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Client Alert

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COD Income Realized by a RIC on the Repurchase of its Own Debt Is Qualifying Income

In a private letter ruling we obtained on behalf of a client that will be published by the IRS in January 2010, the IRS held that cancellation of indebtedness income ("COD income") arising from the repurchase of a company's own notes constitutes qualifying income under Section 851(b)(2).[1] Under the analysis of this ruling, a company could realize substantial COD income from repurchasing its own notes at a discount and not adversely impact its ability to qualify as a regulated investment company ("RIC") for federal income tax purposes. [2]

Facts

The Taxpayer, a RIC for federal income tax purposes and registered as a business development company under the Investment Company Act of 1940 (the "1940 Act"), issued notes (the "Notes") in a private placement offering. The Taxpayer used the proceeds from the issuance of the Notes to purchase a diversified portfolio of loans (the "Loans") meeting the Taxpayer's investment criteria.

Under Section 851(b)(2), in general, 90% or more of a RIC's annual gross income must be derived from dividends, interest, payments with respect to securities loans, gains from the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to the RIC's business of investing in stock, securities or currencies. The Taxpayer represented that the Loans were securities and any income and gains from the Loans would be qualifying income under Section 851(b)(2).

The Taxpayer also represented that the purchase of the Loans could be traced to the proceeds from the issuance of the Notes under Section 1.163-8T(a)(3).

The Notes subsequently became available for purchase at substantial discounts from their adjusted issue price.[3] The Taxpayer determined it would be in the best interest of its shareholders to repurchase the Notes, and repurchased a portion of the Notes in compliance with the 1940 Act and the Taxpayer's investment objectives policies and procedures. The Taxpayer recognized COD income upon the repurchase of the Notes, which may have exceeded 10% of the Taxpayer's annual gross income.

The question presented in the ruling was whether the COD income realized from the repurchase of the Notes would be qualifying income under Section 851(b)(2).

Holding

To the extent the proceeds from the issuance of the Notes could be traced to the purchase of the Loans, the COD income from the repurchase of the Notes is qualifying income for the purposes of Section 851(b)(2) because the COD income is other income derived with respect to the Taxpayer's business of investing in securities.

In reaching this holding, the IRS noted that a direct connection must be demonstrated linking the COD income to the Taxpayer's business of investing in securities. In the present case, this connection was demonstrated by the ability to trace the proceeds from the issuance of the Notes, within the meaning of Section 1.163-8T(a)(3), to the purchase of the Loans, which were securities under Section 851(b)(2). In general, Section 1.163-8T(a)(3) contains provisions for the allocation of interest expense on a debt by tracing disbursements of the debt proceeds to specific expenditures. The IRS noted that, while the authorities under Section 1.163-8T are not controlling for purposes of Section 851(b)(2), they provide useful guidance in interpreting substantially similar concepts under Section 851(b)(2).

Impact of the Ruling

This private letter ruling indicates that a RIC would not subject its shareholders to adverse tax treatment—and potential disqualification as a RIC—from taking advantage of opportunities to purchase its own debt instruments at a substantial discount, at least where the proceeds of the debt instruments can be traced to the purchase of qualifying securities. It enables a RIC in at least some cases to act in the best interest of its shareholders, reducing the expense associated with the acquisition of investments and, therefore, enabling a higher rate of return for their shareholders. It is uncertain, however, whether the IRS would rule favorably if the taxpayer cannot establish tracing of the debt instrument to the purchase of qualifying securities.

This ruling does not address whether COD income is qualifying income for other purposes, e.g., whether COD income would be treated as qualifying income under the publicly traded partnership rules. The ruling also does not address whether a RIC can defer recognition of COD income under Section 108(i), which permits some taxpayers to defer recognition of COD income realized in 2009 or 2010 until future tax years.

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1 All Section references are to the Internal Revenue Code or the Treasury Regulations promulgated thereunder.

2 Pursuant to Section 6110(k), IRS private letter rulings cannot be relied upon by taxpayers (other than the particular taxpayer to whom they are issued); however, they do provide insight as to the current views of the IRS National Office on various issues.

3 The adjusted issue price is usually the issue price plus accruals of original issue discount, less accruals of bond issuance premium, and less principal payments made before the discharge. Prop. Treas. Reg. §1.163-13(d)(5); Treas. Reg. §1.1275-1(b).

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