Tax Alert

IRS Untangles Application of § 163(L) in Cross-Border Hybrid Financing Transaction

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"In terrorem" or anti-abuse provisions often receive a lack of judicial and administrative interpretation. Section 163(l) of the Code, enacted in 1997, is no exception, so that even now certain fundamental questions relating to its interpretation and application in practice remain somewhat uncertain. In PLR 201517003, the IRS favorably resolved one such question regarding how convertible debt held by the debtor's parent company should be analyzed under § 163(l), while leaving unanswered the broader question of when convertible debt is considered "substantially certain" to be exercised. Importantly, the PLR also illustrates how § 163(l) can be a potential trap for the unwary for a foreign parent corporation planning a hybrid financing of its U.S. subsidiary.

Facts

PLR 201517003 dealt with intercompany debt between a foreign taxpayer, Parent, and its second-tier U.S. subsidiary, Taxpayer. Parent owned all of the stock of Parent (also foreign), which, in turn, owned all of the stock of Taxpayer. To refinance existing intercompany debt, Taxpayer borrowed foreign currency from Parent under an interest-bearing, convertible promissory note. Interest on the loan was payable solely at maturity. Taxpayer could not prepay the loan without Parent's consent. Absent a default or a change-in-control, Parent also could not call the loan prior to maturity.

At maturity, Parent, as holder, could elect to convert the loan into new shares of Taxpayer.[1] The number of shares received on conversion was a product of the following formula:

Shares = Redemption Amount (i.e., principal plus accrued interest) / FMV of Taxpayer shares at issuance of note * "Factor"

The conversion price adjustment or "Factor" is unstated. However, Taxpayer proposed to use a number greater than 1.0. Thus, the Factor effectively caused the conversion feature to be "out-of-the-money" on the issuance date. How much greater than 100% of FMV was unstated in the ruling. The note's conversion ratio also was subject to certain anti-dilution adjustments in the event of a merger, etc., involving Taxpayer.

Importantly, the convertibility of the note gave rise to a potential foreign tax benefit: it was represented that Parent, on either a conversion of the note to stock or payment in cash, could treat the accrued interest as a capital gain for foreign tax purposes in its home country. The foreign consolidated group containing Parent and Company 1 represented to the IRS that it had the equivalent of US capital loss carry-forwards that would offset the foreign country capital gain, thus effectively reducing (or eliminating) home country taxation of the accretion on the note in Parent's hands.

The IRS's Analysis and Conclusion

The ruling addressed whether the conversion feature of the note caused interest expense to be disallowed under § 163(l). In such an inbound financing transaction, deductibility of interest expense in the U.S. is a major consideration. While a taxpayer planning such a financing would routinely

1 On a conversion, therefore, Taxpayer would have become partly owned by Parent and partly owned by Company 1.

consider a number of applicable rules, such as debt-equity analysis and Section 163(j), section 163(l), if applicable, could also operate to disallow interest expense on the debt.

Section 163(l) disallows all interest deductions with respect to "disqualified debt instruments," which are generally debt instruments that are payable in equity. Specifically, a debt instrument is considered to be payable in equity for this purpose and, thus, to be disqualified debt instrument, if it fails any one of three tests:

a. a "substantial amount" of the principal or interest is *required to be paid* or converted, or *at the option of the issuer or a related party*, is payable in, or convertible into, equity;

b. a "substantial amount" of principal or interest is determined by reference to value of the taxpayer's equity (or may be so determined at the taxpayer or a related party's option); or

c. the instrument is part of an arrangement reasonably expected to result in a transaction described in (A) or (B). *See* § 163(l)(3).

In addition, under the flush language of § 163(l)(3), interest or principal is treated as payable in equity if the holder can convert the debt into equity and there is a "substantial certainty" that the holder will elect to convert the debt to equity.

The interpretive puzzle addressed in the ruling was how to analyze the conversion right of a holder (Parent) that is also a related party described in clause (A). Under the rule applicable to convertible debt generally, interest would be disallowed only if Parent were "substantially certain" to exercise the conversion right. On the other hand, such a right also literally is described in clause (A), since the holder, as a party related to the issuer, has the option to convert the debt to equity. If so, the instrument would automatically be tainted by § 163(l) and all interest expense would be disallowed as a deduction.

Characterizing this fact pattern as "an unaddressed possibility," PLR 201517003 concluded that the general rule for conversion features took priority over the automatic disallowance rule in clause (A). The Service emphasized the legislative intent of § 163(l), which it found "to indicate a Congressional preference for treating convertible debt instruments as valid debt in most cases…." Accordingly, the Service ruled that flush language governed this situation and the interest expense would be deductible so long as the conversion right was not "substantially certain" to be exercised.

The ruling explicitly did not address whether the conversion right was "substantially certain" to be exercised. The Taxpayer, however, represented that the Factor would be greater than 1.0 and the Service cited the legislative history for the proposition that Section 163(l) was not intended to apply to convertible debt with an exercise price "significantly higher" than FMV on the debt's issue date.[2] How much greater the Factor would have to be than 1.0 is a question that the Service left for another day. Also, Parent obtained the same foreign tax benefit whether the note was converted into stock or redeemed for cash. Thus, the foreign tax planning presented by the transaction did not compel Parent to convert the debt into equity.

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2 In other areas, the term "substantial certainty" has been interpreted to require a conversion feature that is significantly in-the-money on the date of grant. *See* Treas. Reg. § 1.1361-1(l)(4)(iii)(C) (subchapter S safe harbor where option's exercise price is equal to at least 90% of the current FMV). In PLR 201517003, however, the Service cited the legislative history of § 163(l) for the proposition that the conversion price must be "significantly higher" than FMV on the date of grant.

Appraisal of PLR 201517003 and its Implications

On the technical question addressed, the ruling reaches the right result in light of the statutory purpose. Specifically, given the Congressional intent not to disallow interest deductions on most convertible debt, it is hard to see why convertible debt held by a related party should be treated differently from other convertible debt. Further, if section 163(l)(3)(A) applied to the facts of the PLR, arguably the same principle could apply to any intercompany debt since a parent company, by virtue of its sole shareholding, always has the right inherent in its related party status to capitalize the debt and cause it to be converted into equity. Clearly, section 163(l) was not intended to reach *that* result.

One related question noted, but not addressed, by the PLR is whether section 163(l) should apply at all to a convertible note held by a sole shareholder. Specifically, as noted in PLR 201517003, since Parent already owned all of Taxpayer's equity through Company 1, the conversion of the debt to Taxpayer equity would have little if any economic significance. In fact, in other contexts, the IRS has treated the issuance or surrender of stock as a "meaningless gesture" where the parent remained the sole shareholder in all events.[3]

On the other hand, other lines of authority have generally respected the rights and entitlements of different instruments issued by a subsidiary to its sole shareholder. Under § 165(g)(3), the Tax Court held in *HK Porter & Co. v. Commissioner*, 87 T.C. 689 (1986), that a parent company's common stock in a liquidated subsidiary was worthless because all proceeds were payable with respect to its preferred. In rejecting the IRS's argument that the sole shareholder's preferred stock had no economic substance, the court stressed that the preference was "not 'illusory' or part of a financial facade constructed of shuffled papers." *Id.* at 697. *See also Commissioner v. Spaulding Bakeries*, 252 F.2d 693 (2d Cir. 1958). Similarly, in calculating cancellation of indebtedness income, the IRS has respected a sole subsidiary's issuance or non-issuance of shares with respect to a capitalized loan as determining whether § 108(e)(6) or § 108(e)(8) applies to the transaction. *See, e.g.*, PLR 201016048. These authorities would suggest that it would be necessary to test a related party convertible debt under § 163(l).

Thus, a foreign parent company structuring an intercompany debt financing should consider § 163(l) and its implications for interest deductibility wherever the debt is convertible or has other equity-linked features. If not properly structured, such a conversion feature could put the U.S. subsidiary's interest deduction at risk. It also should be recalled that, in applying the test in the legislative history as of the "issue date" of an instrument, an instrument that is significantly modified under Treas. Reg. § 1.1001-3 is treated as reissued for U.S. tax purposes. Thus, certain modifications of a subsidiary's debt, such as a significant extension of the payment date, could necessitate a new § 163(l) analysis.

Finally, the Obama administration's 2015 and 2016 "Greenbooks" have included a proposal to disallow a U.S. tax deduction for interest expense arising from certain "hybrid arrangements."[4] According to the 2016 Greenbook, the proposed rule would apply primarily where the hybrid payments are deductible in the U.S. and "there is no corresponding inclusion to the recipient in the foreign jurisdiction."[5] In PLR 201517003, the Taxpayer obtained a tax benefit not from the lack of an income inclusion in the foreign jurisdiction, but from the hybrid character of the transaction (capital

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3 *See, e.g.*, Rev. Rul. 81-3, 1981-1 C.B. 125. *See also* § 367(c)(2); Treas. Reg. § 1.368-2(l).

4 *See* Obama 2016 Greenbook, at pp. 35-36, proposal to "Restrict the Use of Hybrid Arrangements that Create Stateless Income."

5 *See id.*

gain to the holder and ordinary deduction to the issuer), which allowed the utilization of Parent's [Parent and Company 1's] home-country tax attributes (capital loss carry-forwards). This differs significantly from deduction / no income inclusion result at which the Greenbook and other recent anti-hybrid proposals have been primarily addressed.[6]

6 Namely, the OECD's BEPS Project's Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements.

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