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Exchanges of Short-Term Debt Instruments in Reorganizations

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Under the provisions of the Internal Revenue Code (the "Code") relating to corporate reorganizations, a holder of securities issued by a corporation that is a party to a reorganization who exchanges those securities for securities in the same corporation or in another corporation which is a party to the reorganization is not required to recognize gain on that exchange, so long as the principal amount of the securities received by a holder does not exceed the principal amount of the securities surrendered.

The term "securities" as used in these provisions is not defined in the Code or the Treasury Regulations. However, it is clear from judicial and administrative authorities accumulated through the years that many instruments that would be considered securities for purposes of the securities laws will not qualify as securities for this purpose. Thus, in this context, the term "securities" fails to include many debt obligations.

In particular, short-term debt obligations -- with the upper limit of "short-term" falling somewhere in the range of an initial term of five to ten years -- have generally not been considered securities. A recent revenue ruling, however, concluded that a debt instrument with an initial term of just two years could constitute a security, where the debt instrument was being issued in exchange for an outstanding debt "security" of another corporation in connection with an acquisition of assets pursuant to a corporate merger and the new debt instrument represented a continuation of the former security holders' investments in the acquired corporation.

Background

The exchange of one debt instrument for another will generally result in recognition of gain by the holder, if the fair market value of the debt instrument received exceeds the tax basis of the debt instrument surrendered. This recognition of gain can be avoided, however, if the new debt instrument is so similar to the debt instrument surrendered that it can be said that no "exchange" has occurred or if, as described above, the transaction constitutes an exchange of "securities" in the context of a corporate reorganization.

Regulations under Code section 1001 address when the terms of the old and new debt instruments will be sufficiently different for an "exchange" to have occurred for tax purposes. A change in the obligor of a debt instrument will not be considered, in itself, sufficient to cause an exchange, if the change occurs in the context of (i) an acquisition of assets in connection with a corporate reorganization described in Code section 368 (other than a stock-for-stock "B" reorganization or certain divisive transactions) or a liquidation of a wholly owned subsidiary corporation into its corporate shareholder under Code section 332, or (ii) a transaction consisting of an acquisition of substantially all the assets of the original obligor by a new obligor, so long as the transaction does not result in a change in payment expectations (from "primarily speculative" to "adequate" or *vice versa*) with respect to the debt instrument.

Thus, for example, if a corporation transfers substantially all of its assets to another corporation in exchange for voting stock of the acquiror and distributes the stock received to its shareholders, in a reorganization qualifying under Code sections 368(a)(1)(C) and 354, and debt obligations of the transferor corporation are assumed by the acquiring corporation without any other change in terms, a former holder of the debt obligations of the transferor, which were assumed by the acquiror in the transaction, will not be required to recognize gain by reason of the surrender of those debt obligation and the receipt of debt obligations of the acquiring corporation, regardless of whether or not those debt obligations constituted securities and regardless of whether there is a formal exchange of old for new debt instruments.

Conversely, other changes to a debt instrument, such as a change in the interest rate or yield by more than a small amount, a change resulting in a material deferral of scheduled payments with respect to the debt, or a change in the nature of a debt instrument from recourse to nonrecourse, will generally constitute an "exchange" under these rules, with the effect that gain will be required to be recognized, unless that exchange is one of "securities" in the context of a corporate reorganization.

If there is a taxable exchange of one debt instrument for another, the amount of gain required to be recognized by the holder of the debt instrument is generally the face amount of the new debt instrument (see Treasury Regulation section 1.1001-1(g)(1)) over the holder's tax basis in the old debt instrument. This can result in the triggering of a significant amount of gain if, for example, the holder acquired the debt instrument at a significant discount from its principal amount and the value of the instrument has since increased because of an improvement in the issuer's financial condition or changes in the overall interest rate environment.

Debt Exchanges in Reorganizations

The corporate reorganization provisions provide an important exception to the rule that an exchange of debt instruments will result in the recognition of gain for tax purposes. For example, in a statutory merger described in section 368(a)(1)(A) of the Code in which T Corp. is merged into P Corp., with P Corp. surviving and with the shareholders and security holders of T exchanging their stock and securities for stock and securities issued by P, the security holders of T Corp. will generally not recognize gain or loss unless the principal amount of the securities received by a holder exceeds the principal amount of securities surrendered. If the consideration received by a former security holder consists, however, of short-term debt instruments not constituting securities, that holder will be required to recognize gain to the extent of the excess of the principal amount of the new debt instruments over the holder's basis in the old debt instruments.

Qualification as "Security"

Thus, from the perspective of the holder of a corporate debt instrument who, but for the reorganization rules, would be required to recognize gain by reason of the receipt of a new debt instrument with terms different from those of the debt instrument surrendered, the qualification of the new debt instrument as a "security" becomes very important. If the new debt instrument *is* a security, numerous significant changes can often be made to the interest rate, payment schedule, and other terms of the debt instrument without causing the holder to recognize gain or loss on the exchange. Conversely, if the debt instrument is *not* a security, even a relatively modest change in terms, such as a change of 26 basis points (0.26%) in the interest rate of the debt instrument, will generally result in a taxable exchange.

As noted above, a number of cases and rulings have addressed the factors that determine whether debt obligations constitute a security for this purpose. The maturity date of the obligation seems to be most significant. Specifically, a debt obligation with an initial term of five years or less is generally not considered a security; by contrast, a debt obligation with an initial term of ten years or more will generally be considered a security. (Initial terms of five to ten years fall into a grey area.)

Other factors that have been cited include the purpose for which the obligation was incurred and the extent to which the instrument represents a participation in the earnings or growth of the business. Some practitioners refer to the "mermaids and locomotives" test: whether the instrument is evidenced by a certificate in the ornate form customarily used for corporate debentures. (With the increased ubiquity of uncertificated securities, however, the continued viability of this standard is open to question.)

Revenue Ruling 2004-78

Rev. Rul. 2004-78 describes a reorganization entered into by a corporation (Target) that had one outstanding class of common stock and had issued debt instruments on January 1, 2004, with a maturity date of January 1, 2016. The debt instruments provided for a market rate of interest on the date of issue and, with their initial term of twelve years, were securities within the meaning of Code section 354 on that date.

Ten years after the issuance of the securities, *i.e.*, two years before their scheduled maturity, Target merged into another corporation (Acquiring) in a statutory merger constituting a reorganization within the meaning of Code section 368(a)(1)(A).

In the merger, the shareholders of Target exchanged their common stock for common stock of Acquiring. In the same transaction, the holders of the Target securities exchanged those securities for debt instruments of Acquiring having an identical maturity date (2 years from the date of the merger) and other identical terms, except for a change in interest rate. The ruling notes that the change in interest rate may have been made by reason of a difference in creditworthiness between Target and Acquiring. The ruling states that the change in interest rate was such as to cause the substitution of debt instruments to constitute an "exchange" under section 1.1001-3 of the Regulations.

Analysis

The ruling briefly reviews relevant provisions of the Code and regulations relating to the definition of a reorganization and the treatment of exchanging shareholders and security holders. It notes legislative history relating to the reorganization rules to the effect that where a taxpayer receives stock or securities in exchange for other stock or securities in connection with a readjustment of the corporate structure, the stock or securities received should be "treated as taking the place of" the stock or securities exchanged.

The ruling also discusses cases relating to the definition of a security. It notes that, under the case law, a debt obligation with an initial maturity date only two years after the date of issue generally would not be treated as a security, with the effect that the exchange of old "securities" for new "non-securities" would be a taxable event to the holders of the old debt instruments. Because the Acquiring debt instruments described in the ruling were issued in a reorganization in exchange for securities of Target, however, and had the same terms (apart from the interest rate and identity of obligor) as the securities surrendered, the ruling concludes that the debt instruments of Acquiring represented a continuation of the security holders' investment in Target in substantially the same form, and therefore constituted securities within the meaning of Code section 354.

Observations

The ruling reaches a sensible result and should generally be welcomed by corporate tax practitioners as removing a potentially difficult problem concerning tax planning for security holders in transactions involving debt-for-debt exchanges. The ruling does not elaborate, however, regarding whether and in what circumstances additional significant changes (beyond a change in interest rate) to the terms of the debt instrument issued by the acquiring corporation, as compared to those of the original debt instrument of the acquired corporation, might lead the IRS to assert that the replacement debt obligation should not be viewed as a mere continuation of the investment of the former security holders of Target, such that the status of the new debt instruments as securities would be determined without regard to the status of the surrendered debt instruments of Target as securities for tax purposes.

Intuitively, it would seem that the modification of other terms should not give rise to a different result so long as they are consistent, in the aggregate, with an objective of providing to the security holders debt obligations substantially equivalent in economic terms to the debt obligations being surrendered. It would seem prudent, however, to try to minimize the extent of such modifications where nonrecognition treatment is sought based on the rationale set forth in the ruling.