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A Bridge Between Debt and Equity: Taxation of Bridge Convertibles

by Y. Bora Bozkurt and Michael E. Bauer

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In this article, Bozkurt and Bauer examine bridge convertible debt and argue that in many cases, its tax treatment ought not to deviate materially from that of plain vanilla convertible debt, noting that this determination requires a careful review of the terms of the instrument and the facts involved in its issuance.

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While the pandemic has generated increased demand for "plain vanilla" convertible debt offered to the public markets, the bespoke convertible debt market has also been active. Bespoke convertible debt — that is, any convertible debt that is not plain vanilla convertible debt offered to the public markets — has long been a common way to finance companies. Although an established market and generally accepted terms exist for plain vanilla convertible debt,[1] bespoke convertible debt transactions tend to be privately negotiated between borrowers and lenders, based on the needs of the borrower and the financial return requirements of the lender. The terms of bespoke convertible debt are thus heavily negotiated and varied.

This article focuses on bridge convertible debt. Bridge convertible debt is a type of financing transaction generally intended to provide financing to a private issuer that may not have access to traditional debt markets, in anticipation of an equity financing transaction. The anticipated equity financing is generally an issuance of equity or a public offering (which could include a traditional initial public offering, a de-SPAC[2] IPO, or a direct listing) for a private issuer. Bridge convertible debt often raises several tax considerations that are not typically raised by plain vanilla convertible debt. This article will examine some common features of bridge convertible debt and develop general principles in analyzing these instruments.

First, this article discusses whether bridge convertible debt is properly characterized as debt for federal tax purposes. It observes that while bridge convertible debt may contain terms that may be somewhat indicative of an equity

[1] Plain vanilla convertible debt is the common variety of convertible debt issued by companies whose stock is already publicly traded and: (1) pays interest (if any) semiannually in cash; (2) has an original term of five years or slightly longer; and (3) is convertible into (or exchangeable for) publicly traded stock of the note issuer or its parent (or, in some cases, cash or a combination of cash and shares) at the holder's option at a fixed conversion price. Investors in plain vanilla convertible debt are entitled to be paid interest and principal amounts, but if the conversion value of the notes at maturity exceeds the final principal payment, then the investor would choose to convert instead of hold the debt to maturity. *See* Y. Bora Bozkurt, "Non-Plain Vanilla Questions About Taxation of Plain Vanilla Convertible Debt," *Tax Notes Federal*, Dec. 6, 2021, p. 1335.

[2] A de-SPAC transaction is one in which a private company goes public by merging with a special purpose acquisition company.

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investment, the ultimate economics may not be materially different from plain vanilla convertible debt in some ways. Second, it considers whether bridge convertible debt should be subject to the contingent payment debt instrument (CPDI) rules, which can result in adverse tax consequences. To this end, it observes the lack of detail around what constitutes convertible debt for purposes of the various debt rules governing convertible debt and discusses how those provisions might apply (or not) to convertible debt that automatically converts into equity of the issuer on the occurrence of specific events. Finally, it considers the treatment of the issuer of bridge convertible debt, including whether accrued interest (original issue discount) should be disallowed under section 163(l).

I. Bridge Convertibles: Common Terms

The terms of bridge convertible debt vary widely. Each of the key components of the instrument can be tailored by the parties to achieve the issuer's business objectives and the investor's financial return requirements. The following are some key terms commonly found in bridge convertible debt.

Interest: Depending on market conditions, the interest rate on bridge convertible debt can be as low as 0 percent or higher than 10 percent. Interest may be payable in cash or, as is often the case, in kind (by increasing the principal amount by the amount of accrued interest).

Maturity Date/Term: Bridge convertible debt is commonly issued with a short term (for example, two years or less), but in some cases has a longer term (for example, seven years or longer).

Conversion Provisions: Bridge convertible debt instruments generally become convertible (often automatically) on the occurrence of one or more specified events, such as a qualified public event (for example, an IPO) that results in a market capitalization for the issuer that exceeds a threshold.[3] As another example, bespoke convertible debt may automatically convert into equity on the occurrence of the next round of equity financing (which generally will be an issuance of equity that exceeds a specific fixed amount). As noted, conversion will often occur automatically, although in some instances, the conversion feature is drafted as an optional conversion coupled with the issuer's right to redeem the notes at their outstanding principal amount.[4] For an IPO, while market practice is highly varied, the shares received upon conversion may be subject to lockup restrictions, whereby the investors cannot sell the shares they received for a specific period (for example, 180 days).

The conversion price in the event of an equity transaction (such as a qualified public event) is also highly variable. For example, it could be the volume-weighted average price for the listed security immediately following the qualified public event (that is, effectively yielding a number of shares intended to be worth approximately the principal amount of the debt upon conversion), or the conversion can be set at a discount to the price in the qualified public event (that is, effectively yielding a number of shares intended to be worth the specified percentage above the principal amount of the debt upon conversion). Some earlier-stage bridge convertible debt converts into

[3]For example, depending on the type of company and the size of the convertible debt, it could be a public offering that results in a market cap ranging from $100 million or lower to $10 billion or higher on a major stock exchange (*e.g.*, the New York Stock Exchange or the NASDAQ). The restrictions around the definition of qualified public event are intended to ensure the liquidity of the security underlying the convertible debt. Investors in bridge convertible debt frequently require a minimum market capitalization to be achieved by the public offering because they may otherwise prefer owning their investment in the form of debt, as opposed to owning a large portion of a public equity class. If the equity received is such a large portion of the outstanding public equity class, the issuer may have concerns with liquidity in disposing of its equity ownership (among other concerns).

[4]The intention is, in the event the company can carry out an IPO or other qualified public event, to provide the investor with an exit opportunity at a profit and clear up the company's capital structure from the outstanding convertible debt. One may wonder why, given the tax uncertainty that results otherwise, all bridge notes are not drafted to provide the holder with an option to convert the notes under the qualified public event. Even though the investor is most likely to convert, most issuers want the certainty, agreed to by the issuer and the holders at issuance that the IPO will clean up the company's pre-IPO debt structure, because in the unlikely chance that any holder does not convert, the issuer may lack cash to pay back the notes if the instrument lasted until maturity.

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equity based on the pricing of the next round of private equity financing. In some instances, the discount factor may also change at specified intervals. As a result, that bridge convertible debt instrument may effectively yield a number of shares that increase in value at specified intervals.[5]

Finally, bridge convertible debt instruments may also have conversion mechanics triggered upon a change-of-control transaction (for example, a sale to a third party).[6]

Repayment at Maturity: If the instrument is not converted into equity, the investor can generally demand payment in cash at any time on or after the maturity date. The amount of repayment is generally the principal amount plus accrued and unpaid interest; however, in some instances, the amount payable (in cash) at maturity is determined by taking into account the discount factor. Alternatively, the investor may have the right to convert into equity, sometimes at a conversion price equal to fair market value or the price for the last round of equity raise (in each case, potentially subject to a discount factor).

II. Debt or Equity?

A threshold question when reviewing any debt instrument is whether it constitutes debt for tax purposes. Some commentators believe this analysis is more challenging for bridge convertible debt.[7] As noted, bridge convertible debt is generally issued to "bridge" to — or to provide capital to fund operations in advance of — an equity transaction, such as an IPO (which itself would frequently give rise to an automatic conversion). The conversion feature commonly found in bridge convertible debt will generally provide for a discounted conversion price (for example, the conversion price will be 80 percent of the price paid for the shares in the equity transaction). For this reason, it could be argued that the acquisition of bridge convertible debt is tantamount to acquiring shares of the issuer at a discount to the public sales price when the parties believe the likelihood of a conversion is rather high.[8]

Debt treatment generally requires a "sum certain" to be paid at maturity. The automatic conversion feature commonly found in bridge convertible debt may prevent holders from being able to demand payment in cash. The IRS has warned that any security requiring a holder to accept payment of principal solely in stock of the issuer is at risk of not being treated as debt for federal income tax purposes.[9] However, other guidance implies that a debt instrument that is automatically, or is highly likely to be, converted can still remain as debt for federal income tax purposes if the amount to be received will result in the repayment of the outstanding principal balance.[10] The equity treatment argument would be further supported by the fact that it is common for those instruments to be issued in a situation in which the issuer could only repay the loan through an automatic conversion upon an equity transaction. In the absence of that transaction, the cash issuer may lack the means to repay the debt at maturity.

[5] Other variations are also possible, *e.g.*, if the size of the market cap of the issuer under the qualified public event is larger than a threshold, the investor may want its discount factor (and thereby its yield) to grow by using a cap price mechanic. The cap price constitutes a cap on the valuation of the issuer, meaning the conversion consideration grows as the market cap of the issuer grows above the valuation cap.

[6] In many cases, a qualified public event, and not a change of control, is the expected mode of exit for the convertible debt investors.

[7] For a discussion on this issue, see David C. Garlock et al., *Federal Income Taxation of Debt Instruments*, para. 102.10 (2022).

[8] In various instances in the code, the IRS considers options that are highly likely to convert as akin to equity for U.S. federal income tax purposes. *See, e.g.*, section 163(l) (treatment of options embedded in convertible debt in the context of interest deductibility), reg. section 1.1361-1(l)(4)(iii) (treatment of options on S corporation stock), and reg. section 1.1504-4(g)(3)(i)(A) (treatment of options for corporate consolidation purposes). Given it is often at a discount to the IPO price, the conversion feature in bridge convertible debt, if not automatic, is indeed highly likely to be exercised once conversion is available; however, the availability of conversion is, in turn, subject to a significant contingency — namely, the successful execution of an IPO or other qualified public event.

[9] Notice 94-47, 1994-19 IRB 1, confirms the validity of a ruling finding that some mandatory convertible notes examined in Rev. Rul. 85-119, 1985-2 C.B. 60, would be treated as debt instruments. The notice cautions that those notes would have been unlikely to qualify as debt if they included: (1) a provision requiring the holder to accept payment of principal solely in stock of the issuer (or in some circumstances a related party); (2) a right to elect payment in cash that is structured to ensure the holder would choose the stock; or (3) a nominal right to be paid in cash that "does not, in substance give the holder the right to receive cash because, for example, the instrument is secured by the stock and is nonrecourse to the issuer." The notice thus could stand for the proposition that debt legally or in substance payable in equity would be treated as equity and would be treated differently from a debt instrument in which holders can receive equity at their option.

[10] As discussed later, there is often a higher risk that an issuer may not be able to deduct interest that accrues under a bridge convertible debt under section 163(l). However, section 163(l) does not itself alter the treatment of the instrument as debt in the first place, and even if it applies to disallow an issuer's interest deductions, holders would continue to accrue interest income on the debt instrument.

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While the debt/equity determination for bridge convertible notes may be more challenging than for plain vanilla convertible debt, bridge convertible debt and plain vanilla convertible debt (which are generally regarded as indebtedness for tax purposes) are similar in some important ways.

First, both instruments are generally principal protected. The ability to be repaid a fixed amount (a sum certain) at maturity has been considered the sine qua non of debt characterization.[11] The question raised by bridge convertible debt instruments is whether there is an entitlement to a return above the principal amount (and if the way in which that amount is determined and paid should affect the instruments' tax treatment).[12] In many cases, the likelihood of a conversion (often an automatic conversion) of a bridge convertible note is quite high (indeed, much higher than a typical plain vanilla convertible debt instrument). It is unclear how much emphasis should be placed on the likelihood of conversion in determining whether an instrument will be regarded as debt for tax purposes. For example, if an instrument is fully principal protected (with enforceable creditors rights), should an instrument labeled as debt be treated as equity for tax purposes solely because the parties are relatively confident that the debt will convert into equity? Given that the debt-equity test is a multifactor test, it is unclear whether courts or the IRS would place a disproportionate amount of weight on this one factor.

Second, some bridge convertible debt instruments automatically convert upon the occurrence of an event, after which, if the debt instrument has instead been optionally convertible (at the same conversion price), most (if not all) holders would have preferred exercising their conversion rights over receiving back their principal amount (in cash). The automatic conversion provision would not require the investor to accept stock that is worth less than the principal amount of the convertible debt, and is economically similar to where the investors would be if they instead had an optional conversion right in the event of an equity financing round. In this way, the automatic conversion provision could be simply viewed as the holders agreeing in advance to exercise their conversion rights upon the occurrence of some (pre-identified) events.[13]

Finally, bridge convertible debt is commonly issued by issuers that have cash flow concerns in the absence of an IPO. However, while a higher risk of default may denote a higher risk of equity treatment, it is not clear that the risk of nonpayment on bridge convertible debt would necessarily cause those instruments to be more at risk of equity characterization than some plain vanilla convertible debt. Plain vanilla convertible debt, while denoted as senior debt by its terms, is normally not secured and is, in many instances, structurally subordinated to operating debt.

Bridge convertible debt often provides for a lockup period (during which the holder cannot sell the stock it receives on conversion), which appears to be an equity-linked aspect that is different from plain vanilla convertible debt. Specifically, upon conversion of a bridge convertible debt, in the event of an IPO, the investor is often prohibited from selling the shares for some time (for example, a lockup period of 180 days). The lockup feature is intended to stabilize the trading of the shares by restricting trading by insiders following an IPO. While the existence of a lockup may not change the investor's decision to convert into shares, even if it were optional to do so (as long as the conversion discount is sufficiently material), it complicates the picture in terms of the investor's ultimate recovery from the investment. The lockup period could be a substantial time during which the investor is exposed to market conditions. It is unclear whether the lockup period that applies upon

[11] *See* Garlock et al., *supra* note 7.

[12] To this end, in a sense, bridge convertible debt is less equity linked than plain vanilla convertible debt because it has an event-based return, tied to a qualified public event like an IPO, as opposed to a return that changes daily with the equity market conditions and the trading price of the shares. On the other hand, the qualified public event taking place is itself tied, in large part, to the valuation of the shares and the equity market conditions.

[13] Some bridge convertible debt transactions envision the note to be converted into stock at a conversion price equal to the trading price at or following an IPO, but without any discount. For that bridge convertible debt, assuming there is no lockup mechanic or other securities law limitations, the investor would be effectively getting paid its principal amount by publicly traded stock that it generally can liquidate into cash as necessary.

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conversion of the debt instrument should be examined as a feature of the debt instrument that may affect its treatment as debt for federal income tax purposes.[14] Alternatively, the investor may be treated as receiving a payment of value on conversion, and the lockup period could instead be taken into account in determining the value of the shares received on conversion. In that case, any subsequent price movement (either an increase or decrease) would not affect the debt characterization of the transaction.

In sum, the application of debt/equity considerations to bridge convertible debt is unclear, and given the unique terms of that debt, it can frequently be challenging to gain a high level of comfort that the instrument is (or is not) debt for tax purposes. Indeed, because of this tax uncertainty (and the possibility for unfavorable tax treatment to both parties, as discussed below), some parties to bridge convertible debt instruments have included a statement providing their intention to treat those instruments as equity for tax purposes. Equity characterization depends on all the facts and circumstances, and the IRS is not bound by the issuer's determination. This article focuses on the tax consequences arising from treating those instruments as debt for federal income tax purposes.

III. Convertible Debt Exception

Perhaps the most challenging and highly debated issue concerning bridge convertible debt instruments (assuming they are indeed regarded as debt for tax purposes) is whether the conversion option is ignored for purposes of the OID rules and the CPDI rules. This section will first discuss why bridge convertible debt instruments are (potentially) at risk of being characterized as CPDIs. It will then address why the CPDI rules ought not to apply to typical bridge convertible debt and when that conclusion may be in doubt.

Given the materially different and often adverse tax consequences under the CPDI rules (for all parties involved), whether bridge convertible debt is subject to CPDI treatment is a crucial determination. The CPDI rules apply to some debt instruments that provide for one or more contingencies, subject to several exceptions.[15] Under reg. section 1.1275-4(a)(4), in determining whether a debt instrument provides for a contingent payment, conversion options are generally ignored. If the conversion feature is not described in this exception, it is likely to be treated as a contingency (and, as a result, the debt instrument will likely be treated as a CPDI), unless conversion is a highly unlikely outcome (that is, it is a remote possibility on the issue date of the debt that a conversion will occur).[16]

The exception for convertible debt is as follows:

> A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.[17]

This language is the same as that included in reg. section 1.1272-1(e), which provides that a conversion feature of the sort described in the regulation is ignored in determining the OID schedule for a debt instrument. So, presumably, if a conversion feature is not covered by the above definition, there would also be a question of whether it can create OID for federal income tax purposes. We will refer to both rules collectively as the convertible debt exception.

The optional conversion feature found in plain vanilla convertible debt is generally considered to qualify for the convertible debt exception. Plain vanilla convertible debt will generally provide the holder with the right to

[14] The IPO lockup could in effect risk the principal protection of the instrument, and the question then is when the debt treatment of the instrument is at substantial risk in the first place. This concern is not raised by plain vanilla convertible debt because it typically lacks lockup restrictions and is principal protected. Similarly, if bridge convertible debt is expected to convert into equity in a financing round when the company remains private, the effect may be comparable to receiving public equity with a significant lockup period when the investor ultimately recovers less than its principal amount.

[15] The exceptions are provided in reg. section 1.1275-4(a)(2)-(5).

[16] *See* reg. section 1.1275-4(a)(5).

[17] Reg. section 1.1275-4(a)(4).

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convert the debt instrument into a fixed number of issuer's shares.[18]

The convertible debt exception, by its terms, is not limited to plain vanilla convertible debt. First, the rule does not specify if its application depends on whether the option is for conversion into (1) a fixed number of shares; (2) a variable number of shares; or (3) shares that are worth a fixed or variable amount. Relatedly, there is no requirement that the amount of the conversion consideration correlates with the stock price. Further, the rule also does not specify whether the application of the rule changes based on the likelihood of exercise. Finally, while the rule does not specify whether the option to convert needs to belong to an issuer or a holder, it refers to there being an option.

Bridge convertible debt instruments have a variety of conversion options with different potential tax treatments under the convertible debt exception. Now we consider a few common varieties of bridge convertible debt conversion features.

Fixed Discount Conversion Option: If upon conversion, the investor is entitled to convert its debt at its option into shares at a conversion price with a discount, whether that conversion qualifies for the convertible debt exception depends on whether the exception requires the investor to receive an amount of conversion consideration that changes based on the stock price.

> Base Case Example: Consider a convertible debt instrument issued by a private issuer with a three-year term that pays 5 percent cash interest per annum and becomes convertible into stock if and when the company undertakes an IPO that qualifies as a qualified public event, at a certain discount to the IPO price.
>
> Assume the company issues $1,000 of notes at a time when the stock is private. However, when the company does undertake a qualified IPO, the notes become convertible into shares (at the investor's option) at a conversion price that represents a 20 percent discount to the IPO price. The discounted conversion feature is intended to represent a return to the investor. The debt becomes redeemable by the issuer at par if an IPO occurs and the investor does not convert. If the issuer never undertakes an IPO, the debt is required to be redeemed (for cash) at maturity.

The conversion feature of this instrument is structured to result in a fixed amount. If the issuer eventually undertakes an IPO, a holder of a note having a principal amount of $1,000 would convert its notes into shares worth $1,250. The exact IPO price would not ultimately matter in determining the value the investor receives upon conversion.[19] However, the conversion option is still subject to a major equity-linked contingency that also largely depends on the market's valuation of the company's stock. So, even though the return is not directly linked in this example to the exact IPO stock price, as in the case of plain vanilla convertible debt, it would appear that the conversion feature is still captured by the wording (as well as the spirit) of the convertible debt exception.

Growing Discount: For some bridge convertible debt instruments, the discount factor changes based on the timing of the IPO.

> Alternative 1: Same facts as the base case example, except the discount factor grows (and, thereby, the return received at IPO grows) by 4 percent every six months.

While the existence of a growing discount may encourage the issuer to undertake the IPO sooner rather than later, it would likely still not guarantee that the issuer would undertake an IPO. Under these circumstances, an analysis

[18] Generally, the conversion option, which effectively requires the investor to forgo its principal payment, will be exercised only if, upon conversion, the investor receives an amount that exceeds the principal amount. Further, the amount received at conversion depends on stock price — the higher the stock price, the higher the return of the investors. Typically, a holder of a plain vanilla convertible debt holds the debt until maturity and converts it only if the amount of shares to be received upon conversion multiplied by the share price exceeds the principal amount of the debt instrument. Relatedly, the higher the stock price at conversion, the higher the value of the consideration that is to be received by the investor. The notes are often issued out of the money; that is, at issuance, the trading price of the shares is significantly less than the conversion price of the notes.

[19] As discussed previously, some bridge convertible debt instruments have a share cap mechanic that when the market capitalization of the issuer upon the IPO exceeds a specific limit, the value of the shares the investor receives upon conversion also increases.

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similar to the analysis in the fixed discount example would seem to apply (so this conversion feature would be covered by the convertible debt exception).

No Discount Conversion: If the conversion feature embedded in the bridge convertible debt is intended to result in the investor receiving shares that are equal in value, at the time of conversion, to the principal amount of the debt (that is, there were no discount factor), it is arguably more appropriate to view that conversion as a principal repayment and not delve into the application of the convertible debt exception (because the conversion feature does not provide for a payment contingency, other than perhaps when the payment may occur).[20]

Automatic Conversion: Given that the convertible debt exception references an option to convert, a key question is whether the application of the convertible debt exception applies to conversions that occur automatically under the terms of the debt instrument.

> Alternative 2: Same facts as the base case example, except in the event of a qualified IPO, the convertible debt converts into stock automatically.

In this instance, the conversion feature of the bridge convertible debt requires the investor to convert its notes into equity at the time of an IPO at a substantial discount to the IPO price. If the automatic conversion in a bridge convertible debt more closely resembles a scenario in which the investor, if it had an option to convert at the time of the IPO (that is, the base case example above), would have converted anyways, there is arguably no clear policy reason why optional and automatic conversion features should be handled differently.[21] In this way, the automatic conversion provision could be simply viewed as the holders agreeing in advance to exercise their conversion rights upon the occurrence of some (pre-identified) events. That is, one could interpret the terms of the loan as providing for an option that the investors agreed (at issuance, so their agreement was documented in the final loan terms) to exercise on the occurrence of some specified events (that is, an IPO). With that said, there may be instances in which parties perceive differences between optional and automatic conversions,[22] and given the plain language of the convertible debt exception (which applies to conversion options), it may be challenging to reach a strong level of comfort on this issue.

Guaranteed Return: Qualification for the convertible debt exception results in an exception to the OID rules, so query whether the convertible debt exception should apply when the conversion option is effectively intended to provide a guaranteed return to the investor that would have otherwise been treated as OID under the regulations.

> Alternative 3: Same facts as the base case example, except if the issuer never undertakes a qualified IPO, the debt becomes convertible at the holder's option at maturity. Upon exercise of such conversion option, the parties agree to mutually determine a value for the issuer's equity using a valuation expert, and the issuer delivers stock taking into account the discount factor that would have been applicable to an IPO.

In this example, the conversion at maturity is not contingent on stock price or a stock-linked event like an IPO. The conversion feature therefore appears to be structured to provide a return to the holder in all cases. In this instance, query whether the more appropriate analysis may be to view the excess of the expected amount to be

[20] Even in that instance, there may be a question whether an early repayment at par may result in CPDI considerations, especially if the debt was issued with a discount at issuance. This issue comes up with some frequency in loans with excess cash flow sweep features. *See, e.g.*, Sara B. Zablotney, "Debt Instruments Subject to Timing Contingencies: A Discussion and Proposal," BNA Tax Management Memorandum (2013); Paul Kunkel, Ivan Thomann, and Liz Dyor, "Accruing Original Issue Discount on Excess Cash Flow Sweep Loans," 11 *J. Tax'n of Fin. Products*, 3, 27-34 (2013); *see also* Garlock et al., *supra* note 7, at para. 903.02. Note that if the contingency relates purely to timing, and has no effect on the yield to maturity (which would not be the case for debt issued at a discount), the OID rules generally ignore the prepayment and provide that the parties should accrue interest at the yield of the debt. *See* reg. section 1.1272-1(d).

[21] By analogy, in determining the relevant payment schedule for OID purposes, the rules assume that an investor would be deemed to exercise an option if the exercise increases its yield. *See* reg. section 1.1272-1(c)(5). So the rules have an implicit assumption that investors would act in favor of their economic interests.

[22] *See supra* note 5.

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received at maturity over the principal amount as OID for federal income tax purposes. Given that a conversion option qualifying for the convertible debt exclusion results in an exception to the OID rules, the option definition arguably ought not to be applied to circumstances in which the conversion option is effectively intended to result in a guaranteed return to the investor that would have otherwise been treated as OID under the regulations. On the other hand, the plain language of the convertible debt exception would still appear to cover this fact pattern. Also, the guaranteed return at maturity is likely in the form of private company shares, which, as discussed previously, could be seen as economically different from a guaranteed return in the form of cash that would otherwise more clearly constitute OID.

In sum, while there is no clear guidance on the issue, it is still possible to discern a general framework for the application of the convertible debt exception to various bridge convertible debt instruments based on the existing OID and CPDI frameworks. Given that the exception was inspired by plain vanilla convertible debt that features options that are contingent on stock price, one possible approach is to interpret the option definition to cover options that are generally linked to the company's equity — be it stock price or stock-based events (like an IPO) — but not all payments that are linked to any contingency or payments intended to be a part of the investor's guaranteed return. Further, given that qualification for the convertible debt exclusion results in an exception to the OID rules, the convertible debt exception arguably should not apply when the conversion option is effectively intended to result in a guaranteed return to the investor that would have otherwise been treated as OID under the regulations. Finally, while the inclusion of the word "option" in the convertible debt exception makes applying the exception to automatically convertible debt challenging, arguably the exception ought to apply to an automatic conversion feature that requires conversion in a situation in which the (economically rational) holder would have chosen to convert if it had an optional conversion.

IV. Convertible Debt as a CPDI

A. Holders

Investors generally prefer to avoid the application of the CPDI rules to their convertible debt investments. The CPDI rules provide for the accrual of interest (in the form of OID) at a comparable yield for federal income tax purposes. A comparable yield is the yield at which the issuer would issue "a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument."[23] In determining the comparable yield of a convertible debt instrument that is a CPDI, the point of reference would be a nonconvertible (non-contingent) debt instrument that otherwise has similar terms and conditions.[24] Convertible debt instruments typically provide for a lower stated interest rate than nonconvertible debt (as a result of the value of its embedded conversion option). The comparable yield of a contingent convertible debt instrument would therefore be higher than the stated interest rate, resulting in higher interest income accruals to the investor.[25] Further, and of particular concern to investors, under the CPDI rules, any conversion of convertible debt instruments would likely be a taxable event for federal income tax purposes, even if the investor receives stock,[26] and any resulting income (in addition to the interest income that has already accrued at the comparable yield before conversion) would likely be ordinary income. The potential for a tax on conversion may come as a surprise to investors, many of whom may be

[23] Reg. section 1.1275-4(b)(4)(i).

[24] *See* Rev. Rul. 2002-31, 2002-1 C.B. 1023.

[25] If the convertible debt instrument is for nonpublicly traded stock or for stock of an issuer treated as a Foreign Investment in Real Property Tax Act company, there may be a question whether the interest on the convertible debt is "contingent" for purposes of portfolio interest exemption, which may, in return, result in withholding tax concerns for non-U.S. investors for the contingent portion of the interest income. *See* section 871(h)(4)(C).

[26] If a convertible debt instrument is a CPDI, receipt of stock under the debt instrument would generally constitute a contingent payment subject to the positive and negative adjustment rules. Assuming the FMV of the stock exceeds the projected payment for the period (which is likely to be limited to the interest coupon except at maturity), that excess is likely to constitute a "positive adjustment" that results in ordinary income. *See* reg. section 1.1275-4(b)(6). However, query whether an unscheduled retirement — which the regulations treat as a repurchase by the issuer for the amount paid by the issuer — may qualify as a tax-free recapitalization under section 368(a)(1)(E) (assuming the convertible debt instrument is a security). *See* reg. section 1.1275-4(b)(7)(v).

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familiar with the general tax-free treatment on conversion afforded to plain vanilla convertible debt.[27]

B. Issuers

CPDI treatment may also provide mixed results for issuers of convertible debt. The accrual of interest at a comparable yield often results in additional interest deductions over the term of the debt instrument, because, as noted, the comparable yield would be determined by reference to the rate that may apply to nonconvertible debt.[28] One may assume issuers would welcome this result, but the reality is often much more complicated. From a nontax perspective, issuers of bridge convertible debt frequently have limited financing options and therefore are keenly focused on the successful execution of the transaction. Any provision that may complicate the investor's tax treatment or require the issuer to conduct complex tax analysis (such as determining the comparable yield and calculating a projected payments schedule) is a concern for the issuer. Further, the additional interest expense deductions may be of limited use to many issuers of bridge convertible debt. First, any interest deductions may be permanently disallowed under section 163(l). We discuss this provision in more detail later. Also, issuers of bridge convertible debt are frequently in a loss position and do not project to become profitable over the term of the debt instrument, so the additional interest deductions may be of limited value (that is, they may be deferred under section 163(j) or otherwise contribute to the issuer's net operating loss carryforward).

The tax treatment of an issuer of CPDI convertible debt is further complicated by the asymmetrical treatment of the adjustments at maturity or settlement. As noted, a CPDI convertible debt will typically result in interest deductions that (often greatly) exceed the cash coupon over the term of the instrument. Those deductions would increase the adjusted issue price of the debt instrument. Assume that debt is converted into stock and the conversion consideration to be delivered exceeds the adjusted issue price of the debt instrument. Under section 249, the issuer generally will not be able to deduct that excess.[29] On the other hand, if the CPDI convertible debt ultimately does not convert, but rather is settled by just paying the principal amount, or if the amount delivered at conversion is less than the adjusted issue price, the difference between the adjusted issue price and the amount paid or delivered triggers income for the issuer (a settlement income inclusion), which will generally be characterized as interest income (to the issuer) for section 163(j) purposes.[30]

To this end, reg. section 1.163(j)-1(b)(22)(iii)(B) provides:

> (B) Treatment of ordinary income or loss on certain debt instruments. If an issuer of a contingent payment debt instrument subject to section 1.1275-4(b), a nonfunctional currency contingent payment debt instrument subject to section 1.988-6, or an inflation-indexed debt instrument subject to section 1.1275-7 recognizes ordinary income on the debt instrument in accordance with the rules in section 1.1275-4(b), section 1.988-6(b)(2), or section 1.1275-7(f), whichever is applicable, the ordinary income is treated as interest income of the issuer.

Under this rule, ordinary income recognized by the issuer under the CPDI rules would be treated as interest income. Although this rule seems to clearly apply to a conversion (or repayment) at maturity,[31] it is slightly less clear

[27] If bridge convertible debt were automatically convertible, there is a risk that the conversion into stock is taxable, regardless of whether the debt is CPDI. The source of this ambiguity is that both Rev. Rul. 72-265, 1972-1 C.B. 222, and reg. section 1.1001-3 refer only to conversions resulting from the holder's exercise of its conversion right. Thus, the tax treatment of a conversion of plain vanilla convertible debt into equity of the issuer is well established — the transaction is not treated as a realization event to the holder, who will not recognize gain or loss. In contrast, an automatic conversion may result in the realization of gain or loss to the holder, regardless of CPDI treatment, unless conversion is a recapitalization under section 368(a)(1)(E) (or the argument prevails that automatic conversion is simply a pre-agreement to exercise an option in circumstances in which it would have made economic sense to do so).

[28] *See generally* Rev. Rul. 2002-31.

[29] *See* Rev. Rul. 2002-31 ("Section 249 does not affect Corporation X's ability to deduct periodic interest accruals on the debt instrument. However, if the debt instrument is converted into Corporation X stock having a value in excess of the debt instrument's adjusted issue price, Corporation X may not be able to deduct this excess under section 249.").

[30] *See* reg. section 1.1275-4(b)(7)(iv) and -4(b)(6).

[31] *Id.*

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whether any cancellation of debt (COD) income on an early conversion would likewise be interest income under this rule. This conclusion appears to rest on whether an early conversion is a "scheduled retirement" for purposes of the CPDI rules.[32] Although unclear, the authors believe that the regulation ought to be read to provide parity between early conversions and conversions at maturity,[33] and therefore any income recognized by the issuer on conversion (or retirement) ought to be treated as interest income for section 163(j) purposes.

Assume, however, the deductions were disallowed under section 163(l): The issuer is now facing an income item — which is, in effect, a reversal of deductions that the issuer has not been able to use in the past — whose tax treatment may be complicated.

In a situation in which an issuer of CPDI convertible debt is subject to section 163(l) and has been unable to take interest deductions over the course of the debt, there remains some uncertainty about whether that issuer can be responsible for a potential settlement income inclusion regarding amounts that represent the unused interest deductions. Under one approach, that settlement income inclusion is justified because section 163(l) is intended to be a punitive provision, and excluding the settlement income inclusion would deny the intended effect of section 163(l). A similar issue arises for personal interest. For example, other than home mortgage interest, personal interest payments are not deductible under the law; however, if that personal interest is forgiven, it would (arguably)[34] constitute COD income to the individual under the argument that there is accession to wealth. However, as applied to CPDI convertible debt and section 163(l), that argument makes less sense. CPDI convertible debt does not legally accrue interest (other than the coupon interest), and the parties did not renegotiate the terms of the debt to forgive interest payments. Both the deductions over the course of the debt instrument and the settlement income inclusion are hypothetical items deemed to exist under the rough justice system of the CPDI regulations, and it is difficult to say there is true accession to wealth when there is an income item for U.S. tax purposes under the corrective CPDI rules. For this reason, interpreting the interaction of the CPDI regulations and the section 163(l) regulations to result in income for the taxpayer seems particularly unfair.[35] Still, it may be difficult to reach a strong level of comfort that a settlement income inclusion is not income to the issuer.

In sum, CPDI treatment is frequently undesirable for both the issuer and investors of convertible debt.

1. Section 163(l).

Section 163(l) provides interest disallowance rules for some convertible debt issued by a corporation. Under section 163(l)(3), interest payments on a convertible note (in which the holder of the debt holds the conversion right) are not deductible if there is substantial certainty that the conversion option will be exercised. The legislative history for section 163(l) suggests that it is not expected to apply to traditional plain vanilla convertible debt that provides for a conversion premium at issuance.[36] On the other hand, section 163(l)(3)(A) provides a stricter rule

[32] If conversion were instead viewed as an unscheduled retirement, then on an early conversion, the issuer would be treated as repurchasing the debt for the amount paid. If the amount paid is less than the tax-adjusted issue price, the issuer would have COD income (under reg. section 1.61-12(c)). Because the income is provided for under the COD rules and not the CPDI rules, the section 163(j) provision described above arguably may not apply. The authors do not believe that this is the only (or necessarily the best) interpretation of the regulation.

[33] To that end, a conversion before maturity may be treated as a scheduled retirement — that is, the determination of what is (and is not) a scheduled payment ought not to be determined based solely on the issuer's projected payment schedule, which solely reflects one of many potential payment schedules under the terms of the debt (each of which is arguably a schedule for purposes of reg. section 1.1275-4(b)(7)(iv)).

[34] *See generally* Richard C.E. Beck, "The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt," 53 *N.Y. L. Sch. L. Rev.* 1025 (2008-2009).

[35] Taxpayers and practitioners frequently wrestle with whether an issuer should have COD income for interest for which those rules have permanently disallowed a deduction (for example, under the applicable high-yield discount obligation rules in section 163(i)). One line of authorities that some practitioners point to as support for not reporting COD income in that case is *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932), *nonacq.*, X-2 C.B. 99 (July-Dec. 1931), and *United States v. U.S. Steel Corp.*, 848 F.2d 123 (Fed. Cir. 1988), *rev'g* 11 Cl. Ct. 375 (1986). These cases could be interpreted to provide that, if the issuer did not benefit from the deduction (for example, it was disallowed under section 163(l)), it should not have COD income when the obligation to repay the same amount is later canceled. *See also* Garlock et al., *supra* note 7, at para. 1501.02[C].

[36] H.R. Rep. No. 105-148, at 458 (1997) ("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.").

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— at least on its face — for automatic conversions. Under section 163(l), interest payments on a note are not deductible if a substantial amount of the principal or interest is required to be paid or converted into equity, with no substantial certainty qualifier. That qualifier may be considered implicit if bridge convertible debt automatic conversions are viewed as akin to a pre-agreement to exercise an option in circumstances in which it would have made economic sense to do so.

Alternatively, because the issuer does not have an unconditional right to force a conversion (that is, a conversion will occur only on the occurrence of one or more events), the conversion feature may be examined under section 163(l)(3)(C), which provides that section 163(l) will apply when "the indebtedness is part of an arrangement which is reasonably expected to result in a transaction described in subparagraph (A) or (B)."[37] Under this approach, section 163(l) would apply (and therefore interest expense deductions on the debt instrument would be disallowed) if it was reasonably expected that an event triggering an automatic conversion would occur. Therefore, under this approach, if it was reasonably expected that an IPO would occur — and therefore that the debt would automatically convert into equity of the issuer — section 163(l) would disallow the issuer's interest deductions. We are unaware of any guidance defining "reasonably expected" for purposes of section 163(l)(3). As a result, determining whether an event is sufficiently likely to occur so that section 163(l)(3) could be implicated can be challenging.

V. Parting Thoughts

Bespoke convertible debt (and, more specifically, bridge convertible debt) has become a common financing tool for companies of all sizes, both public and private. Despite its increased prevalence, the tax treatment of bridge convertible debt is often misunderstood, and its complexity is unappreciated. Often, the tax treatment of bridge convertible debt may be much different than plain vanilla convertible debt — but should it be? The authors believe that in many cases, the tax treatment of bridge convertible debt ought not to deviate materially from the tax treatment of plain vanilla convertible debt. However, this determination requires a careful review of the terms of the instrument and the facts involved in its issuance. As always, the devil is in the details. ■

[37] The legislative history in H.R. Rep. 105-22 (1997) states that "An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt . . . or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised." *See generally* Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, para. 1306.3.1.4 (2021); Eileen M. Marshall, "Practical Run-Ins Between Conventional Convertible Debt Instruments and Certain Interest Disallowance Provisions of the Code," *Taxation of Financial Products and Transactions*, at 39-40 (2008).

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