IRC §249

Deduction of bond premium on repurchase

Description

Generally, if an issuer repurchases its own debt instrument for an amount in excess of the amount borrowed (adjusted for any original issue discount or premium), the excess (repurchase premium) is deductible as interest so long as the debt instrument is not a convertible obligation.

In the case of convertible debt, section 249 of the Internal Revenue Code (IRC) provides that no deduction is allowed for a repurchase premium on a convertible bond except to the extent (1) of a "normal call premium" on a comparable nonconvertible bond or (2) the issuer can show the premium was attributable to the cost of borrowing and not attributable to the conversion feature.

For the second exception, the regulations provide that the portion of the repurchase premium that is attributable to the cost of borrowing and that is not attributable to the conversion feature is the amount by which the selling price of the convertible obligation *increased* between the issued and repurchase dates due to a *decline* in yields.

Recent projects

A few examples of IRC 249 tax valuation engagements for which KPMG professionals have recently served include:

— Publicly-traded truck manufacturer with $150 million in convertible notes with redemptions over $50 million.

— Publicly-traded pharmaceutical company with $150 million in convertible notes with a capped call and induced conversions over six valuation dates in two tax years.

— Publicly-traded vehicle rental company with $475 million in convertible notes converted in six separate tranches.

— Privately-held apparel retailer with $115 million in convertible notes.

Holistic approach

Valuation & Business Modeling Services professionals will team with KPMG Washington National Tax (WNT) professionals and Financial Institutions and Product (FI&P) specialists to estimate the repurchase premium attributable to the change in the cost of borrowing. We can assist by estimating the difference between the fair market value (FMV) of the plain debt component of the convertible notes at redemption using issuance date yields versus redemption date yields.

Valuation professionals may require the market yield as of the issuance date and settlement date for the plain bond component of the notes based on consideration of yields implied from various sources, including, but not limited to a combination of the following:

- Yields and credit ratings implied from comparable debt issued by the same taxpayer
- Binomial lattice models to derive the implied plain debt rate of the subject debt
- Synthetic credit rating analyses and estimation of yields observed from comparable market indices, as well as comparable bonds with similar credit ratings.

The selected yields are then applied to estimate the FMV of the plain bond component of the convertible notes.

Our analysis is documented in a comprehensive written narrative with supporting schedules. While our reports are used generally for tax compliance purposes, they may also be modified for financial reporting purposes.

Why KPMG?

When choosing an adviser, investors want a firm that has the technical skills and the practical experience to provide objective advice. KPMG has the knowledge, coverage, and trusted name to help meet your valuation needs.

We deliver objective advice that can assist investors, boards, auditors, and regulators.

Our valuation professionals have extensive experience providing estimates of fair value and fair market value. Our professionals can provide regulatory insight and a coordinated approach, as well as consistency in methodology and adherence to U.S. and international standards. As a member of KPMG global network of member firms, we bring significant experience and leading practices from financial institution valuation issues in the U.S. and abroad.

Contact us

Milind Shah
Principal, Washington National Tax - Valuation
T: 202-533-8984
E: milindshah@kpmg.com

Yuwon Pak
Managing Director, Washington National Tax - Valuation
T: 202-533-4021
E: ywpak@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia