Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-128842-14

Date:
January 26, 2015

Taxpayer	=
Parent	=
Company 1	=
Company 2	=
Country 1	=
Country 1 Currency	=
Industries	=
Dollar Amount 1	=
Dollar Amount 2	=
Dollar Amount 3	=
Repayment Date	=
Default Event	=

Change of Control =

Initial FMV =

Factor =
Percentage 1 =

Dear :

This is in reply to a letter dated July 28, 2014, submitted on behalf of Taxpayer by its authorized representative. Taxpayer requests a ruling that for a debt instrument for which the holder has an option to convert the instrument into stock of the issuer, the issuer has no such option, and the issuer and the holder are related in a manner described in section 267(b), the instrument is a disqualified debt instrument under section 163(l) only if there is a substantial certainty the option will be exercised.

FACTS

Parent is the 100 percent owner of Company 1. Both Parent and Company 1 are incorporated in Country 1. Company 1 is the 100 percent owner of Taxpayer, and Taxpayer is the 100 percent owner of Company 2. Both Taxpayer and Company 2 are incorporated in the United States. Parent and its affiliated companies, including Taxpayer and Company 2, provide equipment and services to the Industries on a global basis.

Currently, Taxpayer owes Parent Dollar Amount 1, and Company 2 owes Parent Dollar Amount 2. Taxpayer intends to borrow from Parent the Country 1 Currency equivalent of approximately Dollar Amount 3. Taxpayer will issue to Parent a convertible debt instrument ("Convertible Note")[1] denominated in Country 1 Currency, with a stated principal amount equal to the amount advanced by Parent. Taxpayer plans to contribute to Company 2 Dollar Amount 2 of the Convertible Note proceeds, after which Company 2 will repay its Dollar Amount 2 debt to Parent. Taxpayer also intends to repay its existing Dollar Amount 1 debt to Parent, but Taxpayer has not yet decided whether this repayment will occur immediately after the issuance of the Convertible Note or at some later date.

Under the general terms of the Convertible Note, the stated principal amount is equal to the amount advanced by Parent, and the stated interest rate will be set at a market rate on the issue date. Taxpayer represents that the interest rate will exceed the Applicable Federal Rate in effect on the issue date. Stated interest will accrue monthly

[1] For convenience, we refer to the instrument issued by Taxpayer using the label Taxpayer has assigned to the contract. We express no opinion about whether the conversion feature is "payable in equity," as described in section 163(l)(2), when the party that can exercise the conversion feature already owns, directly or indirectly, 100% of the issuer.

but will not be paid until maturity. On the Repayment Date, Taxpayer must pay to Parent the stated principal amount plus all accrued stated interest ("Redemption Amount"). Taxpayer will make this payment in cash unless the Convertible Note is converted into shares of Taxpayer's stock.

Taxpayer must obtain Parent's consent if it wishes to satisfy the Convertible Note earlier than the Repayment Date. Parent generally may not put the Convertible Note back to Taxpayer before the Repayment Date. Parent may accelerate repayment by Taxpayer if either a Default Event or a Change of Control that dilutes the current ownership of Taxpayer occurs.

The terms of the Convertible Note permit Parent to convert some or all of the Redemption Amount into Taxpayer common stock that will be the same class as all other common shares issued and outstanding. The maximum number of shares subject to conversion will be determined on the issue date using the following formula:

$$number\ of\ shares = \frac{Redemption\ Amount}{Initial\ FMV\ \times\ Factor}$$

The number of shares that Parent is eligible to receive may be adjusted if certain organizational actions occur that would, without adjustment, dilute or concentrate Parent's potential ownership interest. The number of shares subject to the conversion feature will be adjusted to put Parent in the same position as if it had exercised the conversion feature immediately before the organizational action. The number of shares that Parent is eligible to receive also may be adjusted if third parties subscribe to capital infusions or purchase convertible bonds, warrants or other similar instruments for less than the market price of the instruments on the date those instruments are issued. If the Taxpayer is liquidated or merged, Parent may require that the Redemption Amount be transferred to the receiving company on similar terms and conditions that will, to the extent possible, make the financial value of the Redemption Amount before and after the event correspond to one another. If Taxpayer distributes a dividend in excess of Percentage 1 of distributable profits, the terms of the conversion will be adjusted to put Parent in the same position as it would have been had the conversion occurred immediately before the dividend distribution. The number that Taxpayer proposes to use for Factor is greater than 1.0.

Taxpayer makes the following representations:

1) Under Country 1 tax laws, the portion of the Redemption Amount that exceeds the principal (i.e., the accrued but unpaid stated interest) is treated as capital gain regardless of whether Taxpayer delivers cash or shares. Parent and its Country 1 subsidiaries currently have the Country 1 equivalent of a capital loss carryforward that will be offset by the capital gain on the Convertible Note.

2) Conversion by Parent would conserve Taxpayer's cash flow and would create a lower cost of borrowing for Taxpayer.
3) The relationship between Parent and Taxpayer is described by section 267(b).
4) Other than the terms described in the Convertible Note, Taxpayer and Parent do not have any other agreements or understandings regarding payment of the Convertible Note or exercise of the conversion feature.
5) Parent will exercise the conversion feature only if the value of the stock to be received exceeds the Redemption Amount.
6) Taxpayer understands that because interest will not be paid currently in cash, the stated interest on the Convertible Note is original issue discount ("OID"), and the OID is not deductible under section 163(e)(3) until the Taxpayer delivers either cash or shares to repay the Redemption Amount.

LAW AND ANALYSIS

Section 163(l)(1) provides that no deduction shall be allowed for any interest paid or accrued on a disqualified debt instrument. Section 163(l)(2) provides that the term "disqualified instrument" means any indebtedness of a corporation that is payable in equity of the issuer or a related party or equity held by the issuer (or any related party) in any other person. Section 163(l)(3) prescribes several sets of circumstances in which a debt instrument shall be treated as payable in equity of the issuer or any other person.

Section 163(l)(3)(A) provides that a debt instrument shall be treated as payable in equity of the issuer or any other person if 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, such equity. The flush language that ends section 163(l)(3) further provides: "For purposes of this paragraph, principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised." This flush language is very similar to explanatory language from the legislative history for section 163(l).

The legislative history that accompanied the enactment of section 163(l)(3) states clearly that Congress was "concerned that corporate taxpayers may issue instruments denominated as debt but that more closely resemble equity transactions for which an interest deduction is not appropriate." See H.R. Rep. No. 105-148, at 457 (1997). The report explained:

> An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as . . . certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. For example, it is not expected that the provision will affect debt with a conversion

feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt.

Ibid. at 458 and H.R. Rep. No. 105-220, at 524 (1997). Congress did not provide an explanation or example of when a conversion price is treated as being "significantly higher" than the market price.

Section 163(l)(3)(A) and the flush language to section 163(l)(3) both prescribe conditions that can be satisfied by a convertible debt instrument for which the holder is related to the issuer. On one hand, section 163(l)(3)(A) can be satisfied because a substantial amount of the principal or interest on the instrument is convertible into equity of the issuer at the option of a related party (the holder). On the other hand, the flush language can be satisfied if a substantial amount of the principal or interest on the instrument is required to be converted into equity of the issuer at the option of the holder, but only if there is a substantial certainty the option will be exercised. It is not clear whether it is section 163(l)(3)(A) or the flush language to section 163(l)(3) that should be used to determine whether the instrument is payable in the equity of the issuer.

Congress did not explicitly address the case of a convertible debt instrument for which the issuer and the holder are related. Such an instrument satisfies the condition in section 163(l)(3)(A) because of an unaddressed possibility: the related party with the option to convert is the holder. On the other hand, the instrument satisfies the condition in the flush language to section 163(l)(3) apart from the "substantial certainty" clause in the way Congress addressed: by virtue of being a convertible debt instrument. This analysis suggests that a determination that the instrument is a disqualified debt instrument under section 163(l) should require that there be a substantial certainty the option will be exercised

In some obvious cases that satisfy the condition in section 163(l)(3)(A), the issuer or a related party different from the holder has an option to convert the convertible debt instrument into equity of the issuer. In these cases, the issuer, by itself or with the cooperation of the related party, can convert the instrument into its own equity without the consent of the holder. In the case under discussion in this letter, the only party with an option to convert the instrument into equity of the issuer is the holder, and the holder indirectly owns 100 percent of the issuer. These differences also suggest that a determination that the instrument is a disqualified debt instrument under section 163(l) should require that there be a substantial certainty the option will be exercised.

The conclusions above are confirmed by previously quoted language from the legislative history: "For example, it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt." H.R. Rep. No. 105-220, at 524 (1997). The flush language indicates that a convertible debt instrument should be treated as

payable in equity when there is a substantial certainty that the holder will end up with equity. This appears to indicate a Congressional preference for treating convertible debt instruments as valid debt in most cases, and the holder is not presumed to receive equity unless it is substantially certain that the holder will in fact receive equity. Based upon this Congressional preference, we believe it is appropriate in this case to read the language of section 163(l)(3)(A) in conjunction with the flush language at the end of section 163(l)(3).

CONCLUSION

Based solely upon the information submitted and the representations made, we conclude that for the Convertible Note, for which the holder has an option to convert the instrument into stock of the issuer, the issuer has no such option, and the issuer and the holder are related in a manner described in section 267(b), the note is a disqualified debt instrument under section 163(l) only if there is a substantial certainty the option will be exercised.

Except as specifically set forth above, no opinion is expressed or implied concerning the tax consequences of any aspect of the Convertible Note or any item discussed or referenced in this letter. In particular, we express no opinion whether the facts provided by Taxpayer indicate that there is substantial certainty that Parent will exercise the conversion feature of the Convertible Note. We further express no opinion whether the amount described in the Factor is “significantly higher” than the market price of the stock on the issue date, as described in the legislative history of section 163(l)(3).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the terms of a power of attorney on file in this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Charles W. Culmer
Senior Technician Reviewer, Branch 3
(Financial Institutions & Products)