



American Taxation Association Mid-year meeting

“The Taxation of Sophisticated Financial Instruments”

Richard G. Larkins, Partner
Ernst & Young LLP
National Tax Department
Washington, D.C.

February 20, 2009

 **ERNST & YOUNG**
Quality In Everything We Do

Agenda

- ▶ Convertible debt
 - ▶ Traditional convertible
 - ▶ Contingent payment convertible
 - ▶ Call spread convertible

Background – Traditional Convertible Debt

- ▶ The conversion feature of convertible debt is generally ignored for tax purposes. Thus, the issuer simply deducts interest at the stated rate.
- ▶ Contrast the treatment of an “investment unit,” consisting of debt issued together with warrants. In that case, the issue price of the unit is allocated between the debt and warrants in proportion to their fair market values. So the debt is treated as having been issued at a discount, which is deductible over the life of the debt.
- ▶ Economically similar, but taxed very differently. The key is whether there is a single financial instrument or two separate instruments that are separately tradable.

Background – sections 163(l) and 249

- ▶ Section 163(l) denies a deduction for any interest on a disqualified debt instrument.
 - ▶ A disqualified debt instrument is one on which a substantial amount of interest or principal is payable in, or determined by reference to the value of, the stock of the issuer or a related party, either mandatorily or at the option of the issuer or a related party.
 - ▶ Indebtedness that is part of an arrangement which reasonably expected to result in a transaction described above can be a disqualified debt instrument.
 - ▶ Generally, convertible debt is not subject to section 163(l) because it is payable in stock of the issuer at the option of the holder. But debt is disqualified if the conversion feature is substantially certain to be exercised.
- ▶ Section 249 denies a deduction for premium paid upon the redemption of a convertible debt except to the extent (i) of a “normal call premium” or (ii) attributable to the cost of borrowing and not attributable to the conversion feature. An interesting issue is how this rule interacts with the Integration and Contingent Debt rules.

Contingent Payment Debt Instruments (CPDIs)

- ▶ Special rules governing CPDIs are found in Reg. §1.1275-4.
- ▶ In determining whether a debt instrument is a CPDI, remote and incidental contingencies are disregarded.
- ▶ A debt instrument is not treated as a CPDI merely because of a conversion feature.
- ▶ On a CPDI, interest accrues at the “comparable yield,” defined as the yield on a comparable noncontingent debt instrument with similar terms and conditions. Comparable yield limited to AFR unless issuer can show a higher borrowing cost by clear and convincing evidence.
- ▶ Issuer must devise a projected payment schedule consistent with the comparable yield.
- ▶ Differences between actual contingent payments and projected payments are treated as positive or negative adjustments when the contingent amounts become fixed. For the issuer, positive adjustments are generally deductible as interest and negative adjustments are treated first as an offset to interest, then as ordinary income.

Contingent Payment Convertibles

- ▶ Contingent payment convertibles are just like ordinary convertibles, except that the holder is entitled to additional interest payments upon the occurrence of a contingency.
- ▶ Contingency typically relates to the trading price of the convertible (e.g., payable if convertible trades at more than 120% of face). Contingency is designed not to be “remote.”
- ▶ Amount of contingent interest is designed to be more than an “incidental” amount but not so large as to be terribly costly (typically 25-50 bps).
- ▶ Contingent convertibles typically have a term of 20 years, but are generally callable after 7 years, and sometimes also have holder put rights.
- ▶ However, if the debt does not convert, there is a full “recapture” of the excess tax deductions under the CPDI rules.

Rev. Rul. 2002-31

- ▶ Corporation X issues for \$625x a 20-year debt instrument with a stated principal amount of \$1,000x.
- ▶ The debt instrument is convertible at any time into a number of shares of Corporation X common stock having a value that is significantly less than \$625x.
- ▶ The debt instrument provides that, beginning in 3 years, contingent interest is payable in any semi-annual period if the average market price of the debt is greater than 120 percent of the instrument's accreted value.
- ▶ The amount of contingent interest that is payable is equal to the greater of (1) the regular cash dividend per share of Corporation X common stock multiplied by the number of shares into which the debt converts, or (2) y percent of the average market price of the debt instrument.

Rev. Rul. 2002-31

- ▶ After 3 years, Corporation X has the option to redeem the debt instrument for cash in an amount equal to the accreted value.
- ▶ At 3 years and 10 years, the holder of the debt instrument has the option to put the debt instrument to Corporation X for an amount equal to the instrument's accreted value.
- ▶ If the holder exercises this option, Corporation X can satisfy its obligation with cash, shares of Corporation X common stock, or a combination of both.

Rev. Rul. 2002-31

- ▶ The contingent interest is neither a remote nor an incidental contingency within the meaning of § 1.1275-2(h).
- ▶ Taking into account both the likelihood of conversion of the debt instrument and the likelihood that the instrument will be put by the holder, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of the issuer.
- ▶ Corporation X takes the position that the noncontingent bond method applies to the debt instrument and that the comparable yield for the instrument is 7 percent, compounded semiannually.

Rev. Rul. 2002-31

- ▶ The CPDI rules apply as long as the contingent interest is not remote or incidental
- ▶ The comparable yield is a comparable nonconvertible yield
- ▶ The OID anti-abuse rule does not apply
- ▶ Section 163(l) does not disallow interest deductions on these types of instruments
- ▶ Section 249 does not disallow interest deductions at the comparable yield, but does apply to prevent deductions for positive adjustments on conversion (because these are attributable to stock appreciation).

AM 2007-0014

Call Spread Convertibles

- ▶ Convertible Bonds integrated under Treas. Reg. §1.1275-6 with Call Option partially financed by sale of Warrants or Convertible Bonds integrated with Capped Call Option.
- ▶ Per AM 2007-0014, a corporation issues at par 5-year Convertible Bonds with a zero interest rate.
- ▶ On the issue date of the Bonds, the corporation purchases from a bank affiliated with the underwriter Call Options on its stock. Each Call Option entitles the corporation to purchase a number of shares of its common stock equal to the number of conversion shares at a strike price equal to the conversion price of the Convertible Bonds. The Call Options are automatically exercised if the corresponding Convertible Bonds are converted.
- ▶ The Call Options expire on the same date on which the Convertible Bonds mature.
- ▶ Both the Convertible Bonds and the Call Options can be physically settled, cash settled, or net share settled at the election of the corporation.

AM 2007-0014

Call Spread Convertibles

- ▶ Also on the issue date of the Convertible Bonds, the corporation sells Warrants to the bank.
- ▶ Each Warrant entitles the bank to purchase a number of shares of the corporation's common stock equal to the number of conversion shares at a strike price that is significantly greater than the strike price of the Call Options.
- ▶ The Warrants do not refer to the Convertible Bonds or the Call Options. The Warrants, which are "European-style," may not be physically exercised. The Warrants must be settled on a cash or net share basis.
- ▶ The Warrants expire several months after the maturity date of the Convertible Bonds.

AM 2007-0014

Call Spread Convertibles

- ▶ For tax purposes, the corporation integrates the Convertible Bonds with the Call Options, but not with the Warrants under Treas. Reg. §1.1275-6, which produces a synthetic nonconvertible debt. The corporation reduces the issue price of the synthetic debt instrument by the premium paid for the Call Options, which produces deductible OID in the amount of that reduction.
- ▶ Taking the Warrants into account, the corporation has created from an economic standpoint, a synthetic high-strike convertible debt.
- ▶ A Capped Call Option is economically similar to the Call Options combined with the Warrants in a single option, rather than separate options. In the case of an integrated Capped Call Option, however, the OID created by the integration would be the equivalent of the net amount paid by the corporation for separate Call Options and Warrants, rather than the full amount paid for the Call Options.

AM 2007-0014

Call Spread Convertibles

- ▶ The IRS lists several criteria supporting its conclusion that the Call Options can be integrated and the Warrants need not be integrated:
 - ▶ The Call Options and the Warrants can be sold by each party separately.
 - ▶ The Warrants expire several months later than the Call Options.
 - ▶ The Call Options are automatically exercised upon conversion of the Convertible Bonds, while the Warrants are European-style.
 - ▶ The Warrants do not refer to the Call Options or to the Convertible Bonds.
 - ▶ Neither the corporation nor the bank has rights of offset with respect to the other party's obligations in any bankruptcy or liquidation proceeding.

Legging Out (Timing)

- ▶ Taxpayer legs out if the (i) §1.1275-6 hedge ceases to meet the requirements for a §1.1275-6 hedge, (ii) taxpayer ceases to meet the requirements for integration, or (iii) taxpayer disposes of or terminates all or part of the qualifying debt instrument or §1.1275-6 hedge.
- ▶ Does the worthlessness of the Call Option or Capped Call Option constitute a legging out transaction? Does the Call Option or Capped Call Option cease to meet the requirements for a §1.1275-6 hedge because it is no longer an effective economic hedge?
- ▶ Is the Call Option or Capped Call Option considered worthless if the counterparty files for bankruptcy?
- ▶ When is the Call Option or Capped Call Option terminated? Counterparty bankruptcy? Bankruptcy of parent of counterparty? Fixed claim in bankruptcy?

Legging Out (Fair Market Value)

- ▶ If Taxpayer legs out of integrated transaction, then deemed termination of the synthetic debt instrument for its fair market value under Treas. Reg. §1.1275-6(d)(2)(ii).
- ▶ What is fair market value for purposes of Treas. Reg. §1.1275-6(d)(2)(ii)?
- ▶ The trading price of the Convertible Bonds less the value of the Call Options taking counterparty credit quality into account or not?
- ▶ The amount paid to retire the Convertible Bonds less amount for which the Call Options settle?
- ▶ Hypothetical FMV of nonconvertible debt with terms similar to that of synthetic debt?

Legging Out (Fair Market Value), cont'd

- ▶ EXAMPLE: Day 1, issuer issues Convertible Bond for \$1,000, buys Call Option from counterparty for \$300, and sells Warrant to counterparty for \$100. Issuer elects to integrate Bond and Call Option, creating synthetic debt instrument with issue price of \$700. Day 2, counterparty files for bankruptcy and Call Option and Warrant terminate under ISDA terms. Issuer has \$300 claim in bankruptcy worth \$25.
- ▶ If FMV is hypothetical value of SDI of \$700, what happens to \$275 economic loss? Disallowed by §1032? Bad debt deduction?
- ▶ If FMV is sum of parts of \$975, excess over adjusted issue price should be deductible as bond repurchase premium.

Legging Out (Bonds Trading at Premium)

- ▶ If Taxpayer legs out of integrated transaction when the FMV of the synthetic debt is greater than the adjusted issue price of the synthetic debt, the Taxpayer would appear to have bond repurchase premium. Can the Taxpayer deduct the bond repurchase premium?
- ▶ What about section 249? Is the synthetic debt a convertible subject to section 249? If it is a Capped Call Convertible then yes. What about other Call Spread Convertibles? What if the potential to pay make-whole shares was unhedged by the Call Options?
- ▶ If the Convertible Bonds remain outstanding after legging out of integrated transaction because, for example, the legging out was caused by counterparty default on the Call Options, what adjustments are made to the Convertible Bonds under Treas. Reg. §1.1275-6(d)(2)(ii)(C) (“adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument”)?

Legging Out (Bonds Trading at Premium), cont'd

- ▶ In the event that the adjustments result in premium on the Convertible Bonds, is that premium includible as an offset to qualified stated interest (“QSI”) as described in Treas. Reg. §1.163-13? What if the Convertible Bonds do not have enough QSI to offset the entire amount of the premium? Does the Taxpayer have ordinary income at maturity?
- ▶ If Taxpayer subsequently pays off the Convertible Bonds early for par, would the Taxpayer have COD income to the extent of the unamortized premium? What if Taxpayer did not get a deduction for the bond repurchase premium that created the adjustment due to section 249?
- ▶ **EXAMPLE:** As a result of the bankruptcy of the Call Option counterparty and resulting termination of the Call Option, integrated instrument terminates at a time when its AIP is \$800 and it has 6 years remaining to maturity. Convertible trades at \$1200 and the hypothetical value of similar straight debt is \$900. Issuer’s claim in counterparty’s bankruptcy has a face value of \$300 but is worth \$25.

Legging Out (Bonds Trading at Premium), cont'd

- ▶ Is issuer's repurchase premium equal to \$100 (reflecting the hypothetical straight debt value of \$900) or \$375 (reflecting the trading price of the Convertible (\$1200) less the FMV of the Call Option claim (\$25))? In either case, is the deduction subject to Section 249? If the repurchase premium is only \$100, what happens to the remaining \$275 economic loss?
- ▶ An "adjustment" of \$200 must be made to the underlying Convertible to reflect the difference between FMV (\$1200) and AIP (\$1000). Does this adjustment create \$200 of bond premium? If so, is the bond premium required to be amortized against interest on the Bond? If it is not required to be amortized, or if the premium exceeds the QSI on the Bond, does the issuer have income at maturity or an earlier retirement?

Legging Out (Bonds Trading at Discount)

- ▶ If Taxpayer legs out of integrated transaction when the FMV of the synthetic debt less than the adjusted issue price of the synthetic debt, the Taxpayer would appear to trigger realization of cancellation of debt (“COD”) income.
- ▶ If the Convertible Bonds remain outstanding after legging out of integrated transaction because, for example, the legging out was caused by counterparty default on the Call Options, what adjustments are made to the Convertible Bonds under Treas. Reg. §1.1275-6(d)(2)(ii)(C) (“adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument”)?
- ▶ In the event that the adjustments result in discount on the Convertible Bonds, is that discount deductible as interest over the remaining term of the Convertible Bonds? Effective yield method?
- ▶ If the discount is deductible over the remaining term of the Convertible Bonds, is it OID? Is it potentially subject to limitation under the applicable high-yield discount (“AHYDO”) rules of sections 163(i) and 163(e)(5)?

Legging Out (Bonds Trading at Discount), cont'd

- ▶ EXAMPLE: As a result of the bankruptcy of the Call Option counterparty and resulting termination of the Call Option, integrated instrument terminates at a time when its adjusted issue price (“AIP”) is \$800 and it has 6 years remaining to maturity. Convertible trades at \$600 and the hypothetical value of similar straight debt is \$500. Issuer’s claim in counterparty’s bankruptcy has a face value of \$100 but is worth \$25.
- ▶ Is issuer’s COD income equal to \$300 (reflecting the hypothetical straight debt value of \$500) or \$225 (reflecting the trading price of the Convertible (\$600) less the FMV of the Call Option claim (\$25))? If issuer has COD income of \$300, what happens to the \$75 loss arising from the counterparty’s bankruptcy?
- ▶ An “adjustment” of \$400 must be made to the underlying Convertible to reflect the difference between FMV (\$600) and AIP (\$1000). Does this create \$400 of OID? Is the Convertible Bond now subject to the AHYDO rules?

Legging Out (Partial or Total)

- ▶ Taxpayer legs out of the “synthetic debt instrument” if (i) §1.1275-6 hedge ceases to meet the requirements for a §1.1275-6 hedge, (ii) taxpayer ceases to meet the requirements for integration, or (iii) taxpayer disposes of or terminates all or part of the qualifying debt instrument or §1.1275-6 hedge.
- ▶ What if the Call Option or Capped Call Option is bought from two different broker/dealers and one dealer defaults but not the other?
- ▶ Does it matter whether or not the identification statement identified each Call Option as hedging each \$1,000 Convertible Bond?