REPORT #908

TAX SECTION

New York State Bar Association

Report on 'Gross Up' Provisions in Debt Obligations and Contingetn Payment Debt Under Section 1275 of the Code

Table of Contents

TAX SECTION

New York State Bar Association

July 24, 1997

Donald C. Lubick, Esq.
Acting Assistant Secretary
(Tax Policy)
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Michael P. Dolan, Esq.
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary, Lubick and Commissioner Dolan:

Over the past year since the contingent payment debt regulations (the "Regulations")[1] were issued in final form, practitioners have had the opportunity to apply the Regulations to a variety of different debt securities As discussed in greater detail below, some practitioners believe that the Regulations might be read to apply in the common situation in which the borrower agrees to indemnify the lender for withholding taxes imposed. Application of the Regulations in this situation would produce aberrant results which we do not believe could have been contemplated by the drafters, and we believe that there is a strong technical basis for the conclusion that the Regulations do not apply. We therefore recommend issuance of a revenue ruling confirming this Conclusion.

---

[1] Treas. Reg. § 1.1275-4. All section references are to the Internal Revenue Code of 1986, as amended, and to the Treasury Regulations promulgated thereunder

In lending transactions involving cross-border payments it is commonplace to provide a withholding tax gross-up so that the lender is made whole if withholding tax is imposed, or the rate of such tax is increased, on payments under the obligation. Concern has been expressed that a debt instrument containing such a provision might be treated as a "contingent payment debt instrument" under the Regulations unless: (i) the likelihood of payment under the gross-up obligation, or of a change in the withholding tax rate, is remote over the life of the instrument,[2] (ii) the gross-up payments are incidental in relation to the total amount payable under the instrument,[3] (iii) a single payment schedule under the instrument is significantly more likely than not to occur[4] or (iv) the instrument can be characterized as a variable rate debt instrument.[5]

As discussed below, one or more of the first three conditions will be met in certain circumstances; in those circumstances, a debt instrument with a withholding tax gross- up will not be subject to the contingent debt regulations. We believe that, in any case in

---

[2] See Treas. Reg. §§ 1.1275-4(a)(5), 1.1275-2(h)(2). Under Treas. Reg. § 1.1275-2(h)(4), all contingent payments that might be made under the instrument must be taken into account in determining whether there is a greater than i emote likelihood that the contingent payments, in the aggregate, will be made.

[3] Treas. Reg. §§ 1.1275-4(a)(5), 1.1275-2(h)(3)(i). The aggregation rule of Treas. Reg. § 1.1275-2(h)(4) similarly requires that all contingencies involving incidental payments be considered to determine whether such payments, in the aggregate, are incidental.

[4] Treas. Reg. §§ (1.1272-1(c)(2) and 1.1275-4(a)(2)(iii).

[5] Treas. Reg. §§ (1.1275-5(a)(3),(c), 1.1275-4(a)(2)(ii). We note, however, that this exception will not apply if the debt instrument is not publicly traded and is issued in exchange for non-publicly traded property. See Treas. Reg. §§ 1.1274-2(f)(2) and 1.1275-5(a)(6). Special relief may be appropriate to avoid application of the regulations, and attendant harsh results, in such a case.

which none of these three conditions is met, such a debt instrument should be characterized as a variable rate debt instrument (or “VRDI”).

As regards (i), there will be many cases in which the imposition of withholding tax (or change in the rate thereof) over the life of the debt will be regarded as highly unlikely. The stringency of the remoteness standard creates a basis for concern, however, especially in the case of long-term debt in the context where changes in law could well occur.

As regards (ii), there is significant support in the regulations for treating gross-up payments as incidental since the debt holder receives no additional amounts by reason of the lender's making gross-up payments. Moreover, the additional income resulting from gross-up payments will generally be offset, either by a deduction or credit for foreign taxes paid. A question arises how to apply the aggregation requirement in this context; but if other payments under the debt instrument would be regarded as incidental on a stand-alone basis, gross-up payments that provide no additional receipts to the lender should not change the status of the other payments.

Relief under (iii) will be available in cases in which a single payment pattern under the instrument is significantly more likely than not to occur. Thus, if there were, say, not more than a one-third likelihood of an imposition of withholding tax, or change in the rate thereof, contingent debt status should be avoided. Unfortunately, however, the regulation can be read to provide that the potential exercise of unrelated call features, for example, is taken into account in determining whether a single payment schedule is significantly more likely than not to occur.[6]

---

[6] Under this reading of the regulation, the fact that such call provisions would be disregarded because they do not lower the issuer's cost of borrowing (see Treas. Reg. § 1.1272-1(c)(5)) is apparently not relevant in determining whether a single payment schedule is significantly more likely than not to occur.

A technical question relevant to this approach is whether the timing and amount of the payments that comprise each payment schedule are known as of the issue date, since the range of possible withholding tax rates is at least theoretically infinite.[7] Failure to meet this condition prevents utilization of the relief rule applicable where a payment schedule is significantly more likely than not to occur.[8] It would seem reasonable, however, to read the regulation as taking into account only those payment patterns that might realistically be expected to occur.

With respect to (iv), we believe that a debt instrument providing a withholding tax gross-up, but not satisfying one or more of the first three conditions, should satisfy the definition of a VRDI. In general, VRDIs include debt instruments that provide for no stated interest other than stated interest compounded or paid at least annually at a single objective rate. An objective rate is a rate that is determined using a single fixed formula and that is based on objective financial or economic information. The withholding tax rate in effect in a particular jurisdiction is clearly "objective" information, and that information is "financial or economic" in nature. A debt instrument that provides for interest to be paid at a fixed or floating rate, grossed up based on the applicable withholding tax rate, provides for interest at a rate determined using a "single fixed formula" that is based on the withholding tax rate.

To illustrate, assume that a debt instrument provides for interest at a rate of 6%, grossed up for withholding tax, payable annually. Such a debt instrument can be viewed as providing for interest at a rate equal to 6%

---

[7] See Treas. Reg. § 1.1272-1(c)(1).

[8] Even if relief were available under Treas. Reg. § 1,1272-1(c)(2), by reason of Treas. Reg. § 1.1273-1(c)(2), all amounts payable by reason of the imposition of a withholding tax would arguably be considered original issue discount, a result inconsistent with the treatment typically expected.

divided by (1-w), where w is the applicable withholding tax rate. Although the interest rate on the debt will change if the applicable withholding tax rate changes, the formula used to determine the interest rate is a single formula and is fixed for the life of the debt instrument. The only variable in the formula is the withholding tax rate, which is objective financial or economic information. Accordingly, such a debt instrument should qualify as a VRDI.

We recognize that the amount by which interest payments are increased because of a gross up may depend on the tax rate applicable to the particular holder, and thus may vary depending on whether the holder is a corporation or individual, and on the terms of the applicable tax treaty. We do not believe, however, that the fact that an interest rate may vary depending on which of several broad categories of persons the holder falls into should affect the conclusion that the rate is determined using a single fixed formula and is based on objective financial or economic information.

Although we believe that debt instruments with withholding tax gross-ups should qualify as VRDIs (if not otherwise excluded from the contingent debt rules), the lack of authority directly on point, the importance of certainty in international capital markets transactions and the harsh consequences of application of the contingent debt rules, all argue for guidance clarifying the treatment of such instruments.

The failure to avoid contingent payment debt instrument status would mean (i) that issuer and holder compute interest expense and income utilizing the comparable non-contingent bond method and (ii) that any gain on disposition of the instrument be treated as ordinary.

Denial of capital gain treatment on disposition, together with the burden of applying the non-contingent bond method, seems plainly wrong as a policy matter for cases in

which contingent debt status would result from the presence of a withholding tax gross-up in the debt instrument.

We urge that the uncertainty that exists as to the treatment of withholding tax gross-ups be addressed by issuance of a revenue ruling holding that a debt instrument is not a contingent debt instrument merely because it provides for a withholding tax gross-up. Such a ruling would confirm that withholding tax gross-up payments are "incidental" within the meaning of Treas. Reg. 1.1275-2(h)(3), or that an instrument providing such a gross-up is a VRDI. If the former alternative is adopted, it should also be confirmed that the aggregation rule of Treas. Reg. § 1.1275-2(h)(4) will not cause unrelated payments that would otherwise qualify as incidental to lose that status by reason of the possibility that gross-up payments will be made.

As an alternative to issuance of a revenue ruling, the Service could eliminate taxpayer concerns in this area by amending the regulations to provide a generic exclusion from the definition of contingent payment for payments pursuant to a customary withholding tax gross-up provision.[9] A similar exclusion is presently provided in the Regulations for the possibility that a payment will not be made due to insolvency, default or similar circumstances.[10] Given the pervasive use of withholding tax gross-ups, parallel treatment seems warranted. We are not aware of any way in which such an exclusion might be used to defeat the policy underlying the Regulations.

---

[9] So-called increased cost provisions in loan documents create some of the same issues discussed herein with respect to withholding tax gross-up provisions. Under a typical increased cost provision, the lender is indemnified for costs associated with the loan in question that the lender would not otherwise have incurred. We suggest that a exclusion similar to that provided for withholding tax gross-ups be provided for payments pursuant to customary increased cost provisions.

[10] See Treas. Reg. § 1.1275-4(a)(3).

If we can be of further assistance in addressing this issue, please do not hesitate to call me.

Very truly yours,

Richard O. Loengard, Jr.

CC: Kenneth J. Krupsky
Deputy Assistant Secretary
(Tax Policy)

Jonathan Talisman
Tax Legislative Counsel

Clarissa Potter
Acting Deputy Tax Legislative
Counsel

Hon. Stuart L. Brown
Chief Counsel
Internal Revenue Service

William E. Blanchard
Senior Technical Reviewer
Internal Revenue Service