Contingent Convertible Debt Instruments—Request for Comments

Notice 2002–36

Rev. Rul. 2002–31, 2002–22 I.R.B., dated June 3, 2002, provides guidance on the tax treatment of a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments (contingent convertible debt instruments). The revenue ruling holds that, in the described circumstances, the noncontingent bond method described in § 1.1275–4(b) of the Income Tax Regulations applies to these debt instruments. In addition, the revenue ruling addresses how an issuer determines the comparable yield used to determine the interest accruals, the effect of § 163(*l*) of the Internal Revenue Code on the accruals, and the consequences of a conversion of the instrument, including the application of § 249. See Rev. Rul. 2002–31 for a discussion of these issues.

The Internal Revenue Service and the Treasury Department are aware that the contingent convertible debt instruments described in the revenue ruling have been the subject of considerable comment within the tax bar and the media regarding whether the applicable tax rules are those generally governing contingent debt instruments or those generally governing convertible debt instruments. Existing regulations dealing with contingent debt instruments establish a general rule that issuers of such instruments are required to accrue interest expense (and holders are required to accrue interest income) as if the debt instruments bore a yield equal to the rate at which an issuer would issue a comparable debt instrument. However, certain convertible debt instruments are generally excluded from the application of the noncontingent bond method.

Specifically, § 1.1275–4(a)(4) provides that a debt instrument does not provide for contingent payments merely because it provides for an option to convert the instrument into the stock of the issuer, into the stock or debt of a related party, or into cash or other property in an amount equal to the approximate value of such stock or debt. Because of this exclusion from the noncontingent bond method for straight convertible debt (that is, debt with no contingencies other than the conversion privilege described in § 1.1275–4(a)(4)), issuers and holders of such instruments accrue interest expense and income at a yield that assumes the instrument will not be converted (the nonconversion yield). That yield generally is considerably less than the yield for a comparable nonconvertible debt instrument. By contrast, if a convertible debt instrument providing for the possible payment of additional interest upon the occurrence of particular contingencies is eligible for the application of the noncontingent bond method, relatively insignificant changes in the investment economics of a convertible debt instrument can effect a dramatic change in the amount of interest accruals.

Some commentators have argued that the general approach of the noncontingent bond method, which requires issuers and holders of contingent debt instruments to accrue interest income and expense based on the yield of comparable debt instruments, is economically sound. They argue that the exclusion of straight convertible debt from this general approach simply reflects the historical treatment of convertible debt instruments but is otherwise inconsistent with the economic rationale for the general rule. Accordingly, these commentators argue for limited application of the exclusion for straight convertible debt and assert that sound policy supports the application of the comparable yield methodology to contingent convertible debt instruments.

Other commentators support the exclusion for straight convertible debt (or have assumed its continued existence) and have questioned whether contingent convertible debt instruments should be subject to the comparable yield methodology, particularly if the result is to permit an issuer to deduct interest accruals based on the yield of comparable nonconvertible debt instruments. These commentators have suggested that the discontinuity between the treatment of straight convertible debt and the treatment of contingent convertible debt instruments could be eliminated, or substantially ameliorated, by requiring use of the nonconversion yield on a straight convertible debt instrument as the comparable yield for accruals on contingent convertible debt instruments under the noncontingent bond method.

Several commentators have focused attention on the rule that only remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument. See §§ 1.1275–4(a)(5) and 1.1275–2(h). To the extent that § 1.1275–4 takes into account contingent payments that are relatively unlikely to occur (but not so unlikely as to be remote) and relatively insignificant in amount (but not so insignificant as to be incidental), the narrow scope of the exception tends to make largely elective the exclusion of straight convertible debt from the noncontingent bond method. That is, through changes in the terms of debt instruments that result in relatively small economic differences, issuers can trigger the application of the comparable yield methodology. Critics of this result have suggested an expansion of the universe of contingent payments that are disregarded in determining whether debt is contingent debt.

As a policy matter, the Service and the Treasury are concerned whenever significantly different tax results obtain for economically similar financial instruments, such as (1) straight convertible debt and (2) convertible debt that provides for contingent payments that, while not remote or incidental, are relatively insignificant in amount or in likelihood of occurrence. Such inconsistencies create market inefficiencies and increased transactional expense.

Disparate tax treatment for economically similar financial instruments exists in other instances, however, and the means for achieving equivalent tax treatment may not be clear or acceptable. With respect to contingent convertible debt instruments, for example, differing considerations support competing answers to the question of whether the comparable yield used for interest accruals should be based on a comparable nonconvertible debt instrument or a comparable convertible debt instrument.

Referring to nonconvertible debt instruments to ascertain the comparable yield is more consistent with the economic rationale underlying the comparable yield methodology, although using the nonconversion yield of convertible debt instruments would minimize the cliff effect and discontinuity in tax treatment that result when a contingent convertible debt instrument ceases to be eligible for the exclusion and becomes subject to the comparable yield methodology.

Similarly, changing the rule disregarding remote and incidental contingencies, which applies to nonconvertible debt instruments as well as convertible debt instruments, could have broader effects than simply reducing the cliff effect of adding contingent interest to a convertible debt instrument. The rule generally simplifies administration by avoiding the necessity of applying the comparable yield methodology (and the associated requirements for payment projections and adjustments for differences between projected payments and actual payments) to instruments having contingent payments that are insignificant in amount or unlikely to occur. Any expansion of the rule could cause the universe of instruments to which the comparable yield methodology is inapplicable to include cases in which the possibility of contingent payments has a significant depressing effect on the noncontingent yield on the instrument. The result would be the accrual of income and deduction in amounts less than the true economic yield on the instrument.

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The Service and the Treasury are concerned whenever issuers and their counsel are uncertain about the tax consequences of new financial instruments that are widely used and broadly traded in the capital markets. The capital markets operate most efficiently when the tax treatment of various financial instruments is clear. To resolve the existing controversy and to eliminate confusion in the marketplace, Rev. Rul. 2002–31 sets forth the position of the Service and the Treasury regarding the tax treatment of contingent convertible debt instruments under current law and regulations. This notice invites comments and suggestions for changes in the relative tax treatment of straight convertible debt instruments and contingent convertible debt instruments to eliminate or reduce the disparity in treatment of these instruments.

The Service and the Treasury invite comments and suggestions for the use of existing regulatory authority (including regulatory authority under § 1275(d)), as well as other administrative measures, to modify the rules governing the tax treatment of straight convertible debt instruments and contingent convertible debt instruments. Specifically, comments and suggestions are invited on whether the exclusion from the noncontingent bond method for straight convertible debt instruments should be eliminated, expanded, or modified; whether the rules for determining a comparable yield for purposes of applying the noncontingent bond method to a contingent convertible debt instrument should be revised to require comparison with a straight convertible debt instrument; and whether the rule that remote and incidental contingencies are disregarded in determining whether a debt instrument is a contingent debt instrument should be modified.

As part of the discussion of the tax treatment of contingent convertible debt instruments, some commentators also have raised issues regarding whether it is appropriate as a matter of public policy to allow issuers deductions for interest accruals on convertible debt instruments to the extent that payment of the accrued interest can ultimately be effected only by the issuance of the issuer's stock. Sections 163(*l*) and 249 contain restrictions on the deductibility of amounts based on the value of an issuer's stock, but those restrictions have limited scope. See the discussion of §§ 163(*l*) and 249 in Rev. Rul. 2002–31. Persons responding to this request for comments may want to include a discussion of how the policies underlying §§ 163(*l*) and 249 relate to suggestions they may make for changes in regulations or other administrative measures.

The Service and the Treasury note that in Notice 2000–29, 2000–1 C.B. 1241, they had previously requested comments on certain federal tax consequences of options to acquire partnership interests and partnership debt instruments convertible into partnership interests. Persons responding to this invitation for comments and suggestions may want to include a discussion of whether a suggested treatment of convertible debt instruments issued by corporations also should apply to similar instruments issued by partnerships.

Please submit all comments by August 30, 2002. Written comments should be sent to:

Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

or hand delivered between the hours of 8 a.m. and 5 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:ITA:RU (Notice 2002–36)
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Alternatively, comments may be submitted electronically via e-mail to the following address: *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2002–36" in the subject line. All comments will be available for public inspection and copying in their entirety.

The principal authors of this notice are Dale S. Collinson and William E. Blanchard of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Mr. Collinson at (202) 622–3900 and Mr. Blanchard at (202) 622–3950 (not toll-free calls).