

Notice of Proposed Rulemaking and Notice of Public Hearing

Reopenings of Treasury Securities and Other Debt Instruments; Original Issue Discount

REG-115932-99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations, notice of proposed rulemaking, and notice of public hearing.

SUMMARY: This document proposes, by cross-reference to temporary regulations in T.D. 8840, amendments to the final regulations concerning the federal income tax treatment of certain reopenings of Treasury securities. In the temporary regulations in T.D. 8840, on page 575 of this Bulletin, remove the requirement that the issuance of the Treasury securities in the reopening must be intended to alleviate an acute, protracted shortage of the original securities. The text of the temporary regulations also serves as the text of the proposed regulations. This document also contains proposed regulations that would provide guidance on the Federal income tax treatment of reopenings of debt instruments other than Treasury securities. The proposed regulations would provide guidance to holders and issuers of debt instruments. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written and electronic comments must be received by February 3, 2000. Requests to appear and outlines of topics to be discussed at the public hearing scheduled for March 22, 2000, at 10 a.m., must be received by March 1, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-115932-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R

(REG-115932-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslst.html. A public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, William E. Blanchard, (202) 622-3950; concerning submissions and the hearing, Michael L. Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in T.D. 8840, page 575, amend the Income Tax Regulations (26 CFR part 1) relating to section 1275 of the Internal Revenue Code (Code). The temporary regulations provide rules for qualified reopenings of Treasury securities. See §1.1275-2T(d).

This document also proposes new rules under sections 163(e) and 1275 of the Code for qualified reopenings of debt instruments other than Treasury securities.

Explanation of Provisions

Reopenings of Treasury Securities.

The text of the temporary regulations (§1.1275-2T(d)) also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Reopenings of Debt Instruments Other Than Treasury Securities.

A. In General.

Over the past few years, a number of issuers have developed programs or practices where debt instruments with identical terms and CUSIP numbers are sold subsequent to their original issue date. These subsequent sales are often called "reopenings." The original issue discount

(OID) rules generally accommodate reopenings during periods of stable or falling market interest rates. As is explained in more detail below, during periods of rising market interest rates, the OID rules can effectively prohibit reopenings. The proposed regulations in this document would modify the OID rules to accommodate certain qualified reopenings.

Under §1.1275-1(f), two or more debt instruments are part of the same issue if they have the same payment and credit terms and are sold reasonably close in time either pursuant to a common plan or as part of a single transaction or series of related transactions. Usually, there is little doubt as to what constitutes an issue because all of the relevant debt instruments have identical terms, have the same CUSIP number, and are sold on the same day. When the third condition is not met, however, there is a question as to whether the subsequently sold debt instruments are part of the original issue or are themselves a new issue.

This question—whether the subsequently sold debt instruments are part of the original issue—has important tax consequences. If the subsequently sold debt instruments are considered part of the original issue, they have OID only to the extent the debt instruments in the original issue have OID. Thus, if the original debt instruments were issued without OID, the subsequently sold debt instruments also do not have OID. In this case, any discount on the subsequently sold debt instruments generally is market discount, not OID. Conversely, if the subsequently sold debt instruments are a separate issue for tax purposes, any discount that arises as part of their issuance is OID if it equals or exceeds the OID *de minimis* amount for the debt instruments. See §1.1273-1(d) to determine the *de minimis* amount.

The holder and issuer have different tax consequences depending upon whether the discount is characterized as OID or market discount. For the holder, the primary difference is whether the holder has to include the discount in income on a current basis as it accrues. If it is OID, the holder must include the accruals in income currently; if it is market discount, the holder generally does not have to in-

clude discount in income until the debt instrument is disposed of or redeemed. The issuer's tax consequences also depend on whether the discount is OID or market discount. If the subsequently sold debt instruments are part of a separate issue and if the discount is OID, the issuer (or a broker or middleman) generally is required to make OID information reports for these debt instruments. See §1.6049-5. To comply with this reporting obligation, the issuer must be able to distinguish the subsequently sold debt instruments (which require OID information reports) from the originally sold debt instruments. As a practical matter, the only way the subsequently sold debt instruments can be distinguished is if they are assigned new CUSIP numbers. The assignment of new CUSIP numbers prevents the debt instruments from being fungible and, thereby, defeats the purpose of the reopening.

B. Qualified Reopenings.

This document proposes new qualified reopening rules. Under these rules, additional debt instruments sold in a qualified reopening would be part of the same issue as the original debt instruments. As a result, the additional debt instruments would have the same issue date, the same issue price, and (with respect to holders) the same adjusted issue price as the original debt instruments.

A qualified reopening would be a reopening of original debt instruments that meets the following conditions: (1) The original debt instruments are publicly traded; (2) The issue date of the additional debt instruments (treated as a separate issue) is not more than 6 months after the issue date of the original debt instruments; (3) Seven days before the date on which the price of the additional debt instruments is established, the yield of the original debt instruments (based on their fair market value) is not more than 107.5 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate); and (4) The yield of the additional debt instruments (based on the sales price of the additional debt instruments) is not more than 115 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no

more than a *de minimis* amount of OID, the coupon rate).

A qualified reopening also would include a reopening of original debt instruments if the first two conditions described above are met and the additional debt instruments (treated as a separate issue) were issued with no more than a *de minimis* amount of OID. A qualified reopening, however, would not include a reopening of tax-exempt obligations or contingent payment debt instruments.

The qualified reopening rules attempt to strike a balance between tax policy concerns about the conversion of OID into market discount and the need to have the tax rules reflect current capital market practices. The IRS and the Treasury Department believe the appropriate balance is to provide reopening rules for situations where the issuer can prove by objective, market-based information that the reopening will convert, at most, only a small amount of OID into market discount. To clearly and accurately measure the conversion benefit across different interest rate environments and debt instrument terms, the proposed regulations use a yield-based standard. The 107.5 percent standard was designed to give some relief to the reopening of relatively short-term issues (that is, issues with a remaining term of 10 years or less). These issues tend to be the most impacted by the OID *de minimis* rule standard.

The two yield-based rules are designed to work in tandem. The 107.5 percent of yield restriction is tested 7 days before the anticipated pricing date. This rule is designed to give the issuer a preliminary indication that its reopening will be a qualified reopening prior to the issuer's announcement of the reopening. Importantly, this preliminary indication is not controlling. Absent the 115 percent rule, if market interest rates were to move sharply upward in the week between the announcement date and the pricing date, the reopened debt instruments would go out with a significant amount of market discount (instead of OID) notwithstanding the fact that seven days before the pricing date the instruments satisfied the 107.5 percent rule. In this presumably rare and unusual case, the tax policy concern of converting a significant amount of OID into market discount becomes relatively more important. The proposed reg-

ulations, therefore, limit the total amount of discount that can be converted into market discount with the 115 percent rule.

C. Definition of Issue.

The proposed regulations also change the definition of *issue* that is currently in §1.1275-1(f) of the final OID regulations (described above). Essentially, the proposed regulations limit the "reasonably close in time" standard of current law to 13 days. The IRS and the Treasury Department believe that reopenings should be done through the proposed qualified reopening rule (discussed above), not through an expansive interpretation of the regulatory definition of issue. The 13-day limitation was chosen to prevent an issuer that comes to market every two weeks from stretching the definition of issue to cover two consecutive market sales. If an issuer wants to reopen more than 13 days after the initial offering, the sole test should be whether the reopening qualifies under the proposed qualified reopening rules.

D. Issuer's Treatment.

This document also proposes rules that clarify the issuer's treatment of the debt instruments comprising an issue when there is a qualified reopening. The proposed regulations require the issuer to take into account, as an adjustment to its interest expense, any difference between the amounts paid by the holders to acquire the additional debt instruments issued in the qualified reopening and the adjusted issue price of the original debt instruments. This difference would either increase or decrease the aggregate adjusted issue prices of all of the debt instruments in the issue (both original and additional) with respect to the issuer (but not the holder). The issuer would then, as of the reopening date, recompute the yield of the debt instruments in the issue based on this aggregate adjusted issue price and the remaining payment schedule of the debt instruments. The issuer would use this re-determined yield for purposes of applying the constant yield method to determine its accruals of interest expense over the remaining term of the debt instruments in the issue.

During the consideration of the issuer's treatment of the additional debt instruments, a question arose as to whether the

issuer's all-in-cost-of-capital should be used to determine the issuer's interest expense for a particular borrowing. Under current law, the costs of anticipatory hedges and bond issuance costs (such as underwriter fees) are not treated as interest expense even though they affect the issuer's cost of acquiring funds (the issuer's all-in-cost-of-capital). The IRS and the Treasury Department request comments on whether the issuer's all-in-cost-of-capital should be used to determine the issuer's interest expense for a particular borrowing.

E. Proposed Effective Dates.

Section 1.163-7(e) of the proposed regulations would apply to qualified reopenings where the reopening date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**. Section 1.1275-2(k) of the proposed regulations would apply to debt instruments that are part of a reopening where the reopening date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**.

The proposed revision to the definition of the term *issue* would apply to debt instruments whose issue date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**. For debt instruments issued prior to the effective date of the regulations, no inference is intended as to how the term *issue* should be interpreted under the current final regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments (a signed original and eight (8) copies, if written) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how the regulations may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 22, 2000, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identifications to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments by February 3, 2000, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 1, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is William E. Blanchard, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.163-7 is amended by:

1. Redesignating paragraph (e) as paragraph (f).
2. Adding a new paragraph (e).
3. Revising newly designated paragraph (f).

The revision and addition read as follows:

§1.163-7 Deduction for OID on certain debt instruments.

* * * * *

(e) *Qualified reopening*—(1) *In general*. In a qualified reopening of an issue of debt instruments, if a holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument, the issuer treats this difference as an adjustment to the issuer's interest expense for the original and additional debt instruments. As provided by paragraphs (e)(2) through (e)(5) of this section, the adjustment is taken into account over the term of the instrument using constant yield principles.

(2) *Positive adjustment*. If the difference is positive (that is, the holder pays more than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference increases the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(3) *Negative adjustment*. If the difference is negative (that is, the holder pays less than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference reduces the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(4) *Determination of issuer's interest accruals*. As of the reopening date, the issuer must redetermine the yield of the debt instruments in the issue for purposes of applying the constant yield method described in §1.1272-1(b) to determine the

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issuer's accruals of interest expense over the remaining term of the debt instruments in the issue. This redetermined yield is based on the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) and the remaining payment schedule of the debt instruments in the issue. If the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) are less than the aggregate stated redemption price at maturity of the instruments (determined as of the reopening date) by a *de minimis* amount (within the meaning of §1.1273-1(d)), the issuer may use the rules in paragraph (b) of this section to determine the issuer's accruals of interest expense.

(5) *Effect of adjustments on issuer's adjusted issue price.* The adjustments made under this paragraph (e) are taken into account for purposes of determining the issuer's adjusted issue price under §1.1275-1(b).

(6) *Definitions.* The terms *additional debt instrument*, *original debt instrument*, *qualified reopening*, and *reopening date* have the same meanings as in §1.1275-2(k).

(f) *Effective dates.* This section (other than paragraph (e) of this section) applies to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on this section (other than paragraph (e) of this section) for debt instruments issued after December 21, 1992, and before April 4, 1994. Paragraph (e) of this section applies to qualified reopenings where the reopening date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**.

Par. 3. In §1.1275-1, paragraph (f) is revised to read as follows:

§1.1275-1 Definitions.

* * * * *

(f) *Issue—(1) Definition.* Two or more debt instruments are part of the same issue if the debt instruments—

- (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; and
- (iii) Are issued within a period of 13 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.

(2) *Cross-references for reopening and aggregation rules.* See §1.1275-2(d) and (k) for rules that treat debt instruments issued in certain reopenings as part of an issue of original (outstanding) debt instruments. See §1.1275-2(c) for rules that treat two or more debt instruments as a single debt instrument.

(3) *Effective date.* This paragraph (f) applies to debt instruments whose issue date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**.

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Par. 4. In §1.1275-2, paragraph (d) is revised and paragraph (k) is added to read as follows:

§1.1275-2 Special rules relating to debt instruments.

* * * * *

(d) [The text of this proposed paragraph (d) is the same as the text of §1.1275-2T(d) published in T.D. 8840.]

* * * * *

(k) *Reopenings—(1) In general.* Notwithstanding §1.1275-1(f), additional debt instruments issued in a qualified reopening are part of the same issue as the original debt instruments. As a result, the additional debt instruments have the same issue date, the same issue price, and (with respect to holders) the same adjusted issue price as the original debt instruments.

(2) *Definitions—(i) Original debt instruments.* Original debt instruments are debt instruments comprising any single issue of outstanding debt instruments. For purposes of determining whether a particular reopening is a qualified reopening, debt instruments issued in prior qualified reopenings are treated as original debt instruments and debt instruments issued in the particular reopening are not so treated.

(ii) *Additional debt instruments.* Additional debt instruments are debt instru-

ments that, without the application of this paragraph (k)—

- (A) Are part of a single issue of debt instruments;
- (B) Are not part of the same issue as the original debt instruments; and
- (C) Have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.

(iii) *Reopening date.* The reopening date is the issue date of the additional debt instruments (determined without the application of this paragraph (k)).

(iv) *Qualified reopening.* A qualified reopening is a reopening of original debt instruments (other than tax-exempt obligations, as defined in section 1275(a)(3), and contingent payment debt instruments, within the meaning of §1.1275-4) that meets all of the following conditions:

(A) The original debt instruments are publicly traded (within the meaning of §1.1273-2(f)).

(B) The reopening date of the additional debt instruments is not more than 6 months after the issue date of the original debt instruments.

(C) The debt instruments satisfy either the test described in paragraph (k)(3) of this section or the test described in paragraph (k)(4) of this section.

(3) *Yield test.* For purposes of paragraph (k)(2)(iv)(C) of this section—

(i) Seven days before the date on which the price of the additional debt instruments is established, the yield of the original debt instruments (based on their fair market value) is not more than 107.5 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate); and

(ii) The yield of the additional debt instruments (based on the sales price of the additional debt instruments) is not more than 115 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate).

(4) *De minimis OID test.* For purposes of paragraph (k)(2)(iv)(C) of this section, the additional debt instruments are issued with no more than a *de minimis* amount of OID (determined without the application of this paragraph (k)).

(5) *Special rule for Treasury reopenings.* See paragraph (d) of this section for special rules for reopenings of Treasury securities.

(6) *Issuer's treatment of a qualified reopening.* See §1.163-7(e) for the issuer's treatment of the debt instruments that are part of a qualified reopening.

(7) *Effective date.* This paragraph (k) applies to debt instruments that are part of a reopening where the reopening date is on or after the date that is 60 days after the date final regulations are published in the **Federal Register**.

David A. Mader,
*Acting Deputy Commissioner
of Internal Revenue.*

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