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TAXING CONVERTIBLE DEBT: A LAYMAN’S PERSPECTIVE

Edward D. Kleinbard*

I. INTRODUCTION

PROFESSOR Jeff Strnad’s new paper, Taxing Convertible Debt, is an ambitious and formal (in the academic sense) inquiry into the correct taxation of convertible debt. Professor Strnad’s paper first articulates the academic corporate finance theories explaining why corporations issue convertible debt, and then applies those theories to illuminate appropriate tax policy. Professor Strnad’s central hypothesis is that tax policy should function in aid of—or at least not be inconsistent with—the formal corporate finance functions served by convertible debt. Finally, Professor Strnad applies this principle to judge the merits of a legislative proposal made several years ago by the Clinton Administration to defer the deductibility of accrued original issue discount on discount convertible debt until and unless that debt is paid off in cash, rather than converted.

The editors of this journal were in a mischievous mood when they asked me to comment on Professor Strnad’s article. I admire (from a great distance) Professor Strnad’s extensive academic training, not only in tax law, but also in economics, corporate finance theory, and mathematics. I have neither training nor aptitude in any of the last three disciplines, and the decision to subtitle this brief comment as A Layman’s Perspective is, if anything, unduly self-flattering.

Of necessity, then, this comment does not tackle Professor Strnad’s ambitious analysis on its own terms; instead, I approach his paper from the perspective of a day laborer in the fields that Professor Strnad seeks to describe in academically formal terms. There is both merit and utility to formal academic work, but this comment is directed primarily to whether Professor Strnad’s analysis has practical utility—for example, in informing the Internal Revenue Service’s call for comments on how the tax rules for contingent and convertible instruments should intersect.2

This comment expresses some skepticism about the practical application of Professor Strnad’s conclusions. My principal concern, however, is both more general and more depressing: the gap between tax policy aca-

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demics and tax practice is too large, and probably growing larger. As a result, academic tax analysis often fails to resonate in the workaday world, and practitioners’ efforts (through bar associations as well as articles) to advance tax decision-making often repeat unexamined (and therefore unappreciated) economic error.

II. WHY CORPORATIONS ISSUE CONVERTIBLE DEBT

A. Corporate Finance Theory: Convertible Debt as Bad News Bonds

Professor Strnad devotes the largest section of his article to summarizing and analyzing modern corporate finance theory as to why corporations issue convertible debt. Strnad begins by postulating some “stylized” (what I would call “archetypal”) features of convertible debt. He concludes that convertible debt’s “call” features—in particular an issuer’s ability to effect a “soft call” (a practical forced conversion into equity) prior to maturity—is the key difference between convertible debt and bond-warrant units. Strnad then notes that issuers in fact delay exercising their “soft calls” when straightforward finance theory might suggest that they should (to take away from convertible bond-holders the implicit “put” right represented by their ability not to convert and to receive cash at maturity).

Strnad explains both the corporate decision to issue convertible debt and the decision of when to exercise a soft call through a sophisticated “signaling” theory. Under this theory, corporations issue straight debt when insiders feel their prospects are better than the market believes (i.e., they hoard their own equity as too cheaply valued). Strnad labels this scenario as the “good” case. Corporations issue equity when insiders feel that their stock is overvalued (the “awful” case). Finally, corporations issue convertible debt in in-between circumstances—what Strnad calls the “bad” case, but which might just as well have been called the “fair-to-middling” case.

Signaling theory suggests that the markets attach the meanings summarized in the preceding paragraph to corporate actions. For example, the market sees the issuance of new equity as a signaling by insiders of negative news, and as a result the stock of a corporate issuer trades down as a result of a new equity offering. As I understand the Strnad paper, signaling theory suggests that the attractions of convertible debt to an issuer are: first, that the signaling consequences of convertible debt are a more muted negative than the outright issuance of stock, and second, that the issuer in effect can control the timing of some of that negative signaling through its decision to defer its soft call.

Strnad reviews two other corporate finance theories that he finds helpful, but not as comprehensive, in explaining why corporations issue con-

4. See id. at 412-18.
vertible debt. The "risk-shifting" theory states, in effect, that "straight" debt encourages management to behave in risky ways, and that a convertible security mitigates that bias; making some of a creditor's compensation take the form of equity "upside" aligns creditors' interests to some extent with those of management, and therefore might be an efficient form of compensation. The "risk uncertainty" theory argues that sometimes even insiders are not omniscient, and that management can tailor the terms of convertible debt in such a manner as to share that uncertainty in an equitable manner with suppliers of capital. Both the risk-shifting and the risk uncertainty theorems thus view convertible debt as an efficient way of pricing risk, albeit from slightly different perspectives as to the nature of that risk.5

Strnad finds these last two theories to be not wrong, but incomplete. In particular, he argues that they do not explain the existence of the soft call that is ubiquitous in convertible debt, and therefore do not explain the preference of issuers for convertible debt over bond-warrant units. Strnad therefore concludes that flexibility in signaling is the key driver in explaining the popularity of convertible debt.6

B. THE PRACTICE OF CONVERTIBLE DEBT ISSUANCE

It is a truism, and by no means a criticism of Strnad's analysis, to observe that chief financial officers generally spend little time explicitly debating the formal "signaling" effects of different means of raising capital when making funding decisions; it is completely possible that they have intuitively internalized the signaling theorem into their decision-making. Nonetheless, Strnad's analysis can, I think, fairly be said to suffer from four deficiencies: first, it reads too much into commonplace market behavior; second, it understates the number of constituents who receive the signals in question; third, it ignores other critical archetypal features of convertible debt; and fourth, it analyzes a convertible bond market that by current standards is hopelessly quaint.

In practice, management's analysis of the world is, if anything, perfectly consistent with the signaling theorem, but in a cartoonish sort of way. The simple fact is that management always hates to issue equity, because management always believes that its virtues and prospects are underappreciated and undervalued by the market. (Those managers who in fact believe the opposite understand the signaling theorem well enough to pound the table even more loudly that they would never sell their own equity.)

Management's intransient bullishness on its own stock can be seen by looking for examples of S&P 500 companies (other than utilities, which through the rate-making process in effect get a specific cash incentive for issuing equity) that over the last few years have done non-IPO primary

5. See id. at 418-22.
6. See id. at 419, 422.
public offerings of their common stock for cash. Even through the recent historic bull market, there have been relatively few such offerings. From management’s perspective, the issuance of common stock is reserved for acquisitions and management compensation, and hardly ever for outright selling for cash.

If a non-IPO primary offering of common stock is rare, an issue of bond-warrant units is the corporate finance equivalent of sighting an ivory-billed woodpecker.7 I can think of only one or two such deals, in fact, over the last several years.8

More generally, to my knowledge there has never been a significant public market in long-term issuer warrants to purchase common stock.9 At best, one can say that warrants have sometimes been issued in acquisition contexts, and during the heyday of leveraged buyouts warrants were often used to induce lenders to buy into a risky transaction (where, as often as not, the warrants retained only sentimental value in the restructurings that followed).

To rely on a signaling game between issuer and the equity markets to explain convertible debt offerings thus might prove too little. A pragmatist’s alternative view of the world would be that corporations traditionally have issued convertible debt, not because they wanted to deliver a muted message to the equity markets, but because (i) they had no other viable public debt capital markets financing opportunities, (ii) they wanted to deliver a positive message to market constituents other than equity holders, or (iii) they wanted to take advantage of arbitrage opportunities. Each of these reasons is discussed briefly below.

The “proves too little” line of thinking relies on some “stylized” aspects of the public capital marketplace that Strnad’s paper ignores. First, the convertible bond market has been mostly a low-end investment grade market; top-rated firms do not generally issue coupon-bearing convertible debt.10 While it is true that this observation is not necessarily incon-

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7. Some commentators believe that the differences in accounting treatment for convertible bonds, on the one hand, and bond-warrant units, on the other (higher interest expense in the case of the latter resulting from the allocation of a portion of a bond’s issue price to the warrant, which creates original issue discount for accounting purposes), are the primary reason why American companies prefer convertible bonds to bond-warrant units. See, e.g., GERALD I. WHITE ET AL., THE ANALYSIS AND USE OF FINANCIAL STATEMENTS 490-93 (2d ed. 1998).

8. See, e.g., REINSURANCE GROUP OF AMERICA, INC., PROSPECTUS SUPPLEMENT FOR $225,000,000 TRUST PREFERRED INCOME EQUITY REDEEMABLE SECURITIES (PIERS) UNITS (Dec. 12, 2001); WASHINGTON MUTUAL, OFFERING MEMORANDUM FOR $1,000,000,000 TRUST PREFERRED INCOME EQUITY REDEEMABLE SECURITIES (PIERS) UNITS (Apr. 24, 2001).

9. Intel’s issuance of approximately $300 million of long-term warrants is the exception that seems to prove the rule. See INTEL CORP., PROSPECTUS SUPPLEMENT, 1998 STEP-UP WARRANTS TO PURCHASE 10,000,000 SHARES OF COMMON STOCK (Mar. 2, 1993).

10. This “stylized” feature has become less prevalent in recent markets because the very large increase in overall market volatility in recent years made the stock of even established, stable companies highly volatile by historical standards. The result has been that higher credit quality companies that traditionally would not have issued convertible debt were able to issue unsecured senior convertible notes with very high premiums and very
consistent with signaling theory, many issuers of convertible bonds would explain their action, not through signaling theory, but by the simple observation that convertible debt was the only form of debt that public investors were willing to buy, at least at remotely affordable rates. (There are, of course, substantial adverse signaling effects from selling straight debt at inordinately high yields.) It may be the case that top-rated firms typically can fund growth through internally generated funds or straight debt (with its neutral signaling consequences), but in this respect, at least, the nature of the convertible bond marketplace seems at least as consistent with the alternative risk-sharing hypothesis as with a signaling theorem.

Strnad’s response to this point no doubt would be that one still needs recourse to signaling theory to explain why lower-end investment grade issuers offer convertible debt rather than bond-warrant units. My difficulty with this argument, however, is that it ignores another market truism, which is that there is no real market in long-term issuer warrants. In other words, the comparison of convertible bonds to bond-warrant units is a little strained in a world where the capital markets have never developed an active market in issuer warrants. Is it that the negative signaling effect is overwhelming, or is there some other explanation for the complete absence of a vigorous and efficient warrant marketplace? One could, of course, design in a few minutes “callable” warrants to replicate the soft-call economies of convertible debt, but until this year no one has bothered even coming close to doing so. This leads me to suspect that more attention needs to be brought to the question of why we do not have a marketplace in corporate warrants before we can conclude that signaling alone explains the utility of convertible debt.

A final note in this “proves too little” line of thinking is that Strnad’s presentation of the signaling dynamic ignores the message of another completely ubiquitous feature of convertible debt, which of course is that convertible bonds can be converted only at a premium. Traditionally, that conversion premium was on the order of 20 or 25 percent. More low fixed returns. See Avital Louria Hahn, Converts: They’re Baa-aack, Inv. Dealers’ Dig. (Oct. 22, 2001); Ian Sprengsteel, An Edgy Dance, Inv. Dealers’ Dig. (Mar. 12, 2001); Press Release, BERKSHIRE HATHAWAY, BERKSHIRE HATHAWAY ISSUES FIRST EVER NEGATIVE COUPON SECURITY (May 22, 2002), available at http://www.berkshirehathaway.com (last visited Oct. 2, 2002).

11. High-yield convertibles were often used during the recent market bubble by telecom and Internet issuers that needed to lower their interest costs by offering investors a way to participate in the potential upside offered by their equity. When the market for those shares collapsed, convertible investors turned to more defensive issues. See Sprengsteel, supra note 10, at 14.

12. But see supra note 7 (discussing differences in accounting treatment).

13. The number of warrants traded on NYSE in August 2002, for example, was less than 0.2% of the number of shares traded. NYSE TRADING STATISTICS, Last 12 Months, available at http://www.nyse.com/pdfs/movolume0208a.pdf (last visited Oct. 2, 2002).

14. See BERKSHIRE HATHAWAY, supra note 10. This transaction represented a bond-warrant unit with unusual terms that replicated much of the economics of a zero-coupon (actually, negative-coupon) convertible, but presumably because of its short maturity, did not contain a “soft call.”
recently, many deals were completed with conversion premia of 40 or 50
percent. Strnad acknowledges that the signaling theorem does not ex-
plain the terms of a particular offering; one wonders, however, just how
negative the message really is if management signals its willingness to sell
equity at 50 percent above current levels.

The signaling theorem as presented by Strnad essentially posits two
parties to the signaling “game”: managers and equity holders. By
phrasing the corporate finance decision as an elaborate game between
management and the equity markets, Strnad’s analysis ignores important
additional constituencies, in particular the debt markets and their attor-
neys-in-fact, the rating agencies.

Turning first to the role of creditors as constituents in the capital issu-
ance calculus, Strnad ignores another ubiquitous “stylized” feature of
convertible debt, which is that it usually is subordinated debt. A new
class of subordinated capital, which is likely (although not guaranteed) to
convert to equity, therefore conserving cash, may send a negative signal
to equity holders, but is reassuring news to existing creditors, and thereby
arguably reduces future “straight” debt costs.

This point becomes more powerful when the convertible debt is not
only subordinated but also zero-coupon (as has been true for the bulk of
convertible debt offerings in recent years). Subordinated zero-coupon
bonds as a practical matter cannot go into default prior to maturity, be-
cause there is no current interest coupon to be paid. In a “current pay”
convertible bond, by contrast, the issuer’s failure to pay interest when due
will trigger an event of default, which in turn, through cross-default provi-
sions, will trigger events of default on essentially all the issuer’s debt,
thereby forcing the issuer into bankruptcy. Senior debtholders may rank
ahead of subordinated convertible bondholders in the bankruptcy peck-
ing order, but all creditors always suffer to some extent in bankruptcy.
Zero-coupon convertible debt avoids the bankruptcy trip-wire. For that
reason alone, creditors find this layer of junior non-defaultable (at least
prior to maturity) debt to be particularly comforting. Rating agencies in

15. See, e.g., Sprengsteel, supra note 10. The reason for the increase in conversion
 premiums is that as an issuer’s stock’s volatility rises, so does the value of the embedded
 option in the issuer’s convertible debt. High (by historical standards) volatility in recent
 years increased the value of optionality embedded in convertible bonds, thus enabling issu-
ers to insist on higher conversion premiums.
16. See Strnad, supra note 1, at 413-14.
17. As Professor Strnad points out, “[m]ost convertible bonds do end up being con-
verted rather than extinguished by a repayment of principal when the bond matures.” Id.
at 401-02.
18. From 1997 to the present, zero-coupon convertible bonds increased from 10.7% to
30.5% of total convertible debt outstanding. See Tatyana Hube & Yaw Debrah, Mer-
rill Lynch, Convertible Market Monitor: Convertible Total Market Value
Unchanged Despite Positive Performance in August, Due to Negative Net Issu-
nance (Sept. 3, 2002) (on file with author). Zero-coupon convertibles accounted for more
than a third of all new convertible issues in 2000 and more than 60% of all new convertible
issues in the first quarter of 2001. See Venu Krishna, Salomon Smith Barney, Zero-
ing in on Zeros, Convertible Special Report (Apr. 2001) (on file with author); With
Hedge Fund Demand High, Zero Boom Continues, Inv. Dealers’ Dig. (Feb. 12, 2001).
Strnad also ignores financial accounting considerations, which in a perfect world would not be a separate constituency, but which in practice is just that. As recent events have regrettably demonstrated, the public capital markets (both debt and equity) rely all too heavily on financial accounting presentation as the perspective from which to analyze a company’s prospects, and accommodating financial accounting norms therefore becomes as important a component in the corporate finance issuance calculus as any other. In other words, the signaling game is communicated largely in the language of financial accounting, and therefore must to some extent conform to its syntax, whether logical or not.

The syntax of financial accounting explains, for example, a novel feature of convertible debt that has become, if not ubiquitous, then certainly extremely popular over the last two years: the “contingent conversion” (“CoCo”) feature, under which a convertible bond may not be converted by a holder until the bond is in-the-money by some specified percentage. Thus, imagine that an issuer’s common stock is trading at $40. The conversion feature in a traditional convertible bond might be priced “up 25”—that is, at a 25-percent premium to current market price—in this case, $50, so that a $1,000 bond would be convertible into 20 shares of stock (at a time when the investor could have purchased 25 shares outright for the same $1000). A CoCo feature would still provide that a holder could convert its convertible bond at an effective stock price of $50, but not until the stock reached, say, $60.

The reason for this is entirely driven by financial accounting. When the CoCo feature is present, the issuer is not required to include the stock into which the convertible bond may be converted in its earnings per share figures unless and until the CoCo barrier is pierced. Thus, even for the equity markets, the signaling aspects of a CoCo convertible bond might be significantly different than posited by Strnad.

The above discussion has suggested that, if Strnad had begun with a more complete consideration of the “stylized” (archetypal) terms of convertible debt, he would have emphasized soft calls less, and would have developed a different, or at least more nuanced, view of the signaling game. That more comprehensive view would take into account in particular the clustering of convertible debt issuers nearer the bottom, rather than the top, of the investment grading hierarchy, evolving conversion

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19. Standard & Poor’s, A Hierarchy of Hybrid Securities (Mar. 25, 1996). Issuers also receive “equity credit” for current-pay convertible debt, presumably because of the likelihood of conversion. Both forms of convertible debt receive more “equity credit” than does nonconvertible debt.

20. For a good discussion of the CoCo provision, see Michael O’Connor et al., Deutsche Bank, Convertible Structures, 17-20 (2002) and T. Anne Cox & Anne Elliott, Merrill Lynch, Convertible Special Report (Aug. 9, 2001). The new breed of convertibles proved to be extremely popular with the issuers. See id. at 1 (“Without a doubt, contingent issuance has hit the U.S. convertible market like a Tsunami.”).

21. See O’Connor et al., supra note 20, at 17.
The differing signaling dynamics of zero-coupon and current-pay convertible debt, and the fact that convertible debt is usually subordinated debt; it would also filter all these factors through the refractors of financial accounting norms and rating agency criteria, because those are the glasses through which much of the financial community views an issuer. Even this more comprehensive view, however, would not explain the explosion of convertible debt offerings in the 2000-2001 period, because it would ignore the importance of puttable/callable/zero-coupon convertible bonds and the specialized marketplace that exists for them.

Nearly 20 years ago Merrill Lynch & Co. developed a convertible bond structure that was subordinated, zero-coupon, callable by the issuer, and "puttable" by holders on specified anniversaries at the bond's accreted issue price. The trade name for these securities was LYONS; they are now, of course, marketed by every major investment bank under a great many trade names, but for convenience I will stick with "LYONS" as a near-generic term in the marketplace.

The enormous number of convertible debt offerings in 2000-2001 were to a large extent LYONS-style bonds, not classic current-pay convertible debt. One reason for the surge was the CoCo feature described earlier, which reduced negative financial accounting signaling to the equity markets. Another reason was the development of the "contingent payment" variant, analyzed in detail in Revenue Ruling 2002-31, which lifted an issuer's current interest deduction on its convertible debt to the same yield as its interest deduction on its straight debt, at least tentatively.

The Strnad paper is silent on these recent events, effectively limiting its analysis to the markets circa 1998. This is a pity. Much has been written on the tax policy aspects of "contingent payment convertibles" in particular, but there was another, non-tax dynamic at work that was the real driver of this recent convertible bond bubble. This other dynamic, which

22. Puttable bonds have become especially popular in recent years, as the put feature makes the high conversion premiums more palatable for investors. See Scott R. Lange et al., Goldman Sachs, Convertible Viewpoint (Oct. 11, 2001); No Free Money After All: Will Put Exercise be the Death of CoCos?, Inv. Dealers' Dig. (Nov. 5, 2001).


24. See, e.g., With Hedge Fund Demand High, Zero Boom Continues, Inv. Dealers' Dig. (Feb. 12, 2001). For a description of zero-coupon convertibles, see O'Connor et al., supra note 20, at 48-49.

25. See id. O'Connor et al., supra note 20, at 17.


deserves close academic study, was the rapid emergence of hedge funds as the marginal buyers of convertible debt, particularly LYONS-style zero-coupon convertibles.

Whatever the merits of Strnad’s signaling theorem in years past, I think that most market observers agree that the recent explosion of convertible bond offerings was fueled by hedge fund appetite for convertible paper. Previously, convertible debt was purchased largely by retail investors, by “equity-income” funds, and by other “conservative growth” investors. Hedge funds, by contrast, have a completely different agenda: they buy convertible debt, synthetically strip off the straight debt component in the credit derivatives market, and are left with a complex long-term call option that they can hedge in the cash equity markets.

Virtually overnight, it seems, the convertible bond market has gone from being a “conservative growth,” investor-driven market to an arbitrage-driven market. As a result, convertible bonds are now volatility plays, pure and simple. Conversion premia were bid up in the 2000-2001 period well beyond what traditional investors could stomach, because the cash equity markets themselves were so volatile, and hedge funds could still earn substantial arbitrage profits even at those unusual conversion premia by going long the convertibles, and short the underlying. By stopping his analysis circa 1998, Strnad not only misses this fascinating story, but also overlooks this important aspect of the corporate finance role of convertible debt, in which it might be said that the issuers and investors alike now understand that issuing convertible debt is not a “bad news” signal, but a “moderation of volatility” signal.

At least as practiced in the 21st century, then, convertible bond offerings are not so much about signaling management views on absolute stock prices as they are about issuers selling, and hedge funds buying, volatility. Issuers of convertible debt in these turbulent markets have been able to sell LYONS-style offerings that are not only zero-coupon, but are also at or near zero-yield; that is, all the return is in the conver-

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28. “[I]t is convertible arbitrage funds that now determine the pricing of convertibles.” JEREMY HOWARD & MICHAEL O’CONNOR, DEUTSCHE BANK, CONVERTIBLE SECURITIES: AN INVESTOR’S GUIDE 56 (2001). Hedge funds are estimated to own as much as 50% of convertible securities outstanding. Id. at 40. Traditional buyers were, in effect, priced out of the market by hedge funds’ ability to analyze instruments with features adverse to investors (e.g., conversion premiums of 40-50%) and still make money. See Sprengsteel, supra note 10.

29. See, e.g., HOWARD & O’CONNOR, supra note 28, at 40.

30. See, e.g., id. at 56-60; LANGE ET AL., supra note 22. The perception of convertible bonds as volatility plays contributes to the demand for credit derivatives, which effectively allow a separation of the volatility and credit components of a convertible issue. See Navroz Patel, Serving the Credit Funds, Risk (Aug. 2002).

31. See, e.g., HOWARD & O’CONNOR, supra note 28, at 40; Sprengsteel, supra note 10. For a more comprehensive discussion of convertible debt hedging, see JAMES PEATTIE & LORRAINE LODGE, MERRILL LYNCH, HEDGING CONVERTIBLES: AN INTRODUCTION TO TECHNIQUES (Dec. 1999).

32. Because convertible debt came to be regarded as a volatility play, even highly rated issuers with volatile equity have entered the convertible market in recent years. See, e.g., Sprengsteel, supra note 10.
sion premium and the cash contingent payment feature, which is not payable in early-put scenarios.\textsuperscript{33}

If (as the issuer effectively is wagering) volatility is lower than buyers anticipate, the convertible bond will remain outstanding for many years, providing very attractive financing and a tax deduction measured by the issuer's comparable yield on its straight debt. If, by contrast, the issuer's stock performs exceptionally well, the issuer will be forced to sell new equity relatively soon—but at a price 40 or 50 percent higher than issue-date levels. Finally, if the stock performs exceptionally poorly, holders are likely to "put" their debt back to the issuer at one of the first scheduled put dates, in which case the issuer would have enjoyed short-term financing at rates that often reach zero percent. These last two possibilities are the worst case scenarios!

The history of the convertible bond markets over the last two years thus seems to be consistent with the risk uncertainty hypothesis that Strnad briefly considers, or perhaps a variant of that hypothesis. Most issuers of convertible debt have been, and remain, at the lower end of the investment grade spectrum in that their equity prices ordinarily are more volatile than the norm.\textsuperscript{34} Thus, regardless of whether managements know something that the markets do not, convertible debt issuers can command large volatility premia for the embedded options they are selling. Strnad explores some of the complications introduced by the soft-call feature, but it remains for a subsequent article to develop a formal analysis of the finance and information theory associated with the terms of today's most prevalent form of convertible debt and the arbitrage analysis that drives the investor side of the equation.

**III. CONVERTIBLE DEBT AND TAX POLICY**

**A. The Bond-Warrant Unit as Tax Desideratum**

Having reviewed the competing corporate finance explanation for the role of convertible debt, Professor Strnad turns to the tax treatment of convertibles. Strnad first effectively assumes that the bifurcation of a convertible bond into a straight bond and an option should be the tax "desideratum."\textsuperscript{35} Strnad then correctly concludes that, compared to this ideal, current law understates the interest expense/interest income component of convertible debt issued at par or at a discount, because (phrasing matters from the issuers' perspective) current law does not permit an interest deduction with respect to the portion of a convertible bond's is-

\textsuperscript{33} For a discussion of these instruments, see O'Connor et al., supra note 20, at 52 and Cox, supra note 23, at 15-18.

\textsuperscript{34} Because of the optionality embedded in convertible debt, issuers with highly volatile equity can offer that debt on more attractive terms. See, e.g., Sprengsteel, supra note 10. See also supra note 15.

\textsuperscript{35} Strnad, supra note 1, at 425.
Imagine, for example, that an issuer could issue a convertible bond for $1,000 that paid current interest of three percent and entitled the holder to $1,000 at maturity (if not converted), or alternatively a bond-warrant unit with similar terms for the same $1,000, of which $800 went to purchase the bond and $200 the warrant. In the first case, the issuer would deduct its three-percent coupon but no original issue discount; in the second case, by contrast, the issuer would deduct an additional $200 of original issue discount.

Strnad then discusses a legislative proposal offered several times by the Clinton Administration (most recently in 2000, and not reproposed under the current administration), which Congress rejected each time it was proffered. Under that proposal (known colloquially both on Wall Street and within the Beltway as the “Anti-LYONS” proposal), an issuer of original discount convertible debt (i.e., convertible debt whose redemption price at maturity exceeded its issue price, as in the case of zero-coupon LYONS-type obligations) would not be permitted any original issue discount deductions over the life of the instrument, but instead could deduct that discount only if and when the bond was retired for cash rather than converted into stock. Alternatively, Strnad posits as a possible reform a proposal under which issuers of convertible debt would never be permitted to deduct original issue discount, even on a cash settled basis (but apparently would be permitted to deduct coupon interest on par convertible debt).

To this reader, at least, one of the most puzzling aspects of the Strnad paper is its acceptance of the Clinton Administration’s proposal as an intuitively rational idea, without any effort to check that proposal against Strnad’s own tax “desideratum” of the bond-warrant unit. In fact, since the Clinton Administration’s proposal would not have applied to bond-warrant units, a principal consequence of the suggestion would have been to exacerbate current tax law’s bias in favor of formal unit structures over convertibles.

36. See Treas. Reg. § 1.1275-4(a)(4) (as amended in 1999) (excluding convertible debt from the scope of contingent debt regulations, which permit deductions at a “comparable yield”).

37. Strnad, supra note 1, at 427.

38. See Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2000 Revenue Proposals 127 (1999); Department of the Treasury, General Explanations of the Administration’s Fiscal Year 1999 Revenue Proposals 97 (1998); Department of the Treasury, General Explanations of the Administration’s Fiscal Year 1998 Revenue Proposals 38 (1997); Department of the Treasury, General Explanations of the Administration’s Fiscal Year 1997 Revenue Proposals 64 (1996) [hereinafter Anti-LYONS Proposals].

39. See Anti-LYONS Proposals, supra note 38.

40. Strnad, supra note 1, at 427.

41. See Anti-LYONS Proposals, supra note 38. The proposals would, however, cover bond-warrant units in which the debt instrument could be used to satisfy the exercise price of the warrant.
In practice, of course, a bond-warrant unit behaves much like a discount convertible bond, because the unit typically is held as a unit, rather than separated into its component pieces, and holders ordinarily do not convert until maturity. As a result, the cash flows on a bond-warrant unit are indistinguishable as a practical matter from those on a convertible. Either the bond-warrant unit will pay off solely in cash, or the bond component effectively will be "used" (via the cash due at maturity) to purchase the issuer's stock on the date the bond matures (and the warrant expires).

This result of course holds true regardless of whether the bond yield on the bond-warrant unit comprises some interest coupon plus economic discount, or is structured as entirely discount (i.e., a zero-coupon bond-warrant unit). In other words, in the bond-warrant unit case, which Strnad offers as the tax desideratum, interest on the bond component is fully deductible, regardless of whether it is paid as stated interest or as discount—and regardless of the fact that, if the bond's yield is paid as discount and the warrant is exercised, that bond discount is paid indirectly through the delivery of stock (since the warrant typically is not exercised until the maturity date).

If the tax desideratum in fact is a bond-warrant unit, current taxation of a convertible bond (whether coupon-bearing or zero coupon) understates the interest component on the embedded bond by the amount of the bond's yield that is reflected as discount. The Clinton Administration's proposed deferral/disallowance of interest deductions in respect of discount on convertible bonds would simply have exacerbated that difference, which is one of the reasons that Congress sensibly rejected the proposal every time it was proffered.

The other fundamental fallacy in the Clinton Administration's "anti-LYONS" proposal was that it treated the delivery of stock in satisfaction of a claim for accrued original issue discount as a sort of "non-payment" of that discount. The belief that an issuer cannot use stock as consideration to pay accrued discount (or interest for that matter) is simply inconsistent with every other tax construction of what "payment" encompasses. Thus, for example, if Issuer X acquires a division of Corporation Y in exchange for X stock in a transaction that falls outside the scope of § 351 or the reorganization provisions, we find it completely unremarkable that Corporation X takes as its cost basis in those divisional assets the fair market value of the stock it has used as payment. "Cost" is

42. The principal reasons for early conversion are (i) the dividend yield on the underlying stock exceeds the investor's potential return on his cash and (ii) an arbitrageur's need to obtain stock to close out a short position, where that short has become unaffordably expensive to maintain.

43. The convertible bond accrued interest case law in this respect can be understood as a literal reading of badly-phrased bond indentures that no doubt never had the benefit of review by the drafters' tax colleagues. See Marathon Oil Co. v. Comm'r, 838 F.2d 1114 (10th Cir. 1987); Tandy Corp. v. United States, 626 F.2d 1186 (5th Cir. 1980); Scott Paper Co. v. Comm'r, 74 T.C. 137 (1980); Bethlehem Steel Corp. v. United States, 434 F.2d 1357 (Ct. Cl. 1970); Rev. Rul. 74-127, 1974-1 C.B. 47; Rev. Rul. 68-170, 1968-1 C.B. 71.
the measure of what a person *forges* by an expenditure. In the case of Issuer X, its cost basis reflects the fact that it could have sold that stock for cash, and it is that forgone cash that therefore reflects Issuer X's cost for the Corporation Y divisional assets.

For the same reason, the zero-basis conundrum with respect to an issuer's own stock in tax-free incorporations or reorganizations that has bedeviled tax practitioners for years, and which the Internal Revenue Service from time to time addressed in a desultory and patchwork manner, is simply a false concern.\textsuperscript{44} An issuer's cost in its stock is the value of the cash it forgoes by not selling it—not the cost of the piece of paper on which the share certificate number is printed—and a subsidiary (for example) that obtains parent stock in a tax-free incorporation transaction therefore in fact should be understood to have a tax basis in that parent stock equal to that economic cost.

It might be objected that § 163(l), added to the Code as part of the Taxpayer Relief Act of 1997,\textsuperscript{45} is intended to prevent the use of an issuer's stock as payment for interest, whether in the form of interest coupons or original issue discount. I have discussed § 163(l) at length elsewhere,\textsuperscript{46} but the essence of the matter is that § 163(l) (which admittedly is a terrible piece of legislative drafting) is fundamentally a punitive tool for distinguishing debt from equity. Its purpose is to disallow interest expense on instruments that are excessively equity flavored, while still preserving all the negative consequences of debt characterization for investors. (Why this particular form of debt that strays too close to the debt-equity DMZ should be subject to this double punishment is an interesting question, not explained by the legislative history.) Perhaps the best way of understanding § 163(l) is as a sort of prescriptive evidentiary rule: instruments that are mandatorily payable solely in stock are simply too difficult to distinguish from equity from an administrative point of view.

It is true that accrued discount on a convertible bond might be paid through the delivery of stock in lieu of cash, but the same is factually true of a bond-warrant unit. In any event Congress exempted bona fide convertibles from the scope of § 163(l), and the Clinton Administration continued to propose its "anti-LYONS" rule even after the adoption of § 163(l). All of this is consistent with the idea that § 163(l) should not be viewed as reversing fundamental tax norms of what constitutes a "pay-

\textsuperscript{44} For an overview of the "zero-basis problem" and the Service's response, see, for example, Gary B. Mandel, *The Zero Basis Problem as a Result of the Issuance of Stock or Debt*, 429 PLI/Tax 269 (1998); Michael L. Schier, *Exploring the Boundaries of Section 1032, 49 Tax Law* 543 (1996). Several years ago, for example, Treasury regulations were adopted that provided for nonrecognition of gain by a subsidiary using its parent's stock in a triangular reorganization. \textit{See} Treas. Reg. § 1.1032-2 (as amended in 2000) and Treas. Reg. § 1.1502-30 (1995). The latest regulations under § 1032, proposed in 1998 and adopted in 2000, extend the § 1032 non-recognition treatment to subsidiaries that are essentially "conduits" using their parents' stock to acquire other property in non-reorganization transactions. \textit{See} Treas. Reg. § 1.1032-3 (2000).


\textsuperscript{46} \textit{See} Kleinbard et al., *supra* note 27, at 1957-59.
ment" of interest or discount outside the relatively narrow application of § 163(1) to debt/equity distinctions.

In sum, Strnad's uncritical adoption of the Clinton Administration's "anti-LYONS" proposal is perhaps the most puzzling aspect of the paper. That proposal was fundamentally at odds with Strnad's own tax "desideratum" of the taxation of bond-warrant units and adopted an economically indefensible view of what constitutes payment of an expense. It is true that Strnad's extensive analysis of the Clinton Administration's proposal retains utility as an example of the application of his thesis that tax reforms in this area should be measured by whether they further the corporate finance aims of the instrument in question, but it is difficult to understand why Strnad chose this unfortunate example of a legislative proposal as a test case to demonstrate his thesis in the first place.

B. TAX POLICY CONSIDERATIONS FOR CONVERTIBLE BONDS

Strnad's ultimate point, I believe, is not that the Clinton Administration's proposals with respect to the taxation of discount convertible bonds were necessarily a good idea, but rather that, in judging any current or proposed tax regime for a financial instrument, we should use as a yardstick the corporate finance purposes served by that instrument, and ask whether a particular tax regime advances or hinders the corporate finance objectives. In the case of convertible bonds, that corporate finance objective, according to Strnad, is the signaling theorem described earlier. Strnad therefore analyzes the Clinton Administration's anti-LYONS proposal, and the more radical complete interest disallowance alternative proposal, against this yardstick.

Strnad's technical analysis is a lengthy exercise in mathematics at a level beyond any that I was ever taught (or at least retained), so I cannot comment on that portion of his paper. It is, however, worth considering for a moment whether what we can call the Strnad thesis in fact should be the prime driver in designing a tax regime for financial instruments, or whether instead it should serve only as a second or third order sort of objective.

I have two basic concerns with the Strnad thesis. First, current tax law already permeates corporate finance decision-making—hence the greater popularity of convertible debt than convertible preferred, in a world where marginal investors are tax-exempt, ineligible for the dividends received deductions, or, by virtue of market-to-market tax accounting, effectively tax indifferent between the two. Intuitively, at least, it seems to be extraordinarily difficult to extract "pure" corporate finance behavior from this tax-infused factual tapestry.

47. See Strnad, supra note 1, at 447 ("Convertible bonds appear to play a major role. Provisions such as the Clinton Administration's proposal may enhance that role or destroy it. Not knowing which is the case, perhaps the best course is to do nothing and at least preserve the role that exists now.").
Second, our tax system is so fundamentally at odds with any non-tax economic corporate model—particularly in our treatment of the cost of debt capital compared to the cost of equity capital—that I have to believe that our existing tax biases will overwhelm any efficiency gains from, for example, enhancing the signaling effects of convertible bonds.

In a related vein, we do not today design any significant aspect of our tax regimes for different financial instruments with a view to economic efficiency in general or corporate finance theorems in particular. Instead, as I have described elsewhere, our tax system is best understood as a sort of neo-platonic model of economic reality, with a relatively limited number of idealized tax “cubbyholes” into which we force new financial products.

In doing so, the tax law applicable to financial instruments appears to operate on three largely unstated premises. First, every new financial product should fit into one (and only one) tax cubbyhole—that is, we have an institutional bias against bifurcation. Second, we rarely add new tax cubbyholes, because to do so requires major revisions throughout the larger model. Third, and most important, we define the dimensions of those cubbyholes, not by recourse to economic efficiencies or corporate finance substitutability, but rather by reference to various formal and legal characteristics that relate back to commercial norms that are now nearly 100 years old. Thus, convertible debt and convertible preferred are near relatives when measured by the yardstick of signaling theory, but are at best third cousins, once removed, in a tax universe that relies on the holder’s enforceability claims against the issuer as the yardstick for distinguishing debt from equity. The result is a taxonomy categorized by reference to idealized formal types, through the tools of analogy and formal correspondence—hence its appeal to former graduate students in medieval studies.

If one accepts the fundamental tenets of this neo-platonic world of idealized tax types, then the tax policy issues raised by convertible debt are reasonably clear, even if inconsistent with economic reasoning. First, because convertible debt has a fixed maturity date, a fixed minimum return equal to or greater than its issue price, and affords its holders creditors’ remedies, convertible debt satisfies the formal criteria of indebtedness. It is therefore taxed under the same regimes as apply to senior nonconvert-

50. Thus, the realization that swaps could only be addressed through defining a new cubbyhole meant in turn that numerous specific Code provisions had to be reworked to define the character and timing of swaps income, the source of that income, the withholding and treaty regimes applicable to that income, and so on.
ible bonds—not the regimes applicable to equity (notwithstanding the
greater force of attraction of equity characterization in an economist's
model of reality).

Second, as the Internal Revenue Service itself recently stated, a prin-
cipal purpose of our original issue discount regime (i.e., our rules for the
taxation of debt, to which the non-discount debt rules are just an unim-
portant simplifying corollary) is to: "[T]ax holders of debt instruments
according to [their] economic income as determined by the constant-yield
method. These provisions ensure that the holders of a debt instrument
cannot artificially avoid, defer or offset timely recognition of the eco-

conomic income from a debt instrument."51

Under this worldview, the consequence of debt characterization is cur-

current income/expense on a constant-yield basis of an "economic" quantum

of income each period—what the contingent interest regulations call the
"comparable yield" of an instrument.52

Finally, the anti-bifurcation principle suggests that the constant yield of

a convertible bond should be determined by reference to the bond's en-
tire issue price, not the embedded "pure" debt component. Here, then, is
the core tax policy issue for convertible debt, and the source of its attrac-
tiveness to tax mavens as a subject for debate. There is a fundamental
conceptual conflict within the tax model—a sort of contemporary Sic et
Non—between the non-bifurcation principle on the one hand, and the
rule of tax correspondences on the other, which argues that a convertible
bond should produce closely analogous tax results to that of its close eco-
nomic kin, the bond-warrant unit.

If one accepts the non-bifurcation principle as paramount, as current
regulations require,53 then it is easy to conclude, as I have elsewhere, that
given the fundamental constraints of our tax model, it is the current taxa-
tion of convertible debt (more technically, its excusal from the applica-
tion of the contingent debt regulations), that is the tax policy outlier,
because it understates interest payable on the unitary debt instrument.54
Conversely, if one chooses to emphasize the principle of correspondences
under which instruments with closely similar formal characteristics (here,
bond-warrant units and convertible debt) should yield closely similar tax
results, then current law still mismeasures the yield of a convertible bond,
but the right base is the issue price of the embedded pure debt compo-
nent, not the instrument's full issue price.

53. The final contingent debt regulations preclude the bifurcation of an instrument
into a non-contingent bond a contingent property right (e.g., an option). See Treas. Reg.
§ 1.1275-4 (as amended in 1999). This is in sharp contrast to an earlier approach, explicitly
providing for such bifurcation. See Department of the Treasury, Notice of Proposed
54. See Kleinbard et al., supra note 27, at 1956-57.
The fundamental issue for readers of Strnad's paper is whether Strnad, like Abelard in Sic et Non, reconciles the apparently irreconcilable differences that dominate the current tax scholastic wrangling on convertible debt with his alternative decision-making tools. Regrettably, I am not convinced that he does. Strnad's approach forces us to acknowledge many of the assumptions in our tax model that otherwise would lie unexamined. At the same time, however, its objectives are those of a system that is only casually related to the tax model, and the result therefore is like asking a Mahayana Buddhist to comment on the scriptural passages with which the author of Sic et Non wrestled.

It may be that we should completely overhaul the taxation of financial instruments in order to bring the tax results more closely in line with contemporary economic theory. In that new world, however, the important correspondence will be between convertible debt and convertible preferred stock, and the resulting revisions to our tax system necessary to break down the artificial tax barriers of debt versus equity will have far broader repercussions than the nuances of signaling theory. Strnad thus seems to me to be solving a problem that does not yet exist, which is, how to go about fine-tuning an as-yet undeveloped new tax model that emphasizes the economic/corporate finance objectives of financial instruments, rather than their formal/legal characteristics. It does not help to suggest that we should honor both models simultaneously because they are fundamentally so different as to make that objective completely unworkable. Moreover, as the current debates indicate, we are not yet doing all that well following through on the logical lessons of the model we have been developing for the last several decades.

As a final note, I would like to register my regret that Jeff Strnad broke off his analysis as early in the history of convertible debt as he did. The challenges to the tax system posed over the last two years or so by the rise in contingent convertibles, and the resulting debates in the tax literature, including the publication of Revenue Ruling 2002-31, have been exciting developments that could well use the objective and formal analytics of someone of Professor Strnad's capabilities. By leaving out this story, by not interviewing market participants or reviewing investment banking research material on, for example, the rise of arbitrage activity as a driver of the convertibles market, Professor Strnad essentially invites practitioners and market professionals not to read his paper. This, in my view is regrettable; there is a great deal in Professor Strnad's analysis that is illuminating to non-academics. If, however, we are going to make real progress in actual tax policy applicable to real life commerce, tax policy academics will need to descend into the hurlyburly of the marketplace, and product merchants and their advisors will need to look beyond their narrow debates to the larger premises and consequences of their models.

of analysis. It is a sobering and unintended consequence of Jeff Strnad's paper that this gap between tax policy academics and the marketplace seems, if anything, to be growing wider.