III. Obligation to Explain in Future Tax Cases

Whatever the ultimate fate of Judge Ambro's contention in the section 6015(f) cases, does "failure to explain" have a future in other cases? I think the answer is "yes"—*if* taxpayers' counsel are willing to immerse themselves in general administrative law enough to argue the issue skillfully.

It is clear that general administrative law does apply to tax rules and regulations. With exceptions not here relevant, the APA applies to all federal agencies, including Treasury and the Service. 5 U.S.C. § 551(1). Despite the desire of some to deny it, it has long been clear that tax is not exempt from general administrative law. The Supreme Court's unanimous *Mayo* decision ends any question in this regard. *See Mayo*, 131 S. Ct. at 712–13.

Moreover, Judge Ambro's opinion is not the first time the explanation obligation has appeared in a tax case. Some (though not many) previous cases have addressed it. *E.g.*, *American Standard, supra; Georgia Fed. Bank, F.S.B. v. Commissioner*, 98 T.C. 105, 110 (1992). More cases entailing challenges to tax regulations would have dealt with this issue had it been raised more often by taxpayers' counsel.

Mayo makes it more likely that counsel will wade into these waters in the future. In *Mayo* and in some other cases, taxpayers challenging Treasury regulations argued in part as follows: (1) *National Muffler*, not *Chevron*, provides the governing standard when tax regulations (especially general authority regulations promulgated under section 7805(a)) are challenged; (2) *National Muffler* is more rigorous than *Chevron*; and (3) the challenged regulation fails to pass muster under *National Muffler. National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472 (1979).

As I argue in my March *Tax Notes* article, this argument was wrong and contorted the real meaning of *National Muffler*. In any event, the argument was decisively rejected in *Mayo*. *See* 131 S. Ct. at 711–14. It no longer is available to taxpayers, creating the need for aggrieved taxpayers to find other doctrinal bottles into which to pour the vinegar of their discontent.

That being so, one may expect taxpayers—in addition to pressing standard substantive contentions, such as that the regulation is inconsistent with the governing statute—to seek procedural grounds on which to attack inconvenient regulations. One of those grounds may be a *Mannella*-style argument that Treasury failed to adequately explain and justify the choices it made in the regulation. It will be interesting in the years to come to see what develops along this front. ■

The Service Traces Clearer Definitions in the Proposed Regulations on "Publicly Traded" Debt Instruments

By AJ Picchione*

My law school Contracts professor took some pleasure in pointing out various lexical oddities in our material. I vividly recall his introduction of the "parol evidence rule" as the triple misnomer. "Rule" is a misnomer because it is a principle, not a rule. "Evidence" is a misnomer because it is a principle of contract law, not of evidence. "Parol" is a misnomer because it applies to written as well as oral (*i.e.*, parol) statements. Tax law is similarly rife with inaccurately named concepts and defined terms that seem to defy common sense. One such crime against language perpetrated by the Service is the definition of "traded on an established securities market" under Regulations section 1.1273-2 or, as it is more commonly referred to, the "publicly traded" debt rule. Recently, the Service issued proposed regulations that, by most accounts, should substantially clarify many of the uncertainties under the current regulations.

Code section 1273 provides rules for determining the amount of original issue discount, or OID, attributable to certain debt instruments. Very generally, under section 1273, if the "issue price" of a debt instrument is less than the amount to be returned to the investor upon maturity of the instrument (excluding any normal interest payment that is paid at maturity), then that debt instrument is said to have been issued with OID. The consequence of holding a note with OID is that the holder must take portions of that "discount" into income over the term of the note, even though the cash is not received until maturity. This is the so called "phantom income" that haunts the debt markets. As a result of this phantom income, debt instruments issued with OID have a more limited pool of investors than do issuances of so called plain vanilla debt instruments. Specifically, taxable U.S. investors are generally less likely to purchase OID instruments. In the case of new issuances, OID instruments are often purchased by tax-exempt and non-U.S. investors. However, problems can arise

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for issuers when they offer to exchange a newly issued OID instrument for an outstanding, plain vanilla instrument. Why would an issuer do this? The answer is that, as a result of the peculiar definition of "publicly traded," a double misnomer worthy of ridicule in law school classes, the issuer may have no choice.

The publicly traded debt rule is relevant to determining the issue price of a debt instrument that is issued in exchange for property (*i.e.*, anything other than cash). Generally, the rules provide that if debt is issued for cash, the issue price for such instrument is the first price at which a substantial amount of the issue is sold. If debt is issued in exchange for property and if either the debt instrument or the property for which the debt instrument is being exchanged is "publicly traded," the issue price of the debt instrument is the "fair market value" of the instrument on the issue date. Although not specifically provided in the current regulations, fair market value, for this purpose, is generally understood to be the price at which the property is listed on the market on which it is "traded."

The Current Regulations

That all seems to make sense, but the point at which this exercise gets weird is when one looks to the regulations to see what needs to be true in order for a debt instrument to be considered traded on an established securities market/publicly traded. Although the regulations include several types of listings that most rational people would easily recognize as indicative of public trading (*e.g.*, if the property is listed on the New York Stock Exchange, the property would be "traded on an established securities market"), a few of the definitions in the current regulations are true head scratchers. Specifically, the inclusion of "readily quotable debt instruments" as well as "property appearing on a quotation medium" as "publicly traded" is a little hard to swallow.

With respect to the former, a debt instrument is treated as "publicly traded" if price quotations are readily available from dealers, brokers, or traders. Practitioners have debated about what "readily available" means. Does it mean that if I dial up a broker and he or she is unable to immediately give me a price quotation that it is not "readily available"? If the broker has to look at the financial statements of the issuer or, god forbid, type a few numbers into a calculator, surely that means that the price quotation is not readily available … right? The truth is that, although there are safe harbors that tell taxpayers when an instrument is not readily quotable, there is no clear guidance indicating what level of effort a broker must exert to arrive at a price quotation before the Service would view the quotation as not "readily available." Moreover, qualifying as "publicly traded" under this provision requires neither trading, nor a platform that is available to the general public.

Just as perplexing is the provision that provides that "property appearing on a quotation medium" will be considered to be "publicly traded." The regulations provide that a "quotation medium" is a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of one or more identified brokers, dealers, or traders or actual prices, but does not include a directory or listing of brokers, dealers, or traders for specific securities, that provides neither price quotations nor actual prices of recent sales transactions. Though the regulations do not provide a list of quotation media, one system that practitioners have gotten fairly comfortable qualifies as a "quotation medium" is Trade Reporting and Compliance Engine ("TRACE"), a subscription-only database service maintained by the Financial Industry Regulatory Authority ("FINRA"). FINRA requires that all TRACE-eligible bond trades be reported to TRACE. Basically, when a TRACE-eligible bond is issued, it is added to a list that is disseminated electronically to brokers. If a broker executes a trade on a TRACE-listed instrument, the broker has to report the trade data (volume, price, date) to the TRACE system within a certain number of days following the trade. In recent years, FINRA has made some TRACE data publicly available on its website.

The problem with this definition is that it relies on the adequacy of the medium and not on the actual trading that is reported on the medium to determine the issue price of a debt instrument. In an active debt market, TRACE likely could provide a reasonable basis for determining the value and, accordingly, the issue price, of a debt instrument. But in a slow market or with a debt instrument that trades infrequently regardless of the market, it is hard to know if the prices that appear on TRACE really represent the value of a debt instrument. Moreover, as noted above, a security can be listed on TRACE without being traded. In such a case, logically one might think that this definition would not apply and the instrument should not be considered publicly traded. But under a literal reading of the definition, the property appears on a medium that provides a reasonable basis to determine fair market value. So, even though there are no trades on the instrument in question, because the medium itself is adequate, it is difficult to conclude that the instrument is not "publicly traded" under the regulations, even if it has never actually been traded.

These definitional issues have had a significant impact on the ability of some issuers to refinance debt during the economic downturn, as depicted in the following example:

In 2006, Company X issued plain-vanilla debt with a six-year term, a fixed interest rate and a stated redemption price at maturity of 1,000. The majority of the debt is held by a handful of institutional investors. Although the debt is listed on TRACE, trades are few and far between because of the concentration of the issuance with a relatively small number of holders. In early 2008, seeking to capitalize on the economic

downturn, a new investor instructs a broker-dealer to offer to buy the Company X debt instruments for twenty cents on the dollar. The broker then phones other brokers with a 200 bid on the Company X notes. Eventually a seller is found, but only a few of the notes are sold at the 200 price. The trade is reported on TRACE. Later in 2008, Company X seeks to exchange new notes with a four-year term and an interest rate and stated redemption price at maturity identical to those of its 2006 notes for all of its outstanding 2006 notes. Because the notes for which the 2008 notes are being exchanged appear on a quotation medium, the 2008 notes will be issued in exchange for publicly traded property. Accordingly, the issue price of the 2008 notes would seem to be 200, the price of the most recent trade on the TRACE system.

For the issuer, the best case scenario is that the holders of its outstanding notes are tax-indifferent parties and are not deterred from participating in the exchange by the OID that they will need to take into income over the term of the new debt instrument as a result of the disparity between the issue price and the stated redemption price at maturity. Even in this best case scenario, the issuer could have a substantial inclusion of cancellation of debt ("COD") income in the year of the exchange. That sting of the COD income in the year of the exchange will be mitigated by deductions for OID over the term of the newly issued debt instrument, but for an issuer that does not have a net operating loss carryforward to offset the COD income, this result may be a bitter pill to swallow. But if the majority of the holders are taxable entities, a far worse fate likely awaits the issuer, *i.e.*, a failed exchange offer.

The Proposed Regulations

In January of this year, the Service issued proposed changes to these regulations. The proposed regulations reorganize the concepts in the current regulations and, by most accounts, will create much clearer rules as to what debt instruments will be considered publicly traded. Specifically, the proposed regulations will require that, in order for an instrument to qualify as "publicly traded" mere listing on TRACE or similar services will not be sufficient; there will need to be actual sales prices or price quotations (either firm or indicative) for the security in question. Moreover, if the only information is an indicative price quote, under the proposed regulations, if the taxpayer determines that the quote materially misrepresents the fair market value of the property, the taxpayer can use any method that provides a reasonable basis to determine the fair market value of the property.

Another notable proposed change is that the proposed regulations will include a presumption that the fair market value of a debt instrument will equal the trading price, listing price or quoted price under the new rules. But perhaps the most important change proposed is a new de minimis trading rule. Under the new de minimis rule, a debt instrument will not be treated as traded on an established market if (A) each trade of such debt instrument during the 31-day period ending 15 days after the issue date is for quantities of one million dollars or less; and (B) the aggregate amount of all such trades does not exceed five million dollars. *See* Prop. Treas. Reg. § 1.1273-2(f)(7)(ii). If such a de minimis rule were in effect in the example discussed above, as a result of the low trading volume, the newly issued notes would not be treated as traded on an established securities market and the issue price likely would be significantly higher. As a result there likely would have been less OID for the holders, less COD income for the issuer and a greater likelihood of a successful exchange offer.

For all of the positive changes that the proposed regulations will make, the Service still insists on designating these concepts as "[t]raded on an established market (publicly traded)," though even under the proposed regulations actual trades made by investors on a public market are not required for a debt instrument to be considered publicly traded. But if the worst thing that can be said about the new regulations is the fact that one of its headings is a double misnomer, then the Service has done an admirable job revising regulations that, for many years, have had much more serious shortcomings. ■

Is Your Client Planning to Expatriate? Why the HEART Act May Cause a Change of Heart

By Vlad Frants*

On its surface, legislation known as the Heroes Earnings Assistance and Relief Tax Act of 2008 ("HEART Act") provides a number of pay and employee benefits to military personnel. Pub. L. No. 110-245, 122 Stat. 1624. But at its core, the HEART Act significantly changes the tax system applicable to U.S. citizens and lawful permanent residents who expatriate by relinquishing, respectively, their citizenship or permanent resident status. This Article discusses the tax consequences of U.S. citizens who relinquish their citizenship and long term residents of the U.S. who cease to be lawful permanent residents within the meaning of section 7701(b)(6).

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