Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:
Financial Products Specialist

from: Bernard Audet
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subject: Application of Sections 1.263(a)-4 and -5 to Consent Payment

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views. This memorandum may not be used or cited as precedent.

This memorandum responds to your request for assistance. This memorandum relies solely upon the facts you have provided. If any facts have changed, or if we have misstated any facts, our analysis may change. In such case, please contact this office for our views.

I. ISSUE

Whether a payment (the "Consent Payment") made by ("Company,") to noteholders (the "Holders") owning percent of the aggregate outstanding principal amount of Company's Notes Due (the "Notes") to induce the Holders to consent to amendments to the Notes' indenture (the "Indenture") was a capital expenditure subject to capitalization under sections[1] 1.263(a)-4 or -5.

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[1] All "section" or "§" references are to the Internal Revenue Code of 1986, as amended, and to the regulations promulgated thereunder, unless otherwise noted.

II. CONCLUSION

The Consent Payment was a payment on the Notes for purposes of section 1.1275-2(a).[2] Section 1.1275-2(a), addressing payments on debt instruments with original issue discount ("OID"), supersedes sections 1.263(a)-4 and -5 in this case.[3] The Consent Payment was first a payment of OID that had accrued on the Notes but had not been allocated to prior payments, and second a payment of principal.

III. FACTS

a. Background

b. The Notes

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2 [redacted]

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c. The Agreement and Plan of Merger

d. The Consent Solicitation

e. <u>Subsequent Events and Tax Reporting</u>

IV. <u>LAW AND ANALYSIS</u>

a. <u>Authorities</u>

1. General Capitalization Principles

Taxpayers may deduct all ordinary and necessary expenses paid or incurred during the taxable year in the carrying on of a trade or business or an activity engaged in for profit. §§ 162(a), 212. Corporations may not deduct amounts paid or incurred in connection with the reacquisition of stock, though this prohibition does not apply to amounts deductible as interest. §§ 162(k)(1), (2)(A)(i).

Taxpayers may not deduct capital expenditures, which are amounts paid out for new property, or for permanent improvements made to increase the value of any property or estate. § 263(a)(1).

2. Costs to Facilitate the Acquisition of a Trade or Business, a Change in Capital Structure, and Certain Other Transactions Under Section 1.263(a)-5

Capital expenditures include amounts paid[4] to facilitate a restructuring, recapitalization, or reorganization of the capital structure of a business entity, as well as amounts paid to facilitate a borrowing. § 1.263(a)-5(a)(4). A borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a reorganization. § 1.263(a)-5(a)(9).

For these purposes, an amount facilitates a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. § 1.263(a)-5(b)(1). Whether an amount facilitates a transaction depends on all facts and circumstances. Id. The fact that an amount would (or would not) have been paid but for the transaction is relevant, but not determinative. Id.

Section 1.263(a)-5 does not change the treatment of any amount specifically provided for under any other provision of the Code and regulations (except for sections 162 and 212). § 1.263(a)-5(j). Section 1.263(a)-5 applies to amounts paid or incurred on or after December 31, 2003. § 1.263(a)-5(m).

3. Costs to Facilitate the Acquisition or Creation of Intangibles Under Section 1.263(a)-4

Capital expenditures also include amounts paid[5] to another party to facilitate the acquisition, creation, origination, renewal, or renegotiation of intangibles. §§ 1.263(a)-4(a), (d)(2)(i). The definition of "facilitate" under section 1.263(a)-4 is the same as the one under section 1.263(a)-5, discussed above. § 1.263(a)-4(e)(1)(i). Intangibles include debt instruments. § 1.273(a)-4(d)(2)(i)(B).

Section 1.263(a)-4 does not change the treatment of any amount specifically provided for under any other provision of the Code and regulations (except for sections 162 and 212). § 1.263(a)-4(b)(4)(i). Section 1.263(a)-4 applies to amounts paid or incurred on or after December 31, 2003. § 1.263(a)-4(o).

4. Interest and Original Issue Discount

Section 163(a) allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 163(e) allows as a deduction in a taxable year the portion of a debt instrument's original issue discount ("OID") equal to the aggregate daily portions of the OID for the days of the taxable year.

OID is the excess of a debt instrument’s stated redemption price at maturity ("SRPM") over its issue price. § 1.1273-1(a). The SRPM is the sum of all payments provided by the debt instrument other than qualified stated interest ("QSI") payments. § 1.1273-1(b). QSI is stated

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[4] For accrual method taxpayers, substitute the word "accrued." See § 1.263(a)-5(h) (amounts are "paid" when liability is incurred).

[5] Again, substitute the word "accrued" for accrual method taxpayers. § 1.263(a)-4(j).

interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate. § 1.1273-1(c)(1)(i). The issue price of a debt instrument is generally the first price at which the issuer sells a substantial amount of the debt instruments for money, with exceptions not relevant here. § 1.1273-2(a)(1).

Accordingly, interest payable in kind for a given accounting period at the issuer's option is not QSI, regardless of whether the issuer exercises the option. See, e.g., § 1.1272-1(j) (Example 7). In the Example, an issuer sold a five-year note to a holder at par for $100,000. The note provided for five annual interest payments of $6,000. The note gave the issuer the unconditional right to issue to the holder a second debt instrument (the "PIK instrument") in lieu of the first interest payment due on the note. The PIK instrument bore a principal amount of $6,000, and had the same maturity date as the note. The PIK instrument provided for four annual interest payments of $360. Under the payment schedule that would result if the issuer exercised the option, the Example concluded that no payments on the note would be QSI, and $6,000 of OID would accrue in the first accounting period. If the issuer did not exercise the option, $6,000 of OID would accrue during each accounting period.

5. Debt Modifications Under Section 1.1001-3

Section 1001 provides rules for the computation of gain and loss from the sale or other disposition of property. Such gain or loss is realized upon the exchange of property for other property differing materially in kind or in extent. Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 566 (1991).

The modification of a debt instrument constitutes an exchange under section 1001 if the modified debt instrument is materially different from the original. Rev. Rul. 89-122, 1989-2 C.B. 200. Section 1.1001-3 provides specific guidance on whether a modification of the terms of a debt instrument so materially alters the debt instrument that an exchange occurs for purposes of section 1001. A modification means any alteration, including any deletion or insertion, in whole or in part, of a legal right of obligation of the issuer or holder of a debt instrument, whether the alteration is evidenced by an express agreement, conduct of the parties, or otherwise. § 1.1001-3(c)(1)(i).

A significant modification of a debt instrument results in an exchange of the original debt instrument for a modified debt instrument that differs materially either in kind or in extent. § 1.1001-3(b).

Generally, a modification of a debt instrument is a significant modification if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered is economically significant. § 1.1001-3(e)(1). The regulations also deem significant modifications to occur in certain specific circumstances mostly not relevant here. See §§ 1.1001-3(e)(2)-(6) (addressing modifications to yield, timing of payments, obligor security, nature of debt, and certain customary accounting or financial covenants).

A change in the yield of certain[6] debt instruments is deemed to be a significant modification if the yield computed under subparagraph (e)(2)(iii) varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of (1) 25 basis points or (2) five percent of the annual yield of the unmodified instrument. § 1.1001-3(e)(2)(ii).

The yield computed under subparagraph (e)(2)(iii) is the annual yield of a debt instrument with (1) an issue price equal to the adjusted issue price[7] of the unmodified instrument on the date of the modification (increased by accrued by unpaid interest and decreased by any accrued issuance premium[8] not yet taken into account, and adjusted to reflect payments made to the issuer or to the holder as consideration for the modification); and (2) payments equal to the payments on the modified debt instrument from the date of the modification. § 1.1001-3(e)(2)(iii).

For example, a payment to an issuer to abstain from exercising a call right is a payment under the debt instrument that changes the instrument's yield for purposes of section 1.1001-3. See § 1.1001-3(g) (Example 1). This Example addressed a 30-year, fixed-rate bond that gave the issuer the option to call the bond at 102 percent of face value after ten years. At the end of the eighth year, the holder paid the issuer to waive its call right. As the payment modified the bond (and its yield), the Example concluded that the modification would have to be tested for significance under section 1.1001-3(e)(2)(ii).

Section 1.1001-3 as discussed herein (except for the Example discussed above[9]) is effective for modifications to debt instruments occurring on or after September 24, 1996, though taxpayers may rely on it for modifications occurring after December 2, 1992. § 1.1001-3(h).

6. Payment Ordering Rules for Debt Instruments with OID Under Section 1.1275-2

Sections 1.446-2 and 1.1275-2 govern the tax accounting of interest. Subject to exceptions, each payment under a debt instrument is treated first as a payment of accrued but unpaid interest, and second as a payment of principal. § 1.446-2(e)(1). Section 1.446-2 applies to debt instruments issued on or after April 4, 1994. § 1.446-2(j).

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[6] The yield-based bright-line test applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to section 1.1272-1(c), debt instruments that provide for a fixed yield subject to section 1.1272-1(d) (such as certain demand loans), and variable rate debt instruments. § 1.1001-3(e)(2)(i). Whether a change in the yield of other debt instruments is a significant modification is determined under the general rule of section 1.1001-3(e)(1). Id.

[7] The adjusted issue price at the beginning of the first accrual period is the issue price. § 1.1275-1(b)(1). Thereafter, the adjusted issue price is the issue price of the debt instrument (1) increased by the amount of OID previously includable in the gross income of any holder; and (2) decreased by the amount of any payment previously made on the debt instrument other than a payment of QSI. Id.

[8] Issuance premium is the excess of the issue price of a debt instrument over its stated redemption price at maturity. § 1.163-13(c).

[9] Section 1.1001-3(g) (Example 1) applies to modifications occurring on or after July 6, 2011.

Section 1.446-2 does not apply to income and deductions taken into account as OID. § 1.446-2(a)(2)(i)(A). To the extent a debt instrument has accrued but unpaid OID, each payment is treated first as OID to the extent accrued and not allocated to prior payments, and second as principal. § 1.1275-2(a)(1). Section 1.1275-2(a)(1) has the same effective date as section 1.446-2. T.D. 8517, 59 Fed. Reg. 4799 (Feb. 2, 1994).

7. Caselaw

A. Woodward v. Comm'r

In Woodward, the Court held that expenses incurred by majority shareholders in appraisal litigation were capital expenditures because the expenditures had their origin in a stock purchase transaction. 397 U.S. 572 (1970). The taxpayers in Woodward held or controlled a majority of the shares of common stock of a telegraph company. Id. at 573. In 1960, the taxpayers became legally obligated to purchase the stock held by a minority shareholder. Id. The taxpayers could not agree on a value with the minority shareholder, and so brought an appraisal action in state court to determine the value of the minority holder's shares. Id. The taxpayers incurred over $25,000 in legal, accounting, and appraisal fees in connection with the court proceeding, which they currently deducted on their 1963 federal income tax returns as ordinary and necessary business expenses paid for the management or conservation of property held for the production of income. Id.

The Service determined that the fees represented capital expenditures incurred in connection with the acquisition of stock. 397 U.S. at 574. After examining the origin and character of the state court appraisal litigation, the Court sustained the Service's determination. Id. at 578. The Court reasoned that, where property is acquired by purchase, establishment of a purchase price is an integral part to the purchase transaction. Id. Therefore, the expenses of the appraisal litigation were properly treated as part of the purchase price of the minority holder's shares. Id. at 579.

B. Denver & Salt Lake Ry. Co. v. Comm'r

In Denver & Salt Lake, the court held that consent payments made to bondholders to secure consents to participate in a 1946 corporate reorganization were nondeductible reorganization costs, rather than ordinary and necessary business expenses. 24 T.C. 709, 718-19 (1955). The taxpayer in Denver & Salt Lake was the subsidiary of a corporation undergoing a bankruptcy reorganization. Id. at 714. The final, court-approved plan of reorganization presented two alternative options to the taxpayer: to not participate in the reorganization; or to merge into its parent, cancel its outstanding bonds, issue new bonds with a later maturity date and a lower interest rate, and receive from its parent any taxpayer-issued bonds held by its parent. Id. at 714. In order for the taxpayer to participate in the reorganization, it would have had to secure the consent to amendments to its bond indentures from at least 90 percent of its bondholders. Id.

Participation being to its financial advantage, the taxpayer chose to participate in its parent's reorganization. 24 T.C. at 715. To secure the necessary consents, the taxpayer enlisted two firms to distribute promotional materials, contact the bondholders, and obtain affirmative ballots. Id. at 715. The taxpayer incurred $11,3656.21 in direct and indirect costs related to securing the consents, which it deducted as an ordinary and necessary business expense on its 1946 return. Id. at 716. The Service disallowed the deduction on the ground that the expenses were capital in nature and connected to a reorganization. Id.

Holding for the Service, the court determined that the taxpayer incurred the costs to secure the bondholders' consent in anticipation of and as an integral part to the reorganization. Id. at 719. The court noted that any advantages accruing to the taxpayer from the amendments to the indentures were contingent upon the reorganization's occurrence, and that the reorganization could not occur without the amendments to the indentures. 24 T.C. at 719. As the expenses were inextricably intertwined with the plan of reorganization and petitioner's participation in it, the expenses were capital expenditures incurred in connection with the reorganization. Id.

8. Administrative Practice[10]

A. PLR 201431003

In PLR 201431003, the Service determined that section 1.1001-3 applied to a payment made to noteholders to secure their consent to a tax-free spinoff. The taxpayer's wholly-owned subsidiary had issued several series of publicly traded contingent payment debt instruments pursuant to an indenture. The indenture contained a provision (the "successor provision") that prohibited the taxpayer from transferring substantially all of its assets unless the transferee entity assumed the taxpayer's obligations under the indenture.

The taxpayer planned to contribute businesses and assets owned by its subsidiary to a new corporation, the stock of which the subsidiary would then distribute to the taxpayer in a tax-free reorganization transaction. Prior to an earlier such spinoff, the subsidiary's noteholders had sued the taxpayer over whether the earlier spinoff would have violated the successor provision. Though the taxpayer eventually prevailed in the litigation, the dispute was costly to the taxpayer and delayed the earlier spinoff. Taxpayer believed that a similar dispute could arise in connection with the spinoff at issue, though it also believed the dispute would be without merit. In order to avoid the potential delay and cost associated with such litigation, the taxpayer decided to make a one-time cash payment to its noteholders that would modify the successor provision to allow the spinoff to proceed.

The Service determined that the consent payment was a payment on the subsidiary's notes, and so addressed the payment's tax treatment under section 1.1001-3. The Service determined that the payment modified the indenture because, as an amount to which the noteholders had not been previously entitled, it altered the legal rights and obligations of the

[10] PLRs and TAMs cannot be used or cited as precedent. § 6110(j)(3).

holders and the issuer of the notes. § 1.1001-3(c)(1)(i). Additionally, the Service noted that the payment changed the yield on the notes, and would have to be tested for significance under section 1.1001-3(e)(1).[11] Thus, even though the consent payment removed a potential impediment to the taxpayer's proposed spinoff, the Service evaluated the consent payment under section 1.1001-3 as a payment under a debt instrument.

B. PLR 201105016

In PLR 201105016, the Service determined that section 1.446-2 superseded section 263 in governing the treatment of a consent payment made to noteholders to secure consent to a business restructuring.[12] The taxpayer contributed certain of its businesses to a limited partnership in exchange for cash and limited partnership units. The restructuring was conditioned on the closing of a tender offer to repurchase certain of the taxpayer's outstanding notes. The letter ruling does not state that the restructuring was conditioned on any amendment to the note indentures.

The taxpayer then announced a tender offer and consent solicitation/payment to obtain the noteholders' consent to amend the note indentures. The consent solicitation offered a payment to the noteholders in exchange for their consent to amendments to the indentures that clarified that certain covenants would not apply to the proposed reorganization. The offer and solicitation were conditioned on the taxpayer obtaining a sufficient number of consents to amend the indentures, and the amendment of the indentures. Although the taxpayer believed it could have completed the reorganization without amending the indentures, it engaged in the consent solicitation to eliminate any uncertainty in that regard.

Despite the fact that the consent payment secured indenture amendments that removed uncertainty from a reorganization, the Service ruled that the consent payment, as consideration for the modification of the indentures, should be treated as a payment on the notes under section 1.1001-3(e)(2)(iii). See § 1.1001-3(e)(2)(iii) (payment to issuer or holder as consideration for modifying debt instrument must be taken into account when calculating change in yield); see also § 1.1001-3(g) (Example 1) (same, for payment to issuer in exchange for waiver of call option). The Service also ruled that section 1.446-2 applied to treat the consent payment first as a payment of accrued but unpaid interest, and second as a payment of principal. Notably, the Service expressly determined that section 1.446-2 superseded section 263 in governing the treatment of the consent payment. See §§ 1.263(a)-4(b)(4), 1.263(a)-5(j).

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[11] The debt instruments were contingent payment notes; therefore, modifications to their yield were subject to the general significance test of section 1.1001-3(e)(1), rather than the bright-line yield significance test of section 1.1001-3(e)(2).

[12] In its ruling request, the taxpayer sought rulings that (1) the premium, if any, that it paid as a result of repurchasing its notes would be deductible in the year of repurchase under section 1.163-7; and (2) the consent payments it made to the noteholders would be treated first as the payment of accrued but unpaid interest, and second as the payment of principal, under section 1.446-2.

C. TAM 9641001[13]

In TAM 9641001, the Service addressed the deductibility of expenses incurred in connection with a consent solicitation and debt tender offer. The taxpayer, the parent of a controlled group including corporations W, X, and Y, engaged in the following reorganization:

1. W acquired all equity interests in X.

2. X acquired all equity interests in Y that it did not own prior to the reorganization. In this transaction, X set up an acquisition subsidiary, S, to acquire the Class B common stock of Y held by Z. S then merged into Y, and Y survived. Y used proceeds from loans and debenture issuances to acquire its Class B common stock held by Z.

Prior to the reorganization, Y had issued two series of bonds. The bond indentures contained a covenant that prohibited Y from making any payments to redeem, purchase, or acquire its capital stock. Y, therefore, had to secure the consent of its bondholders to amend the indentures to permit the reorganization. To induce the bondholders to consent to the proposed amendments, Y made a tender offer and consent solicitation. The reorganization was expressly conditioned on Y's obtaining of sufficient consents to amend its indentures, and the debt tender offer was expressly conditioned on the consummation of the reorganization.

In connection with the above-described transactions, Y incurred costs (1) to obtain the bondholders' consent to the proposed amendments; and (2) to repurchase its outstanding bonds pursuant to the tender offer (i.e., repurchase premiums). Y currently deducted the expenses on its return. Exam disallowed the deductions on the ground that the expenses were nondeductible capital expenditures under section 263.

The Service determined that the consent payment was a nondeductible capital expenditure because the payment had its origin in Y's redemption of its common stock, and was inextricably tied to the reorganization. The Service applied the origin of the claim test of Woodward to conclude that the consent payment, as necessary to secure amendments to enable Y's redemption of its Class B common stock, had its origin in the acquisition of a capital asset, the Class B common stock. Alternatively, the Service concluded that, under Denver & Salt Lake, the consent payment was inextricably tied to the reorganization because the reorganization was expressly conditioned upon amendment of Y's indentures. Under either rationale, the Service determined that the consent payment was a nondeductible capital expenditure.

In contrast, the Service determined that the bond repurchase premium was deductible because it had its origin in preexisting debt obligations, rather than a capital transaction. The Service noted that the bond repurchases were not necessary to consummate the reorganization,

[13] TAM 9641001 addressed payments and transactions occurring before the current sections 1.263(a)-5 and 1.1001-3 came into effect. This TAM should not be relied upon when addressing the tax treatment of the Consent Payment. Moreover, the TAM is factually distinguishable, as discussed below. [redacted]

and so were not an integral part to the transaction. The Service noted that bond repurchase premiums, like prepayment penalties, were essentially compensation to the lender for the privilege of using the lender's money for a shorter period of time than originally intended. See General American Life Ins. Co. v. Comm'r, 25 T.C. 1265, 1267 (1956), acq. 1956-2 C.B. 5. Applying the origin of the claim test of Woodward, the Service determined that the repurchase premium originated in Y's debt obligation, and so was deductible as interest under section 163.

b. Analysis

As noted above, this memorandum relies on the facts you have provided. If any facts have changed, or if we have misstated any facts, then our analysis may change. In such case, please contact this office for our views.

Sincerely,

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Bernard Audet
Attorney (LB&I)