

TESTIMONY OF
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BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MARCH 14, 2007

Chairman Rangel, Ranking Member McCreery, and members of the Committee, thank you for inviting me to testify. I am a lawyer in private practice with the firm of Cleary Gottlieb Steen & Hamilton LLP, and I am testifying today on behalf of the Securities Industry and Financial Markets Association (“SIFMA”). SIFMA represents the shared interest of more than 650 securities firms, banks and asset managers.

I am here today to speak in opposition to Section 230 of the Senate-passed version of H.R. 2, which would reverse settled law by changing the taxation of “contingent convertible” debt instruments. Before addressing this issue, I would like to note SIFMA’s opposition to other provisions in the Senate bill. Specifically, SIFMA has serious concerns with the Senate bill’s provisions that would deny the deductibility of settlement payments, impose an arbitrary cap on nonqualified deferred compensation arrangements and expand the Section 162(m) limit on the deduction of executive compensation. These proposals have unintended consequences that would go beyond the stated goal of closing loopholes and tax shelters.

Turning to the purpose of my testimony, contingent convertible bonds are simply debt instruments that are publicly issued by U.S. corporations, just like any other debt offering. These bonds have two additional features. First, a holder of a contingent convertible bond can convert it into the issuer’s stock at the holder’s option. (This feature is common to both contingent convertible bonds and traditional convertible bonds.) Second, contingent convertibles also

contain an economically meaningful promise to pay additional cash “bonus” interest if certain future conditions are met. (This feature is common to other forms of contingent payment debt obligations as well.)

Contingent convertible debt instruments may sound exotic, but they in fact are a common and important financing tool that many American corporations have used over the last few years to raise over \$90 billion in capital. These corporations often are growing companies with lower credit quality ratings for which the markets for more traditional capital markets instruments are foreclosed, or prohibitively expensive.

The Senate bill would undo settled law by cutting back the interest deduction available to issuers of contingent convertible bonds. Instead of deducting an amount of interest comparable to what they can deduct on all of their straight debt or on other contingent debt obligations, issuers would be limited to a smaller deduction equal to their cash interest payments, as is also true for traditional convertible bonds. This result in turn understates an issuer’s true cost of borrowing.

The IRS and Treasury have extensively reviewed the tax analysis of contingent convertible bonds, and these experts confirmed the legal analysis that the Senate bill proposes to reverse. In doing so, these experts also confirmed that the current law has a built-in bias that favors the government because issuers’ tax deductions for these instruments are subject to a special cap, while investors’ taxable interest income inclusions are not. As a result, under current law, a contingent convertible bond investor’s ultimate taxable interest income will often *exceed* the issuer’s interest deductions.

For example, imagine a typical issuer that normally could borrow at 8 percent, but, in order to conserve its cash, decides to issue a contingent convertible note. Because the right to

convert the debt into issuer stock is valuable, one might expect, in a typical issuance in today's market, for the issuer to pay cash interest on the debt of, say, 2 percent. Under current law, the issuer would be allowed a deduction of 8 percent, which represents the expected total cost of the issuer's debt. Under the Senate proposal, the issuer would deduct only 2 percent for its out-of-pocket cash costs. This is the same deduction that would be allowed for a traditional convertible bond. If, at the end of the day, the bond gets converted into stock, and it turns out that the holder realized an effective yield on the bond of 20 percent, that entire 20 percent is included in the investor's taxable income, but the issuer's effective interest deduction will be subject to a cap of 8 percent.

Why is the Senate proposal wrong as a matter of tax policy? After all, it appears to conform the taxation of contingent convertibles to the rules for traditional convertible bonds. That sounds superficially sensible. Phrased differently, why should the addition of a contingent interest feature give issuers a different tax treatment? That in essence is the Senate Finance Committee's argument.

The Senate Finance Committee's reasoning is problematic for four reasons:

First, it claims to treat contingent convertible bonds like other convertible bonds. However, it does not do this. The proposal applies the convertible bond rules for purposes of taxing the issuer, but does not apply the convertible bond rules for purposes of taxing the investor. This creates a "worst of all worlds" result in which issuers' deductions are limited to their out-of-pocket cash expenses, but holders' interest income is not similarly capped. Instead, holders are required to include as taxable interest income their entire economic profit – both the cash they receive and the value of any stock they obtain on conversion.

Second, the Senate proposal denies issuers a full deduction for the real economic cost of their borrowings. The Senate proposal overlooks the economic reality that an issuer's true cost of borrowing includes the value of the conversion option that it conveys to investors. A conversion option has real value to investors, and a real cost to the issuer, just as the issuance of compensation options has real value to an employee, and a real cost to the issuer.

Third, the Senate proposal will be difficult for the IRS to administer because it mistakenly assumes that there is a single typical convertible bond yield for every issuer. In fact, convertible bonds are complex instruments to construct, and the relative mix of cash interest payments and conversion premium varies from deal to deal.

Fourth, the Senate Finance Committee's underlying assumption was that the "extra" contingent payment features in contingent convertible bonds are "economically meaningless," and therefore should not drive the tax results. This assertion is incorrect. The IRS today audits exactly this question, and requires an issuer to demonstrate that the additional contingent interest that it promises to pay is economically meaningful – the contingency must be non-remote and substantial.

Taking a step back, I believe that a persuasive case can be made that it is the taxation of traditional convertible bonds, not the taxation of contingent convertible bonds, that is the logical outlier in the current system. Indeed, traditional convertible bonds are the *only* debt instruments of which I am aware that are not taxed under the "*economic expectations*" model. This model, which is based on the observation that rational issuers and investors expect that all debt instruments, however constructed, will over time produce a yield approximately the same as the issuer's normal cost of borrowing. The treatment of traditional convertible bonds is an historical

anomaly, and its preservation in today's tax law can best be understood as a "grandfathering" of a preexisting market instrument.

In reality, the grandfathered tax rules for traditional convertible bonds contain a hidden, and underappreciated, tax deduction for *investors*. That is, in a traditional convertible bond, investors are permitted to take what should be ordinary interest income and use that to acquire a capital asset – an option to purchase issuer stock. Effectively, then, the traditional convertible bond analysis permits *investors to make tax-deductible investments in capital assets*.

The Senate Finance Committee describes the taxation of traditional convertible bonds as consistent with "the current operation of the Code and general tax principles." But why do we want to elevate to a general principle of law a tax result that gives investors the equivalent of tax-deductible investments in capital assets, and that at the same time takes away from issuers – often relatively young companies trying to preserve their cash flows – a tax deduction for their true economic cost of borrowing?

In its explanation of the Senate bill, the Senate Finance Committee acknowledges that there is an irreducible logical inconsistency in the current taxation of convertible instruments, and argues that the resolution of the question be deferred until it can be "addressed legislatively through comprehensive reform of the tax treatment of financial products." We agree with this sentiment, but we respectfully submit that it is the Senate proposal that is introducing piecemeal change, without regard to the larger context. The tax experts at the Treasury Department and the Internal Revenue Service exhaustively considered the issue of how contingent convertible bonds should fit into the larger tax system, and came to a carefully-reasoned conclusion. We submit that these experts' analysis of the "the current operation of the Code and general tax principles" is correct, and should not be overturned in this *ad hoc* fashion.