Part I

Section 1275.--Other definitions and special rules

26 CFR 1.1275-4: Contingent payment debt instruments.
(Also §§ 163, 249; 1.249-1.)

Rev. Rul. 2002-31

ISSUES

Does the noncontingent bond method described in § 1.1275-4(b) of the Income Tax Regulations apply to a debt instrument that is convertible into stock of the issuer and that also provides for one or more contingent cash payments? If so, how is the comparable yield determined, and does either § 163(*l*) or § 249 of the Internal Revenue Code affect the issuer's ability to deduct the interest that accrues on the instrument under the noncontingent bond method?

FACTS

On January 1, 2002, Corporation X issues for $625x a 20-year debt instrument with a stated principal amount of $1,000x. Except for the contingent interest payments described below, the debt instrument does not provide for any stated interest. The

debt instrument is convertible at any time into a number of shares of Corporation X common stock having a value, on the date of issue of the debt instrument, that is significantly less than $625x. The debt instrument is part of an issue that is not marketed or sold in substantial part to persons for whom the inclusion of interest from the instruments in the issue is not expected to have a substantial effect on their U.S. tax liability.

The debt instrument provides that, beginning after January 1, 2005, interest ("contingent interest") is payable for any six-month period ending on June 30 or December 31 if the average market price of the instrument for a measurement period before the applicable six-month period is greater than 120 percent of the instrument's accreted value. Under the terms of the debt instrument, accreted value is defined as the issue price of the instrument plus the economic accrual to any date of determination of a portion of the difference between the issue price and the stated principal amount at maturity. The amount of contingent interest that is payable is equal to the greater of (1) the regular cash dividend per share of Corporation X common stock for the six-month period multiplied by the number of shares into which the debt instrument may be converted, or (2) y percent of the average market price of the debt instrument for the measurement period. The contingent interest is neither a remote

nor an incidental contingency within the meaning of § 1.1275-2(h).

On or after January 1, 2005, Corporation X has the option to redeem the debt instrument for cash in an amount equal to the instrument's accreted value as of the date the instrument is redeemed. In addition, the holder of the debt instrument has the option to put the debt instrument to Corporation X on January 1, 2005, or January 1, 2012, for an amount equal to the instrument's accreted value as of each such date. If the holder exercises this option, Corporation X can satisfy its obligation with cash, shares of Corporation X common stock, or a combination of cash and shares of Corporation X common stock, in each case having a total value equal to the instrument's accreted value. Taking into account both the likelihood of conversion of the debt instrument and the likelihood that the instrument will be put by the holder, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of the issuer.

Corporation X takes the position that the noncontingent bond method applies to the debt instrument and that the comparable yield for the instrument is 7 percent, compounded semiannually. (To determine the comparable yield under § 1.1275-4(b), Corporation X used the yield at which it would issue a comparable

fixed-rate, nonconvertible debt instrument.) In preparing the projected payment schedule required by the noncontingent bond method, Corporation X projects payments of contingent interest and a payment at maturity (based on a projected exercise of the conversion privilege) in an amount sufficient to cause the yield on the debt instrument to equal 7 percent, compounded semiannually. When the debt instrument was issued, the long-term applicable Federal rate (AFR) was 5.39 percent, compounded semiannually.

LAW AND ANALYSIS

Section 1.1275-4 provides rules for the treatment of contingent payment debt instruments. In general, if a contingent payment debt instrument is issued for cash or publicly traded property, the noncontingent bond method applies to the instrument. See § 1.1275-4(b). Under the noncontingent bond method, interest accrues on the debt instrument as if it were a fixed-payment debt instrument. This fixed-payment debt instrument is constructed by using the instrument's comparable yield and a projected payment schedule.

In general, under § 1.1275-4(b)(4)(i), the comparable yield for a contingent payment debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. Relevant terms and conditions include the level of

subordination, term, timing of payments, and general market conditions. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the AFR. In certain situations, the comparable yield is presumed to be the AFR. See § 1.1275-4(b)(4)(i)(B).

The projected payment schedule for a debt instrument includes each noncontingent payment and a projected amount for each contingent payment. See § 1.1275-4(b)(4)(ii). In general, if a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment as of the issue date. If the projected payment schedule and the instrument's issue price do not produce the comparable yield, then the schedule must be adjusted to produce the comparable yield. In most cases, the issuer's determination of the projected payment schedule will be respected unless it was set with a principal purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. See § 1.1275-4(b)(4)(v).

If the actual amount of a contingent payment is different from the projected payment, then the difference is taken into

account as either a positive or negative adjustment. A positive adjustment results when the actual amount is greater than the projected amount. In general, a net positive adjustment is treated as interest and is includible in income by the holder and deductible by the issuer in the taxable year in which the adjustment occurs. A negative adjustment results when the actual amount is less than the projected amount. In general, a net negative adjustment (1) reduces interest accruals on the debt instrument for the taxable year, (2) to the extent of any excess, is treated as an ordinary loss by a holder and ordinary income by the issuer, but only to the extent of prior accruals on the debt instrument by the holder or issuer, and (3) to the extent of any further excess, is a carryforward to the next taxable year. See § 1.1275-4(b)(6) for the specific rules that apply to negative and positive adjustments.

Except as provided in § 1.1275-4(a)(2), § 1.1275-4 applies to any debt instrument that provides for one or more contingent payments. A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See § 1.1275-2(h) for rules relating to remote and incidental contingencies.

In addition, 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. Section 1.1275-4(a)(4). However, this exception does not apply when the debt instrument provides for contingent payments other than the conversion feature and those contingent payments are neither remote nor incidental.

Although the debt instrument issued by Corporation X provides for an option described in § 1.1275-4(a)(4), the debt instrument also provides for one or more contingent payments (the contingent interest) that are neither remote nor incidental. As a result, the debt instrument is a contingent payment debt instrument subject to the noncontingent bond method described in § 1.1275-4(b). Although a conversion feature alone does not cause a convertible debt instrument to be subject to the noncontingent bond method, the possibility of a conversion is nevertheless a contingency. Therefore, the comparable yield for a convertible debt instrument subject to the noncontingent bond method is determined under § 1.1275-4(b) by reference to comparable fixed-rate nonconvertible debt instruments. Moreover, the projected payment schedule is determined by treating the stock received upon a conversion of the debt instrument as a contingent payment.

Under § 1.163-7, the amount of interest that is deductible each year on a contingent payment debt instrument is determined

under § 1.1275-4. Therefore, for purposes of § 163(a), Corporation X computes its interest deductions for each year the debt instrument is outstanding based on the comparable yield of 7 percent, compounded semiannually. Based on the facts set forth above, the original issue discount anti-abuse rule in § 1.1275-2(g) does not apply because the result reached is not unreasonable in light of the purposes of § 163(e), §§ 1271 through 1275, or any related section of the Code. The anti-abuse rule, therefore, does not affect Corporation X's ability to compute its interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Certain provisions of the Internal Revenue Code, such as § 163(*l*) and § 249, may affect an issuer's ability to deduct the interest computed under the noncontingent bond method.

Section 163(*l*), which was added to the Internal Revenue Code by the Taxpayer Relief Act of 1997, § 1005, 1997-4 (Vol. 1) C.B. 125, provides that no deduction is allowed for any interest paid or accrued on a disqualified debt instrument, which is any indebtedness of a corporation that is payable in equity of the issuer or a related party. Under § 163(*l*), indebtedness is payable in equity only if (A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or a related party is payable in, or convertible into, such equity, (B) a substantial amount of the

principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity, or (C) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in either (A) or (B) above. Principal or interest is required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

The conference report on the 1997 legislation indicates that an instrument is treated as payable in stock if it is part of an arrangement designed to result in payment with or by reference to such stock, including certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. The conference report further states that it is not expected that § 163(*l*) will affect debt with a conversion feature if the conversion price is significantly higher than the market price of the stock on the issue date of the debt. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523-24 (1997), 1997-4 (Vol. 2) C.B. 1993-94.

Under the terms of the debt instrument issued by Corporation X, none of the instrument's principal or interest is required to be determined by reference to the value of Corporation X's stock. Although the value of Corporation X's stock is used in constructing the debt instrument's projected payment schedule, this projected payment is not determinative in applying § 163(*l*) to the instrument. Under the noncontingent bond method, the projected payment schedule is a mechanism for comparing actual payments to projected payments and then applying the rules for negative and positive adjustments.

The debt instrument will be paid in stock on conversion and may be paid in stock, at the option of Corporation X, if the holder exercises its put option. Nevertheless, it is not substantially certain that a substantial amount of the principal or interest on the debt instrument will be required to be paid in stock or will be payable in stock at the option of Corporation X. Therefore, the debt instrument is not a disqualified debt instrument under § 163(*l*), and § 163(*l*) does not bar Corporation X's accrual of interest deductions based on the comparable yield of 7 percent, compounded semiannually.

Section 249 provides that no deduction is allowed to the issuing corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note or certificate or other evidence of indebtedness that is convertible into the stock of

the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness that are not convertible. However, § 249 does not apply to the extent the corporation can demonstrate to the satisfaction of the Secretary that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature. See § 1.249-1. For purposes of § 249, a conversion is a repurchase. See Clark Equipment Company v. United States, 912 F.2d 113 (6th Cir. 1990). See also §§ 1.61-12(c)(2) and 1.163-7(c).

Section 249 was added to the Internal Revenue Code in 1969 because, in the case of a premium paid upon a corporation's repurchase of its convertible indebtedness, Congress believed that the amount of the premium in excess of the cost of borrowing is not analogous to an interest expense or deductible business expense. Instead, the amount is paid in a capital transaction analogous to a corporation's repurchase of its common stock and, therefore, is not deductible. H.R. Rep. No. 413 (Part 1), 91st Cong., 1st Sess. 1, 110 (1969), 1969-3 C.B. 200, 269; S. Rep. No. 552, 91st Cong., 1st Sess. 1, 149 (1969), 1969-3 C.B. 423, 518.

Section 249 applies only to a premium paid to repurchase a convertible debt instrument. Therefore, § 249 does not affect

Corporation X's ability to deduct accruals of interest based on the comparable yield. However, § 249 applies to a conversion of the debt instrument into stock having a value in excess of the debt instrument's adjusted issue price. See Clark Equipment; National Can Corp. v. United States, 687 F.2d 1107 (7th Cir. 1982); and § 1.249-1. Therefore, this excess is not deductible by Corporation X, except to the extent the excess does not exceed a normal call premium under § 1.249-1(d) or Corporation X can demonstrate that the excess is attributable to the cost of borrowing and not to the conversion feature.

HOLDINGS

The noncontingent bond method described in § 1.1275-4(b) applies to the convertible debt instrument issued by Corporation X. The yield at which Corporation X would issue a comparable fixed rate nonconvertible debt instrument is used to determine the instrument's comparable yield and, therefore, the accruals of interest on the instrument. In addition, the debt instrument is not a disqualified debt instrument under § 163(*l*). Moreover, § 249 does not affect Corporation X's ability to deduct periodic interest accruals on the debt instrument. However, if the debt instrument is converted into Corporation X stock having a value in excess of the debt instrument's adjusted issue price, Corporation X may not be able to deduct this excess under § 249.

DRAFTING INFORMATION

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