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Example 11(d). Majority of the loans are sold at one price, remainder of the loans sold at various other prices, and some of the loans are sold at a price that most closely reflects the cumulative amount of OID.

Example 11(e). Substantial amount of the loans are sold at the average price of all loans sold, but a plurality of the loans are sold at another price.

Example 11(f). Substantial amount of the loans are sold at the average price of all the loans sold, a greater amount of the loans are sold at another price, but no particular price has a majority or a plurality.

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Debt Fungibility

By Eli Weiss*

I. Introduction.

When I decided to write a paper on fungibility, one of my children said, “I wish I knew more about mushrooms.” I am not sure what he meant by that, but the topic of the article is not mushrooms. It is about whether two debt instruments are sufficiently identical so that they are fungible, which is defined as “of such a nature that one part or quantity may be replaced by another equal part or quantity...interchangeable”1 Such a determination is relevant in a number of cases, some of which will be discussed in this paper. The most obvious case is where an additional debt instrument is issued with terms that are the same as an outstanding debt instrument. If the two debt instruments are fungible, then they can trade together as a single tranche of debt, and both the original and the additional debt instruments will benefit from the increased liquidity afforded by the larger tranche size. By contrast, if the debt is not fungible, each tranche will be smaller and less liquid.

While it may seem that whether two debt instruments are fungible is a simple legal determination and the terms of the instrument merely must be the same, that is not the case. Even though two instruments may be identical from a legal perspective, they can still have different tax characteristics, which will cause the two instruments not to be fungible.

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This article addresses a number of practical issues within the topic of debt fungibility. Sections II and III of the paper discuss the some background and basic tax rules applicable to whether two debt instruments are fungible. Section IV of this paper discusses (a) tax issues that arise when additional debt instruments are issued between interest payment dates of the original debt instruments and how to deal with the original debt being entitled to interest for periods prior to the issuance of the additional debt; (b) tax issues that arise when two debt instruments have the same economic terms and interest accruals from a tax perspective, but are not part of one “issue” for tax purposes, and when an outstanding debt instrument is modified to become identical to another outstanding debt instrument; (c) cases in which two debt instruments are very nearly identical but have minor differences and whether those differences have debt fungibility consequences; (d) establishing the issue price of an issue of debt instruments in which the debt was sold on the issue date for more than one price; (e) the tax consequences to the holders and issuer of purchasing or selling a debt instrument at original issue at a price other than the issue price; and (f) tax issues that arise in connection with related-party debt purchases.

II. Background.

A. Types of Debt and CUSIP Numbers.

This article generally discusses three types of debt instruments. These types are bonds, bank loans, and mezzanine and other closely held debt. Bonds are debt issued in the form of notes that are either registered and sold to the public, or exempt from registration under Rule 144A, which generally limits their availability for resale. Bonds generally trade through a depositary that is not able to trace the ownership history of each bond through the chain of title. Additional issuances of identical bonds are referred to as “add-on offerings.” Bank loans are debt lent by banks, or syndicates of lenders that generally include banks, which are generally
documented in the form of credit agreements and are often times tradable in the syndicated loan market, frequently based on documentation provided by the LSTA. Transfers of the loans generally take place through assignment agreements, and the administrative agent generally retains the documentation related to each sale and is thus able to trace ownership history through the chain of title for each interest in the loan. Additional bank loans are called “incremental loans.” Mezzanine debt and other closely held debt instruments generally issued in the form of notes and often have transfer restrictions or otherwise do not trade widely.

In the case of bonds and bank loans, a CUSIP is used to identify a particular security. The CUSIP is an alphanumeric number obtained by the issuer from the CUSIP Service Bureau. Once the issuer obtains a CUSIP, market participants buy and sell all debt classified with that CUSIP interchangeably. Interestingly, there is no requirement in connection with obtaining a CUSIP that all of the debt identified with that CUSIP have identical tax treatment. However, in practice, issuers will not classify U.S.-marketed debt instruments with identical legal rights but different U.S. tax treatments under one CUSIP Number. Doing so would create a situation where holders would be unable to know how much income to include with respect to their debt instruments, issuers would be unable to comply with their original issue discount reporting rules, and confusion and disruption would exist in the market.2

B. OID and Market Discount Rules.

When a debt instrument is issued for an amount that is less than its stated redemption price at maturity, that amount is called original issue discount (“OID”) and a series of rules called the original issue discount rules (the “OID Rules”) apply.3 These rules are based on the

2 Hochberg & Orchowski, What Looks the Same May Not Be the Same: The Tax Treatment of Securities Reopenings, 67 Tax Lawyer 143 (2014).
3 See Sections 1272-1275 of the Code.
principle that when a debt instrument pays a holder at maturity more than the holder paid at issuance, that excess is economically equivalent to interest, and should be taxed in same manner as interest. The rules therefore require both the holder and the issuer to take the OID into income on a constant yield to maturity basis over the life of the instrument. Thus, each year the holder will need to take into income a portion of the OID, and the issuer will be able to deduct a portion of the OID. This treatment of the instrument continues to apply after the holder sells the debt instrument, so that a subsequent holder will also need to take into account a portion of the OID each year.

By contrast, if a holder acquired an instrument from an issuer without OID (or with less than a de minimis amount of OID), and then resold that instrument for a price that is less than the stated redemption price at maturity, that sale will not cause the OID rules to apply to the second holder. Instead, the so-called “market discount rules” apply. Under these rules, so long as the second holder continues to hold the instrument, the holder is not required to take into account any income as a result of the difference between the price at which he purchased the instrument and the stated redemption price at maturity. Once the instrument is disposed of, however, the holder will be required to recognize any market discount that accrued during the time he held the debt as ordinary income. The market discount rules are therefore more favorable to a holder than the OID rules, in that they permit a holder to defer the inclusion of the discount until the time that the holder disposes of the debt.

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4 There is an exception if the amount of OID is de minimis. See Section 1273(a)(3) (“If the original issue discount ... is less than (A) ¼ of 1 percent of the stated redemption price at maturity, multiplied by (B) the number of complete years to maturity, then the original issue discount shall be treated as zero.”).

5 See Sections 1276-1278.
C. Additional Debt Instruments – Overview.

When the issuer issues an additional debt instrument that is identical to an outstanding debt instrument, there are reasons to treat the two debt instruments the same for tax purposes. Identical treatment would create greater liquidity for each tranche of debt instruments, since the size of the instrument would be larger and would thus be more heavily traded, which encourage issuance of debt in the capital markets. The greater liquidity would also benefit the issuer by causing the pricing on the debt to improve. Finally, identical treatment would make it easier for the issuer and the holder to report the interest and OID on the instruments.

However, if the tax rules would allow the holder to treat that additional debt in the same manner as the original debt in all cases, a holder would be permitted to convert what would otherwise have been OID into market discount, and to defer income attributable to the discount until he sold the instrument. For example, assume an issuer issued a debt instrument with a principal amount of $100 for a price of $100 that bears interest at 10% and has a maturity date in ten years. Circumstances then change and the issuer is unable to borrow at that same rate, so the issuer issues an identical debt instrument for $90. If the parties were to treat new debt instrument in the same manner as the old debt instrument, the instrument would have no OID and a holder could defer taking into account any income as result of the $10 discount until he sold the instrument. By contrast if the new debt instrument were not treated the same as the original debt instrument, the new debt instrument would have OID and a holder would be required to report the discount on a constant yield to maturity basis under the OID rules.

The tax rules compromised between these two policy goals by providing a mechanism that treats certain issuances of additional debt as being fungible with outstanding debt, but limiting the mechanism to certain cases. The rules accomplish this by treating certain additional
debt as being part of the same issue as the original debt. In other words, the parties treat the additional debt as having the same issue price and the same issue date as the original debt even though they actually sold the additional debt at a different price and a different date than the original debt, which causes the additional debt to have the same tax treatment as the original debt. The mechanism, however, is limited to two cases: (a) where two debt instruments are issued closely in time as part of one plan (presumably under the theory that it would not be practical to treat debt instruments as two separate issuances of debt instruments for tax purposes when they are part of one offering for all non-tax purposes) and (b) where the additional instruments are sufficiently identical to the original debt instruments so as to qualify under the “qualified reopening” rules. The rules treat issuance of additional debt that does not meet these two rules as separate debt instruments, and thus the additional debt may have a different tax treatment than the original debt instruments.

III. Relevant Tax Rules.

A. “Issue” for Tax Purposes.

One way for debt to be fungible is to be part of the same “issue” under the Treasury Regulations as a result of having been issued closely in time. Two or more debt instruments are part of the same issue if they

(i) Have the same credit and payment terms;

(ii) Are issued either pursuant to a common plan or as part of a single transaction or a series of related transactions;

(iii) Are issued within a period of thirteen days beginning with the date on which the first debt instrument that would be part of the issue is issued to a person other than
a bond house, broker, or similar person or organization acting in the capacity of
an underwriter, placement agent, or wholesaler; and

(iv) Are issued on or after March 13, 2001.\(^6\)

A few observations on the 13-day period in this rule are that: (1) the 13-day time period
includes the issue date, so that the issuer effectively has only 12 days following the issue date to
issue debt that qualifies under this rule, (2) the days are calendar days not business days and (3)
the rule contains no exception if the final day is a legal holiday.

It is not entirely clear what is meant by the requirement that the two debt instruments are
part of “a common plan or as part of a single transaction or a series of related transactions”. One
approach is to say that in cases where the original debt instrument contemplates the issuance of
the additional amount, and provided that the additional amount would be governed by the same
indenture or credit agreement as the original debt instrument (so that, for example, voting would
be done by a majority of the outstanding debt of both tranches), the two issuances are “related
transactions” as result of such an arrangement. This would be the case in almost all add-on
bonds and incremental syndicated bank loans. In any event, a “green shoe” should meet the
requirement.

**B. Qualified Reopening Rules.**

The qualified reopening rules treat certain additional debt instruments as being fungible
for tax purposes with the original debt instruments. The rules make the debt instruments

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\(^6\) Treas. Reg. §1.1275-1(f)(1). Debt issued after April 4, 1994, and before March 13, 2001 are part of the same issue
if they:

(i) Have the same credit and payment terms; [and]

(ii) 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; …

fungible by treating the new instruments as part of the same “issue” as the original debt
instruments, and therefore having the same issue date and issue price as the original debt
instruments. This reflects a policy decision to allow fungibility of additional debt instruments
where the additional debt instruments satisfy certain specific criteria discussed below, including
not having OID significantly in excess of the OID on the original debt instrument.

To obtain treatment as a qualified reopening, in all cases the additional debt instruments
must “have terms that are in all respects identical to the terms of the original debt instruments as
of the reopening date.”\footnote{Treas. Reg. §1.1275-2(k)(2)(ii)(C).} Additionally, either (a) the original debt instrument must be publicly
traded (within the meaning of Treas. Reg. §1.1273-2(f))\footnote{Treas. Reg. §1.1275-2(k)(3)(ii)(A) for reopenings within six months and Treas. Reg. §1.1275-2(k)(3)(iii)(A) for reopenings with de minimis OID.} or (b) the additional debt instrument
must have issued for cash to persons unrelated to the issuer (as determined under Sections 267(b)
or 707(b) of the Code).\footnote{Treas. Reg. §1.1275-2(k)(3)(iv).}

Finally, the additional debt instruments must meet one of the following three
requirements.\footnote{Treas. Reg. §1.1275-2(k)(3)(i).}

\begin{enumerate}
\item[(a)] \textit{Issued with de minimis OID.}
\end{enumerate}

The additional debt instruments (looking at the additional debt on a stand-alone basis, in
other words, ignoring for this purpose the qualified reopening rules) have no more than a de
minimus amount of OID at issuance.\footnote{Treas. Reg. §1.1275-2(k)(3)(iii) and Treas. Reg. §1.1275-2(k)(3)(iv). See FN 4 for a summary of the de minimis OID rules. Interestingly, for purpose of whether an additional debt instrument is treated as having been issued in a qualified reopening on account of de minimis OID, the test is whether it has “no more than” a de minimis amount of OID. Thus, if the additional debt has an amount of OID that is exactly de minimis it would seem to qualify. On the other hand, for purposes of whether a debt instrument is subject to the OID accrual rules, only debt with “less than”}
(b) 110% of Yield Test.

If issuance of the additional debt instruments occurs within six months of the original issue date, the additional debt instruments meet a 110% of yield test. The rules apply this test in the following manner. If the additional debt instruments are issued for cash, the test is whether the yield of the additional debt instrument (looking at the additional debt on a stand-alone basis) on the date on which the price of the additional debt instrument was established (or if earlier the announcement date) was a yield that is not in excess of 110% of the yield on the original debt instrument on its original issue date.\(^\text{12}\) If the original debt instruments are publicly traded, the test is whether the yield of the original debt instrument on the date on which the price of the additional debt instrument was established (or if earlier the announcement date) was a yield that was not in excess of 110% of the yield on the original debt instrument on its original issue date.

(c) 100% of Yield Test.

If issuance of the additional debt instruments generally occurs more than six months after the original issue date, the test is generally the same as the 110% of yield test, except the relevant percentage is 100%.\(^\text{13}\)

This paper refers to the 110% of yield test and the 100% of yield test as the “Yield Comparison Tests.” For purposes of the Yield Comparison Tests, if the original loan had de

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\(^\text{13}\) Treas. Reg. §1.1275-2(k)(3)(v). Although interestingly, the 100% of yield test seems to compare the yield of the additional debt instrument to the yield of the original debt instrument in all cases, while the 110% of yield test compares the yield of the additional debt instrument to the yield of the original debt instrument in the case of debt issued for cash, but compares to the yield of the original debt instrument (on the issue date or if earlier the announcement date of the additional debt) to the yield of the original debt instrument in the case of publicly traded debt.
minimis OID on the original closing date, the test treats the yield on the original loan, and not the 
actual yield, as the coupon rate.

The qualified reopening rules do not apply to certain debt instruments. They do not apply 
if the debt is either a contingent payment debt instrument within the meaning of Treasury 
Regulation §1.1275-4 or a tax-exempt obligation defined in Section 1275(a)(3).\textsuperscript{14}

IV. **Problems and Examples/Case Studies Involving Fungibility.**

A. **Reopenings of Debt Instruments between Interest Payment Dates.**

An additional debt instrument that is intended to be identical to and fungible with an 
existing debt instrument is often issued between interest payment dates of the original debt 
instrument. When this occurs, there is a complexity in that the original debt instrument entitles 
the holders to interest from the previous interest payment date (or the original issue date) to the 
date of the issuance of the additional debt instrument (so called “pre-issuance accrued interest”), 
while the additional debt instrument does not. Two practices are used to deal with this 
complexity: one practice is used in the loan market and the other is used the bond market. Both 
methods are generally accepted as resulting in additional debt instruments that will be treated as 
identical to the original debt instruments for purposes of “qualified reopening” rules.

1. **Loan Market Practice – Pays Interest on Incremental Loans Only 
Beginning from Their Issue Date.**

The first method is to pay the interest on the additional debt for only the portion of time 
that the additional debt is outstanding. This means that the additional debt instruments will 
receive a smaller initial interest payment than the payment made on the original debt instrument. 
The loan market uses this method. From a commercial perspective, it makes sense to use this

\textsuperscript{14} Treas. Reg. §1.1275-2(k)(3)(vi).
method on loans, because it is also how secondary purchases of existing loans account for intraperiod interest. Loans are directly sold in transactions between buyers and sellers; in those transactions, the seller generally retains the right to interest that accrued prior to the trade date.\textsuperscript{15} Thus, this method will treat original purchasers of the additional debt instrument in the same manner as secondary purchasers of the original debt instrument and the original purchasers will not receive interest that accrued prior to the period in which they acquired the debt. It is also administrable, since the administrative agent of a loan retains documentation with respect to the holders of the loan to enable it to differentiate between purchasers of the original loan and purchasers of incremental loans, and thus there is no need to issue two separate loans.\textsuperscript{16}

One might argue that the additional debt is not fungible with the original debt in this case because the additional debt instrument does not have the right to receive the pre issuance interest while the original debt does, and therefore the additional debt does not “[h]ave terms that are in all respects identical to the terms of the original debt instruments as of the reopening date” as required by Treas. Reg. §1.1275-2(k)(2)(iii)(C). The argument is that, as a technical matter, two debt instruments cannot be identical when one debt instrument entitles the holder to receive more cash than the other. However, accepted practice is to treat the additional debt instruments as identical and fungible nonetheless. The thinking is that a purchaser of the additional debt

\textsuperscript{15} This is the method generally used for par/near par trades, see Standard Terms and Conditions for Par/Near Par Trade Confirmations (Published by The Loan Syndications and Trading Association, Inc.® as of November 7, 2016) (providing that “unless otherwise specified … all Interest and Accruing Fees accrued but unpaid before the Settlement Date shall be for the account of Seller”). A different method is generally used for distressed trades, see Standard Terms and Conditions for Distressed Trade Confirmations (Published by The Loan Syndications and Trading Association, Inc.® as of November 7, 2016).

\textsuperscript{16} In fact, under the standard documentation used in assignments, when an interest in a loan is transferred between interest payments dates, the Administrative Agent pays amounts that have accrued on the loan through the transfer date to the Sellers and pays interest that accrued on the loan after the transfer date to the buyer. See LSTA Model Credit Agreement Provisions, August 8, 2014, Annex 1, Standard Terms and Conditions for Assignment and Assumption, Section 2.
instrument does in fact have terms identical to the original instrument. The failure to receive pre-issuance interest is not a different term; it only reflects the fact that the additional debt instrument accrued interest for a shorter period than the original debt instrument. Additionally, in practice the instrument has the same terms as the original debt instrument with respect to holders of the original instrument that acquired those instruments in secondary purchases on the date of the issuance of the additional debt. This is because a purchaser of the original debt instrument in between interest payment dates will also not receive interest that accrued prior to the trade date.\footnote{Note that although the treatment of a purchaser of additional debt instruments and the treatment of a secondary purchaser are generally the same, they are not exactly identical. If the payment of interest due immediately after the additional debt is issued is not paid on its due date, but is instead paid late, then in the case of a secondary purchaser, the interest payment for the entire accrual period will go to the purchaser under the relevant LSTA documentation. By contrast, in the case of an incremental loan, only a partial interest payment will be made.}

2. **Bond Market Practice- Pre-Issuance Accrued Interest.**

Another method is to have the additional debt receive an interest payment equal to the payment made on the original debt. This means that holders of the additional debt will receive a full interest payment even though they held the instrument for less than the entire accrual period. This is the method used in the bond market. The reason this method is used with respect to bonds is that when bonds are traded, the buyer becomes entitled to receive all of the interest paid after the trade date, and thus it makes sense for a purchaser of additional bonds between interest payment dates to be entitled to receive the same payment that would be received by a purchaser of the existing bonds. Additionally, bonds generally trade through a depositary that is not able to trace the origin of each bond through its chain of title. Thus, it would be very difficult to have a portion of the holders of the bonds receive a payment of one amount and a portion of the holders receive another amount.
From a tax perspective, this method works to make the instrument identical as well. It is important however to pay attention to the market convention used in pricing add-on bonds issued between interest payment dates. That convention is for purchasers to purchase the bonds for a price stated (usually expressed as a percentage of face) and to pay an additional amount equal to the pre-issuance accrued interest. If that convention is adhered to, then the issue price for tax purposes will be the price stated (usually expressed as a percentage of face) which will be used to determine whether the add-on qualifies as a qualified reopening because it either priced with less than de minimis OID or it met the Yield Comparison Test. If the market convention is not used, and the purchasers do not pay additional amounts equal to the pre-issuance accrued interest, then the issue price for tax purposes will not be the amount paid, but will be the amount paid less the amount of the pre-issuance accrued interest. That issue price will be used to determine whether the add-on qualifies as a qualified reopening because it either priced with less than de minimis OID or to meet the 110% Yield Comparison Test.18 While this point may seem obvious to tax practitioners, market participants who know that additional debt instruments

18 This is because the issuer will generally elect under Treas. Reg. §1.1273-2(m) to treat the issue price of the instrument as being reduced on account of the pre-issuance accrued interest. Even if this election is not made and the issue price for the instrument is not reduced by the amount of the pre-issuance accrued interest, the instrument will have the same amount of OID than it would have had if the election had been made. This is because the amount of the first payment that is in excess of the interest that accrued until that point would not be qualified stated interest and instead would be treated as adding to the stated redemption price at maturity. Thus both the issue price and the stated redemption price at maturity would be increased by an equal amount, which would cause the overall amount of OID on the instrument to be the same. See NY State Bar Ass'n Tax Section, Report on Ambiguities and Uncertainties In the Original Issue Discount Regulations (2010), available at http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1212Report.pdf. As noted in the report, however, while the amount of OID would be the same under either option, the issue price would differ slightly, since if the election is made is the issue price will be reduced by the amount of the pre-issuance accrued interest and if the election is not made, the issue price will be the full amount paid for the debt instrument. This in turn will affect the timing (although not the amount) of the OID accruals since OID would accrue in respect of the amount of pre-issuance accrued interest until such amount is paid on the first interest payment date. Unfortunately, it is not clear how the election is made and whether it is made by the holders or the issuers. See NY State Bar Ass'n Tax Section, Report on Ambiguities and Uncertainties In the Original Issue Discount Regulations (2010), available at http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1212Report.pdf
cannot be fungible with the original debt instruments if they are issued at a price so far below par so as to have more than de minimis OID sometimes think they have “found” a way to make them fungible by issuing the add-on offering without adjusting the price for pre issuance accrued interest. Unfortunately this does not work.

3. **Examples.**

*Example 1. Bank debt issued between interest payment dates.*

Borrower enters into a credit agreement on January 1 at par that pays 6.00% interest with quarterly interest payments. On February 15, at the midpoint of the first interest payment period, Borrower enters into an incremental facility at par with identical terms. On March 31, the holder of the original loan will receive a payment of 1.50%, and the holder of the additional debt will receive a payment of 0.75%.

*Analysis:* As discussed above, the incremental loan is treated as identical to the original loan and therefore the incremental loan is treated as having been issued in a qualified reopening and is treated as fungible with the existing loan.

*Example 2. Bonds issued at a price plus pre-issuance accrued interest.*

Borrower issues bonds at par on January 1, Y1, that pay a 6.00% coupon quarterly for five years, with repayment on December 31, Y5. Interest is payable quarterly. On Feb 15, Y3, at the midpoint of the first interest payment period in the third year, Borrower issues add-on bonds at par with identical terms as the original issuance. The purchasers pay par plus 75 basis points. On March 31 after the add-on, holders of both the original issue and the add-on issue will receive a full coupon payment of 1.50%.

*Analysis:* As discussed above, the incremental loan is treated as having been issued in a qualified reopening and is treated as fungible with the existing loan.
**Example 3. Bonds issued without accounting for pre-issuance accrued interest.**

Same as Example 2, except that the holders purchase the add-on at par without any additional payment for pre-issuance accrued interest.

**Analysis:** As discussed above, the 75 bps of pre-issuance accrued interest must be subtracted from the proceeds paid to Borrower in order to determine the issue price of the add-on. OID is treated as less than de minimis only if the amount of the OID is less than 25 basis points times the number of complete years to maturity. Since there are only two complete years remaining to maturity, the add-on is treated as having been issued with more than de minimis OID. Because the add-on bonds have OID and the original notes do not, the two issuances cannot be treated as part of a qualified reopening and will not be fungible.

**B. Practical Fungibility.**

1. **Existing Debt Instrument Is Modified to Become the Same as Another Outstanding Debt Instrument.**

   Occasionally, a borrower may have two outstanding debt instruments, and may want to modify one of the debt instruments to have terms identical to the other. This sometimes occurs

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19 Alternatively, as discussed in the previous footnote, the issue price may remain par but the instrument will be treated as having a stated redemption price at maturity that is increased by the amount of the pre-issuance accrued interest. Under this alternative as well, in the example above the instrument will be issued with more than de minimis OID.

Regardless of which method is used, whether the debt instrument has more than de minimis OID should generally not be affected. This is because even though the debt instrument’s stated redemption price at maturity will differ depending upon whether or not an election is made, the additional amount of stated redemption price at maturity would generally not affect the de minimis OID calculation, which only takes into account payments of principal for which there is at least one complete year remaining.

See Treas. Reg. §§1.1273-1(d)(1), (2) and (3); (e)(1) and (3); NY State Bar Ass'n Tax Section, Report on Ambiguities and Uncertainties In the Original Issue Discount Regulations (2010), available at http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1212Report.pdf at FN 53.

20 Note that with the reduction in issue price, the add-on also cannot meet the requirements for a qualified reopening under the Yield Comparison Tests. Because this add-on was made after 6 months from the original issue date, the 100% Yield Comparison Test applies. Under that test for these notes, the issue price would have to be higher than 99.9972 to satisfy the qualified reopening rules of Treas. Reg. §1.1275-2(k)(3)(v).
when a borrower repays a portion of an issue of debt instruments, which in turn causes the amount of the debt that is outstanding to be too small to have liquidity on its own. It also occurs when a borrower wants to extend the term of a loan in order to adjust the borrower’s capital structure, and when the borrower extends the terms it is convenient to have the extended loan be fungible with another pre-existing loan, both to simplify the capital structure by reducing the number of outstanding issues and to give each issue greater liquidity. The consequence of such a modification will depend on whether (a) the modification is a significant modification pursuant to Treas. Reg. §1.1001-3 and (b) whether the unmodified debt instrument is publicly traded. If both of those conditions are met, the qualified reporting rules would generally be expected to apply. If both are not met, there will be an interesting result.

Example 4. An outstanding debt instrument is modified to have the same terms as another outstanding debt instrument, and the changes give rise to a significant modification. The debt is publicly traded and has no OID.

Borrower has an outstanding debt instrument with a maturity date in five years that pays interest at a rate of 7.00% and has no OID. Borrower as another outstanding instrument with a seven year maturity that pays interest at a rate of 7.50% and has no OID. The seven-year debt instrument is publicly traded and is traded at par. Borrower agrees with Lenders that the five-year instrument will be modified so that it will be identical to the seven-year instrument, i.e., (a) the maturity date will be extended to be the same as the maturity date of the seven year instrument and (b) in exchange therefore the interest on the five year instrument will be increased from 7.00% to 7.50%.

Analysis: Under Treas. Reg. §1.1001-3, the modification of the debt instrument is a significant modification. While the extension of the maturity is not a significant modification
under the safe harbor of Treas. Reg. §1.1001-3(e)(3), the change to the interest rate is significant under the change in yield test of Treas. Reg. §1.1001-3(e)(2). Accordingly, the existing debt instrument is treated as if it were exchanged for a new debt instrument under Treas. Reg. §1.1001-1(a). The issue price of that deemed new debt instrument will be its public trading price under Treas. Reg. §1.1273-2(b), which in our example is par. Because the former five-year debt instrument is treated as having been issued as a new debt instrument (a) with terms identical to an existing debt instrument, (b) without OID and (c) the existing debt instruments are publicly traded, the new debt instrument will be treated as having been issued in a qualified reopening with de minimis OID pursuant to Treas. Reg. §1.1275-2(k)(3)(iii). Accordingly, the modified debt instrument would be treated as part of the same issue as the existing outstanding seven-year debt instrument, and the modified debt instruments would thus be fungible with the previously outstanding seven-year debt instruments.21

Example 5. An outstanding existing debt instrument is modified to have the same terms as another outstanding debt instrument, and the changes DO NOT give rise to a significant modification.

Same as previous example except that the existing seven year debt pays interest at 7.25% and thus the existing five year instruments are modified so that their rate increases by 25 bps, from 7.00% to 7.25%.

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21 If the seven-year notes were trading so far below par that an instrument issued at that price were to have more than de minimis OID, and the instrument did not qualify for the Yield Comparison Tests under Treas. Reg. §1.1275-2(k)(3), then the modified former five-year debt would not be treated as having been issued in a qualified reopening and would not be fungible with the outstanding seven-year debt instruments. In such a case, the modified debt would have an issue price of fair market value and that debt would be treated as issued with OID and would not be fungible with the original seven year notes. If the seven-year notes were not publicly traded, then the modified debt instrument would also not be treated as having been issued in a qualified reopening, see Example 5 below.
Analysis: The modified five-year instrument did not undergo a significant modification because the change in yield was not greater than the safe harbor in Treas. Reg. §1.1001-3(e)(2). Thus, the modified debt instrument cannot be treated as having been subject to a deemed exchange under Treas. Reg. §1.1001-3 and having been newly issued at the time of the modification. Since the modified debt instrument was not treated as issued at the time of the modification, it cannot be treated as having been part of a qualified reopening, which requires an “additional debt instrument to be issued.” Nonetheless, for tax purposes the debt instruments will be fungible from a practical perspective.

2. **Practical Fungibility Defined.**

The reason for this is that will be referred to in this paper as “Practical Fungibility.” This is the idea that where two debt instruments have no (or less than de minimis) OID, pay interest at the same rate and have identical terms (so that among other terms, the interest payment dates and maturity dates are the same), holders of the two instruments will accrue identical amounts of taxable interest income. Since the instruments are the same from both a tax and non-tax perspective, they are in a practical sense identical even though they are not part of a qualified reopening. In cases such as these, it is market practice to issue the instruments under a single CUSIP number where the instruments are issued under one instrument, so long as both of the instruments have identical FATCA treatment as discussed below.

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22 *See* Treas. Reg. §1.1275-2(k)(1).

23 This concept will be used numerous times in this paper. The author of this paper first saw this term used in a client alert from Latham & Watkins authored by Jiyeon Lee Lim, *et. al.*, dated October 6, 2015 which referred to this concept as “practical” fungibility. The author liked this term but thought it made more sense to put both words together so that the concept would be referred to as “Practical Fungibility” instead.

24 Prior to the revisions of the qualified reopening rules by T.D. 9599 on September 12, 2012, Practical Fungibility applied to an additional category of additional debt instruments that came up frequently. Prior to those revisions, if an existing issue of debt instruments were not publicly traded, newly issued identical debt instruments issued for cash could not qualify as being issued in a qualified reopening. Accordingly, if an issuer that had an outstanding debt issue that was not publicly traded issued additional debt, the new debt could not qualify as fungible under the...
Note however, that there are a number of important caveats and differences between a qualified reopening and Practical Fungibility. All of these difference arise as a result of the fact that, in a qualified reopening, the reopened debt is treated as part of the same issue as the original debt, with the same issue date and the same issue price, while, in Practical Fungibility, there are two separate debt instruments.

(a) FATCA

One important limitation on the utility of Practical Fungibility is where one of the debt instruments was issued before July 1, 2014, while the other was issued after July 1, 2014. Because Practical Fungibility does not actually cause the debt instruments to become one debt instrument, the instrument that was issued before July 1, 2014 will be grandfathered and not be subject to FATCA, while the instrument that was issued after July 1, 2014 will be subject to FATCA.\(^{25}\) Therefore, the instruments will not be fungible and will not be able to be issued under the same CUSIP. This is in contrast to a qualified reopening, where the debt that was issued in the qualified reopening is treated as part of the same issue as the original debt instrument and thus is also treated as grandfathered and not subject to FATCA.\(^{26}\)

\(^{25}\) Treas. Reg. §§1.1471-2(b) and 1.1471-2T(b)(2)(i)(A)(1) (providing that payments made under a grandfathered obligation or gross proceeds from the disposition of such an obligation are not withholdable payments; grandfathered obligations are defined to include “any obligation outstanding on July 1, 2014”).

\(^{26}\) The rule that the newly issued debt is not subject to FATCA would not necessarily result from the application of the qualified reopening rules themselves, since those rules do not state that the newly-issued debt was actually outstanding prior to their issue, but only provide that the newly-issued debt is part of the same issue as the original debt instruments for purposes of the OID rules, see Treas. Reg. §1.11275-(2)(k)(1). However, the FATCA rules provide that the debt is not subject to FATCA. See Preamble to T.D. 9610, 2013-15, I.R.B. 765,770 (“whether debt issued in a qualified reopening will be treated as a grandfathered obligation depends on the issue date of the original debt, which is the issue date of the debt issued in the qualified reopening.”).
There may arguably be a solution to this problem in some cases. That solution is for the parties to agree to treat the original instrument as subject to FATCA under contract. If that is done, there is no practical difference between the original note and the modified note, since in any event the withholding agent will apply FATCA withholding and reporting. While this is not a perfect solution since the IRS could treat the two instruments differently upon audit, query whether that would be enough to prevent instruments from being fungible and trading separately? Since Practical Fungibility relies on the “identicalness” of the two debt instruments in a practical (rather than strictly legal) sense, it is reasonable to consider two debt instruments to be “practically fungible” with each other as a result of a binding contractual agreement to treat both debt instruments identically. To implement this solution would not be difficult in the context of syndicated loans, since there is often an amendment to the unmodified loan that permits the modified loan to have identical terms and trade under the same indenture. Thus, it would be straightforward as part of the amendment to agree to treat the original loans as not being FATCA grandfathered.27

(b) Subsequent modifications

Another difference between a qualified reopening and Practical Fungibility is where the debt instruments are further modified, such that the modified debt instrument had a significant modification while the unmodified debt instruments did not. For example, assume the debt

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27 It is common practice as part of any amendment to a securitized loan for the parties to either (a) agree to treat the amended loan as not significantly modified and thus grandfathered and not subject to FATCA or (b) to agree to treat the amended loan as not grandfathered and subject to FATCA. See LSTA Market Advisory August 26, 2014, FATCA Loan Amendments and Determining Grandfathered Status, available at http://www.lsta.org/news-and-resources/news/lsta-publishes-fatca-advisory-loan-amendments-and-determining-grandfathered-status.

In the author’s experience, it is the rare borrower that agrees to the treat the modified loan as grandfathered in any case at all, because to do so under the LSTA documentation, the borrower agrees to indemnify the Agent for any harm resulting from that categorization, and the path of least resistance is to simply treat all loans as not grandfathered.
instruments in the examples above were further modified to increase their yield by 25 basis points, so that in Example 4 the yield increased to 7.75% and in Example 5 the yield increased to 7.50%. In Example 4, the change in yield would not give rise to a significant modification for any of the debt, since all of the debt is treated as part of one issue that was issued with an interest rate of 7.50%, and the change in rate to 7.75% would not be a significant modification. By contrast, in Example 5, the increase in yield to 7.50% would not give rise to a significant modification for the previously unmodified debt, which had an original yield of 7.25% upon original issuance, while it will give rise to a significant modification to the previously modified debt, which had a yield of 7.00% upon original issuance. This problem is particularly acute where the practically fungible debt instruments have been combined in a manner such that the significantly modified and unmodified debts cannot be distinguished from each other.

(c) Differences in Issuer Treatment.

Another difference between a qualified reopening and Practical Fungibility is in the treatment for the debt by the issuer. In the case of debt treated as practically fungible, an issuer will deduct the stated interest payment on both the original debt and the modified debt in the same manner, since both debt instruments have identical stated interest payments, but other deductions and inclusions may differ.

(d) De minimis OID

Under Treas. Reg. §1.163-7(b) an issuer that has an outstanding debt instrument with de minimis OID may choose to deduct the de minimis OID either at maturity or over the life of the instrument (either on a straight line basis or in proration to the stated interest payments). This election is made separately for each debt instrument. As a result of this, the deductions for de minimis OID under the original debt instrument and the modified debt instrument may differ if
different elections were made for the two instruments upon original issue. This is in contrast to
the treatment of a qualified reopening, where the instrument would seem to be treated as one
instrument subject to one treatment.28

(e) Partial Redemption

Another difference is where a portion of the outstanding debt instruments is redeemed.
Redemption of debt at a price other than the adjusted issue price requires an issuer to take into
account cancellation-of-debt (“COD”) income in the amount of the excess of the adjusted issue
price over the redemption price,29 and would permit the issuer to deduct, as retirement premium,
the excess of the redemption price over the adjusted issue price.30 It also permits the issuer to
deduct any previously undeducted de minimis OID,31 as well as any OID caused by borrowing
costs.32 In the case of a qualified reopening, those amounts would be calculable with certainty
since there is only one debt instrument. By contrast, when Practical Fungibility is used and the
debt instruments are trading under one CUSIP and are held through a depositary, so that it is
impossible to tell whether the redemption occurred with respect to the unmodified or the
modified debt, the issuer may be unable to calculate the amount of the COD income, retirement
premium, and de minimis OID attributable to each of the two instruments. The issuer would be
required either to take the position that gives rise to fewer deductions and more income, or to

28 Treas. Reg. §1.163-7(e)(4). Note that under Treas. Reg. §1.163-7(e)(4), it would seem that upon a qualified
reopening, the issuer can change its previous election with respect to treatment of de minimis OID, but any such
change would apply for all of the de minimis OID of the issue.

A similar analysis would apply to borrowing costs to which Treas. Reg. §1.446-5 would apply.

29 See Treas. Reg. §1.61-12(c)(2)(ii).

30 See Treas. Reg. §1.163-7(c).

31 See Treas. Reg. §1.163-7(c).

assume that the redemptions took place pro rata between both debt instruments, which assumption could be challenged by the IRS.33

Example 6. An outstanding debt instrument is modified to have the same terms as another outstanding debt instrument, the changes give rise to a significant modification, and the debt is NOT publicly traded.

Borrower has an outstanding debt instrument with a maturity date in five years that pays interest at a rate of 7.00% and has no OID. Borrower as another outstanding instrument with a seven-year maturity that pays interest at a rate of 7.50% and has no OID. The seven-year debt instrument is not publicly traded. Borrower agrees with Lenders that the five-year instrument will be modified so that it will be identical to the seven-year instrument, i.e., (a) the maturity date will be extended to be the same as the maturity date of the seven-year instrument and (b) in exchange therefore the interest on the five-year instrument will be increased from 7.00% to 7.50%.

Analysis: The modified debt instrument will not be treated as having been issued in a qualified reopening because the instrument was not issued for cash and the existing debt instrument is not publicly traded. Nonetheless, both instruments have no OID and have identical terms, so Practical Fungibility will apply.

Example 7. A debt instrument is issued that is identical to an outstanding debt instrument, except it is issued with an interest holiday.

Issuer has debt outstanding that pays interest quarterly and has no OID. Issuer issues additional debt that is identical to the existing debt, except that the additional debt does not pay

33 Note that this would generally not be a problem in credit agreement debt where it would be possible to trace through the register the amount of the debt instrument of each issue that were redeemed, at least where an exchange transaction has not been done that commingles the tranches.
any interest on the first quarterly payment date. The issue price of the debt is such that despite
the interest holiday, the debt would be treated as having been issued with less than de minimis
OID.\footnote{\textit{See} Treas. Reg. §1.1273-1(d)(4) and (e), Ex. 5.}

\textbf{Analysis:} The debt would not seem to be able to be treated as a qualified reopening
because the additional debt instruments do not have the same interest payment terms.\footnote{Depending on the facts, there could be an argument that the failure to make the first payment of interest is very insignificant, and therefore should be ignored by analogy. Treas. Reg. §1.1275-2(h)(3). Under this regulation, a payment that is “incidental” is ignored for purposes of the OID rules. Treas. Reg. §1.1275-2(h)(1) (“Except as otherwise provided, the treatment of the contingency under this paragraph (h)[pertaining to remote and incidental contingencies] applies for all purposes of [S]ections … 1271 through 1275 and the regulations thereunder.”).}

However, once the interest holiday passes, the debt instruments ought to have Practical
Fungibility. Nonetheless, if the issuer values fungibility, debt with such an interest holiday may
be inadvisable and the issuer would be better off omitting the interest holiday. Presumably, the
issuer wants to issue the additional debt instrument debt with an interest holiday because the
additional debt instrument is issued between interest payments dates and it is administratively
easier for the issuer not to have to make partial interest payments to holders of the additional
debt. This administrative convenience will come at a cost, since, as discussed earlier, Practical
Fungibility has significant disadvantages as compared to a qualified reopening.

\textbf{C. What Does It Mean to Be Identical?}

From a practical perspective, in order for two debt instruments to be fungible, they need
to be identical. If they are not identical, then they will not be fungible because holders of one
instrument will have different rights and obligations as compared to holders of the other. From a
practical perspective, whether minor variations will affect fungibility will depend on the
particular instrument and why there is desire for fungibility. For example, in the bond context,
where all of the bonds are actually held by a clearinghouse and sales of bonds take place through
book entry, it would be problematic to have any variation between two debt instruments and still have the debt instruments be fungible. If there were a variation, a holder of a debt instrument through the book entry system would not be able to tell which instrument he is holding. By contrast, in a system such as those used for many loans, where transfers are recorded in a register, it would be theoretically possible to have minor variations between debt instruments — for example, future changes that have no affect on the value of the instrument — and still have the debts be fungible from a practical perspective. If and when the future changes becomes relevant, it would be possible to break what is currently one instrument into two separate instruments that would trade separately at that time. Nonetheless, we are not aware of syndicated loans that trade under one CUSIP that have distinctions between different amounts of the loans.

This idea is also reflected in the applicable tax regulations. Interestingly, it is expressed in two different ways in two different areas of the tax law dealing with fungibility. In the context of whether two or more debt instruments are part of one issue, the standard is whether the two debt instruments are part of the same issue is whether the debt instruments “[h]ave the same credit and payment terms.”36 By contrast, in the context of whether additional debt instruments are treated as having been issued in a qualified reopening, additional debt instruments only qualify if they “[h]ave terms that are in all respect identical to the terms of the original debt instruments as of the reopening date.”37 Query whether the language was meant to apply a different standard to qualified reopening of debt instruments than the standard that applies to two debt instruments issued at the same time. From a policy perspective, there would seem to be little reason for two standards to apply. The likely explanation for the use of different language

would seem to be that the two regulations were written at different times, but were not meant to reflect different standards.\textsuperscript{38}

The following examples discuss variations between original debt instruments and additional debt instruments, and whether those variations would cause the additional debt instruments not to be identical with the original debt instruments, and thus not to qualify as being issued in a qualified reopening.

\textit{Example 8. An additional debt instrument is issued that is identical to outstanding debt, but securities law restrictions on resale apply to the additional debt instrument.}

Issuer issued bonds under Rule 144A that have been outstanding for twelve months and therefore resales are permitted under applicable securities regulations. Issuer issues additional notes with identical terms. Those additional notes, because they have not been outstanding for twelve months, have restrictions on resale under applicable securities law.

Alternatively, issuer issued notes that were registered and therefore were permitted to be resold under applicable securities laws. Issuer issues additional notes with identical terms. Those additional notes have not been registered and have prohibitions on resale under applicable law.

\textit{Analysis:} From a business perspective, the two debt instruments are not fungible when issued, because they have different securities law restrictions. In practice, they will therefore have separate CUSIP numbers when issued. However, when the securities law restrictions on the newly-issued debt go away (either because of the passage of time in the case of the debt

\textsuperscript{38} This seems part of a general observation that when Treasury promulgated the regulations that apply to qualified reopening, some of the concepts and rules also applied in situations outside of qualified reopenings, but identical principals and language was not adopted both situations. For example, in the context of a qualified reopening sold at a price other than the issue price, Treas. Reg. §1.163-7(e) requires an issuer to take into account the difference between the issue price and the price at which the debt is sold, yet in other cases whether debt is old as part of an issue at a price other than its issue price no regulation applies.
added on to existing 144A debt or because of a registration statement in the case of the debt added on to the registered debt), the newly-issued debt will be given the same CUSIP as the existing debt and the two instruments will become fungible, but only if the additional debt instruments are fungible from a tax perspective.

From a tax perspective, if both the original and the additional notes are issued with less than de minimis OID, the two debt instruments will become fungible because of Practical Fungibility (so long the original instrument is not grandfathered for FATCA purposes). However, if the new notes were issued with more than de minimis OID, Practical Fungibility would not apply. The new notes will only be fungible with the original debt instruments if they could be treated as having being issued in a qualified reopening, and in order to be so treated the new notes need to be identical to the original debt. The question is therefore whether to treat on resale debt instruments that are subject to securities law restrictions as identical to debt instruments without securities law restrictions. Market practice is to treat these instruments as identical for purposes of the qualified reopening rules. One argument for such treatment is that restrictions on resale are not related to the actual credit and payment terms of the instrument, so that no holder will receive more or less cash because of those restrictions, and thus should not be taken into account in determining whether the instruments are identical. Another similar argument is that restrictions on trading are just legal restrictions on the holder imposed by a governmental authority that are not intrinsic to the instrument itself and do not affect the obligations and rights of the issuer and the holder to each other.³⁹ Additionally, from a policy

³⁹ The argument that differences that do not affect cash flow should be ignored and the argument that differences that are extrinsic to the debt instrument should be ignored are slightly different and would not apply in all cases equally. If there was a law that applied to the additional notes related to something other than restrictions on resale, for example if foreign law applied a withholding tax or other obligations with respect a buyer, arguably the argument that differences do not affect the cash flow should be ignored would not apply, while the argument that that differences that are extrinsic to the debt instrument should be ignored would. On the other hand, if there was a restriction on resale imposed by contract and not required by law, the argument that that differences that do not
perspective, there seems to be no reason not to treat these instruments as fungible, and the law also ought to be interpreted in such a way as to encourage the facilitation of capital markets.

Example 9. Instruments are identical, but a very remote contingency may occur to cause different payments to be made.

Issuer issued notes that are registered and therefore are permitted to be resold under applicable securities laws. Issuer issues additional notes with identical terms. Those notes have not been registered and have prohibitions on resale under applicable law. The notes provide that the issuer is obligated to register the additional notes by a certain date, and if the notes are not registered by that date, the issuer will pay an additional 25 bps of penalty interest a quarter until the notes are registered.

Analysis: As in the previous example, from a business perspective the notes will not be fungible and will trade under a separate CUSIP until the registration is completed, but once the registration is completed, the notes will trade under the same CUSIP number so long as the notes at that time are fungible from a tax perspective.

From a tax perspective in the case as well, if both the original and the additional notes are issued with less than de minimis OID, the two debt instruments will be fungible because of Practical Fungibility (so long the original instrument is not grandfathered for FATCA purposes). However, if the new notes are issued with more than de minimis OID, they will only be fungible

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40 While it is true that the qualified reopening rules permit a holder to convert what would otherwise have been market discount to OID, there was a policy decision to permit a limited amount of such conversion in cases where the new debt instruments would become fungible with previously issued debt instruments in order to facilitate additional issuance of debt. There would seem to be no reason that this policy decision ought not to apply in cases where there were minor variations between the debt instruments at the time they were issued that would go away over time.

41 Hochberg & Orchowski, What Looks the Same May Not Be the Same: The Tax Treatment of Securities Reopenings, 67 Tax Lawyer 143 (2014).
if the new debt instruments are treated as part of a qualified reopening on the grounds that the new instruments are identical to the old instruments despite the fact that the new notes will receive penalty interest if they are not registered. Market practice in this case as well is to treat these instruments as identical for purposes of the qualified reopening rules. Enormous numbers of debt instruments are issued with an obligation to pay penalty interest and it is extraordinarily rare for penalty interest to be paid. Because the likelihood of penalty interest is so small and should not affect the expectations and behavior of the holders in any way, its possibility should be disregarded in determining whether the instruments are identical. Additionally, remote contingencies are generally ignored for purposes of the OID rules, and thus should be ignored for this purpose as well.

Example 10. Instruments are identical, but a contingency may occur to cause different payments to be made.

Issuer issued notes as part of an acquisition or other transaction that will require funds in the future. Issuer issues additional notes, with the funds going into an escrow. The conditions of the escrow are that if the transaction does not take place the funds will be released back to the holders with interest until the date of the release.

From a business perspective here as well, the notes will not be fungible and will trade under a separate CUSIP until the escrow clears. However, once the escrow clears, the additional notes will trade under the same number so long as the notes at that time are fungible from a tax perspective.

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43 The likelihood of an issuer paying penalty interest in an ordinary situation based on the authors experience is less than 1%. Accordingly, in the authors view the argument to disregard the payment in this case is not just based on the regulations that permit remote possibilities to be ignored, but also based on the fact that penalty interest is truly a possibility that issuers and holders do not take into account at all.
From a tax law perspective, the analysis is similar to the previous example, but in this case, it may be more difficult to conclude that the possibility of the release of the funds out of escrow back to the holders is sufficiently unlikely to be ignored. It is not clear to us that there are a sufficient number of offerings of this kind to establish a market practice and the conclusion in each case may be different depending on its specific facts.

**D. What Is the Issue Price of Identical Debt Instruments Sold at Different Prices?**

Another issue that arises in practice is how to establish the “issue price,” for U.S. federal income tax purposes, of an issue of debt instruments that are sold to purchasers at different prices. The applicable rule for determining the issue price of debt instruments issued for money is Treas. Reg. §1.1273-2(a), which provides that, “[i]f a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money.”44 This rule applies where debt instruments are sold at different prices and the sales occur at different times, in which case the first time at which a “substantial amount” of the debt instruments in the issue is sold determines the issue price. However, in a typical syndicated loan financing, all of the loans within a tranche are generally syndicated at the same time. Treas. Reg. §1.1273-2(a) does not provide guidance as to how the issue price should be determined in this or other comparable circumstances.

It would be incorrect to argue that where identical debt instruments are sold to purchasers at the same time, but at different prices, that each of the debt instruments have a different issue price.

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44 The standard for being treated as significant is thought by a leading commentator to be 10%. Garlock, *Federal Income Taxation of Debt Instruments*, ¶2.03.03[A] (arguing by analogy that the issue price under Sections 1273 and 1275 should be similar to the issue price of tax exempt bonds under Section 148).
price. It is clear that all of those debt instruments are part of one issue.\textsuperscript{45} While the regulations may not be perfectly clear in providing a single issue price in our particular case, in all other cases the regulations establishing issue prices for different types of debt instruments provide one issue price to all of the debt instruments in an issue, so it runs against the design of the regulations to have more than one issue price for the debt instruments that are part of one issue.\textsuperscript{46} Additionally, it is clear that if the debt instruments were issued one after the other within 13 days, there would be only one issue price, which would be set at the price at the first sale. There does not seem to be any reason to differentiate between cases where the two portions were issued one after the other and cases where the two portions of the debt were issued at one time. Finally, if different debt instruments that were part of one issue could have different issue prices, many provisions of the OID regulations would not work. For example, in a qualified reopening, the debt instruments issued in the qualified reopening have the same issue price as the originally issue of the debt,\textsuperscript{47} but that issue itself may not have one issue price. Accordingly, there must be one issue price in a case where identical debt is sold at one time at different prices, but there are no clear rules for establishing what that issue price is.

This paper proposes that, where identical debt instruments are sold to purchasers at the same time, but at different prices, the issue price is one of the prices at which “a substantial amount of debt is sold” as provided in the regulation, and the choice of which of those prices ought to be determinative should generally be established by reference to two principles: (1) the

\textsuperscript{45} Treas. Reg. §1.1275-1(f)(1) (which provides that identical debt instruments sold within a 13-day period are part of one issue).

\textsuperscript{46} See Treas. Reg. §1.1273-2(a), setting rules for establishing the issue price of “each debt instrument in an issue” for (a) debt issued for cash, (b) publicly traded debt issued for property, (c) debt issued for publicly traded property and (d) other debt instruments.

\textsuperscript{47} See Treas. Reg. §1.1275-2(k)(1).
relative proportions of the debt instruments in the issue that are sold at each price (particularly if a majority of the debt instruments are sold at one price) and (2) the accurate reflection of the cumulative amount of OID present in the entire issue of debt.

Some examples of the difficulties in establishing issue price, and the application of this approach to resolving these difficulties, are illustrated below. For purposes of these examples, assume a syndicated term loan financing in which all of the loans are identical and all of the loans are sold to the syndicate lenders at the same time.

1. **Examples.**

   **Example 11(a). Majority of loans are sold at one price, minority are sold at another price.**

   A corporation borrows $100 million of loans. $60 million of the loans are sold to lenders at par. The remaining $40 million of the loans are sold to lenders at 97.

   **Analysis:** The regulation determining the issue price of debt issued for money states, “the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money.” In the example described above, we believe that, since the majority of the loans were sold at one price, that price ought to establish the issue price of the entire issue of loans, and the fact that a minority of the loans were sold at a different price (or prices) ought to be ignored. In addition, adopting a rule that treats the price at which a majority of the loans are sold as the issue price is easily administrable and furthers the goal of simplicity, at least in a case in which a majority of the loans are sold at one price. Although there is no explicit rule that provides for this result, it could be viewed as consistent with Treas. Reg. §1.1273-2(a) in that, since a majority of the loans in the issue were sold at par, the minority of the loans that were sold at another price is not “substantial” in comparison.
**Example 11(b). Half of the loans are sold at one price, half are sold at another price.**

A corporation borrows $100 million of loans. $50 million of loans are sold to lenders at par. The remaining $50 million of loans are sold to lenders at 97.

**Analysis:** In this case, it is more difficult to determine the correct issue price. There is no price at which the greatest proportion of the loans were sold and, accordingly, the portion of the loans sold at each price are equally “substantial” compared to each other. An argument can be made that the issue price ought to be the blended average issue price of the entire issue of loans, which would be 98.5 in this example. From a policy perspective, such an issue price would make sense, since it would accurately reflect the cumulative amount of OID required to be accrued by the borrower and received by the lenders over the life of the loan. However, Treas. Reg. §1.1273-2(a) requires the issue price to be established as “the first price at which a substantial amount of the debt instruments is sold for money,” meaning, the issue price must be one of the prices at which a sale of the loans occurred. Establishing the issue price at any value other than the price at which a substantial amount of the debt is sold it does not accord with the language of the regulation.

**Example 11(c). Substantial amount of the loans are sold at the average price of all the loans sold, and no greater amount of the loans are sold at any other specific price.**

A corporation borrows $100 million of loans. $33.3 million of the loans are sold to lenders at par. $33.3 million of the loans are sold to lenders at 97. $33.3 million of the loans are sold to lenders at 98.5.

**Analysis:** In this case, there is a very good argument for establishing the issue price as 98.5. Establishing the issue price as 98.5 comports with the principle that the issue price should accurately reflect the cumulative amount of the OID on the loan. In addition, since a substantial
amount of the loans were sold at this price, it also comports with the language of Treas. Reg. §1.1273-2(a) that the issue price is the price “at which a substantial amount of the debt instruments is sold for money” and there is no other price at which a greater amount of loans were sold, so there is no argument that another price is more “substantial” than 98.5.\footnote{The analysis in the example would also apply if instead of $33.3 million of loans having been sold at 98.5, they were sold at 98. Establishing the issue price as 98 generally comports with the policy goal of having an issue price that accurately reflects the cumulative amount of the OID on the loan, since 98 is the price that most closely approximates the cumulative amount of OID on the loan.}

Example 11(d). Majority of the loans are sold at one price, remainder of the loans sold at various other prices, and some of the loans are sold at a price that most closely reflects the cumulative amount of OID.

A corporation borrows $100 million of loans. $60 million of the loans are sold to lenders at par. $20 million of the loans are sold to lenders at 96. $20 million of the loans are sold to lenders at 99.

Analysis: In this case, there is a conflict between the two principles previously discussed. On the one hand, a majority of the debt was sold at par, which cuts in favor of establishing the price as par. On the other hand, a significant portion of the debt was sold at 99, which is the price that most closely reflects the cumulative amount of OID. Although not clear, an argument can be made that, in this case, the issue price ought to be the price at which a majority of the debt was sold. Such a rule is most consistent with the language of the regulation, is easily administrable, and furthers the goal of simplicity. These factors collectively would seem to outweigh the advantage of having an issue price that reflects the cumulative amount of OID.
Example 11(e). Substantial amount of the loans are sold at the average price of all loans sold, but a plurality of the loans are sold at another price.

A corporation borrows $100 million of loans. $40 million of the loans are sold to lenders at par. $30 million of the loans are sold to lenders at 97. $30 million of the loans are sold to lenders at 98.6.

Analysis: In this case, it is not clear what the issue price of the loans should be. Although there is no price at which a majority of the loans were sold, an argument can be made for establishing the issue price as the largest amount of loans (a plurality) were sold, and that the goals of ease of administration and simplicity would be best advanced by using a plurality rule. Under this argument, the issue price would be par. On the other hand, there is less of a textual argument to adopt a principle of plurality than to adopt a principle of majority. Additionally, under a plurality rule, it may not always be easy to tell what issue price was the plurality, and a small dollar amount of loans that may not be material and may comprise only a small portion of the overall amount of loans will be able to sway the issue price. Thus, it may make more sense not to adopt a plurality rule and instead to adopt a rule even where there is a plurality issued at one price, the issue price ought to be the price which most accurately reflects the cumulative amount of OID on the entire loan. Under this rule, the issue price in this case would be established as 98.6.

Example 11(f). Substantial amount of the loans are sold at the average price of all the loans sold, a greater amount of the loans are sold at another price, but no particular price has a majority or a plurality.
A corporation borrows $100 million of loans. $40 million of the loans are sold to lenders at par. $40 million of the loans are sold to lenders at 97. $20 million of the loans are sold to lenders at 98.5.

**Analysis:** In this case there is a good argument in this example that the issue price should be 98.5. Neither par nor 97 represents a majority or a plurality of the loans, so it would be appropriate to also consider the price that most accurately reflects the cumulative amount of OID on the entire loan. This suggests establishing the issue price as 98.5.

2. **Possibility of Self Help.**

A question that sometimes arises is whether the borrower and the lenders could exercise self-help in any of the above cases to make the determination of the issue price more straightforward, or to avoid setting the issue price at an undesirable value. Below are two potential approaches for self-help, although whether either approach would be respected would depend on the particular facts and circumstances.

(a) **Timing Self Help.**

The borrower and the lenders could agree to cause one portion of the debt to be sold before the others and treat that first portion of the debt sold as establishing the issue price of the entire tranche. For example, the parties can draft the legal documentation to provide that one lender’s loan closes first, or the wires can be timed on the same day so that one lender wires first. In any circumstance in which all of the debt instruments are issued as part of an integrated transaction and each of the debt instruments in the issue would not be issued without the others, we are skeptical that deliberate ordering of the sales would be respected where the ordering of the transactions had no economic effect, particularly if done for the purpose of minimizing OID in favor of market discount. We believe that the OID rules should be interpreted in accordance
with their intent, which is to cause the OID to be taken into income as it is earned. It does not seem consistent with this intent to allow formalistic distinctions to increase the issue price of a debt instrument and thereby allow OID to be converted into market discount.

(b) Quantity Self Help.

Another potential avenue for self-help is for the borrower and the lenders to adjust the relative amounts of the debt instruments being sold and/or the prices at which the debt instruments are being sold. For example, if 50% of the debt instruments were to be sold at par to one lender and the remaining 50% of the debt instruments were to be sold at 97 to another lender, these proportions could be adjusted so that the lender paying par is buying more than 50% and the lender paying 97 is buying less than 50%. We believe this quantity self-help would be more likely to be respected than the timing self-help discussed above, since a change in the actual quantities of debt to be purchased by each lender has greater inherent significance than mere reordering of the times at which the debt purchases take place, although, query how much the relative proportions of debt to be purchased by each lender would need to be adjusted in order to have the appropriate substance.\footnote{A potential standard that could be applied by analogy is that of Rev. proc 89-12, pursuant to which the IRS issued guidance on the U.S. federal income tax classification of a limited partnership if the general partner had a one percent or greater interest in each item of partnership income, and the partners’ contribution to capital was greater than $50 million, the general partners' minimum percentage needed to be the greater of (1) one percent multiplied by the ratio of $50 million to the sum of the partners' contributions or (2) 0.2 percent. Applying this standard to our example of a debt instrument with a principal amount of $100 million, a significant amount would be $500,000.}

3. Possible Alternative Characterizations of the Transaction.

The above discussion begs the question of why purchasers in negotiated transactions would acquire interests in identical debt instruments at different prices, and a suspicious tax practitioner may naturally ask him or herself why this is occurring (particularly if said tax practitioner cannot determine the appropriate issue price for the issue of debt instruments).
some cases it may suggest that the transaction contains an additional element, such that the
discount received (or premium paid) by the “off market” debt purchaser actually reflects a
payment that relates to a different aspect of the transaction and consequently should not be
considered in determining the issue price of the debt instruments in the issue. However, we
believe the mere fact that the debt instruments in an issue are being acquired at different prices
should not result in a recharacterization. Such transactions occur with regularity for a number of
commercial reasons that are consistent with the understanding that the different purchasers
simply paid different arms-length prices for the debt instruments in the issue. For example, an
anchor lender may receive an additional discount to purchase price in exchange for agreeing to
take a large position is a loan or debt purchase, while other lenders that take much smaller
positions may be required to pay higher prices. In a syndicated financing, a certain lender may
be more desirable to the arrangers, for example, if the arrangers believe that a particular marquee
lender will help the arranger to attract other lenders to the syndicate. There may also be other
circumstances in which a particular lender simply has greater bargaining power and is
consequently able to negotiate a lower price. Accordingly, the price paid by each purchaser in
exchange for a substantial amount of the debt instruments in the issue generally should be taken
into account for purposes of determining the issue price.

(a) Underwriter Sale.

One circumstance in which a recharacterization of a debt purchaser’s discount may be
possible is where the purchaser has unclear intentions and agrees to subscribe for a significant
amount of the debt instruments in an issue at a discount with the possibility of selling a portion
of the debt instruments that it has acquired to other purchasers. In such a case, the subscriber,
depending on whether such intention comes to fruition and depending on the timeframe of the
sale, could be treated as an underwriter with respect to the instruments sold and the price at
which that subscriber purchases the portion of the debt that was ultimately resold would not be
taken into account in determining the issue price.\footnote{See Treas. Reg. §1.1273-2(e) (ignoring sales to “bond houses, brokers, or similar persons or organizations acting in the capacity as underwriters, placement agents or wholesalers”).}

(b) Commitment Fee.

Another circumstance in which a recharacterization may be possible is where a subscriber
agrees to commit to purchase a portion of the debt instruments in advance of the other
subscribers. In such a case, any additional discount received by the “committed” subscriber
could be viewed as akin to a commitment fee. However, we believe that so long as there is no
separate payment for making the commitment, and the only benefit that the purchaser receives
for making the early commitment is an additional discount to the purchase price of the debt
instrument, and the additional discount is contingent on the closing of the entire debt issuance,
the much better answer would seem to be that the additional discount is taken into account in the
purchase price of the debt instrument, and not treated as a separate fee.\footnote{A similar issue arises in the context of bond tender offers, in which bondholders that agree to tender prior to a
certain date receive additional consideration in exchange for the early tender of their bonds. In this situation,
although not clear, we believe there is a strong argument that the early tender premium should be treated as part of
the consideration paid in exchange for tendering the bonds, rather than as a separate payment for agreeing to tender
(or agreeing to tender early). See PLR 201105016; Garlock, \textit{Federal Income Taxation of Debt Instruments},
¶1305.04 (2016). In practice, it appears that most tax disclosures written for tender offers that include early tender
premiums weigh in favor of treating the early tender premium as additional consideration rather than as a separate
payment for agreeing to tender (early), although the matter is not clear.}

It should be noted that, in our experience, this situation often arises where there is no clear quid pro quo for lenders that
subscribe early, and the arranger is merely filing its book at prices that reflect the demand in the
market at that particular moment, and the lenders that subscribe early may not even be legally
committed to purchase the debt, all of which makes it even more clear that the additional
discount ought not be re characterized as separate payment to the purchaser of the debt.
4. **Practical Example.**

*Example 12. Private debt where different purchasers treat the discount differently.*

An issuer issues $100 million principal amount of notes to purchasers in a private transaction. A purchaser buys $30 million of the notes from the issuer at 97. Another purchaser buys the remaining $70 million of the notes from the issuer at 100% and the issuer makes a payment of $2.1 million (equal to 3% of $70 million) to an affiliate of the purchaser as a “structuring” or similar fee. The purchaser and the affiliate receiving the structuring fee are under common control, but not common ownership.

*Analysis:* This situation is not uncommon. We believe that the fee paid to the affiliate of the purchaser generally ought to be respected as such. Although it could be argued that, since the purchaser and the affiliate are under common control the fee should be recharacterized into something other than a separate fee paid to the affiliate, such an argument does not appear to be particularly strong. In many cases, the affiliate performs services in connection with the purchase of the debt, such as sourcing and negotiating the transaction, and it is common for such services to be compensated.\(^{52}\) The fact that other purchasers of debt in the same market (or even in the same issuance) have a practice of not causing the issuer to pay a fee to the purchasers’ affiliates, and instead receive their economics entirely through reduction in the purchase price of the debt, generally ought not to cause the “structuring” and similar fees that are paid to affiliates to be recharacterized, as long as the services are performed. Accordingly, we believe that, in the above example, $30 million of the notes should be viewed as purchased at 97 and $70 million of the notes should be viewed as purchased at 100%. Under the principles discussed earlier in this

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\(^{52}\) However, the amount of the fee, particularly if the fee is large, could be challenged under transfer pricing principles.
section, since the majority of the notes were sold at 100%, that price ought to establish the issue price of the entire issue of notes.

As a practical matter, the arrangement described in the preceding example may not be obvious from reading the note purchase agreement. The note purchase agreement may provide that each purchaser will purchase notes at par and the issuer will make a payment equal to 3% of the principal amount of the notes purchased to the persons provided on a separate schedule, some of which may be note purchasers and others of which may be affiliated management entities.

Under Treas. Reg. §1.1273-2(g)(2), in general, “a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan.” Accordingly, the payments made to the note purchasers directly are treated as an offset against the amount of funds advanced by that purchaser to the issuer, while Treas. Reg. §1.1273-2(g)(2) would not seem to affect the treatment of the payments made to the affiliates of the purchasing entities.53

In some instances in which structuring or similar fees are paid to an affiliate of a note purchaser, that note purchaser may prefer that the issue price of the notes be established as par (without regard to the fact that other note purchasers that receive the same economics as discount are, in effect, purchasing their notes at a lower price). When the “par” note purchasers are purchasing a majority of the notes in the issue, this treatment would seem quite reasonable. However, it is hard to justify this treatment when the “par” note purchasers are in the minority. In some cases, the remaining purchasers will be willing to accommodate and also take the

53 Interestingly, Treas. Reg. §1.1273-2(g)(4) calls for recharacterization of certain payments made by a third party to the debt purchaser, or made by the debt purchaser to a third party, based on the substance of the transaction, but does not call for recharacterization of payments by an issuer to third parties. Whether this omission is by design is unclear.
discount as a fee to an affiliated entity, but in many cases a note purchaser that is receiving its economics as OID will be reluctant to recharacterize the OID as a fee since it could have an economic impact (if the fee were paid to an entity not under common ownership) or a tax impact (if the fee were characterized as income effectively connected with a U.S. trade or business or otherwise resulted in the acceleration of taxable income).

E. Consequences to Holder and Issuer of Purchasing/Selling the Debt Instrument at a Price Other Than the Issue Price.

The preceding section discussed a method for setting the issue price of debt instruments that were sold to purchasers at the same time, but at different prices. The discussion focused on debt instruments that are all part of a single issue (which requires, among other things, that the debt instruments are all sold within the 13-day period described in Treas. Reg. §1.1275-1(f)(1)). However, the purchase of debt instruments that are part of the same issue at different prices can also occur in a qualified reopening, since the price paid for the additional debt instruments will oftentimes be different than the issue price of the original debt instruments in the issue. In any case in which debt instruments that are part of a single issue are sold at different prices, it is important to understand the tax consequences to the issuer and the holders that result from this disparity.

1. Holder Tax Consequences.

A holder that acquires a debt instrument at original issuance for less than the debt instrument’s issue price is generally required to take into account that difference (subject to a de minimis exception) as “market discount” in the same manner as a holder that acquires a debt instrument in the secondary market at a discount.\textsuperscript{54} A holder that acquires a debt instrument at

\textsuperscript{54} See Section 1278(a)(1)(D)(ii).
original issuance for more than the debt instrument’s issue price is generally permitted to claim that excess as acquisition premium (or bond premium) in the same manner as a holder that acquires a debt instrument in the secondary market.\textsuperscript{55}

2. Issuer Tax Consequences.

If an issuer issues debt at a price that differs from its adjusted issue price in a qualified reopening, Treas. Reg. §1.163-7(e) provides that the issuer is required to take into account that difference in price over the term of the debt instrument using constant yield to maturity principles. Thus, if the issuer issues debt in a qualified reopening at a price that is higher than the debt’s adjusted issue price, the excess increases the aggregate adjusted issue price of all of the debt instruments in the issue (i.e., both the original and the additional debt instruments), which has the effect of decreasing the issuer’s OID deductions. Similarly, if the issuer issues debt in a qualified reopening at a price that is lower than the debt’s adjusted issue price, the difference decreases the aggregate adjusted issue price of all of the debt instruments in the issue, which has the effect of increasing the issuer’s OID deductions. This rule effectively causes the issuer to take into account any difference between the price at which debt is sold and the debt’s adjusted issue price on a constant yield to maturity method.

Interestingly, there is no Code section or regulation that addresses the consequences to an issuer of issuing debt at a price that differs from its issue price outside of the context of a qualified reopening. Nonetheless, it would seem apparent that an issuer ought to be required to take into account the difference between the issue price and actual price at which the debt is sold, or permanent distortions will result. For example, if an issuer issues $100 principal amount of

\textsuperscript{55} \textit{See} Section 1272(a)(7); Treas. Reg. §1.1272-2(b)(2) and (b)(3) (explicitly extending the premium rules to debt acquired at original issuance).
debt for $97 as part of an issue of debt that has an issue price of $100, the issuer would receive
$97 and ultimately pay out $100 to a holder at maturity without the issuer ever receiving a
deduction its $3 economic loss. Similarly, if an issuer issues $100 principal amount of debt for
$100 as part of an issue of debt that has an issue price of $97, the issuer would be entitled to $3
of OID deductions over the life of the debt instrument, even though the issuer never suffered a
Corresponding economic loss. We believe that a reasonable approach in such instances is to
apply the methodology used in Treas. Reg. §1.163-7(e) for such cases. Alternatively, the issuer
could take into account any discrepancy between the actual price at which a debt instrument is
issued and the issue price of the debt under general tax accounting principles, rather than the
OID rules. Under this approach, the issuer may have greater flexibility, and thus, for example,
may be able to use a straight line method to take into account the discount or premium, rather
than a yield to maturity method.  

F. Related Party Purchases.

This Section will discuss issues related to purchases of debt instruments by the issuer and
persons related to the issuer and the resale of such debt instruments to the public. A number of
issues need to be considered in connection with that situation, including, what is the tax
treatment of such a debt instrument, whether such purchases and sales would pose tax
compliance problems to the issuer and the holders, and how to deal with any such problems.

Example 13. Issuer repurchase and sale of its debt.

Issuer has outstanding debt, issuer purchases that debt at a significant discount and resells
that debt to unrelated persons at a significant discount.

56 See also Garlock 203.03[A]. Garlock also addresses another similar where an issuer received a greater amount of
proceeds on the debt than the issue price of the debt. In that case, the issuer engaged an underwriter and the
underwriter sold the debt at a price that was less than the price the underwriter paid to the issuer. Although the
question has additional complexity, we would generally think the analysis above would also apply to that situation.
**Analysis:** When an issuer purchases its own debt that debt is treated for tax purposes as extinguished. When the debt is then sold it is treated as newly issued from a tax perspective, accordingly, the new debt will only fungible with the old debt if it is either issued in a qualified reopening or qualifies for Practical Fungibility. If the debt is sold at a significant discount, it will meet neither of these conditions. Thus, the reissued debt will have OID, while the original debt will not, and the two debt instruments will not be fungible.

However, this does not end the discussion, because from a corporate law perspective the debt continues to exist, and in some cases the repurchased debt continues to be held in a depositary together with other debt held by the public and to trade under the same CUSIP number and it is not possible to identify which persons hold original debt and which persons hold debt required from the issuer. In such a case, if the issuer sold the debt, it would be impossible for the issuer or the holder to know which debt had OID and which debt did not. The question is whether it would be sensible from a tax perspective for an issuer to put itself in such a position. We are not aware of anyone who has done so. It does not seem appropriate for an issuer to issue debt in a manner that it cannot report the correct amount of OID to its holders and for an issuer to put its holders in a position where they would not be able to know how much income to report to the IRS.\(^{57}\)

\(^{57}\) Sections 6721 and 6722 provide penalties for “any failure to include all of the information required to be shown on the return or the inclusion of incorrect information,” with respect to both the information returns filed with the Service and statements furnished to payees. These sections impose a $250 per return penalty each, with a provision that doubles the penalties for issuers that “intentionally disregard” their filing obligations, which could potentially cost issuers an annual penalty of $1,000 per holder.
Example 14. Controlling Person purchase and resale of issuer debt.

Same facts as Example 11, but the issuer is a corporation the majority of whose stock is owned by a private equity fund (“PE Fund”). PE Fund purchases the debt at a significant discount and resells that debt to unrelated persons.

Analysis: Under Code Section 108(e)(4), and Treas. Reg. §1.108-2(g), purchases of debt by a related person at a discount cause the issuer to recognize COD income, which in turn causes the debt to be treated as newly issued debt with an issue price equal to the purchase price by the related person and OID equal to difference between the purchase price and the stated redemption price at maturity.\(^{58}\) The PE Fund is related to the corporation because it owns more than 50% of the stock of the corporation.\(^{59}\) Accordingly, when the PE fund purchases the debt at a discount, the debt will be treated as having been reissued with OID, and will not be fungible with the remainder of the debt.

From a practical perspective, the purchase of the debt by the PE Fund would not be problematic from a reporting and compliance perspective. So long as the PE Fund keeps the issuer informed, the issuer and the PE Fund can take into account the COD income and the correlative adjustment to the OID. However, if the PE were to resell the debt into the market in a case where all of the debt is held by a depositary and there is no method to determine chain of title (e.g., the bond market), this would cause the compliance and reporting difficulties outlined in the previous example. Although not as clear as in the previous example, we believe market practice in situations such as this is not to sell to debt to unsuspecting purchasers on the grounds

\(^{58}\) Treas. Reg. §1.108-2(d)(2).

\(^{59}\) The applicable test for being treated as related is Section 267(b) with some modification. See Treas. Reg. §1.108-2(d)(2).
that it would not be advisable for the PE Fund to cause a corporation in which it owns more than 50% of the debt to fail to properly report the OID.

Example 15. Noncontrolling related person purchase and resale of issuer debt.

All of the LPs in PE Fund own interests directly in the PE Fund. The PE Fund owns the majority of the stock of a corporation that issues debt that has no OID. A flesh and blood individual LP in the PE Fund acquires the debt at a significant discount and resells that debt to unrelated persons at a significant discount.

Analysis: Although it seems surprising, for purposes of Section 267, the individual would seem to be treated as owning the majority of the stock of the corporation. Thus, his or her purchase will be treated in the same manner as a purchase by the PE fund in the previous example. The debt will therefore be treated as reissued with OID and will not be fungible with the remaining debt. However, in this example it is hard to see any reason why the individual ought to be prohibited from selling into the market. He is not related to the corporation from any common sense perspective, and the fact that if he or she sells the debt, the corporation and the remaining holders would not be able to correctly report OID income, ought not to be that individual’s problem. He is just buying and selling debt.

The question for the issuer then, assuming the issuer is aware of this purchase, is how the issuer will be able to report the OID to the holders. There is little the issuer can do. The issuer cannot tell which purchasers bought the debt from the individual so as to report the OID to that purchaser. The issuer cannot take the amount of OID that it knows exists, and report that amount

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60 This is because section 267(c), provides that “an individual will be considered as owning all of the stock owned, directly or indirectly, by or for his partner.” Since the partners in the PE Fund collectively indirectly own more than 50% of the stock of the corporation, the individual will be treated as owning all of that stock, and will be related to the corporation. This would certainly seem to be the case if the other partners in the PE Fund are individuals. However, if the other partners in the fund are entities, the rule may not apply. See PLR 201208025; OH NO! Not Attribution Rules!, May/Jun 2014, Journal of Corporate Taxation (WG&L).
of OID pro rata to all of the holders, because that would not be correct, since the holders who did not purchase the debt from a related holder have no OID. There is simply no way to report the OID correctly, short of repaying all of the debt and issuing new debt, and it would seem absurd to require the holder to do so.\textsuperscript{61}

One method for dealing with this might be for the issuer to defer taking an interest deduction with respect to the debt instrument in an amount equal to the unreported OID until such time as the debt instrument is repaid. This would be, in a sense, rough justice to the fisc. While the fisc is suffering from a holder not deferring the OID income on the debt until it is repaid, the fisc is also benefitting from the issuer not claiming an interest deduction equal to the amount of that OID. However, query whether to implement such a scheme would require administrative approval by the IRS? Additionally, in cases where the issuer is not currently a taxpayer, the fisc would not be made whole.\textsuperscript{62}

In connection with this idea, when the IRS proposed the Section 108 regulations, the IRS requested comments on whether to adopt a rule that after the related purchaser sells the debt, the debtor's deduction of OID and the holder's inclusion of OID are deferred and taken into account at maturity.\textsuperscript{63} The IRS ultimately decided not to adopt such a rule because they believed that disposition of the debt by the related party “would not be a common business transaction, thus, the complexity involved in the alternative proposal was not considered justified.”\textsuperscript{64}

\textsuperscript{61} It would likely also be an expensive undertaking. Since we are addressing a case where the debt was purchased at a discount, the market seems to believe the debt is not worth par, and in order to raise new debt worth par and pay off the old debt, the issuer would need to increase the rate or otherwise make the term on the new debt more favorable to the holders.

\textsuperscript{62} If the idea were implemented through a regulatory scheme in all cases, it would arguably still be fair to the fisc overall. That is because while some issuers deferring OID deductions are not taxpayers, some holders deferring OID inclusions are not taxpayers as well.


Unfortunately, the rule actually implemented, which requires that the OID still be taken into account after the debt instrument is sold by the related party only works when the holder can be identified. When the holder cannot be identified, it leaves the issuer in a position of not being able to properly report the OID.