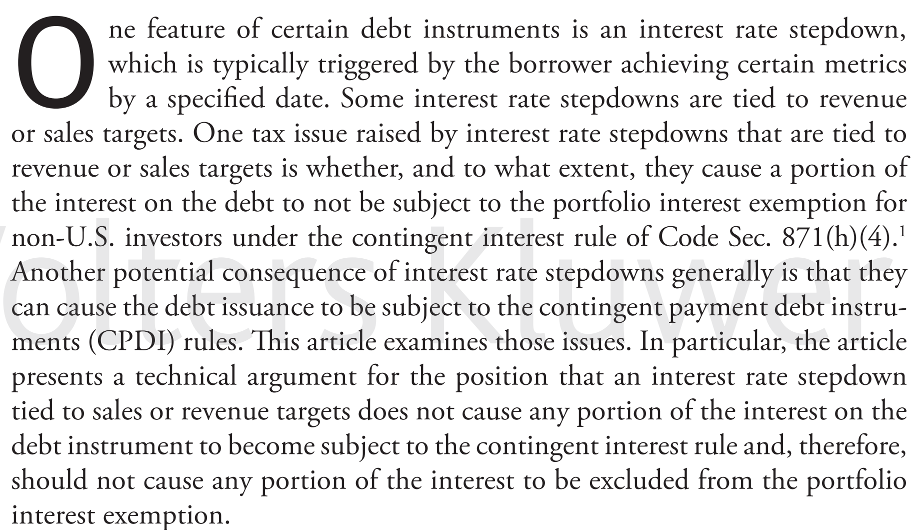
The Tax Treatment of Interest Rate Stepdowns

By Eli Dubin*

One feature of certain debt instruments is an interest rate stepdown, which is typically triggered by the borrower achieving certain metrics by a specified date. Some interest rate stepdowns are tied to revenue or sales targets. One tax issue raised by interest rate stepdowns that are tied to revenue or sales targets is whether, and to what extent, they cause a portion of the interest on the debt to not be subject to the portfolio interest exemption for non-U.S. investors under the contingent interest rule of Code Sec. 871(h)(4).[1] Another potential consequence of interest rate stepdowns generally is that they can cause the debt issuance to be subject to the contingent payment debt instruments (CPDI) rules. This article examines those issues. In particular, the article presents a technical argument for the position that an interest rate stepdown tied to sales or revenue targets does not cause any portion of the interest on the debt instrument to become subject to the contingent interest rule and, therefore, should not cause any portion of the interest to be excluded from the portfolio interest exemption.



I. Interest Rate Stepdowns

Interest rate stepdowns are not an uncommon feature of certain types of debt instruments, although interest rate stepdowns that are tied to sales or revenue targets are less common. The interest rate stepdown operates as follows. The interest rate is defined as the sum of the base interest rate, such as the three-month secured overnight financing rate (SOFR) term rate, plus the "applicable margin." The term "applicable margin" is defined as a specified percentage rate per annum, but the definition provides that if the borrower hits a specified trigger, for example, a sales or revenue target, the "applicable margin" is reduced by some specified amount. Therefore, when the sales or revenue trigger is hit, the interest "steps down" to the base rate plus a lower "applicable margin." Some stepdown provisions provide that the sales or revenue target must be met by a certain date in order for the interest rate to be stepped down. Others allow for the interest rate to be stepped down if the sales or revenue target is met at any point during the term of the debt issuance.

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Interest rate stepdowns are generally intended to reflect the improved creditworthiness of the borrower and can be thought of as an implicit refinancing between the borrower and the lender. In other words, rather than have the borrower refinance its loan at a reduced interest rate based on its improved creditworthiness, the terms of the debt instrument itself provide for a reduced interest rate upon the borrower's achievement of a metric that reflects an increased creditworthiness of the borrower.

II. Contingent Portfolio Interest

A. The Portfolio Interest Exemption

The general rule is that interest and dividends received from sources within the United States are taxable to foreign individuals and corporations at the rate of 30 percent.[2] However, most U.S. source interest is exempt from U.S. tax under the portfolio interest exemption, which applies to U.S. source interest paid on obligations that are in registered form with respect to which the borrower received the applicable withholding certificate.[3]

The portfolio interest exemption was implemented by the Deficit Reduction Act of 1984 (DEFRA).[4] Prior to that time, U.S. corporations seeking to avoid withholding on interest payments to foreign borrowers would set up international finance subsidiaries in foreign jurisdictions, primarily in the Netherlands Antilles, to issue Eurobonds. Those finance subsidiaries would then lend the capital raised by the Eurobond issuance to the U.S. parent and an exemption from U.S. withholding would be claimed under the treaty between the foreign jurisdiction and the United States.[5] Congress decided to provide an exemption for portfolio interest in order to allow U.S. borrowers to directly access foreign capital, rather than relying on costly indirect financing structures.[6]

Several kinds of lenders are not eligible for the portfolio interest exemption. Ten-percent shareholders or partners are not eligible for the portfolio interest exemption because Congress believed that it was inappropriate to allow foreign persons the double benefit of a deduction for U.S. tax purposes and the portfolio interest exemption.[7] Similarly, interest paid to a controlled foreign corporation by a related person is also not eligible for the portfolio interest exemption.[8] Foreign banks are also not eligible for the portfolio interest exemption on interest received on extensions of credit made in the ordinary course.[9] This exclusion is due to a Federal Reserve concern regarding reserve requirements, as well as concerns that allowing foreign banks to take advantage of the portfolio interest exemption would place U.S. banks at a competitive disadvantage.[10]

B. Contingent Interest

In 1993, Congress amended the portfolio interest exemption to exclude certain contingent interest.[11] Specifically, interest is excluded from the portfolio interest exemption "if the amount of such interest is determined by reference to

(I) any receipts, sales, or other cash flow of the debtor or a related person,
(II) any income or profits of the debtor or a related person,
(III) any change in value of any property of the debtor or a related person, or
(IV) any dividend, partnership distributions, or similar payments made by the debtor or a related person."[12]

Additionally, a broad grant of authority is provided to the Secretary to exclude any other type of contingent interest from the portfolio interest exemption if the "denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax."[13] Several kinds of contingencies are excluded from the scope of this rule, including timing contingencies, contingencies attributable solely to the fact that the interest is paid with respect to nonrecourse or limited recourse indebtedness, and contingencies related solely to a hedge of interest rate risk or currency fluctuations, as well as certain other contingencies.[14]

The purpose of this provision is to prevent foreign investors from structuring equity investments as debt in order to take advantage of the portfolio interest exemption.[15] Because interest that is contingent on profits is economically similar to a distribution of those profits, it should be subject to tax in the same manner as a dividend distribution of such profits.[16]

The legislative history provides that if there is both contingent and noncontingent interest on a single debt instrument, only the contingent portion of the interest is excluded from the scope of the portfolio interest exemption.[17] That is consistent with the purpose of the exemption described above. To the extent that a portion of the interest is not contingent, it is not economically similar to a dividend and should be eligible for the portfolio interest exemption.

C. Application of the Contingent Interest Rule to Interest Rate Stepdowns

An interest rate stepdown that is tied to a sales or revenue target generally operates in an opposite manner to the type of contingent interest that Code Sec. 871(h)(4)

was intended to exclude from the scope of the portfolio interest exemption. Contingent interest that is similar to a dividend *increases* as sales or revenue increase. By contrast, the interest rate stepdown causes interest to *decrease* as sales or revenue decrease. However, the broad language of the exclusion applies to "any interest if the amount of such interest is *determined by reference to* any receipts, sales or other cash flow ...."[18] In the period of a debt instrument with an interest rate stepdown preceding the sales or earnings trigger being hit, the amount of interest seems to be "determined by reference to" the relevant sales or earnings metric. By way of example, if the interest rate on a debt instrument is three-month SOFR plus 6.5 percent but that interest rate steps down to three-month SOFR plus six percent upon the borrower achieving $300 million in net sales on a trailing 12-month basis, then the amount of interest paid by the borrower is "determined by reference to" the sales of the borrower. Because Code Sec. 871(h)(4) does not specify that the amount of interest must be increased by reference to increased receipts, sales, or cash flow or decreased by reference to decreased receipts, sales, or cash flow, a plain reading of Code Sec. 871(h)(4) would seem to include even a situation where the interest is decreased by reference to increased sales or revenues.

However, there is a strong argument that interest rate stepdowns that are tied to sales or revenue targets are not caught within the scope of the contingent interest rule because the contingent interest rule refers to interest that is "determined by reference to *any* receipts, sales or other cash flow." The word "any" implies the existence of the thing described. Because interest must be "determined by reference to *any* receipts, sales or other cash flow," interest must be determined by reference to positive receipts, sales, or other cash flow in order to be subject to the contingent interest rule. In the context of an interest rate stepdown that is tied to a sales or revenue target, the increased interest is not attributable to the positive receipts, sales, or other cash flow of the borrower but rather to the amount of receipts, sales, or other cash flow that the borrower did not achieve. For instance, in the example above of an interest rate of three-month SOFR plus 6.5 percent stepping down to three-month SOFR plus six percent upon the borrower achieving $300 million in net sales on a trailing 12-month basis, the borrower would have to pay three-month SOFR plus 6.5 percent even if its receipts, sales, or other cash flow were negative or zero. Therefore, the interest rate is not determined by reference to positive receipts, sales, or cash flow.

One may counter that the interest rate is determined by reference to "any" sales because it is possible that the interest rate will be determined by reference to positive sales because the interest rate would be determined to be three-month SOFR plus 6.5 percent, even if the borrower had positive revenues of $250 million. However, this counterargument is fundamentally flawed. As described above based on the legislative history,[19] only the contingent portion of interest on a debt instrument is intended to be excluded from the portfolio interest exemption. In the example above of an interest rate of three-month SOFR plus 6.5 percent stepping down to three-month SOFR plus six percent, only the interest equal to the 50 basis points that is subject to a stepdown is actually determined by reference to sales or earnings and therefore only those 50 basis points are excluded from the portfolio interest exemption. The remainder of the interest is not contingent on any sales or earnings and should therefore be eligible for the portfolio interest exemption.

On that basis, Code Sec. 871(h)(4) should be read in the context of only the contingent portion of the interest rate. In other words, in the example above the relevant question is not whether the general interest rate of three-month SOFR plus 6.5 percent is determined by reference to the net sales of the borrower; the question is whether the 50 basis points that are subject to a contingency are determined by reference to any sales of the borrower. In the context of only the portion of the interest rate that would be stepped down on hitting the relevant trigger, the determination of the interest rate is not made by reference to positive receipts, sales, or other cash flow; it is made strictly by reference to the absence of receipts, sales, or other cash flow.

Consider the example above. The borrower pays interest at the rate of three-month SOFR plus six percent regardless of the borrower's net sales. Accordingly, that portion of the interest is clearly not determined by reference to the borrower's net sales. Assume that the borrower's net sales on a trailing 12-month basis are $250 million, which is $50 million less than the net sales trigger for stepping down the interest rate. In that case, the question of whether the borrower is required to pay an additional 50 basis points of interest is not determined by reference to the $250 million in net sales that the borrower did achieve; it is determined only by reference to the $50 million in net sales that the borrower did *not* achieve. Therefore, the determination of the amount of interest is clearly not made by reference to "any" sales, but only by reference to the lack thereof.

Although this reading may perhaps seem somewhat strained, it is supported by the policy underlying the contingent interest rule in Code Sec. 871(h)(4), which is to prevent disguising equity investments as debt and passing on dividend-equivalent amounts in the form of contingent interest.[20] It is clearly the case that an amount

of interest determined by reference to negative receipts, sales, or other cash flow is in no way similar to a dividend.

Some additional support can be adduced from the fact that the statute uses the word "any" rather than the word "the" in describing interest determined by reference to receipts, sales, or other cash flow or to income or profits of the debtor or a related person.[21] The word "the" would seem to have been the better fit for describing receipts, sales, or other cash flow if the drafters had intended to capture even negative receipts, sales, or other cash flow. If the statute would describe interest determined by reference to "the" receipts, sales, or other cash flow of the borrower, that would possibly apply even if the determination was made by reference to negative receipts, sales, or other cash flow. Therefore, the use of the word "any" may be taken as some indication that interest determined by reference to negative receipts, sales, or other cash flow was not intended to be subject to this rule.

Based on the foregoing, there seems to be a strong position that an interest rate stepdown that is tied to a sales or revenue target should not cause interest that is otherwise eligible for the portfolio interest exemption to be treated as contingent interest for purposes of Code Sec. 871(h)(4). For debt instruments where there is a single U.S. partnership that acts as an aggregator for U.S. and non-U.S. lenders, the borrower is not required to withhold any amounts on payments of interest to such partnership notwithstanding that some of its partners are non-U.S. persons.[22] Rather, such U.S. partnership will control all of the withholding[23] and may be willing to take the position that Code Sec. 871(h)(4) does not apply and that it does not need to withhold on payments to the non-U.S. lenders. However, where the borrower pays interest directly to the non-U.S. lenders, the borrower may not be willing to assume any degree of risk with respect to its withholding position without a creditworthy indemnity, in which case the non-U.S. lenders would need to seek a refund of any withheld tax.[24] Therefore, non-U.S. lenders should consider including language in the debt instrument providing that no portion of the interest is subject to Code Sec. 871(h)(4) and providing that the borrower may not take any withholding position inconsistent therewith.

In addition, even for taxpayers who are not comfortable relying on this argument and who therefore do treat such interest as subject to the contingent interest rule, there are two points that such taxpayers should be able to rely on to mitigate the effect of the rule's application. The first is, as described above in greater detail and based on the legislative history,[25] that only the portion of the interest rate that can be stepped down should be treated as contingent interest because the rest of the interest is not contingent. The second is that, where the relevant sales or earnings trigger must be hit by a certain date in order for the interest rate to step down and the trigger is not met by such date, the contingent interest rule should arguably cease to apply as of such date, and all of the interest should be subject to the portfolio interest exemption. After such date, the amount of such interest ceases to be "determined by reference to" the sales or earnings of the borrower because the borrower is no longer entitled to a stepdown on the sales or earnings trigger being hit. In other words, the interest rate becomes wholly noncontingent after the date on which the interest rate can no longer be stepped down. However, one could theoretically take the view that the amount of such interest is determined by reference to the amount of sales or earnings of the borrower in the period prior to the date on which the interest rate can no longer be stepped down and therefore the portion of the interest rate that could have been stepped down should be treated as contingent interest for the duration of the debt instrument.

III. CPDI Considerations

This section considers the implications of the special rules applicable to debt instruments that provide for one or more contingent payments, or CPDIs, for debt instruments with interest rate stepdowns. If these rules apply, the schedule on which the holders of such debt instruments must include interest income in respect of the debt instrument, and the schedule on which the issuer may deduct such interest, will be affected, as more fully described below. In addition, any gain on disposition of the debt instrument will give rise to ordinary income rather than capital gain.[26] Classification of a debt instrument as a CPDI may also give rise to significant reporting complexities. Part A of this section examines the exceptions to CPDI treatment and their application to debt instruments with interest rate stepdowns. Part B discusses the treatment that applies if a debt instrument with an interest rate stepdown is determined to be a CPDI.

A. Whether the CPDI Rules Apply

Generally, the CPDI rules apply to any debt instrument that provides for one or more contingent payments.[27] There are several enumerated exceptions that do not generally apply to interest rate stepdowns.[28] However, there are three general exceptions that may be relevant to debt instruments with interest rate stepdowns: (i) the remote exception, (ii) the incidental exception, and (iii) the significantly more likely than not payment schedule exception. Each of those exceptions is described below,

and their application to debt instruments with interest rate stepdowns is explored.

1. The Remote Exception

Generally, a payment is not treated as a contingent payment for purposes of a debt instrument being treated as a CPDI if the contingency is "remote" as of the issue date.[29] The Treasury Regulations provide that a contingency is remote "if there is a remote likelihood either that the contingency will occur or that the contingency will not occur."[30] This definition is somewhat tautological—referring as it does to a "remote likelihood"—and therefore not very instructive.[31] The general market convention is that a contingency will be treated as remote if the chance that it occurs is less than five percent.

If the likelihood of occurrence is remote, then it is assumed that the contingency will not occur, and if the likelihood of non-occurrence is remote, then it is assumed that it will occur.[32] If a change in circumstances occurs, causing the occurrence of a contingency that was considered remote, then the debt instrument is generally treated as retired and reissued on the date of such change in circumstances for an amount equal to the instrument's adjusted issue price on such day.[33] The issuer's determination that a contingency is remote is binding on all holders unless the holder explicitly discloses that its determination is different than the issuer's in a statement attached to its tax return.[34]

Accordingly, if the parties take the position that the possibility of the stepdown trigger being met is remote, then the debt instrument will not be treated as a CPDI. Because the issuer's determination is generally binding on the holder, the lenders may prefer to stipulate the reporting position that the borrower will take in the loan agreement. However, as a general matter, it seems somewhat difficult to take the position that a specified stepdown trigger would be remote, given that one would not expect commercial parties to negotiate a stepdown of an interest rate with a trigger whose occurrence or non-occurrence is remote.

2. The Incidental Exception

A payment is also not treated as a contingent payment for purposes of a debt instrument being treated as a CPDI if the contingency is "incidental" as of the issue date.[35] A contingency as to the amount of a payment is treated as incidental if, "under all reasonably expected market conditions, the potential amount of the payment is *insignificant* relative to the total expected amount of the remaining payments on the debt instrument."[36] No definition of "insignificant" is provided for this purpose, and there does not appear to be any authority in this context or any examples in the Treasury Regulations that might prove instructive. However, there are several analogous contexts that practitioners may look to for guidance.

One relevant context is the "*de minimis* OID" rule, which provides that a debt instrument is not treated as having original issue discount (OID) if the OID on the debt instrument is less than 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity.[37] Under that analogy, it would seem relatively clear that if the change in rate would be less than 25 basis points per annum, such contingency could be treated as incidental. However, there are several scenarios that would remain unclear. One scenario whose treatment is ambiguous under this analogy is where hitting the stepdown trigger would decrease the total yield by less than 25 basis points but increase the interest payment in a given year by more than 25 basis points. For example, if the debt instrument bears interest at 10 percent, has a four-year term, and there is a stepdown of 30 basis points that cannot be triggered before the beginning of the third year of the term. If the stepdown is triggered in the third year, the interest payment for the third and fourth years will be decreased by more than 30 basis points, but the total yield of the debt instrument will only be reduced by roughly 14 basis points. It is unclear whether the analogy to the *de minimis* OID rule would apply to the yield, and therefore treat the contingency as incidental, or to the changes to the annual interest payments, in which case it might not be treated as an incidental contingency.

Another ambiguity is how a stepdown of exactly 25 basis points (either to yield or to annual interest payments, depending on one's view as to the previous question) would be treated. On the one hand, the *de minimis* OID rule requires that a debt instrument have OID of less than 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity. If the OID is equal to exactly 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity, then there will be OID on the debt instrument. However, in the context of an instrument with OID, the stated redemption price at maturity will always exceed the issue price,[38] so 0.0025 multiplied by the product of the issue price and the number of complete years to maturity would, by definition, be less than 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity. In the context of a debt instrument with an interest rate stepdown but no OID, meaning that the issue price and the stated redemption price at maturity are identical, it is unclear whether the proper analogy would be to the issue price of an OID

instrument or to the stated redemption price at maturity of the OID instrument. If the proper analogy is to the former, then even a stepdown of exactly 25 basis points could be considered incidental. If the proper analogy is to the latter, then the stepdown would need to be less than 25 basis points to be incidental.

Another potential analogy that practitioners may look to is the change in yield rule under the Treasury Regulations governing significant modifications of debt instruments.[39] Under those rules, a change to the yield of a debt instrument does not trigger a significant modification of a debt instrument unless the change is more than the greater of 25 basis points or five percent of the yield of the unmodified instrument.[40] Similarly to the analogy to the *de minimis* OID rule, there would be some ambiguity as to whether this analogy should apply to the yield on the debt instrument as a whole or to the annual interest payments. However, this analogy would more clearly apply to an interest rate stepdown of exactly 25 basis points.

If a contingency is treated as incidental, it is ignored until the payment is made.[41] If a change in circumstances occurs, causing an incidental contingency to become fixed at an amount that is not insignificant, then the debt instrument is generally treated as retired and reissued on the date of such change in circumstances for an amount equal to the instrument's adjusted issue price on such day.[42] The issuer's determination that a contingency is incidental is binding on all holders unless the holder explicitly discloses that its determination is different than the issuer's in a statement attached to its tax return.[43]

Based on the foregoing discussion, there may be circumstances in which the issuer could reasonably take the position that a contingency is incidental and that therefore the CPDI rules do not apply but rather the contingency is ignored until the payment is made, depending on the stated interest rate and how many basis points are stepped down on hitting the trigger. However, there are significant ambiguities as to how this rule should apply in practice and lenders should consider stipulating the proper treatment in the credit agreement.

3. Significantly More Likely Than Not Payment Schedule

In addition to the foregoing exceptions to the CPDI rules, the Treasury Regulations provide a special rule for debt instruments that have one payment schedule that is significantly more likely than not to occur. Those rules provide that "if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date" and that, based on the facts and circumstances as of the issue date there is one payment schedule that is significantly more likely than not to occur, the yield and maturity of the debt instrument is computed based on that payment schedule.[44] If this rule applies, then the qualified stated interest on the debt instrument is the lowest amount of interest that would be payable under any payment schedule.[45] Any additional interest amounts under the significantly more likely than not payment schedule accrue under the OID rules, and if a contingency occurs (or does not occur) that causes a different payment schedule to apply, the debt instrument will be treated as retired and reissued on the date of such occurrence (or nonoccurrence).[46] The Treasury Regulations do not provide guidance as to what constitutes a "significantly more likely than not" probability for this purpose. Because a 51-percent probability is "more likely than not," the "*significantly* more likely than not" threshold must be "significantly" more than 51 percent. Some commentators suggest that a probability of two-thirds should be sufficient.[47]

One threshold question for the application of the "significantly more likely than not payment schedule" rule is whether it applies only when the debt instrument specifies the alternative payment schedules or if it applies even when the number of alternative payment schedules is not specified in the debt instrument, but a finite number of alternative payment schedules can be computed under the debt instrument. In other words, where there is both a cap and floor on the interest amounts that may be paid under a debt instrument, even where there is wide variability as to timing and amounts of payments, the timing and amounts of each payment schedule are theoretically known. This is in contrast to an uncapped interest rate that tracks a market index; there is theoretically an infinite number of payment schedules and therefore all payment schedules cannot be "known" as of the issue date. It appears that most practitioners take the view that the alternative payment schedules do not need to be specified for the "significantly more likely than not payment schedule" rule to apply.[48] Under that view, in the context of a debt instrument with an interest rate stepdown, because there are a finite number of possible payment schedules that can be computed under the debt instrument (because there is a floor and a cap on the interest rate), if there is a single payment schedule that is "significantly more likely than not to occur," the CPDI rules should not apply.

The possibility that there is a single payment schedule that is "significantly more likely than not to occur" appears most likely in a scenario where there is a hard date by which the stepdown must be triggered, as it would seem reasonable in many instances to take the position that it is "significantly more likely than not" that the trigger will not be hit by that date. If there is such a single

payment schedule that is significantly more likely than not to occur, there will be qualified stated interest at the stepped down rate, with OID accruing to the extent of the difference between the stepped down rate and the stepped-up rate. If there is ultimately a different payment schedule on the debt instrument, there will be a deemed retirement and reissuance at the adjusted price. For example, if a debt instrument is issued with an interest rate of three-month SOFR plus 6.5 percent but that interest rate steps down to three-month SOFR plus six percent upon the borrower hitting the stepdown trigger by a specified date. It seems reasonable that the parties may take the view that it is "significantly more likely than not" that the borrower will not hit the stepdown trigger by such specified date. In that case, the debt instrument will have qualified stated interest of three-month SOFR plus six percent and will accrue an additional 50 basis points of OID. If the borrower does hit the stepdown trigger, then the debt instrument will be deemed retired and reissued with an interest rate of three-month SOFR plus six percent.

The initial Treasury Regulations related to the "significantly more likely than not payment schedule" rule provided that the issuer's determination as to whether there was such a payment schedule was binding on the holders unless the holder explicitly disclosed on a statement attached to its tax return that it was taking a different position than the issuer.[49] However, that provision was deleted in 1996, and the Treasury Regulations have since been reserved for a "consistency rule."[50] Even though that rule does not technically apply, it would still be beneficial for lenders to include a provision in the loan agreement stipulating whether the "significantly more likely than not payment schedule" rule applies. However, issuers may be hesitant to include such explicit language because it could possibly be construed as a representation as to the future performance of the borrower.[51]

B. Application of the CPDI Rules

If none of the above exceptions apply, then the CPDI rules will generally apply to a debt instrument with an interest rate stepdown. Generally, a debt instrument that is issued for money or for publicly traded property is subject to the noncontingent bond method.[52] The noncontingent bond method consists of four steps:

Step 1: A comparable yield for the CPDI is determined.[53] The comparable yield is generally the yield at which the issuer would issue a fixed-rate debt instrument with terms and conditions similar to the CPDI.[54]

Step 2: A projected payment schedule for the CPDI is determined.[55] The projected payment schedule includes each noncontingent payment and an amount in respect of each contingent payment.[56] If the contingent payment is determined by reference to market information (*e.g.*, the trading price of a stock or by reference to a market index), then the amount in respect of the contingent payment is determined by reference to the market price to such a contingent right.[57] If the contingent payment is not based on market information (*e.g.*, the gross receipts of the issuer), then the amount of the contingent payment is the expected value of the contingent payment as of the issue date.[58] The projected payment schedule must equal the comparable yield.[59] The issuer's projected payment schedule is binding on the holders unless the projected payment schedule is unreasonable, in which case the holder must prepare its own projected payment schedule and explicitly disclose that it is not using the issuer's projected payment schedule in a statement attached to its tax return.[60]

Step 3: The daily portion of interest on the CPDI is determined.[61] The amount of interest in each acccrual period is the product of the adjusted issue price of the CPDI and the comparable yield and the daily portion of interest is determined by allocating that interest amount ratably to each day in the accrual period.

Step 4: Make appropriate adjustments for any differences between projected and actual contingent payments.[62] The amount by which a contingent payment exceeded the projected amount of such payment is a positive adjustment and the amount by which the projected amount exceeded the projected amount is a negative adjustment.[63] If the total positive adjustments are greater than the total negative adjustments in a taxable year, there is a net positive adjustment, and if the total negative adjustments are greater, there is a net negative adjustment.[64] Net positive adjustments are treated as additional interest on the CPDI. Net negative adjustments first reduce any further interest accruals and then give rise to ordinary loss for the holder and ordinary income by the issuer, but use of the ordinary loss is limited to the total amount of interest inclusions in respect of such CPDI by the holder and the inclusion of ordinary income by the issuer is limited to the amount of the issuer's total interest deductions on the CPDI (reduced by any other income inclusions in respect of net negative adjustments on the CPDI). Amounts in excess of

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the foregoing limits are carried forward as a negative adjustment carryforward.[65]

The adjusted issue price of a CPDI is generally the issue price of the debt instrument, increased by the amount of interest accrued on the CPDI (without regard to subsequent adjustments) and decreased by the amount of any noncontingent payment and the projected amount of the previous contingent payments.[66] The holder's basis is similarly adjusted by the amount of interest accrued on the CPDI (without regard to subsequent adjustments) and decreased by the amount of any noncontingent payment and the projected amount of the previous contingent payments.[67] Any gain recognized by a holder on a sale, exchange, or retirement of a CPDI is treated as interest income, and loss is treated as ordinary loss to the extent of the holder's total interest inclusions in respect of the CPDI, unless there are no remaining contingent payments due under the projected payment schedule.[68]

When a payment becomes fixed more than six months prior to the payment date, a positive or negative adjustment is applied on the basis of the present values of the projected amount and the actual amount (discounted using the comparable yield), and the projected payment schedule is modified prospectively.[69] The accrual period ends on the date such payment becomes fixed and a new accrual period begins on the following day.[70] The amount of any positive adjustment in respect of fixed payments increases the adjusted issue price of, and the holder's basis in, the CPDI, and the amount of any negative adjustment decreases the adjusted issue price and the holder's basis.[71]

If all contingent payments on the CPDI become fixed substantially contemporaneously, the above rule does not apply but rather positive and negative adjustments "are taken into account in a reasonable manner over the period to which they relate."[72] For purposes of this rule, payments are treated as fixed if all remaining contingencies with respect to the payment are remote or incidental.[73]

In a typical interest rate stepdown, where the likelihood of the trigger being hit in the near term is unlikely, the projected payments for the earlier interest payments would be close to 100 percent of the non-stepped down interest payment, with the expected value of the later payments declining over time. Importantly, there may be some benefit to the holder (and corresponding detriment to the issuer) from classifying the debt instrument as a CPDI because the inclusion in income in respect of the interest accrual in the earlier years of the CPDI will generally be less than the amount actually received (and the issuer's deduction will be correspondingly less than the amount actually paid). For debt instruments that are not likely to be traded, therefore, the only downside to classification as a CPDI may be the reporting complexity.

For a debt instrument with an interest rate stepdown that can be stepped back up over the life of the debt instrument, *i.e.*, the stepped down interest rate is contingent on maintaining a specified metric, the noncontingent bond method will likely apply throughout the term of the debt instrument, unless the possibility of maintaining or not maintaining that metric becomes remote.[74] In a scenario where the trigger must be met by a specified date in order for the interest rate to step down, if the trigger is not hit as of such date (or if the possibility of hitting the trigger becomes remote as of an earlier date), then all contingencies will be fixed as of such earlier date. If the trigger must be hit by a specified date and the interest rate remains stepped down once the trigger is hit regardless of any metric being maintained, then the contingencies on the debt instrument will become fixed as of the earlier of the date that the trigger is hit or the date by which it must be hit for the stepdown to be triggered (or the date on which the possibility of the trigger being hit or not being hit becomes remote).[75]

When all contingencies on the debt instrument become fixed for the reasons described above, the positive or negative adjustments are taken into account "in a reasonable manner over the period to which they relate."[76] The vague formulation of the Treasury Regulations does not provide much guidance.[77] In the context of an interest rate stepdown, it seems reasonable to have a positive adjustment equal to the excess of (i) the sum of the actual interest payments already paid prior to the date of the interest rate becoming fixed over (ii) the total amount of interest accrued under the noncontingent bond method using the comparable yield, and to otherwise treat the fixed interest rate as the interest rate on the debt instrument going forward. In addition, upon the contingencies becoming fixed, subsequent gain on the disposition of the debt instrument should be capital gain and not treated as interest income.[78]

IV. Conclusion

There is a good argument that Code Sec. 871(h)(4) should not apply to any portion of the interest on a debt instrument due solely to the debt instrument having an interest rate stepdown that is tied to a sales or revenue target. There appears to be no policy justification at all for applying Code Sec. 871(h)(4) to such interest rate stepdowns and there is also a strong technical argument that the rule does not apply. Even if the rule does apply, it should apply only to the portion of the interest rate that exceeds the interest rate that would apply after the stepdown is triggered. The

CPDI rules will generally apply to debt instruments with an interest rate stepdown, unless the possibility of the stepdown being triggered is remote or incidental or if there is one payment schedule that is significantly more likely than not to occur. There are significant ambiguities with respect to each of those exceptions, and lenders should consider including a provision in the credit agreement stipulating the agreed-upon tax treatment.

ENDNOTES

* The author thanks Jeffrey D. Hochberg and Ari Blaut for their insightful comments and guidance. The views expressed herein are those of the author and not of Sullivan & Cromwell LLP.

1 Except to the extent otherwise provided, all "Code Sec." and "Reg. §" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury Regulations promulgated thereunder.

2 Code Secs. 871(a) (for individuals) and 881(a) (for corporations). Interest and dividends paid to foreign individuals and corporations are subject to withholding under Code Secs. 1441(a) (for individuals) and 1442(a) (for corporations).

3 Code Secs. 871(h) and 881(c). Interest that is subject to the portfolio interest exemption is not subject to withholding under Code Secs. 1441(c)(9) (for individuals) and 1442(a) (for corporations).

4 Deficit Reduction Act of 1984, P.L. 98-369, Section 127 (Jul. 18, 1984) [hereinafter DEFRA Bluebook].

5 *See generally* John Sarafopoulos, *Eurobond Financings: Current Techniques and New Proposals*, 9 INT'L TAX J. 399 (1983); A. J. Alexis Gelinas, *Tax Considerations for U.S. Corporations Using Finance Subsidiaries to Borrow Funds Abroad*, 7 J. CORP. TAX. 230 (1980).

6 Staff of J. Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84, at 391 (J. Comm. Print 1984).

7 Code Secs. 871(h)(3) and 881(c)(3)(B); DEFRA Bluebook at 393-94.

8 Code Sec. 881(c)(3)(C).

9 Code Sec. 881(c)(3)(A).

10 DEFRA Bluebook at 395; *see also* TAM 9822007.

11 Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, Section 13237 (Aug. 10, 1993).

12 Code Secs. 871(h)(4)(A)(i) and 881(c)(4).

13 Code Sec. 871(h)(4)(A)(ii).

14 Code Sec. 871(h)(4)(C).

15 H. Rep. No. 103-111, 103d Cong. 1st Sess. at 724 (May 25, 1993) [hereinafter House Report].

16 Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1320 (1996).

17 House Report at 725.

18 Code Sec. 871(h)(4)(A).

19 *Supra* note 17.

20 *Supra* note 15.

21 Code Secs. 871(h)(4)(A)(i) and 881(c)(4).

22 Reg. §1.1441-5(b)(1).

23 Reg. §1.1441-5(b)(2)(i)(A).

24 Reg. §1.1464-1(a).

25 *Supra*, text accompanying notes 15–17.

26 Reg. §1.1275-4(b)(8)(iii).

27 Reg. §1.1275-4(a)(1).

28 Reg. §1.1275-4(a)(2).

29 Reg. §1.1275-4(a)(5).

30 Reg. §1.1275-2(h)(2).

31 *See Pacificorp Holdings, Inc.*, 2007 WL 3028436, at *10 (D. Or. Oct. 15, 2007) ("The term 'remote,' as used in Prop. Treas. Reg. §1.1275-4(b)(1), is not defined in either the Internal Revenue Code ('Code') or the regulations. Nor has it been interpreted by any court of law. As noted above, when Treasury finalized regulations under Code §1275, the only guidance it chose to provide relating to the term 'remote' was that 'a contingency is remote is there is a remote likelihood either that the contingency will occur or that the contingency will not occur.' Treas. Reg. §1.1275-2(h)(2).").

32 *Id.*

33 Reg. §1.1275-2(h)(6)(ii).

34 Reg. §1.1275-2(h)(5).

35 Reg. §1.1275-4(a)(5).

36 Reg. §1.1275-2(h)(3)(i).

37 Reg. §1.1273-1(d).

38 Code Sec. 1273(a)(1).

39 Reg. §1.1001-3(e)(2)(ii).

40 *Id.*

41 *Id.*

42 Reg. §1.1275-2(h)(6)(ii).

43 Reg. §1.1275-2(h)(5).

44 Reg. §§1.1272-1(c)(1) and (2).

45 Reg. §1.1273-1(c)(2).

46 Reg. §1.1272-1(c)(6).

47 David C. Garlock, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 510 (2023 Edition).

48 New York State Bar Association Tax Section, Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations 26 (May 5, 2010).

49 Debt Instruments With Original Issue Discount; Imputed Interest on Deferred Payment Sales or Exchanges of Property, 59 FR 4799-01, 4811 (Feb. 2, 1994).

50 Reg. §1.1272-1(c)(4); Debt Instruments With Original Issue Discount; Contingent Payments; Anti-Abuse Rule, 61 FR 30133-02, 30139 (Jun. 14, 1996).

51 *See id.* at 30134-35 (quoting a commenter as expressing concern that "the use of the term projected payment schedule caused securities law problems because the issuer could be seen as making representations to the holder about the expected payments").

52 Reg. §1.1275-4(b)(1). CPDIs that are not subject to the noncontingent bond method, such as a CPDI issued for nonpublicly traded property, are subject to a different rule. Generally, the portion of contingent payments on such a CPDI that exceeds the present value of the payment discounted back to the issue date and using the appropriate test rate is treated as interest and the remainder is treated as a payment of principal. Reg. §1.1275-4(c).

53 Reg. §1.1275-4(b)(3)(i).

54 Reg. §1.1275-4(b)(4)(i)(A).

55 Reg. §1.1275-4(b)(3)(ii).

56 Reg. §1.1275-4(b)(4)(ii).

57 Reg. §1.1275-4(b)(4)(ii)(A).

58 Reg. §1.1275-4(b)(4)(ii)(B).

59 Reg. §1.1275-4(b)(4)(ii)(C).

60 Reg. §1.1275-4(b)(4)(iv).

61 Reg. §1.1275-4(b)(3)(iii).

62 Reg. §1.1275-4(b)(3)(iv).

63 Reg. §1.1275-4(b)(6)(i).

64 Reg. §§1.1275-4(b)(6)(ii) and (iii).

65 Reg. §1.1275-4(b)(6)(iii).

66 Reg. §1.1275-4(b)(7)(ii).

67 Reg. §1.1275-4(b)(7)(iii).

68 Reg. §1.1275-4(b)(8)(iii).

69 Reg. §§1.1275-4(b)(9)(ii)(A) and (B).

70 Reg. §1.1275-4(b)(9)(ii)(C).

71 Reg. §1.1275-4(b)(9)(ii)(D).

72 Reg. §1.1275-4(b)(9)(ii)(G).

73 *Id.*

74 *Id.*

75 *Id.*

76 *Id.*

77 Garlock, *supra* note 47, at ¶ 904.

78 Reg. §1.1275-4(b)(8)(iii)(A).

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