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## TAX TREATMENT OF DEBT SECURITIES ISSUED IN A REOPENING Proposed IRS Regulations Would Answer Some Questions, but Others Remain

By Micah Bloomfield and Mark Eichler<sup>1</sup>

Recently, corporate issuers such as Bank of America, Coca Cola, and General Electric, have “reopened” previously issued series of notes or other debt instruments, issuing additional securities with the same economic terms and CUSIP number as the original series. Reopenings are attractive for a number of reasons, providing both tax and non-tax-related benefits. For example, because the newly issued securities in a reopening have the same CUSIP number as the original securities, they are viewed by the capital markets as part of the original series, thus increasing the float of the series, providing greater liquidity and in some instances more market makers, and generally improving the secondary market for the securities. In addition, in a rising interest rate environment such as ours, securities issued in a reopening can be issued at a discount from their stated redemption price at maturity – i.e., with what normally would be original issue discount (“OID”) – without the negative tax consequences of OID to holders of the securities.

Although reopenings can provide significant benefits to an issuer, to qualify for the tax and other benefits provided by a reopening, issuers must carefully structure the newly issued securities. As a practical matter, the ability of an issuer to reopen a particular series depends on whether the newly issued securities will be fungible with the originally issued securities, which in turn depends on whether

the newly issued debt securities will be treated as part of the same issue as the original debt securities.

Under current law, the answer to *that* question depends on IRS regulations (the “Current Regulations”)<sup>2</sup> and private letter rulings that, while providing some guidance to issuers contemplating reopenings, leave a number of important questions unanswered, thereby creating legal uncertainty for issuers and potential investors. In November 1999, the IRS issued proposed regulations (the “Proposed Regulations” or “Prop. Treas. Regs.”) addressing certain of these issues. The Proposed Regulations will become effective 60 days after they are finalized. This article discusses some of the differences between the Proposed Regulations and the Current Regulations, including the impact of the Proposed Regulations on whether debt securities will be treated as part of a previously issued series. This article also examines some of the issues companies should consider when contemplating the reopening of a series of debt securities.

### I. OID and Market Discount Rules

A debt security will have OID if its stated redemption price at maturity exceeds its issue price by more than a *de minimis* amount.<sup>3</sup> Ordinarily, holders of a debt security with OID must recognize interest income to reflect this excess even though no cash actually is received.<sup>4</sup> However, in a

<sup>1</sup> Micah Bloomfield is a partner and Mark Eichler an associate in the Tax Department of Stroock & Stroock & Lavan LLP.

<sup>2</sup> Treasury Regulations (“Treas. Reg.”) § 1.1275-1(f) and Temporary Treasury Regulations (“Temp. Treas. Reg.”) § 1.1275-2T(d)(2).

<sup>3</sup> Section 1273(a) of the Internal Revenue Code of 1986, as amended (the “Code”). The excess is *de minimis* if it is less than 0.25% of the debt security’s stated redemption price at maturity, multiplied by the number of complete years to maturity.

<sup>4</sup> Code § 1272(a).

“reopening” of a series of debt securities issued for cash, any OID of the newly issued securities will be converted to “market discount.”<sup>5</sup>

The conversion of OID to market discount is not the result of alchemy. Rather, it is a function of the definition of “issue price.” The issue price of debt securities issued for cash as part of a series is deemed to be the first price at which a substantial amount of the securities of such series are sold to the public.<sup>6</sup> Consequently, even if debt securities technically have OID (because their stated redemption price at maturity exceeds their *actual* issue price by more than a *de minimis* amount), if they are issued in a reopening, they will have the same issue price as the originally issued securities. Because the original securities were issued without OID, the newly issued securities also will not have any OID.

As noted above, instead of having OID, a debt security that is issued in a reopening generally will have market discount to the extent its redemption price at maturity exceeds its purchase price.<sup>7</sup> A holder of a debt security with market discount generally will not have to recognize any current income in excess of the debt security’s stated interest. However, the holder will have to defer its deduction for interest paid on any indebtedness incurred to acquire the debt security (except to the extent the interest expense in excess of the interest income received on the debt security is greater than the accrued market discount attributable to the debt security).<sup>8</sup> In addition, upon disposition of a debt security with market discount, the holder will be required to recognize ordinary income to the extent of any accrued market discount.<sup>9</sup> Alternatively, a holder may elect to accrue market discount as ordinary income on a current basis, in which case the holder will be allowed to deduct currently the interest paid on indebtedness incurred to purchase the debt security and the sale

of the debt security will not trigger additional ordinary income to the holder.<sup>10</sup>

Clearly, the fundamental question in a “reopening” – whether two issuances of debt securities will be treated as one “issue” for tax purposes – has important implications for the holder. If the discount is OID, the holder will be required to include the discount in income over the term of the debt security. Conversely, if the discount is market discount, unless the holder elects otherwise, the holder is not required to include the discount in income until it disposes of the debt security or the debt security is redeemed. Furthermore, the issuer needs to determine if newly issued debt securities have OID or market discount to report properly such discount to holders and to the Internal Revenue Service (the “IRS”). As discussed below, to answer that question, the issuer must consider both the Current Regulations and the Proposed Regulations.

## II. Current Regulations

The Current Regulations provide that Treasury obligations issued in a reopening will be treated as part of the original series if they: (i) have the same economic terms as the original Treasury obligations, and (ii) are issued within one year of the initial issuance.<sup>11</sup> Unfortunately, this provision of the Current Regulations does not apply to non-Treasury obligations and thus is useful only by way of analogy.

With respect to non-Treasury obligations, the Current Regulations provide that “[t]wo or more debt instruments are part of the same issue if they have the same credit and payment terms and are sold reasonably close in time either pursuant to a common plan or as part of a single transaction or a series of related transactions.”<sup>12</sup> There is no IRS guidance, however, as to the meaning of the phrase

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5 For the purposes of this article, it is assumed that debt securities issued in initial issuances do not have OID and are issued for cash.

6 Treas. Reg. § 1.1273-2(a)(1).

7 Code § 1278(a). A debt security will not be deemed to have any market discount if the excess is less than 0.25% of the security’s stated redemption price at maturity, multiplied by the number of complete years to maturity.

8 Code § 1277. The deduction is deferred until the holder disposes of the debt security or, if the holder elects, until such time as the interest received on the debt security exceeds the interest expense. Accrued market discount is an amount which bears the same ratio to the market discount on a debt security as the number of days which the taxpayer holds the debt security bears to the number of days after the date the taxpayer acquires the debt security and up to (and including) the date of its maturity. Code § 1278(b)(1). There is an alternative to this ratable accrual method, under which taxpayers may elect to compute accrued market discount on the basis of a constant interest rate, in which case the accrual of market discount will increase over time (taking into account the compounding of interest). Code § 1276(b)(2).

9 Code § 1276(a)(1).

10 Code § 1278(b).

11 Temp. Treas. Reg. § 1.1275-2T(d)(2).

12 Treas. Reg. § 1.1275-1(f).

“reasonably close in time” in the context of reopenings of debt securities. Nor has the IRS provided interpretive guidance with respect to the regulatory requirement that the debt instruments in question be sold “either pursuant to a common plan or as part of a single transaction or a series of related transactions.”<sup>13</sup> In 1984, the New York State Bar Association Tax Section suggested that the regulations include a presumption that two debt obligations are part of the same issue if they are sold within a 30-day period under the same prospectus, prospectus supplement, or other offering documents.<sup>14</sup> The Treasury, however, never adopted this suggestion and taxpayers were left to their own devices to make sense of the amorphous rule that was promulgated.

A few private letter rulings issued prior to the promulgation of the Current Regulations addressed the question of what constitutes a single “issue” for tax purposes. These rulings are useful in determining what factors the IRS historically has considered important. In Private Letter Ruling 7412309930A (December 10, 1974), the IRS cited Securities Act Release No. 33-4434, which indicates the following factors should be considered in determining whether offers and sales are part of the same issue:

1. Whether the offerings are part of a single plan of financing;
2. Whether the offerings involve issuance of the same class of securities;
3. Whether the offerings are made at or about the same time;
4. Whether the same type of consideration is received; and
5. Whether the offerings are made for the same general purpose.

The IRS concluded that the debentures in question were not part of the same issue, reasoning that four of the five factors were not satisfied.<sup>15</sup> Although the preamble to the Current Regulations indicates that debt instruments issued for different consideration can still constitute part of the same issue, the other four factors presumably are still relevant to the general inquiry.

In Private Letter Ruling 8344051 (July 29, 1983), the IRS noted that SEC Rule 415 permits a single registration for an aggregate amount of securities that an issuer reasonably expects to offer and sell within a two-year period (a “shelf registration statement”). The IRS held that a series of debentures issued pursuant to a single registration under this rule would be treated as a single issue for purposes of calculating OID. Although this ruling is helpful to taxpayers hoping to aggregate two debt issuances as a single “issue,” there is no other authority that indicates the IRS would treat two instruments issued up to two years apart as part of the same issue, and the ruling may have been somewhat of an anomaly. Thus, we would be cautious about placing too much emphasis on this ruling.

More recently, the IRS held in Private Letter Ruling 8829067 (April 27, 1988), that two debt offerings were not part of the same issue, basing its holding on three factors. First, the offerings were more than 20 months apart.<sup>16</sup> Second, the consideration received for the debt instruments was different.<sup>17</sup> Finally, the purpose of the two offerings was distinct: one was intended to refinance acquisition indebtedness, to provide working capital, and to retire outstanding indebtedness, and the other was made in connection with a corporate acquisition.

These rulings provide some insight into what factors may be considered in determining whether two obligations are part of the same issue. Clearly, it

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13 The 1992 proposed regulations contained a different requirement: that publicly offered debt instruments had to be sold “pursuant to a common plan of marketing.” In finalizing these regulations, however, the Treasury eliminated this “common plan of marketing” concept in order to enable debt instruments issued in different markets or for different consideration to be treated as part of the same issue. See Preamble to Prop. Treas. Reg. § 1.1271-1275 (1992), 57 FR 60750, 1993-1 C.B. 734.

14 New York State Bar Association Tax Section’s Ad Hoc Committee on Original Issue Discount and Coupon Stripping, “A Preliminary Report on Issues to be Addressed in Regulations and Corrective Legislation” reprinted in 22 Tax Notes 993 (Mar. 5, 1984) at 997-98.

15 One of the factors not satisfied was whether the debentures were issued at or about the same time. The debentures were issued 11 months apart. Although the requirement of the Current Regulations that the instruments be sold “reasonably close in time” is more flexible than the “at or about the same time” standard articulated in the ruling, the Service’s express disapproval of an 11 month time lag in this ruling should be given some weight.

16 The Service’s explicit disapproval of a 20-month time lag in this ruling calls into doubt the continuing validity of the aforementioned Private Letter Ruling 8344051, which seemingly created a safe harbor for all debt obligations issued within a two-year window pursuant to a single registration statement.

17 Again, the Current Regulations were intended to permit debt obligations issued for different consideration to be treated as part of the same “issue.” Thus, this factor has lost most, if not all, of its former relevance.

is useful if the two obligations are issued for the same general purpose. Consequently, issuers should: (i) explicitly provide in their offering documents that they may reopen a series, and (ii) formally approve a resolution indicating the purpose of each issuance of securities. Perhaps the most critical factor, however, is the amount of time between the two issuances. Although there are no objective guidelines, these rulings suggest a significant time lag would be problematic (keeping in mind that eleven months has been deemed “significant.”)<sup>18</sup>

### III. Proposed Regulations

In general, the Proposed Regulations would treat debt securities as part of one issue for purposes of calculating OID if either: (i) the debt securities were part of the same “issue” (as defined below),<sup>19</sup> or (ii) the later debt securities were issued as part of a “qualified reopening.”<sup>20</sup> For this purpose, two or more debt securities would be treated as part of the same issue only if the two debt securities: (i) have the same credit and payment terms, (ii) are issued pursuant to a common plan or as part of a single transaction or a series of related transactions, and (iii) are issued within a 13-day period.<sup>21</sup> The first two prongs of this definition are contained in the Current Regulations. The third prong of the definition (the 13-day requirement), replaces the more lenient “reasonably close in time” standard contained in the Current Regulations.

Alternatively, a debt security that is issued after the original issuance of a series of debt securities will be treated as part of the original series if the terms of the newly issued security are identical to the terms of the original securities and the new security is issued pursuant to a “qualified reopening.”<sup>22</sup> A qualified reopening is a reopening of the original issuance where: (i) the newly issued

security is issued not more than six months after the issue date of the original security, (ii) the original security is publicly traded, and (iii) either (a) the newly issued security is issued with no more than a *de minimis* amount of OID, i.e., at a discount of less than 0.25% of the redemption price at maturity for each full year to maturity, or (b) the two-part “yield test” is satisfied.<sup>23</sup> For this purpose, the original security is “publicly traded” if: (i) it trades on certain designated securities exchanges or on an interbank market, (ii) it appears on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either actual prices or recent price quotations of identified brokers, dealers or traders (which does not include yellow sheets), or (iii) with certain exceptions, if price quotations with respect to the original security are readily available from dealers, brokers or traders.<sup>24</sup>

The two-part yield test is satisfied if: (i) seven days before the pricing date for the newly issued security, the market yield of the original securities is not more than 107.5 percent of the coupon rate (107.5% of the yield, if the original security was issued with more than a *de minimis* amount of OID) of the original security on its issue date, and (ii) the yield of the newly issued security (based on its sales price) is not more than 115% of the coupon rate (115% of the yield, if the original security was issued with no more than a *de minimis* amount of OID) of the original security on its issue date.

The preamble to the Proposed Regulations states that the reopening rules were designed to limit the amount of OID that could be converted into market discount. For example, the Preamble indicates that the “107.5 percent rule” was designed to give the issuer a preliminary indication on the announcement date that the subsequent issuance

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18 See footnote 15.

19 Prop. Treas. Reg. § 1.1275-1(f).

20 Prop. Treas. Reg. § 1.1275-2(k).<sup>21</sup> Prop. Treas. Reg. § 1.1275-1(f)(1).

21 Prop. Treas. Reg. § 1.1275-1(f)(1).

22 Prop. Treas. Reg. § 1.1275-2(k)(1).

23 Prop. Treas. Reg. §§ 1.1275-2(k)(2)(iv), -2(k)(3) and -2(k)(4).

24 Treas. Reg. § 1.1273-2(f).

will be a qualified reopening. However, this preliminary indication is not dispositive. If interest rates rise sharply over the next week, allowing the newly issued securities to be treated as part of the original series would result in a significant amount of OID being converted to market discount. For that reason, the “115 percent rule” limits the amount of OID that can be converted into market discount, but allows for some rise in interest rates between the announcement date and the pricing date.

As a result, if the Proposed Regulations are finalized in their current form, an issuer will be able to reopen an earlier series at any time, and for any reason, within six months of the original issuance, provided the original securities are publicly traded and the newly issued securities are sold at no more than a modest discount.

Note, however, that many commentators have suggested changes to the Proposed Regulations. Specifically, they recommend: (i) extending the period of time during which a series can be reopened, and (ii) eliminating or modifying the two part yield test.<sup>25</sup>

#### **IV. Suggestions for Issuers**

Until the Proposed Regulations are finalized, issuers must comply with the Current Regulations in order for a new issuance to qualify as a reopening – a task complicated by the absence of any bright-line tests under the Current Regulations. However, if an issuer: (i) provides in the original documentation for a series that it may be reopened, (ii) actually issues the new debt securities within four months of the original issuance, (iii) issues the new debt securities for the same purpose as the original issuance, and (iv) at the time of the issuance of the new debt securities, approves a resolution confirming this fact, it is likely that the new issuance will qualify as a reopening.

Nevertheless, because of the uncertainty surrounding the Current Regulations and the fact that the IRS sometimes allows taxpayers to follow proposed regulations (and proposed regulations can give taxpayers substantial authority for purposes of determining if the imposition of penalties is appropriate), the most prudent course of action is to satisfy the Proposed Regulations as well by: (i) ensuring the new issuance meets the 107.5% and 115% rules described above, and (ii) treating the newly issued debt securities as part of the original series only if the original debt securities are publicly traded or are issued within 13 days of the original issuance.<sup>26</sup>

It is important to note that penalties are possible if an issuer is incorrect in its determination that a new issuance qualifies as a reopening, and as a consequence incorrectly characterizes OID as market discount.<sup>27</sup> Generally, an issuer of a publicly traded debt instrument with OID must file IRS Form 8281 (Information Return for Publicly Offered Original Issue Discount Instruments), which provides information regarding, among other things, the amount of OID and the issue date of the debt instrument.<sup>28</sup> If a new issuance qualified as a reopening of an issue that had no OID, the new issue also would have no OID and the issuer would not be required to file IRS Form 8281. However, if an issuer is incorrect, and the new issue has OID, the failure to file Form 8281 could subject the issuer to a maximum one-time penalty of \$50,000.<sup>29</sup> Moreover, the issuer of an OID instrument is required to: (i) provide an annual statement to each payee (other than certain exempt payees, including corporations) that sets forth the amount of OID accrued by such payee, and (ii) file with the IRS an information return for each non-exempt payee that reports the amount of OID accrued by such payee.<sup>30</sup> Failure to provide that information may, depending on (i) the

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25 See e.g., “Companies Suggest Changes to Proposed Regs on Securities Reopenings,” 2000 Tax Notes Today, 102-26; “Freddie Mac Opposes Proposed Regs on Securities Reopenings,” 2000 Tax Notes Today, 62-26; “Fannie Mae Suggests Changes to the Temporary and Proposed Regs on Securities Reopenings,” 2000 Tax Notes Today, 47-23; “Association Criticizes the Temporary and Proposed Regs on Securities Reopenings,” 2000 Tax Notes Today, 47-24.

26 Issuance of the new debt securities within 4 months of the issuance of the original series (as we suggest is prudent under the Current Regulations), satisfies the “six-month” requirement of the Proposed Regulations.

27 This article does not address penalties or liabilities that might arise under state or federal securities laws as a result of such an incorrect determination.

28 Code § 1275(c)(2); Treas. Reg. § 1.1275-3(c).

29 Code § 6706(b).

30 Code §§ 6721 and 6722.

status of the payees, (ii) the reason for the failure, and (iii) the number of payees, subject the issuer to a maximum annual penalty of \$350,000 (\$100,000

for failing to provide the payee statements and \$250,000 for failing to file the information returns).<sup>31</sup>

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<sup>31</sup> *Id.* In cases of intentional disregard the penalties would be higher.

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If you wish to discuss this article further, call Micah Bloomfield at (212) 806-6007 or Mark Eichler at (212) 806-6033.

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## STROOCK & STROOCK & LAVAN LLP

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180 Maiden Lane  
New York, NY 10038  
Tel: (212) 806-5400  
Fax: (212) 806-6006

2029 Century Park East,  
Suite 1800  
Los Angeles, CA 90067  
Tel: (310) 556-5800  
Fax: (310) 556-5959

200 South Biscayne Boulevard,  
Suite 3300  
Miami, FL 33131  
Tel: (305) 358-9900  
Fax: (305) 789-9302

1150 Seventeenth Street, N.W.,  
Suite 600  
Washington, D.C. 20036  
Tel: (202) 452-9250  
Fax: (202) 293-2293

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