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In this article, Bozkurt considers the challenges of using Up-C convertible debt structures as well as the pros and cons of various structural alternatives.

Any errors in this article are solely the author's.

Up-C structures achieve significant tax efficiencies at the cost of increased structural complexity. An Up-C issuer that looks to issue convertible debt must navigate various challenges that traditional issuers do not face. This article aims to uncover those challenges and discuss the pros and cons of the various structural alternatives.

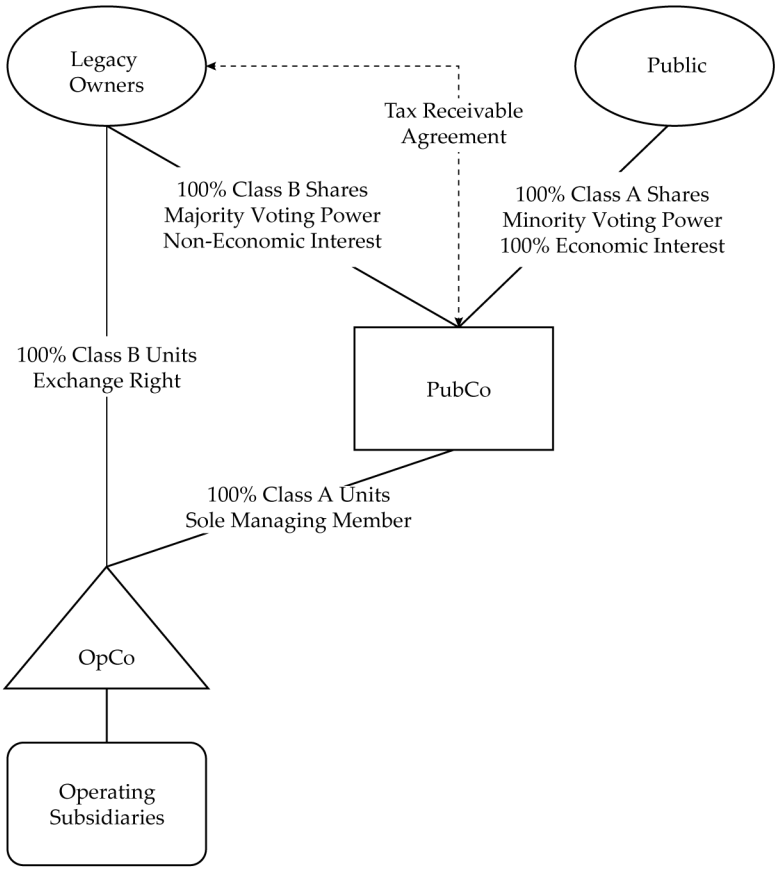
I. Up-C Basics

In essence, Up-C structures consist of a publicly traded corporation (PubCo) that is a holding entity whose sole asset is generally an interest in a partnership (OpCo) that conducts (directly or, more typically, through other subsidiaries treated as passthrough entities) the business operations of the company. Aside from PubCo, OpCo has other owners — generally legacy owners of the business that hold their interests directly through OpCo rather than through PubCo.

The Up-C structure is preferred because of the various tax benefits it bestows upon the legacy owners relative to a traditional structure in which the legacy owners hold their interest in the business through PubCo. For instance, if the business is profitable, the legacy owners are subject to a single layer of tax, since they hold their interests directly through a flow-through entity rather than through a corporation. If the business incurs losses, the legacy owners can use the losses that flow up from its operations to offset their own taxable income (subject to applicable limitations). If they desire liquidity, the legacy owners would convert their interests in OpCo into shares of PubCo to sell down their interests. Under sections 743 and 754 of the IRC, that conversion and sale transaction results in PubCo obtaining an asset basis step-up (and a tax shield) in the operating assets of OpCo deemed sold by reason of the gain incurred by the legacy owners. Legacy owners commonly enter into tax receivable agreements with PubCo, requiring PubCo to share a portion of the tax benefits resulting from that tax shield (as well as, in certain cases, other specific tax attributes) with the legacy owners. As such, the legacy owners are effectively able to receive more consideration for the sale of their interests. For any tax liability resulting from the legacy owners (and PubCo) holding their interests on a passthrough basis, OpCo is obligated to make tax distributions to ensure that PubCo (otherwise a holding entity with no other means to cover its tax liability) and the legacy owners do not come out of pocket for any tax liability.

The Up-C structure is grounded on several key principles. For the legacy owners to have the desired liquidity regarding their interests in

Figure 1. Up-C Structure Basics



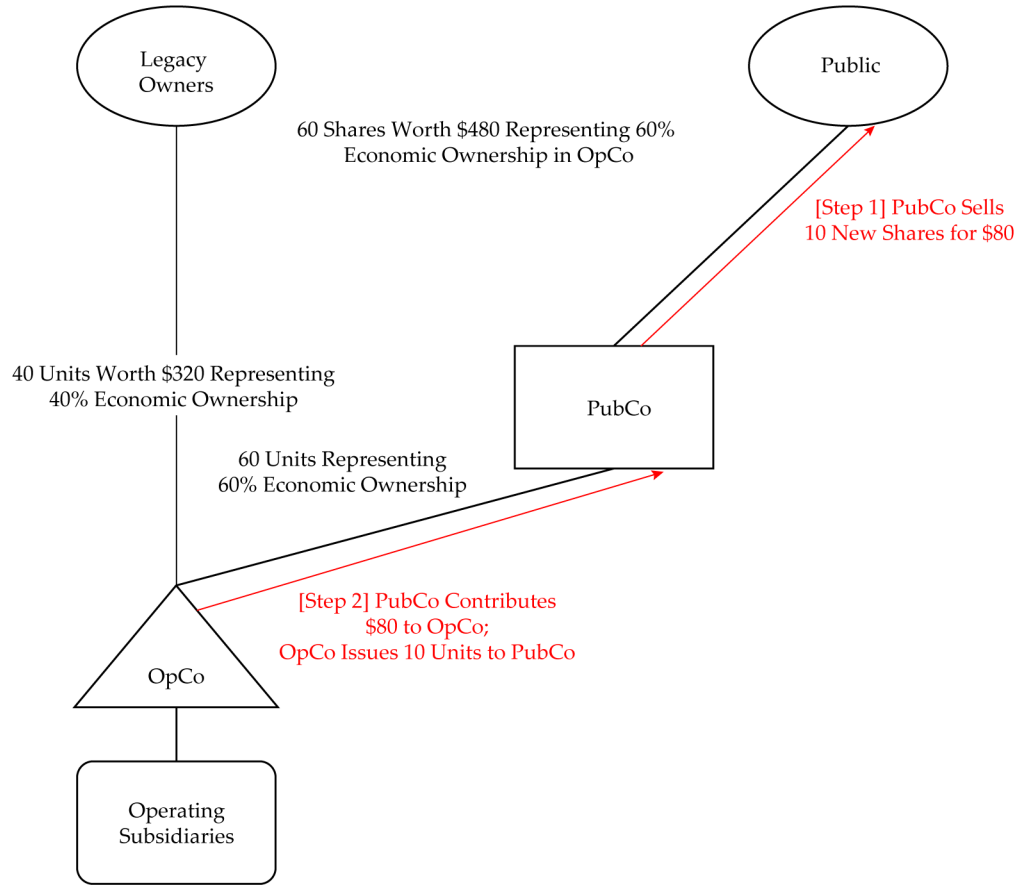
OpCo, they need the ability to promptly exchange their partnership units in OpCo for newly issued PubCo shares and sell their PubCo shares on the stock market. To accomplish this, practically speaking, the units representing the legacy owners' interest in OpCo (in Figure 1, Class B units) must generally be economically equivalent with the units representing PubCo's interest in OpCo (in Figure 1, Class A units). The obvious exception is that the legacy owners can use Class B units to obtain PubCo shares (in Figure 1, Class A shares). Another related principle of the Up-C structure (often referred to as the parity requirement) is that there should be a one-to-one economic equivalence between units in OpCo and Class A shares. Accordingly, PubCo will generally hold an equal number of Class A units to outstanding Class A shares of PubCo. Public shareholders need certainty that if PubCo were to sell more Class A shares, the proceeds would be contributed to OpCo, and OpCo would issue an equivalent number of Class A units to PubCo. Otherwise, PubCo shareholders would experience effective dilution of their economic interest in OpCo. Similar adjustments must be undertaken for PubCo stock redemptions, stock splits, and stock dividends. The parity principle is typically laid out in the partnership agreement for OpCo.[1]

[1] A sample partnership agreement parity provision may read, in simplified form, as follows (subject to further details around stock redemptions, stock splits, stock distributions, etc.): "(a) Except as otherwise determined by the Manager, the Company, and the Corporation, the Parties shall undertake all actions, including, without limitation, an issuance, reclassification, distribution, division, or recapitalization, regarding the Class A Units and the Class A Common Stock and Class B Stock, as applicable, to maintain at all times:

(i) a one-to-one ratio between the number of Class A Units owned by the Corporation, directly or indirectly, and the aggregate number of outstanding shares of Class A Common Stock; and

(ii) a one-to-one ratio between the number of Class B Units owned by Members (other than the Corporation and its Subsidiaries), directly or indirectly, and the aggregate number of outstanding shares of Class B Stock owned by those Members, directly or indirectly."

Figure 2. PubCo Primary Equity Offering Structure: Issuance

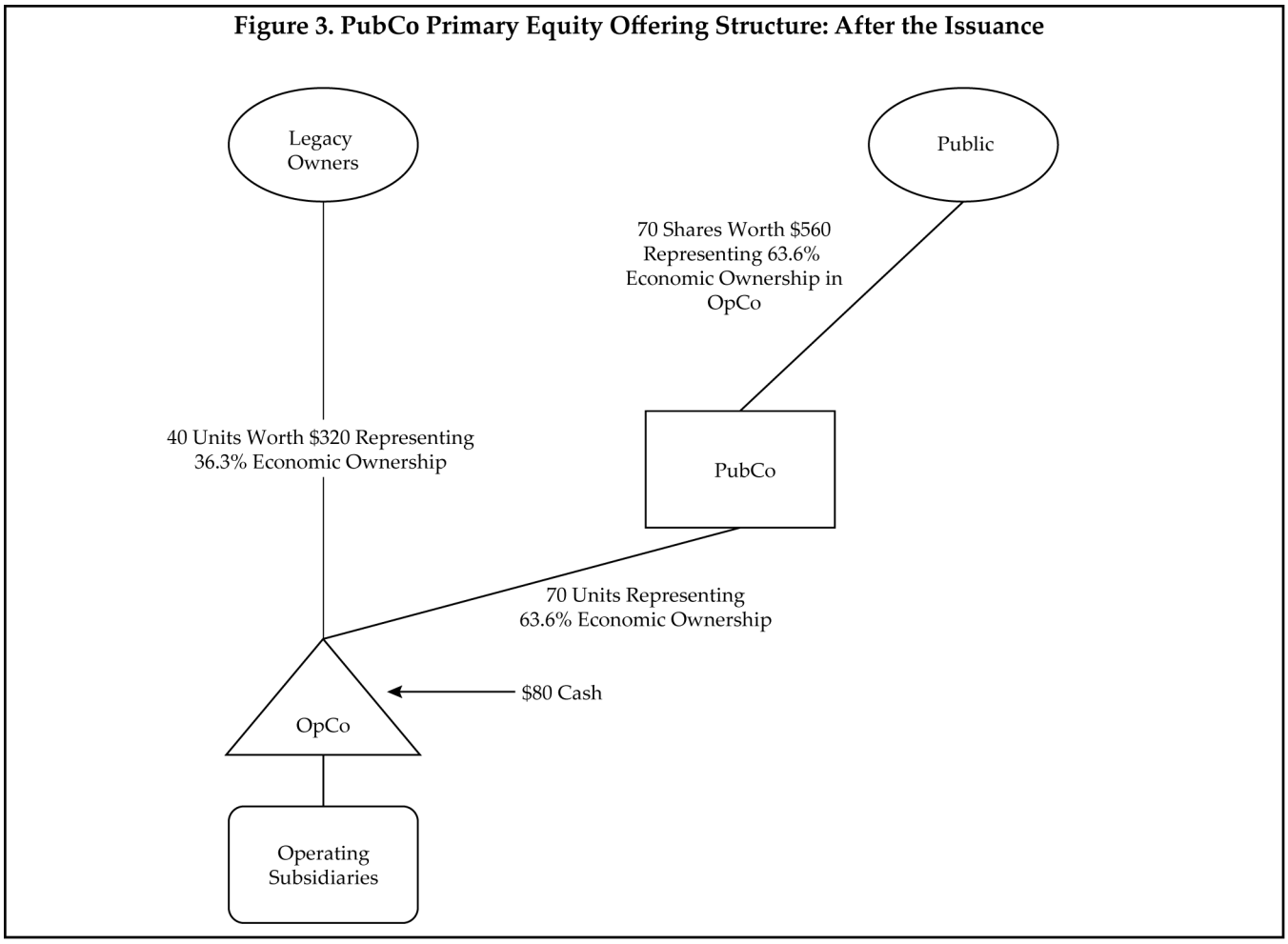


The parity principle can be illustrated by the example of a simple stock issuance by PubCo. PubCo sells 10 new shares worth $80 altogether. The proceeds are presumably needed at the OpCo level, so they need to be transferred to OpCo. If the proceeds are contributed down to OpCo, but additional Class A units corresponding to the number of PubCo shares sold are not issued to PubCo, each public shareholder's pro rata ownership of OpCo on a look-through basis would effectively have a lower number of Class A units per Class A share. Assuming Class A units and Class B units have the same economic entitlement, this would dilute the public shareholders at the OpCo level and enrich the legacy owners. Furthermore, if the legacy owners then exchange their Class B units for Class A shares, their economic entitlement in OpCo (and thereby the assets and operations of the company) would decrease. Since legacy owners are supposed to have the right to exchange one unit of OpCo for one PubCo share, and this exchange is merely intended to be a mechanism to sell shares on the public market, the exchange should not change the legacy owners' share of ownership of the underlying business on a look-through basis.

II. Convertible Debt Up-C Structural Alternatives

In recent years — particularly over the pandemic years — the convertible debt market has grown significantly. Convertible debt instruments are a unique asset class that combines the downside protection of a debt instrument with the upside of equity options. The most popular, plain-vanilla version of convertible debt (1) has a fixed principal amount, (2) generally pays interest (if any) at a fixed percentage semiannually in cash, (3) is unsecured and often has no subsidiary guarantees, (4) has an original term of five years (or slightly longer), (5) is convertible (or exchangeable) into publicly traded stock of the note issuer (or its parent) at the

Figure 3. PubCo Primary Equity Offering Structure: After the Issuance



holder's option at a fixed conversion rate, and (6) has a fixed conversion/exchange price that is "significantly out of the money" relative to the trading price at issuance (in most deals, this is at least 10 percent for securities law purposes, and often significantly more).[2] There are other variations of convertible debt,[3] but this article will focus on the plain-vanilla kind.

In general, Up-C issuers interested in issuing convertible debt can pick one of two structural alternatives:

- convertible alternative: PubCo issuing notes convertible into PubCo shares; or
- exchangeable alternative: OpCo issuing notes exchangeable into PubCo shares.

In both structural alternatives, other than the issuer of the notes and whether the option to receive equity is called a conversion or an exchange, all the economic terms would generally[4] remain the same. However, the tax implications of each alternative are significantly different.

A. Convertible Alternative

In the convertible alternative, PubCo directly issues notes convertible into PubCo shares. The main benefit of this structural alternative is the simplicity from an investor perspective — the convertible debt looks like any other convertible

[2] *See generally* Y. Bora Bozkurt, "Non-Plain Vanilla Questions About Taxation of Plain Vanilla Convertible Debt," *Tax Notes Federal*, Dec. 6, 2021, p. 1335.

[3] *See, e.g.*, Bozkurt and Michael E. Bauer, "A Bridge Between Debt and Equity: Taxation of Bridge Convertibles," *Tax Notes Federal*, Nov. 21, 2022, p. 1095.

[4] One economic difference resulting from the structure is that, in the exchangeable alternative (*i.e.*, convertible debt issued by OpCo rather than PubCo), OpCo would be required to repay the debt instrument. Typically, PubCo is also added as a guarantor, presumably to ensure that PubCo stands behind the obligation to deliver PubCo stock. In the convertible alternative, only PubCo would be obligated to pay the note obligations. This difference is typically not viewed as a point of significant focus for the investors.

debt on the market. And unlike in the exchangeable alternative, there are no additional material securities law complications (as will be discussed further below) that the investors have to understand and address. The straightforward nature of the security generally translates into ease of execution and better pricing for the offering.

The main structural requirement of the convertible alternative is to put in place a mirror convertible debt instrument between PubCo and OpCo at the time of the notes' issuance.[5] There are several reasons to put this instrument in place. PubCo must typically pass the proceeds of the convertible debt offering down to OpCo for use in the business. One possible alternative would be for PubCo to contribute the proceeds to OpCo in return for additional OpCo units. However, if PubCo acquired additional OpCo units in return for passing down the proceeds, it would violate the parity principle because the debt would remain unconverted, as PubCo would own a different number of units in OpCo than the number of PubCo economic shares outstanding on the market. As such, to satisfy the parity requirement, PubCo would need to own convertible debt interest in OpCo with terms similar to those that mirror the external convertible note interest that investors have in PubCo. In addition to passing down the proceeds to OpCo, that mirror convertible debt would pass to OpCo the interest deductions stemming from the interest payments, which makes sense, given that PubCo is a mere holding entity and OpCo, under normal circumstances, would be required to bear the interest expense economically since it is the operating company.[6]

The tax treatment of this intercompany mirror convertible debt, however, poses several complex questions.

Interest deductibility considerations. At a basic level, OpCo would make interest payments to PubCo and should, ostensibly, be able to deduct interest. PubCo would have interest income under the mirror notes, but it would have an offsetting interest deduction. As such, the back-to-back financing should result in a wash, at least from an economic perspective. From a tax perspective, however, the analysis is more complex. PubCo has interest income under the mirror notes that must match the interest deductions under the PubCo notes in timing and amount. PubCo must also ensure that it can deduct the interest payments on the PubCo notes, and OpCo must ensure it can deduct the interest payments on the OpCo notes.

PubCo's deduction of interest payments on the PubCo notes is relatively straightforward. Notably, any section 163(j) calculation done at the PubCo level regarding the deduction of interest payments on the PubCo notes should not result in any additional limitations on the deduction since section 163(j) allows any interest income received to result in a dollar-for-dollar increase in the amount of deductible interest expense. Because PubCo would have interest income on the mirror convertible debt that matches the interest deductions on the PubCo notes that it issued, the interest deductions from the PubCo convertible debt should not give rise to incremental section 163(j) concerns. PubCo would otherwise need to navigate the typical concerns and considerations that apply to interest deductions on publicly offered convertible notes. For instance, the PubCo notes' conversion price should be issued at a significant premium to market price to avoid the section 163(l) limitation applicable to interest payments.[7]

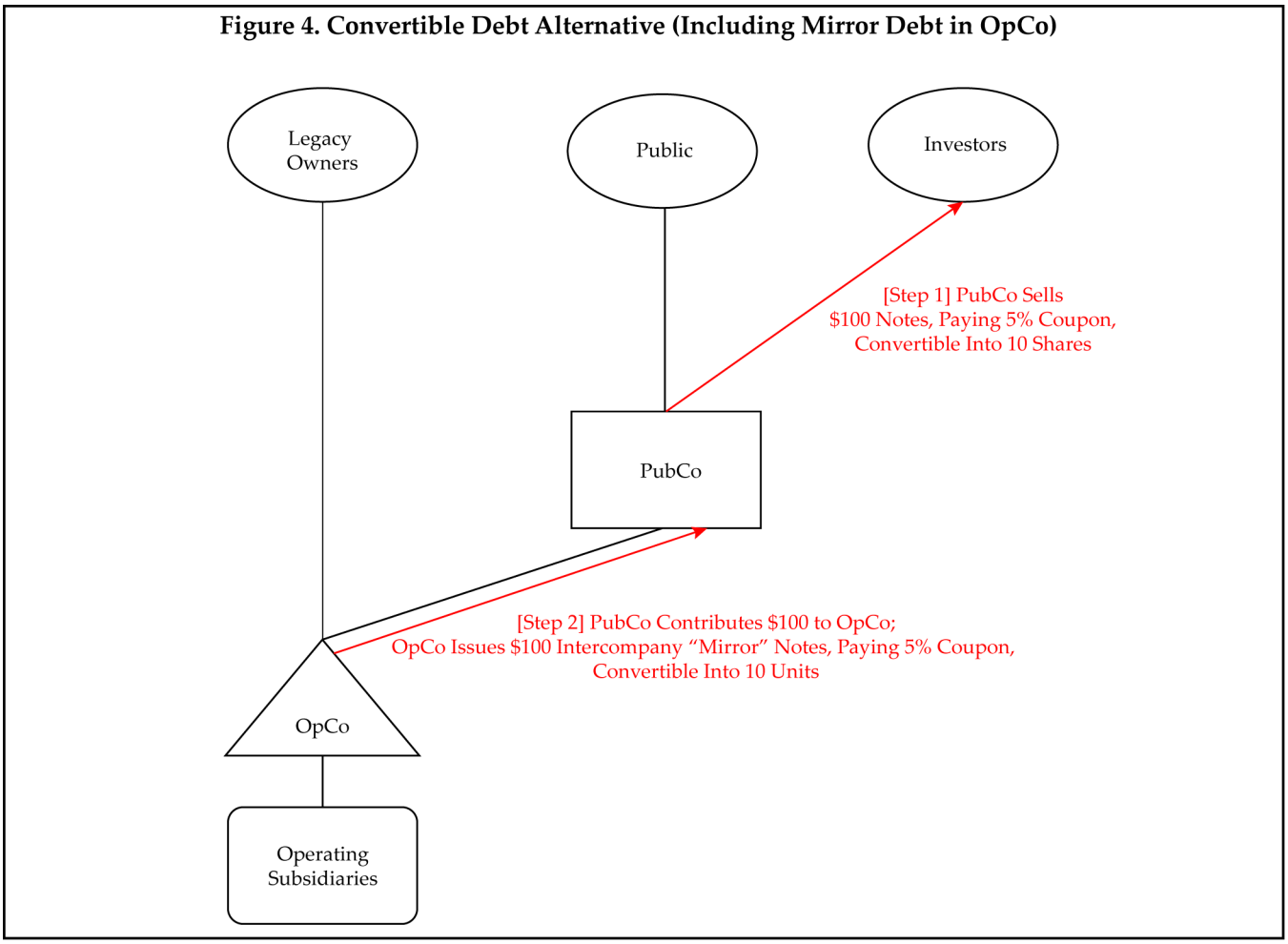
The tax analysis of deductions and income accruals under the mirror notes, however, is much more complex. As an initial matter, PubCo notes, assuming they are plain-vanilla convertible debt,

[5] In addition to a mirror convertible debt, Up-C issuers may find it helpful to put in place an expense reimbursement agreement, whereby the expenses of the convertible debt offering (*e.g.*, legal and underwriting fees) are pushed down to OpCo. Given that the offering proceeds are intended to benefit OpCo, this expense reimbursement makes sense. Oftentimes, under the terms of the limited liability company agreement of OpCo, there is already an expense reimbursement envisioned for any capital markets transaction undertaken by PubCo, even in the absence of such an agreement.

[6] An alternative structure could be an equity instrument that otherwise has the same economics as the mirror notes — *i.e.*, a convertible preferred equity instrument issued by OpCo to PubCo — instead of the mirror notes. This structure has its own complexities, as the tax treatment of the instrument (*e.g.*, allocations of income, tax treatment of distributions) would be governed by the partnership tax rules.

[7] There are arguments that a significant conversion premium is not required for plain-vanilla public convertible debt to avoid the application of section 163(l). *See* discussion of section 163(l) in Bozkurt, *supra* note 2.

Figure 4. Convertible Debt Alternative (Including Mirror Debt in OpCo)



would generally be treated as noncontingent payment debt instruments (non-CPDI). For PubCo's income accruals under the mirror notes to match those of the PubCo note, the mirror notes must also be treated as non-CPDI from a U.S. tax perspective. The treatment of the PubCo notes as non-CPDI is relatively straightforward, given that the conversion option is analyzed and ignored as a contingency that can cause CPDI.[8] However, if the PubCo notes were not CPDI and if the mirror debt were CPDI, there would be a mismatch in the interest income accrual and deduction schedule. Provided that convertible debt that is CPDI would accrue interest at the rate of a comparable nonconvertible debt instrument, this accrual rate would generally be much higher than the coupon rate (since convertible debt typically pays a lower rate of interest than comparable nonconvertible debt).[9] To add, conversions of CPDI convertible debt, even if the debt is fully physically settled by delivering only stock, result in ordinary interest income to its investors,[10] while conversions of non-CPDI convertible debt into stock are usually tax free.[11] As discussed further below, if a conversion under the mirror notes results in significant taxable income to PubCo and the income is not offset by deductions at the PubCo level, this mismatch could result in tax leakage and distortion within the Up-C structure.

The tax treatment of the mirror notes as non-CPDI is not free from doubt. Generally, reg. sections 1.1272-1(e) and 1.1275-4(a)(4) disregard conversion at the option of a holder for purposes of the original issue discount regulations and the

[8] *See* reg. sections 1.1272-1(e) and 1.1275-4(a)(4).

[9] Rev. Rul. 2002-31, 2002-1 C.B. 1023.

[10] *See* reg. section 1.1275-4(b)(7)(v) and (8)(i).

[11] *See* Rev. Rul. 72-265, 1972-1 C.B. 222; and reg. section 1.1001-3(c)(2)(ii).

CPDI regulations, respectively. The mirror notes are convertible in a manner similar to PubCo notes, but in the event that PubCo notes convert, the conversion option of mirror notes is effectively required to be exercised for structural reasons to maintain parity. As such, there may be a question as to whether the conversion feature of the mirror notes is really an "option," as envisioned in the Treasury regulations, or whether the instrument is mandatorily convertible into equity. This concern seems surmountable, though, assuming the mirror instrument is by its terms drafted to be optional.[12] When the Treasury regulations refer to conversion being optional under reg. sections 1.1272-1(e) and 1.1275-4(a)(4), the term "optional" is the notion of optionality likely intended to have a broad meaning, considering that when a holder converts, it is rarely truly optional. Oftentimes, when an investor converts its convertible debt, it does so because the notes are in the money (so it does not make economic sense not to convert). And, for example, in some cases, the holder may be compelled to convert because it needs the stock conversion consideration to cover a hedge position. It would be unusual to think that a holder having strong incentives to convert its convertible notes under certain circumstances, when those circumstances are outside the terms of the notes, would render the conversion no longer optional. It would not be an administrable standard to require an assessment of terms and circumstances outside the four corners of a debt instrument in determining the applicability of the option for a convertible debt instrument. In sum, one can argue that the mirror notes remain optionally convertible, and thus the conversion should be disregarded for purposes of the CPDI regulations.

Section 163(l) is yet another obstacle that OpCo must overcome to ensure that the interest payments on the mirror notes are deductible. Section 163(l) is a provision that applies to disqualified debt instruments issued by corporate taxpayers. Notably, while section 163(l) generally only applies to convertible debt if it is substantially certain that the option to convert would be exercised, the statute seems to imply that section 163(l) would automatically apply to convertible debt when the option to convert is in the hands of a related party without requiring substantial certainty of exercise.[13] Depending on the facts, PubCo would likely be a related party to OpCo within the meaning of section 163(l). With that said, mirror notes are technically issued by a partnership (not a corporation), so they are not directly within the ambit of section 163(l). However, Treasury regulations under section 701 that set up the subchapter K antiabuse rule include an example providing that, for purposes of section 163(e)(5), a partnership is treated as an aggregate of its partners, regardless of whether any party had any tax avoidance purpose.[14] Accordingly, if a partnership issues a debt instrument that meets the definition of an applicable high-yield discount obligation (AHYDO) under section 163(i), a direct or indirect corporate partner in that partnership will be subject to the AHYDO rules for that debt instrument. Furthermore, legislative history indicates that Congress expected section 163(l) to apply to convertible debt issued by partnerships to the extent of their corporate partners.[15] As such, section 163(l) could apply to corporate partners — that is, PubCo — of a partnership that holds convertible debt. Even so, it seems hard to justify the application of the antiabuse rule in this context. The regulations envision treating a partnership as "an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue

[12]This conclusion is more difficult if the mirror instrument is, by its terms, automatically converted when the PubCo notes are converted because the exception to CPDI treatment for convertible debt specifically refers to an option to convert. However, there may be arguments even then that this feature is not immediately fatal to non-CPDI treatment. *See* Bozkurt and Bauer, *supra* note 3, at n.27 (arguing that automatically convertible bridge debt could be seen as non-CPDI since "automatic conversion is simply a pre-agreement to exercise an option in circumstances in which it would have made economic sense to do so").

[13]There is reason to think the statute would not be interpreted as strictly in practice. *See* Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, para. 1306.3 (2025) (arguing that there may be alternative interpretations of section 163(l) "where an equity or equity-based payment or conversion feature is conditioned upon the occurrence of a contingency not within the control of the issuer or a related party").

[14]Reg. section 1.701-2(e) and (f), Example 1.

[15]H.R. Rep. No. 105-148 ("No deduction is allowed for interest or OID on an instrument issued by a corporation *(or issued by a partnership to the extent of its corporate partners)* that is payable in stock of the issuer or a related party." (emphasis added)).

Code or the regulations promulgated thereunder."[16] If the partnership was treated as an aggregate in this fact pattern, a partner would be both the holder and the issuer of the debt. The partnership antiabuse rule does not seem to have been intended to apply to a debt instrument issued by a partnership to a partner. Moreover, under LTR 201517003, the IRS interpreted section 163(l) to contain a substantial certainty requirement even when the conversion option was in the hands of a related party. Furthermore, according to the IRS, an "obvious" case that results in a section 163(l) disallowance is the absence of a substantial certainty of conversion in a situation in which a related party that is not the holder has an option to convert a debt into equity without the holder's consent. The conversion feature of the mirror notes mirrors the conversion feature of the plain-vanilla PubCo notes, for which there is typically a substantial conversion premium at issuance. As noted above, a conversion feature of this sort is not typically considered substantially certain to be exercised.

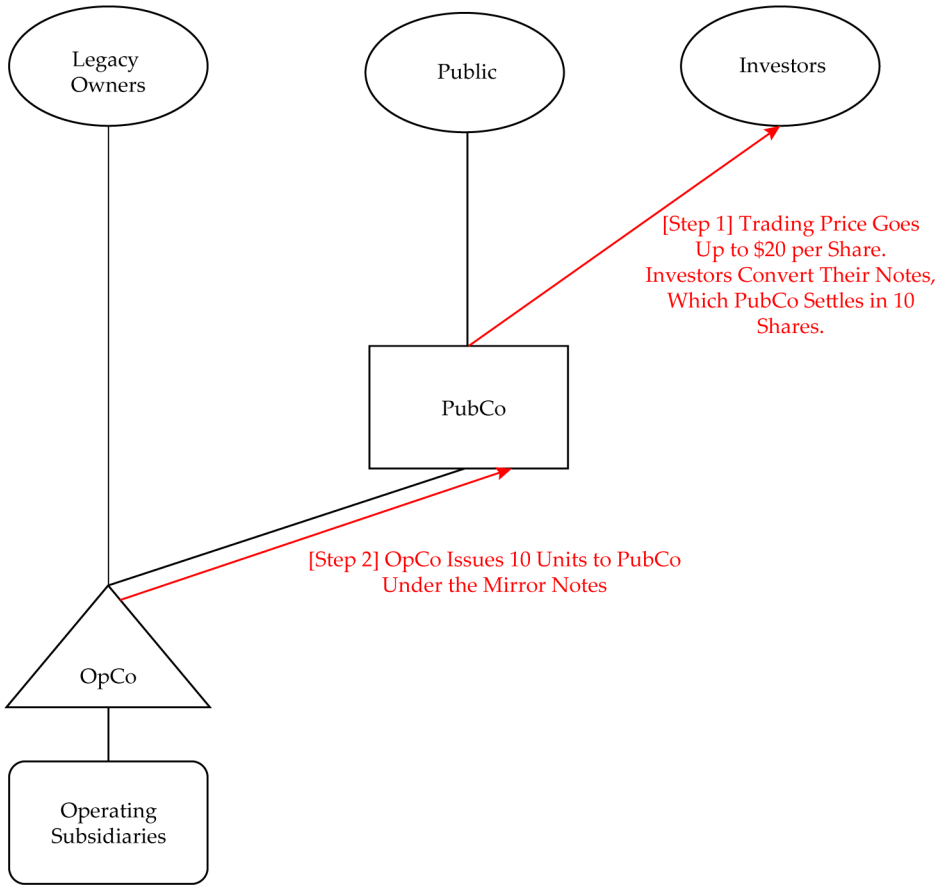
Treatment of settlements. Another thorny topic in the area of Up-C convertibles issued by PubCo is the tax treatment of the notes' settlements at conversion. The settlement terms of convertible debt can vary. Convertible debt can either be Instrument X (that is, at conversion, they can be settled entirely in cash, shares, or any combination of the two at issuer option) or Instrument C (that is, at conversion, the principal amount will be settled in cash and the remainder will be settled in cash and shares in any combination). For parity reasons discussed previously, mirror notes are generally set up with the same settlement terms (albeit in OpCo units) as PubCo convertible debt (vis-à-vis PubCo shares) to ensure that the number of outstanding OpCo units held by PubCo is equal to the number of PubCo shares that the public holds in PubCo.

With limited exceptions, the challenge for Up-C convertibles arises from the fact that, under section 249, PubCo is not entitled to deduct any premium above the adjusted issue price incurred upon the repurchase or conversion of convertible debt so long as that premium is attributable to the conversion feature. Notably, this rule applies regardless of whether the premium is paid in cash or stock. As such, upon the settlement of convertible debt issued by corporate issuers, there is potentially a material amount of premium that will be denied deductibility. If the stock price rose significantly over the life of the notes, the amount of the premium that could not be deducted would be extremely large.

In the context of full physical settlements (that is, settlement entirely in PubCo shares) of both the PubCo convertible debt and the OpCo mirror notes, the tax analysis is relatively straightforward. In the example depicted in the chart below, there would be a repurchase premium of $100 (since convertible debt of $100 would be converted into shares worth $200) that PubCo generally cannot deduct under section 249. The tax treatment of the mirror notes' settlement would be governed under subchapter K. Under reg. section 1.761-3(a), a noncompensatory option is treated as a partnership interest for federal tax purposes if (1) on the date of a measurement event, the option provides the option holder with rights that are substantially similar to the rights afforded a partner, and (2) there is a strong likelihood that failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate federal tax liabilities. Reg. section 1.761-3(d) provides that an option provides the holder with rights that are substantially similar to those afforded to a partner if, among other things, the option is reasonably certain to be exercised. Assuming the mirror notes are issued with a substantial conversion premium (that is, the conversion price is significantly higher than the trading price at the time of issuance), the convertible notes would not be "reasonably certain to be exercised" and therefore not be treated as a partnership interest for subchapter K purposes under reg. section 1.761-3. This could change if a measurement event occurs over the course of the debt instrument at a time when the conversion option is reasonably certain to be exercised. However, measurement events (including certain assignments and certain adjustments to terms) are not typically expected in this context. As such, until the mirror note is converted, it is unlikely to be treated as a

[16] Reg. section 1.701-2(e).

Figure 5. Mirror Note Structure Consequences (Full Physical Settlement)



partnership interest. Once the conversion option embedded in the mirror note is exercised, though, it would be treated as a tax-free section 721(a) transaction.[17] Under reg. section 1.721-2(g)(5), the principal amount of the debt instrument (or, if different, its adjusted issue price) would constitute the exercise price of the option embedded in the convertible debt. Thus, PubCo would not have any taxable income upon the exercise of the mirror notes if they were entirely settled in OpCo units.[18] Since PubCo would receive $200 of OpCo units by being treated as contributing $100, PubCo would have a built-in gain in its OpCo units, which may have ancillary, albeit manageable, consequences.

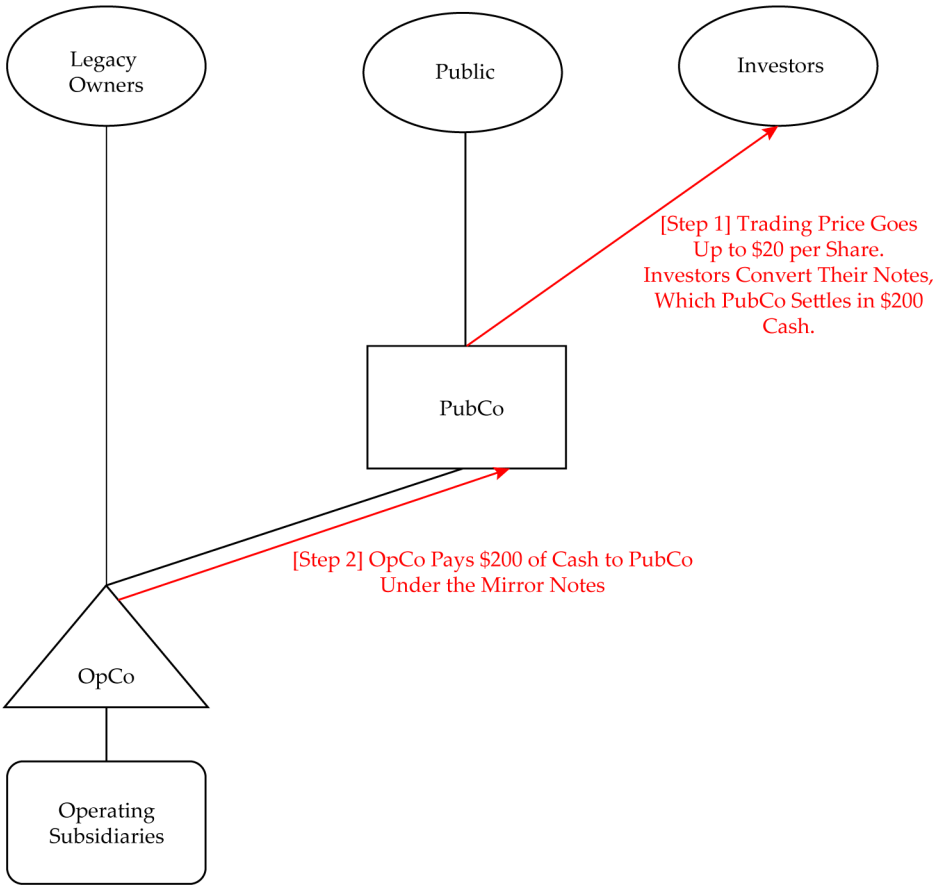
The analysis is more complex, however, if the mirror notes are settled in cash. Reg. section 1.721-2 does not apply to the extent that the settlement of mirror notes is in cash.[19] On its face, it may appear that PubCo owes tax regarding any cash it receives above the principal amount (or, if different, adjusted issue price) of the mirror notes. Interestingly, section 249 does not apply to partnerships, and as such, OpCo should presumably be allowed to have a corresponding deduction under reg. section 1.163-7(c) for the amount of premium that PubCo recognizes as income. However, it is likely that the deduction of this repurchase premium cannot be entirely allocated to PubCo so as to offset that income.

[17] Reg. section 1.721-2.

[18] One interesting question is whether, if the mirror notes are settled entirely in partnership units, the excess of the value of OpCo units over the principal amount of the notes could result in a repurchase premium deduction to OpCo, given that section 249, by its terms, would not apply to convertible debt issued by a partnership. Since the exercise of the conversion option would be a section 721 transaction under the noncompensatory option regulations, and since section 721 requires no gain or loss to be recognized to the partnership, the answer would depend on whether section 721 would be read to overrule the repurchase premium deduction otherwise provided under reg. section 1.163-7(c).

[19] Reg. section 1.721-2(d).

Figure 6. Mirror Note Structure Consequences (Cash Settlement)



Since the deductions on the debt are borne by all the partners, the premium deductions should be received by all the partners pro rata. It is also possible that since any deduction of repurchase premium under reg. section 1.163-7(c) is considered an interest deduction, this deduction could be subject to the 30 percent limitation under section 163(j) — potentially giving rise to a character mismatch because the gain on repayment of mirror notes would likely be considered capital gain. Such a mismatch is, of course, unfair in the context of this transaction: PubCo is not enriched by its investment in the mirror notes given that the investment is entirely offset by the amount PubCo is required to deliver to the public under the PubCo notes. Furthermore, depending on the exact drafting, it may not be entirely clear whether any tax owed by PubCo could be covered by tax distributions to be made under OpCo's partnership agreement. Alternatively, there may be an argument as to whether OpCo and PubCo can characterize this transaction more appropriately as a tax-deferred settlement of mirror notes in OpCo units followed entirely by a cash distribution in redemption of the OpCo units, so as to potentially reach a tax-deferred result.

Call spread considerations. In many convertible debt transactions, the issuers of the convertible debt also enter into a derivative overlay to synthetically raise the conversion price of the notes. These transactions are often in the form of capped call options that the company buys from investment banks. To the extent that the notes are converted into money, up to the cap price, the investment bank delivers consideration to the company, offsetting its delivery obligations as a result of the conversion option (that is, generally, the delivery obligations over par). The issuers can then choose whether to integrate the capped call and the notes for U.S. federal income tax purposes. If integrated, the issuer treats the notes

and the capped call as a single instrument for U.S. federal income tax purposes — the issuer would be treated as having issued a convertible debt instrument that is convertible at the cap price under the capped call and issued with OID that is equal to the premium paid to acquire the capped call.[20]

The most straightforward way to implement a capped call transaction in the context of an Up-C convertible debt structure is to integrate the capped call with the PubCo notes. When integrated, PubCo can collapse the two instruments as described above. As for the mirror debt instrument, it can be drafted as a single debt instrument that has the combined economics of the capped call and the PubCo notes (including having the same conversion timing and composition in terms of the net amount of cash and shares to be delivered, and including being issued at an amount of OID equal to the premium paid to acquire the capped call). Notably, it would not be feasible for PubCo to buy a mirror capped call from OpCo and try to integrate it with the notes because a hedge instrument between two related parties is generally ineligible for tax integration.[21] As such, the mirror debt instrument must instead carry the combined economics of the capped call and the convertible notes in a single instrument.

PubCo, however, may have reasons to prefer to keep the capped call stand-alone (that is, nonintegrated) on a basis with the convertible notes. By opting not to tax integrate the capped call, the company would have to contend with not being able to deduct the premium paid to acquire the capped call. However, the company may determine that the downsides of tax integration are more problematic than losing the ability to deduct the capped call premium. Notably, under the prevailing market practice, tax-integrated capped calls are subject to automatic unwind when the convertible notes are converted early. Under certain circumstances, this early unwind — as opposed to keeping the capped calls outstanding even after the notes have been converted early — may result in a significant reduction in the amount that the issuer receives under the capped call, which companies sometimes find unacceptable.[22] A non-Up-C issuer that keeps its capped call on a nonintegrated basis does not have to worry much about having any income on its capped calls. For a non-Up-C issuer, the premium paid to acquire the capped call option is not deductible, and the amounts received under the capped call in the case of an eventual exercise are not taxable under section 1032.

If an Up-C issuer issuing convertible notes desires to enter into the capped call on a nontax integrated basis, they must be careful to balance the requirements of the parity principle against the tax consequences of owning a stand-alone call option. More specifically, there are several structural alternatives for effectuating a stand-alone (nonintegrated) capped call transaction for an Up-C issuer. Under the first alternative, PubCo can enter into the capped call with the banks but not enter into a mirror capped call between PubCo and OpCo. The question would then be what kind of mirror notes would be put in place between PubCo and OpCo. If PubCo and OpCo put in mirror notes that reflect the combined economics of the PubCo notes and the capped call, those mirror notes would have OID equal to the premium paid to acquire the capped call. This OID would result in income for PubCo, but the corresponding OID deductions would not be entirely allocated to PubCo since, as previously discussed, the deductions on the debt are borne by all the partners, including the legacy owners. If the mirror notes merely carry the economics of the PubCo notes but not the capped call, the structure could presumably create concerns under the parity principle.

As a second alternative, PubCo can buy a capped call from the banks and, in turn, sell a (stand-alone) mirror capped call to OpCo

[20]These transactions are sometimes also structured in the form of a bond hedge that the company buys from an investment bank. This structure fully hedges the conversion option and a warrant that the company sells to the investment bank that captures the conversion deliveries above the cap price. The IRS has acknowledged and approved the tax integration of the bond hedge (while keeping the warrants as a stand-alone option) under AM 2007-0014. For simplicity, we will focus on just the capped call variation for the purposes of this discussion. The bond hedge warrant variety is even harder to implement in the context of the Up-C, as it raises similar difficulties to those for stand-alone capped calls.

[21]Reg. section 1.1275-6(c)(1)(ii).

[22]These considerations and other downsides of tax integration were analyzed in Bozkurt, *supra* note 2, at Section IV.A.

regarding the OpCo units. This structural alternative would not have any parity concerns. However, PubCo, as the writer of the mirror capped call, may have income for the premium it receives from OpCo. This would result in potential tax leakage that is not offset by the deduction of the premium PubCo pays to the banks (given that the premium is not deductible under section 1032) or offset (at least not entirely) by the deduction of the premium paid by OpCo to buy the mirror capped call that may pass through (presumably pro rata) to PubCo.

As a third alternative, OpCo can simply buy a capped call from the banks. In this fact pattern, given that OpCo is not the issuer of the shares underlying the capped call, section 1032 may not apply (at least to the extent that OpCo is owned by legacy owners). If OpCo receives deliveries from the banks upon the settlement of the capped call, this may create a tax liability for OpCo, and thereby its partners.

If PubCo enters into the capped call on a tax-integrated basis (and the mirror debt reflects the combined economics of PubCo notes and PubCo's capped calls), but the capped call becomes stand-alone by the early termination of the notes, the company has to again contend with similar tax considerations to those described above. While tax-integrated capped calls are generally set up to be unwound automatically if the notes are terminated or converted early in accordance with their terms, capped calls nowadays are often set up to allow them to survive a termination of the notes outside their terms (for example, such a termination outside the terms would include an open market repurchase or refinancing of the notes). This flexibility is not considered problematic from a tax integration perspective as the transaction would be outside the terms of the notes and therefore not part of the tax integration analysis. Further, this flexibility is considered important as it may allow the issuer to recover a larger amount under the capped call. By entering into a single mirror debt instrument that reflects the combined economics of the capped call and the notes, the issuer would make it difficult to address a circumstance in which it terminates the notes early but keeps the capped call outstanding. If PubCo and OpCo intend to revisit that intercompany arrangement, they would need to be careful to do so in a manner ensuring that any tax leakage to PubCo is minimal.

B. Exchangeable Alternative

In the exchangeable alternative, OpCo issues notes that are exchangeable into PubCo shares. PubCo is often added as a guarantor to the note indenture, presumably to comfort the investors that PubCo will stand behind the obligation to deliver shares in the case of a settlement of the notes in equity.[23]

In the exchangeable alternative, OpCo issues notes exchangeable into PubCo shares. Exchangeable notes by Up-C issuers have their own pros and cons and are more commonly seen in the context of Up-C structures in which the issuer is a real estate investment trust instead of a regular C corporation — structures known as Up-REITs.

A major downside of this exchangeable structural alternative is the securities law complications it poses for investors. Investors in privately placed convertible or exchangeable notes typically rely on SEC Rule 144 to freely resell any shares of common stock they receive upon conversion or exchange. Among other things, Rule 144 requires a minimum holding period for the securities to be resold. In the case of securities of a company that is a public, SEC-reporting entity at the time of and during the 90 days preceding the resale, a minimum of six months must elapse from the time the securities were last acquired from the issuer (or any of its affiliates) and the purchase price was fully paid. Ideally, investors rely on the "tacking" provisions of Rule 144, which permit the holding period of any common stock received upon conversion or exchange to include the holding period of the notes converted or exchanged (that is, "tacking"

[23]While not directly material for the purposes of this article, one issue that stems from the PubCo guarantee is whether that guarantee results in the notes issued by OpCo failing to be treated as partner nonrecourse indebtedness. While normally debt guaranteed by a material partner could indeed fail to be treated as partner nonrecourse indebtedness, assuming that the only asset of PubCo is equity in OpCo, and since OpCo is already a borrower in the debt, the PubCo guarantee probably does not add further credit support so as to render the debt recourse to PubCo. *See* reg. section 1.752-2(k) (considering the partner as not bearing the economic risk of loss if "there is not a commercially reasonable expectation that the [partner] will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable").

the holding period of the notes onto the holding period of the common stock). In the case of exchangeable notes, tacking is not permitted if the note issuer (OpCo) is not a wholly owned subsidiary of the common stock issuer (PubCo). In the absence of tacking, the holding period resets upon exchange, which can delay the ability to resell freely under Rule 144 for six or more months from the time of exchange. To address this issue, the issuer typically provides registration rights, and the investors must "double print" the shares they receive upon exchange to close out physical short positions — an inefficient outcome for both the issuer and investors.[24]

Of course, the main advantage is that, in an exchangeable note offering, PubCo does not have a parity concern and does not need to put in place a mirror security to achieve parity and/or to push down the proceeds of the offering or related interest deductions. The notes are already issued at the OpCo level, which means the debt liability already affects both the legacy owners and PubCo equally. As such, the structure is much simpler. Upon the settlement of the exchangeable note, if PubCo shares are to be delivered, OpCo would at that point issue OpCo units to PubCo to maintain parity. Such an issuance of OpCo units would not require a separate agreement between PubCo and OpCo, as it can be handled in accordance with the general parity provisions under the OpCo partnership agreement. Thus, since there is no mirror debt, the company can also avoid the potential income accrual and deductibility mismatch complications associated with having an intercompany mirror instrument.

The exchangeable alternative, however, poses its own tax challenges. First, per the exception to the CPDI rules under reg. section 1.1275-4(a)(4), an exchange feature in an exchangeable debt instrument is only ignored as a contingency that could cause CPDI treatment if the exchange is into a related company within the meaning of section 267(b) or 707(b)(1). This means that if PubCo owns less than 50 percent of OpCo (because the legacy owners own a majority of the OpCo units), the debt issued to OpCo that is exchangeable into stock of PubCo will likely be CPDI. Most convertible debt on the market today is treated as non-CPDI, and investors may balk at the adverse tax consequences of holding CPDI convertible debt. As discussed previously, when convertible/exchangeable debt is treated as CPDI, the investor must accrue interest at "comparable yield," which in this case would likely far exceed the cash coupon. For exchangeable debt, even if the debt is not CPDI, the exchange is a taxable transaction, given that upon exchange the investors receive shares in a different entity — therefore disqualifying the exchange for recapitalization or otherwise tax-free treatment. If the exchangeable debt is CPDI, the exchange is still taxable to the extent that the consideration exceeds the investor's tax basis, but in this case the exchange would trigger additional ordinary interest income (instead of capital gains).[25] Furthermore, the additional interest income triggered under the CPDI rules upon exchange is contingent on the price of the issuer's equity and could arguably be treated as interest income that is "contingent interest," which is ineligible for the portfolio interest exemption vis-à-vis foreign investors. The contingent interest rules relating to eligibility for the portfolio interest exemption have an exception for when the interest payments are determined based on actively traded property.[26] The actively traded exception is generally helpful in this context (given that the PubCo stock is likely to be actively traded), but this exception in turn has its own exception for when the actively traded property is a U.S. real property interest, which may be relevant for certain real-estate-heavy PubCos, such as REITs.

[24] Anecdotally, Up-REIT issuers often opt for the Up-C notes that use the exchangeable alternative on the market, whereas Up-C issuers other than REITs usually opt for the convertible debt alternative. One possible (nontax) explanation given for the difference is that REIT stocks tend to be less volatile than typical non-REIT issuers of convertible debt. Therefore, the conversion option is comparatively less valuable for REIT issuers than for non-REIT issuers. As such, the securities law "tacking" issues that apply to stock received upon exercise of the conversion option are not as material a concern to investors (though, in practice, that is not likely true for all REIT issuances or for all investors therein). Further, some of the tax concerns (namely, PTP concerns) that may apply to the exchangeable alternative are less material for REIT issuers. Yet another reason given for the difference is merely historical — Up-REIT issuers have historically used exchangeable note offerings, and the market has simply gotten comfortable with that structure in the Up-REIT context.

[25] *See* reg. section 1.1275-4(b)(7)(v) and (8)(i).

[26] *See* section 871(h)(4)(C)(v)(I).

Second, an exchangeable note offering — especially if these notes are sold on the public markets through a widely held capital markets offering — would pose at least a theoretical concern that OpCo is a publicly traded partnership treated as a corporation under section 7704. This concern could arise as a result of two arguments under which the exchangeable note is viewed as a partnership interest within the meaning of reg. section 1.7704-1(a)(2). Under the first argument, an exchangeable note offering can actually be viewed as a convertible note — convertible into OpCo units such that, at settlement, the note holder receives OpCo units for a moment in time and then immediately exchanges those units for corporation stock. This view can be supported by the fact that, under the OpCo partnership parity provisions discussed above, the settlement of the exchangeable note with PubCo stock would generally be accomplished contemporaneously with the issuance of OpCo units to PubCo. Alternatively, under the first argument, the exchangeable note could be respected as convertible debt but the conversion option in OpCo could be at risk of becoming a partnership interest under the reg. section 1.761-3 noncompensatory option rules. Under those rules, the exchangeable note would then be viewed as an "interest in the capital or profits of the partnership" under reg. section 1.7704-1(a)(2)(A).

As a counterargument, there is no mention in the exchangeable note offering documents of the investors receiving OpCo units, and the tax disclosures in these offerings uniformly do not consider the holders of the notes as holding partnership options. Viewing the noteholders as holding OpCo units, even if momentarily, could also cause effectively connected income and other similar tax issues for foreign and other tax-sensitive investors, which further supports the notion that this issuance should not be deemed to occur. Additionally, the settlement of the exchangeable notes in stock can just as easily be viewed as OpCo exchanging its units in return for PubCo stock (which is treated as tax free to PubCo under principles of reg. section 1.1032-3) and in turn using the PubCo stock directly in satisfaction of the exchangeable notes, which would avoid the above characterization. Under the second argument, given that the sole asset of PubCo is an interest in OpCo, an exchangeable note could be seen as a "financial instrument or contract the value of which is determined in whole or in part by reference to the partnership" within the meaning of reg. section 1.7704-1(a)(2)(i)(B). This rule has an exception for debt that is "not convertible into or exchangeable for an interest in the capital or profits of the partnership and does not provide for a payment of equivalent value," but the concern can again be that PubCo shares are of equivalent value to OpCo units. The counterargument, of course, is that the main tenet of Up-C structures is to respect the separate existences of OpCo and PubCo.[27] Lastly, it is worth noting that, if there were indeed a real publicly traded partnership concern, most exchangeable note offerings in Up-C structures are conducted by REITs, under which OpCos can derive mostly passive income and qualify for the qualifying income exception under section 7704(d), exempting OpCo from publicly traded partnership status.[28] As such, although any publicly traded partnership concerns may not be material for Up-REIT issuers of convertible/exchangeable debt, they may be more significant for regular Up-C issuers.

Call spread considerations. Exchangeable note issuers with Up-C structures must be mindful of tax considerations when entering call spread transactions. Again, focusing on the unitary capped call variety of call spread transactions, if the exchangeable note issuer is interested in tax integration, it must purchase the capped call at the OpCo level. That is because, under reg. section 1.1275-6, one key requirement of tax integration is for the issuer of the debt instrument and the capped call to be the same entity.[29] Upon eventual settlement of the notes and the capped call, the issuer must ensure that any additional units issued are under the terms of the OpCo partnership agreement, taking into account the

[27] There is further support for this position under reg. section 1.7704-1(a)(2)(iii) ("For purposes of section 7704(b) and this section, an interest in a partnership or a corporation . . . that holds an interest in a partnership (lower-tier partnership) is not considered an interest in the lower-tier partnership.").

[28] *See generally* Eric Matuszak and Robert J. Crnkovich, "When Might an OP in an UPREIT Be a PTP, and Why Should You Care?" *Tax Notes*, Aug. 18, 2014, p. 855.

[29] Reg. section 1.1275-6(c)(1)(iii).

PubCo shares delivered under the notes and the PubCo shares received back under the capped call to ensure that the parity principle is not violated. Upon tax integration, any premium paid to acquire the capped call would result in OID for U.S. federal income tax purposes. The issuer must be mindful of the AHYDO rules because, even though the issuer in this instance would be a partnership and the AHYDO rules do not technically apply to partnerships, under the partnership antiabuse rule, the AHYDO rules can still be relevant to the extent that a partnership has a corporate partner (in this case, PubCo).[30]

On the other hand, if the capped call is to be entered into in a non-tax-integrated (that is, stand-alone) manner, the capped call should be entered into at the PubCo level. That is because section 1032 only applies to the settlement of the capped call if the holder of the capped call is the same as the issuer of the underlying stock. And if section 1032 does not apply (which would be the case if the capped call is entered into at the OpCo level), the legacy owners would be exposed to significant potential income tax liability upon settlement of the capped call. However, this structure could in turn cause some of the parity concerns discussed above, assuming there are no corresponding mirror capped calls at the OpCo level. ■

[30] Reg. section 1.701-2(e) and (f), Example 1.