Office of Chief Counsel
Internal Revenue Service
memorandum

Number: **201651014**
Release Date: 12/16/2016

CC:FIP:B03: ADubert
PREF-113527-16

UILC: 162.00-00, 446.11-04

date: August 30, 2016

to: Associate Area Counsel (South Florida)
Large Business & International Division

from: Helen Hubbard
Associate Chief Counsel
(Financial Institutions and Products)

---

subject: , PREF-113527-16
Unamortized Debt Issuance Costs

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Year 1 =
Year 2 =
Year 3 =

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =

Interest Rate =

ISSUE

What is the proper treatment of unamortized debt issuance costs for convertible debentures upon the conversion of the debentures into warrants exercisable into the issuer's common stock?

CONCLUSION

Under Rev. Rul. 72-348, 1972-2 C.B. 97, and the cases cited therein, upon the conversion of the debentures into stock, the unamortized debt issuance costs assume the character of a capital expenditure in connection with the issuance of the stock. In this case, the debentures were converted into warrants, the exercise price of the warrants is a nominal sum, and the warrants are treated as stock. Accordingly, the issuer is not entitled to deduct its remaining unamortized debt issuance costs in the taxable year of the conversion.

FACTS

In Year 1, Taxpayer issued Amount 1 Interest Rate convertible debentures due in Year 2 ("Debentures"). At issuance, Taxpayer incurred debt issuance costs, which it capitalized and amortized on a yearly basis over the term of the Debentures. In Year 3, per the terms of the Debentures, the holder ("Holder") exercised its right to convert the Debentures into Taxpayer's warrants exercisable into Taxpayer's common stock ("Warrants"). The exercise price of the Warrants is a nominal sum, Amount 2 per share. Taxpayer paid Holder a cash incentive fee of Amount 3. At the time of the conversion, the unamortized balance of debt issuance costs was approximately Amount 4 ("Costs"), all of which Taxpayer seeks to deduct in the taxable year of the conversion.

LAW AND ANALYSIS

Section 162 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, certain expenses are required to be capitalized under § 263(a). Under § 1.263(a)-5(a)(9) of the Income Tax Regulations, debt issuance costs generally are required to be capitalized. Capitalized debt issuance costs are amortized over the term of a loan. See Enoch v. Comm'r, 57 T.C. 781 (1972); § 1.446-5, discussed infra; § 162(a).

Rev. Rul. 72-348, 1972-2 C.B. 97, addresses, inter alia, the tax treatment of unamortized bond expense when an issuer's bonds are converted into capital stock of the issuer. Under the facts of the ruling, the taxpayer incurred costs for commissions and miscellaneous expenses upon the issuance of convertible debt. The ruling provides:

> The bond expense was incurred in connection with the issuance of the bonds. Upon the conversion of each bond into stock, there was clearly no loss suffered by the taxpayer as a result of the transaction. It was purely a capital transaction. Its obligation to convert the bonds into stock was

> incurred when the bonds, with respect to which the expense in question was incurred, were issued. For amortization purposes, the issuance of the bonds is not a separate and distinct transaction from the conversion of the bond to stock and from the time of conversion any expense incurred in connection with the issuance of the original obligations should be treated as expense in connection with the issuance of stock of a corporation.

In support of these conclusions, the ruling cites Liquid Carbonic Corp. v. Comm'r, 34 B.T.A. 1191, 1196 (1936) ("[T]he conversion of bonds into capital stock of the obligor is purely a capital transaction; that is, a readjustment of the obligor's capital structure, which does not result in either a deductible loss or a taxable gain."); Chicago, Rock Island & Pacific Railway Co. v. Comm'r, 13 B.T.A. 988, 1036 (1928) ("[The issuer] exchanged its stock for its bonded liability. This was a purely capital transaction, which did not result in deductible loss or taxable gain."), aff'd in part, rev'd in part, 47 F.2d 990, cert. denied, 284 U.S. 618 (1931); Chicago, Milwaukee, St. Paul and Pacific Railroad Co. v. U.S, 404 F.2d 960, 967 (1968) (holding upon the exchange of the company's bonds for the company's stock in a bankruptcy reorganization, unamortized debt issuance costs attributable to the issuance of the bonds were no longer deductible).

Rev. Rul. 72-348 further provides that expenses paid in connection with the issuance of stock in a corporation are not deductible as ordinary or necessary expenses of carrying on a business. Rather, such expenses are regarded as capital expenditures. Rev. Rul. 72-348 (citing Emerson Electric Manufacturing Co. v. Comm'r, 3 B.T.A. 932 (1926), and Simmons Co. v. Comm'r, 8 B.T.A. 631 (1927), aff'd, 33 F.2d 75 (1st Cir. 1929)).

Based on the authorities above, Rev. Rul. 72-348 concludes:

> [U]pon the conversion of the bonds into stock the unamortized bond expense at that date assumes the character of a capital expenditure under section 263 of the Code in connection with the issuance of the stock into which the bonds were converted and is not deductible by the taxpayer.

The Warrants afforded Holder the right to purchase Taxpayer's common stock for Amount 2 per share, a nominal sum. The nominal purchase price guaranteed that Holder would exercise the right to acquire the stock under all reasonable scenarios. Accordingly, Rev. Rul. 72-348 applies to the conversion because the Warrants are treated as stock. See Rev. Rul. 82-150, 1982-2 C.B. 110.

Taxpayer argues that it is entitled to deduct the remaining unamortized Costs in the taxable year in which the conversion took place on the grounds that Rev. Rul. 72-348 is obsolete following Congress' enactment of § 108(e)(8). Taxpayer asserts that, under current law, the retirement of debt for stock is treated the same way as a retirement for cash.

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness ("COD income"). Section 108 provides additional rules for determining the amount of COD income an issuer must recognize. Section 108(b) requires certain debtors to reduce certain tax attributes in an amount equal to the excluded amount of COD income.

Before 1980, courts had formulated an exception to the inclusion of COD income or reduction in the debtor's tax attributes if the debtor exchanged its stock for its indebtedness ("stock-for-debt exception").[1] Beginning with the Bankruptcy Tax Act of 1980, however, the stock-for-debt exception was progressively limited by statute until its repeal by the Revenue Reconciliation Act of 1993. The Tax Reform Act of 1984, which added §108(e)(8) (formerly §108(e)(10)(A)), provided a general rule that when stock was issued for debt, the debtor would be treated as having satisfied the debt with an amount of money equal to the fair market value of the stock. In other words, as a general rule, there would be no stock-for-debt exception. However, an exception (formerly §108(e)(10)(B)) was also added providing for a stock-for-debt exception when the debtor was insolvent. The Revenue Reconciliation Act of 1993 repealed the stock-for-debt exception effective generally with respect to stock transferred after 1994 in satisfaction of any indebtedness.

Section 108(e), as evidenced by § 108(e)(1) and (e)(8), sets parameters around the exception set forth in § 108(a) that gross income does not include COD income in certain circumstances. Taxpayer is generally correct that the repeal of the stock-for-debt exception results in section 108 treating a debt repurchase, including a conversion, as a cash retirement equal to the fair market value of the stock. What Taxpayer fails to acknowledge is that § 108(e)(8) applies only in specified circumstances. The introductory language to § 108(e)(8) makes clear that the scope of the provision is limited to "determining income of a debtor corporation from discharge of indebtedness."[2]

Had Congress intended, with the repeal of the stock-for-debt exception, to overturn Rev. Rul. 72-348 or to cause stock-for-debt exchanges to be treated as cash retirements for all purposes of the Code, Congress would have said so explicitly in the statute. See CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987).

Taxpayer asserts that, under current law, the retirement of debt for stock is treated the same way as a retirement for cash. In Taxpayer's view, the tax treatment of unamortized debt issuance costs should be the same whether the debt is retired with

[1] See e.g., Comm'r v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946), acq., 1947-1 C.B. 3; Comm'r v. Capento Securities Corp., 140 F. 2d 382 (1st Cir. 1944); Alcazar Hotel Inc. v. Comm'r, 1 T.C. 872 (1943).

[2] Section 108(e)(8) provides: "*For purposes of determining income of a debtor from discharge of indebtedness*, if . . . a debtor corporation transfers stock . . . to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation . . . shall be treated as having satisfied the indebtedness with the amount of money equal to the fair market value of the stock . . . [emphasis added].

cash or with equity of the issuer. Accordingly, Taxpayer asserts that it should be entitled to a current deduction for the remaining Costs.

As support for this position, Taxpayer points to the 1997 amendment to § 1.61-12(c)(2)(i), which amended the term "repurchase" to include the conversion of a debt instrument into stock of the issuer. Section 1.61-12(c)(2) provides, in pertinent part, that:

> (i) In general. An issuer does not realize gain or loss upon the repurchase of a debt instrument. . . . For purposes of paragraph (c)(2), the term "repurchase" includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under § 1001) of a newly issued debt instrument for an existing debt instrument.
>
> (ii) Repurchase at a discount. An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of § 1.1275-1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. See section 108 and the regulations thereunder for additional rules relating to income from discharge of indebtedness. . . .
>
> (iii) Repurchase at a premium. An issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price (within the meaning of § 1.1275-1(b)). See § 1.163-7(c) for the treatment of repurchase premium.

Taxpayer is generally correct that an issuer is entitled to a current deduction for unamortized debt issuance costs upon the retirement of its debt for cash. See Helvering v. California Oregon Power Co., 75 F.2d 644 (D.C. Cir. 1935); Helvering v. Central States Electric Corp., 76 F.2d 1011 (2d Cir. 1935) (per curiam); Helvering v. Union Public Service Co., 75 F.2d 723 (8th Cir. 1935). However, § 1.61-12(c)(2) does not equate a stock-for-debt exchange to a cash retirement of debt for all purposes of the Code.

We have found no reason to believe that Rev. Rul. 72-348 has been obsoleted by revisions to § 108 or by the amendments to § 1.61-12(c)(2)(i).

Lastly, Taxpayer makes an argument based on § 1.446-5, which was issued in 2003. Section 1.446-5 provides rules for allocating debt issuance costs over the term of the debt. In many cases, § 1.446-5 will require the issuer to allocate debt issuance costs as if the costs were OID subject to § 1.163-7. Taxpayer infers from this use of the rules in § 1.163-7 that any unamortized debt issuance costs at the time of a conversion

should be treated as if they were repurchase premium subject to § 1.163-7(c). However, § 1.446-5 applies only to debt issuance costs that are “otherwise deductible.” § 1.446-5(a).

Both stock issuance costs and debt issuance costs are capital expenditures. See § 1.263(a)-5(a)(8) and (9). However, debt issuance costs are amortizable whereas stock issuance costs are not. See Enoch v. Comm’r, 57 T.C. 781 (1972); McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981); Barbour Coal Co. v. Comm’r, 74 F.2d 163 (10th Cir. 1934); Affiliated Capital Corp. v. Comm’r, 88 T.C. 1157 (1987); Pacific Coast Biscuit Co. v. Comm’r, 32 B.T.A. 39 (1935), acq. in part, 1935-1 C.B. 15, non-acq. in part, 1935-1 C.B. 35, withdrawing non-acq.,1954-1 C.B. 6; Van Keuren v. Comm’r, 28 B.T.A. 480 (1933); Simmons Co. v. Comm’r, 8 B.T.A. 631 (1927), acq., 1928-2 C.B. 3, aff'd, 33 F.2d 75 (1st Cir. 1929); Appeal of Emerson Electric Manufacturing Co., 3 B.T.A. 932 (1926). Taxpayer’s argument would create a tax incentive to issue convertible debt and have a holder immediately convert into its stock rather than to issue the stock outright, which would be inconsistent with § 1.263(a)-5(a)(8).

Having found that Rev. Rul. 72-348 is still valid, we conclude that the principles therein are determinative to the facts here. The issuance of Taxpayer’s Debentures was not a separate and distinct transaction from the conversion of the Debentures into Warrants in accordance with the terms of the Debentures, and from the time of conversion, the remaining Costs assume the character of an expense in connection with the issuance of the Warrants. Accordingly, Taxpayer is not entitled to deduct its remaining Costs in the taxable year in which the Holder exercised its right under the conversion feature.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-6945 if you have any further questions.

By: ______________________________
Charles W. Culmer
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Financial Institutions & Products)