

Non-Plain Vanilla Questions About Taxation of Plain Vanilla Convertible Debt

by Y. Bora Bozkurt

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In this report, Bozkurt explores the tax rules governing plain vanilla convertible debt in the context of common fact patterns and offers practical suggestions for improvement or clarification that better consider the unique economics of convertibles.

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I. Introduction

Convertible debt is exceptionally attractive to investors in volatile markets because it offers the security of a bond with the upside of equity. That is why convertible debt was one of the strongest asset classes during the pandemic. In the early part of 2020, convertible debt constituted the biggest portion of equity fundraising in the financial markets.¹ In May 2021, 97 U.S.-listed companies had issued \$54.3 billion worth of convertible bonds, representing the “highest year-to-date volume ever.”² In fact, the more volatile the equity markets are, the more valuable the conversion option embedded in the convertible debt becomes, and the security would be attractive to investors even if it pays a lower coupon or has a high conversion price. Convertible notes in 28 of the 97 offerings referenced above paid no interest,³ and the average interest rate was 1.41 percent per annum. On average, the initial conversion price of these convertible notes represented a premium of 39 percent over the trading price of the common

¹ Corrie Driebusch, “Cash-Hungry Companies Reach for Lifeline in Convertible Bonds,” *The Wall Street Journal*, Apr. 30, 2020.

² See Maureen Farrell, “Convertible-Bond Sales Are Soaring in 2021 – Often at 0 Percent Interest,” *The Wall Street Journal*, May 28, 2021. See generally Andrew Bary, “Why Companies Like Peloton Are Issuing Convertible Debt on Attractive Terms,” *Barron’s*, Feb. 11, 2021.

³ In fact, as discussed in this report, there have been some issuances in the foreign markets that featured a negative yield, in which convertible notes were sold at a premium with zero coupon.

stock at the time of the offering. Reflecting on the economic terms of these offerings, an industry specialist claimed, “These are the best terms in the history of the market. . . . We’ve never seen anything like this.”⁴ On top of these favorable terms, investment banks are often able to offer hedging products that allow issuers to synthetically increase the conversion price of their convertible notes, limiting potential dilution of their outstanding stock if there are future conversions. As such, issuers of convertible debt are able to reduce their risk of stock dilution while minimizing interest expense and therefore cash outflow.

In light of the staggering increase in the number and amount of convertible debt issuances, having a properly functioning set of rules around the taxation of convertible debt instruments has become critically important. As discussed later, the current system of taxation on convertible debt is built on the questionable foundation that convertible debt should generally be treated as one indivisible debt instrument, with several special rules and exceptions that are intended to address the equity-like nature of the security. However, this premise of indivisible debt treatment subjects these securities to a body of law that was originally not intended for convertible debt, and the accompanying special rules and exceptions are either uncoordinated or difficult to administer in practice, or they swing the pendulum too far in the equity direction. This report explores the tax rules governing convertible debt — in particular, the plain vanilla variety sold widely in the convertible debt market — in the context of common fact patterns, and it offers practical suggestions for improvement or clarification that better consider the unique economics of convertible debt.

As the term is used in this report, a “plain vanilla convertible debt” (1) pays interest (if any) semiannually in cash, (2) is unsecured and often

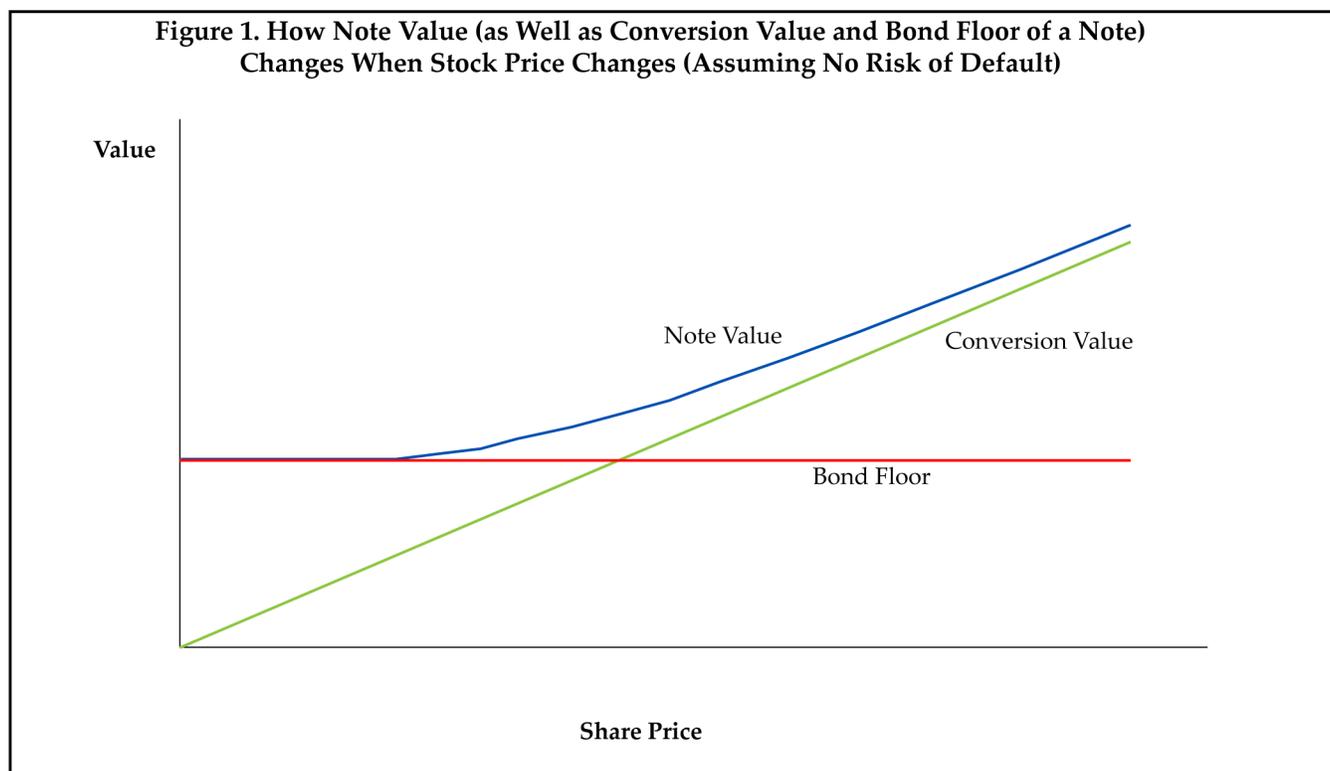
has no subsidiary guarantees,⁵ (3) has an original term of five years or slightly longer, and (4) is convertible or exchangeable into publicly traded stock of the note issuer or its parent at the holder’s option at a fixed conversion rate (subject to adjustment for specific organizational events). Investors are entitled to be paid interest and principal amounts, but if the stock price reaches a level such that the stock price multiplied by the conversion rate exceeds the principal repayment and accrued interest, the investor would choose to convert instead of receiving the principal amount and accrued interest. However, that simplicity belies a complex interaction between the equity aspects and the debt aspects of a convertible debt instrument — both legally and economically — that is difficult to unpack.

In terms of economic rights, convertible debt is often described as a security that represents a unit of a debt instrument and an equity option bundled together. These two components, however, cannot separately exist legally upon settlement of the convertible debt with the issuer. To exercise the option, the investor must relinquish the debt instrument and forgo the interest payments and the guaranteed principal payment. Similarly, if the investor prefers to receive the principal amount (for example, in a situation in which the company offers to buy back the notes) before maturity, the investor must relinquish its rights to the upside of the equity. Further, most convertible debt in the market can be settled entirely or partially in cash, so even if the convertible note is converted, the investor may not receive any shares. Therefore, convertible debt may be thought of as a single security that has an equity-linked return (the conversion option) with a floor (the principal amount) and a periodic yield (the coupon), rather than as a unit consisting of a debt instrument and a conversion option. Nevertheless, viewing convertible debt in terms of its so-called debt and conversion option

⁴Farrell, *supra* note 2.

⁵If the note is issued by a subsidiary of the publicly traded parent entity, the notes may be guaranteed by that parent entity. In some transactions in which the convertible debt is used as acquisition indebtedness, subsidiary-level guarantees may be provided to ensure that the convertible debt is not considered subordinated by virtue of structural subordination and section 279 is therefore inapplicable. See LTR 8337018 and LTR 8336009.

Figure 1. How Note Value (as Well as Conversion Value and Bond Floor of a Note) Changes When Stock Price Changes (Assuming No Risk of Default)

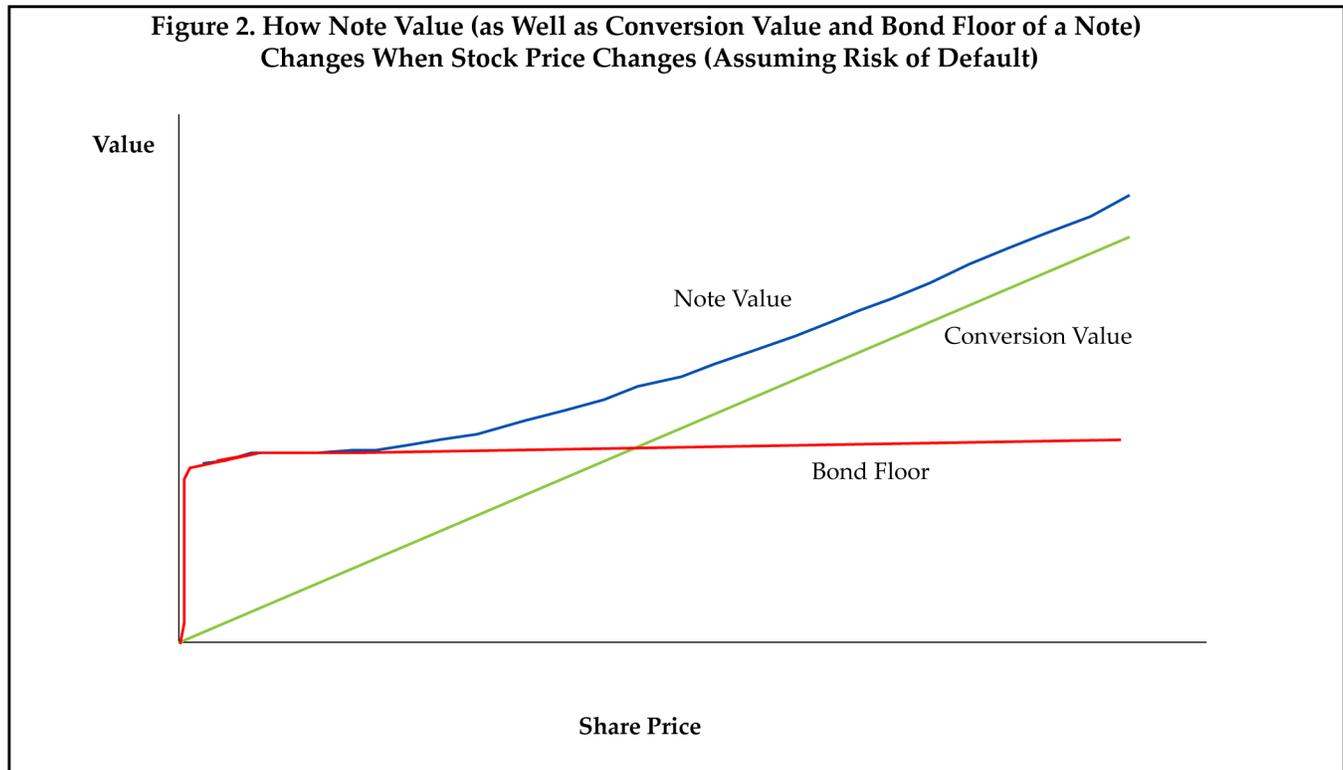


components is helpful in analyzing how market participants ascribe value to convertible debt.

The value that investors ascribe to convertible debt is highly dependent on market conditions. If the issuer's equity has not increased significantly in value since the notes were issued, the main driver of value for convertible debt would be the right to a return of the principal amount. If the equity of the issuer has increased in value significantly since the notes were issued, the value of the convertible debt would be governed largely by the value of the shares to be received upon exercise of the conversion option. Further, even if the equity has not yet increased significantly in value, the value of the convertible debt would benefit from higher volatility of the equity of the issuer or the longer duration of the remaining term of the debt. In sum, the value of convertible debt is a multifactor calculation that requires weighing the value of the principal amount, the value of the equity to be received upon conversion of the option, and the remaining time value of the option.

To illustrate the correlation between the value of convertible debt and market factors, it may be helpful to develop a simplified model⁶ showing, at any given time, the correlation between the value of a plain vanilla convertible note and the stock price graphically (while keeping other variables, such as volatility, fixed). For purposes of this discussion, I refer to the value of a convertible note attributable to its debt features as the bond floor; it reflects the principal repayment and interest payments that an investor is legally entitled to receive regardless of the stock price. Assuming the issuer cannot default on interest or principal payments, at any given time the bond floor would be worth the discounted interest and principal payments of the debt instrument regardless of how well the issuer's stock is performing. The value received upon conversion of the option is the conversion value (as known as intrinsic value) — the amount of share value or its cash equivalent that the investor is entitled to

⁶ A similar model with a more in-depth discussion was originally included in Appendix B of Gregory P. Rodgers and Arash Aminian Baghai, "Demystifying Modern Convertible Notes," Latham & Watkins LLP (Aug. 2019).



receive if the note were converted. The difference between the note value and the conversion value is often referred to as the time value. At lower stock prices, the note's value will approach the bond floor. As stock price increases, the note's value will approach the conversion value as the conversion value overtakes the bond floor. Further, at least in theory, regardless of how high the stock price is, the note value would be expected to exceed the conversion value, even if minimally, as long as a meaningful time to maturity remains. The rationale for this outcome is that an investor would prefer to hold a convertible debt instrument and retain the protection of the bond floor in a potential downturn scenario over receiving the stock early. The remaining coupon payments would also increase the value of convertible debt vis-à-vis conversion value. This interaction is illustrated in Figure 1.

The interaction between the equity trading price and the value of the convertible note discussed above becomes even more complex if we remove the assumption that the issuer cannot default on its obligation to pay the principal and

the coupons. As the trading price of the company's equity approaches zero, the potential of default on the principal amount becomes a more realistic possibility. As such, the investors would begin to assign lower values to the principal protection to take into account the likelihood of possible default. At very low stock prices, the value of debt instruments — particularly debt instruments that are close to the equity in the capital structure — will begin to correlate with the value of equity. This phenomenon is not unique to convertible debt, but it is applicable to debt (in particular, debt that is close to equity in the capital structure) generally. This interaction is illustrated in Figure 2.

In summary, if the trading price of the company's equity is sufficiently high, the value of convertible debt would indeed start correlating more strongly with the trading price of the company's equity. If the option embedded in the convertible debt is in the money, the value of the convertible debt will begin to correlate with the equity into which it is convertible (also known as the conversion value), as it becomes increasingly

likely that the notes will be converted.⁷ Further, similar to other debt instruments, if the trading price of the company's equity is sufficiently low, that low trading price may signal that the company is distressed and potentially unable to pay its obligations, and the value of the convertible will once again begin correlating with the equity.

Fundamentally, from a U.S. tax perspective, convertible debt is generally treated as a single indivisible debt instrument; the tax rules do not bifurcate the convertible debt instrument into a debt instrument and an equity instrument. This treatment dates back to the 1971 decision in *Chock Full o'Nuts*.⁸ Notably, it was a case in which the taxpayer lost — the taxpayer unsuccessfully tried to bifurcate the security into its components and treat the value of the conversion feature as constituting original issue discount on the convertible debt instrument that is deductible over the term of the debt.⁹ The rules enacted after *Chock Full o'Nuts* made sure to take plain vanilla convertible debt out of the contingent payment debt instrument rules, which meant that the receipt of the stock upon conversion was not treated as a contingency, but the implicit premium paid by the investor for the option embedded in a convertible note was ignored in determining the amount of deductible OID.¹⁰ Convertible debt pays materially¹¹ below-market interest rates because of the value of the conversion option

embedded into the instrument. The tax rules, however, limit the interest deductions solely to the actual cash coupon paid by the issuer.¹²

Even though the interest deduction permitted for convertible debt does not take into account the cost of the embedded option, the tax rules include several indications that the government is concerned about the abuse of convertible debt. Section 163(l) and the related legislative history imply that issuers of convertible debt with a conversion feature when the conversion price is not significantly higher than the market price of the stock on the issue date of the debt should not be able to deduct the interest payments under the instrument. Section 385(b)(4) indicates that “convertibility into stock of the corporation” is a factor in favor of equity treatment. As discussed later, the rules that govern the cancellation of debt (COD) income and the deductibility of repurchase premium appear, at least on their face, to apply asymmetrically, requiring issuers to include income in situations in which an issuer of convertible debt experiences income that is attributable to a decrease in equity price or the time value of the option, whereas the rules disallow deductions for losses attributable to an increase in the value of the conversion option.

Further, in situations in which debt treatment would have been preferable for an investor, the tax rules prioritize the equity component embedded in a convertible debt. Convertible debt does not qualify as an “interest solely as a creditor” for purposes of the 1980 Foreign Investment in Real Property Tax Act rules, and therefore investors are subject to potentially adverse tax rules applicable to holders of interests in U.S. real property holding corporations (USRPHCs). The 5 percent small investor exception to FIRPTA taxation, as well as the FIRPTA withholding tax rules, not only fail to make taxpayer-friendly concessions for

⁷ As described later, a common measure of the correlation is “delta.” As the stock price increases, the delta of a convertible note approaches 1 (although, theoretically, not actually reaching 1 unless and until the notes mature in the money). Delta is generally described as the ratio of the change in the fair market value of a derivative instrument to a small change in the FMV of the number of shares of the underlying asset referenced by that derivative instrument. (See, e.g., reg. section 1.871-15(g)(1).)

⁸ *Chock Full o'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971).

⁹ This position is now formalized under reg. section 1.1273-2(j), which indicates that the issue price of a debt instrument includes amounts paid for the embedded option. For an excellent discussion of the history of the taxation of convertible debt, see Lucy W. Farr, “Curves Ahead: Navigating Your Convertible Through the Twists in the Tax Law,” Tax Club (May 16, 2019).

¹⁰ Reg. sections 1.1272-1(e) and 1.1275-4(a)(4).

¹¹ As part of the tax integration analyses, it is common for banks that sell convertible debt hedging products to ascribe an arm's-length cost to an instrument that fully hedges the conversion option embedded in a convertible debt. Taking the value ascribed to those products as a proxy for the value of the conversion option embedded in the convertible debt, the typical decrease in yield resulting from a convertible debt's conversion feature has tended to be approximately 3 to 4 percent in recent years.

¹² Conceptually, taking the position that a convertible debt has OID equal to the value of the conversion option would have probably meant the holder of the convertible debt (assuming it is a U.S. taxable investor) would include OID in income over the course of the security's term. However, the difference in taxation from an investor's perspective appears to be one of timing only (because the investor will eventually pay any taxes it owes, even if it is when the notes mature or settle or the shares received upon conversion are sold) and potentially the character of income (because OID would have constituted ordinary income, whereas the investor might take capital gains on taxable disposition of the notes or shares received upon conversion).

convertible debt, but they are also harsher in some respects than the rules applicable to equity. Similarly, a convertible debt can be an interest in a passive foreign investment company. The PFIC rules apply as harshly, if not more harshly, to the holders of convertible debt than they would if applied to holders of equity interests underlying the conversion option, because taxpayers are not permitted to make mitigating tax elections that are otherwise available to a direct investment in the underlying equity.

This report explores the unique nature of convertible debt by discussing: (1) various scenarios in which the debt treatment of plain vanilla convertible notes is uncertain; (2) the application of specific debt modification rules to convertible debt; (3) the considerations that arise from convertible debt hedging transactions; and (4) the application of FIRPTA and PFIC rules to convertible debt. In the process, this report cultivates an appreciation for the difficulty of designing sensible rules that govern this unique security given its original treatment as an indivisible debt instrument, and it highlights areas in which the existing rules can be improved or clarified to be more easily administrable and balanced in their application.

II. Debt/Equity; Interest Deductibility

Various provisions that apply to convertible debt demonstrate an implicit concern that convertible debt may begin to resemble equity to such a degree that the indivisible debt treatment and the associated benefits (such as deductible interest payments) are no longer appropriate. These provisions lay out criteria to measure the level of the equitylike nature of convertible debt.

For the deductibility of interest payments under convertible debt, the relevant inquiry under section 163(l) relies on whether the convertible debt is “substantially certain” to convert. In the context of section 871(m), whose rules were developed mainly for total return swaps and other non-principal-protected equity derivatives but also apply to convertible debt, the tax rules have looked to the delta of the instrument to determine whether specific adjustments or payments under the instrument should be treated as U.S.-source dividend income and raise U.S. withholding considerations. In yet

other contexts — provisions that focus on the unconditional promise of return of the lender’s investment and are intended for straight (nonconvertible) debt — the tax rules have treated instruments issued at a significant premium as violating the requirement that a debt instrument promise to pay a sum certain and as signaling an equitylike nature.

For plain vanilla convertible debt, the application of any of the foregoing standards is difficult and likely to lead to arbitrary results. The situations under which plain vanilla convertible debt resembles equity typically arise from circumstances attributable to postpricing or post-issuance changes in equity market conditions or the financial condition of the issuer that are independent of the terms of the debt. Given the original premise that convertible debt is treated as debt for federal income tax purposes, and given that it is a natural result of the convertible debt’s economics to correlate with equity value upon changes in market conditions, the sensible approach is for convertible debt to retain its debt status notwithstanding such changes after the original pricing of the debt.

A. 163(l) and Certainty of Conversion

Under section 163(l), interest payments on a convertible note are not deductible if there is substantial certainty that the conversion option will be exercised. The policy underpinning this rule is not clear.¹³ The main hint to its practical application is in the legislative history to section 163(l), which indicates, “It is not expected that the provision will affect debt with a conversion

feature where the conversion price is *significantly* higher than the market price of the stock on the

¹³ Some commentators observe that the section 163(l) rule may be justified in light of the principles of section 1032. However, the coupon embedded in a plain vanilla convertible note is fixed, and it therefore has no correlation to the value of the call option embedded in the convertible note. As such, the application of section 1032 principles to payments that have no relation to the value of the underlying equity may not be entirely justified. See generally Andrew R. Walker, Eileen M. Marshall, and David R. Gerson, “More From the Abyss of Debt and Equity,” Proceedings of 63rd Annual Institute on Federal Taxation, at section 7.07, parts [5][b] and [5] (2005).

issue date of the debt” (emphasis added).¹⁴ The ambiguity of what “significantly” means has been observed by many.¹⁵ However, a straightforward reading of the rule and the legislative history indicates that there is a deductibility concern for convertible notes issued with a smaller amount of conversion premium. For securities law reasons, the initial conversion price is often already required to be set at least 10 percent above the trading price of the underlying shares.¹⁶ However, it is not clear whether that 10 percent differential between the trading price and conversion price measured on the pricing date¹⁷ is in all cases significant enough (or even necessary in the first place) or whether the rules require a higher amount of conversion premium. In some situations, the tax analysis can look to the financial experts to prepare models predicting the likelihood of conversion. While these models often estimate a low likelihood of conversion that few would argue rises to substantial certainty, the extent to which those models would be sufficient to fulfill the requirements of section 163(l) is not clear.

In the context of plain vanilla convertible debt issued with a conversion premium, expecting issuers to undertake any type of rigorous analysis to ensure there is no substantial certainty that their notes will be converted is a difficult requirement. Even if the price of the stock increases sufficiently for the conversion to be

allowed under the terms of the instrument, investors in convertible debt do not normally convert their notes as soon as the trading price of the shares exceeds the conversion price. In fact, asking whether a note is substantially certain to convert is tantamount to asking whether the notes will end up in the money at maturity (which is often at or over five years from issue date). That is because, regardless of where the stock price is at any point, the conversion decision would generally be made at maturity.¹⁸ Requiring a tax attorney — or for that matter, even a financial expert — to determine whether it is substantially certain that the stock price of the company will be at or above a specific limit price in a number of years would not be possible in practice without a clear and practical definition of substantial certainty.¹⁹

Section 163(l) is not the only instance in which the tax rules face the question of when options should be treated as exercised.²⁰ In the S corporation context, regulations analyze whether options should be treated as exercised (and thereby constituting a second class of stock) for purposes of the S corporation single class of stock requirement.²¹ Further, in the context of section 1504, regulations analyze whether options should be treated as exercised (and thereby potentially

¹⁴ H.R. Rep. No. 105-148, at 458 (1997).

¹⁵ See Marshall, “Practical Run-Ins Between Conventional Convertible Debt Instruments and Certain Interest Disallowance Provisions of the Code,” *Taxation of Financial Products and Transactions*, at 38 (2008); and Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocup, *Mergers, Acquisitions, and Buyouts*, at para. 1306.3.4 (2021).

¹⁶ Most plain vanilla convertible debt is initially issued under rule 144A of the Securities Act of 1933, which requires the initial conversion price of the convertible notes to be at least 10 percent above the trading price of the underlying shares.

¹⁷ The section 163(l) legislative history excerpted above refers to conversion price being significantly higher than market price on the issue date (which is typically interpreted as the closing date of the offering). It is therefore theoretically possible that as a result of fluctuations in share price between the pricing date and the closing date (which is typically a few business days), a convertible note is issued in the money. In similar contexts, the IRS has permitted the tax analysis to be conducted as of the time of pricing. See, e.g., reg. section 1.871-15(g)(2)(ii). On that basis, it would make sense to ignore the fluctuations in trading price between the pricing date and the settlement date, at least in situations in which the pricing and settlement are not more than a couple business days apart. See *infra* note 30.

¹⁸ A fundamental, albeit surprisingly complicated, point to understand is that a rational investor would not choose to convert its notes early, even if the stock’s trading price exceeds the conversion price during the life of the instrument (except in unusual circumstances, such as when a change-of-control event occurs, the issuer pays a significant dividend that is not appropriately compensated for under the terms of the convertible notes, or the cost of stock borrowing is sufficiently high). A holder of the notes would rather hold onto them (or, if it really needs liquidity, sell the notes in the market) than convert them early and extinguish the time value. Further, an early conversion would mean the investor is giving up its future coupons.

¹⁹ The analysis here resembles the “substantially certain” analysis under section 1259. In that context, Congress acknowledged that the sale of an at-the-money call option does not trigger a constructive sale. See S. Rep. No. 105-33, at 126 (1997); see generally David Schizer, “Constructive Sales Under Section 1259, How Perfect Must the Hedge Be?” in *Financial Instruments: Special Rules*, BNA Portfolio 186-2nd. Needless to say, everything else equal, an at-the-money option is more likely to be exercised than an out-of-the-money option featured in typical convertible notes.

²⁰ See generally Ginsburg, Levin, and Rocup, *supra* note 15, at para. 1306.3.4.

²¹ Reg. section 1.1361-1(l)(4)(iii).

threatening affiliated entity status).²² Notably, not only does neither of these regulations require the conversion price to be significantly higher than the market price of the stock at the time of issuance, but they also both contain exceptions for stock options that are not more than 10 percent in the money.²³ Perhaps more importantly, the section 1504 regulations contain an exception for publicly traded options, under the rationale that their sales “ordinarily do not have an abuse potential.”²⁴ While this “publicly traded” safe harbor would not appear, as drafted, to address the over-the-counter markets that plain vanilla convertible notes typically trade on, the rationale of the rule appears to apply to the facts of convertible notes.²⁵ Plain vanilla convertible debt is typically sold to investors that are interested in their unique economics, rather than investors that are simply looking to acquire stock, especially given that these notes are issued by companies whose stock is already publicly available on the stock market.

In sum, for any plain vanilla convertible debt offering in the market that is consistent with market standards, it should be possible to generally assume — regardless of whether the conversion price significantly or slightly exceeds the trading price at issuance — that there will be no substantial certainty that the conversion option will be exercised within the meaning of section 163(l).²⁶ Additional guidance that expands the section 163(l) relief under the legislative history to plain vanilla convertible debt more broadly

would be helpful to give taxpayers certainty in this regard.

B. Debt/Equity Analysis

Absent special circumstances, plain vanilla convertible debt issued in the market is issued at par²⁷ with an initial conversion price that exceeds the trading price of the stock at the time of issuance.²⁸ However, after issuance, because of increases in the trading price (which would increase the intrinsic value of the conversion option) or the volatility of the stock (which would increase the time value of the conversion option), this convertible debt can commonly begin trading at a substantial premium above par. The general view is that debt/equity status is measured only once, at original issuance. So a plain vanilla convertible debt that trades at a substantial premium above par or whose built-in conversion option becomes in the money would not suddenly become equity for federal income tax purposes solely because of the changes in value or volatility of the stock into which it is convertible. For the sake of completeness, the same approach should generally apply to section 163(l) as well — that is, the application of section 163(l) is typically ascertained only at original issuance.²⁹

A question around debt/equity status (or relatedly, around the application of section 163(l)) could still arise, however, in several special fact patterns that involve plain vanilla convertible debt instruments. For example, the convertible debt could undergo a deemed exchange when trading at a high premium above par. Or the

²² Reg. section 1.1504-4.

²³ Reg. sections 1.1361-1(l)(4)(iii) and 1.1504-4(g)(3)(i)(A).

²⁴ Preamble to CO-152-84, 57 F.R. 7340 (Mar. 2, 1992).

²⁵ The “publicly traded” safe harbor under the section 1504 regulations contains an antiabuse rule for transactions motivated by a principal purpose of avoiding the application of section 1504 rules. That purpose is inferred when (1) an exercise price or conversion or exchange premium is materially less than, or a term to maturity is materially longer than, those customary for publicly traded instruments of their type; or (2) when a large percentage of an issuance is placed with one investor and a very small percentage is traded. The plain vanilla convertible debt issuances in the market would not normally fit within those facts.

²⁶ Further, as discussed in Section II.C, an alternative reading would encourage issuers to issue their convertible debt with a higher conversion price, which would mean the notes have to pay a higher coupon to clear the market at par. In a sense, that alternative reading would mean the government would be encouraging issuers to pay a higher coupon to ensure the coupon is deductible.

²⁷ An exception to this practice may be some convertible debt offerings that are structured as “bought” deals, in which the underwriter agrees to sell the convertible debt with pre-agreed terms on a firm commitment basis. In those deals, the notes are issued at prices other than at par in some instances. In some limited cases, convertible notes with 0 percent coupons are also priced at a premium. See Section II.C.

²⁸ As discussed, it is theoretically possible for a plain vanilla convertible note to be issued in the money, even if it is priced at a significant conversion premium, as the result of an increase in stock price between the pricing date and closing date. This is because the conversion price is determined on the pricing date, typically scheduled several business days before the settlement of the notes. It is common and reasonable to look to the conversion premium on the pricing date. See *supra* note 17.

²⁹ Although that statutory language of section 163(l) is silent on this point, the legislative history analyzed in Section II.A indicates that “it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt” (emphasis added). See also Ginsburg, Levin, and Rocard, *supra* note 15, at para. 1306.3.4.

issuer may want to issue additional notes intended to be fungible with already outstanding convertible debt (a tack-on) that is trading at a high premium. Alternatively, the investor may have agreed to purchase the convertible notes at a conversion price that is set at a substantial premium to the trading price of the common stock at the time of agreement, but the terms of the note were agreed to long before issuance, such that the notes are in the money when they are issued.³⁰ Even though the legal form of the instrument remains debt, the instrument will have principal protection as well as default remedies, and it will lack any of the traditional stockholder rights. If the value of the security is largely driven by its equity features at the time of issuance or deemed reissuance, are the debt features of the instrument sufficient to continue to treat the instrument as debt for federal income tax purposes? Or could that convertible debt be treated as equity for federal income tax purposes?³¹

While the concern is easy to articulate, it is difficult to come up with an administrable standard to distinguish convertible debt instruments that should be treated as debt from convertible debt instruments that have crossed the line into equity territory. There are a few possible frameworks that can be potential criteria in drawing such a distinction for debt/equity status.

One could argue that a debt/equity concern arises if, at the time of issuance or deemed reissuance, the notes are trading at a substantial amount of premium to par. The argument would be that a debt instrument has to pay a sum certain, and an instrument deemed issued at, for example, 150 percent and that promises a principal repayment at 100 percent at maturity (or, in other words, two-thirds of an investor's investment) is

³⁰ While rare, such fact patterns could arise — for example, when the convertible debt is issued in acquisition financing, with terms committed significantly ahead of time, as was the case in some recent so-called de-SPAC transactions. Or the convertible debt could be issued in connection with a restructuring plan, under which the terms are set long before they are issued. Those convertible notes are most often non-plain-vanilla convertible debt.

³¹ See section 385(b)(4) (listing “convertibility into the stock of the corporation” as a factor in determining whether an interest is stock or debt); see also Farr, *supra* note 9 (“In particular, debt with an unusual or outside conversion right can be characterized as equity. The dividing line between debt and equity generally appears to be based on the likelihood of conversion.”).

not a debt instrument. Notably, in some nonconvertible debt contexts, 10 percent risk of loss of principal is seen as a rule of thumb in determining whether an instrument is debt or equity for federal income tax purposes.³²

Under that view, one could argue that any convertible debt issued at above 110 percent would be at substantial risk of equity treatment. This rule could be considered sensible in the context of a nonconvertible debt instrument because such an instrument issued at a premium more than 10 percent over the expected coupon most likely indicates an unusual (and possibly suspect) economic arrangement. However, a 10 percent trading premium could commonly arise in the context of convertible debt. As such, this type of rule of thumb is probably too inflexible and not reflective of economic realities for a convertible debt instrument.

One could argue that the debt/equity concern arises if the convertible note is highly likely to convert, which is an aspect the government has previously focused on in analyzing convertible instruments.³³ If likelihood of conversion were the correct metric, it may be appropriate to look to the substantial-certainty-of-conversion test of section

³² See David C. Garlock et al., *Federal Income Taxation of Debt Instruments*, at para. 102 (2021) (“Practitioners are generally comfortable that an instrument that promises a sum certain of at least 90 percent of the issue price will not fail to qualify as debt on this ground, but the level of confidence drops off rapidly as the percentage decreases. For example, most practitioners do not believe certain commodities-linked notes regulated investment companies purchase are debt, given that the ‘principal’ returned could be as low as 55-70 percent of the original investment.”).

³³ Rev. Rul. 83-98, 1983-2 C.B. 40, was the key authority in which the government concluded that adjustable-rate convertible notes (ARCNs) are treated as stock for federal income tax purposes. Each ARCN was sold at a price of \$1,000, promised a principal payment of only \$600, was convertible into 20 shares when the stock price at issuance was \$50, and allowed an issuer to call the note at \$600 starting with the second year. In other words, unless the stock price fell by 40 percent, from \$50 to \$30, the notes were mostly likely going to be forced to convert at the end of two years. On top of everything, the interest payments on the ARCNs were set by reference to the common stock as equal to the dividend paid on common stock plus a fixed margin. These features do not occur in the plain vanilla convertible notes that are the subject of this report.

163(l) to determine the likelihood sufficient for the notes to be treated as equity.³⁴ After all, treatment of the convertible notes as equity would have more comprehensive tax consequences than the consequences under section 163(l), which solely pertains to deductibility of interest and arguably implies that the instrument is otherwise properly characterized as debt. As discussed earlier, under most circumstances, swings in stock prices generally cannot be ruled out with any meaningful time remaining to maturity of the convertible note, and therefore, it would be difficult to conclude that conversion is substantially certain to happen. That argument would often hold true even if the conversion option were in the money at the time of issuance, because the stock could lose its value.

One could also argue that the debt/equity concern arises if the value of the convertible note starts highly correlating with the stock price. If that is the inquiry, delta stands out as a potential candidate as a criterion. As discussed, delta is the change in the price of a security or a financial instrument based on an incremental change in the stock price referenced by the security. It is a metric widely used by market participants. For instance, arbitrage investors of convertible debt regularly measure delta in setting their hedge positions because delta also indicates the amount of stock that the note investor has to sell short to theoretically eliminate its exposure to stock price movements. So if the investor holds a \$1,000 note convertible into 30 shares, and if the stock price were to increase by \$1, and the value of the notes would be expected to go up by \$15, delta would be 0.5. If the investor wants net zero exposure to equity movements, it will need to short 15 shares

(that is, borrow from stock lenders 15 shares and sell those 15 shares into the market). At sufficiently high stock prices³⁵ with time left to maturity, delta of the option embedded in convertible debt will (asymptotically) approximate 1, but it will generally not equal 1.³⁶ With that said, accepting delta as the indicator of equitylikeness may produce concerning results. Delta is a snapshot that will change over time based on the market conditions at measurement. Delta is sensitive to all the inputs to valuation, including stock price, volatility, and time to maturity. And to be sure, a convertible note can have a very valuable option, and therefore a high delta, even when it is relatively uncertain whether the note will be converted.

The difficulty in coming up with an administrable standard to test the debt/equity nature of convertible debt prompts the question of whether we should be concerned about debt/equity characterization in these special fact patterns in the first place.

The government has already expressed reluctance to revisit the debt/equity status of a debt instrument in the context of a significant modification. The rules under reg. section 1.1001-3(f)(7) provide that, except under limited circumstances, the deterioration in the financial condition of the issuer does not result in a debt instrument being treated as equity for federal income tax purposes. In a sense, that rationale can be extended to conclude that the government has acknowledged that the correlation that arises between a convertible debt instrument and the

³⁴ For further background, see Walker, Marshall, and Gerson, *supra* note 13, at section 7.07, part [5]. Also, legislative history indicates that section 163(l) is not intended to change debt/equity analysis of convertible debt instruments. H.R. Rep. No. 105-220, at 524 (1997) (Conf. Rep.) (“The House bill is not intended to affect the characterization of instruments as debt or equity under present law; and no inference is intended as to the treatment of any instrument under present law.”). With that said, if debt/equity determination were to be predicated on likelihood of conversion, it would be incongruous to have a debt instrument not subject to section 163(l) be treated as equity under general tax principles.

³⁵ Interestingly, if the convertible note issuer is distressed, it is possible for the delta of the convertible debt, within the nontax meaning of the term, to be higher than 1. In other words, at low enough stock prices, in this example, \$1 of stock price movement can move the price of the convertible debt by more than \$30. That phenomenon arises because under those market conditions, the value of the debt component of the convertible note would also have a delta (*i.e.*, start correlating strongly with stock prices). For U.S. tax purposes, however, the definition of delta under section 871(m) specifically requires the delta of an equity derivative embedded in a debt instrument to be determined without taking into account the changes in the market value of the debt instrument. See reg. section 1.871-15(g)(1).

³⁶ The increase in stock price will cause the conversion value to increase, and in fact there will effectively be a one-to-one relationship between the stock price and the conversion value. However, the rise in the stock price will cause time value to decrease (because although time value is low but still positive at high stock prices, it will tend to approach zero as the stock price appreciates further and the valuation of the instrument begins to become indistinguishable from the valuation of the equity into which it is convertible). Conceptually, it is this decrease in time value that causes the delta to be less than 1 before maturity.

company's equity resulting from an extreme decrease in stock price should not result in debt/equity concerns. Further, under reg. section 1.1001-3(c)(2)(ii), an alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification unless the alteration occurs in accordance with a holder's option under the terms of the instrument to convert the instrument into equity of the issuer. There is an argument that while this rule was originally intended to clarify that a holder's plain vanilla conversion of notes into shares is not a taxable event, the rule also creates an inference that an option to convert under the terms of the convertible debt instrument, even if it is deep in the money, should not result in equity treatment.

It is not difficult to envision a set of extreme facts in which the delta of the conversion option is close to 1 and the likelihood of conversion is extremely high. For example, consider a situation in which the notes are deeply in the money, the stock has low volatility, and the time to maturity is very short, and the company proceeds to issue notes in the form of a tack-on or to an investor that had an existing commitment. Can one not say any instrument issued or deemed issued under those circumstances should be treated as equity? In the market for plain vanilla convertible debt, a real-life scenario in which an issuer wants to undertake a transaction under those market conditions would seem unlikely or indicative of some other arrangement not squarely within the terms of the notes. Consider a scenario in which the company is looking to issue a tack-on under those market conditions. If the issuer is effectively certain that any tack-on notes that it issues are going to convert, and that is the intent of the parties from the inception, it would be surprising if the issuer or investors still opted for a convertible note offering over a straightforward common stock offering. Likewise, if the notes undergo a significant modification under those market conditions, it does not seem sensible to penalize the issuers or investors by requiring

them to start treating the notes as anything other than debt.³⁷ Further, from a federal income tax perspective, the main downsides of equity treatment are that the coupon is no longer deductible and the relatively more generous exemptions afforded to interest withholding tax are no longer available.³⁸ However, if the notes are sold at a high premium to par, the coupon will likely be a minor amount compared with the value of the security, and under section 249, the issuer already cannot deduct premium attributable to the conversion option. Whatever the exact rationale, it is also telling that the government has chosen not to apply the new section 871(m) regulations (at least until 2023) in most situations in which delta is less than 1.³⁹ As such, for a security like convertible debt that generally has a delta of less than 1, an argument can be made that the concern around equity-like treatment is low enough — or alternatively, the complexity of coming up with administrable rules is substantial enough — to the point of being ignored. In sum, barring an abusive fact pattern, debt/equity concerns should be cast aside for customary transactions involving plain vanilla convertible debt instruments prevalent in the market.

C. Negative Yield Convertibles

As mentioned previously, absent special circumstances,⁴⁰ plain vanilla convertible debt in the market is structured to be issued at par at the time of its original issuance. Parties structuring the terms of the convertible debt typically adjust

³⁷ In particular, this equity recharacterization may raise complications in transactions involving issuers of convertible debt that are intended to be structured as tax-free reorganizations. The specifics of those complications are beyond the scope of this report.

³⁸ A major downside of equity treatment for a tack-on offering is that the additional notes would not be tax-fungible with the outstanding notes for federal income tax purposes. The outstanding notes would be treated as proper debt, and the tack-on notes cannot trade together with the outstanding notes if they are treated as equity. It is not clear whether the existing qualified reopening rules under reg. section 1.1275-2(k) would be of any help since they presumably apply only to debt instruments. Notably, the rationale behind the qualified reopening regulations is the different tax treatment of OID and market discount and the potential abuses that can result therefrom. Because the notes in this context would be issued at a premium to par, the original rationale behind the qualified reopening regulations would not be relevant.

³⁹ Treating a delta 1 instrument as equitylike is also in line with private letter rulings that treated penny warrants as equity for U.S. tax purposes. See, e.g., LTR 9747021.

⁴⁰ See *supra* note 27 for examples of these special circumstances.

the coupon and the conversion price of the security to clear the market at par. Assuming that par price, a higher conversion price would clear the market at a higher coupon, and a lower conversion price would clear at a lower coupon. As discussed previously, tax rules not only do not discourage an issuer from attaining a higher coupon by setting a higher conversion price, but rather, under section 163(l), the IRS threatens the deductibility of interest for convertible debt that has a comparatively lower conversion price (and hence lower coupon). In a sense, the rules encourage issuers to charge a higher coupon to ensure the coupon is deductible.

Unfortunately, the conversion price can be only so high for convertible debt to remain attractive to investors. The current low-interest environment coupled with the volatility of the stock market (which in turn increases the value of equity options) have created market conditions in which many convertible notes are priced with a 0 percent coupon at par. In the foreign markets, some convertible debts, perhaps surprisingly, have been priced with a negative yield because they had to be sold at a premium with a 0 percent coupon,⁴¹ and it is possible there are or will be such issuances in the U.S. market as well. Say convertible debt is issued at 103 percent at original issuance and a 0 percent coupon. What happens to that 3 percent at redemption if the notes do not convert and are redeemed at par? As discussed in further length later in this report, given the absence of a special rule under section 108 governing convertible debt, and given the general rule under reg. section 1.163-13(d)(4)(ii) that indicates any unamortized premium is taken into income at retirement of a debt instrument, it would appear that the 3 percent premium would result in income at maturity or upon redemption at par.

This result arguably fits within the framework of the indivisible debt treatment under *Chock Full o'Nuts*. The tax rules do not allow any interest

deductions to an issuer that manages to decrease the yield it pays — say, from 3 percent to 0 percent, by adding a conversion feature. As such, it would then make sense that an issuer that manages to decrease the yield it pays — say, from 0 percent to -3 percent, by adding a conversion feature — be treated as having taxable income. However, taking this argument one step further, because interest deductions are to be computed without regard to the equity component, the tax rules should arguably also allow any repurchase premium to be deductible regardless of whether it is attributable to the conversion option. However, that deduction is generally not allowed under section 249. In a sense, under current law, the issuer is implicitly including in income the cost of the conversion option (by taking lower interest deductions than inherent in the debt component), but at settlement, if the issuer loses money on the option, it is not entitled to take a loss on the same transaction. As such, it appears difficult to reconcile the result under section 249 with the unitary debt treatment envisioned under *Chock Full o'Nuts*.

Ultimately, if section 249 is to remain a part of the system of the tax rules governing convertible debt, it would at least make sense to have a mirror exclusion under section 249 (or perhaps under section 108 or reg. section 1.163-13(d)) for any income arising at retirement and attributable to a note's conversion feature.⁴² This approach is not without precedent — section 1032 requires issuers to exclude both gain and loss on their equity transactions. More specifically, in the fact pattern discussed above, given that the market interest rates are not negative, any premium and the resulting negative yield of a convertible debt would appear to be a product of the equity nature of convertible debt. If the convertible debt is retired at maturity at a price of par, given that the value of the embedded option in a situation in which holders choose not to convert is by definition zero, the 3 percent income would be

⁴¹ See Fiona Lau, "Xiaomi Makes HK Tech Dream Real," *International Finance Review*, Dec. 4, 2020 ("Xiaomi also priced the \$855 million zero-coupon [convertible bond], which was issued at a price of \$105.25, at aggressive terms. The [convertible bond] was sold at a negative yield-to-put of -1.021 percent and a negative yield to maturity of -0.73 percent. The conversion premium was set at 55 percent, above the indicative range of 42.5 percent to 52.5 percent.").

⁴² This concern around COD income in connection with convertible debt is magnified in the context of convertible debt deemed reissued when trading at a premium upon a deemed exchange or upon the leg-out of a tax-integrated hedging instrument, as further discussed in Section III.D and at the end of Section IV.A.

excluded because it would be entirely attributable to the note's conversion feature.⁴³

III. Modifications of Convertibles

The treatment of convertible debt as debt for federal income tax purposes produces unusual results when the typical rules that govern deemed exchanges of debt are applied to plain vanilla convertible debt. Such convertible debt can often trade at a significant premium over the course of its life because its value is strongly tied to the underlying stock price and volatility. Therefore, the existing deemed exchange rules, in particular the rules around yield change deemed exchange, are not well equipped to handle circumstances in which the convertible debt is trading at a significant premium and especially if the convertible debt is deemed reissued at a significant amount of premium. Further, there is an inherent lack of clarity about how the change in the conversion option would be analyzed as a deemed exchange within the framework of the rules governing deemed exchanges of debt instruments.

A. Yield Change Test Generally

Reg. section 1.1001-3 is intended to measure the economic significance of amendments to the terms of a debt instrument, and the yield change deemed exchange test is intended to create a workable framework to evaluate economic significance. The unspoken premise of these rules is that interest yield is a fundamental economic term of debt, the change in which indicates a significant modification of the instrument. Under these rules, a yield change triggers a deemed exchange if it triggers a change in yield by more than the greater of 25 basis points or 5 percent of existing yield. Most convertible notes in the

market are issued at par and have coupons that are significantly less than 5 percent.⁴⁴ So assuming the existing yield change deemed exchange debt test is the relevant framework for determining the significance of a change to the yield of convertible debt, for most such debt, the yield change deemed exchange threshold would appear to be 25 basis points.

It is worth observing the oddity of running the yield change deemed exchange test based on the yield of a debt instrument that has an artificially reduced cash coupon because of its embedded call option. It may also be argued that the interest yield is only a small portion of the overall economic yield on a convertible that the parties expect to realize. One therefore could advocate applying the reg. section 1.1001-3 rules by backing out the value of the conversion option entirely from the issue price and looking at the yield of the nonconvertible debt instrument. This approach could be inspired by the comparable yield approach under the contingent payment debt instrument rules⁴⁵ or the approach of reg. sections 1.163-13(c) and 1.171-1(e)(1)(iii), which requires that the value of the conversion right be subtracted in determining the issue price (albeit only for purposes of determining the bond premium in calculating the holder's interest income and the issuer's interest deductions).⁴⁶ However, there is no comparable analogous rule in the context of reg. section 1.1001-3, and that approach may appear at odds with the long-

⁴⁴ In fact, as noted earlier, countless convertible debt instruments are issued at coupons below the applicable federal rate, and many are now issued with 0 percent coupon rates. Those low coupons are not attributable to a non-arm's-length arrangement or a disguised dividend but rather to the value of the built-in conversion option. Therefore, debt/equity concerns or section 7872 concerns should not arise from the mere fact that the notes pay coupons that are less than the applicable federal rate (or no coupon whatsoever). See also Farr, *supra* note 9, at n.4.

⁴⁵ The IRS has acknowledged the possibility of running the yield change deemed exchange test based on comparable yield for contingent payment debt instruments. See LTR 201431003. If plain vanilla convertible debt were treated as a contingent payment debt instrument, taxpayers could have been able to rely on that letter ruling to argue that the yield change deemed exchange calculations should be run using comparable yield, which would effectively account for the yield stemming from the conversion option.

⁴⁶ As observed by other commentators, the approach under these regulations is extreme in that they subtract the full conversion value — not just the differential in the value of the embedded call option above the value of the option at issuance — in determining the amount of amortizable bond premium. As such, these rules effectively prevent a convertible note from having an amortizable bond premium altogether even if the premium arises from changes in interest rates. See Farr, *supra* note 9, at 7, n.7.

⁴³ If the same note is retired at par before maturity (*e.g.*, through an open market repurchase), it is hypothetically possible a portion of the resulting income is attributable to an increase in the interest rates (instead of a decrease in the value of the conversion feature). Therefore, similar to section 249, any rule providing for an exclusion from income in this fact pattern would ideally have an exception for any income resulting from a decrease in note value attributable to the cost of borrowing.

standing practice of treating a convertible debt as a single debt instrument.

Another interesting point is that the yield change deemed exchange calculations are done by reference to the original issue price. Therefore, even if a convertible debt is, say, trading at 200 percent of its face value, the payment of a relatively tiny consent fee or a minor coupon change could trigger a deemed exchange, even though, for the parties to the note, those amounts have become irrelevant to the economics of the overall investment under the circumstances.⁴⁷ Although the same concern technically exists for straight debt as well, convertible debt, because of its equity-linked economics, is far more prone to trading with significantly larger amounts of premium. Again, reg. section 1.1001-3 does not provide any indication that the trading price of convertible debt at the time of amendment can be taken into account in yield change deemed exchange determinations.

B. Yield Change Test After Reissuance

Consider convertible debt that undergoes a deemed exchange while it is trading at a significant premium. From the date of that deemed exchange onward, the convertible debt would have an issue price that reflects a material amount of premium and therefore, potentially, a negative yield. If that same convertible debt is amended again, how would the yield change deemed exchange test even apply to that fact pattern?

Example 1: A convertible debt undergoes a significant modification and a deemed reissuance when trading at 200 percent, with a five-year remaining term and a 1 percent coupon (payable semiannually). One year later the convertible debt is amended again to effectuate a *de minimis* increase in coupon (for example, 0.01 percent).

Under the existing rules, it would appear that both the unmodified yield and the modified yield have to be calculated using an issue price of 200 percent.⁴⁸ This approach would lead to an unusual result. The debt instrument would have a negative unmodified yield, and the modified yield would get even more negative merely as a result of the passage of time. In Example 1, based on yield calculations, the original yield would correspond to -12.7 percent and the modified yield would correspond to -15.9 percent. Thus it would appear that there has been a material change in yield.

This result does not seem sensible. The change in yield in this example would arise merely because the premium is not being amortized.⁴⁹ A more appropriate approach would be to calculate the unmodified yield using an issue price of 200 percent but calculate the modified yield after amortizing the premium. This approach is better at least in the sense that the passage of time alone would not change the yield. Another approach could be to ignore the premium entirely. For purposes of the calculations, the unmodified yield would be 1 percent and the modified yield would be 1.01 percent. These alternative approaches would at least prevent a situation in which any alteration would trigger recognition of the change in yield of a convertible debt instrument that has occurred because of the passage of time.

A related question would be how to calculate the yield change deemed exchange threshold. A debt instrument undergoes a yield change deemed exchange when its yield changes by more than the greater of 25 basis points or 5 percent of the yield of the unmodified instrument. It is again unclear whether the “greater of” language would mean the threshold is automatically 25 basis points in cases in which the yield is negative. The literal reading of the regulation would imply that

⁴⁷ Another interesting question could arise if the issuer of the convertible debt has entered into a tax-integrated call spread overlay (either in the form of a unitary tax-integrated capped call or a bifurcated bond hedge/warrant structure in which only the bond hedge is integrated). It is not clear whether the yield change deemed exchange would be applied by reference to the yield of the synthetic (*i.e.*, integrated) debt instrument, which will often have a significantly higher yield than the coupon of the convertible note. See pages 54-56 of Marcy G. Geller and Marshall, “A User’s Guide to Call Spread Convertibles,” *Taxation of Financial Products and Transactions* (2009).

⁴⁸ The issue price would remain fixed at 200 percent because reg. section 1.163-13(c) would disallow the issuer from offsetting its coupon deductions with the premium.

⁴⁹ New York State Bar Association members wrote a commentary letter observing a similar phenomenon for the application of the yield change deemed exchange test to debt instruments issued with *de minimis* OID. Even though *de minimis* OID is not deductible, the letter recommends that the OID be accrued or ignored entirely for purposes of the yield change deemed exchange calculations. Otherwise, once again, the yield of the instrument would similarly change simply by the passage of time. NYSBA Tax Section, “Effect of *De Minimis* OID Under Reg. Section 1.1001-3(e)(2)” (Dec. 22, 2010).

the threshold should be 25 basis points, because 5 percent of a negative yield is technically lower than 25 basis points, taken as a positive number.

On the other hand, because the regulation is focused on change in yield (which can be a reduction or increase), one could argue that 25 basis points signifies a quantum rather than a positive number. In that case, under some circumstances 5 percent of yield might be a relevant threshold (that is, in Example 1, 5 percent of 12.7 percent). Needless to say, none of the approaches is entirely workable but they are attempts to come up with an appropriate result for a security whose economics are materially different from a typical debt instrument that presupposes positive compensation for the time value of money.

C. Changes in Conversion Option

The most common way a change in the conversion option occurs is through an acquisition or other change-of-control transaction. Most convertible debt tax disclosures in the market include a warning that changes in conversion consideration resulting from an acquisition or other change-of-control event could trigger a significant modification. It is questionable whether that disclosure is warranted and whether a typical change-of-control transaction can indeed trigger a deemed exchange.

Convertible debt in the market contains specific provisions that govern the consequences of the issuer of a convertible debt instrument being acquired by another company:

- If the issuer is acquired by another company, the notes, by operation of their terms, become convertible or exchangeable into the consideration that the holders of the common stock become entitled to receive (the conversion consideration adjustment provision). Under this provision, if the common stock of the convertible note issuer is acquired in return for acquirer shares, the notes become convertible into acquirer shares. Conversely, if the common stock of the convertible note issuer is acquired in return for cash, the notes become convertible into that fixed amount of cash.

- Under a typical change-of-control covenant, the convertible note issuer is permitted to merge into another entity, often only a U.S. corporation.
- If the issuer undergoes specified fundamental changes, the issuer usually has to offer to redeem the notes at par. Some fundamental changes also constitute a make-whole fundamental change (MWFC) that may give the holders the concurrent right to convert the notes at a make-whole rate (that is, a temporarily increased rate of conversion). The quintessential MWFC event is the issuer's acquisition of a convertible debt in return for cash consideration. In that circumstance, MWFC adjustments are deemed necessary to compensate holders because the notes are convertible into a fixed amount of cash and the time value of the option embedded in a convertible note is entirely eliminated. For the same reason, an acquisition resulting in the notes becoming convertible into 90 percent or more of shares of another public entity is not considered an MWFC (because, theoretically, the noteholders would continue to hold their options, albeit in another entity).

Reg. section 1.1001-3 and the history surrounding it contain a few reference points that may be relevant for the purposes of this analysis:

- Under reg. section 1.1001-3(c)(1)(ii), subject to exceptions under reg. section 1.1001-3(c)(2), any alteration that occurs by operation of the terms of a debt instrument is not a modification.
- Under reg. section 1.1001-3(c)(2)(i), any change in the issuer of a debt instrument is a modification, even if it occurs under existing terms.
- Under reg. section 1.1001-3(e)(4), a change in the issuer of a debt instrument is generally not a significant modification if it is in accordance with a section 381(a) transaction or if the obligor acquires substantially all assets of the prior obligor.
- There is no specific rule under reg. section 1.1001-3 addressing whether a change in

conversion consideration is a significant modification. Prop. reg. section 1.1001-3 had a rule on changes in conversion considerations that indicated that the alteration of conversion rights was a significant modification if the alteration significantly affects the value of the conversion option or changes the corporation whose stock is received in the conversion.⁵⁰ When finalized, reg. section 1.1001-3 ended up being silent on that point. Instead, the preamble to the final regulations indicated that the government declines to articulate a specific rule and is punting to the general economic significance rule to determine the treatment for changes in conversion options.⁵¹

With this background, let us address some common fact patterns that arise in the change-of-control transactions involving issuers of convertible debt.

Example 2: The issuer is acquired by another public company, and the issuer's common stock shareholders receive listed public company stock. The issuer becomes a subsidiary of the public company. Under the conversion consideration adjustment provision, the notes would automatically become exchangeable into public company shares. The merger covenant and MWFC adjustments would not be implicated, because the issuer is remaining intact, and the notes become convertible into public company shares.

One way of viewing the conversion consideration adjustment provision could be to say that all changes occur by operation of the terms and therefore there should be no

modification that needs to be analyzed for significance under reg. section 1.1001-3. This approach appears to be the most sensible and in line with market expectations. One counterargument would be that reg. section 1.1001-3 rules indicate that a change in the issuer of a debt instrument is a modification (even if it occurs by operation of the terms). That rule should apply in this context by analogy. As such, the relevant inquiry should be, if this transaction were analyzed as a change in issuer, whether it would qualify for one of the safe harbors under reg. section 1.1001-3(e)(4) that indicate that a change in issuer is not a significant modification. The rebuttal to that counterargument, however, is that the issuer of the debt (or, even if there were deemed to be a separate option, the issuer of the option) is not changing (because the only change is in the reference stock of the underlying option). The historical tax treatment of convertible debt is as a unitary instrument, so analyzing the conversion option by itself relies on a bifurcated view for purposes of applying section 1001 and is therefore inappropriate.⁵²

Another interesting phenomenon in this fact pattern is that the notes, which used to be convertible, have now become exchangeable, which means the conversion of notes into the referenced shares is no longer tax free. Any adjustments of the exchange ratio would (arguably⁵³) no longer be subject to the section 305(c) deemed dividends rule because the issuers of the notes and the shares into which they are convertible are different. Other changes in tax treatment also can result. For example, the new parent could be a foreign corporation treated as a PFIC, potentially exposing the convertible notes

⁵⁰ See former prop. reg. section 1.1001-3(e)(2)(iv), proposed in FI-31-92, 57 F.R. 57034 (Dec. 2, 1992) ("The addition or deletion of a term giving the holder the right to convert into stock of the issuer or exchange the instrument for stock of another corporation is a significant modification if the conversion or exchange right has significant value at the time of its addition or deletion. The alteration of an existing conversion or exchange right is a significant modification if the alteration significantly affects its value or changes the corporation whose stock is to be received in the conversion or exchange.")

⁵¹ See T.D. 8675 ("With the addition of the general significance rule, certain specific rules of the proposed regulations have not been included in the final regulations. . . . The proposed regulations provide similar rules for the addition, deletion, or alteration of a conversion or exchange right. . . . These rules have not been included in the final regulations because the general significance rule provides adequate guidance.")

⁵² In his seminal article on modification of non-debt instruments, James M. Peaslee observes: "A derivative contract based on a single stock obviously would have a value that depends fundamentally on the identity of the stock. Thus, it can fairly be assumed that a change in the underlying stock permitted by the terms of the contract would be a fundamental change, unless perhaps the two stocks were in some manner similar or related." Peaslee, "Modifications of Nondebt Financial Instruments as Deemed Exchanges," *Tax Notes*, Apr. 29, 2002, p. 737, 766. The question in this fact pattern would then be whether the issuer of the stock before the change-of-control transaction and the issuer of the stock after the change-of-control transaction could be considered related.

⁵³ A strong argument exists that section 305 by its terms does not apply to an instrument exchangeable into stock of other than the issuer's stock. This result is implicit in the wording of section 305, but it was still listed as a point requiring clarification in the relevant NYSBA report. See discussion of exchangeable debt in NYSBA Tax Section, "Report on Proposed Regulations Under Section 305(c)" (Aug. 10, 2016).

to the PFIC regime.⁵⁴ Reg. section 1.1001-3 generally does not provide specific rules on whether a change in the tax treatment of a debt instrument can constitute a modification or a significant modification. Arguably, a change in the tax rules that apply to a debt instrument should categorically not be an alteration within the meaning of reg. section 1.1001-3.⁵⁵ Further, even if changes in tax treatment were deemed to be alterations that are governed by the economic significance rule under reg. section 1.1001-3, the investor pool in convertible debt is varied in terms of their tax sensitivities. As such, it would be difficult to analyze whether and when any change in the tax treatment of convertible debt can be considered generally economically significant for the investors.

Example 3: The issuer is acquired by a company, and the issuer's common stock shareholders receive entirely cash. The issuer becomes a subsidiary of the public company. Under the conversion consideration adjustment provision, the notes become convertible into a fixed amount of cash that the noteholders would have received if they already held conversion shares. That consideration could then be temporarily increased by operation of the required MWFC adjustments. The merger covenant would not be implicated, because the issuer is remaining intact.

The interesting point in this fact pattern is that the notes are no longer convertible debt but rather simply represent a right to receive a fixed amount of cash (potentially much greater than the principal amount). It can be argued that there was a deemed exchange or deemed disposition of the convertible debt because the option has turned into a fixed cash consideration (and if that cash consideration is larger than the principal amount of the notes, the principal amount of the debt would have lost its relevance). The better approach still appears to be to view all the

changes as occurring automatically under existing terms and thereby not triggering a deemed exchange.

Also, many convertible debt tax disclosures indicate that MWFC adjustments could result in deemed dividends under section 305(c). As discussed in my earlier article,⁵⁶ that conclusion is also doubtful.

Example 4: Same facts as Example 2 (that is, the issuer is acquired by another public company, the issuer's common stock shareholders receive listed public company stock, and the issuer becomes a subsidiary of the public company), but the acquisition transaction is achieved by way of a merger into a subsidiary of the acquirer that is treated as a limited liability company, and the LLC survives. Because the merger covenant does not permit such a merger, the parties seek consent from holders of existing notes. Assume that the consent fee paid in connection with the consent is not alone sufficient to trigger a deemed exchange and that no other amendments are taking place.

That fact pattern raises the question whether, if the merger itself would not have been allowed under the existing terms, a simple amendment of the merger covenant would itself be sufficient to view all the changes that are happening to the terms of the instrument as an amendment. That amendment on its own would probably be considered a change in financial covenants and not material under reg. section 1.1001-3(e)(6). As such, the sensible treatment again appears to be that the requirement for a minor covenant amendment should not change the general treatment of whether the change in conversion consideration happens under existing terms, even if the covenant amendment was intended to permit a larger transaction that would result in the change in conversion consideration.

D. COD Income Risks Due to Reissuances

As compared with nonconvertible debt, the tax consequences of a deemed exchange for convertible debt can be more drastic. Earlier parts of this report discussed the potential risk of the application of section 163(l) and the potential risk

⁵⁴ Section 1298(a)(4); prop. reg. section 1.1291-1(d) and (h)(3), Example.

⁵⁵ See Peaslee, *supra* note 52, at 769 ("It can be argued with some force that the substantive tax rules governing debt instruments are not part of the package of 'legal entitlements' that are relevant in finding a [reg. section 1.]1001-3 exchange. In the words of the regulations, the change in tax status does not involve an 'alteration' and hence cannot be a modification.").

⁵⁶ See Michael E. Bauer, Y. Bora Bozkurt, and Matthew H. Brown, "The Odd Couple: Code Section 305(c) and Make-Whole Fundamental Changes," 16 *J. Tax'n & Reg. Fin. Inst.* 43 (2019).

of equity recharacterization that arise upon a deemed exchange of a convertible debt when it is trading at a premium. A separate issue could arise, however, as a result of asymmetry in the application of sections 249 and 108.

An issuer of convertible debt cannot deduct any repurchase premium because of the application of section 249, subject to minor exceptions (which have limited practical utility⁵⁷). The result under section 249 is justifiable under principles of section 1032. However, as discussed in Section II.C, section 249 is a one-way street (unlike section 1032, which prohibits corporations from recognizing either gain or loss on their own stock). As such, it would appear there is no mirror rule for section 108.⁵⁸

Example 5: A convertible debt originally issued at par undergoes a significant modification and a deemed reissuance when trading at 200 percent.

If the notes underwent a deemed exchange when they were trading at 200 percent, the issuer would have a repurchase premium of 100 percent. However, the issuer under most circumstances⁵⁹ will not get any repurchase premium deductions under reg. section 1.163-7(c) because of the application of section 249.

Example 6: After the significant modification, because of changes in stock volatility or stock price, the same notes in Example 5 begin trading at 150 percent. The notes are thereafter redeemed at 150 percent.

Unfortunately, section 249 does not provide a special rule adjusting the issue price of the notes after the significant modification. The rules under reg. sections 1.163-13(c) and 1.171-1(e)(1)(iii) (that is, rules that would exclude the conversion option from the issue price) specifically apply solely for bond premium purposes. Further, section 108 does not appear to contain a special rule governing COD income for convertible debt. So

under a plain reading of the rules, the issuer would have an issue price of 200 percent upon the amendment and, upon a redemption at 150 percent, may be subject to 50 percent of COD income. That result appears especially unjustified under the principles of section 1032. A more sensible result is for taxpayers to be exempt from the application of section 108 in this fact pattern, if not entirely, at least to the extent section 249 has previously applied to deny the taxpayer's deduction of repurchase premium in the context of a prior deemed exchange.

IV. Hedging Transactions

As discussed, typical convertible debt has a conversion price that significantly exceeds the trading price of the equity into which the debt is convertible. However, the convertible debt often has a term to maturity of at least five years, and the price of the stock underlying convertible debt is often volatile. As a result, issuers of convertible notes are still concerned about the dilution that may result if their convertible debt matures in the money and is converted. The solution is that in many, if not most, convertible debt offerings, the issuer also buys a hedge from the investment banks to synthetically raise the conversion price.

Opting for a tax integration of these hedging transactions allows the issuer to deduct the premium paid to acquire the hedge as if it were OID on the convertible debt. On its surface, this treatment may appear to be a departure from the result the government sought and obtained in *Chock Full o'Nuts* and reg. section 1.1273-2(j). In practice, however, tax-integrated convertible debt transactions are far from a true bifurcation of a convertible debt into its components, because they come at potentially material economic costs to the issuer.

Further, even for taxpayers that do not integrate their hedging transactions, the gaps in coverage between sections 249 and 1032 could lead to situations in which taxpayers that enter into these hedging transactions may be required to recognize material taxable gain with no offsetting deductions.

⁵⁷ See NYSBA Tax Section, "Report on Section 249" (June 8, 2017).

⁵⁸ This asymmetry between sections 249 and 108 has been previously observed. See Farr, "Code Sec. 1032 — Taking Stock of the Situation," 8 *J. Tax'n Fin. Products* 35, 48 (2009) ("Unfortunately for taxpayers, code section 249 is an asymmetrical provision. There is, under current law, no comparable provision overriding generally the treatment of cancellation of debt income recognized by an issuer with respect to a convertible debt obligation.").

⁵⁹ Section 249 has limited exceptions, but they would be negligible for the purposes of this analysis. See NYSBA Tax Section, *supra* note 57.

A. Downsides of Tax Integration⁶⁰

As mentioned, many issuers that issue convertible debt buy hedging instruments to diminish the potential equity dilution that they may suffer if their convertible notes mature in the money. That hedge often takes either of two forms. The first is the bifurcated approach, in which the company buys a call option that offsets the conversion feature embedded in the convertible debt and sells a warrant with a higher strike than the conversion price of the notes. The second approach, which has become more popular in recent years, is the unitary approach, under which the company buys a capped call option that has similar economics to the combined economics of the bifurcated approach (with distinct key differences), but it is a single instrument.

Tax and nontax consequences affect the decision of whether to use the bifurcated approach or the unitary approach. Normally, under section 1032, an issuer cannot recognize gain or loss on an option on its own stock. As a result, the issuer does not deduct the premium it pays to acquire the bond hedge. Tax integration, however, changes the treatment to favor the taxpayer. By applying reg. section 1.1275-6 to the bifurcated approach, the issuer can treat the notes and the bond hedge as an integrated debt instrument that approximates (but is not exactly) a nonconvertible fixed-rate debt instrument issued at an OID equal to the premium paid to acquire the bond hedge.

In that approach, the warrant is left as a stand-alone instrument that is not tax-integrated. As a result, the issuer would have higher OID deductions than it would have under the unitary approach.⁶¹ In the latter case, the issuer can treat the notes and the capped call as an integrated debt instrument that approximates (but is not exactly) a convertible fixed-rate debt instrument issued at an OID equal to the premium paid to acquire the capped call and convertible debt at the cap price

of the capped call. Because a bond hedge would cost more than a capped call, the capped call structure would result in a lower amount of OID deductions.

Although the issuer benefits more from the bifurcated structure in terms of OID deductions, it may be at a disadvantage in terms of nontax costs. To ensure the separate tax treatment, bifurcated deals are commonly structured to have the warrants expire at least 90 days later than the bond hedges. The company would effectively have a naked bet against its own stock for at least 90 days after its notes and bond hedge have settled, which can be a significant amount of exposure given how volatile even a single day of trading in an equity market can be. Further, in bifurcated deals in which the notes are redeemed or converted early because of a change-of-control transaction, differences in valuation methods used to determine the amount to be delivered under the bond hedge and warrant instruments can result in materially smaller net recoveries to the company than the amount the company would have recovered in an unwind of a capped call. Change-of-control transactions are not negligibly unlikely scenarios for the type of issuers typically drawn to issuing convertible debt. In sum, for a taxpayer to choose the bifurcated approach, it has to be putting real value on the additional OID deductions at the risk of facing additional economic costs in transaction structure.

Even for an issuer that has preferred the unitary capped call as its hedge, reg. section 1.1275-6 tax integration is not a straightforward, purely tax-advantaged election. In addition to the economic differences between unitary and bifurcated structures, there are also real economic differences between tax-integrated and non-tax-integrated transactions. For both bifurcated and unitary structures, to achieve tax integration, the notes and the note hedge or the capped call must have terms that are well enough matched to be able to compute a yield on the resulting instrument and therefore result in the synthetic instrument acting like a true debt instrument. These limitations can be a costly impediment to the company, with the impact ranging from more limited flexibility on how and when the note

⁶⁰ I moderated a panel on tax integration in the American Bar Association Section of Taxation 2021 midyear tax meeting titled "To Integrate or Not to Integrate and Other Hedging Questions," on January 29, at which these topics were discussed in further depth.

⁶¹ The tax integration of the bond hedge (while keeping the warrants as a stand-alone option) has been acknowledged and approved by the IRS under AM 2007-0014.

hedge or the capped call is exercised to how much that instrument delivers, as described next.

To give one example, if the notes are converted early (which typically can occur in a change-of-control transaction), capped calls are often required to be exercised automatically as a feature of tax integration. This feature forces the issuer to give up the flexibility to keep its capped call outstanding or receive (depending on the market variables at the time and the method used to calculate capped call early unwind amounts) significantly less than what it would have received if capped calls reached maturity. Take, for example, a \$1,000 convertible debt with a conversion price of \$50 (that is, a conversion rate of 20 shares).

Assume the issuer has bought a capped call that synthetically raises the conversion price to \$70. Assume the notes are converted early, at a conversion price of \$70, into a conversion consideration of \$1,400. One may (mistakenly) think that in this fact pattern, because the notes are within the cap price of the capped call, the issuer should receive \$400 from the hedging bank and net out to zero. However, that is unlikely to happen. In an early unwind, under the standard market terms, the hedging bank would generally deliver to the company the fair value of the capped call option. The fair value of the capped call generally is determined based on the economic components of the capped call, which simplistically are a call option that the issuer buys at an exercise price of \$50 and a call option that the issuer sells at an exercise price of \$70. As discussed, the value of an option is equal to its intrinsic value plus its time value. Although the intrinsic value of the option that the issuer has (economically) bought minus the intrinsic value of the option that the issuer has (economically) sold should indeed intuitively equal \$400, the time values of the two options would not match. In a situation in which the stock price is at \$70, the option that the issuer has (economically) sold, because it is an at-the-money option, would have a potentially much higher remaining time value than the in-the-money option the issuer has (economically) bought. As such, it is likely that the issuer would receive an amount that may be materially less than \$400 by being required to exercise its capped call early. Further, under some

circumstances, to achieve a high degree of comfort around the tax integration treatment and to ensure the issuer would be treated as unconditionally required to repay the outstanding amount of the synthetic debt, the issuer would even be required to voluntarily limit the amounts it is expected to receive under the hedge instrument in early termination scenarios to an amount that is even smaller than the fair value of the capped call.⁶²

The potential effects of tax integration are not limited to the economic concessions that the issuer has to make upfront. A potential surprise may await the issuer if the taxpayer were to terminate the hedge early but leave the note outstanding. Under the rules of reg. section 1.1275-6, the termination of the hedge early generally results in a leg out and a deemed reissuance of the notes at their then-current market price. If the notes are trading at a price significantly above par when the hedge is terminated, the issuer will end up with a debt instrument that has an issue price at a significant amount of premium from the date of the leg out onward.⁶³ An issue price that has a significant amount of premium would implicate the various issues previously discussed over the course of this report (especially a potentially material COD income risk at retirement). Therefore, a taxpayer that has tax-integrated convertible debt with a bifurcated or a unitary hedge is well advised to, when possible, redeem or otherwise terminate the notes at the same time if it is ever going to terminate the hedging instruments.

In sum, the choice to tax-integrate a hedge and whether to use a bifurcated or a unitary structure is a complicated decision that requires multifactor

⁶² Practitioners have created the concept of a tax cap, in which they limit the amount the issuer receives under tax-integrated hedging instruments such that, effectively under any scenario that arises under the terms of the notes, the issuer must pay back (on the basis of the net deliveries under the convertible note as offset by the tax-integrated hedge) at least the amount of the outstanding amount of the synthetic debt resulting from tax integration. This concept was created so that the net delivery under the notes and the hedge is at all relevant times sufficient to ensure that the issuer is unconditionally obligated to repay its debt, which is a hallmark of debt treatment.

⁶³ See reg. section 1.1275-6(c)(ii)(C) ("If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, 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.").

analysis. Tax integration does not allow taxpayers to circumvent the holding of *Chock Full o'Nuts*, at least not without the risk of a real economic cost. The strongest proof that these economic differences are real is that most convertible debt hedges now use the unitary capped call structure and in many (and perhaps most) cases, issuers decide against pursuing tax integration altogether.

B. Unintegrated Capped Calls

As discussed, convertible note issuers commonly enter into unitary capped call transactions, and it is also common for a U.S. issuer to choose not to tax-integrate the capped call and to forgo the potential tax deductions resulting from tax integration to avoid suffering the potential nontax limitations required for successful tax integration. The tax treatment of a stand-alone (that is, nonintegrated) capped call is normally straightforward because section 1032 indicates a corporation cannot recognize gain or loss on an option on its own stock.

Example 7: The company issues notes convertible into its own shares. The share price at issuance is \$30. Each \$1,000 note is convertible into 25 shares (put differently, the conversion price is \$40). The company buys a capped call with a strike of \$50 and cap price at \$65 for an option premium of \$100 (per \$1,000 note). Economically, the combination of the note and capped call is roughly equivalent to the company issuing a note convertible at \$50 per share. The notes mature in five years, when the share price is \$60. The holders convert and receive \$1,500. The capped call pays out \$250 ($(\$60 - \$50) * 25$), resulting in an economic gain of \$150 ($\$250 - \100) under the capped call.

In this fact pattern, under section 249, the company's repurchase premium on the convertible notes of \$500 would not be deductible.⁶⁴ Under section 1032, the company

also would not have to recognize the gain of \$150 on the capped call.

Section 249, by its terms, applies to debt that is convertible into stock of "a corporation in the same parent-subsidary controlled group (within the meaning of section 1563(a)(1)) as the issuing corporation." However, section 1032 does not appear to have a similar rule that applies to related-party stock. Assume that in Example 7, instead of the public company issuing the notes, the U.S. subsidiary of a U.S. company issued the same notes as exchangeable into its parent's shares. If the capped call is not tax-integrated and if section 1032 does not apply, the company may be required to recognize a significant taxable gain on the capped call without getting an offsetting deduction because of the application of section 249. Subject to the discussion in the next paragraph, taxpayers are often able to structure around this issue by having the public company hold the capped call in nonintegrated structures even if a subsidiary is the issuer of the convertible (in this instance, technically exchangeable) notes. Nevertheless, for the sake of consistency, it would have been more sensible that if section 249 would apply to convertible debt that is convertible into related-party debt, section 1032 would also be applicable to an offsetting hedging instrument that is concerned with the same transaction.⁶⁵

A similar scenario can also arise unexpectedly. Assume the company in Example 7 has been acquired in a transaction by another public company (New PubCo) such that the common stock shareholders of the issuer have received New PubCo stock. Under typical convertible debt provisions, the conversion consideration would automatically adjust to New PubCo stock. The capped call options often have similar terms that automatically adjust the capped call if there is an acquisition transaction such that the capped call delivers the acquirer company's stock. If the capped call were not integrated and the holder of the capped call is unable to transfer the capped call to the public company, the company would

⁶⁴Technically, section 249 denies repurchase premium solely on a repurchase of the convertible note. However, the word repurchase is widely interpreted to also cover conversions. See Farr, *supra* note 9 ("The regulations under section 61 governing the treatment to an issuer of the repurchase of debt state that the term 'repurchase' includes the conversion of debt into stock of the issuer, and case law holds that a conversion is in fact a repurchase at least for purposes of section 249.").

⁶⁵Section 1032 regulations do address some fact patterns in which related parties acquire the issuing corporation's stock in section 351 exchanges and some other transactions. See reg. section 1.1032-3. However, these regulations read as narrow exceptions and, on their face, do not appear to apply to an option that the subsidiary holds for its parent's stock.

find itself in a similar situation as the exchangeable stock example in the prior paragraph. Is the capped call no longer covered under section 1032 such that the issuer has to recognize \$150 of gain on the capped call at settlement? The sensible view appears to be that a capped call transaction that was a section 1032 transaction at its inception should not lose that status as a result of previously unexpected events that occur under the terms of the option. As a result, the gain on the capped call ought to continue to be subject to section 1032. Alternatively, at the very least, the transition of the capped call from an instrument that is subject to section 1032 to an instrument that is not subject to section 1032 should be considered a deemed exchange, and that deemed exchange should be subject to section 1032, such that the holder of the capped call does not have to recognize the gain that accrued on the instrument before the acquisition transaction.

V. FIRPTA/PFIC

Plain vanilla convertible debt is subject to the FIRPTA and PFIC regimes even though convertible debt is generally supposed to be an indivisible debt instrument for tax purposes, and FIRPTA and PFIC regimes otherwise exclude debt instruments from their coverage. In fact, these regimes may apply to convertible debt in ways that are more stringent than how they would have applied if the investor had simply acquired the equity underlying the convertible debt directly. These areas would benefit from more balanced rules that acknowledge the hybrid nature of convertible debt.

A. Convertibles as USRPIs

Under current law, a convertible debt issued by a USRPHC is, subject to exceptions, a U.S. real property interest (USRPI) under the FIRPTA rules.⁶⁶ This result does not directly follow from the statute, which defines a USRPI as “an interest (other than an interest solely as a creditor).” In the absence of regulations, these words could

perhaps have been read more narrowly. However, the regulations leave (almost⁶⁷) no room for argument that plain vanilla convertible debt of a USRPHC can be other than a USRPI. They indicate that an interest solely as a creditor does not include an interest that is “in whole or in part, a direct or indirect right to share in the appreciation in value of an interest in the [stock of a USRPHC].” The regulations also add that an interest that is not an interest solely as a creditor also includes a “right (whether or not presently exercisable) directly or indirectly to acquire, by purchase, conversion, exchange, or in any other manner,” a stock of a USRPHC.⁶⁸ The regulations therefore do not appear to make any special concessions for the debt instrument inherent in a plain vanilla convertible debt instrument in whether that instrument should be treated as a USRPI.⁶⁹

Under these circumstances, foreign investors in convertible debt issued by a USRPHC have to turn to the various FIRPTA safe harbors to analyze whether they can avoid the adverse tax consequences that may apply upon a disposition of their notes (including potentially through a conversion⁷⁰). Because convertible notes are normally convertible into common stock regularly traded for purposes of section 897, the 5 percent exception under section 897(c)(3) and the related regulations create an important, potentially available, safe harbor. The 5 percent exception applies to convertible debt in an unusual manner. In simplified terms, under reg. section 1.897-9T, if the notes themselves are a regularly traded class, the investor has to own less

⁶⁷The regulations indicate that if a person “holds both interests solely as a creditor and interests other than solely as a creditor in real property or in an entity, those interests will generally be treated as separate and distinct interests.” Reg. section 1.897-1(d)(4). Given the historical treatment of convertible debt as a unitary debt instrument, this rule alone is probably not sufficient to exclude convertible debt from the application of FIRPTA.

⁶⁸Reg. section 1.897-1(d)(i)(D) and (E).

⁶⁹As discussed in the introduction to this report, even straight debt may correlate with the appreciation in the value of equity under some circumstances. Therefore, if not for the fact that the regulations are defining what it means to have an interest that is an “interest solely as a creditor,” a person that has extended merely straight (nonconvertible) debt to a USRPHC may wonder whether it is holding an “interest solely as a creditor” within the meaning of section 897.

⁷⁰Any conversions of convertible notes issued by USRPHCs, while partially or fully tax-free transactions for other purposes of the code, could become subject to FIRPTA tax (depending on the application of the rules governing nonrecognition exchanges under reg. section 1.897-6T).

⁶⁶Section 897(c)(1)(A)(ii).

than 5 percent of the notes for the 5 percent exception to apply.

If the notes themselves are not regularly traded, the investor has to own notes that are worth no more than 5 percent of the value of the class of stock into which the notes are convertible. Because convertible notes typically trade over the counter as opposed to on a securities exchange, convertible notes need to be regularly quoted by brokers or dealers making a market in those interests in order to be treated as traded on a domestic established securities market.⁷¹ These “regularly traded” regulations go back to 1988⁷² and pertain to a bygone era in which over-the-counter markets functioned very differently from the way they do today. Although convertible notes have trading prices that market participants can obtain easily and some convertible debt tranches are fairly liquid, whether brokers or dealers that regularly buy and sell convertible notes are making a market in the notes is a difficult factual inquiry. To be sure, whether the notes are regularly traded could be an important determination. The value of the common shares class is normally much larger than the overall value of the convertible notes class, which means that if the notes are not regularly traded, an investor that holds more than 5 percent of the convertible notes can potentially still qualify for the 5 percent exception and be considered to not hold a USRPI. If the convertible notes are regularly traded, however, the determination boils down to whether the investor holds 5 percent or more of the convertible class.

An alternative, more balanced framework of determining whether convertible debt qualifies for the 5 percent exception could have been more mindful of the hybrid nature of convertible note. The investors are promised the principal amount of the debt regardless of whether the notes are

converted; in form and in substance, the investors are creditors of the principal amount. As such, in testing for the 5 percent exception, the numerator could have been set as the value of the notes to the extent that value exceeds the principal amount. Further, given that convertible debt is considered a debt instrument and the reason for USRPI treatment of the convertible debt is the built-in conversion option into common stock, the materiality of a convertible note investor’s ownership of equity should arguably be measured against the total value of common stock. As such, a more sensible approach could have been to take the fair market value of the common stock class as the numerator in testing for the 5 percent exception, irrespective of whether the convertible notes themselves are a regularly traded class within the meaning of reg. section 1.897-9T. Otherwise, under the current framework, holders of convertible debt are subject to rules that are harsher than the rules that would have applied if the investors held the underlying common shares directly.

B. FIRPTA Withholding

Reg. section 1.1445-2(c)(2) indicates that no FIRPTA withholding is required upon “acquisition of an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market.” The rule is a sensible one that appears to extend the section 1445 withholding exemption for transactions in publicly traded stock to equity-linked transactions that may reference publicly traded stock, in an effort to exempt those transactions from the burdensome certification rules that apply to equity transactions. However, reg. section 1.1445-2(c)(2) also has flush language that contains an exception to the main rule under reg. section 1.1445-2(c)(2) for an “acquisition, from a single transferor in a single (or related transferors (as defined in [reg.] section 1.897-1(i))) transaction (or related transactions), of an interest described in [reg.] section 1.897-1(c)(2)(iii)(B) (relating to substantial amounts of non-publicly traded interests in publicly traded corporations).” It is unclear if and how this rule should apply if the notes themselves were not publicly traded.

To preserve the administrability intended by the central rule of reg. section 1.1445-2(c)(2), either

⁷¹Reg. section 1.897-9T(d)(2). Reg. section 1.897-9T(d)(1)(i) provides a general rule that includes a quantitative test to determine whether a class of interests is regularly traded. Nevertheless, for interests traded on a domestic established securities market, it is more customary to rely on the tests laid out under reg. section 1.897-9T(d)(2).

⁷²One may wonder whether these rules, promulgated as temporary regulations in 1988, are still effective given that temporary regulations are supposed to expire three years after issuance under section 7805(e)(2). Section 7805(e)(2), however, applies only to regulations issued after November 1988, and reg. section 1.897-9T was issued shortly before then, in May 1988.

this exception under the flush language would have to be interpreted narrowly to exclude regular trading of convertible notes, or the convertible notes would have to be more readily considered regularly traded (which would make the flush language inapplicable but would then pose the other complications discussed in Section V.A). Any interpretation other than these two would appear to require some type of a certification procedure around all trades of convertible notes (presumably even for convertible notes of issuers that are not even USRPHCs), which could significantly impair trading in convertible debt and, once again, put convertible debt on worse footing than trading in the stock underlying convertible notes.

If it were to apply to convertible debt, the 15 percent gross withholding tax imposed by section 1445 also appears more strict than necessary. Section 1445 is intended to impose a tax on the gross proceeds of the sales of equity and equity-like interests in a USRPHC to encourage investors to file U.S. tax returns so they can get offsets for their tax basis and pay taxes on their actual gains. The tax is imposed on gross proceeds presumably because the buyer or other withholding agent may not be in a position to determine the tax basis of the seller. However, since a convertible debt investor is entitled to the principal repayment under all circumstances, it is effectively a creditor for the principal amount. Therefore, a more sensible and relatively easier-to-implement approach could have been to impose the 15 percent withholding tax on any proceeds of a seller of convertible notes that exceed the principal amount of the note. In this proposed approach, the amount of the withholding tax would be calculated based on that excess regardless of the holder's basis,⁷³ under the theory that the holder's economics up to the principal amount of the convertible debt resemble that of a nonconvertible debt instrument, which is otherwise entirely excluded from FIRPTA under section 897.

⁷³ A similar approach could be used when holders file U.S. income tax returns to pay taxes on their gains on the disposition of their convertible debt interests. The holders can be subject to tax on their gains in an amount not to exceed their amount realized minus the principal amount of the debt.

C. PFIC Rules

Domestic holders of convertible debt issued by foreign issuers also have to be aware of the strict rules that apply to investors in equity of PFICs. Although the law is unclear,⁷⁴ most tax disclosures included in offering documents either treat or disclose a material risk of treatment of a convertible note issued by a PFIC issuer as interests in a PFIC. Further, there would appear to be no possibility of a qualified electing fund election⁷⁵ and no PFIC mark-to-market election⁷⁶ available to an investor eager to avoid the punitive excess inclusion regime of the PFIC rules. There have been several proposals by commentators to remedy this gap in the context of equity options generally. For example, regarding the application of QEF elections to equity options, a popular proposal appears to be to allow an investor to make a QEF election on an as-exercised basis.⁷⁷

In the context of convertible debt, however, even that result would appear too harsh. The convertible note holder is effectively a creditor up to the principal amount of the notes and, in many circumstances, will receive only the principal amount. As such, a more reasonable compromise in the context of convertible debt would have been to calculate the number of shares the investor would receive if the notes were "net share" settled (that is, settled by paying the principal amount in cash and the excess in shares) and apply the QEF election accordingly. In the case of a potential mark-to-market election for options, commentators recommend allowing investors of options to either mark to market the value of the option or, if option value is hard to calculate, to calculate a mark-to-market inclusion based on the

⁷⁴ To the extent provided in regulations, section 1298(a)(4) treats holders of options as if they owned the stock underlying the options for purposes of the PFIC rules. Although there are no final regulations, the proposed regulations have a retroactive effective date and contain rules that explicitly treat convertible notes as interests in a PFIC. See prop. reg. section 1.1291-1(h)(3), Example.

⁷⁵ See reg. section 1.1295-1(d)(5).

⁷⁶ See reg. section 1.1296-2(a)(3) and (e). It nevertheless appears possible for some investors to claim the benefits of a mark-to-market regime under section 475. See section 1291(d)(1) (flush language).

⁷⁷ See NYSBA Tax Section, "Report Commenting on Select Issues With Respect to the Passive Foreign Investment Company Rules," at 63-66 (Mar. 8, 2010). See also New York City Bar, "Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules," at 22-23 (Sept. 21, 2009).

value of the shares underlying the option and the exercise price of the option.⁷⁸ These approaches can be structured to work for a convertible debt as well, with a similar net-share settlement overlay. As in the FIRPTA context discussed, the current rules not only fail to make any allowances for the fact that convertible debt is a hybrid instrument with a significant debt component, their application to convertible debt results in a treatment more stringent than if the investor held the underlying shares directly.

VI. Conclusion

So long as separate rules govern the taxation of debt and equity, coming up with sensible rules for the taxation of convertible debt, which combines significant elements of both, will remain a challenge. An alternative system of taxation for convertible debt — more in line with how the rules under generally accepted accounting principles treat some convertible debt⁷⁹ and more consistent with economic realities — would be to reject *Chock Full o’Nuts* and bifurcate the security. If the security is tracked in separate components, it might then be possible to calculate the inherent yield of the debt instrument and the option premium paid for the equity exposure component at original issuance, and to apply the respective debt and equity rules accordingly. However, such a system would bring complexity in terms of the required valuation of the components and pose its own novel challenges.

At the very least, though, the tax rules governing plain vanilla convertible debt can be improved to create more symmetry and to eliminate scenarios in which the taxpayers face the risk of a whipsaw. It should be possible to assume, more readily, that plain vanilla convertible debt is not subject to section 163(l).

Taxpayers should have the benefit of a mirror rule to section 249 to have more certainty around the tax treatment of any gain that arises from modifications of convertible debt instruments and other deemed disposition transactions. The reg. section 1.1001-3 rules around “deterioration in financial condition” of an issuer can be expanded to clarify that a plain vanilla convertible debt instrument does not begin to get treated as equity merely as a result of a deemed exchange transaction that occurs when that debt is trading at a significant premium or when the conversion option is in the money. Sections 249 and 1032 can be better aligned to apply to related-party transactions and avoid scenarios in which issuers are subject to tax in a transaction in which they have offsetting losses economically. Again, it would be sensible to loosen the FIRPTA and PFIC tax nets in a way that takes into account the debt aspects of convertible notes while ensuring that holders of convertible notes are not treated worse than holders of the shares underlying the convertible notes.

When convertible notes were evolving, the government may have been skeptical of how they worked or wary of potential abuse. However, convertible debt instruments, especially the plain vanilla variety, are no longer an exotic security; they are a common financing method that is well established with issuers and investors. Notably, the recent explosion in the number and amount of plain vanilla convertible debt issuances, most with coupons equal to or almost equal to 0 percent, have demonstrated that they remain attractive for their unique economics and not for the tax-favorable treatment that their coupons may carry. Ultimately, these unique instruments are neither debt nor equity but a true hybrid, and they deserve to be governed not by black-and-white rules that seem to be born out of suspicion or fear of abuse but by more balanced rules that appreciate their true hybrid nature. ■

⁷⁸ See NYSBA Tax Section, *supra* note 77.

⁷⁹ See Bob Leonard, “Popping the Hood on Convertibles,” *Tax Notes Federal*, Oct. 18, 2021, p. 303, 306-307 (“Financial accounting guidance requires some convertible debt instruments to be divided between a debt component and an equity or derivative component. . . . However, the Financial Accounting Standards Board recently issued revised guidance for convertible debt instruments, generally applicable to fiscal years beginning on or after December 15, 2021, that generally eliminates some requirements that assign a value to the conversion feature, resulting in more convertible debt instruments to be accounted for as single liabilities measured at amortized cost. Companies may early-adopt the standard at the start of a fiscal year beginning after December 15, 2020.”).