

Report No. 1372

New York State Bar Association Tax Section

Report on Section 249

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Report on Section 249

This Report¹ provides observations and comments on the existing and future regulations under section 249.

To the extent an issuer of a convertible bond repurchases the bond for a “repurchase price” in excess of the bond’s then-current adjusted issue price, the issuer realizes “bond repurchase premium” expense.² Although an issuer’s bond repurchase premium expense arising from the repurchase of a non-convertible debt instrument is generally deductible as interest in the period in which it is paid,³ section 249 limits or disallows the issuer’s deduction for bond repurchase premium in the case of a convertible bond. The underlying policy is that, to the extent that the repurchase premium is attributable to the appreciation in the value of the embedded option, the repurchase is analogous to a repurchase of equity and, consistent with section 1032, the cost of reacquiring the embedded option ought not to be deductible.

Section 249 provides two narrow exceptions to the disallowance rule. First, under the so-called “Normal Call Premium” exception, if the issuer can demonstrate that comparable non-convertible bonds provide for a normal call premium, the disallowance applies only to the extent the repurchase premium exceeds the normal call premium. Second, and more relevant in most circumstances, under the so-called “Cost of Borrowing” (“COB”) exception, the disallowance

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² Treas. Reg. § 1.61-12(c)(2).

³ Treas. Reg. § 1.163-7(c).

rule does not apply to the extent the issuer can demonstrate that the repurchase premium “is attributable to the cost of borrowing and is not attributable to the conversion feature.”⁴

Regulations under section 249 were issued in 1973 and slightly modified in 2007 and 2011.⁵ The 2016-2017 Priority Guidance Plan states the IRS’s intention to issue regulations under section 249 in 2017.⁶ We understand these regulations are intended to modernize and standardize the COB exception as well as make additional changes. In this Report, we recommend limiting the scope and standardizing the operation of the COB exception. In addition, we discuss an alternative approach to the COB exception. , Finally, we discuss several additional issues under section 249 that warrant clarification through regulations.

I. SUMMARY OF RECOMMENDATIONS

Our recommendations are summarized below.

A. Cost of Borrowing Exception

The current regulations authorize an issuer to deduct repurchase premium expense under the COB exception to the extent the issuer can prove that “such repurchase premium is attributable to the cost of borrowing and is not attributable to the conversion feature.”⁷

Our two primary recommendations with respect to the COB exception are that (1) the COB exception be limited to market or negotiated repurchases of convertible bonds that are not currently callable at par at the time of repurchase, and (2) the process for determining the amount of premium deductible under the COB exception be made explicit in the regulations.

1. Scope Limitation

In the case of a repurchase of a convertible bond at a premium arising from either (i) the holder’s voluntary early conversion (including a holder’s voluntarily early conversion after an issuer’s notice of an intention to call) or (ii) an issuer’s market repurchase at a time when the bond is currently callable, the value of the bond is equal to its “as converted” value and hence the

⁴ Section 249(a).

⁵ T.D. 7259 (Feb 9, 1973), T.D. 8746 (Dec 30, 2011), and T.D. 9533 (July 1, 2011).

⁶ 2017-2017 Priority Guidance Plan, 2016 TNT 158-24 (August 15, 2016).

⁷ Treas. Reg. § 1.249-1(e)(1).

repurchase premium is the excess of this value over its adjusted issue price. In these repurchases, because the bond is immediately callable, a decline in market yields while the bond is outstanding does not materially impact the present value of the remaining cash flows (and therefore does not impact the amount of repurchase premium expense incurred). Because the selling price of the convertible bond cannot be shown to have increased “as a result” of a decline in yields in these situations, we recommend these situations be excluded from the scope of the COB exception.

Once these situations are excluded, the only repurchase-at-a-premium situations in scope would be market or negotiated repurchases of bonds that cannot currently be called. In these situations, if a market or negotiated repurchase occurs at a premium, the premium can be attributable to a decline in yields, an increase in the value of the option, both of these, or another factor entirely (discussed below). Where the embedded option has not increased in value from the time of issue to the time of repurchase, the repurchase premium expense is exclusively attributable to the decline in yields and, hence, can be accurately identified. Where the embedded option has also increased in value, however, the premium generally will reflect both the value of the conversion feature and the decline in yields. Moreover, the premium will be less than the sum of the independent effect of these two factors considered separately. The deeper the embedded option is in-the-money, the more the premium will be driven by the “as converted” value of the bond and the smaller the contribution of a decline in yield will have on the value. Finally, in the case of a repurchase of an in-the-money convertible, it can be argued that the portion of repurchase premium in excess of the “as converted” value, if any, is reflective of neither option value nor a decline in yields.⁸

Our recommendation with regard to the COB exception is heavily influenced by the fact that the existing regulations have been in force for decades and operate to allow a deduction under the COB exception whenever the issuer can prove an interest rate decline. Although we recommend limiting the scope of the COB exception, on balance, we think there is a strong presumption in favor of retaining the long-standing regulatory approach. Accordingly, in the

⁸ A small piece of this excess is attributable to the time value of the option feature. This is discussed in more detail below.

limited cases to which the COB exception would continue to apply, we think it would be reasonable for the forthcoming regulations to continue the approach of the existing regulations.

2. Standardization of Process for determining COB exception amount

In the interest of making the regulations more transparent and administrable, we have several recommendations to standardize the process under which the COB exception amount is determined in the cases in which it remains applicable. Specifically, we recommend that the forthcoming regulations provide:

- a. Amount eligible for COB exception. The deductible amount under the COB exception should be the excess, if any, of the present value of the remaining non-convertible payments determined using a date-of-repurchase non-convertible yield appropriate for the issuer over the present value of the same payments determined using the date-of-issue non-convertible yield appropriate for the issuer.
- b. Determination of payment schedule. For purposes of the present value computations, the “remaining non-convertible payments” should consist of a principal payment on the nearest call date (or final maturity date, if none) and scheduled interest payments between the repurchase date and the nearest call date or maturity date. For this purpose, the nearest call date is the next date on which the issuer has the unconditional right to call the bond based on conditions in effect at the time of the repurchase.
- c. Determination of non-convertible yields. For purposes of the present value computations, the yields should be determined under the principles of Treasury regulations Section 1.1275-4(b)(4)(i)(A) (the “CPDI comparable yield”), determined without regard to the AFR presumption. Thus, the relevant yield as of the issue date should be the CPDI comparable yield determined as of the issue date with respect to a payment schedule that includes the payments between the issue date and the repurchase date (as well as the “remaining non-convertible payments” (as defined above)). The relevant yield as of the repurchase date should be the CPDI comparable yield determined as of the repurchase date for a

debt instrument having a payment schedule equal to the remaining non-convertible payments.

B. Possible alternative approach to the COB exception

We considered a completely different approach to the COB exception that would depart from the longstanding approach reflected in the current regulations. Rather than focus on a decline in yield while the debt was outstanding, it is possible to isolate the element of the repurchase price that is attributable to the embedded option by subtracting from the repurchase price the value of the embedded option. If the repurchase price (after reduction for the value of the embedded option) exceeds the adjusted issue price, the difference is arguably attributable to the COB because it does not reflect the value of the option. Although we do not express a view as to whether the traditional approach ought to be abandoned in favor of this approach, we do believe it is worth considering.

C. Normal Call Premium Exception

The current regulation's Normal Call Premium exception is stated in two parts: a general rule and a one-year's interest safe harbor. The current general rule is useless because the definition of "comparable non-convertible obligation" requires the same stated interest rate as the actual convertible bond and, hence, is unrealistic.⁹ The one-year's interest safe harbor is of limited utility because few convertible bonds provide for a "call premium specified in dollars." Most callable convertible debt is callable at par, not at a premium. We recommend that the Normal Call Premium exception be restated as a simple safe harbor, effectively combining and simplifying the approach in the current regulations. The amount of the safe harbor could simply be one-year's yield or a fixed percentage (such as 5%) reflective of typical call premiums on non-convertible debt instruments.

D. CPDI convertibles

We recommend that the regulations clarify that positive adjustments upon the scheduled retirement of a CPDI convertible are considered "bond repurchase premium" fully subject to

⁹ Treas. Reg. § 1.249-1(d)(1).

section 249. In Rev. Rul. 2002-31,¹⁰ the IRS ruled that this type of positive adjustment was subject to section 249. The ruling's position should be strengthened by embodying it in regulations.

E. Call-Spread convertibles

In a call-spread convertible transaction, an issuer of a convertible bond elects to integrate the convertible bond and a purchased call option (the “bond hedge”) into a single synthetic debt instrument. Although the bond hedge is generally designed to hedge the conversion feature of the bond perfectly, there can be certain limited circumstances in which the hedge is less than perfect,¹¹ thereby resulting in an “unhedged conversion feature.”¹²

We recommend that the forthcoming regulations provide a special section 249 rule for synthetic debt instruments arising from call spread convertible transactions. This rule would limit section 249 disallowance of repurchase premium on a synthetic bond to the excess, if any, of the amount deemed paid to retire the synthetic (under Treasury regulation Section 1.1275-6(d)(iii)(B)) over its principal amount. Thus, for example, if an unhedged conversion feature results in an additional payment above the principal amount of the synthetic, the section 249 disallowance would apply only to the additional payment.

F. Convertibles that do not allow physical settlement

We recommend that regulations clarify that section 249 applies to repurchase premium on all convertible bonds, including those that, by their terms, do not allow for physical settlement.

¹⁰ 2002-1 C.B. 1023.

¹¹ The most prevalent unhedged conversion feature is the so-called “make-whole” amount that has to be paid to holders in the event of an involuntary early conversion, such as one arising from a change in control of the issuer. Banks are often unwilling to include this amount in the bond hedge because it is difficult to value and hence difficult for the bank itself to hedge.

¹² An unhedged conversion feature does not necessarily mean that the convertible bond and the bond hedge do not qualify for integration. If there is only a remote chance that the situation will arise in which the conversion feature is not fully hedged, the contingency can be ignored under Treasury regulation Section 1.1275-2(h). If there is a single payment schedule that is significantly more likely than not to occur, that payment schedule can be used to compute the yield of the synthetic debt instrument under Treasury regulation Section 1.1272-1(c)(2). And because conversion features can be ignored in computing yield under Treasury regulation Section 1.1272-1(e), an unhedged conversion feature does not interfere with the computation of a yield on the synthetic debt instrument and hence does not preclude integration.

II. BACKGROUND

A. Pre-section 249 cash repurchases

In 1962, the Seventh Circuit held that an issuer of a convertible bond was entitled to deduct bond repurchase premium upon its cash repurchase, even where the premium was obviously attributable to the appreciation of the embedded option.¹³ The court looked to the definition of repurchase premium in Treas. Reg. § 1.61-12(c)(1) (which then defined repurchase premium as the excess of repurchase price over issue price)¹⁴ and reasoned:

There is no provision in the Code or the Regulations which requires allocation of a part of the total purchase price to the value of the conversion privilege. . . . If this situation represents a breach in our revenue wall, its repair must be effect by legislative action rather than by judicial interpretation.¹⁵

The *Roberts & Porter* holding operated as a complete end-run around section 1032. A corporation that issued a stand-alone warrant to acquire its own stock at one price and repurchased at a different, higher price clearly had an economic loss but no tax loss per section 1032.¹⁶ If, however, the same warrant were embedded in a convertible bond, *Roberts & Porter* held that the economic loss was deductible as bond repurchase premium provided that the convertible bond were repurchased for cash. This holding created a significant discontinuity at a time when it was estimated that nearly ten percent of all outstanding corporate debt was convertible.¹⁷

In 1967, the IRS non-acquiesced in *Roberts & Porter*.¹⁸ The companion GCM argued that the regulations defining “repurchase premium” ought not to be interpreted to “permit such

¹³ *Roberts & Porter v. Commissioner*, 307 F.2d 745 (7th Cir. 1962).

¹⁴ Currently, Treasury regulation Section 1.61-12(c)(2)(iii) defines repurchase premium as the excess of repurchase price over the debt instrument’s adjusted issue price.

¹⁵ 307 F.2d 747-48.

¹⁶ Section 1032 was not clarified to explicitly address gain/loss on a corporation’s repurchase of warrants over its own stock until 1984. Prior to the 1984 amendment of section 1032, it was thought that loss on warrant repurchase would not be deductible under a broad reading of section 1032 and/or under earlier case law such as *Illinois Rural Credit v. Commissioner*, 3 B.T.A. 1148 (1926) (holding that stock subscription prepayments forfeited to a corporation were “not income” to the corporation).

¹⁷ Fleisher & Cary, “The Taxation of Convertible Bonds and Stock” 74 HARV. L. REV. 473 (1961).

¹⁸ Rev. Rul. 67-409, 1967-2 CB 62.

an anomalous result or windfall.”¹⁹ The GCM advanced the view that the premium was not in fact repurchase price with respect to the bond but more accurately characterized as a separate amount paid by the issuer in order to prevent dilution. The GCM also announced that the IRS intended to strengthen its “no deduction” position with future regulations.

Shortly thereafter, in 1968, the IRS issued regulations limiting the deduction for bond repurchase premium in the case of convertible debt. Paragraph (c)(2) of Treasury regulation Section 1.163-3 (still in existence today, but not effective for bonds issued after May 27, 1969) provides that the deductible portion of repurchase premium with respect to a convertible bond may not exceed the amount of one-year’s interest. In addition, Treasury regulation Section 1.163-3(c)(2) provides an exception to the disallowance rule to the extent the issuer can demonstrate that an amount of repurchase premium in excess of one-year’s interest “does not include any amount attributable to the conversion feature.”

B. Section 249

In 1969, Congress enacted section 249, essentially codifying the IRS’s regulatory position. Section 249(a) disallows an interest expense deduction for repurchase premium arising from the repurchase of a convertible bond to the extent it exceeds a “normal call premium on bonds . . . which are not convertible.” Section 249(a), like the regulation that preceded it, provides an additional exception for the “cost of borrowing.” Specifically, the disallowance rule does not apply to the extent the issuer can demonstrate that the repurchase premium is “attributable to the cost of borrowing and is not attributable to the conversion feature.”

The enactment of section 249 rendered moot the pre-section 249 case and administrative law. Although the Internal Revenue Service (“IRS”) and taxpayers continued to litigate the issue for repurchases in pre-statutory years, after losing *Head Ski v. U.S.*,²⁰ the IRS eventually conceded its pre-statutory position that convertible bond repurchase premium was non-deductible absent section 249.²¹

¹⁹ Gen. Couns. Mem. 33528 (June 8, 1967).

²⁰ 323 F. Supp. 1383 (D. Md. 1971), *aff’d* 454 F.2d 732 (1972).

²¹ AOD *In Re: Head Ski* 1974 WL 35941.

C. The current regulations

The last major development was the 1973 issuance of Treasury regulation Section 1.249-1.²² This regulation restates the general disallowance rule of the statute and provides for two limited exceptions – the Normal Call Premium exception and the Cost of Borrowing exception.

1. Normal Call Premium Exception

The existing regulatory Normal Call Premium exception has two rules of limited utility. Under the general rule, bond repurchase premium is deductible to the extent there exists a “normal call premium” on a “comparable nonconvertible obligation.”²³ A normal call premium for this purpose is any call premium currently in effect for a comparable nonconvertible obligation. Under what is in effect a safe-harbor application of the general rule (the “One Year’s Interest” rule), a call premium “specified in dollars” in the terms of the convertible and that is less than one-year’s interest is deemed to be a normal call premium.²⁴

The general rule has never been functional because it uses an unrealistic definition of “comparable nonconvertible obligation.” The regulations define a “comparable nonconvertible obligation” for purposes of this rule as a debt instrument with the same grade and classification, the same issue and maturity dates, and the same rate of interest as the convertible bond.²⁵ If one reads the “same rate of interest” literally, this test, by definition, can never be met. To the extent the conversion option has value on the day the bond is issued (and all embedded conversion options do), a convertible bond will, by definition, have a different, lower yield than an identical instrument that lacks a conversion feature. The inclusion of a valuable conversion option in a convertible bond allows the issuer to “buy down” the non-convertible yield. Even if one were to read the “same rate of interest” requirement more broadly, so that the comparable nonconvertible

²² T.D. 7259 (Feb. 9, 1973). These regulations were slightly amended in T.D. 8746 (Dec 30, 1997) to include a cross reference to Treasury regulation Section 1.163-7(c) and to clarify the one-year’s interest safe harbor. Temporary regulations were issued in 2011 (T.D. 9533, Sept 7, 2011) to provide additional detail regarding the computations necessary to determine the amount, if any, of repurchase premium deductible under the cost of borrowing exception.

²³ Treas. Reg. § 1.249-(d)(1).

²⁴ Treas. Reg. § 1.249-(d)(2).

²⁵ Treas. Reg. § 1.249-1(b)(3).

obligation only has to have the same coupon rate of interest,²⁶ which would permit comparable nonconvertible obligations with original issue discount to replace the conversion feature, it is still unlikely that a “comparable nonconvertible obligation” would exist; the requirements that the comparable nonconvertible debt have the same issue date, maturity date, and coupon amount are simply too onerous.

The One Year’s Interest safe harbor is functional but rarely used because it applies only if the actual convertible bond is callable at a premium. Most callable convertible bonds are callable at par, not at a premium. Few, if any, convertible bonds have call premiums “specified in dollars.” As a result, the One Year’s Interest safe harbor of the Normal Call Premium rule rarely, if ever applies.

2. Cost of Borrowing Exception

The second, and far more important, exception in the current regulations is the COB exception. Although the existing regulatory text begins by repeating the statutory phrasing that the COB exception is available to the extent the repurchase premium “is attributable to the cost of borrowing and is not attributable to the conversion feature,”²⁷ (stating a two-part test), the regulations effectively provide only a one-part rule: The issuer is entitled to deduct under the COB exception a portion of the repurchase premium expense incurred to the extent the issuer can prove “the selling price of the convertible obligation increased [while the bond was outstanding] by reason of a decline in yields generally on nonconvertible obligations which are as nearly comparable as possible.”²⁸ Significantly, the issuer does not have to prove either: (i) that the actual repurchase premium was in fact attributable to this interest rate decline or (ii) that the actual repurchase premium was not in fact attributable to the conversion feature.

Typically, issuers of repurchased convertible debt determine eligibility for the COB exception by first examining whether non-convertible yields for the issuer have declined while

²⁶ Presumably, the comparable nonconvertible bond would have a higher effective yield as it would need to be issued at a discount to the price at which the convertible is issued. If a 10 year, 2% coupon convertible was issued at par when comparable non-convertible yields for the issuer are 5%, presumably the comparable nonconvertible obligation, were it to exist, would be issued for 76.83% of par – that is, with original issue discount of 23.17%.

²⁷ Treas. Reg. § 1.249-1(e)(1).

²⁸ Treas. Reg. § 1.249-1(e)(2)(i).

the bond was outstanding. If market interest yields have declined, general market practice is that the issuer computes the deductible portion of repurchase premium by measuring the impact of the change in yield to a stream of non-convertible cash flows. There are two common methods of determining the specific stream of non-convertible cash flows – the “discount bond method” and the “coupon gross-up method,” discussed in turn below.

Under the “discount bond method,” the issuer computes the difference between the present values of the remaining cash flows (ignoring the conversion feature) on the redemption date using two different yields – the non-convertible market yield at the time of issuance and the lower, non-convertible market yield at the time of repurchase. This method is colloquially referred to as the “discount bond method” because it measures repurchase premium with respect to the remaining non-convertible cash flows. Had the bond been issued with only these cash flows (that is, without an embedded conversion option), it would have been issued at a discount; hence the name.

Under the “coupon gross-up method,” the discounting process is the same but the cash flows being discounted are different. Under this method, the issuer constructs a hypothetical non-convertible bond having current interest coupons equal to a market yield as of the issue date. Then, as in the case of the discount bond method, these cash flows are discounted at both the original market yield and the market yield at the time of the redemption. The difference is the deductible portion of repurchase premium. This method is colloquially referred to as the “coupon gross-up method” because the hypothetical bond has interest coupons that are greater than (i.e., grossed-up from) the actual coupons. Because these two methods use different cash flows (the discount bond method uses the actual remaining coupon and the coupon gross-up method uses larger, hypothetical coupons), they produce different deductible amounts.

III. DETAILED DISCUSSION

A. Cost of Borrowing Exception

1. Holder’s voluntarily conversion and repurchase of currently callable bond.

If an issuer repurchases a convertible bond at a premium as a result of either (i) the holder’s voluntary early conversion (including a holder’s voluntary conversion after an issuer’s

notice of an intention to call) or (ii) an issuer's market repurchase at a time when the bond is currently callable, the repurchase price will be the "as converted" value of the bond.²⁹ If the holder voluntarily converts, the issuer will be deemed to have retired the bond for the value of the stock (or cash) delivered in the conversion.³⁰ If the issuer repurchases a currently callable convertible bond in the market at a premium, the issuer will typically agree to pay no more than the "as converted" value for the bond because, if the market price were in excess of the "as converted" value, the issuer could simply exercise its current call right and thereby force the holder to accept only the "as converted" value. Thus, in both cases, the issuer's repurchase premium expense will be the excess "as converted" value of the bond over the bond's adjusted issue price.³¹

This repurchase premium expense is exclusively a function of the value of the embedded option. Although a decline in market interest rates economically impacts the value of the remaining non-convertible cash flows (assuming non-conversion), it does not impact the value of the bond at all. This phenomenon is best illustrated with a numerical example. Consider an unconditionally callable convertible bond with a \$1000 principal amount and issue price, a 3% stated coupon, and a right to convert bond into 10 shares of issuer stock. Assume on the issue date the stock is trading at \$70/share. If the stock increases in value to \$180/share, the "as converted" value of the convertible bond will be \$1800 ($\$180 * 10$ shares), regardless of then-

²⁹ When an issuer gives notice of its intention to call a convertible bond, holders of the bond always have at least 30 days prior to the call during which they can exercise their conversion rights, which of course they will do if the conversion feature is in the money. Thus, a call right on a convertible bond functions effectively as a right to force conversion once the conversion feature is in the money.

³⁰ Treas. Reg. § 1.61-12(c)(2)(i). This section specifically provides that the term "repurchase" includes "the conversion of a debt instrument into stock of the issuer." This section clarifies that, from the perspective of an issuer of debt, the exchange of debt for equity (even an exchange pursuant to a per-the-terms conversion) is a taxable event to the issuer. In GCM 25277 (1947-1 C.B. 44), the IRS explained its acquiescence to the "no cancellation of indebtedness income" holdings of a series of Tax Court cases involving the retirement of debt with stock in bankruptcy proceedings. In each of the referenced cases, the value of the stock delivered was less than issuer's amount of liability with respect to the debt at the time of the exchange. The GCM accepted the Tax Court's view that "the issuance of stock for debt does not cancel the indebtedness but merely continues the obligation in another form." This is no longer the law. Under current law, an issuer that issues stock in retirement of debt clearly realizes COD income under section 108(e)(8). Although section 108(e)(8) addresses COD only (and therefore does not discuss the premium situation), the 1997 change to the wording of treasury regulation Section 1.61-12(c)(2)(i) makes clear that an exchange of stock for debt (even one pursuant to the terms of a conversion right embedded in the instrument) will result in repurchase premium to the extent the value of the stock exceeds the adjusted issue price of the debt. In short, while an issuer's retirement of debt for stock used to be a non-taxable transaction to the issuer, it no longer is.

³¹ Treas. Reg. § 1.61-12(c)(2)(iii).

current yields appropriate for the issuer. If the issuer repurchases the bond for its \$1800 “as converted” value, the issuer will have \$800 of repurchase premium expense. From the issuer’s perspective, the repurchase is an exchange of \$1800 of value for the holder’s surrender of the right to receive the remaining non-convertible cash flows. The issuer’s repurchase premium expense will be the same \$800 regardless of whether the value of the remaining payments (assuming no conversion) surrendered to the issuer is on a standalone basis \$700, \$800, \$1000, \$1200 (or any other amount less than \$1800) at the time of the repurchase.

Because the repurchase premium expense in these situations is exclusively a function of the value of the conversion feature and is not at all attributable to the change in interest rates, we recommend that the forthcoming regulations provide that there is no COB exception for repurchases arising from (i) a holder’s voluntary early conversion (including an early conversion forced by an issuer’s call) or (ii) an issuer’s market repurchase when the bond is currently callable. In these cases, a change in the cost of borrowing simply does not impact the repurchase premium expense.

2. Market or negotiated purchase of non-callable convertible bond

The remaining situations in which a convertible bond can be repurchased at a premium are market or negotiated repurchases of bonds that are not currently callable. In these situations, the repurchase premium can be attributable to a decline in yields, an increase in the value of the option, both, or another factor entirely.

The most straightforward case is where there is a market repurchase that results in repurchase premium expense and, at the time of the repurchase, the embedded option has not increased in value. Because convertible debt must be originally issued with the embedded option out of the money, this situation only occurs when the option continues to be out-of-the-money on the date of repurchase.³² In this case, the repurchase premium can be easily identified. Consider, for example, a convertible bond with a principal amount and issue price of \$1000, having a 3% coupon, and convertible into 10 shares of stock of the issuer. Assume further that on the issue date, the issuer’s stock is trading at \$70 and the embedded option is worth \$250. Finally, assume

³² If a convertible debt is issued with an embedded option at-the-money or in-the-money, it could be considered “payable in equity” within the meaning of section 163(l) and, if that section applies, all interest expense (including repurchase premium expense) is disallowed.

that on the issue date, had the bond not had a conversion feature, the issue price would have been \$750 and the yield 5%. If the bond is repurchased for a price in excess of its \$1000 adjusted issue price at a time when the embedded option is worth no more than \$250, the repurchase premium must be attributable to a decline in yields. Thus, for example, if the repurchase price is \$1100 and at the time of repurchase the embedded option has a value of only \$150, we know that all \$100 of repurchase premium expense is attributable to the decline in yield (and not attributable to the conversion feature).³³

The analysis is considerably more complex, however, if the embedded option has increased in value and yields have declined. In this case, the repurchase premium will reflect both the increased value of the option and the decline in yields. The complexity arises from the fact that the actual premium experienced is less than the sum of these two factors considered separately. Consider for example a situation whether the embedded option has increased in value by \$100 (from \$250 to \$350) and the decline in yields has resulted in the present value of the debt components increasing in value from \$700 to \$800. In this case, considered separately, it appears that there would be \$200 of increased value. But it likely will be the case that the bond is worth less than \$1200 and hence can be repurchased for a premium that is less than \$200. If the bond is repurchased for \$1125, the issuer will have \$125 of repurchase premium expense. It is not clear whether the deductible portion under the COB exception in this case ought to be \$100 (the result obtained if premium is considered attributable to the decline in yields first, then attributable to the increase in value of the option), \$25 (the result obtained if premium is considered attributable to the increase in value of the option first, then attributable to the decline in yields), or some number in between \$100 and \$25.

³³ On these numbers, the decline in yield presumably drove the value of the remaining non-convertible payments to \$950 (\$1100 repurchase price less \$150 value of embedded option). This is a \$250 increase over the original \$700 value of the non-convertible payments. Had the option maintained its initial value, the repurchase price would have been \$1250 and therefore the repurchase premium would have been \$250. Had these been the facts, the entire \$250 amount would have been attributable to the decline in interest rates. Here, because the option declined \$150 in value (from \$250 initial to \$100), the repurchase premium expense was only \$100. The effect of the decrease in option value in this case was to reduce the deductible amount, even though the decrease in option value had nothing to do with changes in yield. This “netting” phenomenon is a function of the unitary nature of the convertible bond. Had the transaction been structured as an investment unit consisting of a discount debt instrument and a detachable warrant, the full \$250 of increase in value attributable to interest rates would have been deductible repurchase premium.

As the option moves deeper and deeper into the money, repurchase premiums are increasingly determined by the increased value of the option feature and less and less by changes in yields. But another factor then comes into play. Consider our same bond, repurchased at a time when the stock is trading at \$180/share such that the bond has an “as converted” value of \$1800. If the bond is not currently callable, the issuer cannot force holders to convert at the “as converted” value or accept \$1800 of consideration in exchange. In this type of deep-in-the-money case, to induce holders to sell, the issuer will typically have to offer a purchase price greater than the \$1800 “as converted” price. In determining the purchase price, the parties typically take into account three or four items: (1) the “as converted” value (also referred to as the “intrinsic value” of the option), (2) the remaining “time value” of the option,³⁴ (3) the value of the remaining interest coupons to the earliest issuer call date or, if none, to the maturity date (the forgone interest payments), and (4) in cases where the repurchase is pursuant to a tender offer, an additional amount to induce holders to accept the offer, which might be referred to as a “sweetener.”

Let’s assume the issuer repurchases its \$1000 convertible bond for total consideration of \$1950 (composed of \$1800 of “as converted” value, \$10 of time value, \$100 value of forgone interest, and \$40 value of sweetener). In this case, the issuer’s repurchase premium is \$950 – the excess of the \$1950 repurchase price over the \$1000 adjusted issue price. It hardly matters whether the value of the remaining payments (determined without regard to the conversion feature) have increased from their \$750 date-of-issuance value to some higher value. In this case, it is hard to say that the repurchase premium is attributable to any significant extent to a decline in yields.³⁵

In summary, in the market or negotiated repurchase cases where the debt is not currently callable, there exists a continuum of situations. At the one extreme are repurchases at a premium of out-of-the-money convertible bonds whose embedded option has not increased in value. In

³⁴ As mentioned earlier, the “time value” is the value of the holder’s right not to exercise the option and, instead, demand principal payments. For options that are so deep in the money they are nearly certain to be exercised, the time value is quite small.

³⁵ A decline in yields will influence the value of the forgone interest payments and will have a slight impact on the time value of the conversion option. But both of these effects are relatively small and unrelated to the change in the present value of the remaining cash flows on the bond ignoring its conversion feature.

these cases, it is clear that the entire repurchase premium is attributable to the decline in yields. At the other extreme is the repurchase at a premium of a deep-in-the-money convertible bond. In these cases, the decline in yields does not appear to significantly impact the amount of the repurchase premium. There are also a number of situations in between where the repurchase premium is a function of both an increase in option value and a decrease in yields, but the exact contribution of each cannot be determined by addition as the total repurchase premium is less than the sum of the two amounts determined separately.

Were we commenting on a newly enacted statute, we might very well consider recommending that the IRS exclude from the COB exception repurchase premiums in situations where the embedded option is deep in the money. The reality is that the statute is far from new. The existing regulations have been in force for decades and clearly allow an issuer to claim a deduction for a portion of the repurchase premium whenever the issuer can prove a decline in yields.

On balance, we recommend retaining the long-standing approach of the current regulations. Nevertheless, as discussed above, we recommend limiting the scope of the COB exception so that it no longer applies to voluntary conversions (including conversions forced by an issuer call) and market repurchases of currently callable convertible debt. In the limited repurchase situations that remain (market or negotiated repurchase of currently bonds that are not currently callable), there are some situations where the historic decline in yield approach is quite accurate and economic and others (such as the deep-in-the-money repurchase case) where it is much less so. Furthermore, we recommend that if the forthcoming regulations continue the historic approach in these situations by allowing a deduction under the COB exception based on changes in yield, the regulations should specify the method of computing the deductible amount, as described below.

3. Standardization of Process for determining deductible amount

In the interests of transparency and administrability, the forthcoming regulations should specify and outline a single, uniform method for determining the deductible amount under the COB exception, the discount bond method.

Under this method, the amount attributable to the decline in yield is the excess, if any, of (i) the present value of the remaining non-convertible payments (determined using a current market yield appropriate for the issuer) and (ii) the present value of the same payments (determined using the original market yield appropriate for the issuer).³⁶ The “remaining non-convertible payments” and “market yield appropriate for the issuer” are terms of art that should be further defined.

In cases where a debt instrument has only a single non-convertible payment schedule, the concept of “remaining nonconvertible payments” needs no further elaboration. If, however, the debt instrument is callable on one or more dates certain, there are two or more possible remaining non-convertible payment schedules – (i) the “to maturity” schedule (that is, the schedule assuming the call will not be made) and (ii) the “to call” payment schedules (that is, the schedule assuming the call will be made). We recommend that, in this case, the forthcoming regulations provide that the remaining non-convertible payment schedule be determined by reference to the nearest unconditional call date. The argument for using the nearest unconditionally call date is that the holder does not have a right to interest payments beyond that date. If the embedded option is deep-in-the-money, the holder ought to expect that the issuer will call, forcing the issuer to early convert, thereby cutting off the holder’s right to enjoy post-call coupons.

It is important to note that discounting to the earliest unconditional call date likely does not represent how most taxpayers and advisers are applying the current regulations. Further, this is not the rule that applies for financial accounting purposes under generally accepted accounting principles. Thus, the recommended change may prove controversial.

To standardize the yields used to determine the present values of the remaining payments, we recommend that the regulations provide the yields to be used should be determined under the principles of Treasury regulations Section 1.1275-4(b)(4)(A) (the “CPDI comparable yield”), determined without regard to the AFR presumption of Treasury regulations Section 1.1275-

³⁶ The current regulations do not provide specific rules or examples for the application of the COB exception. Some practitioners and taxpayers believe that for purposes of this computation, it is appropriate to replace the actual interest coupon on the convertible bond with a coupon equal to the market yield on a nonconvertible debt at issue. This is sometimes referred to as the “coupon gross-up method.” Under our recommendation, the coupon gross-up method would not be permitted.

4(b)(4)(B). Thus, the relevant yield as of the date of issuance should be the CPDI comparable yield, determined as of the issue date for a debt instrument having a term ending on the nearest unconditional call date. This yield will be similar to (if not identical to) the yield used for financial statement purposes. The relevant yield as of the date of repurchase should be the CPDI comparable yield determined as of the repurchase date for a debt instrument issued on the repurchase date having a payment schedule equal to the remaining nonconvertible payments, determined above.

It is worth noting that, under this standard, the CPDI comparable yield for the issue date will be determined by reference to the interval of time between the issue date and the nearest unconditional call date (determined as of the issue date) and the CPDI comparable yield for the repurchase date will be determined by reference to the interval of time between the repurchase date and the nearest unconditional call date (determined as of the repurchase date). For this purpose, a call date should be considered unconditional only if (i) based on the facts as of the moment of testing, the embedded option is in-the-money and the call is unconditional or, if conditional, the conditions have been satisfied, or (ii) at the moment of testing, the embedded option is not in the money but the coupon rate on the debt instrument exceeds the current CPDI comparable yield for a debt instrument maturing on the call date. In other words, an unconditional call is to be assumed exercised if the option is in the money and, it appears, could be exercised on the call date or the option is out of the money but market yields are lower than coupon yields such that it is appropriate to assume the issuer would exercise the call.

Under this test, the CPDI comparable yield determined as of the date of issue will be by reference to a longer term than the CPDI comparable yield determined as of the repurchase date. On the issue date, the embedded option will be out of the money³⁷ and it is likely that the coupon rate will be less than the CPDI comparable yield so that even formally unconditional call rights would not be considered exercised. Thus, under this standard, the issue date CPDI comparable yield would likely be determined by reference to the interval of time between the issue date and maturity date. By contrast, on the repurchase date (where the debt is by definition being repurchased at a premium), it is likely that either the embedded option is in the money or, if out

³⁷ If it were not out of the money, there would likely be a section 163(l) “payable in equity” issue rendering the section 249 issue moot.

of the money, the current coupon yield is higher than the current non-convertible yield such that the nearest unconditional call would be assumed exercised. Thus, under the standard articulated above, the repurchase date CPDI yield would likely be determined by reference to the interval of time between the repurchase date and the nearest call date. Accordingly, it is likely that the repurchase date yield will reflect a potentially significantly shorter term than the issue date yield.

The practical effect of this is that, even if market yields do not change between issue date and repurchase date, if the yield curve is upward sloping (as it normally is), the use of a shorter period of time to determine the CPDI comparable yield for the repurchase date will result in a lower yield and therefore an amount of deductible premium under the COB exception. Although one can argue that in this case there is not in fact a “decline in yields” in the sense of a change in market yields, we believe it is appropriate to treat the decline in yield attributable to the movement down the yield curve as a decline in yield for this purpose.

B. Alternative Approach to the COB Exception

As discussed above, in the case of a negotiated repurchase (such as an open market purchase or a purchase through a tender offer) of an in-the-money, non-callable convertible bond, the repurchase price will often exceed the “as converted value” of the convertible bond. The repurchase premium expense in this situation generally reflects (i) the excess of its “as converted value,” over the bond’s adjusted issue price, (ii) the remaining “time value” of the option,³⁸ and (iii) the value of the remaining interest coupons to the earliest issuer call date or, if none, to the maturity date (the forgone interest payments).³⁹ In addition, if the issuer makes a

³⁸ The “time value” of the option is the value of the holder’s right to not exercise the option and, instead, demand principal on the maturity date (or earlier put date). The more certain the option is to be exercised, the less time value the option has. Thus, an option that is deep-in-the-money and (given current volatility and time remaining) is nearly certain to be exercised would have less time value than an option that, although in the money, has a greater likelihood of non-exercise.

³⁹ In the case of a nonconvertible bond, only the excess of the remaining interest payments over a market rate of interest results in bond premium. But in the case of a deep in the money convertible bond, the entire amount of the remaining interest coupons (discounted to present value) will be reflected in the value of the bond. The reason for this is that, unlike a holder of a nonconvertible bond that is redeemed before maturity, the holder of a convertible bond gets little to no economic benefit from receiving the stock early. Assuming the stock pays no dividends, and because the holder already has the current value of the stock and the upside and downside in the stock (down to the conversion price) by virtue of holding the convertible bond, the only benefit of getting the stock early is that the stock may be more liquid than the convertible. Even the potential of an unexpected dividend payment would not influence the decision, because it is now standard for convertibles to contain adjustments to the conversion ratio for dividends.

tender offer for its outstanding convertible bonds, it will have to pay an additional amount to induce holders to accept the offer, which might be referred to as a “sweetener.” Clearly the first two components (portion of premium attributable to as converted value and time value) are attributable to the conversion feature of the bond and should not be deductible under section 249.

If “attributable to the conversion feature” is construed broadly, the portion of repurchase premium expense reflecting both forgone interest payments and sweetener can be viewed as “attributable to the conversion feature.” In cases where the issuer negotiates to repurchase at a premium prior to maturity, it can be argued that the driver to the transaction is the issuer’s desire to retire the embedded option. Under a broad view of “attributable to the conversion feature,” all repurchase premium is attributable to the retirement of the option (and therefore “attributable to the conversion feature”) in the sense that it would not have been incurred at the time of the repurchase *but for* the issuer’s goal of repurchasing the bond (and its embedded option). Moreover, if a decline in market interest rates while the convertible bond is outstanding is the exclusive touchstone for deductibility under the COB exception, the amount of the repurchase premium reflecting the value of the forgone interest payments is largely independent of interest rate movements and therefore not a cost of borrowing in the traditional sense.

On the other hand, if “attributable to the conversion feature” is construed as narrowly as possible, the first two components listed above (the intrinsic and time value of the conversion option) fully account for the value of the conversion feature, and therefore it can be argued that the portion of the repurchase premium attributable to the forgone interest payments (and sweetener, if any) ought to be deductible, as it is better viewed as a cost of repurchasing the debt components than repurchasing the embedded option. The portion of the excess repurchase price attributable to the forgone interest payments is, in a very real sense, a cost of borrowing, even though not attributable to a decline in yields under the standard COB test. The forgone interest payments were contractually promised and the economic expense of satisfying this promise is part of the cost of borrowing the same way a call premium or prepayment penalty on a non-convertible debt is a cost of borrowing.

The sweetener, viewed from the issuer’s perspective, also is arguably a cost of borrowing. Once a convertible becomes deep-in-the-money, the issuer has the disadvantages of both equity (its earnings are diluted by the shares to be issued under the convertible) and debt (it

has to pay interest so long as the convertible remains unconverted). Because the equity remains outstanding once the convertible is converted into stock, from the issuer's perspective, the sweetener is an additional cost of retiring (repurchasing) the debt component of the convertible. Stated another way, once the convertible is deep in the money, the convertible behaves as if it were equity (in the sense that its price moves with the price movements of the underlying stock). From the issuer's perspective, the convertible is less advantageous than pure equity because it obligates the issuer to pay interest. The sweetener is an economic cost of eliminating the obligation to pay future interest payments and in that sense seems attributable to the repurchase of the debt and therefore a cost of borrowing, albeit one that is not dependent on a decline in yields.

If "attributable to the conversion feature" is construed to encompass only the intrinsic and time value of the conversion option, then a deduction could be allowed for the repurchase premium up to the excess, if any, of the redemption price over the sum of the conversion value of the bond plus the remaining time value of the conversion option (the residual method). No special rule would be required to deal with call features because, if a redeemed convertible bond was immediately callable, the redemption price would be essentially equal to the conversion value of the bond, and hence no deduction would be allowed under the residual method. The only complexity in administration of the rule would be the computation of the remaining time value of the option, but this would be a minor issue in most cases.⁴⁰

We did not form a consensus as to this alternative. It would depart from the longstanding approach to the COB exception reflected in the current regulations. Although we are not expressing a view on its desirability, we do recommend that consideration be given to whether the forthcoming regulations should either (i) stay with the existing COB approach (the cost of borrowing is limited to the premium that can be attributed to a decline in yields while the convertible bond is outstanding) or (ii) abandon that approach in favor of a residual method

⁴⁰ Alternatively, if it is felt that the sweetener is not properly included in the "cost of borrowing," a deduction could be allowed only up to the amount of the value of the forgone interest payments. This rule could be made more easily administrable by providing that the value is computed by discounting the forgone interest payments at the AFR on the redemption date. Given that most convertible redemptions occur only a year or two before the maturity or earliest call date of the convertible, the use of a safe harbor interest rate would only slightly increase the amount of the allowable deduction.

(where the cost of borrowing is all costs other than those attributable to the value of the intrinsic and time value of the option).

C. Normal Call Premium Exception

The current regulation's normal call premium exception rule is not sensible. The statute and the regulations disallow repurchase premium arising from convertible bonds to the extent it exceeds a "normal call premium." The general rule of the regulations provides that a normal call premium is a call premium observed on a "comparable non-convertible obligation."⁴¹ The problem is in the definition of "comparable non-convertible obligation." The regulations provide that a comparable nonconvertible obligation is a debt instrument having the same grade and classification, same issue and maturity dates, and same interest rate as the convertible bond. As discussed in the Background section above, a non-convertible debt instrument having the same credit quality and maturity as a convertible debt instrument must have a different yield because it lacks the conversion feature. For this reason, it appears the general rule has never applied.

The current one-year's interest rule of the regulations was added to address the deficiency in the general rule but has only limited utility. This rule provides that a call premium "specified in dollars" is considered to be a normal call premium on the obligation if it does not exceed the interest on the convertible in the year of repurchase.⁴² This rule can apply only to the extent a callable convertible bond actually provides for a call premium. We understand that most callable convertible bonds are callable at par – that is, they do not provide for a call premium.

We recommend that the normal call premium rule be simplified into a single rule. We recommend that the rule deem a fixed amount to be a normal call premium in all cases. That fixed amount could be a one year's interest, a flat percentage (for example 5%) or a graduated percentage (5% for years more than 5 years before maturity dropping one percent per year thereafter). It is also possible to provide a rule that defines normal call premium as zero in all cases. We would recommend against a per-se zero rule, however, as the "normal call premium" concept is statutory and the regulations should give realistic effect to the statute.

⁴¹ Treas. Reg. § 1.249-1(d)(1).

⁴² Treas. Reg. § 1.249-1(d)(2).

D. CPDI convertibles

In Rev. Rul. 2002-31,⁴³ the IRS specifically addressed the tax treatment of a debt instrument that was both a convertible bond and a contingent payment debt instrument within the meaning of Treasury regulation Section 1.1275-4. The ruling considered the impact of section 249 and held that (i) section 249 (as a repurchase premium rule) does not apply to limit the issuer's deduction of accruals of interest at the comparable yield, and (ii) that upon "a conversion of the debt instrument into stock having a value in excess of the debt instrument's adjusted issue price" any additional deduction is subject to section 249.

Very technically, a conversion of the debt instrument can occur early or at maturity. If the conversion is early, it is treated as an "unscheduled retirement" under the CPDI rules and therefore as a "repurchase."⁴⁴ In this case, it is clear that the excess, if any, of the value of stock (or cash) delivered over the projected payment schedule's adjusted issue price is "repurchase premium with respect to a convertible bond, subject to section 249. If, however, the conversion is at maturity, the CPDI rules operate differently. In this case, the excess, if any, of the value of stock (or cash) delivered over the adjusted issue price is a "positive adjustment" resulting in additional interest expense.⁴⁵ Arguably, this interest expense is not technically repurchase premium because of the mechanics of the CPDI rules. The revenue ruling held that this interest expense is subject to section 249, which is clearly the proper tax policy answer. We recommend that this holding be restated in regulations.

E. Call-Spread convertibles

In a call-spread convertible transaction, an issuer of a convertible bond acquires an option from an investment bank to hedge the convertible bond's conversion feature and writes a higher strike call option to the same bank. The combination of the purchased call option (the "bond hedge") and the written call option (the "warrant") is colloquially referred to as a "call spread."

⁴³ 2002-1 C.B. 1023.

⁴⁴ Treas. Reg. § 1.1275-4(b)(7)(v).

⁴⁵ Treas. Reg. §§ 1.1275-4(b)(7)(iv) and (b)(6)(i).

Under Treasury regulation Section 1.1275-6, the issuer elects to integrate the convertible debt instrument and the bond hedge (but not the warrant) into a single synthetic debt instrument.⁴⁶

Although the bond hedge is generally designed to hedge the conversion feature of the bond perfectly, there can be certain limited circumstances in which the hedge is less than perfect. The most prevalent unhedged conversion feature is the so-called “make-whole” amount that is paid to holders upon early conversions in certain change of control transactions. Banks are often unwilling to include this “make whole” amount as part of the settlement value in the bond hedge because it is difficult to value and hence difficult for the bank itself to hedge against such early conversions. Another possible residual convertible feature is a mismatch between the terms of the option component of the bond and those of the bond hedge due to averaging conventions or type of settlements (i.e., net share settle versus net cash). Arguably, the presence of one or more mismatched or unhedged conversion features makes the synthetic debt instrument a convertible debt instrument such that any repurchase premium expense incurred with respect to the repurchase of the synthetic debt instrument remains subject to section 249.

It is also possible for an issuer to hedge its convertible debt with a capped call option that only partially offsets the conversion feature up to a certain stock price. For example, consider an issuer who purchases a “capped call” struck at \$100 and capped at \$150. If this capped call is integrated with a convertible bond that has an implied strike price of \$100/share, the resulting synthetic is a convertible bond with an implied strike price of \$150/share. The synthetic debt instrument in this case is undoubtedly convertible.

If the synthetic debt instrument is technically a convertible debt instrument, it is necessary to consider how the disallowance rule of section 249 should be applied. The synthetic debt instrument is typically a coupon-paying, discount bond. Consider a convertible that is used for \$1000, provides for a 3% coupon, and has a 7-year term. If the bond hedge component costs the issuer \$300, the synthetic debt instrument will be considered to have an issue price of \$700 and OID attributable to the differential between issue price and principal of \$300. If the synthetic debt instrument remains outstanding until maturity, the issuer will simply deduct the \$300 of OID over the life of the synthetic debt instrument on a yield-to-maturity basis. If the

⁴⁶ The IRS has informally acknowledged that this tax treatment is appropriate in Chief Counsel Advice 2007-14.

synthetic debt instrument is unwound prior to maturity either because of a holder early conversion or a corporate action (such as a pending acquisition or divestiture that necessitates a repurchase of the convertible bond), the synthetic will be deemed repurchased for its then fair market value. Often, the economics are such that the fair market value of the synthetic debt instrument upon an early unwind is the principal amount, or an amount slightly in excess of the principal amount (i.e., the value of the convertible debt instrument less the current value of the bond hedge). If the fair market value is the principal amount, the repurchase premium expense realized will be the excess of the principal amount over the adjusted issue price – that is, the unamortized discount relating to the bond hedge. If an unhedged conversion feature causes the repurchase price to be greater than the principal amount, the repurchase premium expense will be greater than the unamortized discount relating to the bond hedge by the same amount.

To the extent the repurchase price relates to value between the adjusted issue price and par, that premium appears to be a function of the remaining OID on the synthetic debt instrument that would be due in any event and not a function of any conversion feature. It can also be argued that, although this repurchase premium reflects only OID that would be deductible had the synthetic not been unwound early, if the early unwind is due to a holder's early conversion of the convertible bond component of the synthetic, the effect is an increase in yield on the synthetic (because accelerating the remaining OID and treating it as repurchase premium increases the synthetic's yield) that was quite literally caused by an exercise of a conversion option in a convertible bond (the bond component of the synthetic) and therefore in a sense attributable to a conversion feature. On balance, we believe that this amount is better characterized as repurchase premium expense relating to a non-convertible bond (the synthetic debt) and therefore not as subject to section 249. To the extent the repurchase premium upon the early termination is greater than the unamortized OID, the excess could very well be attributable to a conversion feature and therefore appropriately subject to disallowance under section 249. The determination of whether excess amounts are deductible should be made under the general section 249 rules discussed above.

Accordingly, we recommend that the forthcoming regulations provide a special section 249 rule for call spread convertible transactions. This rule would limit section 249 disallowance

of repurchase premium on a synthetic bond to the excess, if any, of the amount deemed paid to retire the synthetic debt instrument over its principal amount.

F. Convertibles that do not allow physical settlement

We recommend that regulations clarify that section 249 applies to repurchase premium on all convertible bonds, including those that, by their terms, do not allow for physical settlement. A bond with a mandatory cash settlement feature measured by the value of a fixed number of shares of issue stock is not technically convertible into the issuer's stock, but the economics of the bond are the same as those of a convertible with a physical settlement feature. The only difference is the medium of payment.

From a policy perspective, there can be no doubt that section 249 should apply to bonds of this type. Most if not all practitioners accept that this is the better view of current law. And there is ample precedent for treating financial instruments with cash settlement features the same as the corresponding instrument with physical settlement.⁴⁷ We recommend that the regulations put this issue to rest by an explicit statement that a mandatory cash-settlement feature does not exclude a convertible bond from section 249.

⁴⁷ See, e.g., section 1234(c), which treats cash settled options as options for purposes of section 1234.