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# Tax Treatment of Contingent Convertible Bonds

## 1. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) authorizes the Federal Reserve to require bank and non-financial holding companies "to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress".[1] The Basel Committee and the related Financial Stability Board[2] also have reviewed additional measures that might include capital surcharges, contingent capital and "bail-in" debt.[3] On 13 January 2011, the Basel Committee issued a notice setting out requirements in this area for banking institutions to follow.[4] In the notice, it directed that "all non-common Tier 1 and Tier 2 instruments" issued by any "internationally active bank" must provide that, at the option of the local banking authority, the instrument will be written off or converted into common equity in the event the local banking authority determines the bank would otherwise become "non-viable".

While there is no direct precedent for this form of instrument, the closest instruments that have been issued to date that would satisfy this provision are contingent convertible bonds (CoCos). CoCos convert automatically to common equity when certain capital adequacy metrics are met, or trigger other equity-type features in such an event. Several financial institutions have issued their own versions of CoCos, as described below.

The Lloyds Banking Group, in November 2009, issued subordinated securities with fixed maturities ranging from 10 to 15 years, which automatically convert into equity whenever Lloyd's core Tier 1 ratio decreases to less than 5% (at issuance, its core Tier 1 ratio was approximately 8.6%). The conversion price was set at approximately 65% of the current market trading price of Lloyd's common shares at the notes' date of issuance.

In May of 2010, Rabobank issued instruments that constituted senior debt, but will be redeemed for cash at 25% of their principal amount in the event Rabobank's consolidated equity capital ratio decreases to less than 7% (at issuance, this ratio was 12.5%). The instruments have a term of 10 years. At the time of the issuance of these notes, Rabobank had one of the highest credit ratings in the world, making the redemption unlikely.

In February 2011, Credit Suisse also issued CoCos in the form of subordinated notes with a term of 30 years. The Credit Suisse CoCos were designed specifically to meet the Basel Committee standards. In the event the common equity Tier 1 ratio of the Credit Suisse group falls below 7% (at issuance, it was approximately 10%) or Credit Suisse essentially becomes "non-viable" (within the meaning of the Basel notice on contingent capital), the notes automatically convert into the common equity of the parent Swiss company. The conversion price is the higher of USD 20 or the then-current market price of the shares. Based on the conversion ratio, if the market price at conversion is USD 20 or higher, the holders will receive shares equal to the full principal amount of their investment, but if it is below USD 20, they will suffer a loss equal to the difference between USD 20 and the lower market value.

In all of the examples above, if the issuer becomes financially distressed and the conversion or redemption is triggered, the issuer automatically recapitalizes. Thus, it has been argued that CoCos may help avoid government bailouts in the event of another financial crisis.[5]

## 2. The Issuer

### 2.1. Debt-equity classification

#### *2.1.1. Generally*

The US Internal Revenue Service (the IRS) has issued a public ruling[6] that describes certain conditions under which a contingent convertible debt instrument may be treated as debt for US federal income tax purposes, although such instruments are factually different from the CoCos considered in this survey.

In Rev. Rul. 2002-31, the instrument was a 20-year debt instrument with a stated principal amount of USD 1,000x. Except for certain contingent interest, the instrument did not provide for any stated interest. The instrument was convertible at any time into a number of shares of the issuer's stock having a value, on the date of the issuance of the instrument, that was significantly less than USD

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1. Sec. 165(c) Act, Pub. L. 111-203, H.R. 4173.
2. The Financial Stability Board is an international body that was established in 2009 to coordinate the work of different country financial regulators, and to develop and promote the implementation of effective regulatory policies. Its members are the G-20 countries, certain other significant countries and a number international financial organizations and standard-setting bodies.
3. See Basel Committee consultative document issued in December 2009, "Strengthening the resilience of the bank sector" at 5, 22.
4. Basel Committee "Minimum requirements to ensure loss absorbency at the point of non-viability", issued with a press release on 13 January 2011.
5. For more information on CoCos, see Albul, Boris, et. al., "Contingent Convertible Bonds and Capital Structure Decisions", Federal Reserve Bank of Atlanta 2010 Financial Markets Conference (25 April 2010), available at www.frbatlanta.org/documents/news/conferences/10fmc_tchistyi.pdf.
6. Rev. Rul. 2002-31, 2001-1 C.B. 1023.

635x. The debt instrument was part of an issue that was 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 US tax liability.

The debt instrument in Rev. Rul. 2002-31 provided that, beginning after five years following issuance, interest ("contingent interest") was payable for any six-month period ending on 30 June or 31 December if the average market price of the instrument for a measurement period before the applicable six-month period was greater than 120% of the instrument's accreted value. Under the terms of the debt instrument, accreted value was 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 was payable was equal to the greater of (1) the regular cash dividend per share of the issuer's common stock for the six-month period multiplied by the number of shares into which the debt instrument may be converted or (2) y% of the average market price of the debt instrument for the measurement period. The contingent interest was neither a remote nor an incidental contingency within the meaning of Treas. Reg. Sec. 1.1275-2(h).

On or after five years following issuance, in Rev. Rul. 2002-31 the issuer had 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 was redeemed. In addition, the holder of the debt instrument had the option to put the debt instrument to the issuer five years after issuance, or 10 years after issuance, for an amount equal to the instrument's accreted value as of each such date. If the holder exercised this option, the issuer could satisfy its obligation with cash, shares of its own common stock, or a combination of cash and shares of its own 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, the ruling provides that it was not substantially certain that a substantial amount of the principal or interest on the debt instrument would be required to be paid in stock or will be payable in stock at the option of the issuer.

Rev. Rul. 2002-31 concludes that the non-contingent bond method of Treas. Reg. Sec. 1.1275-4(b) applied to the instrument in consideration, which necessarily means that the instrument was treated as debt.

Although raising similar issues, the CoCo is not sufficient similar to the instrument considered in Rev. Rul. 2002-31 to be able to conclusively rely upon the ruling for a characterization as debt. Thus, the CoCo must be tested under the general rules for distinguishing debt and equity under US tax laws.

Under Sec. 385(a),[7] the Treasury is authorized to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or debt (or as in part stock and in part debt). Sec. 385(b) sets forth some of the factors that the regulations should take into account to determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. These factors include the following: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest, (2) whether there is subordination to or preference over any indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether there is convertibility into the stock of the corporation and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Proposed regulations under Sec. 385(a) were issued on 24 March 1980, which set forth the factors to be considered in determining whether an instrument was stock or debt. Final regulations under Sec. 385(a) were then issued in December 1980 (with a delayed effective date that was extended several times). The final regulations, however, were withdrawn in 1983.[8] There currently are no regulations under Sec. 385.

The IRS has set forth its views on determining whether an instrument is debt or equity in several rulings and other guidance, including Rev. Rul. 85-119[9] and Notice 94-47.[10]

In Rev. Rul. 85-119, the IRS ruled that certain instruments issued by a bank holding company are debt for US federal income tax purposes. The IRS found that the issuer and holder of the instruments intended to create a debtor-creditor relationship. The instruments were publicly issued, widely held and not held proportionately to the bank holding company's stock. They were designated by the parties as debt, and amounts designated as interest were payable quarterly, irrespective of earnings, at a floating rate comparable to the market rate for similar instruments. Any default on the payment of such amounts resulted in a legally enforceable right to the holders against the issuer for payment of the amount in default. The instruments had a 12-year term. The issuer was not thinly capitalized and its debt-to-equity ratio was within the industry norm. The holders were not entitled to vote or participate in management of the issuer.

The IRS found that all of these factors supported debt classification, but also found that other factors supported equity classification. These include the subordination of the rights of the holders to the rights of general creditors, and a convertibility feature at maturity.

The IRS noted, however, that upon insolvency or bankruptcy, the holders had the status of creditors, and despite having their claims be subordinated to other general creditors, were still entitled to priority over the claims of the shareholders of the issuer. In addition, although the

7. Unless otherwise indicated, references to sections are references to sections of the Internal Revenue Code of 1986, as amended.
8. T.D. 7920, 1983-2 C.B. 69.
9. 1985-2 C.B. 60.
10. 1994-1 C.B. 357.


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instruments were convertible into the stock of the issuer at maturity, the fair market value of the stock issued to the holders upon such conversion had to be equal to the principal amount of the instruments. This conversion was to be at the election of the holders, and if a holder were not to elect to receive stock, the issuer would have to sell such amount of stock on behalf of the non-electing holder in a secondary offering with the net cash proceeds to be delivered to the holder. Such net cash proceeds had to equal the principal amount of the instrument. Failure of the issuer to perform its obligation with respect to delivering such cash proceeds would constitute a cause of action for money damages under state law.

All in all, the IRS found that the instruments at issue in Rev. Rul. 85-119 are debt for US federal income tax purposes. However, in Notice 94-47, the IRS emphasized that Rev. Rul. 85-119 is limited to its own facts, and that instruments that are similar to the notes at issue in the ruling but that, on balance, are more equity-like are unlikely to qualify as debt for US federal income tax purposes. In particular, the IRS stated that an instrument would not qualify as debt if it has terms substantially identical to the notes in Rev. Rul. 85-119, except for a provision that (1) requires the holder to accept payment of principal solely in stock of the issuer, (2) structures the right to elect cash in such a way as to ensure the holder would choose stock or (3) is nominally payable in cash but does not in substance give the holder the right to receive cash because, for example the instrument is secured by the stock and is non-recourse to the issuer.

Notice 94-47 provides that the characterization of an instrument for US federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances. Among the factors that may be considered in making such a determination are: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future, (2) whether holders possess the right to enforce the payment of principal and interest, (3) whether the rights of the holders of the instrument are subordinate to rights of general creditors, (4) whether the instruments give the holders the right to participate in the management of the issuer, (5) whether the issuer is thinly capitalized, (6) whether there is identity between holders of the instruments and stockholders of the issuer, (7) the label placed upon the instrument by the parties, (8) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency or financial accounting purposes and (9) the realistic expectation of repayment.[11] The weight given to any factor depends upon all the facts and circumstances. No particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity.[12]

The various factors listed in Notice 94-47 are "... aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship".[13] The important issue is whether there was "... a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?"[14]

Notice 94-47 was issued in response to a number of transactions in which instruments were issued that were designed to be treated as debt for US federal income tax purposes but as equity for regulatory, rating agency or financial accounting purposes. The instruments typically contained a combination of debt and equity characteristics. The Notice states that, upon examination, the IRS will scrutinize instruments of this type to determine if their purported status as debt for US federal income tax purposes is appropriate.

The courts have also applied various factors in determining the classification of an instrument as debt or equity. No one factor controls, and all relevant factors must be considered.[15]

The factors applied by the courts and the IRS may differ slightly from case to case, but those most commonly considered are the following:

(1) the label or name given to the instrument;
(2) the presence or absence of a fixed maturity date;
(3) whether there is a written, unconditional promise to pay on demand, or on a specific date, a sum certain in money in return for an adequate consideration in money or money's worth;
(4) the source of payments on the instrument;
(5) the right to enforce payment of principal and interest;
(6) the extent to which the rights of the holder are subordinated to the general creditors of the issuer;
(7) whether there is identity of interest between holders of the instrument and stockholders of the issuer;
(8) the extent to which the holder has the right to participate in the management of the issuer;
(9) the intent of the parties;
(10) whether the issuer is thinly or adequately capitalized;
(11) the ability of the corporation to obtain loans from outside lending institutions; and

11. Other factors
Other factors that may be relevant in classifying an instrument as either debt or equity for US Federal income tax purposes include the following:
(1) Convertibility of the instrument into stock of the issuer (an equity characteristic). In this case, the transaction documents do not have a conversion feature.
(2) A sinking fund (a debt characteristic). In this case, there is no sinking fund provision.
(3) Contingent payments (an equity characteristic). In this case, there are no contingent payments.
(4) Ability of the issuer to obtain loans from outside lending institutions (a debt characteristic).
(5) Failure of the debtor to repay on the due date or to seek a postponement (an equity characteristic).
See, e.g. *Stinnet's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984).
12. *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).
13. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968).
14. *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).
15. *John Kelley Co.*, 326 US at 530; *Hardman v. United States*, 827 F.2d 1409, 1411-12 (9th Cir. 1987).

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(12) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency or financial accounting purposes.[16]

### *2.1.2. Relevant classification factors*

The following discussion applies the factors listed in Notice 94-47 and other debt/equity factors to CoCos. Below, each of these factors is applied to the characteristics of the CoCos considered in this comparative survey, to determine whether such CoCos should be classified as debt or equity. This determination is also central to whether interest deductions may be taken by the issuer and how the payments under the instrument must be treated by the holder.

#### *2.1.2.1. Label*

The label the parties attach to an instrument may be a relevant factor in determining the classification of that instrument as debt or equity. As the CoCos are referenced as debt instruments in the offering documents, that is one factor that supports debt classification.

#### *2.1.2.2. Unconditional promise to pay a sum certain on demand or a fixed maturity date that is in the reasonably foreseeable future*

An important factor used in classifying an instrument as either debt or equity is whether the instrument has a definite maturity date on which the creditor is entitled to an unconditional repayment of principal. The presence of a fixed maturity date indicates a definite obligation to repay (a debt characteristic), and the absence of a fixed maturity date indicates that the repayment may depend on the fortunes of the issuer (an equity characteristic).[17]

In addition, although the presence of a fixed maturity date to repay the principal is one of the indicia of debt, the date on which payment is due must be a date that is in the reasonably foreseeable future.[18] In determining whether a maturity date for a particular instrument is a reasonable date, the courts have considered a number of factors, including the nature of the issuer's business, the financial condition of the issuer, the length of time the issuer has been in existence and how likely it is that the issuer will be in existence when the instrument matures.[19]

The IRS has stated that the "presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code".[20] In Rev. Rul. 83-98,[21] the IRS concluded that notes payable at maturity in a predetermined number of shares of stock must be treated as equity for tax purposes, but in contrast, in Rev. Rul. 85-119, the IRS found that debt that would be retired at maturity either with shares of stock then-equal in value to the principal amount of the debt or with the proceeds from the sale of stock yielding an amount sufficient to retire the full amount of the debt, constituted true debt for tax purposes. As discussed above, Notice 94-47 warned that certain instruments treated as debt in Rev. Rul. 85-119 would not be classified as debt if the holders of the instruments were required in all events to accept payment of principal solely in the stock of the issuer.

The principle underlying these rulings is that the holder of the debt instrument cannot be put at risk for the fortunes of the issuer with respect to the recovery of its investment. Put differently, there must be a sum certain to retire the debt investment in order for the instrument to be treated as debt for tax purposes. This sum certain cannot exist if it is pegged to a set amount of stock the future value of which cannot be determined at the issuance date.

Whether this factor supports the classification of the CoCos as equity depends on the likelihood the conversion will be triggered, which is based on the capital position of the issuer. The conversion will be triggered only if the issuer's capital ratio falls or threatens to fall below a certain level, and absent a significant deterioration in this capital ratio, the CoCos will be paid in full at maturity. If the possibility of conversion is remote, the conversion feature might be ignored. The authors assume that none of the issuing banks contemplate a forced conversion of the CoCos when they are issued. Nevertheless, at the time of issuance of the CoCos, it is difficult to ascertain the likelihood that the conversion will be triggered prior to maturity.

Conventional convertible debt that will be converted into equity once a trigger price significantly in excess of the price of the issuer's stock on the date of issuance of the debt is reached, is typically viewed as a debt instrument. In the case of the CoCos considered in this survey, the conversion feature is triggered by the worsening condition of the issuer, which is a cause for greater concern as that undermines the requirement for certainty of return on the debt.[22]

#### *2.1.2.3. Source of payments*

If the only expected source of payment is from the profits of the issuer, the instrument may be viewed as equity rather than debt. Thus, if there is not a legal obligation for payment of interest, such as where an instrument provides that interest payments are made at the option or discretion of the issuer, the instrument could be classified

16. See e.g. *Hardman*, 827 F.2d at 1411-12; *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Fin Hay Realty Co.*, 398 F.2d at 696.
17. *O.P.P. Holding v. Commissioner*, 76 F.2d 11 (2d Cir. 1935) (the fixed maturity date a significant factor); *Lee Telephone Co. v. Commissioner*, 260 F.2d 114 (4th Cir. 1958) (a precisely fixed maturity date is strongly indicative of a debtor-creditor relationship).
18. See *Jordan Co. v. Allen*, 85 F. Supp. 437 (M.D. Ga. 1949).
19. For example see *Monon Railroad v. Commissioner*, 55 T.C. 345 (1970), acq., 1973-2 C.B. 3, in which the court, for purposes of classifying instruments with a 50-year term as debt, took into consideration the substantial nature of the taxpayer's business, and the fact that the taxpayer had been in corporate existence for 61 years prior to the issuance of the instruments. Compare *Soby Corporation v. Commissioner*, 9 T.C. 887 (1947), in which a 99-year so-called obligation was classified as equity when it was issued by a corporation whose principal asset was a building which had an anticipated life of less than one third of the term of the instrument.
20. FSA 1999400007 (15 June 1999).
21. 1983-2 C.B. 40.
22. See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 4.03[2][g].

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as equity.[23] Similarly, if an instrument provides for a legal obligation of payment of interest, but there is not a realistic expectation of such payment (e.g. if the shareholders of the issuer are also the creditors), the instrument could be viewed as equity.

The CoCos considered here provide for payment of interest at a fixed rate or a floating rate plus a margin. With respect to the CoCos, one would expect the business operations of the financial institution issuers would be able to generate sufficient cash flow to support repayment on the instruments, at least at the time of issuance of the CoCos. However, a feature of the CoCos here is that payment of interest is at the full discretion of the issuer. Further, interest will not be paid and will be cancelled if on the interest payment date, the distributable reserves of the issuer are insufficient to make the interest payment. These facts may well support the classification of the instrument as equity, rather than debt.

*2.1.2.4. Creditor rights*

The fact that the holder of the instrument has the typical rights of a creditor in the event the issuer defaults on the instrument supports the classification of the instrument as debt.[24] Such rights include:

- the right of the holder to assume control of the issuer on a default;
- the right to sue to enforce payment of principal and accrued interest;[25]
- the right to file a claim as a creditor if the issuer goes into receivership;
- the right to institute bankruptcy proceedings;
- the right to share in the assets of the issuer prior to shareholders if the issuer liquidates or dissolves; and
- the right to recover interest and principal payments against a security interest.[26]

There is no indication that a holder of a CoCo does not have the typical rights of a creditor in the event of the issuer's default, so long as the CoCo has not been converted into equity of the issuer. However, if a CoCo is converted into equity, the holder of the CoCo no longer has typical rights of a creditor, so this factor likely turns on the probability of the conversion feature being triggered.

*2.1.2.5. Subordination*

A holder of a debt instrument generally has the right to share with the issuer's general creditors in the event of the issuer's liquidation or dissolution. Thus, the subordinated status of an instrument is a factor that supports treatment of the instrument as equity.[27] However, subordination to general creditors is not necessarily indicative of a stock interest. For example in Rev. Rul. 85-119, the instruments at issue were subordinated to the rights of all general creditors, but the IRS still found the instrument to be debt.

Courts have also accepted subordination. In *Green Bay Structural Steel, Inc. v. Commissioner*,[28] the notes issued to the holders were subordinate and junior in right of payment to all debt of the issuer, secured and unsecured, present and future. The Court said: "Subordination is not condemned but is an approved business practice … We can find nothing objectionable to subordination when it is dictated by the circumstances as here".[29]

Here, the CoCos are subordinated debt obligations of the issuer. It is unclear whether the CoCos are completely subordinated to all other debt of the issuer, but even if that were the case, courts and the IRS have found complete subordination does not necessarily cause an instrument to be equity. Thus, this factor is likely neutral as to the determination of whether the CoCo is debt or equity.

*2.1.2.6. Identity with shareholders of issuer*

The fact that an instrument's holders are also the shareholders of the issuer of the instrument, supports equity treatment for the instrument. This is because where there is an identity in the holders of the instrument and the shareholders of the issuer, all parties stand to gain or lose equally, depending upon the success of the issuer.

Identity between shareholders and lenders is not determinative of whether an instrument is equity rather than debt, however.[30] Debt has been respected among parent and wholly-owned corporations,[31] and has been respected when held by individual shareholders in proportion to their interests in the corporation.[32] Nevertheless, where there is an identity of interest among the holders of equity and debt, particularly where the equity and debt are held proportionately, courts are more likely to treat a purported debt instrument as an investment in equity.[33]

23. *Berkowitz*, 411 F.2d at 821.
24. *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 639 (11th Cir. 1984); *In re Lane*, 742 F.2d 1311, 1317 (11th Cir. 1984); Estate of Mixon, 464 F.2d at 405-06.
25. See *Gibson Products Co. v. Commissioner*, 637 F.2d 1041 (5th Cir. 1981); *Hambuechen v. Commissioner*, 43 T.C. 90 (1964); *Rouse v. Commissioner*, 23 TCM (CCH) 1823 (1964).
26. *Commissioner v. J.N. Bray Co.*, 126 F.2d 612, 613 (5th Cir. 1942) (holding an instrument to be debt where there was provision for suit to enforce payment of principal and accumulated interest in the event of a default); *Bolinger-Franklin Lumber Co. v. Commissioner*, 7 B.T.A. 402, 407-08 (1927), acq. 1928-1 C.B. 4 (concluding that an instrument permitting holders to assume control of the corporation upon default was properly classified as debt). Meanwhile, the absence of such rights generally indicates that an instrument constitutes equity rather than debt. *In re Lane*, 742 F.2d at 1317 (concluding that an instrument that did not provide for a sinking fund from which interest and principal payments could be made and did not provide for a security interest, was properly classified as equity); *Miele v. Commissioner*, 56 T.C. at 565 (1971), acq., 1972-2 C.B. 1, aff'd, 474 F.2d 1338 (3d Cir. 1973) (holding an instrument to be stock where holders could not file claims as creditors if the corporation went into receivership).
27. *Crawford Drug Stores, Inc. v. United States*, 220 F.2d 292, 296 (10th Cir. 1955); *John Wanamaker Phila. v. Commissioner*, 139 F.2d 644, 647 (3d Cir. 1943); *Miele*, 56 T.C. at 565.
28. 53 T.C. 451 (1969).
29. Id. at 457.
30. *Piedmont Corp. v. Commissioner*, 388 F.2d 886, 889 (4th Cir. 1968) ("While a proportionate relationship between stock and ownership may be 'consistent' with the conclusion that the notes represented an equity contribution, such a relationship, standing alone, does not constitute evidence of that conclusion. Indeed, it begs the question".).
31. See e.g. *Jack Daniel Distillery*, 180 Ct. Cl. 308, 325-33 (Ct. Cl. 1967); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956).
32. See e.g. *Piedmont Corp.*, 388 F.2d 886; *Tomlinson v. 1661 Corp.*, 377 F.2d 291; *Nye*, 50 T.C. 203 (1968).
33. See e.g. *Fin Hay Realty Co.*, 398 F.2d 694; *Miele*, 56 T.C. 556.

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In the case of the CoCos at issue in this survey, there is no indication that the holders of the instruments are also shareholders of the issuers of the CoCos. Thus, this factor does not weigh in favour of equity treatment for the CoCos.

*2.1.2.7. Voting and management rights*

A right to vote and participate in the management of the issuer supports equity treatment.[34] There is no indication that the holders of the CoCos here have voting or management rights, so long as the conversion feature is not triggered.

*2.1.2.8. Intent of the parties*

The intent of the holder and the issuer of an instrument, at the time the instrument was entered into, is also a factor in deciding whether the instrument constitutes debt or equity.[35]

Here, the CoCos are referenced as debt instruments. However, CoCos are issued in part to enable "a fresh injection of capital into a distressed bank",[36] so there is an intention that the CoCos could turn into equity.

*2.1.2.9. Thin capitalization of the issuer*

In general, if a corporation has a nominal stock capitalization coupled with excessive debt, this fact would tend to indicate that an instrument labelled debt might constitute equity.[37] As a result, the debt/equity ratio is another factor used to determine whether an instrument is debt or equity. The debt/equity ratio indicates to what extent a corporation may suffer losses without impairment of the interests of the corporation's creditors. A high ratio lowers the protection afforded to the creditors against sudden business slumps. As a result, a high ratio of debt to equity indicates that the issuance of the instrument is a contribution to capital rather than a bona fide loan.

However, courts have recognized purported debt as debt in cases where a corporation's debt/equity ratio was approximately 30:1,[38] 300:1,[39] 650:1,[40] and in certain circumstances, approximately 20,000:1.[41] Such courts appeared to have considered the debt/equity ratio in the context of determining the reasonableness of the debt holder's expectation of timely repayment, which, by itself, is a significant factor in the debt/equity analysis.[42] Thus, even a finding that an issuer is thinly capitalized may not adversely affect debt classification if cash flows sufficient to service the debt can be demonstrated to be reasonably assured.

No facts have been included in the description as to the capitalization of the issuer, so no conclusion can be reached on this factor.

*2.1.2.10. Availability of outside loans*

The ability of an issuer to obtain loans from independent lenders is relevant to the characterization of a purported debt instrument because a loan that purports to be debt "is obviously a loan in name only" where such "advance is far more speculative than what an outsider would make".[43]

Here, it is likely that the issuers of the CoCos are able to obtain independent loans, outside of the CoCos.

*2.1.2.11. Treatment of instrument for non-tax purposes*

Whether an instrument is intended to be treated as debt or equity for non-tax purposes is also relevant to the tax characterization of the instrument.

CoCos qualify as Tier 1 capital for regulatory purposes. However, the underlying idea behind issuing CoCos could weigh in favour of treating the CoCos as debt. In the recent financial crisis, when some large financial institutions essentially became insolvent, the common shareholders suffered a loss of most, if not all, of their investment. However, sovereign governments bailed out the senior creditors, fearing that if they failed to do so, the banks in question could not fund themselves and the financial system as a whole might falter. Regulators have sought a fashion to put at least some of the senior creditors at risk in order to put additional market discipline (so-called "moral hazard") into the operation of the credit markets for systemically important banks. CoCos are viewed as one means of doing this. Accordingly, from a regulatory perspective, it appears that contingent capital instruments, such as CoCos, were intended to be treated as debt instruments in the credit markets.

### *2.1.3. Conclusion*

On balance, a few of the factors that the IRS and courts have used to determine whether an instrument is debt or equity support the view that the CoCos here are debt, but other factors support the view that the CoCos are equity. In particular, the conversion feature and the lack of an unconditional promise to pay a sum certain, the payment of interest at the discretion of the issuer, the subordinated status of the instruments and the lack of creditor rights upon conversion all weigh in favour of equity treatment. Further, if the term of the CoCos is perpetual, then that factor, combined with the others, would strongly weigh in favour of equity treatment. Assuming that the term is 30 years, however, the ultimate conclusion the IRS or a court reaches will probably rest on the likelihood that the conversion will be triggered. This is because a novel feature of a CoCo is that it has a mandatory conversion feature, which unlike conventional convertible debts that

34. *Estate of Mixon*, 464 F.2d at 406.
35. *Kingsmill Corp. v. Commissioner*, 28 T.C. 330, 337 (1957); *Northern Refrigerator Line, Inc. v. Commissioner*, 1 T.C. 824, 829 (1943).
36. Pazarbasioglu, Ceyla, et. al., "Contingent Capital: Economic Rationale and Design Features," International Monetary Fund Staff Discussion Note (25 January 2011), available at www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.
37. *Stinnett's Pontiac Service, Inc.*, at 639.
38. *Curry v. Commissioner*, 43 T.C. 667 (1965).
39. *Sun Properties v. United States*, 220 F.2d 171 (5th Cir. 1955).
40. *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967).
41. *Byerlite Corp. v. Williams*, 286 F.2d 285 (6th Cir. 1960); *Truschel v. Commissioner*, 29 T.C. 433 (1957).
42. *Bauer v. Commissioner*, 748 F.2d 1365 (9th Cir. 1984).
43. *Fin Hay Realty Co.*, 398 F.2d at 697.

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are generally respected as debt for US federal income tax purposes, does not guarantee that the conversion will give the holder stock having a value equal to or greater than the principal amount of the CoCo. This mandatory conversion feature, depending on the likelihood that it will be triggered, results in the lack of an unconditional promise to pay a sum certain, which is perhaps the most important factor supporting the classification of an instrument as debt.

Absent a ruling from the IRS, the treatment of CoCos cannot be determined with certainty, and equity treatment may become the opinion standard followed by most issuers.[44] However, given the proclivity of the tax authorities to be supportive of the debt treatment of hybrid-type instruments approved by banking authorities, the US tax authorities could still conclude that debt treatment is proper.

## 2.2. Tax deductibility of interest paid on the bonds

In general, Sec. 163(a) provides that all interest paid or accrued on indebtedness within a taxable year is allowed as a deduction. If an obligation is issued by a corporation with original issue discount (OID), the amount of such discount is deductible as interest and is prorated or amortized over the life of the obligation.[45] Sec. 163(e) further adds that, in the case of debt instruments issued after 1 July 1982, the portion of the OID with respect to such debt instrument which is allowable as a deduction will be equal to the aggregate daily portions of the OID for days during such taxable year.

For US tax purposes, an instrument has OID if the issue price of the instrument is less than the amount payable at maturity, including in amounts payable at maturity for the purpose of this calculation all amounts paid on the instrument other than amounts unconditionally payable at fixed periodic intervals of one year or less during the entire term of the debt instrument.[46]

If the yield on a note is in excess of 6% above the US applicable federal rate (AFR) for the month the instrument is issued, a portion of the OID on the instrument may be disallowed as a deduction to the borrower.[47] Under Sec. 163(e)(5), in the case of an applicable high-yield debt obligation as defined in Sec. 163(i),[48] a corporation is not allowed a deduction for the disqualified portion of the OID on the obligation, and the corporation's deduction for the remaining portion of the OID is deferred until the OID is paid in cash or in property (other than debt of the issuer or a related person within the meaning of Sec. 453(f)(1)).

Thus, if the instrument is characterized as debt, some portion of the accretion in value may be allowable as a deduction, subject to the limitations described above and general limitations such as the US earnings stripping rules.[49]

## 2.3. Deductibility on an accrual basis for any deferred interest

Treas. Reg. Sec. 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 non-contingent bond method applies to the instrument.[50] Under the non-contingent 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 Treas. Reg. Sec. 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 applicable federal rate. In certain situations, the comparable yield is presumed to be the applicable federal rate (based on the overall maturity of the debt instrument).[51]

The projected payment schedule for a debt instrument includes each non-contingent payment and a projected amount for each contingent payment.[52] 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, 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.[53]

44. See Lloyds Banking Group Prospectus (Lloyds Prospectus) for 5 billion Sterling Enhanced Capital Note Programme, dated 1 December 2009, which states that for the portion of the notes that has a set maturity date there is a "strong likelihood that … [they] … will be treated as equity for US federal income tax purposes, and … [Lloyds] will treat … [them] … as equity for such purposes …".
45. Treas. Reg. Sec. 163-4(a).
46. IRC Sec. 1273(a)(2).
47. IRC Sec. 163(e)(5)(C).
48. Under IRC Sec. 163(i), the term "applicable high yield discount obligation" means any debt instrument if:
    - the maturity date of such instrument is more than 5 years from the date of issue,
    - the yield to maturity on such instrument equals or exceeds the sum of:
    - the AFR in effect under IRC Sec. 1274(d) for the calendar month in which the obligation is issued; and
    - 5 percentage points; and
    - such instrument has significant OID.
49. IRC Sec. 163(j).
50. See Treas. Reg. Sec. 1.1275-4(b).
51. See Treas. Reg. Sec. 1.1275-4(b)(4)(i)(B). Treas. Reg. Sec. 1.1275-4(b)(4)(i)(B) applies to debt instruments if the instrument is marketed or sold in substantial part to persons for whom the inclusion of interest (or OID) is not expected to have a substantial effect on their US tax liability.
52. See Treas. Reg. Sec. 1.1275-4(b)(4)(ii).
53. See Treas. Reg. Sec. 1.1275-4(b)(4)(v).

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If the actual amount of a contingent payment is different from the projected payment, 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 carry-forward to the next taxable year.[54]

Except as provided in Treas. Reg. Sec. 1.1275-4(a)(2), Treas. Reg. Sec. 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.[55]

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.[56] 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.[57]

Assuming the CoCo instrument is characterized as a debt instrument, the instrument provides for one or more contingent payments (the contingent interest) that are neither remote nor incidental. As a result, the debt instrument would be a contingent payment debt instrument subject to the non-contingent bond method described in Treas. Reg. Sec. 1.1275-4(b). Although a conversion feature alone does not cause a convertible debt instrument to be subject to the non-contingent bond method, the possibility of a conversion is nevertheless a contingency. Therefore, the comparable yield for a convertible debt instrument subject to the non-contingent bond method is determined under Treas. Reg. Sec. 1.1275-4(b) by reference to comparable fixed-rate non-convertible 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 Treas. Reg. Sec. 1.163-7, the amount of interest that is deductible each year on a contingent payment debt instrument is determined under Treas. Reg. Sec. 1.1275-4. However, certain provisions of the Internal Revenue Code, such as Sec. 163(l) and Sec. 249, may affect an issuer's ability to deduct the interest computed under the non-contingent bond method.

Sec. 163(l) 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 Sec. 163(l), indebtedness is payable in equity only if (1) 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, (2) 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 (3) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in either (1) or (2), 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 legislative history behind IRC 163(l) 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, non-recourse 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 Sec. 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.[58]

Sec. 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, Sec. 249 does not apply to the extent the corporation can demonstrate to the satisfaction of the Secretary of the US Treasury that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature.[59] For purposes of Sec. 249, a conversion is a repurchase.[60]

Sec. 249 applies only to a premium paid to repurchase a convertible debt instrument. However, Sec. 249 applies to a conversion of the debt instrument into stock having a value in excess of the debt instrument's adjusted issue price.[61]

54. See Treas. Reg. Sec. 1.1275-4(b)(6) for the specific rules that apply to negative and positive adjustments.
55. Treas. Reg. Sec. 1.1275-4(a)(5). See Treas. Reg. Sec. 1.1275-2(h) for rules relating to remote and incidental contingencies.
56. Treas. Reg. Sec. 1.1275-4(a)(4).
57. Rev. Rul. 2002-31, 2001-1 C.B. 1023.
58. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523-24 (1997), 1997-4 (Vol. 2) C.B. 1993-94.
59. See Treas. Reg. Sec. 1.249-1.
60. See *Clark Equipment Company v. United States*, 912 F.2d 113 (6th Cir. 1990). See also Treas. Reg. Secs. 1.61-12(c)(2) and 1.163-7(c).
61. See *Clark Equipment; National Can Corp. v. United States*, 687 F.2d 1107 (7th Cir. 1982); Treas. Reg. Sec. 1.249-1.


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### 2.4. Tax consequences of conversion

In general, if a lender accepts the stock of the debtor in satisfaction of the liability owed to the lender, the debtor is treated as having paid the liability in an amount equal to the fair market value of the stock issued to the lender.[62] If the issue price of the debt instrument is greater than the amount treated as having been paid, the excess will be treated as cancellation of indebtedness income.

From the debtor's perspective, in general, gross income includes all income from discharge of indebtedness. Thus, absent an exclusion, a debtor will include cancellation of indebtedness income in the calculation of the debtor's gross income.[63] If a debtor is in bankruptcy, the amount of the cancellation is excluded from income.[64] If a debtor is insolvent, but not in bankruptcy, the debtor may exclude the amount of cancellation from income to the extent the debtor is not made solvent by the cancellation.[65]

### 2.5. Withholding taxes

Although the United States normally imposes a 30% withholding tax on the US-source interest income of non-US persons,[66] the United States does not tax portfolio interest received by a non-resident individuals[67] and corporations.[68]

"Portfolio interest" means any interest (including original issue discount) which, but for the portfolio interest exception, would be subject to withholding tax under the Code and (in the case of obligations issued on or before 18 March 2012) which is either:

- (1) paid in respect of an instrument in bearer form,[69] (2) sold under procedures reasonably designed to prevent sale or resale to US persons, (3) payable only outside the United States or its possessions and (4) payable in respect of an obligation (subject to some exceptions) that states on its face that any US person who holds the obligation will be subject to limitations under US tax laws;[70] or
- (1) paid in respect of an obligation in registered form[71] and (2) in respect of which the issuer has received a Form W-8BEN or other required statement as to qualification.

Registered form means, in general, that the right to principal and interest may be transferred only through surrendering the old instrument (with the reissuance of the instrument to the new holder), through a book entry system maintained by the issuer or its agent, or through both of these methods.[72]An obligation is considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation.[73] For obligations issued after 18 March 2012, registered form would include instruments that may be transferred by means of a dematerialized book entry system or other book entry system specified by the US Treasury.[74]

Portfolio interest does not include any interest if the amount of such interest is determined by reference to any receipts, sales or other cash flow of the debtor or a related person, any income or profits of the debtor or a related person, any change in value of any property of the debtor or a related person, or any dividend, partnership distributions, or similar payments made by the debtor or a related person.[75] The exclusion in the preceding sentence does not apply, however, to amounts that are contingent solely because (1) the timing of any interest or principal is subject to a contingency, (2) the interest is paid in respect of non-recourse or limited recourse debt, (3) the debtor or a related party entered into a hedging transaction to manage the interest rate or currency risk or (4) the interest is determined by reference to the value, yield or index of certain publicly traded property.[76]

Although not entirely clear, there is a risk that making the interest payments contingent upon the reserves of the issuer would be viewed as a contingency based upon the receipts or cash flow of the issuer, making the payments of interest ineligible for the portfolio interest exception. Depending upon the location of the tax residence of the investor, this could result in the full 30% withholding rate being imposed. Under some treaties, such a characterization would result in the dividend withholding rate being imposed.

As with interest, the United States generally imposes a 30% withholding tax on the payment of dividends.[77] Thus, if the CoCo instrument were recharacterized as equity, payments on the instrument may be subject to dividend withholding to the extent not eliminated by an applicable treaty.

### 2.6. Indirect taxes, stamp duties, capital taxes or similar taxes upon issue, transfers and/or conversion of the bonds

There is no federal stamp tax or capital tax on the conversion. However, many states tax increases to the contributed capital of corporations, and some states, such as New York, impose taxes on the transfer of stock.

62. IRC Sec. 108(e)(8).
63. The phrasing of this apparently redundant phrase, "gross income means ... income from discharge of indebtedness" is explained by recognition of the common law treatment of discharge of indebtedness. IRC Sec. 61(a)(12). Under the common law analysis, not all discharge of indebtedness creates income, but income is created from discharge of indebtedness when the discharge results in an accession to wealth. *United States v. Kirby Lumber, Co.*, 284 U.S. 1, 3 (1931).
64. IRC Sec. 108(a)(1)(A).
65. IRC Sec. 108(a)(1)(B), 108(a)(3).
66. IRC Secs. 871(a), 881(a).
67. IRC Sec. 871(h).
68. IRC Sec. 881(c).
69. An instrument in bearer form is any instrument not in registered form. Treas. Reg. Sec. 5f.103-1(e)(1). Obligations issued after 18 March 2012, must be in registered form to qualify for the portfolio interest exception.
70. IRC Secs. 871(h)(2)(A)(ii); 163(f)(2)(B).
71. Treas. Reg. Sec. 1.871-14(c)(1); Treas. Reg. Sec. 5f.103-1(c).
72. Treas. Reg. Sec. 1.871-14(c)(1); Treas. Reg. Sec. 5f.103-1(c).
73. Treas. Reg. Sec. 5f.103-1(c)(2).
74. IRC Sec. 163(f)(3).
75. IRC Secs. 871(h)(4), 881(c)(4). Certain other types of contingent interest are excluded, as well.
76. IRC Sec. 871(h)(4)(C).
77. IRC Secs. 1441, 1442.

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## 3. The Bond Holders

### 3.1. Characterization of bonds as debt or equity

Under Sec. 385, the holder of the instrument is generally bound by the characterization of the instrument. Thus, assuming the issuer characterized the instrument as debt subject to the non-contingent bond method, holders would accrue OID on the instrument whether or not they received payments.

If the actual amount of a contingent payment is different from the projected payment, 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 carry-forward to the next taxable year.[78]

### 3.2. Tax treatment on conversion

A holder of a convertible debt instrument generally does not recognize gain or loss when the holder exchanges the debt for stock in the corporation that issued the debt security.[79] Instead, the holder will receive a carry-over basis in the stock received upon conversion. Thus, gain or loss will be recognized when the holder ultimately disposes of the stock, pursuant to general US federal income tax principles.

78. See Treas. Reg. Sec. 1.1275-4(b)(6) for the specific rules that apply to negative and positive adjustments.
79. See e.g. Rev. Rul. 72-265, 1872-1 C.B. 222.

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