A Tax Perspective on Certain Contingent Interest Provisions in Modern Credit Agreements

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I. Introduction

Credit agreements are becoming increasingly lengthy and complex.[1] One instance of this complexity is the increase of provisions that provide for variation in the amount of interest paid by borrowers attributable to changes in prevailing interest rates and the creditworthiness of the borrower. More recently, credit agreements may include interest rate adjustments (decreases) upon the satisfaction of certain sustainability-linked metrics. The tax rules applicable to contingencies in debt instruments can be rigid and difficult to apply; the increased complexity of the interest provisions in modern credit agreements begets additional complexity in the tax analysis for such agreements. This article seeks to provide a framework to analyze the tax impact of several common contingent interest provisions that can be further applied to similar provisions.

II. Background

In many credit agreements, interest is contingent on various factors determined based on circumstances after issuance. For example, floating-rate debt where the interest rate periodically resets based on an index of interest rates (*e.g.*, the Secured Overnight Financing Rate ("SOFR")) contains a contingent interest provision that turns on changes in prevailing interest rates.

Another common example of a contingent interest provision in standard credit agreements is a leverage ratio grid.[2] In these financings, if a borrower has a higher leverage ratio (within certain parameters), the margin over the applicable floating interest rate automatically increases (and if their leverage ratio decreases (within certain parameters), such margin will likewise decrease). Leverage ratio is typically defined as the ratio of the amount of the company's total indebtedness to its "earnings before interest, taxes, depreciation, and amortization" ("EBITDA").[3] In certain other financings, the interest rate is more directly tied to bespoke financial metrics. For example, the interest rate

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may be tied to certain recurring revenues or the value of specified assets that constitute the borrowing base. In practically all of these financings, there is an inverse relationship between these financial health metrics and the interest rate, *i.e.*, the interest rate increases if the asset value, revenue, or similar metric goes down in value.

In a minority of transactions, the credit agreement features a "pay-in-kind" ("PIK") interest rate. The term PIK refers to interest that is capitalized to the loan balance at the end of the interest accrual period (and is not cash paid). The interest rate may be simply "pay-as-you-want" PIK with a "toggle" feature allowing the borrower to PIK subject to an interest rate step up. For example, the borrower can choose to pay the interest in cash, in which case interest accrues at 10%, or PIK, in which case interest accrues at 12%. More typically, in a credit agreement that provides for PIK interest, the borrower is permitted to PIK only during some limited period of time while the loan is outstanding. For example, the borrower may have the option of paying interest in cash entirely at SOFR + 5% or paying only half in cash at that rate and the remainder in PIK at SOFR + 6% during the first four of seven years with interest payable entirely in cash at SOFR + 5% thereafter. Certain PIK debt in the market—referred to as "pay-as-you-can" PIK—provides the borrower with the option to pay the interest in PIK only if the business cannot meet certain metrics, indicating an ability to pay the interest in cash. In these financings, the PIK rate again typically toggles to a higher rate. For example, so long as the borrower has sufficient cash, the borrower would be required to pay interest in cash at a rate of 10%, but if the borrower lacks sufficient cash, the borrower will have the option to cash pay at 10% or PIK at 12%. These PIK financings may also have a floating rate base (*e.g.,* SOFR).

An increasingly common feature of more recent credit agreements is for the interest rate to be pegged to sustainability-based metrics. Under these credit agreements, the interest rate steps down if the company can achieve certain sustainability-based or similar metrics or milestones (and/or steps up if the company fails such metrics or milestones) (generally, "Good Behavior Adjustments"). These provisions are incredibly varied. In some transactions, the interest rate could be based on pollution or emissions. In others, the interest rate provisions could vary based on diversity and inclusion-based metrics (*e.g.*, representation of certain protected groups in management) or safety-based metrics (*e.g.*, workplace or cyber incidents). The variation in the interest rate is usually small—often less than 50 basis points.

The tax issues surrounding contingent interest provisions are those common to every financial instrument: character, timing, and source.[4] Timing and character questions initially turn on whether (and, if so, when) contingent interest provisions result in a sale or other disposition of the debt instrument under Code Sec. 1001.[5] If not, these questions turn on the application of Code Secs. 163(e), 1271, 1272, 1273, and 1275 and the regulations thereunder (the "OID Rules"), which govern the inclusion and deduction of "original issue discount" ("OID"). For U.S. source interest payments,[6] parties must also consider whether a contingent interest provision could impact the ability of a lender to claim the "portfolio interest" exemption under Code Secs. 871(h) and 881(c). Using the three baseline examples described above, this article seeks to provide a framework to analyze the tax impact of similar features.

III. Tax Considerations for Certain Contingent Interest Provisions

A. Code Sec. 1001

A threshold matter for assessing the impact of any contingent interest provision is the determination of whether such variation results in a "realization event" (*i.e.*, a sale or other disposition of the property under Code Sec. 1001). The regulations under Code Sec. 1001 describe a realization event as "the gain or loss realized from the conversion of property into cash, or from the *exchange of property for other property differing materially either in kind or in extent* ...."[7] This rule applies not only to actual exchanges but also to so-called "deemed" exchanges arising out of changes to the legal rights and obligations of the borrower and lender.[8]

Reg. §1.1001-3 broadly tests whether certain changes to the legal rights or obligations between a borrower and lender in respect of a debt instrument constitute a modification and, if so, whether such changes are sufficiently "material" to result in a deemed exchange.

With certain exceptions described in Reg. §1.1001-3(c)(2), an alteration occurring pursuant to the operation of the terms of the loan is not a modification (and therefore, not a significant modification), regardless of whether such alteration is automatic or contingent upon the exercise of an option of the borrower or a lender.[9] The most relevant of these exceptions for purposes of this article is the exception for certain options that are not "unilateral."[10] In order for an alteration to be considered unilateral, it has to meet certain complicated requirements, including that "there does not exist at the time the option is exercised, or as a result of the exercise, the right of the other party to alter or terminate the instrument or put the instrument to a

person who is related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the issuer."[11]

The contingent interest provisions described above generally occur automatically pursuant to the terms of the debt instrument or are unilateral options (*e.g.*, PIK loans)[12] and thus are unlikely to result in modification of the debt instrument (and thus, are unlikely to result in a significant modification).

B. OID Rules

Application of the OID Rules to contingent interest provisions begins with the acknowledgment that such provisions give rise to future payments that are not fixed as to timing or amount, *i.e.*, they give rise to paradigmatically "contingent payments."[13] The main set of rules addressing debt instruments with contingent payments (at least nominally) are the rules under Reg. §1.1275-4 (the "CPDI Rules"), which apply to "contingent payment debt instruments" ("CPDIs"). The vast majority of debt instruments with contingent payments encountered in practice, however, are not governed by the CPDI Rules. Instead, they are governed by the rules in Reg. §1.1272-1(c) (the "APS Rules") or Reg. §1.1275-5 (the "VRDI Rules"), which apply to "variable rate debt instruments" ("VRDIs").[14]

The CPDI Rules accomplish this result by defining CPDIs very broadly (*i.e.*, "any debt instrument that provides for one or more contingent payment"),[15] and then providing a specified list of exceptions. There are two basic categories of exceptions: excepted instruments and excepted contingencies. Excepted instruments include VRDIs and debt instruments subject to the APS Rules. Excepted contingencies include "remote" and "incidental" contingencies in Reg. §1.1275-2(h) (the "Remote or Incidental Exceptions").[16]

1. CPDI Rules and Certain Exceptions

Contingent interest provisions may result in a variation in the yield of a debt instrument[17] and, accordingly, can raise CPDI concerns. If applicable, the CPDI Rules would require taxpayers to determine a comparable yield and construct a projected payment schedule that produces such comparable yield, accrue OID based on such projected payment schedule, and make "positive" and "negative" adjustments to the extent that the payments actually made differ from the amount projected.[18] Payments based on an interest rate index (such as SOFR) would appear to be contingent payments, but for the fact that debt instruments providing for such payments generally are VRDIs and are thus excepted from the CPDI Rules.

Unlike, for example, a contingent convertible debt instrument[19] or an equity-linked note,[20] many debt instruments do not have a yield that varies widely depending on whether the debt is a CPDI or non-CPDI, and the amount and accrual of OID may not materially differ either way.[21] For example, the interest accrual with respect to a contingent convertible debt instrument would be expected to be meaningfully higher if the CPDI rules applied (because the CPDI rules generally would require the parties to accrue OID at the non-convertible, noncontingent cost of borrowing, which would likely be higher than the stated rate on the loan).[22] The same is generally not true for traditional VRDIs (although the application of the CPDI rules to an instrument that would otherwise constitute a VRDI will impact the accrual of interest/OID on such loan).[23] Accordingly, a policy argument (in addition to a number of technical arguments, as discussed below) could be made that the CPDI Rules should not apply to debt instruments that provide for the contingencies discussed in this article. Indeed, the application of the CPDI Rules in these situations would result principally in (i) additional upfront and ongoing issuer compliance costs due to the application of the noncontingent bond method, (ii) treatment of holder gain on the sale, exchange, or retirement of the debt instrument generally as ordinary income,[24] (iii) application of special rules on a significant modification of the debt instrument;[25] and (iv) substantial restrictions on the issuer's ability to issue incremental debt that is fungible for U.S. federal income tax purposes.[26] While items (i)–(iii) create arguably unwarranted additional tax complexity and the potential for unexpected (and unwelcome) tax implications, the impact on fungibility could have a significant adverse impact on the borrower's cost of capital. Where the amount and accrual of OID are not expected to be materially different if the CPDI Rules apply, these concerns may play an outsized role. For these reasons, among others, parties are generally keenly focused on avoiding the application of the CPDI Rules to debt instruments providing for contingent interest provisions.

As noted above, the three principal "outs" from the CPDI Rules are (i) the APS Rules, (ii) the Remote or Incidental Exceptions, and (iii) the VRDI Rules. Reg. §1.1272-1(c) sets forth the APS Rules, which determine the maturity date and yield to maturity of certain debt instruments that provide for "alternative payment schedules" applicable upon the occurrence of a contingency. The APS Rules are only applicable "if the timing and amount of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5)."[27] The APS Rules

generally are considered applicable in instances in which the number of alternative payment schedules is high (for example, where the contingent payment could occur on any day during the term of the loan), and thus each payment schedule is knowable, but it is less clear whether they apply when the number of payment schedules is infinite (for example, there is no cap on a contingent amount payable).[28]

Two specific APS Rules relevant to contingent interest provisions are Reg. §1.1272-1(c)(5) (the "Unconditional Option Rule") and the "significantly more likely than not" rule in Reg. §1.1272-1(c)(3) (the "SMLTN Rule"). Under the Unconditional Option Rule, an issuer is deemed to exercise (or not exercise) an "unconditional" option that requires payments to be made on a debt instrument under an alternative payment schedule or schedules in a manner that minimizes the debt instrument's yield to maturity. Conversely, a holder is deemed to exercise (or not exercise) such an unconditional option in a manner that maximizes the debt instrument's yield to maturity. Notably, the Unconditional Option Rule does not require a subjective analysis of whether the issuer or holder is likely to exercise the option consistent with such an assumption. Under the SMTLN Rule, if, based on all of the facts and circumstances as of the issue date, a single payment schedule is "significantly more likely than not" to occur,[29] such payment schedule is used to determine the yield and maturity date of the debt instrument.[30]

Reg. §1.1275-2(h) sets forth the Remote or Incidental Exceptions, which address the treatment of certain contingencies the likelihood of which occurring (or not occurring) is remote or with respect to payments the amount (or impact on the timing of payments) is incidental. Under the Remote Exception, if there is a remote likelihood that an event will occur, it is assumed that the contingency will not occur for OID purposes.[31] Similarly, if there is a remote likelihood that a contingency will not occur, it is assumed that such contingency will occur. Under the Incidental Exception, a payment will be ignored "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."[32] A similar rule applies to incidental timing contingencies where the potential timing difference is insignificant.[33] No guidance exists with respect to what "remote" (generally considered to be less than 5%)[34] or "incidental"[35] means for this purpose.[36]

2. VRDI Rules

In many cases, the primary (and often, only) path to avoiding the application of the CPDI Rules as a result of the inclusion of a contingent interest rate provision is to rely on the VRDI Rules. The VRDI Rules apply to certain debt instruments that provide stated interest at (i) one or more "qualified floating rates" ("QFRs"), (ii) a single fixed rate and one or more QFRs, (iii) a single objective rate, or (iv) a single fixed rate and a single objective rate that is a "qualified inverse floating rate." In various instances, there can be important distinctions between VRDIs that provide for a QFR and VRDIs that provide for an "objective rate,"[37] and this article first distinguishes between the two and then considers their application to the contingent interest provisions described above.

The VRDI Rules provide that a variable rate is a QFR "if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated."[38] The applicable "borrowing cost" may refer to that of the issuer of the debt instrument or issuers in general.[39] A common example of a QFR is an interest rate that adjusts periodically based on changes in SOFR or the Fed Funds rate.[40]

Generally, an objective rate is a rate (other than a QFR) that is determined using "a single fixed formula and that is based on objective financial or economic information."[41] An important exception, however, applies to exclude "a rate based on information that is within the control of the issuer (or a related party within the meaning of Code Sec. 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of Code Sec. 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock."[42] Perhaps an even more important exception to this exception provides that "a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer."[43]

There is no guidance as to the interaction of the general prohibition on the use of issuer-controlled information or information unique to an issuer and information that is "based on the credit quality of the issuer." Certainly, there may be a substantial correlation between "dividends, profits, or the value of the issuer's stock" and the "credit quality of the issuer," so the distinction likely turns on the tightness of the correlation in any particular circumstance. As discussed further below in the context of the "contingent interest" rules under the portfolio interest exemption, it is possible that the regulations were looking to draw a distinction between equity-like debt instruments and debt instruments that have credit-quality adjustments.[44]

Finally, while the VRDI Rules provide one way of avoiding the CPDI Rules, credit agreements often provide for additional contingencies that may need to be

analyzed under the APS Rules. For example, debt instruments may have optional prepayment provisions (with or without a prepayment penalty), provide for stepped interest rates, or may require mandatory prepayments under certain circumstances (such as certain sales or dispositions or the receipt of insurance proceeds). There is some doubt as to whether the VRDI Rules and APS Rules can be applied to the same debt instrument in order to conclude that the instrument is not a CPDI. A narrow reading of the VRDI Rules may indicate that they require stated interest to be determined at either one or more QFRs, a single fixed rate and one or more QFRs, a single objective rate, or a single fixed rate and a single objective rate that is a qualified inverse floating rate.[45] With that said, notwithstanding the potential ambiguity, the VRDI Rules are commonly applied alongside the APS Rules and could provide reasonable results when applied in that manner.[46]

IV. Contingent Interest Provisions—A Proposed Analytical Framework

A. Leverage Ratio Margin Grids

As discussed above, many credit agreements providing for floating interest rates include a margin table or grid pursuant to which the interest rate payable on the loan will increase (or decrease) based on the borrower's leverage ratio (although other financial metrics may be incorporated in lieu of the leverage ratio[47]). Current market practice is to treat an interest rate that adjusts based on the borrower's leverage ratio as a QFR.[48] The rationale behind this conclusion is that the definition of QFR solely requires that variations in the interest rate reflect contemporaneous variations in the borrower's cost of borrowing. It follows that, because fluctuations in the borrower's leverage ratio are correlated with changes in the borrower's cost of borrowing, interest rate provisions that adjust automatically based on changes in the borrower's leverage ratio could constitute a QFR.

Although we believe that leverage ratio-based interest rate adjustment provisions could constitute QFRs, we nevertheless observe that if such a rate was not a QFR, it could constitute an objective rate (and, importantly, nevertheless avoid application of the CPDI Rules). The argument that a leverage ratio-based interest rate adjustment constitutes an objective rate (assuming it is not a QFR) is predicated on a conclusion that such adjustments are based on the credit quality of the issuer. And to be sure, in order to be an objective rate, an interest rate does not even have to reference a floating index—for example, it could toggle between two or more fixed rates based on credit quality.[49]

While not entirely clear where the line should be drawn between a rate that is based on the credit quality of the issuer and a rate that is unique to the circumstances of the issuer (such that the rate fails to qualify as an objective rate and, absent the application of any other exception, the debt instrument is a CPDI), an interest rate that varies based on credit ratings of the issuer would almost certainly be viewed as based on the credit quality of the issuer. The modern debt market is too varied, however, to be entirely reliant on credit ratings. The prevailing view therefore is to view the term "credit quality" more holistically. Credit quality could denote the likelihood of default of the issuer, which would encompass metrics based on leverage ratio or borrowing base assets. Credit quality could also denote the market's evaluation of the desirability of lending to a particular issuer generally. Defined as such, in addition to more straightforward leverage ratio grid-type provisions, the credit quality exception arguably could encapsulate some of the Good Behavior Adjustments discussed below.

The sole example in the regulations addressing a rate that is based on information unique to the issuer is unclear but does not contradict this view.

> *Example (6).* Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.[50]

It is easy to see how the interest rate described in this example does not measure credit quality because as the gross profits and, presumably, the financial health of the issuer decline, the interest rate declines in tandem. Indeed, if Z has no gross profits, it would owe no interest—precisely when you would expect a third-party lender to demand a higher interest rate. Similarly, under these circumstances, it is easy to see that such a rate would not be expected to measure contemporaneous variations in the cost of newly borrowed funds, and, thus, not qualify as a QFR.

By contrast, if the interest rate decreased based on an increase in Z's gross profits or increased based on a

decrease in Z's gross profits, it could be argued that such a rate would be captured by the credit quality exception and qualify as an objective rate.

B. Good Behavior Adjustments

As discussed above, Good Behavior Adjustments commonly result in an interest rate step down if the borrower can achieve certain sustainability-based or similar metrics or milestones (and/or a step up in the interest rate if the borrower fails to meet such metrics or milestones). It is difficult to analyze such adjustments under the VRDI Rules, given that metrics giving rise to such adjustments are unique to the issuer and, at first glance, do not appear to reflect (or correlate with) changes in the issuer's cost of borrowing or the issuer's credit quality. If one concedes, however, that satisfaction of the sustainability-based or similar metrics or milestones necessary to achieve a Good Behavior Adjustment is indicative of (or necessary to) creating sustainable, long-term value, a borrower that achieves such results may be a more attractive credit risk to lenders.

The Unconditional Option Rule is also often difficult to apply to Good Behavior Adjustments because that rule's application is limited to instances in which the decision to exercise (or not exercise) the option is entirely at the option of the borrower (or lender), with no material conditions attached. Good Behavior Adjustments are conditional on certain metrics being satisfied. Although the performance of such metrics may (in many cases) be within the issuer's control, the presence of such conditions would appear to generally foreclose the application of the Unconditional Option Rule to Good Behavior Adjustments.[51]

Depending on the size of the interest rate adjustment provided under the Good Behavior Adjustment, there is often a compelling argument that the amount of the Good Behavior Adjustment (that is, the amount by which the interest payments are reduced if the relevant metrics are satisfied, or increased if they are not) is "incidental" to the total expected remaining payments under the debt instrument, and therefore may be ignored until the adjustment occurs under the Remote or Incidental Exception. As discussed, the CPDI Rules do not define what is incidental for this purpose. Anecdotally, we understand that practitioners often employ a 2% (of the remaining payments on the debt instrument) threshold for incidental payments.[52] Although the Treasury and the Internal Revenue Service ("IRS") may define what constitutes an incidental payment differently (should they issue guidance on this point), assuming that the adjustment to the interest rate is relatively small (for example, 25 basis points, which is most common), the impact on the total cash flows of a loan resulting from the Good Behavior Adjustment will in most cases be sufficiently immaterial that the parties will be comfortable treating the adjustment as incidental and ignoring the adjustment until it occurs.

Lastly, depending on how difficult it will be for a borrower to meet the conditions of the Good Behavior Adjustment (or, in the case of an interest rate increase, how likely it is that the borrower will fail to meet such conditions), it may be possible to argue that the possibility of achieving or not achieving the Good Behavior Adjustment may be "remote" for purposes of the Remote or Incidental Exception. Under certain formulations of Good Behavior Adjustments, it may also be possible to apply the SMLTN Rules.

C. Pay-as-you-can PIK Toggle

Traditional PIK toggle loans (where the issuer has an unconditional right to either pay interest in cash or PIK (at a higher rate)) are generally analyzed under the Unconditional Option Rule.[53] In most instances (generally, in the absence of OID attributable to a purchase discount),[54] this rule requires the parties to assume that interest will be paid in cash since the yield will be lowest if cash interest payments are made.

The Unconditional Option Rule is difficult to apply to "pay-as-you-can" PIK toggle loans because the option to PIK interest under such loans is subject to limitations based on the issuer's cash flows—and, therefore, is not unconditional. We do not believe that there is a clear policy reason why the Unconditional Option Rules should not apply to such an instrument merely because the option to PIK is subject to a contingency. Failing to apply the Unconditional Option Rule to such a loan could result in the application of the CPDI Rules merely because it provides for a condition or limitation on the ability to make an election (to PIK) that the Unconditional Option Rules would normally otherwise assume the issuer would not make. Put differently, if the issuer does not satisfy the conditions to be obligated to make interest payments in cash, the issuer has the option to make payments in PIK. Assuming the interest rate toggles to a significantly higher rate when the PIK option is exercised, however, in the absence of a large amount of OID, the Unilateral Option Rules would then assume the issuer would make the payments in cash (*i.e.*, because such exercise would always increase the yield).[55] So, whether the Unconditional Option Rule technically applies or not, using a payment schedule for these instruments assuming payments would be made in cash appears reasonable.

The SMLTN Rule may likewise apply to "pay-as-you-can" PIK toggle loans if the issuer is able to conclude that it is significantly more likely than not that the instrument would be paid in cash throughout its term (or, more rarely, would be paid in PIK throughout its term)—such that a single payment schedule that is significantly more likely than not to occur can be created. An unresolved question with respect to these types of instruments arises if there is no single payment schedule as required by the SMLTN Rule, but the difference between projected payment schedules is relatively minor. Some practitioners have argued, in similar contexts, that as long as the difference in yield between various payment schedules is less than the amount that would give rise to a deemed exchange under the yield change test under Reg. §1.1001-3, it should be ignored. This argument, in essence, appears to rely on the exception for incidental contingencies under the Remote or Incidental Exception.[56] In a circumstance where, based on the facts, the SMLTN Rule is not available and in the absence of other arguments, parties may then consider "pay-as-you-can" PIK toggle loans as CPDIs.

Finally, consider whether the same logic above regarding the credit quality exception under the objective rate rules could arguably also apply to "pay-as-you-can" PIK toggle loans such that these instruments can potentially be considered VRDI instruments, irrespective of cash flow projections. These instruments toggle to cash pay, which typically has a lower interest rate, when the issuer has sufficient cash to do so. The existence of such cash could be seen as an indication of credit quality. With that said, the toggle involved in this fact pattern also involves a change from PIK to cash, which further complicates the analysis as to whether parties intended the toggle to be a credit quality adjustment.

D. Portfolio Interest

The portfolio interest exemption plays an important role in facilitating foreign investors' participation in the U.S. debt market. In financing where the lender is not a bank, is not a "10% shareholder" of the borrower, and is not a controlled foreign corporation related to the borrower, the portfolio interest exemption provides a seemingly straightforward avenue to exempt a foreign lender from withholding tax.[57]

However, under Code Sec. 871(h)(4), the portfolio interest exemption is not applicable to "contingent interest." For purposes of the portfolio interest rules, contingent interest is defined as any interest that is contingent on the following:

(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,
(IV) any dividend, partnership distributions, or similar payments made by the debtor or a related person, or
(V) any other type of contingent interest that is identified by the Secretary by regulation[58], where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax.

Among certain other exceptions, interest is not considered to be contingent if "all or substantially all" of the amount of such interest is determined by reference to any amount not described above or by reference to the principal amount of such indebtedness.[59] This exception could be helpful if the contingent portion of the interest is relatively small such that the fixed portion of the interest would constitute "substantially all" of the interest. Unfortunately, there is no clear definition of what constitutes "substantially all." And, if interest is, for this purpose, contingent, only the portion of the interest that is contingent on the impermissible categories is ineligible for the portfolio interest exemption.

In typical credit agreements, the question would then be whether the portion of the interest rate that is contingent on metrics such as the borrower's leverage ratio, asset value, *etc.* would be considered contingent interest. "Pay-as-you-can" PIK toggle debt also poses a similar question about the eligibility for any increased interest resulting from PIK payments to qualify for the portfolio interest exemption. In the example discussed previously—where so long as the borrower has sufficient cash, the borrower would have to pay interest in cash at a rate of 10%, but if the borrower lacks sufficient cash, the borrower would have the option to cash pay or PIK but, if the borrower chooses to PIK, the rate goes up to a rate of 12%—the question then would be whether the 2% differential would be considered contingent interest, which, if applicable, would be subject to 30% withholding tax if the lender was otherwise relying on the portfolio interest exemption.

The contingent interest exception to the portfolio interest exemption was intended to address scenarios where debt instruments resemble equity in their payout.[60] The concern was that the interest rate may be pegged to equity value or similar indicator, allowing foreign investors an equity-like return without the corresponding dividend withholding tax.[61]

One approach would be to conclude that interest rate provisions with interest rate step-up mechanics subject to a leverage ratio grid or similar mechanics are not "contingent" within the meaning of the portfolio interest exemption. One could argue that where the financial health of a business deteriorates to the point that the instrument resembles equity for U.S. tax purposes,[62] the treatment of interest payments as no longer eligible for the portfolio interest exemption could again be a reasonable result. However, there is no indication that the portfolio interest exemption rules are concerned with this extreme scenario. Changes in interest rate due to the application of a leverage grid or similar mechanic are common occurrences that can hardly be argued to be indicative of equity and thus should not put debt treatment for U.S. federal income tax purposes in jeopardy. The mechanics of the contingent interest exception to the portfolio interest exemption also strongly imply the rules are concerned with profit participation—if the exception applies, as discussed, only the contingent portion of the interest payment based on the impermissible categories (and not the fixed portion payable with respect to the principal amount) is subject to withholding tax.[63] On this front, contingent interest provisions in some U.S. tax treaties could also be instructive. Consider the following provision from the UK tax treaty:[64]

a) Notwithstanding the provisions of paragraph 1 of this Article, interest paid by a resident of a Contracting State and determined by reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person, may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State the gross amount of the interest may be taxed at a rate not exceeding the rate prescribed in sub-paragraph b) of paragraph 2 of Article 10 (Dividends) of this Convention.

b) Sub-paragraph a) of this paragraph shall not apply to any interest solely by reason of the fact that it is paid under an arrangement the terms of which provide:

   (i) that the amount of interest payable shall be reduced in the event of an improvement in the factors by reference to which the amount of interest payable is determined; or

   (ii) that the amount of interest payable shall be increased in the event of a deterioration in the factors by reference to which the amount of interest payable is determined.

Clause (a) envisions the Dividends article to apply to the contingent portion of the interest payment, implying that the contingent interest provision is concerned with the distribution of dividend-like amounts through the contingent interest provision. Clause (b) further bolsters this view by specifying that the applicable concern is where there is a direct (and not inverse) relationship between the impermissible categories and the amount of the interest.

The analysis for the typical PIK toggle instruments is similar to the above. For these instruments, if the issuer lacks sufficient cash to pay the coupon in cash, it has the option to PIK the instrument. In this sense, these instruments are different from the typical debt instrument because the PIK is not mandatory, but the borrower has the right to PIK upon a contingency. Since the option only comes into place upon a contingency that is related to the issuer failing to have sufficient cash flow, on its face, it may be argued that the contingency is based on the borrower's cash flow. However, given the inverse ratio between the amount of cash and the increase in interest rate, once again, it would appear that the step-up in the interest rate does not pose the concerns underlying the contingent interest exception under the portfolio interest statute.

With respect to Good Behavior Adjustments, it is often possible to conclude that the interest rate is not contingent on one of the impermissible categories discussed above. The contingent interest definition specifically indicates the interest is considered "contingent" if it is determined "by reference to" one of the impermissible categories, as opposed to a broader provision (such as a category "that may substantially impact" the equity value). Even if Good Behavior Adjustments were somehow considered to result in contingent interest, it should generally be possible to argue that Good Behavior Adjustments are also in inverse relation to the value of the equity. For this reason, they do not carry the potentially concerning fact pattern where dividends are hidden in the form of interest payments.

V. Parting Thoughts

As credit agreements become increasingly more complex, so does the tax analysis. This is particularly true with respect to certain contingent interest provisions.

Applying existing tax rules to such interest provisions can be challenging, but in some instances, the stakes can be high and can dictate whether interest may be subject to withholding and whether an issuer can issue fungible "tack-on" debt to an existing debt issuance. For this reason, taxpayers should carefully analyze interest provisions in new or existing credit agreements to determine whether the tax treatment accounts for any contingencies that the interest rate may provide. In some instances, this may be easier said than done.

ENDNOTES

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In April 2024, while this article was getting finalized for publication, Eli Dubin published an article titled, *The Tax Treatment of Interest Rate Stepdowns*, in the previous edition of the Journal of Taxation of Financial Products that also provides helpful insights regarding this topic. See, J. of Tax'n of Financial Products, Vol. 21, No. 1 (2024), at 5.

1 *See, e.g.*, Ivashina, Victoria and Vallee, Boris, Complexity in Loan Contracts (May 6, 2022), available at SSRN: *ssrn.com/abstract=3218631* or *dx.doi.org/10.2139/ssrn.3218631*, Badawi, Adam B. and Dyreng, Scott and de Fontenay, Elisabeth and Hills, Robert, Contractual Complexity in Debt Agreements: The Case of EBITDA (September 8, 2022). Duke Law School Public Law & Legal Theory Series No. 2019-67, available at SSRN: *ssrn.com/abstract=3455497* or *dx.doi.org/10.2139/ssrn.3455497*.

2 Many modern credit agreements provide for certain other contingencies that adjust the interest rate. For example, some credit agreements provide for a step-down (typically in the range of 25–50 basis points) in the interest rate if the borrower undertakes a qualified initial public offering. Similar to a decrease in leverage ratio that adjusts interest rate downwards in a leverage ratio grid, publicly traded status likely signals potential improvement in financial health and governance, and thereby a decrease in the risk profile of the loan. As a result, while not discussed in detail, parts of the discussion in this article apply equally to such contingencies.

3 Cash flow is an impermissible category under the contingent interest exception to the portfolio interest exemption and there is generally a strong resemblance between EBITDA and cash flows. *See* Section IV.D. for a discussion of the application of the portfolio interest rules.

4 *See* Joint Committee on Taxation, "Present Law and Analysis Relating to the Tax Treatment of Derivatives," (JCX-21-08) at 10 (March 4, 2008); Edward D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): Cost of Capital Allowance System*, 67 Taxes 931, 946 (1989).

5 Unless otherwise indicated all "Code Sec." or "Reg. §" references are with respect to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations promulgated thereunder. Technically, the borrower does not recognize income under Code Sec. 1001 and the scope of the rules in Reg. §1.1001-3 do not appear to explicitly include borrowers. *See* American Bar Association, Tax Section, Comments on Modifications of Debt Instruments under Section 1001, Recommendation 3E at 12–13 (March 7, 2017) available at *www.americanbar.org/content/dam/aba/administrative/taxation/policy/2017/030717comments.pdf*. Instead, the borrower recognizes income under Code Sec. 61(a)(11), Code Sec. 108(e)(10) and Reg. §1.61-12(c)(2). In this regard, Reg. §1.61-12(c)(2) appears to acknowledge that the relevant exchange for these purposes includes "an exchange under Code Sec. 1001"). Thus, as a practical matter, however, Reg. §1.1001-3 provides a strong analogy to the appropriate borrower treatment.

6 Code Secs. 861(a)(1) and 862(a)(1).

7 Reg. §1.1001-1(a) (emphasis added).

8 *See, e.g.*, Rev. Rul. 81-169, 1981-1 CB 429. At one time, there was uncertainty with respect to whether a contingent interest provision would result in a deemed exchange. *See, e.g.*, Philip S. Winterer, *'Reissuance' and Deemed Exchanges Generally*, 37 Tax Lawyer 509 (1984) (developing an analytic approach under Code Sec. 1001 to contingent interest provisions). These questions were largely resolved in favor of deferring realization with the promulgation of Reg. §1.1001-3 in June of 1996, which provide that changes that occur by operation of the original terms of an instrument, generally, do not trigger a Code Sec. 1001 exchange. *See* T.D. 8675, 1996-2 CB 60. For a detailed analysis of Reg. §1.1001-3, *see* Garlock et al., Federal Income Taxation of Debt Instruments, Chapter 14 (2023 ed.) (hereinafter, "Garlock"); Goldring and Neubort, Modifying Debt and Its Consequences, The Corporate Tax Practice Series, Chapter 640 (Practising Law Institute 2023).

9 Reg. §1.1001-3(c)(1)(ii). Examples include (i) an obligation of the issuer to substitute collateral if the value of the original collateral decreases, (ii) an interest rate adjustment that occurs automatically upon the failure of the issuer to file a registration statement with the Securities and Exchange Commission ("SEC") and (iii) the annual resetting of the interest rate based on the value of an index or a specified increase if the value of the collateral declines from a specified level. Reg. §1.1001-3(d) (ex. 2), (ex. 3).

10 Reg. §1.1001-3(c)(2)(iii). These rules also except an alteration that effects a change in obligor or nature of an instrument or a change from debt to a property right that is not debt for U.S. federal income tax purposes. Reg. §§1.1001-3(c)(2)(i) and (ii).

11 Reg. §§1.1001-3(c)(3) and (c)(3)(i). One may contrast the definition of "unilateral option" with the narrower Unconditional Option Rule in Reg. §1.1272-1(c)(5) (discussed below). In addition, for these purposes, an option is not unilateral if, either the terms of the debt instrument or applicable law, require (i) payment of consideration to exercise such option (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a *de minimis* amount, a specified amount, or an amount that is based on a formula that uses "objective financial information" or (ii) consent or approval of the other party, a borrower related party or a court or arbitrator. In addition, to fit within this exception to the exception, a unilateral lender option must not result in (or, in the case of a variable or contingent payment, must not be reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal. Reg. §§1.1001-3(c)(3)(ii) and (iii).

12 *See, e.g.*, NYSBA Tax Section Report No. 1425, Report on Tax Fungibility of Debt Instruments (November 5, 2019), at 19, note 50. In the case of a PIK toggle loan, even to the extent one were to argue that the interest rate step up constitutes "consideration" for purposes of Reg. §1.1001-3(c)(2)(iii), such putative consideration would clearly be either a specified amount or an amount that is based on a formula that uses objective financial information.

13 Code Sec. 1275(d) specifically authorizes the U.S. Department of Treasury ("Treasury") to prescribe regulations addressing certain circumstances where the tax treatment under the OID Rules would be inconsistent with the purpose of the OID Rules, including varying rates of interest, put or call options, indefinite maturities, contingent payments, and a catch all category of other such circumstances. The legislative history of the OID Rules indicates that Congress intended "to eliminate distortions caused by the mismatching of income and deductions by

lenders and borrowers" that was magnified by "noneconomic formula" used by accrual method taxpayers to compute interest deductions. Staff of Joint Committee on Taxation, 98th Cong. 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 110 (Comm. Print 1984). *See also* Rev. Rul. 2000-12, 2000-1 CB 744 (addressing the application of the anti-abuse rule in Reg. §1.1275-2(g) and noting that "[t]he OID rules were intended, in part, to ensure that the holder of a debt instrument cannot artificially avoid, defer, or offset timely recognition of the economic income from the debt instrument.").

[14] Both the APS Rules and the VRDI Rules were promulgated under the same authority as the CPDI Rules. *See* Code Sec. 1275(d).

[15] *See* Garlock at ¶902 ("The regulations do not define 'contingent payment.' However, given the purpose of the regulations to provide guidance on the treatment of debt instruments that do not fit within the rules for debt instruments with fixed payment, a payment should be considered contingent unless it is fixed as to both time and amount.").

[16] The CPDI regulations specifically reserve with respect to their application to timing contingencies. *See* Reg. §1.1275-4(b)(iii)(B).

[17] Because such provisions can impact the yield to maturity, the fixed yield rule in Reg. §1.1272-1(d) is unlikely to apply.

[18] *See* Reg. §1.1275-4(b) (referred to as the "non-contingent bond method"). These rules apply to CPDIs issued for cash or that have an issue price equal to their fair market value (because either the CPDI is publicly traded or because it is issued for property that is publicly traded). The comparable yield under the noncontingent bond method is the "yield at which the taxpayer would issue a fixed rate debt instrument with terms and conditions similar to those of contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions." *See* Reg. §1.1275-4(b)(4)(i). Note that a different set of rules (in Reg. §1.1275-4(c)) apply to CPDIs that are not publicly traded and are issued for non-publicly traded property.

[19] *See* Rev. Rul. 2002-31, 2002-1 CB 1023 (providing that the comparable yield on a contingent convertible debt instrument is the non-contingent, non-convertible cost of borrowing).

[20] *See, e.g.*, Reg. §1.1275-4(b)(4)(vi) (ex. 1).

[21] For a discussion of the potential impact of the CPDI rules to an instrument that provides for floating rate interest, see Garlock at ¶802.06, as follows:

> If a debt instrument contains multiple contingencies and does not qualify as a VRDI under the expanded definition of "objective rate," a tentative projected payment schedule is established using forward prices for all contingent payments based on market information ("market-based payments") and expected payments for other contingencies. Market information for this purpose is any information on which an objective rate for a VRDI can be determined.

See also Garlock at ¶802.06 (discussing variable rate PIK toggle notes), which states:

> [B]ecause the comparable yield must be a fixed rate for the entire term of the debt, the CPDI rules will produce unexpected results even if the projected payment schedule correctly guesses whether the issuer will or will not exercise its PIK option. In a typical yield curve environment, in which longer-term rates are higher than short-term rates, the comparable yield will be higher than the initial value of the variable rate plus spread on the notes. This means that the issuer of the notes will deduct interest at a higher rate in the early accrual periods than it would under the VRDI rules, and the holder(s) of the notes will have correspondingly greater inclusions. While the comparable yield concept is useful in determining how to accrue interest on a debt instrument with meaningful non-interest contingencies, there is no good technical or policy reason to apply this concept to these types of borrowings.

[22] *See* Rev. Rul. 2002-31, 2002-1 CB 1023. The interest rate provided on a convertible debt instrument generally is meaningfully lower than the interest rate on a comparable non-convertible debt instrument because of the embedded option. *See* Edward D. Kleinbard, Erika W. Nijenhuis and William L. McRae, *Contingent Interest Convertible Bonds and the Economic Accrual Regime*, 95 Tax Notes 1949 (June 24, 2002); Dana L. Trier and Lucy W. Farr, *Rev. Rul. 2002-31 and the Taxation of Contingent Convertibles, Part 2*, 96 Tax Notes 105 (July 1, 2002).

[23] *See* Note 22, *supra*.

[24] Reg. §1.1275-4(b)(8)(i). The purpose of this rule is to foreclose electivity between capital and ordinary treatment in the case of an anticipated positive adjustment. *See e.g.*, Paul H. Asofsky, A Guide to the Tax Treatment of Contingent Payment Debt Instruments, Proceedings for the 56th Institute on Federal Taxation, 1997, Ch. 5 at 5-18 (Matthew Bender & Co. 1997); Garlock at ¶904.03[C]. Where there are no contingent payments remaining on the debt, any such gain generally would be capital. Reg. §1.1275-4(b)(8)(iii).

[25] If the modification constitutes a significant modification, the tax implications will depend on whether the debt instrument (either before or after modification) is "publicly traded" within the meaning of Reg. §1.1273-2(f). If so, then the retirement generally is deemed to occur at fair market value and the modified debt instrument remains subject to the noncontingent bond method in Reg. §1.1275-4(b) (discussed in more detail below). If neither the unmodified or modified debt instrument is publicly traded, then the modified debt instrument will be subject to the "wait and see" rules in Reg. §1.1275-4(c). Under these rules, the issuer is treated as retiring the existing debt instrument for an amount equal to the issue price of the noncontingent portion of the debt instrument. *See* Code Sec. 108(e)(10) and Reg. §1.1274-2(g). Such issue price does not take into account any contingent payments under the debt instrument. The holder's amount realized, on the other hand, equals the sum of the issue price of the noncontingent portion of the debt instrument and the fair market value of the contingent payments. *See* Reg. §1.1001-1(g)(2)(ii).

[26] The "qualified reopening" rules in Reg. §1.1275-2(k) except CPDIs. Reg. §1.1275-2(k)(3)(vi). The qualified reopening rules provide flexibility to issue tax fungible additional debt instruments in certain circumstances where such additional issuance would not otherwise qualify as part of the same "issue" pursuant to Reg. §1.1275-1(f) (*e.g.*, such additional debt instruments are not issued with the relevant period of 13 days).

[27] Reg. §1.1272-1(c)(1).

[28] *See* Garlock at ¶902, FN. 48 ("The meaning of this proviso is less than clear ... The apparent intent of the drafters was to exclude the argument that any instrument calling for one or more contingent payments is within the scope of Reg. §1.1272-1(c) because each possible combination of all the contingent payment [*sic*] constitutes a 'payment schedule.' One could argue that all but a finite number of values for each contingent payment are 'remote' contingencies and hence the instrument calls for only a finite number of non-remote payment schedules."); Best Buy Co., Inc., Form S-3 Registration Statement, Exhibit 8.1 (September 24, 2001) available at *www.sec.gov/Archives/edgar/data/764478/000091205701533276/a2059091zex-8_1.htm* (Opinion of Ernst & Young LLP stating "[o]ne could conceivably argue that, since interest rates under the Debentures will be calculated only to the nearest basis point, there are 100 possible payment schedules during each interest reset period, and hence 1 million possible payment schedules overall. This seems an extremely strained reading of Reg. §1.1272-1(c), in that it would make virtually every contingent debt instrument potentially subject to that paragraph rather than the CPDI regulations.") (hereinafter, the "Best Buy Opinion").

[29] While there is no clear definition of what percentage probability constitutes "significantly more likely than not," a helpful rule of thumb could be to consider 60–70% likelihood as "significantly more likely than not" likely.

[30] The Unconditional Option Rule applies "notwithstanding (c)(2)" (*i.e.*, a payment schedule significantly more likely than not to occur), and therefore has priority over the SMLTN Rule, if there is a conflict. By contrast, the Remote or Incidental Exceptions apply "for all purposes of sections 163(e) (other than sections 163(e)(5)) and 1271 through 1275 and the regulations

thereunder," and therefore have priority over both the SMLTN Rule and the Unconditional Option Rule, if there is a conflict. *See* Reg. §1.1275-2(h)(1).

[31] Reg. §1.1275-2(h)(2).

[32] Reg. §1.1275-2(h)(3)(i).

[33] Reg. §1.1275-2(h)(3)(ii).

[34] Jeff Maddrey, Bloomberg Portfolio 181-1st: Time Value of Money—Holders of Debt Instruments, III. Tax Accounting for Yield/Interest, E. Remote and Incidental Rules ("Remote for this purpose is not defined but many assume it is a low probability (5% or less).").

[35] *See* Garlock at ¶902, FN. 19 ("The regulations give no guidance as to the meanings of 'reasonably expected market conditions' and 'insignificant.' It is not even clear whether the test is to be applied based on the undiscounted amount of the payment or its fair market value, although the use of the word 'amount' rather than 'value' tends to indicate the former."). *See also* Sara B. Zablotney, *Debt Instruments Subject to Timing Contingencies: A Discussion and Proposal*, BNA TM Memorandum, Aug. 12, 2013 ("It might be possible to conclude that a reasonable possibility of shifting the timing of relatively small payments of principal is 'incidental' if the change in timing does not change the yield of the instrument overmuch. This seems consistent with the overall purpose of the OID regulations (that is, to reflect the economic accrual of yield) and other analogous scenarios where *de minimis* variations of yield are ignored. For instance, in determining whether a debt instrument has OID in the first place, there is an exception for '*de minimis* OID' equal to one quarter of one percent of the product of the stated redemption price at maturity of the instrument and its term. Additionally, in the context of determining whether a modification of a debt instrument gives rise to a 'significant modification,' the rules provide a similar exception for changes in yield less than or equal to the greater of 25 basis points or 5% of the unmodified yield. However, the regulations concerning 'remote and incidental' contingencies do not explicitly provide for this sort of exception, so reading one in is subject to uncertainty.") (hereinafter "Zablotney").

[36] *See also* Best Buy Opinion (Opinion of Ernst & Young LLP determining that the payment of contingent interest in the form of three accretion-rate resets for successive five-year periods which could increase the yield to maturity on certain debentures by up to 100 basis points should not be considered remote or incidental and indicating that (i) a 10-percent probability that some contingent interest would be paid on at least one of the interest reset dates and at least a 50-percent probability that the maximum amount of contingent interest would not be paid on each of the three interest reset dates should be sufficient to establish that the interest contingency on the debentures is not remote and (ii) a probability in excess of 40 percent that the maximum amount of contingent interest would be paid or accrued for each of the three five-year reset periods should be sufficient to establish that there is a reasonably expected market condition under which the amount of contingent interest will be significant compared to the other payments on the debentures, and thus that such contingent interest should not be treated as incidental); Garlock at ¶1001.05.

[37] For example, the OID accrual schedule under the VRDI Rules is computed by using a fixed rate substitute for QFRs and objective rates. For QFRs, the fixed rate substitute is the value of the rate on the issue date (often referred to as the "snapshot rate"). For objective rates, the fixed rate substitute is a fixed rate that "reflects the yield that is reasonably expected for the debt instrument." *See* Reg. §1.1275-5(e)(3)(i), (c). In addition, in computing the imputed principal amount under Reg. §1.1274-2 (applicable to non-publicly traded debt issued for non-publicly traded property, and commonly applicable as a result of a significant modification under Reg. §1.1001-3), stated interest payments at an objective rate are treated as contingent payments (with the result that such debt instruments are less likely to have adequate stated interest under Reg. §1.1274-2(c)). *See* Reg. §1.1274-2(f)(2).

[38] Reg. §1.1275-5(b)(1).

[39] *Id.*

[40] Reg. §1.1275-5(d) Ex. 2. *See* Garlock at ¶ 802.01.

[41] Reg. §1.1275-5(c)(1)(i). The regulations provide by example that a rate that is based on one or more QFRs or on the yield of actively traded personal property (within the meaning of Code Sec. 1092(d)(1)), generally will qualify as an objective rate. *Id.*

[42] Reg. §1.1275-5(c)(1)(ii).

[43] *Id.* The reason for this exception and the exception to the exception is not entirely clear and the regulatory history of this provision is somewhat complicated. As a result, it is difficult to glean an underlying policy that could provide guidance. The term "objective rate" was first used in the proposed Treasury Regulations promulgated in 1992, which defined an objective rate, in part, as "a rate (other than a qualified floating rate) based on the price of property that is actively traded (within the meaning of section 1092(d)(1)), or on an index of the prices of such property." Former Proposed Reg. §1.1275-5(c)(1) (1992). This represented an expansion of the VRDI rules as compared to the proposed Treasury Regulations promulgated in 1986, which only allowed a debt instrument to qualify as a VRDI if it provided for interest that was based on an "objective index" (*e.g.*, SOFR). *See* FI-189-84, 1993-1 CB 734, 738-39. The former final regulations promulgated in 1994, provided in relevant part that an objective rate included a single fixed formula based on "[t]he yield or changes in the price of one or more items of personal property (*other than stock or debt of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)*), provided each item of property is actively traded within the meaning of section 1092(d)(1) (*determined without regard to section 1092(d)(3)*)." Former Reg. §1.1275-5(c)(1)(iii) (1994). While the preamble to these final regulations acknowledges that the final regulation represented a narrowing of the definition of an objective rate, no mention is made of additional provisions with respect to stock. *See* T.D. 8517, 1994-1 CB 38, 42 ("In response to a comment, the definition of an objective rate has been narrowed in two respects. While the proposed regulations permit a rate based on the price of actively traded personal property, the final regulations permit only a rate based on the change in the price of actively traded personal property to be an objective rate. In addition, the final regulations provide a more general rule relating to the frontloading or backloading of interest such that a variable rate is not an objective rate if it results in significant frontloading or backloading of interest."). The current formulation of the exception was promulgated in proposed form in 1994 and finalized in 1996, in each case, without explanation. *See* FI-59-91, 1995-1 CB 894, 900 ("The proposed regulations redefine an objective rate as a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. The rate, however, must not be based on information that is within the control of the issuer (or a related party) or that is, in general, unique to the circumstances of the issuer (or a related party), such as dividends, profits, or the value of the issuer's stock."). Likewise, the regulatory history with respect to the substantially similar and relatively contemporaneous term "objective financial information" in Reg. §1.446-3(c)(4)(ii) (*i.e.*, "any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock)), which limits the definition of "notional principal contract," does not offer a clear policy objective.

[44] Generally, an equity-like debt instrument would be expected have an interest rate that is tied to the issuer's ability to pay, In this regard, courts have indicated that limiting an issuer's obligation to make interest payments to its earnings is more consistent with treatment as equity. *See*, *e.g.*, *Meridian & Thirteenth Realty Co.*, CA-7, 42-2 USTC ¶9725, 132 F2d 182, 187 (1942). By contrast, the amount of interest payable on a debt instrument with a credit-quality adjustment generally would be expected to increase as the issuer's financial condition declines in order to compensate a lender for any increased risk associated. Thus, in summary, the interest rate on an equity-like debt instrument and a debt instrument with a credit-quality adjustment generally would be expected to be inversely correlated.

One potential policy reason for this exception could be that the VRDI rules were specifically not intended to apply to an instrument whose terms were in effect converting non-deductible

dividends to interest deductions. *Cf.* REG-105801-00, 2001-1 CB 965 (containing proposed regulations applying Code Sec. 263(g) to interest on indebtedness "the payments on which are determined by reference to payments with respect to the personal property or the value of, or change in value of, the personal property.").

[45] Reg. §1.1275-5(a)(3).

[46] *See* Garlock at ¶ 802.06 (arguing it is reasonable for variable rate PIK toggle notes, whose toggle feature is analyzed under Reg. §1.1272-1(c), to also qualify as a VRDI under the VRDI Rules and thereby avoid CPDI).

[47] As another example, the interest rate may adjust based on changes in the company's EBITDA. It is less clear whether changes in EBITDA are sufficiently correlated with changes in an issuer's cost of borrowing such that a margin table based on EBITDA would likewise constitute a QFR.

[48] *See, e.g.*, Garlock at ¶ 802.02 ("Similarly, a floating interest rate where the margin over the index can also toggle between two or more pre-defined fixed spreads based on leverage, interest coverage, or similar proxies for credit quality of the issuer (so-called "grid pricing") should also qualify as a QFR. An example of such a rate is SOFR plus three percent if the issuer's total leverage ratio is below 2:1, and SOFR plus 4 percent if the total leverage ratio is 2:1 or higher."); Jonathan R. Zelnik, Bloomberg Portfolio 882: Time Value of Money—Issuers of Debt Instruments, IV. Variable Rate Debt Instruments (VRDIs) ("It is market practice to treat such a variable rate as a QFR. The variation in the rate incorporates both general market and issuer-specific contemporaneous variations in the cost of newly borrowed funds.").

[49] Garlock at ¶802.02 ("An instrument could also have interest that toggles between two different rates based on a leverage ratio or other measure of credit quality of the issuer (similar to 'grid pricing' discussed above with respect to QFRs, but without the floating index). This type of interest rate would not qualify as a QFR because there are no 'variations' in the rate like there are when the rate is based on an index. Nevertheless, because the rate is based on a single fixed formula that is based on the credit quality of the issuer, such a rate would appear to qualify as an objective rate.").

[50] Reg. §1.1275-5(d) (ex. 6).

[51] *Cf.* Garlock at ¶ 51, addressing when a condition that is within the control of the issuer may qualify for the Unconditional Option Rule:

> [A]n option would seem to be unconditional even if it is subject to the occurrence or nonoccurrence of an event, so long as the event is completely within the control of the party that has the right to exercise the option. However, conditions that require the approval of, or are otherwise controllable by, the other party, or that are only exercisable upon the occurrence or nonoccurrence of a non-remote contingency outside the control of the party with the right to exercise, would generally not be unconditional.

[52] *See also* Note 36, *supra*.

[53] Although unclear, if the likelihood that the issuer will elect to cash pay interest (or PIK interest) can be resolved through the Remote or Incidental Exception, those rules would seem to take precedence over the APS Rules (and therefore would appear to take priority over the Unconditional Option Rules in determining the yield and maturity date of the debt instrument). *See* Reg. §1.1275-2(h)(2).

If the PIK and cash pay interest rates are the same, and the debt was issued for 100% of the stated principal amount, the loan will likely constitute fixed yield debt instrument under Reg. §1.1272-1(d), and therefore will not be a CPDI. *See* Reg. §1.1275-4(a)(2)(iii).

[54] The Unconditional Option Rule requires use of the payment schedule that produces the lowest *yield*, which may not in all cases be the payment schedule with the lowest interest rate. For loans issued with upfront discount/OID, paying interest in cash can increase the yield relative to payments being made in PIK. In the case of debt instruments issued at a discount, it is necessary to calculate whether cash or PIK payments result in the lower yield.

[55] *See* Tyler L. Arbogast and Eileen Marshall, *A Tasting Menu: Selections from Our Favorite Unresolved Issues in the Garlock Treatise*, at 25–28, Taxation of Financial Products and Transactions, Practising Law Institute, 2021.

[56] *See* Zablotney ("It might be possible to conclude that a reasonable possibility of shifting the timing of relatively small payments of principal is 'incidental' if the change in timing does not change the yield of the instrument over much. ... [I]n the context of determining whether a modification of a debt instrument gives rise to a 'significant modification,' the rules provide a similar exception for changes in yield less than or equal to the greater of 25 basis points or 5% of the unmodified yield. However, the regulations concerning 'remote and incidental" contingencies do not explicitly provide for this sort of exception, so reading one in is subject to uncertainty.").

[57] *See* Code Secs. 871(h) and 881(c). One may wonder why the portfolio interest exemption plays such a crucial role in credit agreements. A large portion of syndicated loans are held by collateralized loan obligations (or "CLOs") and other various debt and private capital funds that are typically organized and/or have investors in offshore jurisdictions with no tax treaty protections.

[58] No such regulations have been promulgated. *See* American Bar Association, Comments Regarding Need for Guidance on Portfolio Interest Rules Under Sections 871(h) AND 881(c) of the Internal Revenue Code, March 18, 2004, available at 2004 TNT 54-20.

[59] Code Sec. 871(h)(4)(C)(iii).

[60] The particular instance that Congress appears to have been focused on were instruments with equity-like features in U.S. real property interests that nonetheless qualified as an "interest solely as a creditor" for purposes of Reg. §1.897-1(c)(1) and thus avoided tax under both Code Secs. 897 and 871(a)(1)(A). *See* H. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. at 651 (1993). *See also* Julia M. Tonkovich, Bloomberg Portfolio 6000-1st: Foundations of U.S. International Taxation, II. U.S. Taxation of Inbound Passive Investment, 2. Taxation of Interest, b. Exempt Portfolio Interest, (4) Exceptions, (c) Exception for Contingent Interest ("This treatment of contingent interest is designed to prevent substantial participation of foreign persons in the profits of U.S. business operations from escaping U.S. taxation as portfolio interest, a purpose which also explains the further qualifications of the rule.").

[61] Conlon & Aquilino: Principles of Financial Derivatives at ¶B4.03. U.S. Withholding Tax Issues With Respect to Derivatives: U.S. & International Taxation ("[T]he contingent payment limitation is narrow in scope—intended to prevent the payment of amounts that arguably resemble dividends or key components thereof from qualifying for the portfolio interest exemption.").

[62] *C.f.*, *Helvering v. Alabama Asphaltic Limestone Co.*, SCt, 42-1 USTC ¶9245, 315 US 179, 62 SCt 540 (1942).

[63] *See* Code Sec. 871(h)(4)(c)(iii).

[64] Clause 5 of Article 11 of U.S.-U.K. Income Tax Convention (2001).