

**FASB Emerging Issues Task Force**

**Issue No.** 05-8

**Title:** Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature

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**Date previously discussed:** None

**Previously distributed EITF materials:** None

**References:**

FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* (APB 14)

EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" (Issue 98-5)

EITF Issue No. 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations" (Issue 98-11)

EITF Issue No. 00-27, "Application of Issue No 98-5 to Certain Convertible Instruments" (Issue 00-27)

International Accounting Standard No. 12, *Income Taxes* (IAS 12)

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**\* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

## Background

1. A company may issue a convertible debt security with a nondetachable conversion feature. The nondetachable conversion feature in a convertible debt security is not accounted for separately under APB 14. However, when a company issues a convertible debt security with a nondetachable conversion feature that is in the money, Issue 98-5 requires that conversion feature to be accounted for separately. This kind of conversion feature is defined as a beneficial conversion feature and is recognized and measured separately by allocating to additional paid-in capital a portion of the proceeds equal to the intrinsic value of the conversion feature. That intrinsic value is calculated at the commitment date<sup>1</sup> as the difference between the conversion price and the fair value of the common stock or other securities into which the security is convertible, multiplied by the number of shares into which the security is convertible. The convertible security is recorded at par, and a discount is recognized for the amount that is allocated to additional paid-in capital. The debt discount is to be accreted from the date of issuance to the stated redemption date of the convertible instrument or through the earliest conversion date if the instrument does not have a stated redemption date as discussed in Issue 00-27. The U.S. Federal Income Tax Code includes the entire amount of proceeds received at issuance of the debt as the tax basis of the convertible debt security.

2. For example, Company A receives proceeds of \$100 for issuing convertible debt with a stated principal amount of \$100. The debt is convertible into 4 shares of the issuer's stock with a fair market value of \$30 per share. The intrinsic value of the beneficial conversion feature is \$20

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<sup>1</sup> The commitment date is defined in Issue 4 of Issue 00-27 as follows:

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

- a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield.
- b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.

at the commitment date. For financial reporting purposes, the company recognizes cash proceeds of \$100, convertible debt of \$100 with a debt discount of \$20 (net book basis of \$80), and a beneficial conversion feature of \$20,<sup>2</sup> which is recorded through additional paid-in capital. The tax basis in the convertible debt instrument is \$100.

3. Constituents have asked (a) whether the recognition of a beneficial conversion feature creates a difference between the book basis and tax basis ("basis difference") of the instrument, (b) whether that basis difference, if created, is a temporary difference for which deferred taxes are recorded under FAS 109, and (c) if it is a temporary difference, how the related deferred taxes should be accounted for in the financial statements.

### **Scope**

4. This Issue addresses the accounting for the income tax consequences of issuing convertible debt with a beneficial conversion feature.

### **Accounting Issues and Alternatives**

**Issue 1: Whether the issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying FAS 109.**

*View A: The issuance of convertible debt with a beneficial conversion feature results in a basis difference for purposes of applying FAS 109.*

5. Proponents of View A believe that the recognition of a beneficial conversion feature effectively creates two separate instruments - a debt instrument and an equity instrument. However, under the U.S. Federal Income Tax Code the instrument is accounted for only as a debt instrument. Consequently, the book basis in the debt instrument is different from the tax basis of the debt instrument. Proponents of View A acknowledge that there is also a book/tax basis difference in the equity instrument; however, FAS 109 only considers basis differences for assets and liabilities as defined in paragraph 10(b) of FAS 109.

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<sup>2</sup> The \$20 beneficial conversion feature is calculated as the fair market value (\$30) less the exercise price (\$25) times the number of shares of the underlying equity instrument (4). The exercise price of \$25 per share is calculated as the \$100 proceeds divided by 4 shares of common stock.

6. In the above example, the debt instrument has a book basis of \$80 and a tax basis of \$100, which results in a \$20 basis difference.

*View B: The issuance of convertible debt with a beneficial conversion feature does not result in a basis difference for purposes of applying FAS 109.*

7. Proponents of View B believe that the carrying value of both the liability and the equity allocation component of the financial instrument issued should be compared with the tax basis of the convertible debt for purposes of determining whether a difference in book and tax bases exists for the legal instrument issued. Proponents of View B note that an allocation of the proceeds representing the intrinsic value of the embedded conversion feature to additional paid-in capital, as required by Issues 98-5 and 00-27, does not create two separate and distinct instruments that would be recognized for financial reporting purposes, but simply provides a greater interest charge on the debt that better reflects the entity's borrowing costs. Proponents of View B look to APB 14 and conclude that the settlement of the debt instrument via either the transfer of assets or the conversion into equity is mutually exclusive. Therefore, the basis of both the liability and the equity components cannot be separated (consistent with deferred tax treatment of bifurcated embedded derivatives) in determining whether a difference in the book and tax bases exists for the instrument issued. Proponents of View B also point to the extinguishment provisions under paragraph 12 of Issue 98-5 and under Issue 12 of Issue 00-27 and conclude that the instrument remains one instrument because the extinguishment provisions of those prior consensuses acknowledge that the settlement of the instrument by transferring assets includes a reacquisition of a portion of the beneficial conversion option. The intrinsic value recorded does not represent the fair value of the embedded equity component within the instrument, nor does it create a separate bifurcated equity instrument recognized for financial reporting purposes; that is, it is simply an allocated amount. View B proponents believe that because the financial reporting carrying value of the convertible debt instrument is \$100 and therefore equal to its tax basis, it should not be characterized as a combination of two separate financial instruments recognized for financial reporting purposes.

8. Opponents of View B indicate that subsequent to the issuance date of the instrument, the book and tax bases of the instrument are equal only after combining the two accounting components of a legal instrument that were previously separated for financial reporting purposes. They believe that View B's analysis of the book basis compared with the tax basis subsequent to the issuance date is contrary to the guidance in Issues 98-5 and 00-27 that requires the equity components to be shown separately.

9. Using the fact pattern in the example in paragraph 2 of this Issue Summary, the book basis of the instrument under View B, consisting of the sum of both the debt component and equity component, is \$100, and its tax basis in the instrument is also \$100, so no basis difference exists.

10. If the Task Force selects View A for Issue 1, then the FASB staff requests that the Task Force consider Issue 2 and Issue 3.

**Issue 2: If the issuance of convertible debt with a beneficial conversion feature results in a basis difference, whether that basis difference is a temporary difference under FAS 109.**

*View A: The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is a temporary difference.*

11. Proponents of View A believe that the basis difference meets the definition of a temporary difference under FAS 109. A temporary difference is defined in the glossary of FAS 109 as:

A difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 11 cites 8 examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (paragraph 15), but those temporary differences (a) result from events that have been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions of the tax law. Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

12. Proponents of View A look to the definition of a temporary difference to support their argument that the basis difference in the debt security is a temporary difference because that difference will result in a taxable amount “when the reported amount of the liability is recovered or settled”. To illustrate this concept, consider the example in paragraph 2 of this Issue Summary. If the convertible debt was settled for the book amount of \$80, there would be a tax consequence to the issuer of \$20 because the tax basis in the debt is \$100.

13. International Accounting Standards (IAS) do not require specific accounting for beneficial conversion features. However, under IAS, when a convertible instrument with a nondetachable conversion feature is issued, the proceeds are allocated between the host instrument and the conversion feature based on a with-and-without calculation. The deferred tax accounting for a convertible instrument with a nondetachable conversion feature is included in paragraphs 23 and 62 of IAS 12. IAS 12 requires that the basis difference be accounted for as a temporary difference with the effects recognized in equity. While the bases for allocating the proceeds between the liability component and the equity component are different under IAS and U.S. GAAP, proponents of View A analogize to the deferred tax accounting treatment under IAS 12 as a basis for support for View A.

*View B: The basis difference that results from the issuance of convertible debt with a beneficial conversion feature is not a temporary difference.*

14. Proponents of View B believe that the basis difference in the debt instrument is not a temporary difference because amortization of the discount has no future tax consequences. Proponents of View B note that the issuer does not have the contractual right to settle the convertible debt by delivering fair value consideration equal to its carrying amount when recorded upon issuance because of the presence of the embedded in-the-money conversion option. Rather, the issuer is obligated to either (a) settle the liability at its stated principal amount of \$100 or (b) issue common stock if the holder exercises its conversion rights. Neither of those settlement alternatives has a tax consequence to the issuer. Also, proponents of View B note that the basis difference that exists at inception related to the debt discount represents an

expense that will not be deducted on the tax return. They believe that since amortization of the discount will not be deducted for tax purposes, it should not be considered a temporary difference under FAS 109 because it will not have a tax consequence. Proponents of View B also note that if the interest expense related to the debt discount is not considered a temporary difference, it will be disclosed in the effective tax rate reconciliation and thereby provide greater transparency to the transaction.

15. The FASB staff would like to note the following on the application of Issues 1 and 2 to the financial statements of an issuer of convertible debt with a beneficial conversion feature. Issuers of debt with a beneficial conversion feature often are in net operating loss (NOL) carryforward positions with valuation allowances recorded against their deferred tax assets. In that circumstance, the different views would have no consequence for the issuer's balance sheet, because a deferred tax liability for the basis difference would merely displace an equal amount of valuation allowance recognized against the deferred tax assets. As the issuer amortizes the debt discount to interest expense over the life of the note, however, the reconciliation of the effective tax rate to the statutory tax rate is different. Under View A to Issue 1 and View A to Issue 2, as amortization reduces the temporary difference, an issuer in an excess NOL carryforward position would be required to restore the valuation allowance, and would explain the higher-than-statutory effective rate as a valuation allowance adjustment. By contrast, under View B to Issue 1 and View B to Issue 2, the higher-than-statutory effective rate would be disclosed as nondeductible interest expense.

16. If the Task Force selects View A for Issue 2, then the FASB staff requests that the Task Force consider Issue 3.

**Issue 3: If the issuance of convertible debt with a beneficial conversion feature results in a temporary difference under FAS 109, whether recognition of the deferred tax liability for the temporary difference of the convertible debt should be recorded as an adjustment to additional paid-in capital or through the recording of a deferred charge by analogy to the accounting model in Example 4 of Issue 98-11. (See Exhibit 05-8A for examples of the application of these views.)**

*View A: The recognition of deferred taxes for the temporary difference of the convertible debt with a beneficial conversion feature should be recorded as an adjustment to additional paid-in capital.*

17. Proponents of View A point to paragraph 36(c) of FAS 109, which states that the recognition of the tax effects for an “increase or decrease in contributed capital are credited” directly to the “related components of shareholders’ equity.” Proponents of View A believe that since a portion of the proceeds has been recognized in equity, the conditions of paragraph 36(c) have been met and therefore the establishment of the deferred tax liability for the basis difference should result in an adjustment to the “related components of shareholders’ equity.” Proponents of View A also point out that this is analogous with the treatment under paragraph 62 of IAS 12.

18. Opponents of View A believe that since the company did not physically issue the underlying embedded equity instrument, the contra to the deferred tax liability should not be recognized in equity in accordance with paragraph 36(c) of FAS 109. Opponents also note that since the debt discount that was recognized through equity does not have any related tax effects on the tax return, it should not be recognized in equity because paragraph 36(c) is supposed to recognize only the tax effects in issuing equity.

*View B: The recognition of deferred taxes for the temporary difference for the convertible debt with a beneficial conversion feature should be recorded through the recording of a deferred charge by analogy to the accounting model in Example 4 of Issue 98-11*

19. Proponents of View B believe that an analogy can be made to Issue 98-11. They believe that at issuance, the issuer has incurred a deferred tax liability as a result of a basis difference in the separate debt instrument stripped of the embedded conversion option recognized in equity for financial reporting purposes. Under Issue 98-11, deferred taxes for the temporary difference would be recognized as a deferred charge and amortized through the income tax provision in proportion to the realization of the tax benefits that gave rise to the deferred charge. Consistent with Issue 98-11, the deferred taxes would be recognized as a deferred charge and not a

reduction in the basis of the convertible note since the convertible note meets the definition of a financial instrument. Proponents of View B also note that if the basis difference is accounted for under an Issue 98-11 model, it will be disclosed in the effective tax rate reconciliation and thereby provide greater transparency to the transaction.

20. Opponents of View B believe it is not appropriate to draw an analogy to Issue 98-11. They believe that Issue 98-11 has a narrow scope only related to single asset purchases that are not business combinations in which the amount paid is different from the tax basis of the asset.

### **Transition**

*View A: Retrospective application to all instruments with a beneficial conversion feature accounted for under Issues 98-5 and 00-27 included in the financial statements.*

21. View A would provide more useful information because prior-period balance sheet and income statement amounts would be restated to reflect the consensus in this Issue. View A also would be consistent with FAS 154, which requires the use of retrospective application unless it is impracticable. Proponents of View A believe that since no significant estimates or judgments would need to be made, retroactive application is practicable. This Issue also would be applicable to debt instruments that were converted in prior periods but are still presented in the current financial statements.

*View B: Retrospective application to all instruments currently held with a beneficial conversion feature accounted for under Issues 98-5 and 00-27 included in the financial statements.*

22. View B is consistent with View A except that the consensus would apply only to instruments that are currently held by the issuer. Proponents of View B believe that the effort required to retroactively apply the provisions of this consensus would not be justified for instruments that were settled in prior periods.

*View C: Prospective application to instruments with a beneficial conversion feature accounted for under Issues 98-5 and 00-27 with a commitment date on or after the effective date of the consensus in this Issue.*

23. Proponents of View C believe that the time and effort needed to retroactively apply this consensus would not provide enough benefits to preparers and users of financial statements.

#### **Effective Date**

24. The FASB staff's recommendation is that the consensus in this Issue should be effective for periods beginning after Board ratification of the consensus. Early application of this guidance is permitted in periods for which financial statements have not yet been issued.

#### **Disclosure**

25. The FASB staff believes that regardless of the consensus reached, the existing disclosure requirements related to beneficial conversion features under Issues 98-5 and 00-27 and to income taxes under FAS 109 would be sufficient to ensure transparency of the transactions in the financial statements.

**Exhibit 05-8A****EXAMPLES OF THE APPLICATION OF ISSUE 05-8**

The following example illustrates the application of the different views presented in this Issue.

**Example**

On January 1, 2005, an entity issues an in-the-money convertible debt instrument with the following terms:

Proceeds	\$100
Stated principal amount	\$100
Intrinsic value of beneficial conversion feature	\$20
Enacted tax rate	40%
Maturity date	January 1, 2010

The Company records the following entry on January 1, 2005, to account for the beneficial conversion feature:

Cash	\$100
Debt discount <sup>3</sup>	\$20
Convertible debt	\$100
Additional paid-in capital	\$20

At December 31, 2005, the Company reports the following financial results:

Revenue	\$100
Interest expense excludes amortization of debt discount	\$40

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<sup>3</sup> The debt discount is netted against the debt line item for financial statement reporting purposes.

### **Application of View B—Issues 1 and 2**

Proponents of View B to both Issue 1 and Issue 2 would not recognize a deferred tax liability at the issuance date. The Company records the following entries at December 31, 2005, under these views to recognize current tax expense and amortize the debt discount related to the beneficial conversion feature.

Current tax expense	\$24
Current tax liability	\$24 <sup>4</sup>
Interest expense	\$4.0
Debt discount	\$4.0 <sup>5</sup>

The effective rate for the Company under these views is 43 percent.<sup>6</sup>

### **Application of View A—Issue 3**

Proponents of View A would recognize the tax effect as a charge to additional paid-in capital because the basis difference is a result of the fact that for financial reporting purposes an equity transaction has occurred.

Additional paid-in capital	\$8
Deferred tax liability	\$8

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<sup>4</sup> The current tax liability is calculated as taxable income of \$60 times the enacted tax rate of 40 percent.

<sup>5</sup> Issue 98-5 requires the use of the effective yield method for amortizing the debt discount. The straight-line method was used in this example for illustrative purposes only.

<sup>6</sup> This effective rate is calculated as the tax expense of \$24 divided by the pretax income of \$56. The pretax income is calculated as revenue of \$100 less interest expense of \$40 and amortization of the debt discount of \$4.

The Company records the following entries at December 31, 2005, under this view to recognize current tax expense, amortize the debt discount related to the beneficial conversion feature, and recognize the deferred tax benefit as a result of the basis difference in the convertible debt security.

Current tax expense	\$24	
Current tax liability		\$24 <sup>4</sup>
Interest expense	\$4.0	
Debt discount		\$4.0 <sup>5</sup>
Deferred tax liability	\$1.6	
Deferred tax benefit		\$1.6

The effective rate for the Company under this view is 40 percent.<sup>7</sup>

### **Application of View B—Issue 3**

Proponents of View B to Issue 3 would recognize a deferred tax liability and deferred debit for the tax effect of the basis difference. The deferred debit should be amortized to income tax expense in proportion to the realization of the tax benefits that gave rise to the deferred debit.

Deferred debit	\$8	
Deferred tax liability		\$8

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<sup>7</sup> This effective rate is calculated as the tax expense of \$22.4 (\$24 – \$1.6) divided by the pretax income of \$56. The pretax income is calculated as revenue of \$100 less interest expense of \$40 and amortization of the debt discount of \$4.

The Company records the following entries at December 31, 2005, to record current tax expense, amortize the debt discount related to the beneficial conversion feature, amortize the deferred debit, and recognize the deferred tax benefit as a result of the basis difference in the convertible debt security.

Current tax expense	\$24	
Current tax liability		\$24 <sup>4</sup>
Interest expense	\$4.0	
Debt discount		\$4.0 <sup>5</sup>
Deferred tax expense	\$1.6	
Deferred debit		\$1.6
Deferred tax liability	\$1.6	
Deferred tax benefit		\$1.6

The effective rate for the Company under this view is 43 percent.<sup>8</sup>

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<sup>8</sup> This effective rate is calculated as the tax expense of \$24 ( $\$24 - \$1.6 + \$1.6$ ) divided by the pretax income of \$56. The pretax income is calculated as revenue of \$100 less interest expense of \$40 and amortization of the debt discount of \$4.