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Internal Revenue Service
Memorandum

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to: Director, Field Specialists
(Large and Mid-Size Business)

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subject: Integration of convertible notes with hedges

This memorandum addresses a transaction in which a corporation uses § 1.1275-6 of the Income Tax Regulations to integrate its convertible notes (“notes”) with purchased call options on its common stock (“hedges”) but not also with written call options on its common stock (“warrants”). For federal income tax purposes, the integration of the notes and hedges would result in synthetic debt instruments treated as issued with original issue discount (“OID”) in an amount at least equal to the premium paid for the hedges.

This memorandum should not be used or cited as precedent.

ISSUE

Whether a corporation may integrate the notes with the hedges but not also with the warrants under § 1.1275-6?

CONCLUSION

In general, a corporation may integrate the notes with the hedges but not also with the warrants under § 1.1275-6. However, the transaction could be structured to generate excessive OID deductions through mispricing of the hedges and the warrants.

Such mispricing should be challenged, for example, by applying the OID anti-abuse rule in § 1.1275-2(g) to prohibit integration of the notes with the hedges.

FACTS

Corporation X issues five-year notes in denominations of \$1,000. The interest rate of the notes is zero. The issue price of the notes is the stated principal amount of the notes. The notes are issued through Underwriter, which is unrelated to X.

X may not call the notes at any time before the maturity date. The holders may not put the notes at any time before the maturity date, unless certain changes in ownership, consolidations, or mergers (“fundamental changes”) occur. If a fundamental change occurs, the holders may put the notes for their stated principal amount in cash.¹

The holders may at any time convert each note into a number of shares of X’s common stock (the “conversion shares”) determined by dividing the stated principal amount of the note by the conversion price.² The conversion price is significantly greater than the market price of the stock on the issue date of the notes. Upon conversion, X may elect physical settlement (pay the conversion shares in kind), net cash settlement (pay the value of the conversion shares in cash), or net share settlement (pay the stated principal amount of the note in cash and pay the excess of the value of the conversion shares over the stated principal amount of the note in stock).³ For conversions in connection with fundamental changes, the indenture for the notes includes a “make-whole” provision under which, in certain circumstances, the conversion shares might be augmented by additional shares, depending on the stock price on the effective date of the fundamental change.

Bank is an affiliate of Underwriter. X purchases hedges from Bank on the issue date of the notes, one hedge for each \$1,000 note. Each hedge entitles X to purchase a number of shares of X’s common stock equal to the number of conversion shares at a strike price equal to the conversion price. The hedges are automatically exercised if the corresponding notes are converted. The hedges settle the same way that the converted

¹ In similar transactions in which the notes provide for stated interest, the put proceeds include accrued but unpaid interest.

² We understand that in many of the transactions, for a certain period of time, the notes are convertible only upon the occurrence of one or more contingencies, for example a contingency based on the market price of the issuer’s common stock. This fact would neither cause the notes to be contingent payment debt instruments subject to § 1.1275-4, nor generally affect the conclusion of the memorandum.

³ We understand that in many of the more recent transactions, X may not elect physical settlement of the notes or the hedges. This fact would not affect the conclusion of the memorandum.

notes settle. X has no right to purchase stock under the hedges except in connection with conversions of the notes. The hedges expire on the maturity date of the notes. The hedges do not require Bank to pay X the additional stock or cash that X might be required to pay to converting note holders under the make-whole provision. X pays Bank a premium for the hedges that is based on the fair market value of the hedges.

X sells warrants to Bank on the issue date of the notes, one warrant for each \$1,000 note. Each warrant entitles Bank to purchase a number of shares of X's common stock equal to the number of conversion shares at a strike price that is significantly greater than the strike price for the hedges. The warrants do not refer to the notes or the hedges. The warrants may not be settled physically. They must be settled on a net share or net cash basis. The warrants are European style (they may be exercised only on their expiration date). The warrants expire several months after the maturity date of the notes. Bank pays X a premium for the warrants that is based on the fair market value of the warrants.

The hedges and the warrants have a number of features that are intended to support X's position that they should be treated as separate instruments for federal income tax purposes, including the following features. The hedges may be exercised only through automatic exercise upon conversion of the corresponding notes, whereas the warrants are European style and do not refer to the notes or the hedges. The warrants expire several months later than the hedges. The hedges may be settled physically or on a net share or net cash basis, depending on how the corresponding notes settle, whereas the warrants may be settled only on a net share or net cash basis. The hedges and the warrants are separately documented. X may sell the hedges and retain its position in the warrants, and X is under no economic compulsion to retain the hedges together with its position in the warrants. Similarly, Bank may sell the warrants and retain its position in the hedges, and Bank is under no economic compulsion to retain the warrants together with its position in the hedges. X and Bank have no rights of offset with respect to the other party's obligations in any bankruptcy or liquidation proceeding. The hedges and the warrants use different formulas for determining the value of X's stock for net settlement purposes. The premiums for the hedges and the warrants are separately determined, based on fair market value.

The result of the transaction is the raising of capital by X for general corporate purposes. X engages in this transaction instead of issuing similar convertible notes with a higher conversion price because X believes that there is a deeper market for convertible notes with the actual conversion price, but X desires to avoid the potential dilution from the conversion of its notes (for example, the reduction in earnings per share of X's common stock) at prices lower than that higher conversion price. X also believes that the accounting treatment of this transaction is superior to the accounting treatment that would apply if X issued nonconvertible, discount notes instead of the actual notes and the hedges.

X integrates the notes with the hedges, but not with the warrants, under § 1.1275-6, which produces a synthetic debt instrument. X reduces the initial issue price of the synthetic debt instrument by the aggregate premium for the hedges, which produces deductible OID in the amount of that reduction.

For purposes of this memorandum, we assume that the transaction satisfies the requirements of § 1.1275-6(c)(1) with respect to the notes and the hedges. According to X, it is significantly more likely than not that (1) there will be no fundamental change and (2) the holders of the notes will not convert them before the maturity date.

LAW AND ANALYSIS

A. Integration under § 1.1275-6

The threshold issue is whether § 1.1275-6 permits X to integrate the notes with the hedges. We conclude that it does permit the integration.⁴

In general, § 1.1275-6 provides for the integration of a “qualifying debt instrument” with a “§ 1.1275-6 hedge” or combination of “§ 1.1275-6 hedges” if the combined cash flows of the components are substantially equivalent to the cash flows on a noncontingent debt instrument that pays interest at a fixed rate or qualified floating rate.

The result of integration is a hypothetical “synthetic debt instrument” with the same cash flows as the combined cash flows of the qualifying debt instrument and the § 1.1275-6 hedge. Section 1.1275-6(b)(4). In general, while a qualifying debt instrument and a § 1.1275-6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the § 1.1275-6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the § 1.1275-6 hedge, including § 1092 or § 1.446-4. Section 1.1275-6(f)(1).

Issuers as well as holders may integrate a qualifying debt instrument with a § 1.1275-6 hedge. The rules of § 1.1275-6, however, affect only the party that integrates the qualifying debt instrument with the § 1.1275-6 hedge. Section 1.1275-6(a).

Section 1.1275-6(b)(1) provides that a qualifying debt instrument is any debt instrument other than three kinds. The notes do not belong to any of those three kinds. We conclude that the notes are qualifying debt instruments.

⁴ Without integration, X would not be able to deduct the hedge premium. Rev. Rul. 78-182, 1978-1 C.B. 265; § 162(k). Also without integration, X would not recognize a loss for the hedge premium if the hedges were to expire unexercised. Section 1032(a). The warrants, which X does not integrate with the notes and the hedges, are subject to nonrecognition treatment under § 1032(a).

Section 1.1275-6(b)(2)(i) provides in part:

A § 1.1275-6 hedge is any financial instrument . . . if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under § 1.1275-5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a § 1.1275-6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument.

For purposes of § 1.1275-6, a “financial instrument” is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments, but stock is not a financial instrument. Section 1.1275-6(b)(3).

The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument, reduced or increased as appropriate by any substantially contemporaneous payments or receipts with respect to the § 1.1275-6 hedge. Section 1.1275-6(f)(4).

Section 1.1275-6(c)(1) provides other requirements for integration by a taxpayer (as opposed to the Commissioner). For example, under § 1.1275-6(c)(1)(i), the taxpayer must satisfy the identification requirements in § 1.1275-6(e) on or before the date the taxpayer enters into the § 1.1275-6 hedge. If one of the requirements in § 1.1275-6(c)(1) is not satisfied, the taxpayer (as opposed to the Commissioner) may not integrate the qualifying debt instrument and the § 1.1275-6 hedge.

Under § 1.1275-6(c)(2), the Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a § 1.1275-6 hedge. The Commissioner, however, may not integrate the transaction unless the qualifying debt instrument either is subject to § 1.1275-4 or is subject to § 1.1275-5 and pays interest at an objective rate. The Commissioner may not integrate under § 1.1275-6(c)(2) in this case because the qualifying debt instrument (convertible note) is neither subject to § 1.1275-4 nor § 1.1275-5.

Section 1.1272-1(c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). Section 1.1272-1(c), however, applies only if the timing and amounts of the payments that comprise

each payment schedule are known as of the issue date of the debt instrument and the debt instrument is subject to paragraph (c)(2), (c)(3), or (c)(5) of § 1.1272-1. Section 1.1272-1(c)(2) provides that if, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

Section 1.1272-1(c)(5) applies to debt instruments that provide the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules. Under § 1.1272-1(c)(5), the yield and maturity of such a debt instrument are computed based on the payment schedule that is determined under the rules that (1) the issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, (2) a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument, and (3) if both the issuer and the holder have options, the rules are applied to the options in the order that they may be exercised.

Section 1.1272-1(e) provides that, for purposes of section 1272, an option is ignored if it is an option to convert a debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of § 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

Section 1.1275-2(h) provides rules for remote or incidental contingencies. For example, § 1.1275-2(h)(2) provides that a contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

The hedges are § 1.1275-6 hedges if a yield to maturity for the combined cash flows on the notes and the hedges can be calculated under the principles of § 1272. The hedges are automatically exercised when the corresponding notes are converted, and they can be exercised only when the corresponding notes are converted. If a note is converted and the make-whole provision does not apply to augment the conversion shares with additional shares, X's net payment with respect to the note and the hedge is the stated principal amount of the note. If a note is converted and the make-whole provision does apply to augment the conversion shares with additional shares, X's net payment is treated as the result of a holder exercising a conversion option and is ignored under § 1.1272-1(e). Thus, after the application of § 1.1272-1(e), the schedules of net payments ("net payment schedules") with respect to the combined cash flows on the notes and the hedges consist of net payments of the stated principal amount on the various possible conversion dates (early conversions or conversions on the maturity

date), payments of the stated principal amount on the various possible payment dates for puts made in connection with fundamental changes,⁵ and payments of the stated principal amount on the maturity date (retirements on the maturity date). The net payment schedules corresponding to conversions on the maturity date are the same as the net payment schedules corresponding to retirements on the maturity date. Relying on X's representation that it is significantly more likely than not that there will be no fundamental change and the holders of the notes will not convert them before the maturity date, under § 1.1272-1(c)(2), the yield (and maturity) of the notes are computed based on the net payment schedule in which the stated principal amount is paid at maturity. Thus, a yield to maturity can be calculated under the principles of § 1272. We conclude that the hedges are § 1.1275-6 hedges.

We have concluded that the notes are qualifying debt instruments and that the hedges are § 1.1275-6 hedges. We have assumed in the facts that the transaction satisfies all of the requirements of § 1.1275-6(c)(1). Therefore, we conclude that X may integrate the notes with the hedges.

B. Hedges and warrants--one instrument or two?

It could be argued that the hedges and the warrants should be treated as a single instrument for federal income tax purposes. In that case, X could only integrate the notes with both the hedges and the warrants or with neither of them. We conclude that the hedges and the warrants should be treated as separate instruments for federal income tax purposes.

Rev. Rul. 88-31, 1988-1 C.B. 302, holds that a share of common stock and a contingent payment right issued together as an investment unit are separate items of property for federal income tax purposes because they are separately tradable on a national securities exchange shortly after issuance, the holder may receive a payment on the right without giving up the share of stock, and the value of the right varies inversely with the value of the stock. Rev. Rul. 2003-97, 2003-2 C.B. 380, implies that the nominal components of a unit listed on a national securities exchange are separate instruments for federal income tax purposes. The holding is based in part on the holder's ability to separate the components and sell one while retaining the other one (the holder being under no economic compulsion not to separate the components), the period of time one component will remain outstanding after the other component is terminated, and the expected treatment of the unit in the event of the issuer's bankruptcy.

We conclude that the hedges and the warrants should be treated as separate instruments for federal income tax purposes based on these authorities and the facts of

⁵ For some transactions, a fundamental change or similar event that triggers a put right might qualify as a remote contingency that is assumed not to occur under § 1.1275-2(h)(2).

this case, including the following facts: X may sell the hedges and retain its position in the warrants and Bank may sell the warrants and retain its position in the hedges; the warrants expire several months later than the hedges; the hedges may be exercised only through automatic exercise upon conversion of the corresponding notes but the warrants are European style and do not refer to the notes or the hedges; and X and Bank have no rights of offset with respect to the other party's obligations in any bankruptcy or liquidation proceeding.

It has been suggested that the hedges and the warrants should be treated as a single instrument for federal income tax purposes because X bought or sold them as part of the same transaction. However, the fact that X bought or sold the hedges and the warrants as part of the same transaction does not alone justify treating them as a single instrument. See, for example, Rev. Rul. 88-31 and Rev. Rul. 2003-97.

C. OID anti-abuse rule

If the OID anti-abuse rule in § 1.1275-2(g) applied to the transaction, the Commissioner could either disallow the integration of the notes with the hedges or require the integration of the notes with the warrants as well as with the hedges. Section 1.1275-2(g)(1) provides in part:

If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result.

Section 1.1275-2(g)(2) provides in part:

Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability.

Example 3 of § 1.1275-2(g)(3) provides:

D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See § 1.1273-2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner

generally will not use the authority under this paragraph (g) to depart from the application of § 1.1273-2(j) in this case.

The transaction discussed in this memorandum allows a corporation to convert its actual position as the issuer of convertible notes, purchaser of hedges, and writer of warrants into a synthetic position as the issuer of investment units consisting of nonconvertible, discount notes and warrants. Based on the particular facts of this case, we conclude that the OID anti-abuse rule does not apply to the transaction.

D. Fair market value pricing and other considerations

The conclusion in this memorandum is limited to cases in which the hedges and the warrants are priced at fair market value. If X and Bank agreed to raise the premiums for the hedges and the warrants by the same amount over their fair market values, X would pay and Bank would receive the same net premiums, but X would achieve greater, improper OID deductions, with no apparent downside to X or Bank. Such mispricing should be challenged, for example, by applying the OID anti-abuse rule to prohibit integration of the notes with the hedges. Agents who suspect mispricing should work closely with local counsel. Local counsel should contact us or Issue Management Team counsel Steven Tillem.

Our conclusion is also limited to cases in which the premium paid by X for the hedges is meaningfully greater than the premium received by X for the warrants. In the absence of such a difference, X might be vulnerable to an argument that the hedges and the warrants served no purposes other than tax avoidance. See, for example, Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210 (D.C. Cir. 2001) (“Under the step transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes”); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966) (disregarding a step that “served no legitimate nontax-avoidance business purpose”).

By purchasing notes, writing options similar to the hedges, and not integrating the notes with the options, some taxpayers might be able to create a position equivalent to a discount bond for which the inclusion of OID accruals into income can be deferred until maturity. Agents who observe taxpayers taking such positions or underwriters promoting such positions should contact us or Issue Management Team counsel Steven Tillem.

Please call me at (202) 622-3900 if you have any further questions about this matter.

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