Host Country UNITED STATES

Viva Hammer and Sam Chen,
KPMG, Washington National Tax

I. US federal income tax treatment of contingent convertible bonds

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") authorises 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 January 13, 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"[5] 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 was no direct precedent for this form of instrument in the past, several financial institutions have recently issued instruments (contingent convertible bonds or "CoCos") that would appear to satisfy this provision. 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[6] decreases to less than five percent (at issuance, its core Tier 1 ratio was approximately 8.6 percent). The conversion price was set at approximately 65 percent of the current market trading price of Lloyd's common shares at the notes' date of issuance.

In April of 2010, Yorkshire Building Society issued CoCos in the form of convertible securities to Chelsea Building Society as part of a merger between the two entities. The CoCos have a fixed maturity of 15 years, and automatically convert into Profit Participating Deferred Shares (PPDS)[7] of the combined entity if the consolidated core Tier 1 ratio of the combined entity decreases to less than five percent (at issuance, the core Tier 1 ratio of the combined entity was approximately 10.4 percent). The notes would convert into PPDS with a nominal amount equal to the principal amount of the notes.

Rabobank, in May of 2010, issued instruments that constituted senior debt, but will be redeemed for cash at 25 percent of their principal amount in the event Rabobank's consolidated equity capital ratio decreases to less than seven percent (at issuance, this ratio was 12.5 percent). The instruments have a maturity date 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 November 2011, Rabobank issued additional instruments in the form of notes with a perpetual maturity, callable after 5.5 years. If Rabobank's consolidated equity capital ratio decreases to less than eight percent (as of June 2011, this ratio was approximately 14 percent), these notes will absorb losses pro rata with equity capital and other loss absorbing instruments. The issuer or the regulator can also trigger the write down.

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 seven percent (at issuance, it was about 10 percent) 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 $20 or the then current market price of the shares. Based on the conversion ratio, if the market price at conversion is $20 or higher, the holders will receive shares equal to the full principal amount of their investment, but if it is below $20, they will suffer a loss equal to the difference between $20 and the lower market value.

Finally, in April 2011, Bank of Cyprus issued CoCos in the form of subordinated convertible securities with a perpetual term. The Bank of Cyprus CoCos automatically convert into common equity of the issuer if its core Tier 1 ratio falls below five percent, or if certain non-viability events occur. If a mandatory conversion occurs, the holders will receive common shares of Bank of Cyprus stock equal to the full principal amount of their investment if the market price of the common shares is at or above €3.30 per share. If the market price of the common shares is below €3.30, the holders will suffer a loss equal to the difference between €3.30 and the lower market value, subject to a floor of €1.00. A unique feature of the securities is that they give the holders the option to convert the securities to equity if Bank of Cyprus's common share price reaches €3.30. As of the issuance date of the CoCos, Bank of Cyprus's core Tier 1 ratio was approximately 8.1 percent and its common shares were trading at approximately €2.55.

In all of the examples above, if the issuer becomes financially distressed and the conversion or redemption is triggered, the issuer automatically recapitalises. Thus, it has been argued that CoCos may help avoid government bailouts in the event of another financial crisis.[8]

Although the Basel Committee announced in July 2011 that CoCos may not be used by global systemically important financial institutions to meet additional capital requirements introduced by Basel III,[9] CoCos are still very much relevant. The Basel Committee stated in its announcement that it "will continue to review contingent capital, and support[s] the use of contingent capital to meet higher national loss absorbency requirements than the global requirement, as high-trigger contingent capital could help absorb losses on a going concern basis."[10] Several national regulators have proposed rules that require financial institutions to maintain some level of contingent capital in addition to common equity. In the United States, Dodd-Frank requires a study of the feasibility, benefits, costs, and structure of CoCos to be submitted to Congress by July 2012.[11]

A. Income tax treatment of the CoCos

1. Description of the CoCos at issue

For purposes of this survey from the point of view of the United States, the CoCos are instruments, labelled as debt, issued by US banks or other regulated financial institutions. The CoCos are typically listed on an official exchange. The CoCos are direct, unsecured and subordinated obligations of the issuer. The holders of the CoCos are not shareholders of the issuer.

The CoCos may have no fixed maturity date and repayment of the principal is at the discretion of the issuer, subject to regulatory constraints. Alternatively, the issuer may undertake to repay the principal on a fixed maturity date that is 30 to 50 years from the date of issuance. If the CoCos have a fixed maturity date, payment at maturity would likely be subject to the condition that the issuer's core capital is sufficient at that time and also subject to the consent of the issuer's regulator.

The CoCos would pay a regular coupon, with interest rates that parallel the rate on similar bonds issued publicly by an unrelated bank holding company. However, the interest payment obligation may be deferrable in certain circumstances. The CoCos would be mandatorily convertible into the common equity of the issuer in the event the issuer's regulatory capital dips below a certain prescribed level on its quarterly audited financial statements. The conversion price would be set at a ratio fixed on the date of issuance (generally at a level that would result in some loss of the principal amount of the CoCos upon conversion). Neither the holder nor the issuer would have an option to convert the CoCos.

2. Debt-equity classification

For US federal income tax purposes, whether an instrument is debt or equity of the issuer depends on the substance rather than the form of the instrument.[12] The key characteristic of a debt instrument is that it does not put the debt holder at risk of the issuer's enterprise. One court described the difference between debt and equity as follows:

> The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.[13]

In the United States, an instrument generally is treated as either debt or equity,[14] but not a combination of the two. Almost all courts have taken this "all or nothing" approach to the issue of whether an instrument is properly characterised as debt or equity for US federal income tax purposes. However, no one particular factor is determinative of how an instrument should be classified. Thus, determining whether an instrument is debt or equity involves an examination of all the facts and circumstances surrounding the transaction.[15]

Section 385 of the Internal Revenue Code of 1986, as amended (the "Code"), authorises the Treasury to issue regulations to "determine whether an interest in a corporation is to be treated. . .as stock or indebtedness."[16] Section 385(b) lists the following five factors, among other factors, that the regulations may take into account in determining whether an instrument is debt or equity: (1) 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, and to pay a fixed rate of interest; (2) whether there is a subordination to or a 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. Notwithstanding its authority, however, Treasury never finalised regulations under section 385, despite several attempts.

The Internal Revenue Service (IRS) has set forth its views on determining whether an instrument is debt or equity in several rulings and other guidance, including Revenue Ruling 85119[17] and Notice 94-47.[18]

In Revenue Ruling 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 capitalised 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 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 on 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 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 at the election of the holders, and if a holder did not elect to receive stock, the issuer had 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 Revenue Ruling 85-119 were debt for US federal income tax purposes. However, in Notice 94-47, the IRS emphasised that Revenue Ruling 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 Revenue Ruling 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 nonrecourse to the issuer.

Notice 94-47 also sets forth eight factors that may be taken into account in the proper characterisation of an instrument as debt or equity, although no particular one of these factors is conclusive in the characterisation of an instrument. These factors are:

- 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;
- whether the holders of the instruments possess the right to enforce the payment of principal and interest;
- whether the rights of the holders of the instruments are subordinate to the rights of general creditors;
- whether the instruments give the holders the right to participate in the management of the issuer;
- whether the issuer is thinly capitalised;
- whether there is identity between holders of the instruments and stockholders of the issuer;
- the label placed upon the instruments by the parties; and
- whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

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.[19]

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 risk involved; (6) the right to enforce payment of principal and interest; (7) the extent to which the rights of the holder are subordinated to the general creditors of the issuer; (8) whether there is identity of interest between holders of the instrument and stockholders of the issuer; (9) the extent to which the holder has the right to participate in the management of the issuer; (10) the intent of the parties; (11) whether the issuer is thinly or adequately capitalised; (12) the ability of the issuing corporation to obtain loans from outside lending institutions; and (13) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.[20]

Below, each of these factors is applied to the characteristics of the CoCos subject to this survey, to determine whether such CoCos would 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.

a. 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. To this end, the Tax Court has stated that "[w]hile the name given to a security is not necessarily determinative in regards to its nature, the nomenclature used by the parties is a factor which cannot be ignored."[21] However, courts have generally given little weight to this factor, because it is too easy for the parties to mould the labels to their will, causing the labels to lose their significance.[22]

For example, in *Tyler v. Tomlinson*, the court stated:

> Tax law requires that creditorship have genuine existentiality. This requires more than a declaration of intention to create an indebtedness and more than the existence of corporate paper encrusted with the appropriate nomenclatural captions. . .We therefore look not to mere labels or to the self-serving declarations of the parties, but to the more reliable criteria of the circumstances surrounding the transaction.[23]

Since the CoCos are referenced as debt instruments in the offering documents, this is one factor that supports debt classification, but as stated, this factor is generally given little weight.

b. Fixed maturity date

A fixed maturity date, at which time the holder of an instrument has the unconditional right to return of the principal amount of the instrument, supports the classification of the instrument as debt.[24] If the maturity date is not fixed, or is too far in the future, the holder of the instrument may be exposed to the risks and rewards of the issuer's business rather than merely the credit risks of a borrower. In that case, the instrument would be closer to equity than debt.

Numerous courts have found instruments labelled as debt to be equity, based in part on the fact that such instruments did not provide for a fixed maturity date.[25] Meanwhile, whether a maturity date is too far in the future is generally not a determination in absolute years, but rather in relation to the nature of the issuer's business, the financial condition of the issuer, the length of time the issuer has been in existence, and the likelihood that the issuer will be in existence when the instrument matures.[26] In addition, a 2009 Chief Counsel Advice (the "2009 CCA") indicated that a distant maturity date can put greater or lesser weight on other factors of the instrument.[27]

Here, if the CoCos have no fixed maturity date, then that would strongly imply the instrument is equity rather than debt. If instead, the CoCos have a fixed maturity date of 30 to 50 years, that would support debt characterisation so long as 30 to 50 years is not too far in the future given the issuer's business. Issuers of the CoCos are banks or other financial institutions, which generally are long-term, stable businesses, expected to continue into the foreseeable future, so 30 to 50 years is likely not so long a term as to mandate equity classification (although this assumption was severely tested during the financial crisis). However, the issuers of the CoCos at issue undertake to repay the principal in 30 to 50 years subject to the condition that the issuer's core capital is sufficient at that time and also subject to the consent of the issuer's regulator. Therefore, whether the CoCos truly have a fixed maturity date depends also on whether the issuer's core capital is expected to be sufficient as of the maturity date to repay the principal on the instrument.

c. Unconditional promise to pay a sum certain

A fixed obligation to repay the principal advanced is perhaps the most important factor that supports the characterisation of an instrument as debt. 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".[28] Whether there is an unconditional promise to pay a sum certain can be difficult to determine when the instrument is convertible into the equity of the issuer, whether mandatorily or at the option of the holder or issuer. A convertible feature itself is not necessarily indicative of equity, but if the conversion is almost certain to be exercised, the instrument may be treated as equity. In Revenue Ruling 83-98,[29] 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 Revenue Ruling 85119, 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 Revenue Ruling 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 whose future value cannot be determined at 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. Absent a significant deterioration in this capital ratio, if the CoCos have a fixed maturity date, they will be paid in full on that date. If the possibility of conversion is remote, then the conversion feature might be ignored. We assume that none of the issuers 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 at date of issuance of the debt is reached are typically viewed as debt instruments. In the case of the CoCos, 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.[30] Further, the conversion price was set at a fixed ratio on the date of issuance and at a level which would result in some loss of the principal amount of the CoCos upon conversion.

d. Source of payments

The payment of dividends on equity is contingent on both the declaration by the issuer's board of directors and the availability of sufficient funds for the lawful payment of dividends.[31] The payment of interest on debt is made without action by the issuer's management and is not limited by the requirement that there be legally available funds. Consequently, if the only expected source of payment is from the profits of the issuer, then the instrument may be viewed as equity rather than debt. Thus, if there is not a legal obligation for the 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 as equity.[32] Similarly, if an instrument provides for a legal obligation of payment of interest, but there is not a realistic expectation of such payment, the instrument could be viewed as equity. One court has said that "[i]f the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution. An expectation of repayment *solely* from corporate earnings is not indicative of bona fide debt regardless of its reasonableness."[33] Another court has stated: "if repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation."[34]

The CoCos provide for payment of interest. The obligation to make interest payments may be deferred by the issuer under certain circumstances, but never avoided at the issuer's discretion. 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. Thus, this factor likely supports the classification of the instruments as debt.

e. Risk involved

Generally, "[t]he more the payments are at the risk of and subject to the vagaries of the business, the more they are indicative of equity."[35]

As mentioned above, 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. In addition, the interest rate on the CoCos parallels the rate on similar bonds issued publicly by an unrelated bank holding company in a different jurisdiction, which shows that the CoCos are not necessarily more risky than other purported debt instruments. However, the CoCos are issued with the intention that they would convert to equity to enhance the issuer's capital in the event of distress, in which case, a portion of the principal amount of the CoCos would likely be lost as well. Thus, the CoCos appear to involve more risk than conventional debt and this factor may well support equity characterisation for the CoCos.

f. 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.[36] 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, 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.[37]

Conversely, the absence of such rights generally indicates that an instrument constitutes equity rather than debt.[38] The court in *Jewel Tea v. United States* went so far as to say that, in the absence of a provision that the holder may unconditionally demand its money at a fixed time, the instrument cannot be debt.[39]

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.

g. 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.[40] However, subordination to general creditors is not necessarily indicative of a stock interest. For example, in Revenue Ruling 85-119, the instruments at issue were subordinated to the rights of all general creditors, but the IRS still found the instruments to be debt.

Courts have also accepted subordination. In *Green Bay Structural Steel, Inc. v. Commissioner*,[41] 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."[42]

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.

h. 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 between 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, however, determinative of whether an instrument is equity rather than debt.[43] Debt has been respected among parent and wholly-owned corporations,[44] and has been respected when held by individual shareholders in proportion to their interests in the corporation.[45] 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.[46]

In the case of the CoCos at issue, it is stated that the holders of the instruments are not also shareholders of the issuer of the CoCos. Thus, this factor does not weigh in favour of equity treatment for the CoCos.

i. Voting and management rights

A right to vote and participate in the management of the issuer supports equity treatment.[47] There is no indication that the holders of the CoCos have voting or management rights, so long as the conversion feature is not triggered.

j. 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.[48] One court has stated that "a transfer will be characterised as a bona fide loan if at the time the funds were transferred, there was an unconditional intention on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment."[49] However, courts have emphasised that it is objective intent evidenced by the parties' actions rather than their subjective intent that is the focus of the inquiry.[50]

Here, the CoCos are referenced as debt instruments and the parties may well intend the CoCos to be characterised as debt for tax purposes. However, CoCos are issued in part to enable "a fresh injection of capital into a distressed bank,"[51] so there is an intention that the CoCos could turn into equity, at least for regulatory purposes.

k. Capitalisation of the issuer

The thin capitalisation of an issuer generally is a characteristic that supports treating an instrument as equity.[52] The higher the issuer's debt to equity ratio, the more at risk the payments under an instrument are to the business operations of the issuer. This analysis is not based on some absolute debt-to-equity ratio, which, if exceeded, means an instrument is not debt. Instead, as with the fixed maturity analysis, this analysis depends on the characteristics of the issuer, and whether given those characteristics the debt-to-equity ratio signifies an equity investment rather than debt.[53]

Here, it is not clear whether the issuer's debt-to-equity ratio is high in comparison to other financial institutions at the time of the issuance of the CoCos. The CoCos are intended to be protection for the financial institution issuer in times of future distress, allowing it to meet its regulatory capital requirements. At the time the CoCos are issued, the issuer is likely not in distress and likely has a debt-to-equity ratio in line with other financial institutions.

l. Availability of outside loans

The ability of an issuer to obtain loans from independent lenders is relevant to the characterisation 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."[54]

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

m. 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 characterisation of the instrument.[55]

The CoCos, upon conversion, 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 way to put at least some of the senior creditors at risk in order to put additional market discipline ("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 prior to a conversion.

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 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 fixed in the range of 30 to 50 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 CoCo's novel feature is that it has a mandatory conversion feature that, unlike conventional convertible debt, which is 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.

In the regulations dealing with contingent payment debt instruments, if there is a remote likelihood that a contingency will occur, it is assumed that the contingency will not occur.[56] By analogy, the conversion feature of CoCos might be ignored if their conversion is "remote." Issuing banks likely do not expect that they will be forced to convert the CoCos they issue into common equity. However, the regulatory requirement for the issuance of contingent capital appears to undercut the remoteness argument, and the fact that conversion probably will occur when a financial institution is in financial distress makes a loss of principal in the event of conversion much more likely.

Several cases dealing with "surplus capital notes" issued by insurance companies to meet regulatory requirements also may offer some support for treating CoCos as debt. In these cases, the interest and principal on the notes could only be paid out of surplus capital. Hence, the notes did not have a fixed maturity date as their repayment was contingent on the ability of the issuer to basically make payments out of earnings. Despite this feature of the notes, the courts uniformly found that the notes were debt for tax purposes, relying heavily on the fact that the notes were likely to be paid and that their form was dictated by insurance regulations.[57] One court found the critical factor to be that state regulations and laws limited the taxpayer's options in structuring the transaction, a view that would seem to support the characterisation of CoCos as debt, too.[58] However, another court stated that insurance companies are distinct from other businesses because they must retain large reserves and surplus capital notes are often issued until the company can gradually accumulate sufficient reserves.[59] Thus, the surplus capital note cases may be interpreted as being limited to issuers that are insurance companies.

Absent a ruling from the IRS, the treatment of CoCos cannot be determined with certainty, and equity treatment for tax purposes may become the opinion standard followed by most issuers.[60] However, given the proclivity of the tax authorities to be supportive of the debt treatment of hybrid type instruments approved by banking authorities,[61] the US tax authorities could conclude that debt treatment is proper.

B. Changes to conversion feature

Certain changes to the CoCos may increase the likelihood that they would be characterised as debt for US federal income tax purposes, but because the debt-equity characterisation is based on a facts and circumstances test, it would be difficult to ensure debt treatment.

Nevertheless, the main features of the CoCos that support equity treatment are their lack of a fixed maturity date (or a maturity date that is at least not too far in the future) and, perhaps most importantly, their lack of an unconditional promise to pay a sum certain.

As discussed above, numerous courts have recharacterised instruments issued in the form of debt as equity for tax purposes, based in large part on the presence of a maturity date that is not in the reasonably foreseeable future or the lack of a fixed maturity date altogether. Thus, to help support debt characterisation for tax purposes, CoCos should have a fixed maturity date rather than a perpetual one. A maturity date that is 30 to 50 years in the future may be reasonable since the nature of the issuer's business, i.e. banking, would likely be viewed as relatively stable and the issuer would likely still be in existence when the CoCos mature. However, if the issuer's financial condition is precarious, a shorter maturity date would be more supportive of debt characterisation.

The critical characteristic of CoCos that supports equity treatment for tax purposes is their lack of an unconditional promise to pay a sum certain. The CoCos lack an unconditional promise to pay a sum certain because, if their conversion feature is triggered, a holder is not guaranteed a return of its original investment. Upon a conversion, the CoCos do not guarantee that a holder will receive stock having a value equal to or greater than the principal amount of the CoCos. Instead, the principal amount is generally written down upon a conversion, causing the holder to suffer a loss.

As discussed above, in Revenue Ruling 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. To ensure debt characterisation for tax purposes, the CoCos could provide that, upon conversion, a holder would receive stock having a value equal to the principal amount of the CoCos held by the holder. However, issuers may not be willing to accept the dilutive effect of such a change on their stock, and regulators may also not be willing to accept the destabilising effect of such a change, since it could result in a distressed bank having to issue a large amount of stock to satisfy the conversion feature. Furthermore, it is not certain that such a change would ensure debt characterisation. For example, Notice 94-47 warned that certain instruments treated as debt in Revenue Ruling 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. But if a holder of the CoCos were given the option to accept cash instead of stock, then the purpose of the CoCos to ensure a capital infusion in times of distress would be defeated.

In sum, changes to certain features of the CoCos may support characterising the CoCos as debt for tax purposes, but given the facts and circumstances nature of the debt-equity analysis, it is unlikely that any change can ensure such characterisation, at least without changing fundamental characteristics of the CoCos.

II. Tax treatment of the issuer

A. Interest deduction to issuer

If the CoCos are not classified as debt for US federal income tax purposes, the interest payments on the CoCos will not be deductible. However, even if the CoCos are treated as debt, section 163(l) may still disallow a deduction for interest paid on the CoCos.

Section 163(l) provides that no deduction will be allowed for interest paid on a "disqualified debt instrument." A disqualified debt instrument is defined as one where:

- a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer . . . is payable in, or convertible into [the equity of the issuer];
- a substantial amount of the principal or interest is required to be determined, or at the option of the issuer . . . is determined by reference to the value of such equity; or

- the indebtedness is part of an arrangement which is reasonably expected to result in a transaction described [above].

Neither the statute nor the legislative history under section 163(l) addresses contingent capital type debt instruments.[62] Rather, the section was directed at instruments then being issued in the market that mandatorily were convertible into equity at maturity or could be converted into equity at the option of the issuer. In the present case, the instruments are not mandatorily convertible into equity. Indeed, the issuer does not expect them to be converted into equity, and the issuer has no option to convert them into equity. Hence, their treatment may turn on what is the likelihood that one of the quoted provisions will apply to them. This is a gray area and one probably incapable of exact determination except with the guidance of the US tax authorities.

B. Tax treatment on conversion

Under Treas. Reg. section 1.61-12(c)(2)(ii), an issuer realises income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price. The regulations go on to state that the amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. Section 108 provides further rules for income from the discharge of indebtedness. Under section 108(e)(8), if indebtedness is satisfied by corporate stock, the corporation will be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. The legislative history of section 108(e)(8) provides that the section applies when the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt, and that section 1032 (relating to non-recognition of gain or loss to a corporation on the receipt of money or other property in exchange for its stock) does not prevent the recognition of this income from the discharge of indebtedness.[63] The IRS has also ruled on this issue in Technical Advice Memorandum 200606037, finding that section 108(e)(8) provides that the conversion of a convertible debenture is a discharge that gives rise to discharge of indebtedness income.

If a CoCo is treated as debt and a conversion is triggered, the issuer is treated as exchanging the debt for equity. In the case of a conversion under the terms of a CoCo, the issuer will likely be exchanging debt for equity that has a fair market value lower than the adjusted issue price of the debt, since a conversion is triggered by a decline in the issuer's capital position or other adverse economic conditions. In that case, it is possible the issuer will recognise cancellation of indebtedness income for the difference between the adjusted issue price of the debt and the fair market value of the equity under section 61(a)(12). If the issuer has any net operating losses, loss carryovers or loss carrybacks, any income from the discharge of indebtedness could apply to reduce such amounts.

If, instead, the CoCo is treated as equity and a conversion is triggered, section 1032 likely applies to prevent gain from being recognised by the issuer. Under section 1032, no gain or loss is recognised by a corporation on the receipt of money or other property in exchange for its stock.

C. Other taxes

Under US tax law, there are no indirect taxes, stamp duties, capital taxes or similar taxes due upon the issue, transfer, or conversion of the CoCos.

III. US federal income tax treatment of holder

A. Interest payments to host country holder

Although section 163(l) controls the deductibility of interest by the issuer, the more general debt versus equity determination will control the treatment of the interest payment by the holders. Thus, pursuant to the same analysis as discussed above, if the CoCos are classified as debt, then the interest payments are taxed to the holders as interest. If, on the other hand, the CoCos are classified as equity, the purported interest payments may be taxed as dividends to the extent the issuer has sufficient earnings and profits. For qualifying individuals, the payments will constitute qualified dividend income that enjoys a beneficial tax rate under the current law.[64] For qualifying corporations, the holders may obtain a dividends received deduction.[65]

Note also that section 385(c) requires that the characterisation by the issuer of an instrument as debt or equity, at the time of the issuance of the instrument, binds the issuer and all holders of the instrument, unless the taxpayer discloses any inconsistent treatment of the instrument in the taxpayer's tax return.

B. Payments to foreign country holder

Whether the CoCo is treated as equity or debt, US withholding tax likely applies to payments from a US issuer to a non-US holder that are designated as interest under the terms of the CoCo.

A 30 percent tax is imposed by sections 871(a)(1) (for a non-resident alien individual) and 881(a) (for a foreign corporation) on certain income, including interest and dividends, from sources within the United States. This tax is collected by means of withholding and remittance to the IRS by a withholding agent (i.e., any person having control, receipt, custody, disposal, or payment of income subject to the 30 percent tax).[66] A US issuer of a CoCo will likely qualify as a withholding agent and must withhold on interest and dividend payments to non-US holders of the CoCo.

If the CoCo is treated as debt, then interest payments pursuant to the terms of the CoCo will be subject to 30 percent withholding, unless a treaty between the United States and the country of residence of the holder reduces or eliminates such tax. Similarly, if the CoCo is treated as equity, then interest payments pursuant to the terms of the CoCo will likely be recharacterised as dividends, which are also subject to 30 percent withholding, unless reduced or eliminated by an applicable treaty.

Note that treaties may eliminate withholding on interest that meets the requirements of the treaty, but may only reduce the withholding on dividends. In addition, interest may also be free from withholding if it qualifies as portfolio interest, as defined under section 871(h) and section 881(c).

C. Tax treatment on conversion

A US holder of a convertible debt instrument generally does not recognise gain or loss when the holder exchanges the debt for stock in the corporation that issued the debt security.[67] Instead, the holder will receive a carryover basis in the stock received upon conversion. Thus, gain or loss will be recognised when the US holder ultimately disposes of the stock, pursuant to general US federal income tax principles.

Similarly, a Foreign Country holder of a convertible debt instrument also generally does not recognise gain or loss on a conversion and instead will receive a carryover basis in the stock received upon conversion. Gain or loss will be recognised when the holder ultimately disposes of the stock, pursuant to general US federal income tax principles, if the gain or loss is effectively connected with a US trade or business of the Foreign Country holder. Otherwise, gain or loss from the sale or other disposition of the stock is generally not subject to US withholding tax.

This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

NOTES

[1] Section 165(c) of the Act, Pub. L. 111-203, H.R. 4173.

[2] The Financial Stability Board is an international body that was established in 2009 to co-ordinate 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 of international financial organisations and standard setting bodies.

[3] *See* Basel Committee consultative document issued in December 2009 entitled "Strengthening the resilience of the bank sector" at pp. 5, 22.

[4] Basel Committee "Minimum requirements to ensure loss absorbency at the point of non-viability" issued with a press release on January 13, 2011.

[5] Tier 1 capital consists primarily of common stock and retained earnings, but also may include non-redeemable non-cumulative preferred stock. Tier 2 capital consists of supplementary capital such as undisclosed reserves, revaluation reserves, general loan-loss reserves, hybrid instruments, and subordinated debt.

[6] The core Tier 1 ratio is a bank's ratio of shareholder equity and retained earnings to the bank's risk-weighted assets.

[7] PPDS are core Tier 1 capital instruments issued by U.K. building societies that generally carry voting rights on a one vote per holder basis, pay dividends that are variable and fully discretionary, and can be written down in value based on the lack of profitability of the building society.

[8] For more information on CoCos, see Albul, Boris, et al., "Contingent Convertible Bonds and Capital Structure Decisions" (April 25, 2010), presented at the Federal Reserve Bank of Atlanta 2010 Financial Markets Conference and available at http://www.frbatlanta.org/documents/news/conferences/10fmc_tchistyi.pdf.

[9] *See* Basel Committee consultative document issued in July 2011 entitled "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" at p. 17.

[10] *Id*. at p. 20.

[11] Section 165(c) of Dodd-Frank.

[12] *John Kelley Co. v. Commissioner*, 326 US 521 (1946).

[13] *United States v. Title Guarantee & Trust Co*., 133 F.2d 990, 993 (6th Cir. 1943).

[14] *Commissioner v. H.P. Hood & Sons Inc*., 141 F.2d 467, 469 (1st Cir. 1944).

[15] *Berkowitz v. United States*, 411 F.2d 818, 820 (5th Cir. 1969).

[16] Unless otherwise indicated, all section references are to the Internal Revenue Code or Treasury Regulations promulgated thereunder.

[17] 1985-2 C.B. 60.

[18] 1994-1 C.B. 357.

[19] *John Kelley Co*., 326 US at 530; *Hardman v. United States*, 827 F.2d 1409, 1411-12 (9th Cir. 1987).

[20] *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.

[21] *Miele v. Commissioner*, 56 T.C. 556, 564 (1971), *aff'd* 474 F.2d 1338 (3d Cir. 1973);

[22] See, e.g., *Fin Hay*, 398 F.2d at 697; *Texas Farm Bureau v. United States*, 725 F.2d 307, 312 (5th Cir. 1984).

[23] *Tyler v. Tomlinson*, 414 F.2d 844, 850 (5th Cir. 1969).

[24] *H.P. Hood & Sons, Inc*., 141 F.2d at 470; *Monon R.R. v. Commissioner*, 55 T.C. 345, 359 (1970), *acq.* 1973-2 C.B. 1.

[25] See, e.g., *In re Lane*, 742 F.2d 1311 (11th Cir. 1984); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960), *Commissioner v. Schmoll Fils Associated, Inc*., 110 F.2d 611 (2d Cir. 1940); *Tea Co., Inc. v. United States*, 90 F.2d 451 (2d Cir. 1937).

[26] See *Monon R.R.*, 55 T.C. at 359.

[27] See CCA 200932049 (Aug. 8, 2009) (where the Service stated that while "an extended maturity. . .will decrease the relative economic importance of the eventual return of principal," it will also "concomitantly increase the relative importance of the periodic payments during the term of the instrument"). Pursuant to section 6110(k)(3), written determinations such as Chief Counsel Advice represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and are not intended to be relied upon by third parties and may not be cited as precedent. They do, however, provide an indication of the IRS's position on the issues addressed.

[28] FSA 1999400007 (June 15, 1999).

[29] 1983-2 C.B. 40.

[30] *See* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, Section 4.03[2][g].

[31] Meridian & Thirteenth Realty Co., 132 F.2d at 187 ("Stockholders have no absolute right to dividends until they are declared. A creditor has a right to his interest in any event.").

[32] Berkowitz, 411 F.2d at 821.

[33] *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 631 (6th Cir. 1986).

[34] *Estate of Mixon*, 464 F.2d at 405.

[35] *Segel v. Commissioner*, 89 T.C. 816, 830 (1987).

[36] *In re Lane* at 1317; *Estate of Mixon*, 464 F.2d at 405-06.

[37] *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).

[38] See *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*, 56 T.C. at 565 (1971) (holding an instrument to be stock where holders could not file claims as creditors if the corporation went into receivership).

[39] *Jewel Tea*, 90 F.2d at 453 (stating that a security is not necessarily debt if it contains a provision that the holder may unconditionally demand his money at a fixed time, but "[a]ll we now decide is that in the absence of such a provision the security cannot be a debt").

[40] *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.

[41] 53 T.C. 451 (1969).

[42] *Id.* at 457.

[43] *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.").

[44] See, e.g., *Jack Daniel Distillery*, 180 Ct. Cl. at 325-33; *Kraft Foods Co. v. Commissioner*, 232 F.2d 118.

[45] See, e.g., *Piedmont Corp*., 388 F.2d 886; *Tomlinson v. 1661 Corp*., 377 F.2d 291; *Nye*, 50 T.C. 203 (1968).

[46] See, e.g., *Fin Hay Realty Co*, 398 F.2d 694; *Miele*, 56 T.C. 556;

[47] *Estate of Mixon*, 464 F.2d at 406.

[48] *Kingsmill Corp. v. Commissioner*, 28 T.C. 330, 337 (1957); *Northern Refrigerator Line, Inc. v. Commissioner*, 1 T.C. 824, 829 (1943).

[49] *Geftman v. Commissioner*, 154 F.3d 61, 68-69 (3d Cir. 1998).

[50] *Ragland Inv. Co.*, 52 T.C. at 876.

[51] Pazarbasioglu, Ceyla, et al., "Contingent Capital: Economic Rationale and Design Features," International Monetary Fund Staff Discus-

sion Note, (Jan. 25, 2011), available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.

[52] *Hardman*, 827 F.2d at 1414.

[53] *P.M. Finance Corp, v. Commissioner*, 302 F.2d 786, 788 (3d Cir. 1962).

[54] *Fin Hay Realty Co.*, 398 F.2d at 697.

[55] Notice 94-47.

[56] Treas. Reg. Section 1.1275-2(h)(2). *See also* CCA 200932049 (Aug. 7, 2009) (remote criteria applied outside the scope of the contingent payment regulations).

[57] See *Jones vs. United States*, 659 F.2d 618 (5th Cir. 1981); *Anchor National Life Insurance Co. vs. Comm'r*., 93 T.C. 382 (1989); *Harlan vs. United States*, 409 F.2d 904 (5th Cir. 1969); *Comm'r. vs. Union Mutual Insurance Co of Providence*, 386 F.2d 974 (1st Cir. 1967); Rev. Rul. 68-515, 1968-2 C.B. 297 (IRS will follow the *Union Mutual* decision); 1996 IRS NSAR 5975, 1996 WL 33325654 (July 30, 1996).

[58] *Jones*, 659 F.2d at 623.

[59] *Id*. at 402.

[60] See Lloyds Banking Group Prospectus (Lloyds Prospectus) for 5 billion Sterling Enhanced Capital Note Programme, dated Dec. 1, 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. . ."

[61] See CCA 200932049 (March 10, 2009) and TAM 199910046 (Nov. 16, 1998) on trust-preferred securities.

[62] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (Dec. 17, 1997) at 192-193.

[63] H.R. Rep. No. 98-861 (Conf. Rep.), 98th Cong., 2d Sess. 829 (1984).

[64] Section 1(h)(11).

[65] Section 243.

[66] Sections 1441(a) and 1442(a).

[67] See, e.g., Rev. Rul. 72-265, 1872-1 C.B. 222.