Equity Classification of Convertible Debt?: Tax and Cash Flows Considerations

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Abstract

The issue of debt versus equity classification for hybrid securities has been a source of continuing controversy for tax policy-makers and financial accounting standard setters. A large number of corporations have issued hybrid financial instruments which possess the characteristics of both debt and equity. One of the most common examples of hybrid financial instruments is convertible debt. Issuers of convertible debt were motivated by a desire to raise capital that would be attractive to the capital markets while at the same time exploit tax or reporting rules. For instance, the issuer of convertible debt is allowed a tax deduction for interest expense even though the convertible debt instrument may later be converted to equity, thus avoiding repayment of principal at maturity. The Internal Revenue Service (IRS) allows the issuer a tax deduction for interest expense, while requiring the holder to recognize taxable interest income. However, the IRS and the Financial Accounting Standards Board (FASB) have considered treating convertible debt according to its underlying economic substance and ultimate outcome as opposed to treating it strictly as debt. If the IRS, the FASB, or both were to move towards an economic substance approach with respect to convertible debt, what implications would this have on the issuers and holders of convertible debt? This article speculates on changes in tax and reporting rules for convertible debt and analyzes the potential impact of such changes on the treatment of distributions from convertible debt. Our analysis shows that if convertible debt were treated as equity and its distributions no longer eligible for interest expense deductions, issuers would experience a decrease in cash flow from operations due to the presumed increase in tax liability. Conversely, holders of convertible debt may be eligible for the dividends-received deduction.

Introduction

The issue of debt versus equity classification for hybrid securities has been a source of continuing controversy for tax policy-makers and financial accounting standard setters. A large number of corporations have financial instruments outstanding which possess the characteristics of both debt and equity, broadly referred to as hybrid or compound instruments.

Some hybrid instruments have the legal form of equity, but may in economic substance possess the characteristics of debt, such as issues of redeemable preferred stock. Conversely, other financial instruments have the legal form of debt, but may in economic substance bear a greater resemblance to equity. An example of such an instrument is convertible debt. This study will considers convertible debt and the possible reclassification from debt to equity.

Convertible debt are hybrid financial instruments initially issued in the legal form of debt, but have a conversion feature which allows the holder to convert each instrument into a specified number of shares of the issuing firms' common stock. The conversion feature is either inseparable from the bond or is constructively inseparable, in so far as that the bond must be surrendered to the issuer in order to exercise the conversion feature.

Convertible debt is examined in this study because it is a popular form of hybrid security and because it is a material financial statement item for a large number of firms. A search on the *Compustat*™ database revealed 779 firms reporting convertible debt outstanding for the fiscal year 1992. The aggregate dollar amount of convertible debt outstanding increased over the preceding decade, from $22.2 billion in fiscal 1983 to $65.2 billion in fiscal 1992, an almost 200% increase. In addition, several billion dollars in convertible debt-related interest expense was incurred on corporate income statements, which was also deducted on corporate tax returns. Consequently, a change

in the tax treatment of convertible debt could significantly affect the tax liability, hence cash flow, of a large number of firms.

Corporations were motivated to issue hybrid instruments, including convertible debt, by a desire to offer financial instruments attractive to the capital markets while at the same time exploiting tax or reporting rules in a manner that would be favorable to the issuer. For instance, from the investor or holder's perspective, convertible debt provides a steady stream of interest payments while the holder waits for the underlying stock to grow sufficiently to provide a profit upon conversion. Meanwhile, the issuer of convertible debt is allowed a tax deduction for interest expense even though the convertible debt instrument may later be converted to equity, thus avoiding repayment of principal at maturity.

Traditionally, the Internal Revenue Service (IRS) treatment of most forms of convertible debt has been fairly straight-forward: convertible debt has been classified as debt on issuers' corporate tax returns unless the holder exercised the conversion feature. The issuer is allowed a tax deduction for interest expense, while the holder must recognize distributions as taxable interest income.

However, a combination of IRS rulings and efforts by the Financial Accounting Standards Board's (FASB), the main rule making body for financial reporting, has lead to speculation about future changes in the tax treatment for convertible debt. Both the IRS and FASB's efforts are motivated by a determination to categorize hybrid financial instruments, including convertible debt, based on their underlying economic substance and ultimate outcome as opposed to their initial legal form. This article speculates on possible changes to the tax treatment of convertible debt and analyzes the related tax liability and cash flow impact stemming from those theoretical changes. The discussion and analysis should be of interest to issuers and holders of convertible debt and other parties interested in possible tax and reporting developments related to hybrid financial instruments.

Traditional Tax Classification Rules for Convertible Debt

The correct tax treatment of hybrid securities, including convertible debt, is governed by IRC Section 385. This section authorizes the Secretary (IRS) to write regulations setting guidelines as to whether an interest in a corporation is treated as equity or indebtedness. However, to date, no regulations have been produced concerning Section 385. Section 385(b) lists factors to be considered in the classification question: (a) whether there is a written unconditional promise to pay on demand, on a specified date, a sum certain in money, and there is a fixed rate of interest; (b) whether there is subordination to or preference over any indebtedness of the corporation; (c) the ratio of debt to equity of the corporation; (d) whether there is convertibility into the stock of the corporation, and; (e) the relationship between holdings of stock in the corporation and holdings of the interest in question.

Little other statutory or administrative guidance is given concerning the debt verses equity classification. Thus, the classification rests mainly on the evaluation of case law. Fin Hay Realty Co. v. US (398 F2d 694, CA-3, 1968) is a much cited case concerning debt or equity classification. In Fin Hay, the Third Circuit Court of Appeals refers to sixteen relevant factors in determining whether a security is debt or equity. Several of these factors are listed in IRC Section 385.

These criteria, along with factors developed in numerous other court cases, are often difficult to apply for several reasons. First, the courts never identified any specific criterion to establish debt or equity. Second, the factors are numerous and lack a point system or hierarchical rating.[1] As a result of this ambiguity, issuers of convertible debt and other types of hybrid securities are often uncertain as to the proper tax treatment.

Evolution of Tax Classification: Substance Over Form?

Tax controversy surrounds hybrid instruments due to the potential domino effect of the classification. From a tax standpoint alone, the classification not only affects the deductibility of current distributions (i.e., interest versus dividends) but the ability of a corporation to elect *S corporation* status (i.e., greater than one class of stock) or receive the tax-free benefits of certain organization and reorganization provisions in the Internal Revenue Code (IRC), sections 351 and 368, respectively.[2]

In the past the debt or equity classification relied primarily on a vast body of case law. Recently, however, Congress and the Treasury have attempted to clarify matters by amending IRC Section 385 and by the issuance of Proposed Regulations 1.1275. Although these changes are theoretically more viable, they have increased the uncertainty and complexity in dealing with hybrid securities.

For instance, a departure from the "entirely debt" or "entirely equity" approach has already been reflected in IRS rulings. One such approach is known as the "bifurcation approach," where a portion of the security is deemed to be equity and a portion is deemed to be debt. Several court decisions have followed this approach.[3] In

addition, IRC 385 contains a parenthetical phrase indicating possible mixed debt and equity treatment.[4]

In IRS Notice 94-47, the IRS announced increased scrutiny of financial instruments designed to be treated as debt for tax purposes, but would probably be settled as equity or reported as equity on the issuer's financial accounting purposes.[5] These instruments were called Adjustable Rate Convertible Notes (ARCNs). One of the features of ARCNs which attracted IRS attention was that the redemption value was typically less than the market value of the underlying stock at issue date, creating a strong likelihood of conversion into stock instead of redemption. Notice 94-47 lists several factors used in the debt versus equity determination. Several of these factors are reiterated from Sec. 385. But, Notice 94-47 adds the following: (1) the label placed upon the instruments by the parties, and (2) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.[6] As discussed later, the FASB's has also considered the classification of convertible debt based on economic substance and ultimate outcome, and not just legal form.

The implications of the IRS's economic substance approach to convertible debt embodied in Notice 94-47 is evidenced by considering the case of ARCNs. Even though the ARCNs had not yet been converted by the holder, the IRS deemed that the likelihood of conversion was so probable that the economic substance of ARCNs were more that of equity and than debt. Accordingly, the IRS stated that the issuers will not be allowed an interest deduction for ARCN-related distributions. The obvious impact to the issuers of ARCNs was the increase in taxable income because of the elimination of the interest expense deduction.

The example of ARCNs raises important questions. In the future, could the tax treatment applied to ARCNs be more broadly applied to the entire category of convertible debt? If so what would be the potential tax liability and cash flow impact?

Convertible Debt Treated as Equity?: The FASB'S Debt Versus Equity Project

In August, 1990 the Financial Accounting Standards Board (FASB), the financial accounting rule making body, issued a Discussion Memorandum (DM) entitled "Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both." A DM is intended as a neutral document that outlines financial accounting and reporting issues under consideration by the FASB and alternative methods to addressing those issues. DM's, therefore, have often been an early step in the development of new accounting standards. Accordingly, analyzing issues and alternative methods raised in a DM is an important contribution to accounting research because it anticipates possible changes in accounting standards and alerts the accounting profession to the potential impact of those changes.

The August, 1990 DM, which is part of the FASB's comprehensive project on financial instruments, focuses on accounting by issuers of financial instruments. One of the issues raised in the DM was accounting for convertible debt. Current GAAP requires convertible debt to be classified entirely as debt at the date of issuance regardless of the likelihood of the instrument being converted or settled as equity. The DM, however, considered two approaches which are a departure from the "entirely as debt" rules under current GAAP (FASB, 1990):

Should issuers account for an instrument with both liability and equity characteristics: (a) As being entirely a liability instrument or entirely an equity instrument depending on which characteristic governs at the date of issuance and (b) As consisting of a liability component and an equity component that should be accounted for separately? Conceptual arguments supporting and opposing the two approaches, a. and b. above, were presented in the DM. In addition, related sub-issues concerning implementing either approach were also discussed in detail beyond the scope of this paper.[7] The relevant point is that the FASB has at least considered equity classification for a portion of or all of an outstanding convertible debt issue. The IRS, in some instances, adopts the financial accounting treatment of an item for tax purposes. Therefore, from a tax perspective it is appropriate to consider changes in financial accounting and reporting. Also, Notice 94-47, discussed earlier, lists financial accounting and reporting treatment of convertible debt as a factor in the determination of debt or equity treatment for tax purposes.

If the August, 1990 FASB DM were the only instance that could be cited of the FASB's consideration of equity treatment of convertible debt, it by itself would be intriguing. However, there are already instances under existing GAAP where outstanding convertible debt is required to be classified as equity. The first occurs where convertible debt is issued at a large premium over par value. Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* requires a portion of a large premium to be classified as additional paid-in capital (American Institute of Certified Public Accountants, 1969).

The second instance involves earnings per share (EPS). Accounting Principles Board Opinion No. 15, *Earnings Per Share* requires that all dilutive outstanding convertible securities, including convertible debt, be treated as if they had been converted as of the reporting date for EPS (American Institute of Certified Public Accountants, 1969). Under APB Opinion No. 15, convertible debt found to be "common stock equivalents" have their underlying shares of common stock added to weighted-average shares outstanding and the related interest expense for the reporting period added back to earnings for both primary and fully-diluted earnings per share calculations. Statement of Financial Accounting Standards (SFAS) No. 85, *Yield Test for Determining Whether a Convertible Security Is a Common Stock Equivalent* (Financial Accounting Standards Board, 1985), which superseded SFAS No. 55, *Determining Whether a Convertible Security Is a Common Stock Equivalent* (Financial Accounting Standards Board, 1982), categorizes convertible debt as a common stock equivalent if its effective yield is less than two-thirds the average Moody's™ Aa corporate bond yield.

The relevance of these two examples is that, albeit to a limited degree, existing accounting standards already require equity classification of outstanding convertible debt. In the instance of EPS this is true for one of the most important and widely followed pieces of financial reporting information. Therefore, the equity treatment of outstanding convertible debt considered in the August, 1990 DM is not without at least some degree of precedent.

Of course, for the issuing corporation, the most beneficial combination of reporting and tax treatment would be to include convertible debt as equity in the financial statements to avoid interest expense on the income statement while at the same time treating convertible debt as debt on the tax return to generate an interest expense deduction. However, if convertible bonds are treated as equity on the financial statements, it would seem highly unlikely, especially in light of Notice 94-47, that the IRS would allow conflicting debt treatment for tax purposes (i.e., an interest expense deduction). The equity treatment would thus increase taxable income and reduce cash flow.

A second tax issue raised by the DM is whether the holders of convertible debt receiving distributions would then be allowed a dividend-received deduction. If convertible debt is treated as equity by the issuer, then the resulting distributions should be treated as dividends. Thus, for holders receiving distributions of convertible debt classified as equity on corporate issuers' balance sheets, the dividends-received deduction should apply resulting in a higher effective yield on the securities.

With the IRS having shown a willingness to reduce or disallow interest expense deductions related to convertible debt, and the FASB having at least raised the possibility of classifying convertible debt as equity, the traditional debt treatment of convertible debt on corporate tax returns in the future is less certain. The implications of equity treatment for convertible debt is examined next by analyzing its potential effect upon issuers' interest expense deduction, taxable income, and cash flow from operations.

Impact of Equity Treatment on Outstanding Convertible Debt

In fiscal 1992, 779 firms reported convertible debt (DCVT) on *Compustat*™, some which were large and prominent corporations with household names such as Eastman Kodak Comp., MCI Communications, Inc., and Home Depot, Inc. (See Exhibit 1). These 779 firms are analyzed in this study. We consider the possibility of the entire amount of outstanding convertible debt being treated as equity since this assumption will illustrate the greatest extent of the impact. In the instance of ARCNs, discussed earlier, the IRS required the entire amount of the convertible debt instrument to be treated as equity. The FASB DM also considered entirely debt or entirely equity treatment.

Interest Expense and Tax Liability:

To analyze the potential impact of equity treatment of convertible debt, the interest expense applicable to convertible debt (DCVTINT) was estimated for each firm by multiplying total interest expense (XINT) by a ratio constructed of the average amount of DCVT reported by issuers to the average amount of issuers' total liabilities (LT):

$$DCVTINT = XINT\left({}^{((\text{beginning DCVT} + \text{ending DCVT})/2)}/_{((\text{beginning LT} + \text{ending LT})/2)}\right)$$

where

DCVTINT = convertible debt-related interest.
XINT = total interest expense.
DCVT = convertible debt.
LT = total liabilities.

The estimates of DCVTINT relied on average amounts of reported DCVT and LT instead of just amounts reported at fiscal year-end to avoid overstatement of DCVTINT due to issuances of DCVT occurring in the later part of the fiscal year. Our estimate should be conservative for another reason. The total liabilities (LT) variable used in the denominator includes short-term liabilities, some of which

may not generate interest expense, such as accounts payable. If the denominator had consisted of only long-term liabilities, the estimates of the DCVTINT may have been greater for many firms. So, the use of total liabilities instead of only long-term liabilities adds to the conservative nature of our estimated convertible debt-related interest expense (DCVTINT).

Objections to the use of estimates could be addressed by collecting the actual amount of interest expense for each issue of convertible debt outstanding for each of the 779 firms. This would appear to be impractical, however. A limitation to our approach is that it assumes a uniform rate of interest expense for each classification and type of liability within each firm.

Exhibit 1 shows the estimated decrease in interest expense as well as the potential increase in tax liability for selected firms (assuming the companies did not have net operating losses). As seen in Exhibit 1, several corporations could experience millions of dollars of additional tax (ceteris paribus) due to decreases in their interest expense deduction. For example, Eastman Kodak would experience a decrease in interest expense of $69,242,000 causing an increase in tax liability of $23,542,000. Kroger Co.'s interest expense would decrease by $18,492,000 resulting in an increase in tax liability of $6,287,000. These amounts of additional tax liability can be material to even large corporations, especially if measured in relation to after-tax profits or cash flow from operations, which is analyzed later.

Overall, our analysis indicate that reclassification of DCVT to equity would result in an average percentage decrease in interest expense of 20.2% and an average increase in tax liability of 73.1%. However, the use of averages to assess the overall impact for the sample is misleading because of the presence of firms reporting small amounts of pre-reclassification non-DCVT interest expense and small amounts of pre-reclassification tax liability.

Exhibit 1

Absolute Dollar Amounts for Selected Examples of Increases in Federal Income Tax if Outstanding Convertible Debt Were Treated as Equity, Fiscal Year 1992
(Dollar Amounts in Thousands, 34% tax rate assumed)

Company Name	Ticker Symbol	(a) Decrease in Interest Expense	(b) ((a)x.34) Increase in Tax Liability
1. HITACHI LTD (ADR)	HIT	$ 90,416	$ 30,742
2. SONY CORP (AMER SHARES)	SNE	82,972	28,211
3. EASTMAN KODAK CO	EK	69,242	23,542
4. TELE-COMMUNICATIONS (CL A)	TCOMA	33,898	11,525
5. TURNER BROADCASTING (CL B)	TBS.B	31,880	10,839
6. MCI COMMUNICATIONS	MCIC	25,644	8,719
7. TOYOTA MOTOR LTD (ADR 2 COM)	TOYOY	23,747	8,074
8. FREEPORT MCMORAN INC.	FTX	22,399	7,616
9. BRITISH AIRWAYS PLC (ADR)	BAB	20,760	7,058
10. HOME DEPOT INC.	HD	20,536	6,982
11. MOTOROLA INC	MOT	19,304	6,563
12. KROGER CO	KR	18,492	6,287
13. RJR NABISCO HLDGS CORP	RN	17,617	5,990
14. VOLVO AB SWE (ADR)	VOLVY	14,253	4,846
15. UNION CARBIDE CORP	UK	13,738	4,671
16. CBS INC	CBS	13,167	4,477
17. LITTON INDUSTRIES INC	LIT	12,127	4,123
18. CHIQUITA BRANDS INTL	CQB	11,092	3,771
19. APACHE CORP	APA	10,608	3,607
20. UNISYS CORP	UIS	10,059	3,420

To provide a more realistic measure of the overall impact of the change in treatment we calculated the median percentage change for both interest expense and tax liability. Our analysis showed a median decrease in interest expense of 14.3% and a median increase in tax liability of 8.6%. Using 5%, or even 10%, as a threshold of materiality, the median changes in interest expense and tax liability for our sample would be considered material, underscoring that the magnitude of the impact would be important to many firms. Perhaps more important, though, than the change in interest expense and tax liability would be the impact on cash flow from operations from a change in tax treatment for convertible debt distributions, which is discussed in the next section.

Cash Flow from Operations:

An increase in taxable income due to reclassification of convertible debt from debt to equity would result in a decrease in the cash flow from operations. The dollar amount of the decrease in cash flow from operations is estimated by multiplying the DCVTINT, convertible debt-related interest expense, by a 34% tax rate (DCVTINT X .34 Tax Rate). The tax rate of 34% was selected because it was the rate in effect for the time period under study. The percentage decrease in cash flow from operations therefore is easily determined; (DCVTINT X .34 Tax Rate) / absolute reported amount of cash flow from operations. The absolute amount of cash flow from operations is used to include those firms reporting negative cash flow from operations. The dollar amount and the percentage decrease in cash flow from operations for selected firms is shown in Exhibit 2. The dollar amounts of the change are equal to the amounts of the increase in tax liability, column (b).

Note in Exhibit 2 that for some firms the absolute dollar amount of the decreases in cash flow from operations (i.e.,

Exhibit 2

Selected Examples of Estimated Percentage Decrease in Cash Flow from Operations if Outstanding Convertible Debt Were Treated as Equity, Fiscal Year 1992 (Dollar Amounts in Thousands)

		(a)	(b) ((a)x.34)	(c)	(d) ((b)/(c))
Company Name	Ticker Symbol	Decrease in Interest Expense	Increase in tax Liability	Reported Cash Flow from-Operations	% Decrease in Cash Flow from Operations
1. CONVEX COMPUTER CORP	CNX	$ 3,201	$ 1,088	$ 832	130.8%
2. DICEON ELECTRONICS INC.	DICN	1,173	399	322	123.8
3. ENVIROFIL INC	EFIL	528	180	192	93.4
4. HORIZON HEALTHCARE CORP	HHC	2,589	880	1,306	67.4
5. SOUTHWESTERN PPTY TR INC	SWP	2,484	845	1,542	54.8
6. AMNEX INC	AMXI	155	53	106	49.6
7. COMPUTER PRODUCTS INC	CPRD	2,094	712	1,553	45.8
8. SPARTECH CORP	SEH	934	318	786	40.4
9. TPI ENTERPRISES INC	TPIE	2,049	697	2,502	27.8
10. EXPLORATION CO OF LA	XCL	136	46	213	21.7
11. BURNUP & SIMS INC	BSIM	1,716	583	2,936	19.9
12. ANDERSEN GROUP INC	ANDR	410	139	741	18.8
13. OHM CORP	OHM	2,544	865	5,526	15.7
14. BURNHAM PACIFIC PPTY INC	BPP	3,742	1,272	9,189	13.8
15. GREYHOUND LINES INC	BUS	4,001	1,360	10,846	12.5
16. FORTUNE PETROLEUM CORP	EPX	69	24	197	11.8
17. W. INVT REAL ESTATE TR	WIR	5,187	1,766	15,887	11.1
18. NS GROUP INC.	NSS	2,553	868	8,515	10.2
19. JETRONIC INDUSTRIES INC	JET	482	164	1,625	10.1
20. NATIONAL HEALTH INVS INC	NHI	6,108	2,077	20,592	10.1

Exhibit 3

Distribution of Percentage Changes in Cash Flow from Operations if Outstanding Convertible Debt were Treated as Equity

Range of Percentage Decrease in Cash Flow from Operations	No. of Firms	% of Firms	Cumulative %
0-5	538	69.1%	
5-10	66	8.5	77.6
10-15	32	4.1	81.7
15-20	14	1.8	83.5
20-25	12	1.5	85.0
25-100	24	3.1	88.1
>100	11	1.4	89.5
N/A*	82	10.5	100.0 %
TOTAL	779	100.0%	

* Cash Flow from Operations information was not available for these firms.

increase in tax liability) are in the millions. The percentage decreases are also quite large, especially for firms such as Convex Computer Corp. and Diceon Electronics, Inc., where the amount of the increase in tax liability exceeded the available cash flow from operations. Other firms, such as Computer Products, Inc. and Greyhound Lines, Inc, showed decreases in cash flow from operations in absolute dollar amounts of $1,553,000 and $10,846,000, and percentage decreases of 45.8% and 12.5%, respectively.

Overall, our sample showed an average decrease in cash flow from operations of 9.7% and a median percentage decrease of 1.9%. The disparity between the mean and median suggests that the distribution of the percentage changes is not uniform. To further explore the extent of the impact on cash flow from operations, a frequency distribution of the percentage decrease in cash flow from operations is shown in Exhibit 3. Approximately 66 of the 779 total firms (8.5%) whose data was available on *Compustat*™ would experience between a 5-10% decrease. Another 93 firms (11.9%) would experience a decrease in excess of 10%. Using 5% as a materiality threshold, a large number of firms (20.4%, 159/779) would experience a material percentage decrease in cash flow from operations if convertible debt distributions were no longer deductible because of reclassification to equity. Our analysis also showed an average decrease in pre-tax income of 55.7% and a median percentage decrease of 5.7%. The average decrease in net income was 27.7% and the median percentage decrease was 4.5%. The disparities between the averages and the median again reflect the lack of a uniform distributions for percentage changes.

Overall, these results indicate that the impact of reclassification for tax purposes could have a material impact in terms of absolute dollar amounts and on a percentage basis for numerous issuers of convertible debt. As such, future changes in the tax treatment of convertible debt, either initiated by the IRS or stemming indirectly from changes in accounting rules, would appear to be an issue which would be of importance to issuers of convertible debt.

Dividend-Received Deduction Implications for Interest Income Treated as Dividends

A basic issue discussed in this paper is if an issuer of convertible debt were required to treat the instrument as equity, the distribution would no longer have the character of tax-deductible interest expense but would be considered non-deductible dividends. From the opposite prospective, the dividend treatment of the distribution should entitle a corporate receiver of the distribution a dividend-received deduction (DRD) under IRC Section 243, which provides for either 70%, 80%, or 100% DRD by a corporate holder. The DRD should increase the effective yield of convertible debt instruments and thus make them more attractive to potential investors.

The theoretical impact of the DRD applied to what otherwise would be interest income is illustration in Exhibit 4. Note that the same distribution from a convertible debt instrument as a dividend distribution from an equity instrument will result in an 8.95% effective yield compared to only 6.5% after-tax yield as a distribution in the form of interest income from a debt instrument.

So, while convertible debt treated as equity would be less attractive to issuers, it would become more attractive to holders. How such a change would affect the supply of and demand for convertible debt is unknown. But, in

Exhibit 4

Example of Impact of Dividend-Received Deductions from Convertible Debt (Dollar Amounts in Whole Numbers)

Data considered below:

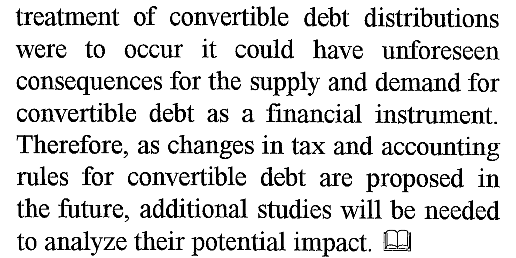
$1,000 convertible debt instrument.
10% face or stated rate.
Assume convertible debt instrument holder is an unrelated corporate investor.
Distribution of $100 per year.
70% dividend-received deduction (DRD).
35% tax rate.

Bond Treated As *Debt:* (Fully taxable distribution)		**Bond Treated As *Equity:*** (Distribution eligible for DRD)	
Taxable income	$100.00	Taxable income	$ 30.00
Tax liability	35.00	Tax liability	10.50
After tax	$ 65.00	After tax	$ 19.50
Non-taxable DRD	---	Non-taxable DRD	70.00
Net proceeds	$ 65.00	Net proceeds	$89.50
Effective yield: ***6.5%***		**Effective yield:** ***8.95%***	

considering a change in tax treatment for convertible debt the implications should be looked at from both the issuer's and the holder's perspective.

Suggestions for Future Research

A large number of firms report convertible debt on their balance sheets and undoubtedly deduct the related interest expense on corporate tax returns. The actions of the IRS and the alternative accounting methods considered by the FASB both point towards treatment of convertible debt according to its economic substance. This raises the possibility that at some point in the future outstanding convertible debt could be classified as equity on corporate tax returns. Our results showed that such a change would have a material unfavorable impact on a large number of issuers' interest deduction, tax liability, and cash flow from operations. This study is important because corporations need to contemplate possible changes in tax and financial reporting regulations and anticipate in advance their potential impact. Moreover, if changes in the tax



treatment of convertible debt distributions were to occur it could have unforeseen consequences for the supply and demand for convertible debt as a financial instrument. Therefore, as changes in tax and accounting rules for convertible debt are proposed in the future, additional studies will be needed to analyze their potential impact.

Footnotes

1. Bittker, B.I. and J.S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 5th edition, 1987, pp. 4-14.
2. Concerning these tax-free transactions, the receipt of debt may be treated as "boot" and may cause the transaction to become at least partially taxable.
3. *Paulsen v. Commissioner*, 469 U.S. 131 (1985); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (CA-2 1960); etc.
4. In 1980 the Treasury issued Proposed Regulations under IRC Section 385 that advocated a combination of debt and equity treatment. These regulations were later withdrawn.
5. Notice 94-47, April 18, 1994., I.R.B. 1994-19.
6. For a more detailed discussion of possible classification methods, see D.W. Thomas and K.F. Sellers. 1992. Dual Classification of Hybrid Securities for Tax Purposes. *Accounting Horizons* (June): 38-46.
7. For a more detailed discussion of the August, 1990 FASB DM, see American Accounting Association's Financial Accounting Standards Committee (1993).

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4. Bittker, B.I. and J.S. Eustice, *Federal Income Taxation of Corporations and Shareholders,* 5th edition, 1987, pp. 4-14.
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