QUALIFIED REOPENING OF DEBT ISSUANCES

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On November 5, 1999, the Treasury issued proposed regulations that provide guidance on an issuer's ability to reopen prior debt issuances and issue additional securities (commonly called "tack-on" or "add-on" securities). Under current federal tax law, during periods of stable or falling market interest rates, an issuer's ability to reopen a prior debt issuance is not restricted. However, during periods of rising market interest rates, the original issue discount rules can effectively prohibit such reopenings in the case of traded securities. The proposed regulations would modify the original issue discount rules and provide a safe harbor for "qualified reopenings". A qualified reopening is a reopening that meets the following conditions:

- the original debt instruments are publicly traded;
- the issue date of the additional debt instruments is not more than 6 months after the issue date of the original debt instruments;
- on the date which is 7 days before the date on which the additional debt instruments are priced, the yield of the original debt instruments (based on fair market value) is not more than 107.5% of the yield of the original debt instruments on their issue date; and
- on the date of issuance of the additional debt instruments, the yield of the additional debt instruments is not more than 115% of the yield of the original debt instruments.

BACKGROUND

If market interest rates have risen since an original debt issuance, a subsequent issuance of debt instruments with identical terms will generally price at a discount to the face amount. When this discount is more than a de minimis amount (generally 25 basis points per year), the additional securities will either have market discount or original issue discount, depending upon whether the additional securities are treated as part of the same "issue" as the original securities. If the additional securities are treated as part of the same issue, they will have market discount.

In contrast, if the additional securities are not treated as part of the same issue, they will have original issue discount. Unlike market discount, original issue discount is accrued into a holder's income currently and the issuer is required to report this accrued amount to the

Internal Revenue Service. To comply with its reporting obligation, the issuer must be able to distinguish the additional debt instruments from the original debt instruments (which were not issued with original issue discount). Thus, the additional debt instruments will have to be given a new CUSIP number and the two issuances will not be fungible.

Under current Treasury regulations, two or more debt instruments are part of the same "issue" if they have the same payment and credit terms and are sold "reasonably close in time" either pursuant to a common plan or as part of a single transaction or series of related transactions. Neither the current regulations nor existing case law provide guidance as to when an additional issuance is reasonably close in time, and this lack of guidance has created uncertainty for debt reopenings. The proposed Treasury regulations would replace the reasonably close in time standard with a bright-line rule of 13 days. The purpose of this modification is to require that all additional issuances made more than 13 days after the original issuance satisfy the proposed qualified reopening rules in order to avoid treatment as a new issue.

QUALIFIED REOPENINGS UNDER THE PROPOSED REGULATIONS

Under the proposed regulations, additional debt instruments sold in a "qualified reopening" would be treated as part of the same issue as the original debt instruments. As a result, the additional debt instruments would generally have the same issue date, the same issue price, the same tax characteristics and the same CUSIP number as the original debt instruments.

A qualified reopening is a reopening that satisfies the four conditions described above. In addition, a qualified reopening includes a reopening of original debt instruments that meet the first two conditions described above where the additional debt instruments are issued with no more than a de minimis amount of original issue discount. A qualified reopening, however, would not include a reopening of tax-exempt obligations or contingent debt instruments.

According to the Treasury, the qualified reopening rules attempt to strike a balance between tax policy concerns about the conversion of original issue discount (taxable as it accrues) into market discount (taxable generally only upon payment) and the need to have the tax rules reflect current capital market requirements. Thus, the proposed regulations permit reopenings when the issuer can prove by objective, market-based information that the reopening will convert only a small amount of original issue discount into market discount.

CONSEQUENCES TO ISSUER

The proposed regulations also provide special rules for the issuer's treatment of debt instruments comprising an issue when there is a qualified reopening. Under these rules, the issuer would be required to adjust the aggregate adjusted issue prices of all of its debt instruments in the issue (both original and additional) based on the difference between the amounts paid by the holders to acquire the additional debt instruments in the qualified reopening and the adjusted issue price of the original debt instruments. The issuer would then recompute the yield of the debt instruments as of the reopening date and would use this redetermined yield to calculate its accruals of interest expense over the remaining term of the debt instruments.

CONSEQUENCES TO HOLDERS

As stated above, if the issuance of the additional securities constitutes a qualified reopening under the proposed regulations, the additional securities will have the same issue price as the original securities. Any non-de minimis difference between the face amount of the additional securities and the holder's purchase price for such additional securities will constitute market discount, rather than original issue discount as would be the case if the additional securities were treated as a different issuance. Unlike original issue discount which a holder must accrue into income currently on a constant yield basis over the term of the debt obligation, market discount is generally not required to be included in a holder's income until the debt obligation is retired or sold.

EFFECTIVE DATE

The proposed regulations are proposed to apply to qualified reopenings where the reopening date is on or after the date that is 60 days after the date final regulations are published in the Federal Register. The proposed revision to the definition of the term "issue" would apply to debt instruments issued on or after the date that is 60 days after the date final regulations are published in the Federal Register. For debt instruments issued prior to the effective date of the regulations, no inference is intended with respect to the interpretation of the term issue under the current final regulations.

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If you have any questions regarding the application of the proposed regulations, please contact John Creed (212-455-3485), Marti Awad (212-455-3041) or Katharine Moir (212-455-3368) in our New York office, Karen Sakanashi (011-852-2514-7655) in our Hong Kong office, or any other member of the tax department.

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