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Report No. 1372
June 8, 2017

The Honorable Thomas C. West
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The Honorable John Koskinen
Commissioner
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The Honorable William M. Paul
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Re: *Report No. 1372 on Possible Amendments to Regulations
Governing the Deductibility of Premium Paid upon the Redemption of
Convertible Bonds*

Dear Messrs. West, Koskinen, and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report contains comments regarding possible amendments to the regulations governing the deductibility of premium paid upon the redemption of convertible bonds.¹

Section 249 of the Internal Revenue Code provides as a general rule that no deduction is allowed to a corporation that has issued convertible debt for any premium paid upon the redemption of that debt, except to the extent of a "normal call premium" on nonconvertible debt instruments. However, the general rule does not apply to the extent the corporation can demonstrate that the premium is "attributable to the cost of borrowing and

¹ Consistent with section 1275(a)(1)(A), the term "bond" as used in this letter and the attached report includes any debt instrument.

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is not attributable to the conversion feature.” In the attached report, we refer to this as the “cost of borrowing” or “COB” exception.

Regulations under section 249 were issued in 1973 and slightly modified in 2007 and 2011. The 2016-2017 Priority Guidance Plan states the government’s intention to issue regulations under section 249 in 2017. We understand these regulations are intended to modernize and standardize the COB exception as well as make additional changes. In the attached report, we make recommendations with respect to the COB exception. In addition, we discuss several additional issues under section 249 that warrant clarification through regulations.

Our principal recommendations are as follows:

1. Limit the application of the COB exception to bonds that are not immediately callable at the time of redemption.
2. Standardize the computation of the deductible portion of the premium under the COB exception.
3. Consider an alternative approach to the COB exception in which the amount of repurchase premium allowable under the COB exception would be determined by subtracting the option value from the repurchase price, rather than by measuring declines in interest rates.
4. Replace the current normal call premium exception with a simple safe harbor equal to either a fixed percentage or a percentage that depends only on the remaining term of the bond.
5. Regarding convertible bonds that are contingent payment debt instruments (“CPDIs”), restate the conclusion in Revenue Ruling 2002-31 that positive adjustments upon the scheduled retirement of a CPDI convertible are considered “bond repurchase premium” fully subject to section 249.
6. Regarding a convertible bond that is integrated with a hedge under Treas. Regulation Sec. 1.1275-6 to form a “synthetic debt instrument,” provide a special rule to address situations in which the synthetic debt instrument is itself a convertible bond because the hedge does not fully offset all conversion features of the bond.
7. Clarify that section 249 applies to repurchase premium on all convertible bonds, including those that, by their terms, do not allow for physical settlement.

Honorable Thomas C. West
Honorable John Koskinen
Honorable William M. Paul

June 8, 2017

We appreciate your consideration of our recommendations. If you have any questions or comments on this report, please feel free to contact us and we would be happy to assist in any way.

Respectfully submitted,



Michael Farber, Chair

Attachment

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