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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-131947-10
RIN 1545-BJ71

Property Traded on an Established Market

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to determining when property is traded on an established market (that is, publicly traded) for purposes of determining the issue price of a debt instrument. The regulations amend the current regulations to clarify the circumstances that cause property to be publicly traded. The regulations provide needed guidance to issuers and holders of debt instruments. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 8, 2011. Outlines of topics to be discussed at the public hearing scheduled for April 13, 2011, at 10 a.m. must be received by March 4, 2011.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-131947-10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-131947-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-131947-10).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, William E. Blanchard at (202) 622-3950; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo.P.Taylor@irs.counsel.treas.gov, at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

The issue price of a debt instrument is determined under section 1273(b) of the Internal Revenue Code or, in the case of certain debt instruments issued for property, under section 1274. Section 1273(b)(3) generally provides that in the case of a debt instrument that is issued for property and that is part of an issue some or all of which is traded on an established securities market (often referred to as "publicly traded"), the issue price of the debt instrument is the fair market value of the debt instrument. Similarly, if the debt instrument is issued for stock or securities (or other property) that are publicly traded, the issue price of the debt instrument is the fair market value of the property. Section 1.1273-2 of the Income Tax Regulations (the "current regulations") also applies to determine the issue price of a debt instrument that is publicly traded or is issued for publicly traded property. Under Sec. 1.1273-2(c)(1), the term property means a debt instrument, stock, security, contract, commodity, or nonfunctional currency. Section 1.1273-2(f) defines when property is traded on an established market (that is, publicly traded) for purposes of section 1273(b)(3) and Sec. 1.1273-2.

In general, under Sec. 1.1273-2(f) of the current regulations, a debt instrument is traded on an established market if either the debt instrument or the property for which the debt instrument is exchanged is described in Sec. 1.1273-2(f)(2) through (f)(5) in the time period 30 days before or after the exchange. Property is described in Sec. 1.1273-2(f)(2) if it is listed on a specified exchange. Property is described in Sec. 1.1273-2(f)(3) if it is of a kind that is traded on a contract market designated by the Commodities Futures Trading Commission or an interbank market. Property is described in Sec. 1.1273-2(f)(4) if it appears on a system of general circulation that disseminates price quotations or recent trading prices. Property is described in Sec. 1.1273-2(f)(5) if price quotations are readily available from dealers, brokers or traders, subject to certain exceptions.

The issue price of a debt instrument has important income tax consequences. As an initial matter, the difference between the issue price of a debt instrument and its stated redemption price at maturity measures whether there is any original issue discount associated with the instrument. A debt-for-debt exchange (including a significant modification of existing debt) in the context of a work-out may result in a reduced issue price for the new debt, which generally would produce cancellation of indebtedness income for the issuer, a loss to the holder whose basis is greater than the issue price of the new debt, and original issue discount that generally must be accounted for by both the issuer and the holder of the new debt. These consequences, exacerbated by recent turmoil in the debt markets, have focused attention on the definition of when property is traded on an established market for purposes of Sec. 1.1273-2(f).

Commenters have criticized the definition of an established market in Sec. 1.1273-2(f) of the current regulations. They argue that comparatively little debt is listed on an exchange described in Sec. 1.1273-2(f)(2), and that even debt that is listed rarely trades on the exchange. They point out that the list of foreign exchanges in Sec. 1.1273-2(f)(2)(iii) is outdated. Commenters also struggle to interpret the meaning of an interbank market in Sec. 1.1273-2(f)(3).

Even more troublesome for commenters is the question of what constitutes a quotation medium for purposes of Sec. 1.1273-2(f)(4) of the current regulations. Debt instruments typically trade in various ways in the current markets, but the vast majority of debt instruments are purchased or sold over-the-counter for a price negotiated between a financial entity (such as a securities dealer or broker) and a customer. A dealer or broker may quote a firm price, sometimes referred to as a "firm" or "executable" quote, entitling a customer to purchase or sell at that price, subject to volume limits or other specified restrictions. Alternatively, a dealer, broker or listing service may quote a price that indicates a willingness to purchase and/or sell a specified debt instrument, again subject to volume limits or other limitations, but not necessarily at the quoted price. This is sometimes referred to as a "soft" or an "indicative" quote. The decision to send a price quote to a customer (or customers) may be initiated by a dealer or broker, or a customer may request a price quote from one or more dealers or brokers. Additionally, a service provider may provide subscribers with valuations based on data collected from contributors that may reflect actual sales, price quotes, or any other information it deems relevant to the value of the debt instrument in question. Commenters struggled to apply the description of a quotation medium in Sec. 1.1273-2(f)(4) to this informal marketplace, which has evolved considerably since the regulations were originally promulgated in 1994.

Finally, commenters pointed out that the general rule in Sec. 1.1273-2(f)(5) of the current regulations, which treats a debt instrument as publicly traded if price quotations are readily available from dealers, brokers or traders could cause almost every debt instrument to be within this definition but for the safe harbors in Sec. 1.1273-2(f)(5)(ii).

Explanation of Provisions

As a general matter, the Treasury Department and the IRS believe that the "traded on an established market" standard established by section 1273(b)(3) is intended to be interpreted broadly. When section 1275(a)(4) was repealed by section 11325(a)(2) of the Revenue Reconciliation Act of 1990, Public Law 101-508, 104 Stat. 1388, 1388-466 (1990), issue price was required to be determined under section 1273 and section 1274 even in a debt-for-debt exchange that qualified as a corporate reorganization. As the depth of trading and the transparency of the markets that trade debt instruments has improved, the earlier concerns that trading prices may not reflect the fair market value of a debt instrument have diminished. Thus, to the extent

accurate pricing information exists, whether it derives from executed sales, reliable price quotations, or valuation estimates that are based on some combination of sales and quotes, the Treasury Department and the IRS believe that that information should be the basis for the issue price determined under section 1273(b)(3).

To address concerns with the current regulations, the proposed Regulations simplify and clarify the determination of when property is traded on an established market. The proposed regulations identify four ways for property to be traded on an established market. In each case, the time period for determining whether the property is publicly traded is the 31-day period ending 15 days after the issue date of the debt instrument.

First, property that is listed on an exchange continues to be publicly traded property under Sec. 1.1273-2(f)(2) of the proposed regulations. Although relatively few debt instruments are listed or traded on an exchange, the regulations may still apply to other property that is listed, such as stock for which a debt instrument is issued in a debt-for-stock exchange. The proposed regulations, however, delete the reference to an interdealer quotation system that is sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 because none exist or are contemplated. Rather than list foreign exchanges, the proposed regulations specify that a foreign securities exchange that is officially recognized, sanctioned, regulated or supervised by a governmental authority of the foreign country in which the market is located is an exchange that causes property to be publicly traded.

Second, Sec. 1.1273-2(f)(3) of the proposed regulations treats property as publicly traded when a sales price for the property is reasonably available. Market participants have access to information about the securities markets from a variety of sources, which are constantly changing and evolving. If information about the sales price of a debt instrument (or information sufficient to calculate the sales price) appears in a medium that is made available to persons that regularly purchase or sell debt instruments, or persons that broker purchases or sales of debt instruments, the sales price will be considered reasonably available. For example, in the case of a debt instrument, a sale that is reported electronically at any time in the 31-day time period, such as in the Trade Reporting and Compliance Engine ("TRACE") database maintained by the Financial Industry Regulatory Authority, would cause the instrument to be publicly traded, as would other pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers.

Third, property is considered to be traded on an established market if a firm price quote to buy or sell the property is available. A firm, or executable, price quote may be labeled as such, or a price quote may function as a firm quote as a matter of law or industry practice. In either case, Sec. 1.1273-2(f)(4) of the proposed regulations treats property with a firm quote as publicly traded.

Finally, a price quote (other than a firm quote) that is provided by a dealer, a broker, or a pricing service (an indicative quote) will cause property to be publicly traded under Sec. 1.1273-2(f)(5) of the

proposed regulations.

The proposed regulations provide that the fair market value of property described in Sec. 1.1273-2(f) will be presumed to be equal to its trading price, sales price, or quoted price, whichever is applicable. However, if there is more than one price or quote, a taxpayer is permitted to reconcile competing prices or quotes in a reasonable manner. In the case of an indicative quote, if a taxpayer determines that the quoted price or prices misrepresents the fair market value of the property by a material amount, Sec. 1.1273-2(f)(6)(ii) of the proposed regulations permits the taxpayer to use any method that provides a reasonable basis to determine the fair market value of the property, provided the taxpayer can establish that the method chosen more accurately reflects the value of the property than the extant quote or quotes for the property.

In response to commenters, the proposed regulations also contain guidance in areas ancillary to publicly traded debt, such as proposed regulations clarifying and revising the rules to determine when an issue of debt instruments is eligible to be part of a qualified reopening under Sec. 1.1275-2(k) and proposed regulations clarifying the treatment of a debt instrument issued in a debt-for-debt exchange under the potentially abusive rules in section 1274(b)(3). In addition, in response to commenters, the proposed regulations include a business day convention to determine if certain stated interest payments affect whether the payments are qualified stated interest.

Proposed Effective Date

The regulations, as proposed, apply to debt instruments that have an issue date on or after the publication date of the Treasury decision adopting these rules as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the

clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 13, 2011, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic by March 4, 2011. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

These regulations were drafted by personnel in the Office of Associate Chief Counsel (Financial Institutions and Products) and the Treasury Department.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1273-1 is amended by adding a new paragraph (c)(6) to read as follows:

Sec. 1.1273-1 Definition of OID.

* * * * *

(c) * * *

(6) Business day convention--(i) Rule. For purposes of this paragraph (c), if a scheduled payment date for stated interest falls on a Saturday, Sunday, or Federal holiday (within the meaning of 5 U.S.C. 6103) but, under the terms of the debt instrument, the stated interest is payable on the first business day that immediately follows the scheduled payment date, the stated interest is treated as payable on the scheduled payment date, provided no additional interest is payable as a result of the deferral.

(ii) Effective/applicability date. Paragraph (c)(6)(i) of this section applies to debt instruments that are issued on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. A taxpayer, however, may rely on paragraph (c)(6)(i) of this section for debt instruments issued before that date.

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Par. 3. Section 1.1273-2 is amended by revising paragraph (f) to read as follows:

Sec. 1.1273-2 Determination of issue price and issue date.

* * * * *

(f) Traded on an established market (publicly traded)--(1) In general. Except as provided in paragraph (f)(7) or (f)(8) of this section, property (including a debt instrument described in paragraph (b)(1) of this section) is traded on an established market for purposes of this section if, at any time during the 31-day period ending 15 days after the issue date--

(i) The property is listed on an exchange described in paragraph (f)(2) of this section;

(ii) There is a sales price for the property as described in paragraph (f)(3) of this section;

(iii) There are one or more firm quotes for the property as described in paragraph (f)(4) of this section; or

(iv) There are one or more indicative quotes for the property as described in paragraph (f)(5) of this section.

(2) Exchange listed property. Property is listed on an exchange for purposes of this paragraph (f)(2) if it is listed on--

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) A board of trade designated as a contract market by the Commodities Futures Trading Commission;

(iii) A foreign securities exchange that is officially recognized, sanctioned, regulated or supervised by a governmental authority of the foreign country in which the market is located; or

(iv) Any other exchange, board of trade, or other market which the Commissioner identifies in guidance published in the Internal Revenue Bulletin (see Sec. 601.601(d)(2)(ii)) as an exchange for purposes of this paragraph (f)(2).

(3) Sales price--(i) In general. A sales price exists if the price for an executed purchase or sale of the property is reasonably

available.

(ii) Pricing information for a debt instrument. For purposes of paragraph (f)(3)(i) of this section, the price of a debt instrument is considered reasonably available if the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available to persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers), or persons that broker purchases or sales of debt instruments.

(4) Firm quote. A firm quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the quoted price is substantially the same as the price for which the property could be purchased or sold. The identity of the person providing the quote must be reasonably ascertainable for a quote to be considered a firm quote for purposes of this paragraph (f)(4). A quote will be considered a firm quote if market participants typically purchase or sell, as the case may be, at the quoted price, even if the party providing the quote is not legally obligated to do so.

(5) Indicative quote. An indicative quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote described in paragraph (f)(4) of this section.

(6) Presumption that price or quote is equal to fair market value--
(i) In general. The fair market value of property described in this section will be presumed to be equal to its trading price on an exchange described in paragraph (f)(2) of this section, or its sales price or quoted price determined under paragraphs (f)(3) through (f)(5) of this section. If there is more than one trading price under paragraph (f)(2) of this section, sales price under paragraph (f)(3) of this section, or quoted price under paragraph (f)(4) or (f)(5) of this section, a taxpayer may use any reasonable method, consistently applied, to determine the price.

(ii) Special rule for property for which there is only an indicative quote. If property is described only in paragraph (f)(5) of this section, and the taxpayer determines that the quote (or an average of the quotes) materially misrepresents the fair market value of the property, the taxpayer can use any method that provides a reasonable basis to determine the fair market value of the property. A taxpayer must establish that the method chosen more accurately reflects the value of the property than the quote or quotes for the property to use the method provided in this paragraph (f)(6)(ii). For an equity or debt instrument, a volume discount or control premium will not be considered to create a material misrepresentation of value for purposes of this paragraph (f)(6).

(7) Exception for property for which there is de minimis trading--
(i) In general. Notwithstanding any other provision in this section, property will not be treated as traded on an established market if there is no more than de minimis trading of the property.

(ii) Definition of de minimis trading for debt instruments. For purposes of paragraph (f)(7)(i) of this section, a debt instrument will be treated as traded in de minimis quantities only if--

(A) Each trade of such debt instrument during the 31-day period ending 15 days after the issue date is for quantities of US\$1 million or less (or, for debt denominated in a currency other than the U.S. dollar, the equivalent amount in the currency in which the debt is denominated); and

(B) The aggregate amount of all such trades does not exceed US\$5 million (or, for debt denominated in a currency other than the U.S. dollar, the equivalent amount in the currency in which the debt is denominated).

(8) Exception for small debt issues. Notwithstanding any other provision in this section, a debt instrument will not be treated as traded on an established market if the original stated principal amount of the issue that includes the debt instrument does not exceed US\$50 million (or, for debt denominated in a currency other than the U.S. dollar, the equivalent amount in the currency in which the debt is denominated).

(9) Anti-abuse rules--(i) Effect of certain temporary restrictions on trading. If there is any temporary restriction on trading, a purpose of which is to avoid the characterization of the property as one that is traded on an established market for Federal income tax purposes, then the property is treated as traded on an established market. For purposes of the preceding sentence, a temporary restriction on trading need not be imposed by the issuer.

(ii) Artificial pricing information. If a principal purpose for the existence of any sale or price quotation is to materially misrepresent the value of property, that sale or price quotation may be disregarded.

(10) Convertible debt instruments. A debt instrument is not treated as traded on an established market solely because the debt instrument is convertible into property that is so traded.

(11) Effective/applicability date. Paragraph (f) of this section applies to a debt instrument issued on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

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Par. 4. Section 1.1274-3 is amended by adding a new paragraph (b)(4) to read as follows:

Sec. 1.1274-3 Potentially abusive situations defined.

* * * * *

(b) * * *

(4) Debt-for-debt exchange--(i) Rule. A debt instrument issued in a debt-for-debt exchange, including a deemed exchange under Sec. 1.1001-3, will not be treated as the subject of a recent sales transaction for purposes of section 1274(b)(3)(B)(ii)(I) even if the debt instrument exchanged for the newly issued debt instrument was recently acquired prior to the exchange. Therefore, the issue price of the debt

instrument will not be determined under section 1274(b)(3). However, if the debt instrument or the property for which the debt instrument is issued is publicly traded within the meaning of Sec. 1.1273-2(f), the rules of Sec. 1.1273-2 will apply to determine the issue price of the debt instrument.

(ii) Effective/applicability date. Paragraph (b)(4)(i) of this section applies to a debt instrument issued on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

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Par. 5. Section 1.1275-2 is amended by revising paragraphs (k)(3)(ii)(A), (k)(3)(iii)(A) and (k)(5) and adding a new paragraph (k)(3)(v) to read as follows:

Sec. 1.1275-2 Special rules relating to debt instruments.

* * * * *

(k) * * *

(3) * * *

(ii) * * *

(A) The original debt instruments are publicly traded (within the meaning of Sec. 1.1273-2(f)) as of the reopening date of the additional debt instruments;

* * * * *

(iii) * * *

(A) The original debt instruments are publicly traded (within the meaning of Sec. 1.1273-2(f)) as of the reopening date of the additional debt instruments;

* * * * *

(v) Non-publicly traded debt issued for cash. Notwithstanding paragraphs (k)(3)(ii)(A) and (k)(3)(iii)(A) of this section, a qualified reopening includes a reopening of original debt instruments if the additional debt instruments are issued for cash to persons unrelated to the issuer (as determined under section 267(b) or 707(b)) for an arm's length price and the other requirements in paragraph (k)(3)(ii) or (k)(3)(iii) of this section are satisfied, whichever is applicable. For purposes of paragraph (k)(3)(ii)(C) of this section, the yield test is satisfied if, on the reopening date of the additional debt instruments, the yield of the additional debt instruments (based on their cash purchase price) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

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(5) Effective/applicability dates--(i) Except as provided in paragraph (k)(5)(ii) of this section, this paragraph (k) applies to debt instruments that are part of a reopening where the reopening date is on or after March 13, 2001.

(ii) Paragraph (k)(3)(v) of this section applies to debt instruments that are part of a reopening if the reopening date is on or

after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.
[FR Doc. 2011-83 Filed 1-6-11; 8:45 am]
BILLING CODE 4830-01-P