The article which appears below appeared in the June 2012 issue of in Bloomberg BNA's Tax Management International Forum, as a response to the following facts and questions, reflecting the law of the United States.

Tax implications of contingent convertible securities

FACTS

In response to the financial crisis, the banking and financial authorities in Host Country may be requiring bank holding companies and banks to hold a much higher level of capital than was previously the case. One form of such capital that might qualify is a new type of contingent convertible securities ("CoCos"). Although the Basel Committee announced in July 2011 that global systemically important financial institutions cannot use CoCos to meet the Basel III requirements,[1] CoCos may still be relevant to meet national capital requirements supplementing the Basel III requirements.

A Host Country bank is considering issuing CoCos. The CoCos would be labelled as debt and would be direct, unsecured and subordinated obligations of the issuer. They may have no fixed maturity date, or alternatively, they may have relatively long maturities in the range of 30 to 50 years. 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, although this might be deferrable in certain circumstances. The interest rate on the CoCos would parallel the rate on similar bonds issued publicly by an unrelated bank holding company.

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 which 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.

It is likely that, at the time of the issuance of the CoCos, the Host Country bank has a debt-to-equity ratio in line with other financial institutions, and the Host Country bank would be able to obtain independent loans outside of the CoCos.

The holders of the CoCos are not shareholders of the issuer.

QUESTIONS

l. With respect to the CoCos:

a. Would the CoCos be treated as debt instruments in Host Country for income tax purposes?

b. Are there any changes to the conversion feature that might be made to insure their treatment as debt?

ll. With respect to the income tax treatment of the Host Country issuer:

a. Would the interest on the CoCos be deductible in Host Country?

b. What would be the income tax treatment of the conversion?

c. Are there other taxes imposed on the payments?

lll. What will be the income tax treatment in Host Country of the holder with respect to:

a. Interest payments, if the holder of the CoCos is a Host Country entity?

b. Interest payments, if the holder of the CoCos is a Foreign Country entity?

c. A conversion upon which the holder receives stock in exchange for the CoCos?

[1] The Basel Committee on Banking Supervision provides a forum for regular co-operation on banking supervisory matters. All countries covered by the *Tax Management International Forum*, except for Denmark and Ireland, have representatives on the committee.

For answers to these Forum questions reflecting the law of other jurisdictions, click here.

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