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Report No. 1500
September 13, 2024

The Honorable Aviva Aron-Dine
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1500 - Report on Certain Fees

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1500 of the Tax Section of the New York State Bar Association, which discusses the tax treatment of amounts commonly referred to as "fees" and paid by issuers of loans, other types of debt instruments or equity securities.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Jiyeon Lee-Lim
Chair

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Report No. 1500

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE TAX TREATMENT OF CERTAIN FEES

September 13, 2024

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REPORT ON THE TAX TREATMENT OF CERTAIN FEES

I. INTRODUCTION

This report (the "**Report**")[1] of the New York State Bar Association Tax Section addresses certain aspects of the tax treatment of amounts commonly referred to as "fees" and paid by issuers of loans, other types of debt instruments or equity securities (collectively, "**Securities**") either pursuant to their terms or in connection with the issuance or modification of these Securities or a commitment to purchase these Securities from the issuer ("**Investment Transactions**").[2] While, in connection with these Investment Transactions, issuers sometimes pay fees to third parties such as guarantors, administrators or servicers, this Report only addresses the tax treatment of amounts paid (or treated for tax purposes as paid) to the Securities' initial purchasers or holders or other parties committed to purchase the Securities from the issuer ("**Capital Providers**", whether acting as investors, lenders, traders, underwriters, brokers, arrangers or placement agents, whether the fee is paid in respect of capital or services and whether the fee recipient is acting in one or more capacities, for example, as both an investor and broker or as either only an investor or only a broker).[3]

The agreements governing these Investment Transactions and the terms of these Securities ("**Transaction Documents**") commonly use the term "fee" to refer to a broad range of payments, including a payment made in exchange for a service, the funding or provision of capital or purchase of a Security, an exercise or waiver of a right, a commitment to fund or provide capital or purchase a Security at specified time or for a specified period, some other type of undertaking or promise, as well as a payment in the nature of a penalty or charge for a covenant breach or failure to timely pay or perform an act, in each case, in connection with an Investment Transaction (collectively, "**Transaction Payments**"). Thus, how Transaction Documents use the term fee to identify or differentiate among types of Transaction Payments varies widely and is often not consistent.[4] For this reason, the label attached to a Transaction Payment is an unreliable indicator of its proper tax treatment, which depends on the substance of

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[1] The principal authors of this Report were James R. Brown, Samuel M. Duncan, and Pamela Lawrence Endreny. Substantial contributions were made by Tyler L. Arbogast, Y. Bora Bozkurt, Andrew H. Braiterman, Robert Cassanos, Edward E. Gonzalez, Robert Kantowitz, Jiyeon Lee-Lim, John T. Lutz, Jeffrey Maddrey, David S. Miller, Michael T. Mollerus, Richard M. Nugent, Yaron Z. Reich, Elena V. Romanova, Jason Sacks, Michael L. Schler, David H. Shapiro, Eric B. Sloan, and Gordon E. Warnke. Avi Laham, Yara Mansour, and Austin T. Morris provided significant research assistance. This Report reflects solely the views of the New York State Bar Association Tax Section and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] The Internal Revenue Service (the "**Service**") and the U.S. Department of the Treasury (the "**Treasury**") have included this item on the Priority Guidance Plan. *See* 2023-24 Priority Guidance Plan (March 18, 2024), p.10.

[3] This Report will only tangentially discuss fees to third parties, such as guarantors, issuers of letters of credit or similar market participants.

[4] For example, as discussed below, an "upfront fee" might describe an amount paid for either the use of capital or services.

which party either pays or receives the payment and what it is for and is sometimes unclear.[5] Moreover, this treatment varies among types of Transaction Payments with respect to the timing of its recognition, tax character and source, which then leads to other significant consequences.[6] Determining the proper tax treatment of a Transaction Payment can thus have meaningful consequences for payors and recipients, whether they are U.S. taxable, tax-exempt or non-U.S. issuers or investors.[7]

The Report focuses primarily on when a Transaction Payment should be treated as a payment for services as opposed to a payment that either represents additional yield or is for something else, such as a property right. It also discusses the proper tax treatment of Transaction Payments that are made for a property right, for example, whether Transaction Payments made for a commitment to provide capital, payable regardless of whether the capital is provided, should be taxed similarly to option premiums.

Part II of this Report summarizes our principal recommendations. Part III groups types of Transaction Payments by reference to their economic similarities and describes how market participants commonly use variations of the term "fee" to identify and differentiate among these types. We have limited this description to lending transactions because the conventions for using the term "fee" are more developed in those transactions as compared to equity financings. Part IV discusses our recommendations in the context of existing authorities and other guidance that taxpayers typically follow when determining the tax treatment of different types of Transaction Payments.

II. SUMMARY OF RECOMMENDATIONS

We recommend the issuance of guidance that provides:

1. A Transaction Payment characterized as a fee in the Transaction Documents of an Investment Transaction, if payable to a Capital Provider by an issuer only on or after the closing of the Investment Transaction (and not payable if the Investment Transaction is not consummated), should be treated as (x) compensation for the provision of capital (i.e., as an adjustment to yield, giving rise to either original issue discount ("**OID**") or market discount in the case of debt Securities) or as (y) paid in exchange for services[8] performed by or on behalf of the Capital Provider for the benefit

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5 Market participants may prefer to use the term "fee" to describe a Transaction Payment for reasons unrelated to the substance of the payment (for example, giving the payment a "fee" label might affect how financial results are reported for book or other non-tax purposes).

6 Numerous commentators have written on various aspects of this topic. *See*, *e.g.*, David H. Shapiro, Michael Yaghmour, and Ryan Schneider, *A Tax Guide to Debt-Related Fee Income*, Tax Notes, June 2, 2014, p. 1027; Y. Bora Bozkurt, Tyler L. Arbogast, and Michael E. Bauer, *It's About Time: Taxation of Delayed Draw Term Loans*, 18 Journal of Taxation of Financial Products 4 (2022).

7 The topic has received heightened focus in light of the recent Tax Court decision in *YA Global Investments, LP v. Commissioner*, 161 T.C. No. 11 (2023), in which the Tax Court found an investment fund to be engaged in a trade or business largely due to the characterization of various fees received in connection with its investments.

8 By "services," we mean personal services that, to be accomplished, require the deployment of human capital (whether or not aided by tools such as software). We do not intend the term "services" to refer to acts for which the use of human capital is incidental, such as the waiver of a covenant, an undertaking or commitment to make

of the issuer. The treatment of the Transaction Payment as being paid in exchange for services should apply only if either (i) the Transaction Documents explicitly attribute it to being paid for specified services required to be performed by or on behalf of the Capital Provider for the benefit of the issuer and for which the fee represents not materially more than reasonable compensation for such service[9] or (ii) the Capital Provider regularly engages in an underwriting or other dealer trade or business and, in the Investment Transaction, is acting primarily as an underwriter, dealer or broker with respect to the Securities purchased.

2. A substantial majority of the Executive Committee of the Tax Section believes that Capital Providers and issuers should treat Commitment Fees like option premiums, with "**Commitment Fees**" defined as payments for a commitment to provide capital or purchase a Security, if the funding or issuance of the Security is at the election of the issuer as opposed to the Capital Provider (whether labeled commitment fees, ticking fees, unused fees, backstop fees, standby fees or some other term).[10]

3. If instead Commitment Fees are treated as ordinary income to the Capital Provider, the income should be sourced based on the residency of the Capital Provider.

III. COMMON USAGES OF THE TERM "FEE" PAID BY DEBT ISSUERS TO CAPITAL PROVIDERS IN LENDING TRANSACTIONS

Fees paid by issuers to Capital Providers over the life of the loan generally fit into one of three categories: payments for services, compensation for provision of capital (i.e., making the loan) and compensation for assuming other economic risk related to the loan (e.g., a commitment to make the loan if called upon to do so).[11] While amounts paid to Capital Providers for their services may be considered paid in their capacity as service provider rather than for capital, depending on the facts, the "service" may be embedded in the provision of capital and/or segregating the amounts paid for services may be extremely difficult under the relevant facts.

At each stage in the life of the loan (from pre-funding through termination), issuers and Capital Providers engage in transactions that fit one or more of the categories above. An issuer may pay a Capital Provider for their underwriting services at funding or in the pre-funding stage and for the administration of the loan during the life of the loan. While it is often the case there is a separate underwriter or administrative agent who does not provide capital, many transactions

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an investment or purchase a Security or an undertaking to make a payment. We do not view these acts as services, regardless of how a payment for the acts is characterized.

9 We recognize that if the fee represents materially more than reasonable compensation for such service, treatment as services income may not be appropriate. In that case, we would expect none of the Transaction Payment would be treated as being paid in exchange for services.

10 A minority of the Executive Committee believes Commitment Fees should be treated like services income to the Capital Provider, as discussed further in this Report.

11 *See* Treas, Reg. § 1.1273-2(g)(2)(i). Except as otherwise indicated, all references to "Section" and "§" refer, respectively, to the Internal Revenue Code of 1986 (the "**Code**") and the Treasury regulations promulgated thereunder.

these days, especially when the financing is not widely syndicated (such as "club deals"), contemplate that the Capital Providers perform these functions (which are in many cases necessary for an investment to take place). Similarly, an issuer may compensate the Capital Provider for the time value of money in the form of ongoing interest payments or advances commonly known as upfront payments.

This section identifies and describes the economic features of some common fees paid from issuers to lenders. The nomenclature used is not necessarily exclusive to a particular type of transaction, which may cause confusion. Later sections will discuss the challenges of characterizing these payments for tax purposes and some of the tax consequences of different characterizations.

1. Common examples of fees not identified as for services:

a. Fees paid to investors (who are not also acting as brokers) only when and if the Security is funded, typically in a fixed amount or a percentage of the amount funded.

i. These are commonly referred to as: funding fees, upfront fees, discounts, points (usually in the context of mortgages or consumer loans), closing fees, or commitment fees.[12]

b. Fees paid for a commitment to purchase or fund the issuer's Security (or otherwise provide capital) in the future, without regard to whether the amount is funded, and which funding is not a right of the investor (or broker). The amount of these fees is sometimes determined by reference to (or accrues over) the period the commitment is outstanding (or with respect to a single specified period) and is sometimes paid periodically with respect to set periods.

i. These are commonly referred to as commitment fees or unused fees and when paid or accrued by reference to a period, ticking fees.

c. Fees paid on the funded (or "used") amount of a commitment, typically when funding is at the option of the issuer and commonly determined by reference to the amount and period of the funded commitment (e.g., these are typically paid periodically based on the drawn commitment).

i. These are commonly referred to as a usage fee or utilization fee.

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[12] As discussed below, the term "commitment fee" is sometimes used to refer to a Transaction Payment paid only when and if a loan is funded and sometimes used to refer to a Transaction Payment paid in exchange for making a commitment to fund a loan. Except where specifically noted otherwise, this Report uses the term "commitment fee" to refer to the Transaction Payment paid in exchange for making a commitment to fund or purchase a loan or other Security.

d. Periodic payments of a fixed rate amount on the entire portion of a commitment amount, regardless of the extent to which it is advanced

i. These are commonly referred to as facility fees.

e. Fees paid in connection with entering into an unconditional obligation to acquire the issuer's Security, with the issuer having the right to "put" the Security to the Capital Provider, in the future, often payable subject to a closing in the future.

i. These are commonly referred to as commitment fees or upfront fees.

f. Fees paid for a commitment to purchase or fund the issuer's Security (or otherwise provide capital) in the future if the Securities cannot be sold to other investors.

i. These are commonly referred to as backstop fees, standby fees, or commitment fees.

g. Periodic, fixed rate amounts paid by borrower to lenders based on the total amount of issued letters of credit under the facility.

i. These are commonly referred to as letter of credit fees.

h. Fees paid by the issuer for a waiver or amendment to the security.

i. These are commonly referred to as amendment or consent fees.

i. Payments to the lender for a commitment of funds where the deal is not consummated or the issuer chooses an alternative financing arrangement.

i. These are commonly referred to as broken deal fees, alternative transaction fees.

j. Payments to the lender for a failure to timely make a payment.

i. These are commonly referred to as late payment fees.

k. Payments to the lender in respect of a prepayment on a loan.

i. These are commonly referred to as prepayment penalty fees or breakage fees.

2. Common examples of fees for services

a. Application fee (the payment of which is not conditioned on a commitment or funding).

b. Arranger fees, placement fees and underwriting fees, paid to the party that has negotiated the terms of a facility and who undertakes to identify lenders willing to loan on such terms (including taking the risk that such lenders cannot be identified).

c. Structuring fees or financial advisory fees, paid to the party who analyzes financials, considers alternative financing structures, and proposes terms for the issuer.

i. These fees may be combined as part of an upfront fee described as including services such as negotiating, structuring, underwriting (e.g., analyzing the credit worthiness of the issuer) or advising on the terms of the Security (or capital raise for the issuer). When received by a Capital Provider, the fee may or may not be described as including services such as underwriting, arranging for the funding or placement of the Security.

d. Administrative agent fee paid to a lender or agent for services handling payment mechanics over the life of the loan.

IV. TAX TREATMENT OF TRANSACTION PAYMENTS

A. Overview

In connection with a typical Investment Transaction, personnel from the Capital Providers perform certain activities for either themselves, other Capital Providers, the issuer, or some combination of the foregoing. These activities might include, among other things, some or all of: (i) an evaluation of the issuer's financial condition and expected future condition, (ii) proposing or negotiating either the structure or terms of the instrument being issued or the terms of a modification of an outstanding instrument, (iii) mediation between the issuer and other potential investors, (iv) potentially selling or distributing the instruments being issued or (v) servicing or administering payments under the terms of the Security or distributing those amounts among its holders (collectively "**Service Activities**").[13] The Transaction Documents

[13] Although we have used the term "Service Activities" for purposes of discussion, these activities would only constitute "services" if performed primarily for the benefit of the Issuer or another third party and not primarily for the Capital Provider itself.

may or may not provide for the issuer to make a Transaction Payment in respect of the Service Activities performed.

In addition, the Transaction Documents might provide for Transaction Payments to be made in exchange for something that is not a Service Activity, including among other things, some or all of: (i) the purchase or funding of the Security, (ii) a commitment to purchase or fund the Security, which might be conditional or at the issuer's option or an unconditional time-based obligation, (iii) the exercise or waiver of a right under the terms of the Security, (iv) some other type of undertaking or promise relating to the Investment Transaction or (v) an entitlement triggered by a covenant breach or failure to timely pay or perform an act (collectively, "**Non-Service Activities**"). The Transaction Documents might also require the provision of a Non-Service Activity but not require the issuer to make a Transaction Payment that is explicitly tied to the Non-Service Activity.

A Transaction Payment might be made for both Service Activities and Non-Service Activities (or multiple activities within each category). Whether made for a Service Activity or Non-Service Activity or both, a Transaction Payment might be payable (i) before or after the Security is issued or funded, (ii) in fixed or variable amounts, (iii) in a lump sum or in increments over time and (iv) in the form of cash or debt or equity or some other property (including a promise or covenant).

The balance of this section of the Report primarily addresses the following questions and our recommendations for guidance with respect to each.

1. First, the extent to which any portion of the consideration transferred to a Capital Provider currently or in the future by the Securities' issuer in an Investment Transaction, whether or not identified as a Transaction Payment, should be treated for tax purposes as being a payment for services provided to the issuer by a Capital Provider (a "**Service Fee**").[14] Here we also discuss our recommendation for guidance on when a Transaction Payment will be treated as a Service Fee (and when it will not be so treated).

2. Second, when a Transaction Payment should be treated for tax purposes as for the use or forbearance of money or otherwise represents an adjustment to the yield on the Security (a "**Yield Adjustment Payment**"), which is accrued as interest (or OID) or treated as market discount (or in some cases payment on retirement), in the case of Securities treated as debt for tax purposes. We make no recommendation for guidance on the taxation of Yield Adjustment Payments (except we agree they should continue to be treated as such).

3. Third, when a Transaction Payment should be treated for tax purposes as for Non-Service Activities but is not for the use or forbearance of money and

[14] We are not addressing when income might be imputed to the Capital Provider in respect of services being performed for the benefit of the issuer because, in general, the value of services performed, unless realized by the Capital Provider in the form of actual consideration, is not recognized as income (or deductible as an expense), absent specific rules to the contrary (e.g., as set forth in Section 482) that are not typically applicable in Investment Transactions.

does not represent a yield adjustment (a "**Payment for Property**"), the taxation of which under current law is unclear and certain respects. Here we also discuss our recommendation for guidance for clarifying this treatment.

B. Transaction Payments Taxed as Service Fees

The label "fee" colloquially connotes a charge for some sort of services. In Investment Transactions, however, labeling a Transaction Payment as a "fee" does not in itself indicate whether the fee should be taxed as having been paid for services performed for the issuer or for something else.[15] That is because in all Investment Transactions, Capital Providers perform services for the primary benefit of themselves (e.g., most fundamentally, services related to making decisions about whether or how to participate in the transaction), and the imputed value of services performed for oneself is not taxable as income. When Capital Providers perform services that primarily benefit only themselves (as opposed to the issuer), any Transaction Payments labeled as a fee would be taxable as an amount paid not for services but rather for something else (e.g., the provision of capital or a property right).[16] That other Capital Providers may benefit from the Capital Provider's activities (and may not receive the same amount of the fee) does not alter the fact that the Capital Provider performs the activities primarily for its own benefit (and would do so regardless of the presence of other Capital Providers).

Only in some Investment Transactions do Capital Providers perform services that are for the primary benefit of the issuer (e.g., in a "best efforts" underwritten transaction, the service of convincing others to purchase the issuer's Securities). In those cases, Transaction Payments made for services, such as underwriting, rather than something else, such as the provision of capital or a property right, should be taxable as being for services.[17]

In many common transactions, however, making these distinctions is not so clear cut because a Capital Provider might function as an investor, receive fees only on or after making the investment in the Securities and also either facilitate the sale of the issuer's Securities to

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[15] Rev. Rul. 72-315, 1972-1 CB 49 ("[I]t is not necessary for the parties to a transaction to label a payment made for the use of money as interest for it to be so treated. The facts of the transaction control its character; not the terminology."); *Wilkerson v. Comm'r*, 70 T.C. 240 (1978), *acq., rev'd on other grounds*, 655 F.2d 980 (9th Cir. 1981) ("What constitutes compensation paid for the use or forbearance of money is controlled by the facts, not terminology."). However, the Tax Court in *YA Global* was very focused on the labels of the Transaction Payments, noting that certain fees were described as "structuring fees" and "monitoring fees" and that "Petitioners' position seems to rest on the premise that the fees [the investment manager] charged portfolio companies were at least misleading, if not downright deceptive." *YA Global Investments, LP*, 161 T.C. No. 11 at 15.

[16] For example, in Rev. Rul. 69-188, 1969-1 CB 54, an amount designated as a loan processing fee was treated as interest. The ruling explains: "It is not necessary that the parties to a transaction label a payment made for the use of money as interest for it to be so treated." See also *Pacific First Fed. Sav. & Loan Ass'n v. Comm'r*, 79 T.C. 512, 520 (1982) ("loan origination fee" payable to a taxpayer in engaged in the business of making real estate loans was interest where certain services were provided free of charge).

[17] *Chesapeake Financial Corp. v. Comm'r*, 78 T.C. 869 (1982) (Chesapeake's commitment fees were treated as payment for services where Chesapeake arranged loan packages for a borrower with institutional investors); *Fort Howard Corp. v. Comm'r*, 103 T.C. 345 (1994) (a portion of fees payable to Morgan Stanley in connection with Morgan Stanley's arrangement of a tender offer of shares was treated as a payment for services, including because it was not based on the amount of loans purchased by Morgan Stanley).

others or perform other services that materially benefit the issuer. The following examples illustrate the difficulty of distinguishing between fees clearly paid for services from those clearly paid for something else, such as the Capital Provider making its capital available to the issuer.

Example 1: In a firm commitment underwriting, which requires the underwriter to close on the loan regardless of whether it has secured commitments from investors to purchase the loan, the issuer pays an underwriter an upfront fee equal to 5% of the loan's stated principal amount. The fee is payable only when and if the loan closes. Not fewer than 20 investors purchase the loan from the underwriter for an amount equal to the loan's stated principal amount, and the underwriter retains none of the loan for investment.

Example 2: Same as Example 1, except that the underwriting is a "best efforts" underwriting, which does not require the underwriter to close without it having secured commitments from investors to buy the loan from it. Prior to closing, a single investor commits to buy half of the loan from the underwriter, after having engaged in extensive negotiation with the underwriter over the loan's terms and having conducted extensive diligence on the issuer, including by directly interacting with the issuer's finance team. The underwriter agrees to share with the investor 3/5ths of the upfront fee attributable to the purchased portion of the loan. None of the other five investors purchases more than 10% of the loan individually, and they all purchase their share of the loan for its stated principal amount.

Example 3: A single investor[18] purchases and holds for investment all of a loan after engaging in extensive negotiations with the issuer over its terms and conducting extensive diligence on the issuer, including by directly interacting with the issuer's finance team. The investor purchases the loan for its stated principal amount and at closing receives a structuring fee equal to 5% of the loans stated principal amount, which, in the funds flow, is netted from the purchase price and was payable only when and if the loan closed. The nonbinding term sheet that the investor and issuer used to negotiate the loan terms describes the structuring fee as a payment for financing-related advice[19] provided to the issuer and reimbursement for the approximate costs incurred by the investor in its negotiation of the loan and evaluation of the issuer's credit, including the preparation of materials for the issuer's credit committee. The investor does not share any portion of the structuring fee with others (including any manager).

Example 4: A single investor purchases and holds for investment half of a loan after engaging in extensive negotiations with the issuer over its terms and conducting extensive diligence on the issuer, including by directly interacting with the issuer's

[18] In many private investment transactions, an investment advisor will act on behalf of several different accounts such as investment funds or accounts of institutional investors over which the advisor has discretionary or nondiscretionary investment authority. In these examples, an investor might be thought of as all the accounts managed by a single advisor, since they would all typically invest on the same terms, for which the advisor would have negotiated on their behalf collectively.

[19] Financial advice refers to advice to the issuer about the material commercial terms of the loan that the investor believes would allow the loan to be attractive to the market (and, in particular, to itself). It does not include advice related to the marketing of the loan.

finance team. The other half of the loan is purchased by five investors, none of whom purchases more than 15% of the loan individually. They all interact only with the large investor regarding the loan's terms and issuer diligence. All investors purchase their share of the loan for its stated principal, but the large investor is paid a structuring fee by the issuer at closing equal to 5% of the stated principal amount of the loan held by the large investor, which was payable only when and if the loan closed. All investors committed to purchase the loan from the issuer on the same day. A nonbinding term sheet used by the large investor and issuer describe the structuring fee as indicated in Example 3. The largest investor and issuer had no agreement regarding the underwriting, arranging or placement of the loan. The primary motivation of the investor to lead the negotiations is to facilitate the consummation of the financing so that it can hold for investment the portion of the loan that it purchases.

Example 5: Same as Example 4, except that the largest investor purchases all of the loan from the issuer, receives a structuring fee equal to 2.5% of the loan's entire stated principal amount (instead of 5% on half of the loan), and sells half of the loan for its stated principal amount to the other five investors, who each committed to buy the loan from the investor prior to but on the same day that the investor committed to purchase from the issuer. The largest investor and issuer had no agreement regarding the underwriting, arranging or placement of the loan.

Example 6: Same as Example 5, except that the largest investor enters into an agreement with the issuer obligating it to introduce to the issuer potential investors and, instead of a structuring fee of 2.5% on the entire loan, the agreement requires the issuer to pay the investor, upon closing and only if the loan closes, a 2% structuring fee on the entire loan plus a 0.5% arranger fee on the portion of the loan purchased by either it or any other investor that it introduces to the issuer.

In our view, the upfront fees paid to the underwriter in Examples 1 and 2 should be treated as Service Fees, and the economic benefit of the upfront fee received by the largest investor in Example 2 should not be treated in the hands of the investor as services income, notwithstanding investor's participation in the loan's origination by negotiating its terms (through the underwriter) and conducting diligence directly with the issuer. By contrast, in our view, none of the fees in Examples 3, 4 or 5 should be treated as paid for services, notwithstanding that in some of the these examples other investors participated in the loan (having relied on the activities of the large investor) without having participated in the fee (or without having participated in as much of the fee) and notwithstanding that the structuring fee is described in a term sheet as a reimbursement for the cost of services performed by the investor. In these examples the investor and issuer have no agreement that provides for underwriting, arranging or placement services to be performed by the investor. The activities performed by the largest investor, including those that have the effect of facilitating others' investment in the loan, were performed for its own benefit, i.e., to permit or facilitate the consummation of the financing so that could earn a return on the capital it put at risk from its purchase and retention of half of the loan.

In Example 6, certainly the 0.5% arranger fee should be treated as paid for services. Arguably, the 2% structuring fee, although not designated as paid for arranging the loan, might

be characterized as such unless the fee was instead paid to induce the investor to make its own investment. Which characterization should prevail might be informed by a variety of other factors not identified in the example, such as the extent to which the investor engages in arranging-type activities in other transactions (including when it invests little of its own capital relative to other investors) and how much of its income comes from those activities as opposed to investment returns on its capital.

We base our conclusion on the principle, as articulated by the Tax Court, that in the lending context, "to determine whether an item of income is a service fee or interest, the primary inquiry is whether the charge compensates the lender for specifically stated services it provided to and for the benefit of the borrower beyond the lending of money."[20] Underwriters, arrangers, brokers and placement agents, for example, are compensated in Investment Transactions for functioning primarily as intermediaries between the issuer and investors, who seek to earn returns derived mostly or entirely from their use of their capital in the purchase of the Securities. While firm commitment underwriters make available their capital by purchasing the Security from the issuer and put their capital at risk to the extent that they miscalculate their ability to resell the purchased Securities for a profit, their function primarily as intermediaries between the issuer and investors and are compensated (usually through an underwriting spread) for the services they provide by acting in that capacity. Consistent with this, underwriters typical seek to minimize taking on risk with respect to any capital advanced or made available to the issuer and instead seek to profit by convincing investors to put their capital at risk. For this reason, fees paid to those who perform this service are generally treated as paid for services, since under the principle articulated by the Tax Court, those services benefit the issuer beyond the underwriter's provision of capital to issuer.[21]

We view the portion of the upfront fee that the underwriter passes along to the large investor in Example 2 as an inducement payment (and not a Service Fee), which results in a basis reduction treated as discount in the hands of the investor.[22] The investor performed no services other than those for itself in connection with its negotiation and diligence of its own investment.

The large investors in Examples 4 through 5 also perform services, such as negotiating the terms of the loan, providing structuring advice and performing diligence, but they do so for the purpose of making the loan, which they are making to earn the yield on their capital that is paid for by the issuer. In general, the investors would not choose (or in some cases be able) to put their capital at risk by making the loan without the benefit of these services, and they perform these services to obtain that benefit for themselves. These services benefit the issuer only insofar as they lead to the issuer being willing to issue a loan that the large investors are willing to buy for a price net of the stated fees received on or after closing (and taking into account the time value of fees received after closing). In other words, the services benefit the issuer because they

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[20] *Cap. One Fin. Corp. & Subs. v. Comm'r*, 133 T.C. 136 (2009), *aff'd*, 659 F.3d 316 (4th Cir. 2011).

[21] *See*, *e.g.*, *Lay v. Comm'r*, 69 T.C. 421 (1977) (2% financing fee paid to mortgage banking firm was treated as paid for services in originating a favorable loan package, including securing FHA mortgage insurance and arranging permanent financing, where the fee had no relationship to the amount borrowed or to the time period for which payment was designated, and the mortgage banking firm was not the party that provided the financing).

[22] *See*, *e.g.*, *Brown v. Comm'r*, 10 B.T.A. 1036 (1928).

facilitate the issuer having the access to and the use of the investors' capital, and the services benefit the investors because without them the investors would not earn the desired return by making the loan. The services are integral to the issuer's use of the investor's capital and the investors' ability to put that capital to work so that it can be compensated for the risk of doing so. For these reasons, we believe that fees paid at closing in these examples should not be treated as paid for services performed by the investor for the issuer but rather should be treated as an adjustment to the yield of the loan, as discussed in the next part of this section of the Report.

We recognize that some of the guidance and case law in the loan context that distinguishes fees for services from fees treated as additional yield base this distinction more on whether the fee is "paid to compensate a lender for the cost of specific services performed *in connection with* a borrower's account" (emphasis added)[23] rather than on whether the services primarily benefit the lender and are payable only when and if the loan is executed and therefore should be treated as either interest or some other inducement to make the loan. For example, in *Goodwin v. Commissioner*,[24] the Tax Court found that certain loan fees paid to banks to obtain financing for construction projects were charges for services, where the facts showed they were attributable to the processing and administration of the loans (including "the analysis of the economic feasibility of the project, inspections of the property before and during construction, credit appraisals, and the processing of loan disbursements during the construction period"), even though the fees were computed as a percentage of the loan amount and there was not a direct relation to the costs of the services performed. The Tax Court further stated:

> In our view, it is irrelevant whether the borrower derives any "direct benefit" from the services performed, for, in either case, the ultimate benefit which the borrower [receives] is the loan itself. The fact remains that charges for services performed by the bank in connection with a loan do not represent compensation for the use of the funds advanced.[25]

Notwithstanding this sweeping language, however, we believe that, under the better view of how the law is or should be applied, in general a Transaction Payment to a Capital Provider by an issuer only on or after the closing of an Investment Transaction should be treated as a payment in exchange for services only if either (i) the Transaction Documents explicitly attribute it to specific services required to be performed by the Capital Provider for the benefit of the issuer and for which the fee represents not materially more than reasonable compensation for such service or (ii) the Capital Provider regularly engages in an underwriting or other dealer trade or business and, in the Investment Transaction, is acting primarily as an underwriter, dealer or broker with respect to the loan. In *Western Credit Co. v. Commissioner*,[26] the Tax Court articulated the basis for this principle as follows:

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[23] Rev. Rul. 69-189, 1969-1 CB 54. In holding that "points" (also called "loan processing fees") are treated as interest, the ruling indicates that the points are not paid for any specific services the lender had performed or had agreed to perform, suggesting that those fees would not be treated as interest.

[24] *Goodwin v. Comm'r*, 75 T.C. 424 (1980).

[25] *Id*. at 441-442.

[26] *Western Credit Co. v. Comm'r,* 38 T.C. 979, 987-988 (1962), *aff'd.* 325 F.2d 1022 (9th Cir. 1963).

> We do not think the mere fact that the contract designates certain uses to which the funds will be put makes the charge any less a fee paid by the borrower for use of the lender's money, unless it is shown that the charge was actually used for such purposes and the charge is justifiably a charge to the borrower separate from interest. Unless such can be shown, we believe the service charges made by small loan companies must be considered interest because basically the nature of the small loan company business is to make a profit in the form of interest on money loaned and the borrower is interested only in obtaining the loan and pays whatever is required of him to get the use of the lender's money.

Consistent with this principle, the relevant authorities generally treat fees payable at or after the closing a loan as paid for services only when the services are explicitly specified, and when concluding that these fees are not for services, these authorities generally make a point of observing that payments for specified services were separately agreed upon and documented by the parties. For example, in *Wilkerson v. Commissioner*,[27] the Tax Court observed, when concluding that an upfront fee should be treated as interest, that "items more clearly recognized as service charge items, such as inspection fees, escrow fees, appraisal fees, title insurance premiums, and accounting fees were paid separately …." Similarly, Rev. Rul. 69-188 and Rev. Rul. 69-189, which treat as interest fees and charges payable on or after the closing of a loan (but not for specified services performed by the lender for the benefit of the borrower), emphasize that the fees or charges would not be so treated if they were for "a title report, an escrow fee, the drawing of a deed" or for "closing costs … and papers drawn."[28]

Two years after deciding *Goodwin*, perhaps to limit the reach of the decision, the Tax Court emphasized in *Pacific First Fed. Sav. & Loan Ass'n v. Commissioner* that the holding in *Goodwin* was based on a "specific finding of fact that the loan fee therein was charged solely to defray expenses incurred in processing and administering two FHA-insured construction loans."[29] In *Pacific First*, the Tax Court found that a "loan origination fee" payable to a taxpayer

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27 *Wilkerson*, 70 T.C. 240 at 256.

28 In indicating that, when required to be paid for specific services specified in the loan documents, fees are taxed as being paid for services, both rulings cite *Workingmen's Loan Ass'n* 142 F.2d 359 (1944), which held that "initial charges" (amounts akin to application fees) paid "in advance" were not interest. Notably, however, Rev. Rul. 69-189 concludes that "if the borrower and lender agreed at arm's length in the loan contract as to what was the proper portion of the maximum loan charge that was interest, such an agreement would ordinarily be accepted for Federal income tax purposes" but that "a statement by lender that the entire charge was interest would not be sufficient if the facts indicated that a portion of the charge was attributable to specific services performed in connection with the borrower's account." Rev. Rul. 69-189, 1969-1 CB 54. Mirroring this conclusion, Rev. Rul. 69-188 states, "Also, even where service charges are not stated separately on the borrower's account, interest would not include amounts attributable to such services [referring to the services in the text above]." Rev. Rul. 69-188, 1969-1 CB 54. We interpret these statements in the two rulings to simply mean that, when services required to be performed by the lender are clearly identifiable, a portion of the payments on loan should be treated as paid for those services if the loan agreement does not otherwise specify a charge for them.

29 *Pacific First Fed. Sav. & Loan Ass'n*, 79 T.C. at 519.

engaged in the business of making real estate loans was interest even though certain services were provided to the issuer free of charge.[30]

Consistent with that approach, we do not believe that the tax treatment of a Transaction Payment should be bifurcated between a payment for services and an adjustment to yield, except perhaps in clearly abusive situation, which we have not seen evidence of in the market.[31] For example, when originated by lenders in the ordinary course of business of lending, loans are generally treated as "acquired for services rendered" within the meaning of Section 1221 (and thus treated as ordinary assets for purposes of taking a bad debt deduction or hedging),[32] but the provision of such services in connection with a lending business does not in itself result in any portion of amounts otherwise treated as payments of interest or principle being treated as Service Fees.[33] Even *Container Corp. v. Commissioner*,[34] which was ultimately overruled by statute,[35] declined to bifurcate the tax treatment of a guaranty fee between its service components and other components while acknowledging that the fee recipients in fact performed some services in respect of the fees.[36] This disinclination to bifurcate the fee was in fact preserved in the statutory override of *Container Corp*.[37] In our view, any attempt to disaggregate a fee for the purpose of treating a portion of it as services income would be entirely unworkable and impractical. Our recommendation is based on treating a fee as entirely a Service Fee or not a Service Fee based on its dominant elements.

We are making our first recommendation, which if adopted would set forth conditions for treating upfront and other Transaction Payments to Capital Providers on or after the closing of a

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30 *Id.* at 519-20.

31 We are aware of only one case that bifurcated the tax treatment of a fee between a payment for services and adjustment to yield. *Wilkerson*, 70 T.C. at 263 (bifurcating a 2% financing fee into an interest portion and a services portion based on expert testimony that the fee was in part interest and in part for services, with a significantly larger portion being treated as interest in light of the services being separately paid or not handled by the lender).

32 *See Burbank Liquidating Corp v. Comm'r*, 39 T.C. 999 (1963), *aff'd in part*, *rev'd in part*, 335 F. 2d 125 (9th Cir. 1964) and *Fed. Nat. Mortg. Ass'n v. Comm'r*, 100 T.C. 541 (1993).

33 Ordinary treatment of the loans in *Federal National Mortgage Association* was important to the taxpayer to permit expense matching against interest income from the loans. *Fed. Nat. Mortg. Ass'n*, 100 T.C. at 541. The Tax Court has found that a "loan origination fee" payable to a taxpayer in engaged in the business of making real estate loans was interest where certain services were provided free of charge. *Pacific First Fed. Sav. & Loan Ass'n*, 79 T.C. at 520.

34 *Container Corp v. Comm'r*, 134 T.C. 122 (2010) (holding that guaranty fee should be sourced in the same manner as income from services on the basis that they are more similar to services income than they are to interest.) *Cf. Centel Communications Co. v. Comm'r*, 92 T.C. 612 (1989), which concludes that no portion of the provision of a guarantee should be treated as a service.

35 Section 861(a)(9).

36 In concluding that, by value, services constituted the more minor component of what was received and thus none of the fee should be treated as a fee for services, the Tax Court specifically found that the "value of [the] guaranty stemmed 'from a promise made and not from an intellectual or manual skill applied.'" *Container Corp*, 134 T.C. at 136, citing *Bank of America v. United States*, 680 F.2d 142, 150 (Fed. Cir. 1982).

37 Section 861(a)(9) sources these fees as entirely from the U.S. when paid by a U.S. corporation or noncorporate resident or if connected with effectively connected income of a non-U.S. person.

Security as not constituting Service Fees, because current law governing the treatment of these fees is arguably ambiguous and the payment of these fees is common in virtually all large Investment Transactions. Clarifying this treatment, at least for the noncontroversial circumstances we suggest, would be a material benefit to market participants. We propose this recommendation now in part because the Tax Court decision in *YA Global* seems to have further contributed to the arguable ambiguity in current law.[38]

In this case, the Tax Court found that an investment fund— "YA Global"— was engaged in the conduct of a U.S. trade or business because it engaged in the performance of services in the U.S. Although we are not commenting on the ultimate outcome of the case, we believe clarification is needed in respect of the Tax Court's analysis of the fees (and purchase price discounts) received by YA Global and its investment manager, "Yorkville Advisors." YA Global invested primarily in microcap and low-priced public companies traded in the over-the-counter public markets and provided funding to such companies in the form of highly stylized convertible debentures, standby equity distribution agreements ("**SEDAs**"), and other securities. In connection with such investments, YA Global and/or Yorkville Advisors received payments labeled as various types of fees. It seems likely that the Tax Court was viewing YA Global as engaging (through its agent) in activities as an arranger or underwriter for the benefit of the issuers of the securities, but the opinion was much broader, and included some sweeping statements about the characterization of such fees.[39]

In considering whether YA Global was engaged in the conduct of a U.S. trade or business through the performance of services (including through Yorkville Advisors as its agent), the Tax Court considered whether the payments were for the use of capital and held that the record did not support such a finding, including because (1) although the fees were not paid unless a

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[38] *YA Global Investments, LP*, 161 T.C. No. 11. The Tax Court attributed the activities of the investment manager to the fund under an agency theory.

[39] The Service had originally argued the fund was engaged in a U.S. trade or business because it was acting as a lender and an underwriter, but the Tax Court declined to reach that conclusion and instead focused on the denomination of the fees. As the Service's position was described by the Tax Court,

> "During the Relevant Period, respondent asserts, "YA Global performed various lending, underwriting, and other financing activities and generally behaved like a lender and underwriter." Regarding YA Global's purported lending business, respondent asserts that, "[d]uring the Relevant Period, YA Global made hundreds of loans directly to companies in exchange for promissory notes and convertible debentures." Respondent concludes that "YA Global's lending activities far exceeded the number of loans needed to establish a trade or business." Respondent describes YA Global's role in a SEDA as that of an "intermediary," acquiring stock in exchange for advances and later reselling that stock in the market. The partnership, he says, "essentially perform[ed] the function of an underwriter." And underwriting services, respondent contends, "are a service provided to an issuer." Respondent suggests that YA Global's transactions in convertible debentures, in addition to being part of a lending business, were also part of an underwriting business. "Like SEDAs," respondent argues, "convertible debentures were targeted to the ultimate issuance of equity to the public markets." Respondent observes that YA Global would typically convert a debenture into stock (and thereby surrender the downside protection afforded by its creditor's rights) only when it was prepared to sell the stock received upon conversion. This practice, in respondent's view, "shows that equity acquired with respect to the convertible debentures was not held as an investment" but that "instead, YA Global made efforts to distribute the stock in a manner consistent with its underwriting or dealing activities."

YA Global Investments, LP, 161 T.C. No. 11 at 11-12. *See also* ILM 201501013 (Sept. 5, 2014).

transaction was consummated, "the payment of fees did not depend on the partnership's putting its capital at risk" (for example, some of the commitment fees were payable upon execution of the agreement before any advances were sought), (2) Yorkville Advisors received cash fees even though Yorkville Advisors did not provide any capital to the portfolio company, (3) certain of the fees were labeled "structuring fees" or "monitoring fees,"[40] and (4) the fees were intended to cover the costs that Yorkville Advisors conducted on behalf of YA Global, including "identifying, sourcing and negotiating transactions, conducting due diligence, and structuring and managing the transactions" (and if "Yorkville Advisors' activities were limited to managing YA Global's investments, the portfolio companies should have been unwilling to cover any of the costs of those activities").

YA Global argued that the commitment fees received in connection with SEDAs were premiums paid for put options, but the Tax Court rejected this characterization because "neither the number of shares to be sold nor the price to be paid for those shares is set upon execution of the contract" in the SEDAs. Rather, based on the description in the case, YA Global would generally be entitled to purchase stock pursuant to a SEDA at a pre-determined discount to then current market price, which stock it would seek to sell in the market as quickly as possible.

The Tax Court seemed focused on the amounts denominated as "fees," rather than on the actual activities performed by YA Global and Yorkville Advisors, being evidence that YA Global was engaged in a U.S. trade or business of performing services for the issuer and that the Transaction Payments were Service Fees.[41] In footnote 33, the Tax Court appears to adopt the commissioner's view that "Taxpayers engaged merely in trading and investment simply do not earn income designated as fees." As described in this Report, however, there are numerous examples of the Tax Court and the Service treating items of income designated as fees as interest or payments for property rights such as option premiums, showing that Transaction Payments must be characterized based on their substance rather than labels used by the parties.[42] Likewise, identifying, sourcing, and negotiating transactions, conducting due diligence, and structuring and management of transactions are all Service Activities that Capital Providers may perform for themselves but in *YA Global*, the Tax Court viewed these activities as having been performed

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[40] "In objecting to proposed findings by respondent about specific types of fees, petitioners claim repeatedly that 'the fees associated with transactions varied, both in name and amount.' Petitioners thereby suggest that the labels applied to different fees had no real consequence. They seem to want us to believe, for example, that describing as a 'structuring fee' an amount paid to Yorkville Advisors does not indicate that the fee was compensation for Yorkville Advisors' efforts in structuring the transaction. As another example, petitioners suggest that ''monitoring' fees were paid in cases where it was clear there would be nothing to monitor.' Petitioners' position seems to rest on the premise that the fees Yorkville Advisors charged portfolio companies were at least misleading, if not downright deceptive." *YA Global Investments, LP*, 161 T.C. No. 11 at 15.

[41] The Tax Court noted that whether or not YA Global was simply an investor "stands or falls on whether, as petitioners claim, the *only returns* YA Global and Yorkville Advisors earned from portfolio companies were returns on capital invested in those companies." *Id*. at 15.

[42] In the investment partnership context, the Treasury regulations similarly specify that a partnership is not engaged in a trade or business by reason of any "activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets." Treas. Reg. §1.731-2(e)(3)(i).

primarily for the securities issuers as customers or clients.[43] Although the Tax Court chose not address the Service's assertion that YA Global was acting as a lender or an underwriter, in focusing on the unique facts surrounding the pricing of the SEDAs and convertible debt as eliminating investment risk, the Tax Court likely viewed the arrangements, including the various "fees," as akin to those traditionally negotiated by underwriters who earn compensation from clients or customers for acting as middlemen.[44] This is the most sensible way to reconcile the *YA Global* decision with the other authorities dealing with the tax treatment of Transaction Payments discussed below.

While the presentation of facts in the YA Global opinion contributes to the difficulty in assessing the soundness of its conclusion, we are not commenting on whether the case was correctly decided insofar as it found the taxpayer to be engaged in a U.S. trade or business based on the overall facts of the case. That said, because it is unclear to us (as well as many others who advise investors who participate in Investment Transactions) what analytical framework the Tax Court applied in reaching its decision, we suggest that the Treasury Department and the Service consider our recommendations, which would mitigate much of the confusion resulting from this decision.

C. Transaction Payments Taxed as Yield Adjustment Payments

As described above, Service Fees do not include Transaction Payments made primarily to compensate a Capital Provider for providing capital to an issuer or in exchange for a property

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[43] The opinion included language suggesting that anything beyond purchasing a pre-existing security could involve the performance of services for the issuer's benefit. *See YA Global Investments, LP*, 161 T.C. No. 11 at 17 ("[The fund's] mere showing up on a . . .portfolio company's doorstep with capital in hand would not have allowed the company to use that capital in its business. More had to be done. And that something more [was] the source of its professed competitive 'edge.' . . . Investors who purchase securities on the open market do not deal directly with the companies in which they invest . . . Even an investor who buys securities upon initial issuance provides no benefit to the issuer other than the capital provided. By contrast, when the purchaser of a security goes beyond simply deciding whether to purchase a security on the terms offered and arranges and structures the transaction in which the security is issued, the issuer realizes a benefit beyond the receipt of capital. In that circumstance, the issuer would have reason to pay for that additional benefit, as YA Global's portfolio companies apparently did in paying fees."). As discussed above, a Capital Provider often performs Services Activities such as due diligence and structuring of investments primarily for its own benefit. The Tax Court may have also been influenced by YA Advisors' solicitation activities and its marketing materials, including those describing the provision of capital funding and structuring solutions to "our clients" as supporting a view that services were performed for the benefit of the issuers. *See, e.g.*, Respondent's First Amended Brief at 21 (Feb. 31, 2021).

[44] *See, e.g., Kemon v. Comm'r*, 16 T.C. 1026 (1951) (Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middleman bringing together buyer and seller, and performing the usual services of a retailer or wholesaler of goods. Such sellers are known as "dealers.") *See also* Treas. Reg. § 1.864-2(b) ("…a dealer in stocks or securities is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom."). We note YA Global sought to show that it did take investment risk (in contrast to an underwriter), pointing to the fact that it held the securities for meaningful periods of time and realized significant long-term capital gains and losses from the securities it acquired. *See* Petitioner's First Amended Opening Brief (Feb. 2, 2021) at 87, 151.

right. When such amounts are paid to a Capital Provider upon the purchase of a debt or equity instrument, they generally reduce the Capital Provider's basis in the instrument acquired (and similarly the issue price of the instrument)[45] and, in the case of a debt instrument, are generally treated as interest or OID. The Supreme Court has defined interest as compensation "for the use or forbearance of money."[46] The most typical form of compensation to a Capital Provider "for the use or forbearance of money" in a lending transaction is stated interest on the loan.[47] However, various other Transaction Payments in a lending transaction are treated as interest.

Transaction Payments made by the issuer of debt to a Capital Provider that are based on the amount of the debt outstanding (as opposed to committed) and/or the amount of time that the debt is outstanding are generally treated as interest (including OID that adjusts the yield on the instrument).[48] For example, an upfront payment to the Capital Provider based on the amount of principal outstanding (which may be effectuated as a reduction to the principal amount advanced) would generally be treated as OID that results in interest accruals throughout the life of the loan.[49] "Points" are an example of upfront Transaction Payments that are generally computed as a percentage of the total principal amount and are treated as interest. This is consistent with the fact that the payment of points typically results in a reduction to the stated interest rate. In Rev. Rul. 69-188, an upfront payment referred to by the parties as a "loan processing fee" was treated as interest because the taxpayer established that it was paid solely for the use or forbearance of money (and there was a separate change under the loan agreement for the services provided).

The Tax Court treated an upfront loan origination fee paid to a taxpayer engaged in the business of making loans for the purchase or construction of real estate as interest because (1) "the loan fee rate charged on a particular loan was dependent upon the same factors relied on in determining the stated interest rate to be charged, namely the degree of risk involved and the current money market" (and the higher the loan fee was, the lower the interest rate would be, and vice versa), (2) "there was no relationship between the cost incurred by petitioner in underwriting a loan and the loan fee charged thereon" (and most of the third-party costs were separately charged to the borrower) and (3) the taxpayer was consistently treating the fee as

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[45] For example, Treas. Reg. §1.1273-2(g)(2)(i) provides that for any lending transaction to which Section 1273(b)(2) applies "a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan." In the equity context, there is case law providing that inducement payments to a buyer reduce the buyer's basis in the shares and are not treated as income. *See, e.g., Brown v. Comm'r*, 10 B.T.A. at 1055; *Freedom Newspapers, Inc. v. Comm'r*, 36 T.C. Memo 1755 (1977).

[46] *Deputy v. Du Pont*, 308 U.S. 488 (1940).

[47] Stated interest is generally a percentage (whether fixed or variable) of outstanding loan balance, but does not necessarily need to be. *Kena, Inc. v. Comm'r*, 44 B.T.A. 217 (1941) (treating payments that are based on a percentage of profit as interest).

[48] Rev. Rul. 72-315, 1972-1 CB 49 ("One of the factors distinguishing a "service charge" from interest is that a "service charge" is a fixed charge having no relationship to the amount borrowed or the time given to pay whereas interest is based on the amount deferred and the time of deferral.")

[49] *See, e.g.*, Treas. Reg. §1.1273-2(g)(2)(i); Rev. Rul. 69-188, 1969-1 CB 54; *Cap. One Fin. Corp. & Subs. v. Comm'r*, 133 T.C. at 160 (treating upfront credit card interchange fees as interest because they are "not a fee for any service other than lending money to cardholders").

interest for complying with "truth in lending," usury and tax laws.[50] Similarly, the Tax Court treated a 2% "initial service change or finance fee" as primarily interest where the stated interest rate was lower than the prevailing market rate and the service charges were, for the most part separately accounted for (either because the borrower directly performed the services or there were separate charges by the lender).[51]

Other Transaction Payments that are generally treated as interest include late payment charges,[52] non-sufficient fund fees and over-the-limit fees,[53]and credit card cash advance fees.[54] The fact that the Transaction Payments may be a flat one-time charge does not preclude them from being treated as interest if it is clear that the payment is intended to be compensation for the use or forbearance of money.[55] The Tax Court has held that a crucial factor in establishing that a particular payment constitutes interest is whether the payment bears some relationship to the amount borrowed.[56]

Similarly, consent fees paid to lenders to induce them to agree to modify or waive the terms of the Security could be characterized as a separate payment to the lenders, taxed as ordinary income. However, they could also be characterized as an additional payment on the Security, in which event it may be characterized as consideration for retirement of the Security (if the transaction involves a deemed reissuance), or as a mere payment on the Security or as an additional payment on the Security (effectively, additional yield). The formal authorities regarding such payments are limited,[57] and practitioners issuing tax disclosure generally hedge, noting that either characterization is possible. In some transactions, consent fees are paid in kind rather than in cash, which can create additional uncertainty as to their characterization.

Finally, some lenders also charge prepayment fees on the early repayment of a Security. These compensate the lender for the risk that they cannot achieve the same return in an alternative transaction if a loan is prepaid—and so would require additional yield to be willing to allow a borrower to repay their loan in advance. These should be, and appear generally to be, treated as additional consideration in retirement of the Security.[58]

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50 *Pacific First Fed. Sav. & Loan Ass'n v. Comm'r*, 79 T.C. at 520.

51 *Wilkerson,* 70 T.C. at 263.

52 Rev. Rul. 72-315, 1972-1 CB 49; Rev. Rul. 74-187, 1974-1 CB 48; Tech. Adv. Mem. 200533022 (May 10, 2005).

53 Tech. Adv. Mem. 200533023 (May 10, 2005).

54 Rev. Rul. 77-417, 1977-2 CB 60; Tech. Adv. Mem. 200533023 (May 10, 2005).

55 Rev. Rul. 77-417, 1977-2 CB 60.

56 *Fort Howard Corp. & Subs.*, 103 T.C. at 375.

57 *See* Treas. Reg. 1.1001-3(e)(2) (consent fees must be taken into account when determining the change in yield of a modified debt instrument for purposes of determining if a "significant modification" has taken place), Priv. Ltr. Rul. 201105016 (treating consent fees paid to noteholders as consideration for a modification as payments on the notes; the modification in this ruling was not a deemed reissuance); Priv. Ltr. Rul. 9641001.

58 *Prudential Ins. Co. of Am. v. Comm'r*, 882 F.2d 832, 835 (3d Cir. 1989) (prepayment charges on corporate mortgages represent capital appreciation, not interest).

D. Transaction Payments Taxed as Payments for Property

1. Relevant Authorities and Guidance

Certain Transaction Payments are neither treated as Yield Adjustment Payments nor as Service Fees, but rather payment for another property right, i.e., Property Payments. For example, Commitment Fees, which generally refer to fees paid as compensation to a Capital Provider for a commitment to make funds available when needed in the future at a firm price and interest rate, are not generally viewed as interest because they are not based on the amount of proceeds actually advanced (if any— generally, these Commitment Fees are payable whether or not any proceeds are advanced) and do not fall within the typical meaning of a service.[59] Rev. Rul. 81-160 described commitment fees in the nature of standby charges as "an expenditure that results in the acquisition of a property right" and as "similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option."[60] Rev. Rul. 81-160 further specifies that if the right is exercised, the fee becomes a cost of acquiring the loan that is deducted ratably, and if the right is not exercised, the taxpayer may be entitled to a loss deduction when the right expires.[61] Treasury Regulations §1.1273-2(g)(2)(i) can be read to treat Commitment Fees as payments for property (rather than payments for interest or services).[62]

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[59] *See* Rev. Rul. 54-43, 1954-1 C.B. 119 ("Commitment fees" incurred by the merchant under the "commitment agreement," being current charges for making business funds available to it on a standby basis and not for the use of funds, do not represent interest incurred but are deductible to it as ordinary and necessary business expenses under section 23(a)(1)(A) of the Code.)

[60] Rev. Rul. 81-160; 1981-1 C.B. 312.

[61] Before Rev. Rul. 81-160, it was the Service's position that loan commitment fees were currently includible by the lender. *See* Rev. Rul. 70-540, 1970-2 C.B. 101 ("…commitment fee is a charge for agreeing to make funds available …rather than for the use or forbearance of money and, therefore, is not interest"), citing Rev. Rul. 56-136, C.B. 1956-1 92. Based on this position, the Service had treated loan commitment fees as payments for services and treated the fees as not subject to withholding where the services were provided by the recipient outside the United States. *See* Priv. Ltr. Rul. 7808038 (Nov. 25, 1977). Rev. Rul. 81-160 treated the payments specifically as for a property right and not for services. Some post-Rev. Rul. 81-160 guidance suggests a Commitment Fee continues to be currently includible by the recipient even though the issuer treats the Commitment Fee as akin to an option premium. *See, e.g.*, Preamble to Section 163(j) Treasury Regulations, 85 FR 56686 (Nov. 13, 2020) ("under existing guidance, commitment fees are treated differently by the borrower (similar to an option premium) and the lender (service income)" citing Rev. Rul. 81-160 and Rev. Rul. 70-540 (Situation 3)). *See also* FSA 200037034 (Sep. 15, 2000) (citing both Rev. Rul. 81-160 and Rev. Rul. 70-540 with approval) and Field Attorney Advice 20182502F (Apr. 11, 2018) and Tech. Mem. Adv. 200514020 (Apr. 08, 2005) discussed further in this Report.

[62] Although we believe this to be the most natural interpretation of the parenthetical in this regulation ("other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs"), it could also be interpreted to mean that commitment fees are Service Fees. The second part of the parenthetical ("commitment fees or loan processing costs") parallels the first part ("a payment for property or for services"), with the commitment fees being either pre-loan fees described in Rev. Rul. 81-160 or yield enhancement, such as the points described in Rev. Rul. 74-607 (partially obsoleted by Rev. Proc. 94-29), in which the Service distinguished points (treated as adjusting the yield on a debt instrument) from fees for services with the following reasoning: "The term 'points' as used in this Revenue Ruling refers to a charge made by the lender (mortgagee) to the borrower (mortgagor) that is in addition to the stated annual interest rate and is paid by the borrower to the lender as an adjustment of the stated interest to reflect the actual cost of borrowing money. The amount of the 'points' charged is determined by the lender upon consideration of the factors that usually dictate an acceptable rate of interest and is not paid for specific services performed or to be

In *Fed. Home Loan Mortg. Corp. v. Commissioner*,[63] a taxpayer received commitment fees equal to 2% of the principal amount of the mortgages for entering into prior approval purchase contracts with mortgage originators, which obligated taxpayer to buy but did not require the originators to sell. These fees were broken into a refundable portion and a nonrefundable portion. The Tax Court found that the taxpayer properly treated the nonrefundable portion as option premium because the terms and economic substance of the prior approval contracts indicated that the taxpayer and originator entered into an option contract, defined by the court as a contract that provides for "(A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration." The Tax Court noted that the policy rationale for treating an option as an open transaction for tax purposes was that "the outcome of the transaction is uncertain at the time the payments are made." Finally, the Tax Court distinguished *Chesapeake Financial Corp. v. Commissioner*,[64] in which the taxpayer, effectively acting as underwriter of loans ultimately issued by institutional investors, received commitment fees treated by the Tax Court as payments for services, on the basis that the taxpayer in *Chesapeake* acted as an originator for the borrower rather than the lender that purchases from the originator, and so there was no argument that the commitment fees were option premiums.

Backstop fees, which are one-time fees paid by an issuer to pre-existing investors that have committed to purchase new debt if other investors do not do so, and ongoing ticking fees, which are periodic commitment fees in respect of the undrawn portion of commitments, could also be viewed as like an option premium under the reasoning in Rev. Rul. 81-160.[65] Two Service pronouncements have created some uncertainty, however, especially with respect to ticking fees and facility fees. In Field Attorney Advice 20182502F (the "**FAA**"), the Service concluded that quarterly commitment fees payable on a taxpayer's revolving credit based on the unused amount of the commitment did not create an option, but rather were related to the rights and benefits of the taxpayer in the 3-month period prior to the payments, and so could be deducted in the taxable year in which they were incurred.[66] Similarly, in Technical Advice Memorandum 200514020 (the "**TAM**"), the Service found that quarterly facility fees in connection with a revolving credit agreement were not in the nature of the standby charges in Rev. Rul. 81-160 and were deductible as ordinary and necessary business expenses, including

performed by the lender. Thus, 'points' as used in this Revenue Ruling are for the use or forbearance of money and are considered to be interest."

[63] *Fed. Home Loan Mortg. Corp. v. Comm'r*, 125 T.C. 248 (2005).

[64] *See Chesapeake Fin. Corp. v. Comm'r*, 78 T.C. at 877 (where the taxpayer in Chesapeake did not argue for option treatment; instead, the case focused on when the "all events" test was met).

[65] Backstop fees are also paid in connection with commitments to purchase common or preferred equity or other securities.

[66] Field Attorney Advice 20182502F (Apr. 11, 2018). The Service considered whether the commitment fees were required to be capitalized under Treas. Reg. § 1.263(a)-4(c)(1), which requires capitalization of amounts paid to acquire an intangible asset in a purchase or similar transaction, or Treas. Reg. § 1.263(a)-4(d)(1), which requires capitalization of amounts paid to create an intangible (which would include an option). The Service determined the unused commitment fees were not capital expenditures because: "[The Unused] Commitment Fees are commonly and frequently incurred in the type of business conducted by the Taxpayer and are appropriate and helpful to the development of the Taxpayer's business, and therefore the payment of the Commitment Fees is an ordinary and necessary expense under section 162."

because "the payment of these fees did not create or enhance a separate and distinct asset with a useful life extending substantially beyond the taxable year, nor did they generate significant future benefits for the Taxpayer." As a result, the characterization of such fees as "option" like arrangements or facility fees under current authorities may be quite nuanced, turning on details of how the fee is calculated and paid.

It is unclear why the Service did not view the arrangements in the FAA and the TAM as akin to options under the existing authorities. Specifically, in the TAM, the taxpayer paid a quarterly facility fee-based on the total commitment for such quarter (whether drawn or undrawn). The TAM concluded that such a quarterly "ticking" fees, was not an option, and was instead currently deductible. (The Service had argued for Rev. Rul. 81-160 treatment). The key distinction, which is unsatisfying to some degree, was effectively that the fees were charged for the prior quarter's available commitments, and not future availability of capital—and so did not create or enhance a separate asset, but merely kept the agreement in place.[67] In the FAA, the taxpayer's fee, again paid quarterly in arrears, was on undrawn amounts (and so, unlike in the TAM, would vary based on how much capital was drawn down). The conclusion again was that such amounts were currently deductible, on the basis that the payments did not constitute fees to obtain an intangible in a purchase, or to create an intangible—with the Service specifically noting that under Rev. Rul 81-160, the amounts would instead need to be capitalized. The FAA does note that even if the arrangement was an option, the option should be viewed as a three-month option ending on the payment date, so permitting current deduction in any event.[68]

As noted above, the court in *Fed. Home Loan Mortg. Corp.* defined an option as a contract providing the holder with (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration.[69] To determine whether a contract constitutes an option, courts look to the economic substance of the agreement rather than nomenclature.[70] Although the premium is typically paid at the outset, the premium can be paid upon exercise or failure to exercise (e.g., a

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[67] *See* Tech. Adv. Mem. 200514020 (Apr. 08, 2005) ("State corp./accrual basis taxpayer would be able to deduct quarterly facility fees paid in arrears, in connection with revolving credit agreement, in taxable year in which they are actually paid, when economic performance would be deemed to have occurred.").

[68] *See* Field Attorney Advice 20182502F (Apr. 11, 2018) (holding that "the Taxpayer is not required to capitalize the Commitment Fees under § 263 and may deduct the Commitment Fees under § 162 in the taxable year in which they were incurred under § 461").

[69] *Fed. Home Loan Mortg. Corp.*, 125 T.C. at 261; *See also Holmes v. Comm'r*, 37 T.C.M. (CCH) 1825 (1977) (where the tax court held that a right of first refusal was not an option because it was contingent on the optionor receiving an offer before the option could be exercised); *W. Union Tel. Co. v. Brown*, 253 U.S. 101, 110 (1920) ("An option is a privilege given by the owner of property to another to buy the property at his election. It secures the privilege to buy and is not of itself a purchase. The owner does not sell his property; he gives to another the right to buy at his election."); *Halle v. Comm'r*, 83 F.3d 649, 654 (4th Cir. 1996) ("The would-be purchaser of the property thus pays a fee for the choice of whether to proceed with the purchase of the property. Inherent in that choice is the absence of any obligation to proceed.").

[70] *See Old Harbor Native Corp. v. Comm'r*, 104 T.C. 191, 201 (1995) ("We look to the substantive provisions of the Lease Agreements and the parties' conduct with respect thereto. We do not afford controlling weight to the terms embodied in the Lease Agreements.").

post-paid option) or paid throughout the holding period.[71] Courts have on occasion refused to treat a contingent arrangement as an option if the option writer was, at least to some extent, being compensated for services and the option writer had a substantial degree of control over whether the option would be exercised.[72] Yet these authorities do not explain what made the FAA and TAM arrangements ineligible for option treatment.

The *YA Global* decision, on the other hand, is distinguishable from Rev. Rul. 81-160 and the option case law in that the Tax Court did not view the taxpayer as taking the investment risk required for option characterization and so rejected the taxpayer's characterization of commitment fees as option premiums.[73] As described by the Tax Court:

> …[the] SEDA commitment fees can be readily distinguished from premiums paid in a typical put option. The premium paid for a put option generally compensates the writer for the risk that it will be called upon to purchase the subject property at a price that proves to be more than the property is worth when the option is exercised…By contrast, the price YA Global would pay for stock issued for a SEDA advance would almost certainly (and by apparent design) be at a discount to the market price. A SEDA would seldom, if ever, require the partnership to purchase stock for a price in excess of its value at the time of purchase.[74]

The Tax Court cited *Fed. Home Loan Mortg. Corp*. with approval but distinguished *YA Global* on its facts:

> In *Freddie Mac*, we treated as option premiums commitment fees that originators of mortgages paid to the taxpayer for the option of selling it mortgages. Although the agreement between the taxpayer and originators provided a formula for determining the price the taxpayer would pay for a mortgage if an originator chose to sell it, the exact price could not be determined when the parties executed the agreement. Instead, that

[71] *See, e.g.*, *Virginia Iron Coal & Coke Co. v. Comm'r*, 99 F.2d 919 (4th Cir. 1938) (where the taxpayer granted an option to acquire, for a specified price, all of the stock of its subsidiary or all of the assets of that subsidiary with premiums for the option due approximately at annual intervals.)

[72] *See Holmes v. Comm'r*, 37 T.C.M. (CCH) 1825 (1977) (holding that a right of first refusal was not an option because it "did not inflexibly bind petitioner to offer his stock for sale . . . for a stated price within a fixed time period").

[73] The Tax Court was likely also influenced by a view that the taxpayer was engaged in business as an underwriter, acquiring stock under SEDAs at a fixed discount to current market price with a plan to sell the stock in the market as quickly as possible.

[74] The Tax Court cited the description of a put option given by the court in *Fed. Home Loan Mortg. Corp.*:

> [I]n a typical put option, the optionee is willing to pay a premium to the optionor for the right to sell a security to the optionor at an agreed price sometime in the future. If the market value of the security falls below the exercise price, the optionee can sell the security to the optionor at a price greater than its value on the exercise date. That potential opportunity is what the optionee paid for. Likewise, the premium received by the optionor is compensation for accepting the potential risk of having to purchase at an unfavorable price. If the market value of the security rises above the exercise price, the option will not be exercised, and the optionor keeps the option premium for having accepted the risk associated with uncertainty." *Fed. Home Loan Mortg. Corp.,* 125 T.C. at 263–64.

YA Global Investments, LP, 161 T.C. No. 11 at 18.

price would depend on the movement of interest rates between the execution of the agreement and any sale of the mortgage. But the formula had the effect of requiring the taxpayer to pay a minimum price…Therefore, the agreement protected the originator from declines in the value of the subject mortgage due to increases in interest rates beyond the specified yield…when YA Global entered into a SEDA, it did not have any exposure to price fluctuations prior to the time of `exercise' (when it acquired stock from the issuer), because it always bought stock at a discount to the prevailing market price…[u]nlike a put option, SEDAs…did not protect issuers against the risk of a decline in their stock price (due to the floating purchase price)….

Further, the Tax Court pointed to a lack of evidence showing the taxpayer actually had treated the fees as option premiums for the years at issue. The Tax Court also questioned how option premium treatment would apply in situations involving multiple draws over time (we discuss this timing issue further below in the next subsection).

In sum, the *YA Global* decision, although rejecting option characterization based on the unusual facts in that case, is not inconsistent with treatment of Commitment Fees as similar to option premiums in more typical fact patterns.

So-called "broken deal" or "breakage" fees have economic similarities to Commitment Fees, insofar as they generally are payable in the event that a borrower pursues an alternative transaction. Because they are paid with respect to the exercise or waiver of a contract right (i.e., the right to terminate the contract), we believe that they should be treated as Payments for Property (as opposed to a Service Fee). However, the tax treatment of breakage fees, when payable with respect to unfunded amounts, is unclear. At least three alternative characterizations are plausible: (1) liquidated damages (generally resulting in ordinary income to the recipient and a current deduction to the payor, though potentially capitalizable into a subsequent transaction if consummated, (2) a contract termination payment under Section 1234A of the Code (generally resulting in capital treatment, at least to the Capital Provider) or (3) treatment like an option premium on the lapse of that option (also resulting in capital treatment).

In our view, either treating these fees as liquidated damages (subject to being capitalizable by the payor in certain circumstances) or as governed by Section 1234A is more compelling than treating the fees as like option premiums, since unlike an option premium, which is payable in all cases to buy or sell property, the breakage fee is paid only if the payor exercises a right to terminate the contract. Historically, authorities and other guidance originally favored characterizing these payments as liquidated damages, and focused mostly on when the payor was required to capitalize the fees.[75] We are unaware of any authorities that mandate capital treatment under Section 1234A, though in our view, sine the payment is with respect to the payor's right to issue a Security, which generally would be a capital asset at least in the hands of the Capital Provider, we believe that applicability of Section 1234A should be considered. Section 1234A very generally requires capital treatment for payments received for the extinguishment of rights with respect to capital assets, though we understand that breakage fees are not what the section was enacted to target.

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[75] *See*, *e.g.*, *U.S. Freight Co. v. United States*, 422 F.2d 887 (Ct. Cl. 1970); Priv. Ltr. Rul. 200823012 (June 6, 2008), Tech. Adv. Memo. 200438038 (Sept. 17, 2004).

2. Timing and Character Considerations

As noted, we recommend that Commitment Fees be treated like option premiums, as a substantial majority of the Executive Committee believes this characterization is consistent with the economics of the arrangement (except in cases where treated as being for services because the Transaction Documents explicitly attribute the fees to reasonable compensation for the performance of services for the issuer or the Capital Provider regularly engages in, and is acting primarily as, an underwriter, dealer or broker with respect to at least a substantial portion of the Security acquired by the Capital Provider). The majority believes reciprocal treatment should apply so that Capital Providers and issuers should treat Commitment Fees like option premiums.[76]

Assuming they are treated for tax purposes like option premiums, Commitment Fees should generally be treated as capital in the hands of the Capital Provider (assuming the option writer is not in business as an underwriter or other dealer), as the character of an option looks to the character of the underlying property,[77] and taxed on an "open transaction" basis—where the income (or purchase price/basis adjustment) is only taken into account when the option has lapsed or been exercised. The timing of this treatment is at odds with pre-Rev. Rul. 81-160 authorities (and the FAA and TAM), which require current income inclusion by the recipient upon receipt.[78]

The timing for the borrower's treatment of a Commitment Fee is generally consistent with the option theory—the borrower does not generally deduct a Commitment Fee when paid, but instead either treats it as a cost of the loan (if it is ultimately drawn), deducted over the life of the loan, or as an ordinary loss if the commitment is not drawn. Note, however, that the FAA and TAM permitted a current deduction in the context of their particular facts.

Option treatment does not resolve all questions as to the tax accounting for Commitment Fees, however, particularly where the Capital Provider is ultimately called upon to advance

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[76] A minority of the Executive Committee believes Commitment Fees should be treated like services income to the Capital Provider and payments for services by the issuer.

[77] Rev. Rul. 58-234, 1958-1 C.B. 279 (in the case of the grantor of an option to sell property, gain on lapse of the option shall be treated as a gain or loss from the sale or exchange of a capital asset held not more than one year); Rev. Rul. 78-182, 1978-1 C.B. 265 (premium for put option decreases basis in property if option is exercised and gives rise to short-term capital gain under section 1234(b) to the option writer if option expires).

[78] *See* Rev. Rul. 56-136, 1956-1 C.B. 92 (revoked by Rev. Rul. 81-160, 1981-1 C.B. 312) ("Since commitment fees or standby charges are not paid upon an indebtedness of the taxpayer, they are not considered to be 'compensation for the use of forbearance of money' and, accordingly, do not represent interest on indebtedness....[T]he fees or charges appear to be expenses applicable to the standby period prior to the issuance of the bonds…. In accordance with the foregoing, the commitment fees or standby charges described herein are held to be business expenses deductible under section 162 of the Code, when paid or accrued, depending on the taxpayer's method of accounting."); Rev. Rul. 70-540 (Situation 3) ("The commitment fee is a charge for agreeing to make funds available to [borrower] rather than for the use or forbearance of money and, therefore, is not interest.... Therefore, the recipient of a commitment fee must account for the income currently, depending on its method of accounting").

funds over time under its commitment, as in the case of revolver loans or deferred draw term loans that may involve multiple drawdowns over time or if one Capital Provider receives a larger fee than others in light of its role as lead investor. Depending on how the fee is allocated among multiple draws and/or Capital Providers, the fee may result in lack of fungibility among the draws if treated as OID, in that each draw may not have the same amount of OID and thus not be treated as the same issue under the OID rules.

Alternatively, if treated as a separate option premium in a property transaction under Treasury Regulations §1.1273-2(g)(2)(i), the fee would not raise fungibility concerns but would simply reduce a Capital Provider's basis in its debt, giving rise to market discount (the "**Market Discount Approach**").[79]

Another alternative would be to treat a Commitment Fee as a payment for a series of one-day put options; depending in the facts, this approach could address fungibility by treating a pro rata portion of the unamortized fee as a purchase price adjustment to each draw in an amount consistent with the original amount of OID, with the remainder of the Commitment Fee amortized over the commitment period (the "**Daily Option Approach**"). The construct of a series of one-day options would generally spread the timing of income and deduction for both Capital Provider and issuer over the period of the commitment.

A further alternative would be for Capital Providers to treat the Commitment Fee asymmetrically from the issuers and report it as current ordinary income.[80] Market practice may differ as to whether participants prefer such treatment or—as seen in some guidance—issuers may seek to deduct such payments currently. It is unusual and not optimal, for parties to the same transaction to characterize the transaction differently.[81] If one of the approaches above that addresses fungibility is adopted, that could mitigate one reason market participants may take disparate positions for Commitment Fees as between issuer and Capital Provider. Therefore, the majority of the Executive Committee favors either the Market Discount Approach and/or the Daily Option Approach as rules of administrative convenience.[82]

3. Source of Income and Withholding Tax Considerations

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[79] This approach is consistent with Treas. Reg. §1.1273-2(g)(2)(i), under which payments "for property or for services" do not reduce issue price.

[80] *See, e.g.*, Preamble to Section 163(j) Treasury Regulations, 85 FR 56686 (Nov. 13, 2020) (suggesting Service's view of current law as involving lack of reciprocal treatment and continuing validity of Rev. Rul. 70-540 for lender's treatment—"…under existing guidance, commitment fees are treated differently by the borrower (similar to an option premium) and the lender (service income)…" citing Rev. Rul. 81-160 and Rev. Rul. 70-540 (Situation 3)); *See also* FSA 200037034 (Sep. 15, 2000) (citing both Rev. Rul. 81-160 and Rev. Rul. 70-540 with approval).

[81] Reciprocal treatment applied in GCM 39434 (Oct. 25, 1985) (underlying Tech. Adv. Mem. 8543004) (annual credit card fees that were charged regardless of whether the card was ever used were akin to standby commitment fees treated as paid for a property right under Rev. Rul. 81-160).

[82] In some cases, such as Commitment Fees for revolvers or delayed draw term loans, the Daily Option Approach may make the most sense, whereas, in other cases, the Market Discount Approach may be more appropriate. We would be happy to address these issues further in a separate report.

The characterization of Payments for Property will affect how such fees are sourced, a key issue for non-U.S. Capital Providers. If treated like an option premium as recommended in the case of Commitment Fees, the Payment for Property would be sourced to the residence of the recipient and thus non-U.S. source in the hands of a non-U.S. person. Regardless of source, the fee would be capital (in the hands of a non-dealer) and exempt from U.S. federal withholding tax on fixed or determinable annual or periodic income ("**FDAP**").[83]

If, however, the Commitment Fee is characterized as ordinary, not capital, in the hands of the Capital Provider, the source of income is less clear. The income may be sourced by reference to where the property is used (the residence of the Capital Provider), by analogy to rules that apply to contracts such as a notional principal contracts[84] or other derivatives (the residence of the Capital Provider), or by reference to the residence of the Capital Provider under the approach in Container Corp.[85] We believe the better approach is by reference to the residence of the Capital Provider.

The majority of the Executive Committee believes that, regardless of how characterized for purposes of timing and character, Payments for Property such as Commitment Fees should not constitute income for services. This is consistent with Fed. Home Mortgage Corp. and Rev. Rul. 81-160. Moreover, neither Rev. Rul. 70-540 (Situation 3), nor prior law Rev. Rul. 56-136 (revoked by Rev. Rul. 81-160), characterized commitment fees as being compensation for services. Instead, the rulings simply required current inclusion and confirmed the fees were not interest.[86] Thus, even if treated as currently includible ordinary income, the source would still be based on residency of the recipient (assuming the fee is not ECI).

A minority of the Executive Committee believes Commitment Fees should be treated like services income. If so treated, the source of income turns on where the services are performed.[87] Where the service consists of an agreement to provide capital in the future, the services should be considered to take place where the Capital Provider resides.[88]

In sum, as discussed above, the majority of the Executive Committee believe a Payment for Property, such as a Commitment Fee, should not constitute services income unless the Transaction Documents explicitly attribute it to being paid for specified services required to be

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83 Section 865(a)(2) (gains from sale of personal property by nonresident is sourced outside the United States); Treas. Reg. §1.1441-2(b)(2)(i) (gains derived from the sale of property (including option premiums) do not constitute FDAP income subject to withholding).

84 Treas. Reg. §1.863-7(b)(1) ("Unless [an exception applies], the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i)").

85 *See*, *e.g.*, *Container Corp.*, 134 T.C. at 140–41 (prior to enactment of section 861(a)(9), Tax Court analogized a guarantee fee to a payment for services that should be sourced to the residence of the guarantor because performance of the guarantee was based on the corporation's assets).

86 *See also id*. at 135–36 (guarantee fee not treated as being compensation for services). *But see* preamble to section 163(l) Treasury Regulations, 85 FR 56686 (Nov. 13, 2020), at 56699 (referencing Rev. Rul. 70-540 (situation 3) for potential services income treatment).

87 Sections 861(a)(3), 862(a)(3) (specifying respectively that compensation for services performed in the United States is U.S. source and compensation for services performed outside the United States is non-U.S. source).

88 *See*, *e.g.*, *Container Corp*., 134 T.C. at 141.

performed by or on behalf of the Capital Provider or the Capital Provider regularly engages in an underwriting or other dealer trade or business and, in the Investment Transaction, is acting primarily as an underwriter, dealer or broker instead of as an investor with respect to at least a substantial portion of the Security acquired by the Capital Provider. Further, we recommend guidance confirm such Fees are like option premiums and thus capital in the hands of the Capital Provider (other than for dealers or underwriters). If, for any reason, the Service determines to treat such Fees as ordinary in the hands of the Capital Provider, a majority believes the Fees should nevertheless be sourced to the residence of the Capital Provider by reference to the rules for similar contracts such as notional principal contracts.