

United States

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Coupling call-spreads and convertibles

The Internal Revenue Service (IRS) recently issued a favourable advice memorandum (the AM) on the treatment of convertible bond call spreads. The AM finds that an issuer can couple a call spread with a convertible bond to create additional original issue discount (OID) deductions, in effect sanctioning such transactions on terms that resemble, to a large degree, offerings seen in the market over the last five years.

The AM involves a classic call spread. A corporation (X) issued zero-coupon five-year notes with an issue price and face amount of \$1000. The note holders could convert each note into a fixed number of shares of X common stock (conversion shares). There was a significant conversion premium. X bought a hedge from a bank, an affiliate of the note underwriter, on the note issue date. Each hedge entitled X to purchase X common stock equal to the conversion shares at a strike price equal to the conversion price. The hedges were automatically exercisable as the corresponding notes were converted and were settled in the same fashion as the notes and expired on the note maturity date. X paid the bank a premium for the hedge based on its fair market value. In addition, X sold one warrant for each \$1000 note to bank. Each warrant entitled bank to purchase a number of shares of X stock equal to the number of conversion shares at a strike price significantly greater than the hedge strike price. The warrants were European style and could only be cash settled or net-share settled. The warrants expired several months after the note maturity date.

According to the AM, X entered into the transaction rather than issue convertible notes with a higher conversion price because it believed there was a deeper market for convertible notes with the actual conversion price. However, X wanted to avoid potential dilution that the lower conversion price would bring.

For tax purposes X integrated the notes with the hedges but not with the warrants under Regulation § 1.1275-6. This produces a synthetic debt instrument with an issue price equal to the note issue price

less the hedge premium, resulting in deductible original issue discount for X equal to the hedge premium.

Applying the various requirements for integration under Regulation § 1.1275-6, the AM holds that X should be permitted to integrate the note with the hedges. In particular, based on X's representations that it was significantly more likely than not that the holders of the notes would not convert the notes before the maturity date, the AM found that a yield to maturity could be calculated for the integrated position based on a schedule in which the note's stated principal amount was paid at maturity. The AM also holds that the hedges and the warrants should be treated as two separate instruments for federal income tax purposes. The AM reasons that X could separately transfer the hedges and retain the warrants and that bank could sell the warrants and retain its hedge position. It notes that X was not economically compelled to hold both the hedges and its position in the warrants. Also, the warrants expired several months later than the hedges. The AM states that the hedges and the warrants should not be treated as a single instrument merely because X bought or sold them in the same transaction. Finally, the AM holds that the OID anti-abuse rule does not apply to disallow integration because the issuer could have issued non-convertible discount notes and warrants with the same tax treatment.

The AM limits its conclusion to cases where hedges and warrants are priced at fair market value and where the premium paid for the hedges is meaningfully greater than the premium received for the warrants.

On the whole, taxpayers are likely to view the AM favourably. However, they will want to parse its requirements to determine precisely how to structure future deals. Taxpayers will want to maintain fidelity with the facts of the AM to the greatest extent possible. Also, taxpayers will want to know what facts are necessary to conclude that it is significantly more likely than not that holders will not convert their bonds before maturity, or to otherwise get comfortable that a yield properly can be calculated for the integrated position.

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