
Taxation: Convertible Notes Issued to Foreigners and the Risk of "Phantom Income"

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Startup companies often structure their seed investments as convertible notes rather than equity to avoid having to address valuation issues and the relatively higher cost of a straight equity financing.

Although, when convertible notes are used, the actual issuance of equity is deferred, the instrument allows the investor to participate--essentially as a piggyback—in the first institutionally priced round of financing. And, that’s why it is popular.

Issues with Convertible Notes and Non-U.S. Persons

Historically, investors did not even consider tax issues when buying convertibles (except for possible interest on the debt instrument). Unfortunately, convertible notes issued to non-U.S. persons may now trigger new U.S. tax rules under Internal Revenue Code § 871(m), against which all convertibles should be tested to determine if the instruments result in taxable "dividend equivalents" and thus, potentially, U.S. withholding tax. This testing should be done even if no payments are actually made under the notes to the foreign person. The rules are complex and counter-intuitive.

Congress added new subsection (m) to Code § 871 in 2010 to prevent non-US persons from using equity-linked instruments, such as convertible notes, to avoid the US withholding tax that would otherwise be imposed had the instruments been characterized as straight "equity," and thus any corresponding payments made on that equity as taxable "dividends" (as opposed to the mere "repayment" of a "loan"). The final Treasury Regulations under § 871(m), which contain most of the complex rules, were not issued until 2015. Those Regulations are now fully applicable to transactions entered into after January 1, 2017. More specifically, § 871(m), and its accompanying Regulations apply to "delta-one transactions" (as defined) that were issued as of January 1, 2017. And, the rules now also apply to "non-delta-one transactions" that were issued as of January 1, 2019. The rules would also likely apply to "simple agreements for future equity" ("SAFEs") if the SAFE is entitled to payments.

What happens when the § 871(m) rules apply to a convertible note?

If certain prerequisites are satisfied in the "testing" of the instrument, the main result is rather draconian: *putative "debt" is changed into equity for U.S. tax purposes, such that there are deemed and taxable "dividend" payments even if no actual payments are made to the investor.* This is known as "phantom income," since income is imputed regardless of whether

any actual distribution is made to pay for the income tax. Any deemed dividends are "US-source income" to the investor that must be reported to the IRS. Moreover, the issuer is required to withhold the tax on the "payments." On top of this drastic transformation of "debt" into "equity," the deemed income does not qualify for the U.S. Portfolio Interest Exemption because it is considered a "dividend" for U.S. tax purposes—and not a payment of "interest" on a debt. And, yes, the non-US investor will have to file a U.S. tax return.

Conclusion

So, bottom line: *the risk is big if the § 871(m) rules are operative.* The best way to avoid this recharacterization result is to know the tests set forth in the § 871(m) Treasury Regulations (or consult an advisor who does) and make sure that the convertible instrument in question flunks all the threshold tests for "dividend equivalence" set forth therein.
