (unless, at the time of the determination, the outstanding stated principal amount does not exceed $100 million, in which case, such debt instrument is considered not to be "publicly traded"). The broadening of the "publicly traded" definition will make it easier to meet the requirements for a qualified reopening. However, the significance of being "publicly traded" was diminished by the Final Regulations, since the original debt is no longer required to be publicly traded if the additional debt is issued for cash to unrelated parties for an arm's-length price.

"Practical" Fungibility When There Is No OID on Either Original or Additional Debt

If both the original debt instruments and the additional debt instruments are issued with identical terms under the same indenture but without OID (or with less than a *de minimis* amount of OID), the issuer's reporting of income on the debt instruments to the holders, as well as the holder's accrual of interest income on the debt instrument, will be the same regardless of whether the additional debt instruments are issued in a qualified reopening. In such a case, there is generally no reason to distinguish between the original debt instrument and the additional debt instrument for purposes of reporting or accrual of OID.[4] As a result, when both the original debt instruments and the additional debt instruments are issued under the same indenture but without OID (or with less than a *de minimis* amount of OID), they are treated as fungible for tax purposes in the market and given the same CUSIP, whether or not the additional debt instruments are issued in a qualified reopening. This "practical" fungibility has been relied on by many issuers when issuing additional debt instruments that did not technically meet the definition of a qualified reopening under the previous regulations.[5]

Fungibility Flow Chart

The following assumes that the additional debt and the original debt have identical terms.[i]



[i] "Contingent payment debt instruments" and "tax-exempt obligations" are generally subject to different rules.

[ii] OID (on a cash pay debt instrument) is generally de minimis if it is less than 25 bps *times* the number of complete years until maturity.

[iii] FATCA grandfathering date is generally Jan. 1, 2014. Debt issued by foreign issuers may be subject to a different grandfathering date.

[iv] The "publicly traded" status is determined, and the yield tests are applied, as of the earlier of (i) the pricing date and (ii) the date of the announcement (but, if the date of announcement is more than 7 days prior to pricing, as of the date that is 7 days prior to pricing).

[v] Tax practitioners are currently seeking guidance to confirm that the IRS actually intended to reference "original debt" in this instance (instead of "additional debt").

The information contained in this chart should not be construed as legal advice. It is not intended or written to be used, and cannot be used, for purposes of avoiding penalties that may be imposed under the Internal Revenue Code or to promote, market or recommend to another party any transaction.

Fungibility Concern Related to FATCA Withholding When Original Debt Is Issued Before, and Tack-On Debt Is Issued After, January 1, 2014

Withholding taxes required under the Foreign Account Tax Compliance Act (FATCA) could create tax fungibility issues when the original debt is issued before January 1, 2014 but the related tack-on debt is issued thereafter. Starting on January 1, 2014, FATCA may impose United States withholding tax on interest payments (and, starting on January 1, 2017, on principal repayments) made by domestic issuers (and certain foreign issuers) to foreign persons, unless the recipients comply with certain certification, reporting and other requirements or otherwise qualify for an exemption. Under recently issued Treasury regulations, FATCA withholding will not apply to any debt outstanding as of January 1, 2014 unless such debt is "significantly modified" thereafter.[6] In addition, the grandfathering of debt issued before January 1, 2014 will extend to related tack-on debt issued after such date, so long as the related tack-on debt is part of the same issue as, or issued in a qualified reopening of, the grandfathered debt. If original debt is exempted from FATCA withholding but the related tack-on debt is not (because the tack-on debt is practically fungible for OID purposes but is neither part of the same issue nor issued in a qualified reopening), the original and tack-on debt instruments may not be fungible for FATCA withholding purposes, and, as a result, the issuer may need to distinguish between them, which could require the tack-on debt to be issued under a different CUSIP or other identification number.

Conclusion

The revised definitions of the terms "qualified reopening" and "publicly traded" under the Final Regulations provide greater flexibility to create fungible tack-on debt instruments in situations where either the original debt or the additional debt is issued with OID and in situations where the additional debt is issued more than six months after the original issuance. As a result, we expect tack-on debt offerings will become easier and simpler in the future.

Endnotes

[1] In the case of a bank loan where there is no CUSIP number, the analogous issue will be whether an additional loan can be treated as the same tranche as the original loan. The tax rules governing fungibility are the same whether it is a bond or a bank loan.

[2] The amount of OID will be considered *de minimis* and thus ignored for tax purposes if the debt instrument is issued at a discount to its face amount that is less than 1/4 of 1 percent of the stated redemption price at maturity multiplied by the number of complete years to maturity.

[3] Tax practitioners are currently seeking guidance to confirm that the IRS actually intended to reference "original debt" in this instance (instead of "additional debt").

[4] Unless the additional debt satisfies the conditions for a qualified reopening, however, the original debt and the additional debt will not technically be the same issue for tax purposes, and each will have its own issue price and issue date. As a result, there may be situations when the inability to separate the additional debt from the original debt may become a burden. For example, when debt is retired, the issuer may be entitled to deduct retirement premium (or required to accrue cancellation of debt income), in each case, computed based on the adjusted issue price of the retired debt . If the debt is only partially retired, it would be difficult for the issuer to establish which of the original debt and the additional debt is being retired in the absence of separate CUSIPs. Accordingly, if both are issued with the same CUSIP, the issuer may have no choice but to take the position that what is being retired is the debt instrument giving rise to fewer deductions or more income.

[5] Under the Final Regulations, given the expanded definition of the term "publicly traded" and the alternative cash issuance requirement, additional debt instruments issued with no OID would normally satisfy conditions for a qualified reopening of the original debt instruments. As a result, when neither the original debt nor the additional debt is issued with OID, the issuers should generally be able to treat the additional debt as a qualified reopening of the original debt, rather than relying on the "practical" fungibility, in order to achieve fungibility for tax purposes.

[6] A different grandfathering date may apply to debt instruments issued by foreign issuers generating foreign source interest.

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