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TAX TREATMENT OF ACCRUED INTEREST ON CONVERTIBLE BONDS—A DILEMMA FOR CORPORATE TAXPAYERS

The popularity of convertible bonds and debentures[1] has increased markedly over the past several decades. As a means of indirect equity financing, the use of convertible bonds enables the issuing corporation to postpone dilution of its equity, an obvious advantage to shareholders, and permits the corporation to deduct from its gross income the interest paid on the bonds up to the time of conversion. Moreover, the conversion feature operates as a hedge for both lender and borrower against possible failure of trading on the equity venture.[2] Generally, the convertibility of bonds enhances their market value and otherwise improves market acceptance of such securities.[3] The use of the convertible bond, however, is not without problems, particularly in the area of income taxation.

The difficulties which a corporation may encounter with respect to its treatment, for income tax purposes, of convertible bond interest accrued but unpaid to the bondholders at the time of conversion were illustrated recently in *Columbia Gas System, Inc. v. United States.*[4]

1. "A convertible bond is simply a bond convertible into stock under certain conditions." *In re* Will of Migel, 71 Misc. 2d 640, 336 N.Y.S.2d 376, 379 (Sur. Ct. 1972). For purposes of this Comment, the distinctions which may be drawn between a bond and a debenture are immaterial.

2. If the venture is successful, holders of convertible debentures presumably would elect to have an ownership share. Such an arrangement is attractive to the debenture holder in that a secured indebtedness is retained until such time as it appears that an equity ownership would be more profitable and that the success of the venture warrants a surrender of the status of secured creditor. The corporation is advantaged, in that it has raised equity funds indirectly while receiving a greater contribution than if it had attempted to finance by sale of its stock. In addition, the dilution of equity which results from conversion under profitable circumstances obviously is of minimal impact.

If the venture is less profitable or fails, the debenture holder would elect not to convert in order to remain protected from loss by his status as a secured creditor. The corporation would be protected from dilution because conversion rights would not be exercised. *See generally* C. PILCHER, RAISING CAPITAL WITH CONVERTIBLE SECURITIES 61, 138 (1955).

3. *See generally* Burns & Levitt, *Package Offerings of Convertible Debentures,* TUL. 19TH TAX INST. 307, 308-10 (1970); Fleischer & Cary, *The Taxation of Convertible Bonds and Stock,* 74 HARV. L. REV. 473, 474 (1961)

4. 473 F.2d 1244 (2d Cir. 1973).

The corporation issued 10-year convertible debentures with interest payable semiannually The debentures contained a "no adjustment" clause which relieved the corporation of liability for cash payment of interest accrued at the date of conversion.[5] Each month, the corporation posted on its books as a reduction of capital surplus the accrued interest on all outstanding debentures. Thus interest similarly was entered as a tax-deductible expense item on the corporation's tax returns, pursuant to section 163(a) of the Internal Revenue Code.[6] When a bond was converted between semiannual payment dates, the corporation, in accordance with the "no adjustment" clause, made no cash payment of the interest accrued since the last payment date. However, no adjustment was made on the corporation's tax returns to reflect the nonpayment of interest previously deducted.

Pursuant to a tax audit, the Internal Revenue Service characterized the nonpayment of accrued interest as a discharge of indebtedness reportable as gross income[7] and assessed a deficiency for the years 1955 and 1956. For the two ensuing years, the Commissioner simply disallowed the deductions. The corporation paid the additional taxes and brought a refund action.

It should be noted that whether an adjustment is made to gross income to reflect a discharge of indebtedness or an interest deduction is simply disallowed, the result is an identical increase in taxable income. The controlling issue in both cases is whether the accrued interest indebtedness formed an integral part of the conversion and should be deemed to have been paid by the corporation in exchange for the conversion stock or, on the other hand, was discharged merely as an incident to the conversion transaction.

The government apparently conceded that the deductions for interest expense were properly taken in anticipation of the future payment of such interest; basic disagreement arose as to whether the interest

5. The clause provided that "there shall be no adjustment in respect of interest or dividends on the conversion of any Debenture " *Id.* at 1246.

6. INT. REV. CODE OF 1954, § 163(a) provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

7. INT. REV. CODE OF 1954, § 61(a)(12) states, in pertinent part: "[G]ross income means all income from whatever source derived, including [i]ncome from discharge of indebtedness." This section is a codification of the tax benefit rule, which dictates, as a matter of logic and fair play, that when an accrual basis debtor has accrued and deducted a liability, the subsequent cancellation of that liability generates taxable income. *See* Helvering v. Jane Holding Co., 109 F.2d 933 (8th Cir.), *cert. denied*, 310 U.S. 653 (1940); B.F Avery & Sons, 26 B.T.A. 1393 (1932); Rich, *The Tax Benefit Rule*, N.Y.U. 17TH INST. ON FED. TAX. 257 (1959).

was actually paid when the bonds were converted. The government contended that upon conversion, the liability for unpaid interest was *discharged* with a resulting tax benefit which, depending on the year in question, either generated income taxable as a discharge of indebtedness or warranted disallowance of the deduction. The corporation responded that at conversion, the bondholder surrendered all claims against it arising by virtue of his bond ownership. Arguing that these claims included the right to accrued interest as well as the right to the bond principal, the corporation characterized the extinguishment of the interest debt as partial *payment* for the stock. Accordingly, it was maintained that the finding of a discharge of indebtedness with a concomitant tax benefit was unwarranted.

The Court of Appeals for the Second Circuit noted that the issue in *Columbia Gas* was "strikingly similar" [8] to that which had faced the Court of Claims in *Bethlehem Steel Corp. v. United States*,[9] although that case involved only a disallowance of accrued interest deductions. The Court of Claims initially had attempted to resolve the opposing arguments by reference to statutory mandate and judicial precedent. No provision of the Internal Revenue Code, however, specifically addresses the treatment to be afforded a bond-for-stock exchange pursuant to a previously agreed upon conversion privilege including a "no adjustment" of interest clause. Moreover, the court in *Bethlehem Steel* found no judicial precedent to guide it,[10] although the corporation, as will be noted, argued the applicability of a series of cases involving corporate reorganizations and recapitalizations.[11] Further complicating

8. 473 F.2d at 1247

9. 434 F.2d 1357 (Ct. Cl. 1970).

10. *Id.* at 1360. The following early administrative promulgation, however, supports the decisions in *Columbia Gas* and *Bethlehem Steel:*

> Where gold notes of the M Corporation were converted into preferred stock of that corporation [pursuant to a conversion privilege] in January, 1934, the unpaid interest accrued from August 1, 1933, to December 31, 1933 was properly treated as an accrued liability deductible in the return for the year 1933. As the liability which was accrued in 1933 was canceled in 1934, the amount thereof constitutes taxable income for the latter year.

I.T 2884, XIV-1 CUM. BULL. 151 (1935).

11. The corporation in *Bethlehem Steel* also attempted to analogize to the treatment of amortized bond discounts. A bond discount is a cost of borrowing money represented by a bond issuance at an amount less than that for which the issuer-debtor obligates himself to pay at maturity An accrual basis taxpayer is permitted to amortize this borrowing cost over the life of the debt. Helvering v. Union Pacific R.R., 293 U.S. 282 (1934); Treas. Reg. 1.64-12(c)(3) (1957); I.T. 1412, I-2 CUM. BULL. 91

the adjudicative task was the finding that the conflicting positions of the litigants seemed equally persuasive, both courts noting the substantiality of the countervailing contentions and the court in *Columbia Gas* stating that it sought "a solution reflecting the equities." [12] The adoption of an equitable position may have been the only rational and fair course under the circumstances; nevertheless, it is indicative of the failure of statutory and judicial authority to provide the high degree of certainty and predictability which, for policy reasons, is essential to orderly administration of the tax laws and to intelligent planning and decision-making by taxpayers.

In *Columbia Gas*, the corporation argued, as had the taxpayer in *Bethlehem Steel*, that *Hummel-Ross Fibre Corp. v. Commissioner*[13] authorized the treatment of interest in a bond-for-stock conversion as having been paid. In *Hummel-Ross*, the Board of Tax Appeals held that where bonds with attached interest coupons, some of which represented accrued but unpaid interest, were exchanged for stock pursuant to a statutory reorganization, the stock constituted consideration for the surrender of the bonds and the associated interest obligations. The Board concluded that since the cancellation of interest indebtedness was an integral part of the exchange, which thus amounted to a payment of the interest, the deduction was properly taken.[14]

The *Bethlehem Steel* court indicated that the *Hummel-Ross* holding was not settled law, noting that in *Capento Securities Corp. v. Commissioner*,[15] an opposite conclusion was reached on facts similar to those in *Hummel-Ross*. Emphasizing that the value of the stock was equal to the principle amount of the bonds exchanged and that the parties had not explained the cancellation of the interest obligation, the Board of Tax Appeals found in *Capento* that the release of the interest obligation

(1922). If the issue is discounted convertible bonds, the discount may be amortized until the bonds are converted. G.C.M. 9674, X-2 CUM. BULL. 354 (1931). Upon conversion, however, the tax benefit received from the deduction of previously amortized discount does not result in taxable income. *See generally* Fleischer & Cary, *supra* note 3, at 511. The corporation in *Bethlehem Steel* argued that because interest and bond discount both are costs of borrowing money, they should be afforded the same tax treatment; the court apparently found the analogy unpersuasive. 434 F.2d at 1358.

12. 473 F.2d at 1248. In *Bethlehem Steel*, the difficulty in "reflecting the equities" was recognized: "We recite these adverse positions not to decide or demonstrate that they outweigh plaintiff's arguments but rather to show that, if plaintiff has substantial grounds for its stance, so does the other side." 434 F.2d at 1360.

13. 40 B.T.A. 821 (1939).

14. *Accord*, Central Elec. & Tel. Co., 47 B.T.A. 434 (1942); Shamrock Oil & Gas Co., 42 B.T.A. 1016 (1940).

15. 47 B.T.A. 691 (1942).

was not an element of the recapitalization, but rather a mere discharge of the indebtedness.

Furthermore, in *Columbia Gas*, as well as *Bethlehem Steel*, *Hummel-Ross* was distinguished on the basis of the circumstances which surrounded the conversion-exchange. In *Hummel-Ross* the terms of the exchange were negotiated with a view to achieving a mutual trade-off at the time of the exchange. As the *Columbia Gas* court noted, the corporation "effected an exchange of securities for outstanding indebtedness—an exchange in which accrued interest specifically was an integral part." [16] Conversely, in *Columbia Gas* and *Bethlehem Steel*, the terms of conversion were fixed at the time the bonds were issued.[17] This distinction, based upon the time of agreement to the exchange terms, appears to be valid. In the reorganization cases, since the terms were negotiated after the interest had accrued, it seems reasonable to assume, in the absence of some contrary indication, that the parties included the interest in their bargain. In the conversion situation, however, since the terms were fixed without knowledge of how much interest would be involved, no such assumption is warranted. Moreover, the courts in *Columbia Gas* and *Bethlehem Steel* emphasized that the fluctuation in the price of the stock (and consequently the value of the conversion rights to the bondholder) bore no relation to the amount of accrued interest at any point in time.

Unable to ascertain the intent of the parties from the general terms of the conversion or by analogy to the reorganization cases, the court in *Columbia Gas* examined the "no adjustment" clause. Quoting extensively from *Bethlehem Steel*, the court stated that resolution of the issue would have been simple if the "no adjustment" clause had made explicit provision for the disposition of accrued interest.[18] Specifically, if the clause had provided that the bondholder's right to accrued but unpaid interest was to be surrendered *in payment* for stock,[19] the court would have considered the accrued interest paid by the corporation and an interest deduction authorized under the principle of *Hummel-Ross*.

16. 473 F.2d at 1248.

17. The court in *Bethlehem Steel* observed: "Since the terms were all pre-fixed, there could not have been a mutual *ad hoc* evaluation and trade-off of relevant elements at the time of the conversion exchange as there was in the *Hummel-Ross* line of cases." 434 F.2d at 1359.

18. 473 F.2d at 1248-49.

19. The *Bethlehem Steel* court used as an example the following clause: "On conversion, unpaid interest on a debenture shall be deemed to be paid through receipt of the common stock exchanged for the debentures being converted." 434 F.2d at 1360.

On the other hand, had the clause provided that the corporation's liability for unpaid interest was to be *discharged* at the time of conversion,[20] the interest would not have been considered paid and the deduction disallowed under the principle of *Capento*.

Unfortunately, the "no adjustment" clause at issue in *Columbia Gas*, like that involved in *Bethlehem Steel*, was sufficiently ambiguous to permit the conclusion that *either* a payment or discharge was intended. Consequently, the court in *Columbia Gas*[21] followed the approach of the Court of Claims in *Bethlehem Steel*,[22] basing its decision not on the substance of the "no adjustment" clause but upon the general rule of contract law that an ambiguous writing must be construed against the draftsman, in this instance the corporation offering the convertible bonds.

A second deficiency was assessed against Columbia Gas System by the Commissioner for two earlier years on the basis of an adjustment in gross income attributable to the "tax benefit" of the discharge of interest indebtedness. While *Bethlehem Steel* did not involve such an adjustment, the court in *Columbia Gas* correctly decided that the dispositive issue with respect to an adjustment for discharge of indebtedness income was identical to that involved in disallowance of interest deductions.[23]

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20. The *Bethlehem Steel* court illustrated such a clause: "On conversion, any unpaid accrued interest on any debenture being converted shall be cancelled, forfeited, and not paid." *Id.*

21. 473 F.2d at 1249.

22. 434 F.2d at 1360.

23. 473 F.2d at 1249.

The taxpayer in *Columbia Gas* argued that even if it should be deemed to have realized income in the year of conversion, it should be able to postpone recognition of the income under INT. REV. CODE OF 1954, § 108(a). That section permits deferred recognition, at the taxpayer's election, of any income generated by a discharge of indebtedness. In conjunction with INT. REV. CODE OF 1954, § 1017, discharge of indebtedness income may be excluded from the debtor's current taxable income if the taxpayer consents to a reduction in the basis of his assets in an equivalent amount. Since this process will result in higher reported income in subsequent years because of a lower depreciation or sales basis in the assets, taxation on the income is simply postponed until the assets are either transferred or fully depreciated. The original object of the consent election, to defer taxation of firms in financial difficulty, remains its major impact in many situations.

For a taxpayer who would otherwise wish to use section 108 to postpone income, a possible dilemma exists if he is unsure whether the debt forgiveness has resulted in taxable income. The Internal Revenue Service requires a filing of the section 108 consent with the same tax return upon which the taxable income would otherwise be reportable. Treas. Reg. §§ 1.1017-1 & -2 (1956). In the convertible bond situation the

The primary import of the decisions in *Bethlehem Steel* and *Columbia Gas* is to demonstrate that existing tax law does not definitively govern the taxability of accrued interest on convertible bonds where the terms of conversion do not clearly provide either that interest indebtedness shall be discharged or that it shall be paid through issuance of stock. Hence, the corporation whose convertible bonds are issued under unclear conversion terms cannot deduct its interest expense with any certainty that it will not be assessed for discharge of indebtedness income on "unpaid" accrued interest when the bonds are converted. The bondholder must also share in the uncertainty, since it is likely that if the corporation is not taxed on accrued interest, the bondholder will be.[24]

There is substantial statutory and judicial support for an approach by which the problem of construing unclear conversion terms might be minimized. The tax law not only permits but requires that a deduction for accrued interest be made in the year in which the interest liability becomes fixed and certain.[25] Where there exists some contingency with respect to the liability, as a general rule, no accrual is permitted.[26] The contingency must be one which determines the legal rights of the parties;[27] mere uncertainty as to whether the debtor will meet his estab-

consent should be filed in the year of conversion, not when it is subsequently determined that there is a deficiency

In special cases, where reasonable cause is shown, an amended consent may be filed. Treas. Reg. § 1.108(a)-2 (1956). However, as the petitioner in *Columbia Gas* discovered, "reasonable cause" does not include genuine uncertainty or confusion as to what constitutes a payment or discharge of indebtedness. Alleviating this dilemma somewhat is the apparent willingness of the Commissioner to accept consents conditioned upon a subsequent determination that the discharge generates income. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 262 (1959); Greenbaum, *Income from Debt Cancellation and Reduction*, N.Y.U. 19TH INST. ON FED. TAX. 53, 62 (1961) Whatever the legal merits of this position, it does not seem logical to expect the Commissioner to accept delayed consents to postponement of income where the income results from an expense deduction that may have been improper in the first instance.

24. The *Bethlehem Steel* court noted this likelihood without deciding the point. 434 F.2d at 1361. *See* notes 36-41 *infra* & accompanying text.

25. Treas. Reg. § 1.461-1(a)(2) (1957) provides: "Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

26. *See, e.g.*, Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341 (7th Cir. 1969); Lutz v. Commissioner, 396 F.2d 412 (9th Cir. 1968); Coopertown Corp. v. Commissioner, 144 F.2d 693 (3d Cir.), *cert. denied*, 323 U.S. 772 (1944).

27 This legal contingency is usually expressed in terms of whether "all events" have occurred which fix both the liability and its amount. Commissioner v. Fifth Ave. Coach Lines, Inc., 281 F.2d 556 (2d Cir. 1960), *cert. denied*, 366 U.S. 964 (1961).

lished legal obligation is insufficient.[28] It is well settled that where an obligation to pay interest is contingent upon the happening of some future event, the interest is not accruable until the contingency has occurred and the duty to pay becomes absolute.[29]

It would appear that in a convertible bond situation where the conversion terms relieve the corporation of liability for cash payment of accrued interest, the obligation to pay such interest is contingent upon the nonconversion of the bonds in the interim between payment dates. However, application of the contingent deduction analysis also requires a determination of whether the forgiveness of interest constituted a payment or a discharge. A corporation seeking to deduct accrued interest on its outstanding convertible bonds may be expected to argue that at conversion, there is a payment and satisfaction of the accrued interest. Under this theory, no contingency is involved, since interest *will* be "paid" either in cash on the interest payment date or in stock at conversion.

Thus, the contingency issue ultimately involves the same question faced in *Columbia Gas*, that is, whether, under the terms of conversion, the parties intended that accrued interest form a basis of the exchange. It is submitted that a potentially useful approach, in all cases where the conversion terms do not explicitly provide that accrued interest shall be deemed partial payment for conversion stock, would be to disallow the deduction of accrued interest and require the taxpayer to claim the deduction for the year in which interest is actually paid in cash, or, if the taxpayer feels it can demonstrate that such interest constituted an element of the exchange, at conversion.[30] The effect

28. It has been held that interest may be deducted once the liability is fixed and certain, "even though the course of conduct of the parties indicated the likelihood of payment was extremely doubtful." Edward L. Cohen, 21 T.C. 855, 857 (1954). *See* Rev. Rul. 70-367, 1970-2 CUM. BULL. 37

29. Burlington-Rock Island R.R. v. United States, 321 F.2d 817 (5th Cir. 1963), *cert. denied*, 377 U.S. 943 (1964); The 1220 Realty Co. v. Commissioner, 322 F.2d 495 (6th Cir. 1963); Pierce Estates, Inc. v. Commissioner, 195 F.2d 475 (3d Cir. 1952); Dixie Pine Prods. Co. v. Commissioner, 134 F.2d 273 (5th Cir. 1943), *aff'd*, 320 U.S. 516 (1944). *Cf.* Campbell v. Sailer, 224 F.2d 641 (5th Cir. 1955).

30. There is even less basis for permitting a deduction of accrued interest where the conversion and consequent discharge of indebtedness, if it be such, takes place in the same tax year as the initial accrual. Several Tax Court decisions support the proposition that if an accrual indebtedness is discharged in the same year as the creation of the accrual, the latter is simply disallowed. McConway & Tarley Corp., 2 T.C. 593, 596 (1943) ("[W]here the indebtedness and interest were cancelled during the taxable year, deduction of such interest for the taxable year may not be allowed."). *See* Pancoast Hotel Co., 2 T.C. 362 (1943); George Hall Corp., 2 T.C. 146 (1943).

of such an approach would be to discourage attempts by corporate taxpayers to take advantage of ambiguity in conversion terms.[31]

The approach suggested here is supported by Revenue Ruling 68-170, which held on facts similar to those in *Columbia Gas* that the interest expense was improperly accrued.[32] The *Bethlehem Steel* court seemed to indicate that Revenue Ruling 68-170 is applicable *only* if the language of the bond agreement made clear that upon conversion, unpaid accrued interest would be discharged and not paid.[33] It is submitted, however, that the language of the ruling is considerably broader, subsuming any situation in which the bondholder, upon conversion, "would lose the interest accruing." [34] The ruling could, with reason, be applied in any instance wherein bond conversion terms do not express clearly that unpaid accrued interest shall be deemed paid through receipt of stock. As a result, corporations would be encouraged to make explicit the terms of conversion, specifically the treatment to be afforded accrued interest.

Arguably, however, the terms of the conversion agreement should not be determinative of the corporation's tax liability, since the agreement controls only the substantive rights of the parties and should not bind

31. Under present law, a corporation may wish to deduct accrued interest, notwithstanding the probability that taxable income subsequently may be generated under the tax benefit/discharge of indebtedness rule, on the theory that any postponement of taxes is an economic gain. If, in such case, the original deduction were disallowed rather than merely adjusting income in the year of conversion, the taxpayer would pay not only the tax on the interest but also interest on the tax running from the year of the disallowed deduction. *See* INT. REV. CODE OF 1954, § 6601. Although the six percent rate of interest on unpaid taxes prescribed by section 6601 is not an absolute deterrent to postponement attempts, it would be a substantial factor militating against a contemplated attempt. Additionally, a postponement attempt could conceivably run afoul of INT. REV. CODE OF 1954, § 6653(a), which provides a penalty for intentional underpayment of tax.

32. Rev. Rul. 68-170, 1968-1 CUM. BULL. 71, provides in pertinent part:

> [N]o deduction for interest is allowable for the period from the prior interest payment date to the date of conversion since no interest ever became due or accruable for that period. The fact that the common stock into which the bond was converted had a value greater than the bond at the time of the conversion has no relevancy to the determination of a deduction for interest on the bonds.

Note, however, that I.T. 2884, XIV-1 CUM. BULL. 151 (1935), reaches an opposite conclusion—the interest was considered accruable during the year, but subsequent conversion discharged the indebtedness and taxable income was generated at that time.

33. 434 F.2d at 1360.

34. Rev. Rul. 68-170, 1968-1 CUM. BULL. 71. It is important to note that bookkeeping entries made to establish accruals in no way alter the outcome. The courts will consider substance and not form as controlling. Helvering v. Lazarus & Co., 308 U.S. 252 (1939).

the Commissioner as to the treatment for tax purposes of the rights thus established. For example, in an agreement such as that involved in *Columbia Gas*, the corporation should not, as the court suggested, be able unilaterally to state that accrued interest "shall be deemed to be paid" and thereby justify a deduction, where the corporation loses and the bondholder gains no substantive benefit by postponing conversion until more interest accrues. This rationale would support a general rule prohibiting bond issuers from deriving any tax benefit from bond conversions in which no adjustment is made in the substantive rights of the parties for the amount of interest accrued but unpaid.[35]

Conversely, it could be argued that the relative tax liabilities of the parties are substantive rights which are the proper subject of a bond conversion agreement.[36] Where, as in *Columbia Gas*, it is found that the bondholder's claim to accrued interest was discharged as an incident of the conversion and did not form a basis thereof, no question arises as to tax liability of the bondholder for such interest. If, however, it is found that the parties intended the bondholder's claim to interest to constitute an element of the exchange, the bondholder's tax liability may be affected.

Ordinarily, the holder of a convertible bond will be willing to relinquish his bond and the accrued interest only in exchange for stock that is worth more than the total of principal and interest. Consequently, the corporation will realize no income on the exchange and the question of recognition will not arise.[37] Although the taxpayer will receive stock worth more than the bonds he converts and thus could be said to realize income on the transaction, the Internal Revenue Service in 1920 promulgated the bond conversion rule to provide that a bondholder will not be taxed on any gain from a conversion until he disposes of the stock.[38] Implicit in the rule is the concept that the stock received will

35. Such a rule could be enforced either by making the adjustments sought by the Commissioner in *Columbia Gas* or by disallowing all deductions for accrued interest on convertible bonds on the ground that they are contingent. *See* notes 25-34 *supra* & accompanying text.

36. In another context, the parties to the sale of a business are permitted to fix the tax treatment of their transaction, within certain limitations, by allocating the proceeds between good will and a covenant not to compete. *See generally* Note, *Judicial Treatment of Covenants Not To Compete: The Third Circuit Takes a Giant Step*, 24 TAX L. REV. 513 (1969).

37. For a general discussion of taxation of corporations upon bond conversion, see Eustice, *supra* note 23; Fleischer & Cary, *supra* note 3.

38. Treas. Reg. 45, Art. 1563, T.D. 2971, 2 CUM. BULL. 38 (1920), provides a cogent explanation of the rule: "Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such

adopt the basis of the bonds transferred and that the transaction constitutes a mere transformation or substitution of security in the hands of the bondholder.[39] This rationale loses force, however, where the gain, realization of which is sought to be postponed, is derived from the "payment" of accrued interest which purportedly takes place in the course of the bond conversion. Since the bond conversion rule traditionally has been narrowly construed,[40] it is likely that a bondholder would be required to realize income if the corporation is deemed to have paid the interest.[41] If the tax liability of both parties, rather than that of the corporation alone, is to turn on the conversion terms, then allowing such terms to be dispositive may be justified.

A general rule governing the deductibility of accrued interest by a corporation where the terms of the conversion are not to be adjusted to reflect the nonpayment of accrued interest clearly is desirable from the standpoint of injecting certainty into the tax laws. Nevertheless, the goal of certainty may be outweighed by the desirability of allowing the parties to determine who should bear the tax liability generated by a bond conversion. The confusion in this area appears to warrant a substantial reevaluation by the Internal Revenue Service of the rules and of the "substantial contentions" which the courts in *Columbia Gas* and *Bethlehem Steel* found to exist on both sides of the question. If it is decided to permit the parties to fix their respective tax liabilities, the Service should promulgate regulations determining the time and manner of taxing the bondholder.[42]

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transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold." The rule was made applicable to subsequent revenue acts by Mim. 3156, II-2 CUM. BULL. 24 (1923); I.T. 2216, IV-2 CUM. BULL. 19 (1925); G.C.M. 18436, 1937-1 CUM. BULL. 101, 102.

39. *See generally* Eustice, *supra* note 23; Fleischer & Cary, *supra* note 3.

40. G.C.M. 18436, 1937-1 CUM. BULL. 101, 102: "This rule of nonrecognition of gain or loss upon conversion is strictly confined to the factual situation upon which it is premised, namely, the exercise by the owner of a bond of a right provided for in the bond of converting the bond into stock of the obligor corporation."

41. Bethlehem Steel Corp. v. United States, 434 F.2d 1357, 1361 (Ct. Cl. 1970).

42. The *Bethlehem Steel* court considered, without deciding, the time at which the bondholder would have to realize income. The government had argued that the receipt of stock by the bondholder in payment of the interest debt could result in gain taxable, not at the time of conversion, but when the stock was ultimately sold. 434 F.2d at 1361, *citing* Treas. Reg. 45 (1920 ed.), Art. 1563; Mim. 3156, II-2 CUM. BULL. 24, 25 (1923); I.T 2216, IV-2 CUM. BULL. 19 (1925); G.C.M. 18436, 1937-1 CUM. BULL. 101, 102; Rev. Rul. 57-535, 1957-2 CUM. BULL. 513, 516; Rev. Rul. 62-153, 1962-2 CUM. BULL. 186, 187; Fleischer & Cary, *supra* note 3, at 477-78. The court observed that "there has been no holding that the receipt of accrued interest as an incident of conversion is not taxable gain at the time." 434 F.2d at 1361.