

**Report #1022**

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON THE TAXATION OF STRAIGHT  
AND CONTINGENT CONVERTIBLE DEBT**

**November 7, 2002**

**New York State Bar Association  
Tax Section**

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and Contingent Convertible Debt**

In Revenue Ruling 2002-31, I.R.B. 2002-22, at 102 (issued May 6, 2002)(the “Ruling”), the Internal Revenue Service (the “Service”) discussed the treatment of certain convertible debt instruments that provided for one or more contingent cash payments that were neither remote nor incidental (so-called “contingent convertible debt”).<sup>1</sup> In the Ruling, the Service applied the noncontingent bond method of Treasury Regulation Section 1.1275-4(b) to determine the issuer's and holder's interest deductions and inclusions.<sup>2</sup> The Ruling also discussed the applicability or non-applicability of Sections 163(l) and 249 to contingent convertible debt.<sup>3</sup> On the facts stated in the Ruling, the Service held that those Sections would not apply to disallow the issuer's deductions for periodic interest accruals, but that if the debt were converted into issuer stock having a value in excess of the value taken into account in determining the debt's projected payment schedule, the issuer would not be allowed to deduct that excess because of Section 249.

At the same time as the Service released the Ruling, it issued Notice 2002-36, I.R.B. 2002-22, at 102 (the “Notice”). In the Notice, the Service observed that, given the applicability of the noncontingent bond method to contingent convertible debt, a potential discontinuity had been created with the treatment of convertible debt instruments that did not provide for contingent cash payments

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<sup>1</sup> The principal drafters of this report were David Schizer and Lewis Steinberg. Helpful comments were received from Peter Blessing, Dickson Brown, Samuel Dimon, Edward Gonzalez, David Hariton, Robert Jacobs, John Lutz, David Mayo, Charles Morgan, Erika Nijenhuis, Deborah Paul, Yaron Reich, Richard Reinhold, Robert Scarborough, Michael Schler, Andrew Solomon, Gordon Warnke, and David Watts.

<sup>2</sup> In applying the noncontingent bond method, the Ruling used the yield at which the issuer could have issued a nonconvertible fixed rate debt instrument as the comparable yield.

<sup>3</sup> All Section references are to Sections of the Internal Revenue Code of 1986, as amended (the “Code”) or to the regulations thereunder.

(so-called “straight convertible debt”). In particular, according to the Notice:

As a policy matter, the Service and the Treasury are concerned whenever significantly different tax results obtain for economically similar financial instruments, such as (1) straight convertible debt and (2) convertible debt that provides for contingent payments that, while not remote or incidental, are relatively insignificant in amount or in likelihood of occurrence.

The Notice pointed out that “[s]uch inconsistencies create market inefficiencies and increased transactional expense” and invited “comments and suggestions for changes in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments to eliminate or reduce the disparity in treatment of these instruments.”

This report of the New York State Bar Tax Section addresses a number of the issues raised in the Notice. It focuses first on the tax treatment of straight convertible debt from the issuer's viewpoint. It identifies three possible approaches for accounting for the issuer's interest deductions with respect to straight convertible debt: (1) the bifurcation method, (2) the traditional method, and (3) the contingent payment method. After discussing the pros and cons of each approach, the report concludes that, on balance, the traditional method remains the most appropriate way to account for interest expense on straight convertible debt.

The report then discusses the appropriate treatment of the issuer of contingent convertible debt if the traditional method is retained for straight convertible debt. It concludes that, under such circumstances, a modified contingent payment method should be adopted, one that accrues original issue discount (“OID”) based upon the yield to maturity at which the issuer could have issued comparable straight convertible fixed rate debt. Under such a method, a contingent convertible debt instrument having relatively insignificant contingent payments (other than the conversion right) would be taxed in a manner that approximates the traditional method.

Finally, the report discusses how holders of both straight and contingent convertible debt should be taxed. It concludes that, on balance, holders should continue to be taxed in a manner symmetrical to that of issuers.

## I. Financial Aspects of Straight Convertible Debt.

Straight convertible debt is conventionally viewed for corporate finance purposes as a hybrid instrument consisting of a combination of nonconvertible debt and a warrant or option on the issuer's own stock.<sup>4</sup> Because of the warrant component, straight convertible debt will generally be priced at a lower yield to maturity than nonconvertible debt having comparable economic terms.

For example, assume that an issuer could issue ten-year (noncallable) fixed rate senior debt at a yield to maturity of 10% per annum.<sup>5</sup> Also assume that a ten-year European style<sup>6</sup> warrant on the issuer's stock having an exercise price of \$1000 would sell for \$122.89. On these facts, ten-year \$1000 principal amount (noncallable) senior convertible debt issued at par would typically have a coupon (and a yield to maturity) of 8% per annum. In essence, the holder would have traded off 2% per annum of yield (as compared to purchasing the issuer's nonconvertible debt) in exchange for the debt's conversion feature.<sup>7</sup>

Applying this understanding of the financial aspects of straight convertible debt, the next section discusses the appropriate tax treatment of issuers of such debt.

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<sup>4</sup> See, e.g., Richard A. Brealey & Stewart C. Myers, PRINCIPLES OF CORPORATE FINANCE 651-59 (6th ed. 2000)

<sup>5</sup> Convertible debt typically pays interest semiannually. For simplicity, the example described in the text provides for annual interest payments.

<sup>6</sup> A European style warrant or option can only be exercised by the holder at maturity. An American style warrant or option, on the other hand, is exercisable at any time during the term of the instrument. While most convertible debt instruments contain an embedded American style warrant on the issuer's stock, the example in the text focuses on a European style warrant for simplicity.

<sup>7</sup> The convertible debt pays \$20 less interest per year as compared to the nonconvertible debt. The present value of ten \$20 annual interest payments, discounted at a 10% discount rate (*i.e.*, at the issuer's nonconvertible borrowing rate), is \$122.89 (*i.e.*, the value of the embedded warrant represented by the conversion feature of the convertible debt).

In the example, the convertible debt has been priced such that the issue price of the convertible debt equals the sum of the "stand-alone" values of the nonconvertible debt and warrant components. In fact, it is our understanding that convertible debt is typically priced on a "theoretically cheap" basis such that the issue price of the convertible debt is less than the sum of the stand-alone values of the two components.

## **II. Approaches to Taxing Straight Convertible Debt: The Issuer's Perspective.**

In deciding how to tax straight convertible debt, four potentially competing tax policy goals need to be taken into account. First, income and expense from issuing the convertible debt needs to be clearly reflected. Second, the rules adopted need to be administrable; moreover, this suggests that, on balance, a simpler approach is to be preferred over a more complex approach. Third, the treatment of convertible debt should be consistent with the treatment of instruments that are close economic substitutes; otherwise, taxpayers will be free to exploit these inconsistencies through tax-motivated planning, leading to reduced revenue for the fisc and distorted taxpayer behavior.<sup>8</sup> Fourth, the method adopted should be consistent with the substantive tax rules and principles that apply in related circumstances.<sup>9</sup>

The following section of the report describes three possible approaches for taxing the issuer of straight convertible debt: the bifurcation method, the traditional method, and the contingent payment method. As the following discussion shows, none of the three methods can fully achieve all the tax policy goals described above. Instead, tradeoffs are necessary, and the precise tradeoff is different for each solution. We consider these three approaches in turn.

### **A. Bifurcation**

As noted above, a convertible debt instrument can be viewed for corporate finance purposes as a package consisting of nonconvertible debt and a warrant on the issuer's stock. As a result, an obvious way of taxing the instrument would be to tax these two embedded components separately – taxing the embedded nonconvertible debt instrument under the tax rules for debt, while taxing the embedded warrant under the general rules for options on the issuer's stock. Such an approach (the “bifurcation method”) would treat the convertible debt described above as an investment unit, applying Treasury Regulation Section 1.1273-2(h). The nonconvertible debt component of the investment unit would have an issue price of \$877.11,<sup>10</sup> and the warrant component of the investment unit would have an issue price of \$122.89.

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<sup>8</sup> This tax policy goal is sometimes referred to as minimizing taxpayer electivity.

<sup>9</sup> In many, although not in all, cases, this goal will overlap with the goal of minimizing taxpayer electivity (and possibly with the goal of clearly reflecting income and expense).

<sup>10</sup> This amount (\$877.11) represents the present value of the interest and principal payments on the nonconvertible debt component of the investment unit, discounted at 10% per annum (*i.e.*, the issuer's nonconvertible borrowing rate).

With respect to the nonconvertible debt component of the investment unit, the issuer would accrue interest and OID deductions. Over the life of the debt, this would result in interest and OID of \$922.89.<sup>11</sup> But with respect to the warrant component, the issuer would *not* accrue any interest or OID – and this is the essential difference between the bifurcation method and the contingent payment method discussed below. Indeed, the issuer would never recognize gain or loss with respect to the embedded warrant by virtue of Section 1032.<sup>12</sup>

The bifurcation method has the merit of conforming the tax treatment of straight convertible debt to the conventional understanding of the financial aspects of the instrument. Furthermore, this approach would only accrue OID and interest on the nonconvertible debt component of the instrument. The denial of a deduction for any interest or OID on the portion of the issue price of the convertible debt attributable to the warrant component is consistent with the policies animating Sections 1032, 163(l) and 249.<sup>13</sup>

These provisions may be viewed as codifying aspects of a broad common law principle, premised on the foundational distinction between debt and equity, that denies corporations deductions with respect to their cost of equity capital.<sup>14</sup>

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<sup>11</sup> This consists of ten annual interest payments of \$80 each, plus OID of \$122.89 (*i.e.*, the excess of the nonconvertible debt component's \$1000 stated redemption price at maturity over its \$877.21 issue price). Note that the OID on the debt component is equal to the value of the warrant.

<sup>12</sup> Section 1032(a), second sentence (corporate taxpayer does not recognize gain or loss with respect to the lapse or acquisition of an option to buy or sell its own stock).

<sup>13</sup> *See* Section 1032 (no gain or loss recognized by taxpayer with respect to its own stock, including lapses or acquisitions of options on its own stock); Section 163(l) (no interest deduction allowed with respect to certain equity-linked instruments); Section 249 (no deduction allowed generally for premium paid with respect to repurchase of convertible debt to the extent it exceeds a normal call premium).

<sup>14</sup> *See also* *Emerson Electric Manufacturing Co. v. Commissioner*, 3 B.T.A. 932(1926) (expenses paid in connection with issuance of stock by corporation nondeductible); *Simmons Co. v. Commissioner*, 33 F.2d 75 (1st Cir. 1929), *cert. denied*, 280 U.S. 588 (1929)(same).

It should be noted that we are not saying that allowing an interest or OID deduction on straight convertible debt in excess of the amount deductible under the bifurcation approach would necessarily violate the relevant Code provisions. *Cf.* Notice 2002-36 (deduction for periodic interest accruals on contingent convertible debt does not violate Sections 163(l) and 249). Rather, we are saying that the bifurcation approach does not implicate the types of Congressional concerns that led to the enactment of such provisions.

In a prior report we recommended imputation of interest income and expense on certain deep-in-the-money options, but declined to apply this recommendation to options that are subject to Section 1032. *See* New York State Bar Association Tax Section Report No. 990, “*Timing and* (...continued)

Moreover, by eliminating any disparity between the tax treatment of issuing straight convertible debt and an investment unit containing a warrant on the issuer's stock, taxpayer electivity will be reduced. In essence, under the current rules, the issuer is relatively free to elect either the bifurcation method (by issuing an actual investment unit), the traditional method (by issuing straight convertible debt), or the contingent payment method (by issuing contingent convertible debt). Applying the bifurcation method to straight convertible debt would thus reduce the issuer's options from three to two.<sup>15</sup>

Notwithstanding these advantages, the bifurcation method is problematic. For example, the bifurcation method presents a number of complexities and ambiguities.<sup>16</sup> In particular, it will be necessary to assign a value to each component of the hypothetical investment unit. Valuing warrants is frequently not a straightforward task. This is particularly the case where what is being valued is the conversion feature of a convertible debt instrument, since such embedded warrants have, in essence, an increasing exercise price,<sup>17</sup> are implicitly subject to any issuer calls and/or holder puts that are terms of the convertible debt instrument, and typically lack publicly-traded analogues.<sup>18</sup> Furthermore, valuations tend to be sensitive to the particular valuation method utilized and the

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*Character Rules for Prepaid Forwards and Options*" (submitted March 26, 2001), reprinted in 2001 TAX NOTES TODAY 64-H (April 3, 2001). While some might argue that such imputations could result in clearer reflection of income and expense, we were concerned about not violating Section 1032-type principles.

<sup>15</sup> Obviously, electivity would be further reduced if the bifurcation method were also applied to contingent convertible debt.

<sup>16</sup> Theoretically, convertible debt can be bifurcated in a number of different ways. However, we believe that this complication could be adequately dealt with by the Service's prescribing a particular characterization, such as requiring that a straight convertible debt instrument be treated as an investment unit consisting of nonconvertible debt and a warrant to acquire the issuer's stock.

<sup>17</sup> Economically, the exercise price of the embedded warrant is the value of the debt component of the investment unit at the time of exercise, which, *ex ante*, can be approximated by the adjusted issue price of the debt from time to time. Where the conversion feature of the convertible debt can be exercised at any time (and thus the embedded warrant is American style, see note 6 above), the exercise price will effectively increase over time.

<sup>18</sup> One way of mitigating some of these valuation issues would be to determine the value of the embedded warrant by subtracting the value of the nonconvertible debt component of the unit from the issue price of the convertible debt. For purposes of valuing the debt component, the interest and principal payments on the convertible debt would be discounted using the issuer's nonconvertible borrowing rate. In the case of floating rate debt, the interest payments would be estimated using forward rates. A similar method could be used to deal with contingent convertible debt instruments, particularly those providing for market-based contingent payments.

inputs (e.g., stock volatility) used, all of which may vary from taxpayer to taxpayer. The difficulty of valuation may therefore encourage self-serving and idiosyncratic valuations.<sup>19</sup> Indeed, such administrability concerns caused the Service to abandon a similar approach to the taxation of (nonconvertible) contingent debt instruments in the early 1990's.<sup>20</sup>

Compounding these issues of application is the fact that bifurcation would only apply to (straight and possibly contingent) convertible debt instruments. Thus, we would have imposed a complex regime of taxation, one that raises unique interpretative and administrative issues, solely on convertibles. This will inevitably increase the compliance burden on taxpayers and their advisors. The question, as always, is whether this burden is outweighed by the advantages of bifurcation from a tax policy viewpoint.

Finally, while treating a straight convertible debt instrument as a notional investment unit may accord with financial theory, it doesn't accord with the fact that, for corporate and bankruptcy purposes, a straight convertible is a single instrument. Not only does this raise certain valuation issues,<sup>21</sup> but it may also suggest that the bifurcation method does not adequately reflect the substance of the overall transaction.<sup>22</sup>

Ultimately, we consider the problems of the bifurcation method to be very significant. On balance, therefore, and while some members of the Executive Committee disagree, the Tax Section would not advocate taxing straight convertible debt using the bifurcation method.

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<sup>19</sup> For instance, tax-sensitive issuers might argue for higher option valuations than tax-indifferent issuers.

<sup>20</sup> See Proposed Regulation Section 1.1275-4(g), 56 F.R. 8303(1991).

One issue that might be raised with respect to bifurcation is whether the Service and Treasury Department have authority to implement it in regulations. Cf. *Chock Full O'Nuts Corp v. United States*, 453 F.2d 300 (2d Cir. 1971) (self-help bifurcation by taxpayer disallowed). We believe that the broad grant of regulatory authority in Section 1275(d) gives the government ample power to adopt the bifurcation method (or any of the other methods discussed herein) in regulations. See also Section 385(a).

<sup>21</sup> As noted in note 7 above, convertibles are typically priced on a "theoretically cheap" basis.

<sup>22</sup> One interesting aspect of bifurcation is that, the greater the value of the embedded warrant and thus the greater the amount of the "equity content" of the convertible, the greater the issuer's OID deductions. To some, at least, this seems rather counterintuitive.

In the case of the traditional method, described below, on the other hand, the issuer's interest and OID deductions decrease as the equity content of the convertible increases.

## B. Traditional Method

A second approach to determining the issuer's deductions with respect to straight convertible debt would be to retain the current regime for taxing such instruments (the "traditional method"). The traditional method simply applies to straight convertible debt the normal interest and OID rules applicable to noncontingent debt instruments. For example, continuing with the example above, the traditional method would allow the issuer to deduct a total of \$800 of interest expense over the life of the bond.

The traditional method shares an important advantage of bifurcation while avoiding one of the latter approach's significant costs. As in the bifurcation approach, under the traditional method the issuer is not entitled to deduct interest and OID on the portion of the issue price of the convertible debt attributable to the embedded warrant. In addition, the traditional method is much easier to administer than bifurcation: it is simple to apply and has the benefit of long usage. Also, as compared to the bifurcation method, the traditional method is more consistent with the fact that a straight convertible debt is a single instrument for corporate and bankruptcy purposes.

As compared to the bifurcation method, the traditional method produces lower interest and OID deductions for the issuer with respect to the convertible debt.<sup>23</sup> This approach would also allow taxpayer electivity. If the issuer is tax indifferent, it might issue straight convertible debt, thereby minimizing the tax liabilities of tax sensitive holders.<sup>24</sup> Alternatively, if the issuer is tax sensitive, it could increase its deductions by issuing an investment unit, such that the tax treatment would be comparable to bifurcation.<sup>25</sup> Finally, if contingent convertible debt continues to be taxed as set forth in the Ruling, the degree of electivity would be maximized.<sup>26</sup> In such case, tax sensitive issuers would secure

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<sup>23</sup> Whether this should be viewed as violating the clear reflection of income goal, however, turns on whether one believes that a straight convertible debt instrument should more properly be viewed for tax purposes as a single instrument (as it is for corporate and bankruptcy purposes) or as a notional investment unit (as it customarily is for corporate finance purposes).

<sup>24</sup> This assumes, of course, that the treatment of the holder and the issuer are consistent, as is the case under current law. *See* Part IV below.

<sup>25</sup> The ability to provide "self-help" bifurcation through issuing investment units predates the development of contingent convertible debt and is an opportunity that has only rarely been availed of by issuers, in part because of the currently less favorable treatment of investment units for financial accounting purposes.

<sup>26</sup> The pre-tax result, of course, would not be identical to that of the straight convertible debt issuance because of the need to include one or more nonremote/nonincidental contingent cash payments. Nevertheless, as the Service itself suggested in the Notice, while such contingent (...continued)

potentially greater deductions, accruing interest expense based on the full issue price of the debt instrument, including the value of the embedded warrant.<sup>27</sup> This third structure presumably could be issued most readily to tax indifferent holders.

### C. Contingent Payment Method

A final approach to taxing straight convertible debt is the noncontingent bond method of Treasury Regulation Section 1.1275-4(b) that, pursuant to the Ruling, currently applies to contingent convertible debt (the “contingent payment method”). Applying this method to our example would result in the issuer deducting \$1119 of interest over the life of the convertible debt,<sup>28</sup> depending upon the issuer's stock price at maturity, however, the issuer might be required to recognize a negative adjustment of up to \$319 at maturity. Nevertheless, in the case where the value of the issuer's stock increased sufficiently over the life of the debt to equal or exceed the value(s) taken into account in determining the debt's projected payment schedule, the contingent payment method would result in greater interest deductions than the bifurcation method (and, *a fortiori*, the traditional method). Indeed, in the case of long-maturity debt, in certain cases the contingent payment method may result in greater tax benefits to the issuer (on a present value basis) than the bifurcation approach even if the issuer's stock price does not increase.

The contingent payment method avoids the valuation and other difficulties associated with bifurcation. In addition, applying the contingent payment method to straight convertible debt would allow for identical treatment of straight and contingent convertible debt (assuming that contingent convertibles continue to be taxed under this approach), as well as for identical treatment of convertible debt and nonconvertible contingent debt.<sup>29</sup> For those who believe that the rules of

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payments cannot be remote and incidental within the meaning of Treas. Reg. Sec. 1.1275-2(h), they may (arguably) have relatively little economic significance, with the result that the taxpayer is essentially free to elect into contingent payment treatment.

<sup>27</sup> See the discussion of the contingent payment method in Part II.C. below.

<sup>28</sup> That is, the issuer will accrue interest each year at a 10% rate, initially on an issue price of \$1000. Since the annual coupon payments on the debt will be only \$80, the excess will result in an increase in the convertible debt's adjusted issue price, thus resulting in compounding of interest. In terms of maximizing tax benefits and reducing cash outflow, the benefit to the issuer increases as (i) the outstanding term of the convertible debt increases and (ii) cash interest payments on the debt are minimized.

<sup>29</sup> The ability to conform the issuer treatment of contingent convertible and contingent nonconvertible debt, however, may be an illusory benefit. Many (perhaps most) issuers of contingent nonconvertible debt hold or enter into positions that hedge their economic exposure to the embedded contingencies. As a result, pursuant to the integration rules of Treasury Regulation (...continued)

Treasury Regulation Section 1.1275-4 represent an economically precise way to deal with contingent payments and can discern no relevant distinction (insofar as determination of the comparable yield is concerned) between contingencies linked to the issuer's own stock and those that are not so linked, adoption of the contingent method would thus result in both reduced taxpayer electivity and clearer reflection of income.

However, as noted above, the contingent payment method may allow for greater interest accruals over the life of the bond than bifurcation or the traditional method. In essence, these enhanced interest deductions are attributable to the warrant component embedded in the convertible debt. In particular, the contingent payment method accrues interest and OID on the full purchase price for the convertible debt instrument, including the portion thereof attributable to the conversion right.<sup>30</sup> We believe that allowing such enhanced deductions to the issuer would be inconsistent with the Congressional purposes behind such provisions as Sections 1032, 163(l) and 249 and, more generally, with the fundamental principle that an issuer is not entitled to a deduction for the cost of its equity capital.<sup>31</sup>

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Section 1.1275-6 or the proposed regulations under Section 263(g), their net interest expense is generally reduced in a manner that approximates (on a present value basis) that of the bifurcation method. Issuers of convertible debt, however, have a "natural" hedge in their ability to issue their own stock. Thus, issuers of convertible debt typically do not enter into separate hedging arrangements. The end result is that the benefit of the contingent payment method is maximized in a case where contingent convertible (versus contingent nonconvertible) debt is issued.

<sup>30</sup> Some may argue that this conclusion begs the question by, in essence, implicitly assuming that bifurcation is the most economically accurate way of taxing a straight convertible debt instrument. One needn't be committed to bifurcation, however, in order to acknowledge that a portion of the purchase price of a convertible must be attributable to the conversion right; after all, absent the conversion right, a holder would pay less for the instrument. (While the traditional method also accrues interest on the entire purchase price of the convertible debt, it does so at a lower rate, thus resulting in even less interest expense than bifurcation.)

<sup>31</sup> Because a warrant does not involve an unconditional promise to pay the holder a sum certain, but rather represents a conditional obligation to issue stock (or its equivalent in value) in the future, assimilating the treatment of stock and warrants (or, equivalently, conversion rights) from the issuer's perspective seems eminently sensible. This, of course, is exactly what Sections 1032 and 249 do.

In Revenue Ruling 2002-32, I.R.B. 2002-22, 102, the Service denied a deduction to the issuer to the extent the value of the stock issued upon conversion exceeded the convertible debt's adjusted issue price, citing Section 249. The policy underpinning this conclusion, as we understand it, is that such amounts constitute part of the issuer's cost of equity capital. Allowing an issuer to accrue deductible interest on the portion of the issue price of the convertible debt attributable to the conversion right would in our view equally contravene that tax policy. In (...continued)

Some members argue that the ability to pay otherwise deductible expenses using a taxpayer's own stock indicates that there is no general Congressional intent to deny deductions with respect to corporate equity. For example, they note that a corporation that pays its employees using stock remains entitled to a compensation deduction. *See* Section 83. Deductions have also been allowed under Sections 162 and 170 for other types of business expenses and charitable contributions paid with stock. Indeed, so long as Section 163(l) is not violated, even interest remains deductible if paid with issuer stock.<sup>32</sup>

This argument, however, is ultimately irrelevant. In the cases cited above, the source of the deduction is an independent transaction unconnected to the issuance of stock by the corporation; rather, stock is merely used as the medium of payment of otherwise deductible expenses. On the other hand, allowing deductible interest to accrue on the portion of the issue price of the convertible debt that is attributable to the conversion right, as in the case of the contingent payment method, creates a deduction for what we believe is properly viewed as the cost of the issuer's own equity capital, a result we find unwarranted and inconsistent with fundamental tax policies.<sup>33</sup>

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essence, such interest would represent the difference between the expected payoff on the conversion right and the portion of the issue price allocated thereto.

It should also be noted that, absent a sufficient increase in the value of the issuer's stock over the life of the convertible debt, the issuer utilizing the contingent payment method will suffer a negative adjustment (and thus a recapture of some of its previous interest deductions). In essence, then, the net amount of interest/OID deductible under the contingent payment method is a function, in part, of the price performance of the issuer's stock over the term of the convertible debt. Put differently, a portion of the interest/OID will be paid, if at all, only with the issuer's stock (or by reference to its value). This seems to us to implicate the policies underlying Section 163(l).

<sup>32</sup> In the past, other restrictions on the use of stock to pay interest and OID have been proposed. *See, e.g.,* Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal (JCS-10-97)* (April 16, 1997). These, however, were never enacted.

<sup>33</sup> Some have argued that straight convertible debt should more properly be conceptualized as an investment unit consisting of (i) nonconvertible debt bearing interest at the issuer's normal (nonconvertible) borrowing rate and issued at par and (ii) a warrant on the issuer's stock, the premium with respect to which is required to be paid over time by the holder out of interest payments on the debt. Thus, in our basic example, the nonconvertible debt component of the investment unit would be viewed as paying interest at a rate of 10% per annum and having been issued at par, and the holder would be viewed as being required to pay \$20 per annum as warrant premium over the ten-year life of the convertible debt. In such case, the issuer would be entitled to \$100 of interest deductions per year, which is less than under the contingent payment method. However, unlike the contingent payment method, the issuer would not be required to recapture a portion of its interest deductions if its stock did not appreciate sufficiently over the (...continued)

## D. Recommendation

On balance then, having rejected the bifurcation approach because of its complexity,<sup>34</sup> and having rejected the contingent payment method because of its inconsistency with the policies underlying Sections 1032, 249 and 163(l) and general principles, the Tax Section supports retention of the traditional method for determining the issuer's deductions with respect to straight convertible debt. In particular, we believe that, as compared to the contingent payment method, the traditional method is more consonant with the prohibition on an issuer's deducting the cost of its own equity capital.<sup>35</sup>

## III. Issuer's Treatment with respect to Contingent Convertible Debt.

If the traditional method is retained with respect to the tax treatment of issuers of straight convertible debt, an obvious question arises: how should issuers of contingent convertible debt be taxed? We have identified two possible approaches.

First, contingent convertible debt could continue to be subject to the contingent payment method, as described in the Ruling. This, however, would maintain the discontinuity between the tax treatment of straight and contingent convertible debt, with the consequent potential for taxpayer electivity.<sup>36</sup>

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term of the debt. Thus, depending on the facts, such a characterization might or might not result in more favorable tax treatment for the issuer than the contingent payment method.

Whatever the merits of such a characterization where the instrument is, in form and substance, structured as an investment unit, we find such a characterization far less compelling where the instrument is structured as a single straight convertible debt instrument. In particular, such a characterization would hypothesize a circular flow of cash (*i.e.*, interest paid on the debt being automatically returned to the issuer as warrant premium) which, under general tax principles, is typically ignored.

<sup>34</sup> As noted above, some members of the Executive Committee would propose using the bifurcation method for taxing issuers of straight convertible debt.

<sup>35</sup> Retention of the traditional method might also ameliorate the tax compliance burdens of unsophisticated issuers and holders by limiting the potential applicability of the contingent payment method. However, we suspect that this is not a practical concern.

<sup>36</sup> If the traditional method is retained for straight convertible debt while the "classic" contingent payment method continues to apply to contingent convertible debt, the Tax Section believes it is imperative that the Service issue guidance as to when contingent payments on convertible debt will be treated as non-remote and non-incidental. A low threshold for this purpose will obviously increase taxpayer electivity. This issue, of course, has ramifications even in the case of nonconvertible debt instruments.

Moreover, as described above, the decision to retain the traditional method for straight convertible debt is premised, in great part, on concerns about allowing deductions for the warrant component of such debt. It is hard to see why these concerns are any less compelling in the case of contingent convertible debt.

A second, and we believe better, approach would be to utilize a modified version of the contingent payment method (the “modified contingent payment method”) for determining the issuer's deductions with respect to contingent convertible debt. This method would apply the noncontingent bond method of Treasury Regulation Section 1.1275-4(b), but, unlike the Ruling, this method (i) would use the issuer's convertible (rather than its nonconvertible) borrowing rate as the comparable yield (the issuer's “convertible comparable yield”) in applying that method and (ii) would not treat the conversion right as a potential contingent payment. The convertible comparable yield is the yield at which the issuer could have issued a straight convertible fixed rate debt instrument with a conversion premium identical to that, and having other terms comparable to those, of the contingent convertible debt instrument that was actually issued.<sup>37</sup>

Compared to the classic contingent payment method, the modified contingent payment method would prevent the issuer from deducting interest and OID with respect to the warrant component of the convertible debt. At the end of the day, this approach, coupled with the inability under Section 249 to deduct positive adjustments attributable to unanticipated increases in the value of the issuer's stock over the life of the debt, should lead to results that approximate the traditional method described above for taxing straight convertible debt. Adopting such a modified contingent payment method would go far to harmonizing the treatment of straight and contingent convertible debt. It would also preserve, to some degree, a continuity between the tax treatment of contingent convertible and contingent nonconvertible debt.

We recognize that determining a convertible comparable yield may be more difficult than determining a nonconvertible comparable yield. Nevertheless, we believe that issuers and investment bankers generally have the analytical ability to make reasonable determinations of convertible comparable yields.

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<sup>37</sup> Unlike the (nonconvertible) comparable yield, the convertible comparable yield should not be required to be at least the applicable Federal rate.

As in the case of determining the projected payment schedule for nonconvertible contingent debt instruments, the projected payment schedule for contingent convertible debt would be based upon forward prices in the case of market-based contingent payments (other than the conversion right), and on the expected values of other contingent payments (again, other than the conversion right). The conversion right, of course, would not be taken into account in determining the projected payment schedule (or otherwise give rise to a deduction).

Indeed, our sense is that bankers typically compute this information in pricing contingent convertible debt instruments.

On balance, therefore, the Tax Section believes that, if the traditional method of taxing issuers of straight convertible debt is retained, the use of the modified contingent payment method would be the most appropriate way to tax issuers of contingent convertible debt. Moreover, to the extent that some, if not all, of the recent issuance of contingent convertible debt is primarily tax motivated (insofar as the addition of contingencies other than the conversion right is concerned), requiring use of the modified contingent payment method may eliminate the perceived benefits of issuing such instruments and make the whole exercise academic.

#### **IV. Tax Treatment of Holders of Convertible Debt.**

Up to this point, we have focused on the tax treatment of issuers of convertible debt. Because that tax treatment implicates Congressional concerns about allowing deductions with respect to an issuer's cost of equity capital, it has received the greatest amount of attention. The tax treatment of holders of convertible debt, on the other hand, would not implicate these types of concerns.

While arguments can be made that, given the absence of Section 1032-type concerns, holders should always be subject to contingent payment treatment, as described in the Ruling, we question whether it is worth the complexity and compliance burdens to mandate differing treatment for issuers and holders.<sup>38</sup> More significantly, at least in the case of straight convertible debt, requiring contingent payment treatment for holders may adversely affect the market for such instruments, with correspondingly negative impacts on issuers' cost of capital. Given all this, we believe that any decision to mandate nonconforming treatment of issuers and holders should not be undertaken lightly and should only be reached after careful study of the resulting economic effects on issuers and holders.

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<sup>38</sup> Some have argued that Section 163(e) would require consistent treatment of issuers and holders. *But see* Section 1275(d) (broad grant of authority to provide regulations modifying the rules of Section 163(e), which governs issuer deductions of OID, as well as the OID rules applicable to holders, to carry out the purposes of the respective sections).

Some have also argued that requiring conformity between the tax treatment of issuers and holders also reduces the potential of tax arbitrage. In our experience, clientele effects are sufficiently strong to seriously weaken this argument.

## **Conclusion**

In conclusion, the Tax Section would support retaining the traditional method for taxing issuers of straight convertible debt, and a modified contingent payment method for taxing issuers of contingent convertible debt. In the case of both straight and contingent convertible debt instruments, the Tax Section believes that it would be best to continue to tax holders and issuers in a symmetrical fashion.