THE TAX CLUB

How Could This Possibly Be? We Don't Know What to Do With a Fee
Musings on a Variety of Finance-Related Fees

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I. Introduction.

One of the most common transactions in financings is the payment of a fee. How that fee is treated for U.S. federal income tax purposes, however, varies dramatically depending upon the context. Moreover, the authorities are often sparse, non-existent, or conflict. The issues for such commonplace transactions are quite fundamental: questions of timing of income or deduction, character of income or deduction, source of the income, treaty treatment of the payment, potential for causing trade or business activity, effectively connected income and/or unrelated business taxable income.

This paper will identify several types of fees encountered in the market, explore how they are treated and where the authorities are not clear, compare the treatment of one type of fee to another, and determine whether there is any guiding principle that should apply across the various types of fees, and propose the extent to which existing treatment should continue, or how it should change and pursuant to what set of principles.

The first part of the paper identifies three common types of fees (guarantee fees, standby commitment fees and consent fees), and discusses the relevant authorities respecting their treatment. The second part of the paper compares the treatment of these three types of fees and explores whether there are any common principles that appear to emerge, and considers the extent to which those principles could or should govern. Finally, the paper proposes a unifying principle that could be used and relied upon in each of the three fee contexts.

II. Existing Authorities Regarding Three Common Types of Fees.

A. Guarantee Fees.

1. Background.

The treatment of guarantee fees has a long and tortured history. Topics such as source, deductibility, inclusion, and treatment as unrelated business taxable income ("UBTI") or effectively connected income ("ECI") have long been debated in the courts, and in IRS and Treasury positions, and in some ways the law is still unsettled. Many authors have also written about this topic.[1]

[1] *See* Miller, *Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis*, 48 Tax Law. 103 1994-1995 (hereinafter, "*Miller*"); Fabrizio, *Shareholder-Guarantor Fees: Deductible Business Expenses or Dividends*?, 40 Tax Law. 905 1987 (hereinafter, "*Fabrizio*"); Levin & Rocap, *Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions*, ¶1001.1 (2013 Ed.) (hereinafter, "*Levin & Rocap*"); Lee-Lim & Morgenstern, *Guarantors and Co-Obligors in the Tax World*, Int'l Tax J. (Jun. 1, 2010).

The area that provides the richest body of law respecting guarantees is the law addressing source. Although much of this law no longer carries precedential value after the enactment of Section 861(a)(9) in 2010,[2] the history of the controversy behind source determinations is informative because it illustrates the difficulty that courts have had in characterizing guarantee fees.

Prior to the enactment of Section 861(a)(9), there were two seminal cases that addressed source, the second of which was the case that the enactment of Section 861(a)(9) overturned. The first of these cases, which did not directly address guarantee fees but addressed similar fees, is *Bank of America v. U.S.*[3] In the *Bank of America* case, the court's task was to consider the appropriate source for three different types of commissions charged by a bank in connection with issuing letters of credit: acceptance commissions, confirmation commissions and negotiation commissions. In confirming a letter of credit, Bank of America informed the beneficiary of a letter of credit that the letter had been issued, forwarded the letter to the beneficiary and committed itself to pay the face amount of the letter of credit; the confirmation commission was the fee that Bank of America charged for confirmation. Acceptance financing was the process by which Bank of America accepted time drafts (amounts payable after a specified period of time) drawn pursuant to a letter of credit, which involved Bank of America analyzing the credit risk that the foreign bank presented; the acceptance commission was the fee that Bank of America charged for acceptance. Negotiation was the process by which Bank of America would

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[2] All Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise specified, and references to the Treasury Regulations are to the regulations promulgated thereunder.

[3] 230 Ct. Cl. 679, 680 F.2d 142 (Jun. 2, 1982)

confirm that the beneficiary's papers met the terms of the letter of credit, therefore qualifying the beneficiary to receive the benefit of the letter of credit; the negotiation commission was the fee charged for negotiation. Because there was no statutory rule for sourcing these commissions, the court stated that it was required to consider the "substance of the transaction" and analogized the commissions to other types of income, eventually deciding that the closest analogy was either service income or interest income. The court found that "the predominant feature of **[acceptance]** transactions is the substitution of **[Bank of America's]** credit for that of the foreign banks" and so the acceptance commissions should be sourced as interest. The court held that confirmation commissions should be also sourced as interest for the same reason. The court found that negotiation commissions, however, should be sourced as personal services because negotiation commissions involve foreign banks paying Bank of America "to perform the physical process of checking documents and nothing more." The *Bank of America* case makes sense on its facts, and as discussed below, other cases in the guarantee fee context have followed its rationale.[4]

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[4] *See*, e.g., *Centel Communications Company v. Commissioner*, 92 T.C. 612, 634 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990); *Container Corp. v. Commissioner*, 134 T.C. No. 5 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011). One interesting question is whether the holding might have changed if, for example, confirmation commissions and negotiation commissions had been charged as a single commission. This hypothetical is not improbable because banks conduct diligence activities in the ordinary course of their business as part of making domestic loans, or undertaking guarantees and other like obligations, with the costs of such diligence included in the interest paid by the borrower, and one could easily see those fees being folded in. Would the court have bifurcated the single fee in the hypothetical case into two components, assigning each fee a different source, or would the court have tried to analyze which of the two functions was the predominant function and characterized the fee by analogy to whichever was the predominant function? Because the court considered the predominant features of the fees under the facts it had and never considered bifurcating the fees, it seems unlikely that the court would have considered bifurcating such a combined fee, and it would likely have considered the work of checking the paperwork (for which the negotiation commissions were charged) merely a part of the work required to earn the confirmation or acceptance commissions. One lesson to be drawn from this would be to separately state subcomponents of fees to the extent different treatment is desired.

The second case, which was overturned by statute, is *Container Corp. v. Commissioner*.[5] *Container Corp.* considered the source of fees paid by a U.S. subsidiary to its foreign parent for guaranteeing payments on notes issued by the subsidiary. The *Container* court distinguished the *Bank of America* holdings by asserting that the *Bank of America* case dealt with fees paid to the bank for substituting its own credit for that of the borrower, while a guarantee merely sought to have the guarantor augment the credit of the borrower.[6] Nevertheless, as in the *Bank of America* case, the court analogized the payments to other types of income for which there are clear sourcing rules. The court determined that the guarantee was not like a loan because the U.S. subsidiary did not borrow funds from the parent and held that the fees are most like services, stating that the fees are "payments for a possible future action," with such action presumably being the parent making payments on its subsidiary's notes. The extent to which this holding was influenced by the especially difficult facts of the case is unclear: some of the language used in the opinion indicated that the court was sympathetic to the downturn in the business of Container Corp's predecessor, which was the subject of this debate. The court stated, in describing the downturn in the business, that "[t]he Commissioner's response to *this series of unfortunate events* was to determine that [the U.S. subsidiary] should have withheld 30 percent of the guaranty fees it paid to [its parent] in 1992-94."[7] Perhaps this is simply an example of how "hard cases make bad law."[8]

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5 *Id.*

6 Arguably, that analysis likens the fees in the *Bank of America* case more closely to standby commitment fees or letter of credit fees, discussed below, than to guarantee fees.

7 *Container Corp*, at 14 (emphasis added)

8 *Northern Securities v. U.S.*, 193 U.S. 197 (1904).

The legislative response to *Container Corp.* was swift. As discussed above, Section 861(a)(9), which modified the result of *Container Corp.*, was enacted by September, 2010, before the Fifth Circuit had even decided the *Container Corp.* appeal. The legislative response, consistent with the *Bank of America* holding, is understandable. From a commercial point of view, the existence of a guarantor should decrease the cost of borrowing money, so it could be considered as analogous to interest and the cost for that benefit is in lieu of paying more interest. The legislative response presumably recognized this simple analogy. By comparison, the *Container Corp* court seemed to strain to find the guarantee fees to be service fees, and as discussed above, may have reached this result out of sympathy for the taxpayer due to the unfortunate turn taken by Container Corp's business.

An interesting perspective on fees generally, which can be applied in the guarantee fee context, can be found in Priv. Ltr. Rul. 200533023, in which the IRS considered several types of fees received by a bank in the credit card context, and whether they should be considered "interest" for U.S. federal income tax purposes.[9] The ruling does not discuss guarantees, but provides insight into how the IRS characterizes fees as payments for services, interest payments or as other types of payments. In the ruling, the IRS states that "[n]either the label used for the fee nor a taxpayer's treatment of the fee for financial or regulatory reporting purposes is determinative of the proper federal income tax characterization of that fee."[10] The fees that the

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[9] PLR 200533023 (May 10, 2005).

[10] *Id.* Citing Rev. Rul. 72-315, 1972-1 C.B. 49 (as to the label); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-43 (1979), 1979-1 C.B. 167, 174-75 (as to financial or regulatory reporting).

PLR considered were late fees, over-the-limit fees, cash advance fees, non-sufficient funds fees, which were all determined to be interest; as well as annual fees and interchange fees received by third parties, which were determined not to be interest. In determining that certain fees should be characterized as interest, the ruling would first rule out the notion that the fee was a payment for services or property and state a simple conclusion based on the facts of the issue. In determining that the annual fee was not interest, the ruling considered whether annual fees charged bore any relationship to the amount borrowed by a cardholder; however, in determining the same about the interchange fee, the ruling analyzed the fee in the context of Treasury Regulations Section 1.1273-2(g)(4), which treats certain third-party payments as creating or increasing original issue discount. That section requires that the fee be made incident to, and part of, a lending transaction; the circumstances must be appropriate for imputing the third-party payment to the borrower; and the payment must not be for property or services. The ruling summarily disposes of this analysis by stating that the taxpayer has not established that the fee arrangement satisfies these criteria, but in a third-party guarantee context, depending on the facts, these criteria might be satisfied, unless the IRS would always argue that the provision of a guarantee is a service.

Interest, as defined in a number of IRS rulings by reference to Supreme Court cases, is "the amount one has contracted to pay for the use of borrowed money, and as compensation paid for the use or forbearance of money."[11] Guarantee fees are not an amount paid to a lender for use of its money, but are paid to a guarantor for use of a third party's money; and guarantee fees certainly are compensation to a guarantor for the use of its money, i.e., money standing ready to

[11] *See, e.g., Deputy v. DuPont*, 308 U.S. 488 (1940); Rev. Rul. 72-315, 1972-1 C.B. 49, (Jan. 1, 1972).

guarantee the obligations of the primary obligor. In discussing some authorities in the area, Rev. Rul. 72-315 further states that one factor distinguishing service charges on loans from interest is that a service charge "is a fixed charge having no relationship to the amount borrowed or the time given to pay whereas interest is based on the amount deferred and the time of deferral." Guarantee fees, which are measured by the amount guaranteed and paid periodically during the period of guarantee, are similar to interest payments under this definition.[12] In addition, the original issue discount rules treat payments from borrowers to lenders as interest, other than payments for property or for services provided by the lender (such as commitment fees or loan processing costs).[13]

One challenge with the characterization of guarantee fees as interest is that the IRS has characterized guarantee fees as income for services in the context of Sections 163(d) and 482.[14] In TAM 8508003,[15] for example, in which the IRS considered whether guarantee fee income was investment income for purposes of Section 163(d)(3)(B), the IRS concluded that guarantee fee income "is not a passive return on capital; it is compensation for the act of serving as guarantor of a loan." This position is not persuasive, however, because the act of serving as a guarantor is a passive activity, or at the very least is as active an activity as lending: it involves the guarantor determining the creditworthiness of the obligor, the risk the guarantor is willing to take, and a

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[12] *See also* Rev. Rul. 69-188, 1969-1 C.B. 54 (Jan. 1, 1969), which concluded that a loan processing fee (points) should be considered interest.

[13] Treasury Regulations Section 1.1273-2(g)(2)(i). *See also* Reich, *U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives*, 2 Fla. Tax Rev. 1 (1994-1995), footnote 37.

[14] *See* Blessing and Lubkin, *905-2nd T.M., Source of Income Rules*, Sec. XV.B.1.b.

[15] Nov. 9, 1984.

rate that adequately compensates the guarantor for its task of standing ready to step in for the primary obligor should the primary obligor become unable to service the debt. The IRS's position in the *Container Corp.* case, discussed below, was divided on this point: the IRS conceded that the entity in question performed services as part of the guarantee, but took the primary position that the guarantee fees should be treated like interest for sourcing purposes.[16]

Finally, it is also worth considering David Miller's seminal article on the subject of guarantees, in which Miller posits that the best characterization of guarantee fees is as a series of cash-settled options pursuant to which the creditor could put the obligation to the guarantor. The appeal of this treatment as compared with debt treatment, as summarized by Miller, is that such treatment "does not require a reasonable expectation that the writer of the option will repay its premium price to the holder." This is an appealing framework for analyzing guarantee fees. However, if the borrower is paying such an option premium, it does so on behalf of the lender. Thus, it should perhaps be a deemed payment of interest by borrower to lender, followed by a deemed payment of an option premium by the lender to the guarantor (although, perhaps when deemed paid by the creditor as part of its lending business or to protect its investment, it should simply be deductible pursuant to Section 162 or 212). This analysis is similar to Rev. Rul. 74-395, in which a lender passes through the cost of a fee paid to the Federal national Mortgage

[16] "The Commissioner does not challenge Container's assertion that Corporativo performed services, but argues that services were not the predominant feature of the guaranty and should be ignored for sourcing purposes." and "The Commissioner argues that Bank of America is controlling because acceptance and confirmation commissions, like guaranty fees, are uses of another's credit and are analogous to interest."

Association ("FNMA") to obligate FNMA to buy the note, and the passed through cost to the borrower was treated as interest.[17]

2. Current Law.

a. Source.

As stated above, much of the case law addressing source no longer carries precedential value after the enactment of Section 861(a)(9) in 2010.

Section 861(a)(9) characterizes as U.S.-source income guarantee fees paid, directly or indirectly, by "a noncorporate resident or domestic corporation," as well as any guarantee fees paid by any foreign person if the fees are connected with income that is effectively connected with a U.S. trade or business,. As mentioned above, the enactment of Section 861(a)(9) was an immediate reaction to *Container Corp.*, which Congress found to be poorly decided. In fact, the first sentence in the technical explanation of this provision makes the intent of the law explicit, stating that "[t]his provision effects a legislative override of the opinion in Container Corp. v. Commissioner…." Unfortunately, however, that sentence is as much background as the legislative history provides for Section 861(a)(9). The rest of the explanation simply describes the effects of the provision. Thus, it is impossible to make a broader inference about whether

[17] *See also* Rev. Rul. 71-399, discussed below.

Congress intended to characterize guarantee fees as being equivalent to interest income, equivalent to services income, or some other characterization.

An inquiry related to the source question is the treatment of guarantee fees for treaty purposes. Most U.S. income tax treaties do not have a specific provision addressing the treatment of guarantee fees, and the 2006 model treaty does not explicitly address guarantee fees. Thus, under most treaties, guarantee fees are relegated to the "other income" provision of the treaty. One treaty that does address guarantee fees, the treaty in force between the U.S. and Canada, explicitly characterizes guarantee fees as other income: the treaty contains a provision in Art. XXII(4) stating that the provision of a guarantee by a resident of a Contracting State is taxable only in that State, unless the fee is "business profits" attributable to a permanent establishment in the other State. The technical explanation to the treaty explains that the business profits provision was added at the request of the United States, but does not provide helpful guidance in interpreting the provision.

b. Shareholder Guarantees.

Most of the case law on the characterization of a guarantee fee has discussed guarantee fees paid to shareholders. Although the timing of deductions is also an interesting topic, there is no direct authority addressing the treatment of prepaid guarantee fees, as discussed below. Fabrizio makes the compelling argument that guarantee fees paid to a shareholder are worthy of scrutiny as an initial matter, but ultimately concludes that the authority on this topic is too strict.

Fabrizio recognizes that "shareholder-employee salaries and bonuses"[18] are "an analogue to shareholder-guarantor fees"[19] and recommends that a standard similar to that of such compensation arrangements be used in shareholder guarantee arrangements. Unfortunately, in the nearly twenty years since the publication of that article, the authority has not become significantly clearer.

The seminal cases in the shareholder guarantee area both involved a business named *Tulia Feedlot.*[20] In Tulia I, Tulia's shareholders had guaranteed the corporation's loans for several years without receiving any payment from Tulia, until a year in which Tulia requested from the shareholders that they increase their guarantees, after which time Tulia paid each shareholder a guarantee fee of three percent of the total amount guaranteed by such shareholder, resulting in a total guarantee fee of $54,000. The IRS challenged Tulia's deduction of this amount as a business expense under Section 162(a). The circuit court allowed the deduction but was overturned by the Fifth Circuit, which held that the payments were distributions to shareholders; the question of whether the payments were more properly characterized as interest or as deductions under Section 162 was not before the court. Tulia II involved fees paid to the same parties in different years, and the Court of Claims found the facts sufficiently different that collateral estoppel did not apply. In holding that the fees paid in Tulia II were deductible business expenses, the court found it important that the fees were not paid to the shareholders in

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[18] At 918.

[19] *Id.*

[20] The first was *Tulia Feedlot, Inc. v. United States*, 513 F. 2d 800 (5th Cir. 1975), cert. denied, 423 U. S. 947 (1975) ("*Tulia I*"), and the second was *Tulia Feedlot, Inc. v. United States*, 83-2 USTC ¶ 9516 (Aug. 9, 1983) ("*Tulia II*")

proportion to their ownership in Tulia, the shareholders would not have made the guarantees without receiving some fee, it was not possible for Tulia to obtain financing without personal guarantees and it was common practice for other corporate owners of cattle feedlots in the area to guarantee loans.

Several later cases used the *Tulia II* factors, among others, in considering the deductibility of guarantee fees paid to shareholders. *Seminole Thriftway, Inc. v. United States*,[21] for example, articulates five factors to analyze in determining whether a distribution is a constructive dividend: (1) how reasonable the fees are; (2) whether it is customary for businesses of comparable size and type to pay the guarantee fees; (3) whether shareholders demand compensation for the guarantees; (4) the sufficiency of a corporation's profits to pay a dividend in a given year, if the corporation did not pay a dividend in that year; and (5) the proportional relationship between the guarantee fee payments and the stock ownership of the guarantors. The primary importance of the *Seminole Thriftway* factors is twofold: first, the factors demonstrate that although the deductibility of a guarantee fee paid to a shareholder is fact-specific, such guarantee fees may be deductible in certain cases; and second, that the determination of deductibility is not well-settled: in the twenty-three year time span between *Tulia I* and *Seminole Thriftway*, no court was able to articulate a clear test for determining the deductibility of such fees.

[21] 42 Fed. Cl. 584 (1998).

As shown in the *Seminole Thriftway* case, the analysis of whether guarantee fees paid to shareholders has become muddled, resulting in a test with multiple, vague prongs. This means that it is nearly impossible for a company to know, at the time it is entering into a guarantee arrangement with a shareholder, whether the fee could be characterized as a deductible expense or as a dividend. This is particularly troubling because non-U.S. jurisdictions will often require payment of a guarantee fee as a matter of law for the parties to be considered acting at arm's length. Moreover, the case law would appear to be inconsistent with U.S. treaty provisions that will often treat guarantee payments to shareholders as "other income," not dividends.

A more reasonable approach might be to treat the guarantee fees as incremental interest, so that the guarantee fee would be reasonable if the fee plus the interest rate on the loan were equal to a reasonable interest rate for the corporation. This would be based on the theory that the borrower could have borrowed the money without the guarantee, but simply at a higher rate. This deemed treatment would be similar to a case where the lender loans to the guarantor shareholder, at the lower rate (reflecting full credit support), and then the guarantor shareholder on lends the borrower at a higher rate, reflecting the diminished credit quality. This treatment is also consistent with the analogy of guarantee fees to interest. It could also be analogized to a case where a lender pays the guarantee fee, and charges the cost through to the borrower as interest, as discussed above.[22]

[22] *See, e.g.,* Rev. Rul. 74-395 for a similar arrangement. *See also* Rev. Rul. 71-399, discussed below.

A second line of authority that considered the proper treatment of guarantee fees paid to shareholders was the *Centel* case.[23] This case considered both the tax treatment of fees by the paying corporation and the receipt of the fees by the shareholder. In the *Centel* case, the shareholders of Centel's predecessor guaranteed the predecessor's debt and were not paid until after the end of the guarantee, several years after the shareholders began guaranteeing the debt. The eventual payment was in the form of warrants, and the question before the court was whether the warrants were transferred in connection with the performance of services, as required by Section 83(h), which in this case would allow Centel to deduct the value of the warrants at the time of their exercise. The court held that the guarantees were to protect the shareholders' investments and that the value provided to Centel's predecessor was more like a capital investment than the provision of a service. The court also found it very important that the shareholders were not employees, stating that "[e]very relevant source supports the employee/stockholder distinction drawn by the Tax Court." Because this was more a case about the applicability of Section 83 than about the characterization of guarantee fees, its application is most likely limited to its facts; however, it does provide one more argument that guarantee fees paid to non-employee shareholders may be business expenses rather than distributions on equity.

Another area that has considered the tax treatment of guarantee fees is the mortgage participation industry, where there is more clear guidance on the topic. Rev. Rul. 71-399,[24] for example, discusses the tax treatment of several different aspects of selling mortgage

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[23] *Supra* note 4.

[24] 1971-2 CB 433 (Jan. 1, 1971).

participations. The relevant aspects of the transaction described by the ruling are as follows: the Federal Home Loan Mortgage Corporation ("FHLMC") would buy mortgage participation certificates representing an eighty-five percent undivided fractional interest in a set of mortgages from the financial institution that originated the mortgages. FHLMC would then issue certificates to investors that corresponded to the mortgage participation certificates it purchased; FHLMC would also guarantee the payments on the certificates it issued. FHLMC would receive interest and principal payments on the certificates it purchased, deduct a fee for management and the guarantee it provided, and pay the remainder to the holders of the certificates it issued. Rev. Rul. 71-399 held that the holders of the certificates issued by FHLMC could deduct the guarantee fees that FHLMC withheld under Section 162, consistent with the certificate holders' methods of accounting. In addition, from the borrower's perspective, it was all simply subsumed in the interest.

Finally, although there is no authority about prepaid fees, Treasury Regulations Section 1.1273-2(g), which addresses payments either from the borrower to the lender or between a lender and a third party in the context of loans, provides rules that might be extended to payments of guarantee fees from the borrower to a third party. This regulation reduces the issue price of the debt by the amount of such a payment, effectively treating such a fee as original issue discount. Unfortunately, Treasury Regulations Section 1.1273-2(g) excludes payments that are "for services provided by the lender, such as commitment fees or loan processing costs", and it is unclear whether the IRS would take the position that a guarantee is a service provided by a lender.

c. Inclusion by Fee Recipient.

There is not much law on the characterization of guarantee fees by the recipients of the fees. Other than the *Centel* case, none of the cases explicitly discuss income inclusion. In *Centel*, the court considered both the deduction by the company and the proper timing for inclusion by the shareholders. In *Centel*, the company deducted a compensation expense of $1,860,000 in the year of exercise, while the shareholders, who were the recipients of the warrants, included the warrants in income in the year in which the warrants were granted, at which time an appraisal showed the value of the warrants to be only $35,000. The result of these conflicting positions was that the company had a deduction that greatly exceeded the amount of income included by the shareholders, and thus placed the IRS in a whipsaw situation.

It seems reasonable to infer from the lack of discussion in the other cases that the courts have assumed that any guarantee fee deductible by the company was included in the recipient's income, either as a dividend if characterized as a dividend, or as ordinary income if a payment for services.

d. Unrelated Business Taxable Income and Effectively Connected Income.

There appears to be little authority addressing the question of whether the mere provision of a guarantee represents the conduct of a business that would cause the guarantee fee to be

considered ECI. Guarantee fees paid by a U.S. subsidiary to its foreign parent were not considered effectively connected income in a footnote in a 2005 IRS Chief Counsel advice, CCA 003322,[25] which primarily addressed the treatment of fees under the U.S.-Japan income tax treaty. The CCA did not have any discussion on the topic, simply stating that the fees were not ECI without elaboration. In holding that guarantee fees paid by a U.S. subsidiary to its foreign parent were U.S.-source FDAP income that was subject to tax under Section 881(a)(1), an earlier Field Service Advice memorandum, FSA 200147033,[26] also implicitly held that such fees were not ECI, since Section 881(a)(1) does not apply to income that is effectively connected with a U.S. trade or business.

There is even less authority on the question of whether guarantee fees constitute UBTI for tax-exempt investors. Section 512(b)(1) specifically excludes "amounts received or accrued as consideration for entering into agreements to make loans" from UBTI, but guarantee fees are not clearly included in this definition.[27] Because there is no other authority addressing this question, it is impossible to provide certainty that guarantee fees do not constitute UBTI.

e. Some Hypothetical Examples Illustrating some Anomalies.

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[25] Jan. 24, 1997, updated Jan. 31, 2005.

[26] Aug. 14, 2001.

[27] This is addressed in the discussion of this rule in **[Levin & Rocap]**, which points out that: "[T]he UBTI rules do not address other types of fee income… such as guarantee fees, equity commitment fees, break-up fees, buyout closing fees, and director's fees."

Example 1.

B, a domestic corporation, borrows $100M from treaty eligible foreign Lender (FL) at a 10% interest rate with no guarantor. This interest is clearly all U.S. source income, possibly eligible for no withholding as portfolio debt interest or under the interest provision of the treaty. The interest deductions would potentially be subject to AHYDO.

Example 2.

Same as example one, but B pays treaty eligible foreign guarantor (G) a 3% annual fee for a guarantee, and the rate on the loan drops to 7%. If guarantor is a parent, and the fee is arm's length (and not treated as a dividend), the treaty would exempt the fee from withholding as "other income" if the treaty has the provision. If the guarantor is in the business of providing guarantees, then withholding/taxation may depend upon whether it is ECI. Only the 7% interest is subject to earning stripping, AHYDO, etc., but not the guarantee portion.

Example 3.

Same as example two, but L pays G the 3% annual fee for a guarantee and passes the cost through to B as interest. Same results for B as example one. If guarantor is a parent, and the fee is arm's length (and the form is otherwise respected), earning stripping rules would apply, unlike in example 2. The treatment of the guarantee fee is a bit odd. Section 861(a)(9) sources the

guarantee payment by L to G as U.S. source, and is thus subject to withholding. Query how treaty relief might apply.

4. The Right Answer.

To the extent a guarantee fee is being paid by the borrower, it seems the treatment that may best capture that fee payment is to treat it as an interest payment for purposes of deductibility by the borrower, as well as sourcing and withholding under the code and treaties. For the income inclusion by the guarantor, the same treatment should apply.

If the lender pays the fee and charges it though as interest, the characterization of the extra cost is the same as it regards the borrower, and it should be a deductible expense of the lender under Section 162 or 212. Here the treatment to the guarantor is a bit troubling because the current source rules would give the U.S. government a second swipe at that guarantee payment, since it is U.S. source. While that is not inconsistent with the approach currently applicable to a number of other like payments,[28] the appropriateness of that approach has been questioned and has been the source of a significant amount of controversy. The author does think this is a case where the government is potentially taxing the value transfer twice. Under the current law, in order to avoid having the U.S. tax the transfer of value twice, it may be preferable for a lender to avoid such a structure, or perhaps to employ David Miller's concept and use a series of options . . .

B. Commitment Fees.

[28] *See, e.g.,* Section 871(m).

1. Background.

a. Definition of Commitment Fee.

The term "commitment fee" is generally used to refer to an amount paid by a borrower to a lender in exchange for the lender's commitment to make funds available to the borrower at pre-arranged terms over a commitment period. As an example, suppose that lender grants borrower the right, at any time during the next three months upon borrower's request, to cause lender to make a ten-year $5 million loan at 7% per annum, and lender charges borrower a fee of $50,000 for this right, which fee is non-refundable even if borrower never exercises its right to borrow. Because borrower has paid for lender's commitment to lend money at a future date, this $50,000 fee fits squarely within the definition of a commitment fee. However, because certain other types of fees (some of which are economically dissimilar) have also been referred to as commitment fees, this paper will refer to such fees as "standby commitment fees." While this article intends to focus mostly on the tax treatment of standby commitment fee, it will briefly mention other types of fees that have at times been labeled commitment fees, because the tax treatment of standby commitment fees has been influenced by (and even conflated with) the tax treatment of other types of commitment fees.[29] In addition, while this article will discuss standby

[29] For a thoughtful discussion of the economically distinct fees which have been labeled "commitment fees," and of the mixed results in attempting to distinguish between these different types of fees for purposes of taxation, see Neuman and Elfman, *The Tax Treatment of Loan Commitment Fees after Rev. Ruls. 81-160 and 81-161,* 60 Taxes 394 (1982).

commitment fees in the loan context, it is expected that its analysis will be helpful in analyzing equity commitment or so-called "backstop" fees.[30]

b. Other Types of "Commitment Fees" and Their Tax Treatment.

Lenders sometimes also charge "commitment fees" for services performed in connection with originating loans.[31] For example, the "commitment fees" charged in Rev. Rul. 75-172 compensated the lender for services such as "construction and architectural inspection, site planning, and engineering services performed in connection with the making of the loan, and also for legal fees" it had incurred in issuing short-term notes and long-term bonds. Such service-based commitment fees have historically been deducted or amortized ratably over the term of the loan by the borrower, similarly to debt issuance costs.[32] Rev. Rul. 75-172 cites *Enoch* and *Lovejoy* for support, two cases in which service-type expenses incurred in connection with acquiring loans were required to be deducted, or capitalized and amortized over the life of the loan.[33]

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30 *See, also* Needham, *A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 2)* Tax Notes (May 27, 2002) for a thoughtful discussion of such fees in the equity financing context.

31 *See, e.g.*, Rev. Rul. 75-172, 1975-1 C.B. 145. This paper will refer to such fees as "service-based commitment fees".

32 Fees incurred in acquiring a loan usually must be deducted ratably of the life of the loan. See S.M. 3691, IV-1 C.B. 145 (1925), *superseded by* Rev. Rul. 70-360, 1970-2 C.B. 103.

33 Herbert Enoch, 57 T.C. 781 (1972) and Julia Stow Lovejoy, 18 B.T.A. 1179 (1930). Although these cases are commonly cited in revenue rulings relating to commitment fees, neither case refers to the fees at issue is "commitment fees" and it is not clear that the fees in either case were, in substance, commitment fees. The fees at issue in *Lovejoy* are referred to as "commissions, fees, and printing costs" and the fees in *Enoch* were "loan and escrow fees." The court in *Lovejoy* stated that the service-flavored fees at issue incurred in acquiring the loan were "not unlike bond discount, prepaid rent, cost of acquiring or disposing of a leasehold or term contract and many other transactions. They should be spread over the definite period of the loan, lease or contract."

c. Exclusion of Commitment Fees from UBTI.

Section 512(b)(1) specifically excludes from UBTI any amount "received or accrued as consideration for entering into agreements to make loans," which presumably covers all standby commitment fees, however labeled. Any fee labeled a "commitment fee" which was re-characterized a payment of interest would independently qualify for the UBTI exemption by virtue of the exclusion in Code Section 512(b)(1) for interest.

Whether a service-based commitment fee could qualify for this UBIT exclusion is unclear. Such a fee would be deemed to be a payment for services, and not for the lender's agreement to make a loan (for example, the commitment fees described in Rev. Rul. 75-172), and thus such a fee likely would not fit within the exclusion. With that having been said, the fact that the income a lender receives from agreeing to enter into a loan has at times been characterized as income from services[34] should not prevent such income from qualifying from the UBTI exception. In other words, a "commitment" fee may be UBTI if it is received for services and not for the lender's agreement to make a loan, but any fee, however labeled, that is received by a lender for agreeing to enter into a loan should probably not give rise to UBTI.

d. Source of Commitment Fees.

[34] *See, e.g.*, PLR 7808038 (Nov. 25, 1977), discussed *infra*.

No provision in the Code or the Treasury Regulations provides specific sourcing rules for standby commitment fees, so taxpayers must source them by analogy. If standby commitment fees represent income from services, they will be sourced to where the relevant services involved in making the funds available (*i.e.*, authorization of the funds and the raising of funds) were performed.[35] Alternatively, amounts paid for personal property are generally be sourced to the residence of the seller of the property, which would be the lender, under Section 865.[36] It seems unlikely that commitment fees would be sourced similarly to interest under current law, given the consensus in the guidance that commitment fees don't constitute amounts paid for the use of money,[37] although as discussed below, that is a position of questionable merit.

Whether a standby commitment fee may be subject to withholding as FDAP income under Sections 1441 or 1442 depends on how the standby commitment fee is characterized.[38] If the fee were characterized, as payment for property (e.g., an option) there would be no withholding upon payment,[39] and the payment would be sourced to the residence of the recipient.[40] If the payment were treated as a payment for services, it would only be subject to

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35 PLR 7808038 found standby commitment fees to be service income and, under the specific facts of the ruling, sourced the income to outside the U.S. Similarly, in PLR 200125030 the Service found that standby commitment fees were U.S. source based on the taxpayer's representation that U.S. personnel performed the activities necessary to secure the availability of funds. The IRS also ruled in PLR 200125030 that the loan commitment arrangements were "other transactions" within the meaning of 864(c)(6)(B).

36 *See* Section 865(c).

37 *See, e.g.*, Rev. Ruls. 70-362, 70-540 and 74-258.

38 Treasury Regulations 1.1441-2(a) defines "fixed or determinable, annual or periodical" income to include all income, as defined in Code Section 61, with the exception of income described in Treasury Regulations 1.1441-2(b).

39 Payments for options are not income at the time of payment (Rev. Ruls. 58-238 and 78-182), and under Treas. Reg. 1.441-2, "amounts subject to withholding" only include income.

40 *See* Code Sections 871(h) and 881(c).

withholding if it were FDAP (i.e., not ECI) and U.S. source. Although one might expect a service payment to be sourced to the location where services are performed, it is not certain that the fees could be sourced to the obligor.[41] It is also worth noting that some treaties source income from financial transactions, such as guarantee fees, to the recipient's jurisdiction as "other income" where it is not earned in connection with a trade or business,[42] and in the case of the U.S.-Japan treaty, the "Other Income" provision covers standby commitment fees.[43]

2. Tax Treatment of Standby Commitment Fees to Borrowers.

a. Tax Treatment Prior to Rev. Rul. 81-160.

The IRS's present position on the ability of a borrower to currently deduct standby commitment fees is set forth in Rev. Rul. 81-160, which generally requires that the standby commitment fee be deducted ratably by the borrower over the term of the loan, or, if the loan is

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41 *See, e.g.*, *Bank of America* (sourcing commissions based on where the obligor was situated).

42 U.S. Dep't of the Treasury, United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 62 (2006) (providing that guarantee fees paid within an intercompany group generally would be covered by Article 21 of the United States Model Income Tax Convention (relating to Other Income) unless the guarantor were engaged in the business of providing such guarantees to unrelated parties).

43 *See*, Convention between the Government of The United States of America and The Government of Japan for the Avoidance of Double Taxation and The Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003 S. Treaty Doc. No. 108-14 **[hereafter, the "U.S.-Japan Treaty"]**. The Technical Explanation of the U.S.-Japan Treaty describes the rule for commitment fees set forth in Paragraph 8 of the Protocol for the U.S.-Japan as "consistent with the rules applicable to income not dealt with in the taxing articles other than Article 21 **[relating to Other Income]**."

not made within the commitment period, to deduct as a loss pursuant to Section 165.[44] Prior to being revoked by the foregoing revenue ruling, Rev. Rul. 56-136 allowed borrowers to deduct standby commitment fees currently, when paid or accrued.[45] The Service's view in Rev. Rul. 56-136 that standby commitment fees should not be required to be deducted over the term of the loan seemed to be based in large part on the notion that standby commitment fees "appear to be expenses applicable to the standby period prior to the issuance of the bonds," and accordingly "they are not considered as bond discount or expense amortizable over the life of the bonds."[46] The treatment of the borrower in Rev. Rul. 56-136 is consistent, from a timing perspective, with the IRS's stated view (which predates Rev. Rul. 81-160) that lenders should include standby commitment fees currently in income, either in the taxable year in which the fee is received (for cash-method taxpayers) or, if earlier, in the year in which the fee is due (for accrual method taxpayers).[47]

One can argue the Service's observation in Rev. Rul. 56-136 that standby commitment fees are properly attributable to the commitment period, and not the life of the loan, makes sense economically. If a borrower desires, at a future date, to have a specified amount of funds available on specified terms, the borrower can achieve its goal without entering into a loan commitment. It could simply enter into a loan today on its desired terms, such that the amount of

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[44] Rev. Rul. 81-160

[45] *See, e.g.*, Rev. Rul. 56-136.

[46] *Id.*

[47] Rev. Rul. 70-540, 1970-2 C.B. 54.

the loan outstanding on the future date would equal the amount of funds desired by the borrower.[48] The benefit to the borrower of a standby commitment fee, therefore, is not having to enter into the loan prior to the future date. The costs of entering into the loan earlier than desired are the interest payments due and the potential interest rate fluctuation risk during the commitment period. Given this view of the benefit to the borrower of the standby commitment arrangement, and what should be a general policy preference to match treatment of the borrower with that of the lenders, one could argue Rev. Rul. 56-136 got it right.

b. Rev. Rul. 81-160.

Rev. Rul. 81-160 revoked Rev. Rul. 56-136 and held that that, where a borrower exercises its right under a standby commitment arrangement, the borrower must deduct its standby commitment fees ratably over the term of the loan or, if the loan is not made within the commitment period, to deduct as a loss pursuant to Section 165. The loan in the revenue ruling was a "draw-down" loan, with the proceeds distributed to the borrower in agreed amounts over a specified period. The commitment fee payable each specified period was calculated as a percentage of the principal of remaining undistributed loan proceeds, in exchange for the lender's willingness to distribute the remainder of the loan and to preserve a fixed interest rate for the total bond issue. The revenue ruling also provides that, where the right to borrow is not

[48] This point is made by Neuman and Elfman, *supra* note 1.

exercised, the payer of the commitment fees generally will be entitled to a loss deduction at the time the right expires.[49]

The revenue ruling compares standby commitment fees to the costs of acquiring an option, the loan being the property acquired upon the exercise of the option.[50] In the case of an option, the cost of the option is added to the basis of the acquired property once the option is exercised.[51] Therefore, if the loan is property acquired with an option, the commitment fee should be treated as a loan acquisition cost, which is deductable ratably over the term of the loan.[52] In support of its position in Rev. Rul. 81-160, the Service cited treasury regulations which generally provide that costs attributable to an expenditure which creates an asset with a useful life extending beyond the current year must be deducted or amortized over the life of the asset.[53] The revenue ruling also cited Rev. Rul. 75-172 and *Francis v. Commissioner*.[54]

One example of where the Service could potentially be viewed as not following Rev. Rul. 81-160 is TAM 200514020, where the borrower was permitted to currently deduct the

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49 Rev. Rul. 81-160, citing Rev. Rul. 71-191, 1971-1 C.B. 77.

50 "A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. See Rev. Rul. 75-172, 1975-1 C.B. 145, and Francis v. Commissioner, T.C.M. 1977-170." Rev. Rul. 81-160.

51 *See* Rev. Rul. 58-234, 1958-1 C.B. 279 and Rev. Rul. 78-182, 1978-1 C.B. 265.

52 For a description of the treatment of loan acquisition costs, see Note 4, *supra*.

53 Treasury Regulations Section 1.461-1(a)(1).

54 Francis v. Commissioner, T.C.M. 1977-170.

commitment fees at issue.[55] The result of the TAM should properly be viewed as factually distinguishable, however, instead of a repudiation of Rev. Rul. 81-160 by the Service. Unlike the standby commitment fees described in Rev. Rul. 81-160, the commitment fees in the TAM were charged in arrears based on the amount of loan outstanding in the prior period, so the Service was able to conclude that the commitment fees were attributable to a benefit realized during a prior period and hence did not create or enhance any separate or distinct asset of the borrower, allowing current deduction.

c. A Critique of Rev. Rul. 81-160.

One could fault the reasoning of Rev. Rul. 81-160 on several grounds, but the precedents cited in the revenue ruling in support of the position that standby commitment fee payments should not be deducted currently (especially Rev. Rul. 75-172 and *Francis*) seem especially weak.[56] The two foregoing precedents clearly stand for the notion that loan acquisition costs should be deducted over the course of the loan to which they relate, but neither lends much support for treating standby commitment fees as a cost of acquiring a loan. As discussed above, the "commitment fees" paid in Rev. Rul. 75-172 were paid for services performed in connection with the loan, not for the commitment to make a loan. This fact makes the citation of Rev. Rul. 75-172 very odd, because Rev. Rul. 81-160 emphasizes the similarity between commitment fees and option premiums, and yet the commitment fees in Rev. Rul. 75-172 bear no economic

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55 TAM 200514020 (Dec. 29, 2004).

56 Neuman and Elfman, *supra* Note 1, includes a helpful discussion of how the precedents cited in Rev. Rul. 81-160 fail to support its position.

resemblance to option premiums. *Francis* is more on-point than Rev. Rul. 75-172 in that the fees in the *Francis* case were standby commitment fees, but the dubious precedent cited in *Francis* casts doubt on the viability of the holding. The *Francis* opinion cites to *Enoch*, *Lovejoy* and Rev. Rul. 75-172 (among others) in support of its holding, and none of the foregoing considered the tax treatment of standby commitment fees. In sum, the precedent cited by Rev. Rul. 81-160, when examined closely, gives the impression that no strong support was available for the revenue ruling's position.

The holding of Rev. Rul. 81-160 also ignores the fact that standby commitment fees are different from loan acquisition costs in that a loan commitment only benefits the borrower during the commitment period. As explained above, a borrower can forego paying loan commitment fees by entering into a loan immediately. While the borrower could enter into the loan at any time it wanted to, the commitment arrangement simply gives the borrower the privilege of not having to enter into the loan during the commitment period. Rev. Rul. 81-160 also creates an inconsistency in the timing of income inclusion between the lender (which, under Rev. Rul. 70-540, is required to include a standby commitment fee currently)[57] and the borrower.

d. Standby Commitment Fees as Payments for an Option.

One of the more unsatisfying features of Rev. Rul. 81-160 is that it compares standby commitment fees to the cost of an option – yet despite this characterization, the revenue ruling

[57] Rev. Rul. 70-540, 1970-2 C.B. 101, Situation 3.

doesn't actually treat commitment fees as the costs of acquiring an option. On a superficial level, Rev. Rul. 81-160 treats the borrower as paying for an option (that is, a call option to acquire a loan) by treating standby commitment fee as a loan acquisition cost which must be amortized by the borrower. However, a standby commitment arrangement is more similar to a put option, that is, an option which gives the borrower the right to put a note to the lender. A better approach would be for the Service to accept the characterization of standby commitment fees as payments for put options and to treat them as such, both on the borrower's side and lender's side.

The IRS currently takes the position that lenders must include commitment fees in income currently, whereas payments for options are not included in the option issuer's income when received.[58] Option treatment would dictate that the lender not have income upon the receipt of the commitment fee, but rather include the commitment fee in income if and when the commitment period expired without a loan being made to the borrower. If standby commitment fees were actually treated as payment for options, the lender would subtract the commitment fee from the amount paid to the borrower upon exercise of the option (*i.e.*, upon issuance of the loan), which would reduce the loan's issue price and create OID, or reduce bond premium. This approach, however, appears to be at odds with the Section 1273 regulations, which treats commitment fees as amounts paid for property or services, the payment of which in connection with the consummation of a loan will not reduce the lender's issue price in a loan.[59] One could

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58 Rev. Rul. 58-234 and Rev. Rul. 78-182.

59 Treas. Reg. 1.1273-2(g)(2(i). Although this regulation by its terms applies only to a lending transaction to which Code Section 1273(b)(2) applies, *i.e.* a lending transaction where the issue price is determined by the amount of cash paid for the loan, the same result would hold where a lender syndicate paid cash for a loan and then sold the loan to the public. In that case, the issue price of the loan would also reflect the lower amount of proceeds paid for the loan.

argue that the term "commitment fee" appearing in Treasury Regulations section 1.1273-2(g)(2) refers to commitment fees paid for services provided by the lender (as in the case of Rev. Rul. 75-172) and would not apply to a standby commitment fee. However, a fee treated as an option premium is arguably a payment for property within the meaning of Treasury Regulations Section 1.1273-2(g). Also, an alternative approach in which the lender would amortize the commitment fee over the life of the loan, would not appear to have much independent support, and would appear to conflict with other guidance on the treatment of standby commitment fees to lenders, including Rev. Rul. 70-540, which requires current inclusion by the lender.[60]

While the treatment of borrowers would not be greatly changed if standby commitment fees were treated as put options,[61] the treatment of standby commitment fees to lenders would be substantially different if these fees were treated as payments for a put option. To the holder of a put, the cost of acquiring the put is a non-deductible capital expenditure,[62] which is consistent with the Service's current position on the non-deductibility of commitment fees. If the put expires without being exercised it is treated as being sold for zero value and the holder is allowed to take a loss. The option premium for a put option is not included in income of the writer of the

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60 *See* also GCM 39434 and TAM 8543009, discussed *infra*.

61 Similarly to option treatment, borrowers are allowed to deduct a loss upon the expiration of an unexercised loan commitment (Rev. Rul. 81-160) and in the case of exercise are deemed to add the standby commitment fee to the basis of the loan and amortize it. The timing of deductions from this amortization may differ slightly from the deductions resulting from an increase in OID, depending on the rate at which interest and principal are deemed to be paid off under the OID rules.

62 Rev. Rul. 78-182, 1978-1 C.B. 265. The ruling seems to leave open the possibility that the purchase of the option premium could be treated as an ordinary expenditure if the underlying asset were held by the put holder as an ordinary asset.

put option (*i.e.*, the lender) when paid,[63] and the option premium would either reduce the basis of the purchased property (if the put option is exercised) or would be included in income when the option expires.

3. Treatment of Commitment Fees by Lender.

Compared with borrowers, to whom standby commitment fees are treated by the IRS as payments for a property right similar to an option,[64] less certainty exists regarding the nature of income which is received by the lender in respect of such a fee. The IRS has provided more clarity to lenders on the timing of inclusion from standby commitment fees, providing in Rev. Rul. 70-540 that lenders should include standby commitment fees in income currently.[65] One might think that the revocation of Rev. Rul. 56-136 has undermined the integrity of Rul. 70-540, given that (1) the current-inclusion rule is consistent, from a timing perspective, with the position of Rev. Rul. 56-136 that standby commitment fees should be deducted currently and (2) Rev. Rul. 70-540 cites to Rev. Rul. 56-136. However, the IRS continues to treat Rev. Rul. 70-540 as if it is still valid and consistent with Rev. Rul. 81-160.[66] And the proposition in Rev. Rul. 56-136 which is cited to, that standby commitment fees represent payments for the willingness of lenders to make loans, and do not represent interest, is non-controversial and was not among the

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63 Rev. Rul. 78-182.

64 *See, e.g.*, Rev. Rul. 81-160.

65 Rev. Rul. 70-540, Situation 3.

66 *See, e.g.*, FSA 200037034, which cites approvingly both Rev. Rul. 81-160 and Rev. Rul. 70-540.

elements of Rev. Rul. 56-136 that was revoked.[67] Therefore, even though Rev. Rul. 70-540 pre-dates Rev. Rul. 81-160 and makes no mention that standby commitment fees represent amounts paid for a property right, it appears that the current inclusion rule in Rev. Rul. 70-540 continues to be viable.

Prior to Rev. Rul. 81-160, in PLR 7808038,[68] standby commitment fees received by a foreign corporation from a U.S. branch of that corporation's foreign parent were found to be income from services, as the commitment fees "are not payments of interest but instead are payments made in order to secure the availability of funds upon need" (citing Rev. Rul. 54-43 and Rev. Rul. 56-136, the latter of which was expressly revoked by Rev. Rul. 81-160).[69] The ruling found that because the relevant services involved in making the funds available were performed outside the U.S. (which services included authorization of the funds and the raising of funds), the standby commitment fees would therefore be sourced outside the U.S. The usefulness of this PLR as support for the notion that a lender should treat standby commitment

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67 A standby commitment fee arguably fits within the definition of interest set forth by the Supreme Court in *Deputy v. Dupont*, 308 U.S. 488, 498 (1939), as it is arguably "compensation for the use or forbearance of money" by the lender, which must forebear the use of money in order to have it available on the commitment date. However, the Service has consistently found that standby commitment fees are something other than interest payments. See, *e.g.*, Rev. Rul. 56-136 and Rev. Rul. 81-160.

68 PLR 7808038 (Nov. 25, 1977). *See also Bank of America v. U.S.*, 680 F.2d 142 where court characterized income from fees for accepting letters of credit as services income.

69 Rev. Rul. 54-43, 1954-1 C.B. 119 and Rev. Rul. 56-126, 1956-1 C.B. 92. Neither ruling provides direct guidance to lenders on the treatment of commitment fees. Rev. Rul. 54-43 involved an arrangement whereby a merchant would sell its installment accounts to a bank at a discount in exchange for the bank's willingness to provide a credit commitment to the merchant. The ruling found that the "commitment fees" at issue were consideration for the right to have credit made available and not for the use of funds, and hence were not interest. Rev. Rul. 56-126 was expressly revoked by Rev. Rul. 81-160, having held that commitment fees charged by a lender under a deferred bond sale arrangement could be currently deducted or capitalized at the election of the bond issuer. The Ruling found that the commitment fees did not constitute interest, and also that, since they appeared to relate to the standby period prior to the issuance of the bonds, they did not constitute bond discount or expense amortizable over the life of the bond.

fees as services income appears to be very limited, in that it predates the issuance of Rev. Rul. 81-160, which also revoked one of the rulings cited by this PLR in support of treating such fees as services income.

Additional insight is found in GCM 39434 (whose facts and analysis gave rise to TAM 8543004), which found that certain annual credit card fees should be analogized to standby commitment fees and treated by the lender as giving rise to income from the exchange of a property right.[70] The GCM suggests that the treatment to the lender of the commitment fee should match the treatment of the borrower ("the character of the loan commitment fee should be the same on both the income and expenditure sides"). To this end, the GCM first cites several prior rulings which found that a commitment fee was not a fee paid with respect to indebtedness and is therefore not interest,[71] and then cites Rev. Rul. 81-160 in finding that commitment fees represent amounts paid for a property right (similar to an option premium), and not amounts paid for services. Accordingly, Rev. Proc. 71-21 (allowing accrual method taxpayers under some circumstances to defer inclusion of services income where the services were to be performed in a later year) was inapplicable and the credit card issuer was required to include the entire amount of the commitment fee in income currently. Since the GCM there has been a paucity of guidance considering the treatment of commitment fees to lenders.

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[70] GCM 39434 (October 25, 1985); TAM 8543004 (July 18, 1985). In justifying the fees charged to its customers in respect of the credit card, the credit card company noted, among others things, that a credit card is a financial management tool which allows customers the security of having standby funds available for emergencies and other needs.

[71] Rev. Rul. 56-136; Rev. Rul. 70-540, 1970-2 C.B. 101 (Situation 3); Rev. Rul. 74-258.

4. The Right Answer.

Ultimately, it is hard to make sense of how Rev. Rul. 81-160 treats a standby commitment fee as an option to acquire property, defining property as the use of money. The money being acquired comes with an obligation to repay it, and cash is typically not viewed as property in this sense. Far more sensible would be to treat the standby commitment fee as the payment of a put option premium whereby the borrower is provided the option of putting its note to the lender(s). The notion of a corporation entering into an option arrangement respecting its own stock is ubiquitous, so it's not clear there is any reason to treat an option arrangement for debt otherwise.

In fact, there is an analogous arrangement that does occur in the equity financing area. Often, distressed companies emerging from a bankruptcy restructuring will use an equity rights offering to raise capital. The equity rights, essentially warrants, will typically be distributed to a creditors group, and a smaller subset of creditors will often agree to exercise any rights not exercised by the other rights holders, thus assuring the distressed company of the ability to raise a set amount of funds. These arrangements are sometimes documented as "backstop" arrangements pursuant to which a backstop "fee" is paid to the group willing to purchase equity in the event that not all of the equity rights issued in the offering are exercised. This is essentially a commitment fee in the equity context, subject to a contingency occurring (i.e., less than full subscription in the rights offering). In some circumstances, however, the arrangement is documented as a put option agreement, pursuant to which the distressed company can put

stock to the backstop group in the event the rights offering is not fully subscribed. The company pays a put premium to the backstop group for that put right. If the put right is not exercised, the company claims a loss under Section 165, and the backstop group includes the amount in income. If the put is exercised, the backstop group subscribes for shares and reduces basis by the amount of the put premium.

It is not clear why this would not apply to the situation where a standby commitment fee is paid. It is virtually identical to having the borrower pay a put premium, allowing the borrower to put its note to the lender. If the put is not exercised, the borrower has a loss (consistent with Rev. Rul. 81-160), and the lender should then have income—but only at that time, upon expiration of the commitment period where no loan is made. In the event the loan is made, the lenders would reduce the basis (i.e., the issue price) of the loan by the amount of the premium (i.e., the commitment fee), and create OID.

This approach would provide for consistent treatment of character and timing among all of the parties, would match the treatment that applies in the put option context, which is virtually identical from an economic perspective, and it would also provide greater clarity and certainty in the sourcing and withholding context in a way that would be consistent with all other aspects of the transaction.

A. Consent Fees.

1. Background.

The treatment of consent fees has also been an area of uncertainty. There has been very little formal guidance, and the result is that taxpayers and practitioners are left with uncertain positions respecting a very common transaction. For example, when consent fees are paid to bond holders in the market, the prevailing practice is for taxpayers to claim uncertainty, pick the treatment that suits the issuer best, and reserve the right to withhold on fees to the extent paid to non-U.S. holders.

In fact, the vast majority of disclosures regarding consent fees in SEC filings provide that the issuer intends to treat the consent fee as a fee paid separately from the debt instrument, resulting in ordinary income to the recipient, and generally subject to 30% withholding (unless it's ECI or eligible for reduced treaty rates). What is particularly interesting about this market practice is that if flies in the face of what little guidance we have from the IRS, and, in some disclosures, the issuers acknowledge as much.

The discussion below considers the limited authority that does exist. Treasury Regulations Section 1.1001-3, dealing with significant modifications, suggests that a consent fee should be treated as affecting the yield of a debt instrument, as opposed to being treated as a separately stated fee or a payment for services. In two separate private letter rulings the IRS has addressed the U.S. federal income tax treatment of fees paid by an issuer to obtain the consent of debt holders to (i) make amendments to debt indentures in connection with a corporate restructuring and (ii) make modifications to terms of the debt. Each private letter ruling, as well as some additional informal guidance, and the effects these limited authorities may have on the issuer and the debt holder are discussed below. This section of the paper will discuss the need

for more formal guidance with respect to the U.S. federal income tax treatment of consent fees, and what such guidance should provide.

2. Legal Framework.

a. Treasury Regulations Section 1.1001-3.

Treasury Regulations Section 1.1001-3 governs the tax rules associated with modifications of debt instruments. In its most common form, a consent fee paid to bondholders in order to effect an amendment to the terms of a debt instrument is essentially a fee paid as consideration for a modification for such debt instrument. In determining whether such a payment has caused a significant modification of the debt instrument by virtue of materially affecting the yield, Treasury Regulations Section 1.1001-3(e)(2) treats such a payment as part of the yield of the debt instrument. Under Section 1.1001-3(e)(2)(iii), it is specified that for purposes of testing the effect on yield of such a payment, the payment should reduce the adjusted issue price. However, while the Section 1001 regulations treat a consent payment as reducing adjusted issue price for purposes of testing the extent to which the debt's yield has changed, it is not clear that the ultimate tax treatment for the parties (i.e., sourcing, character, and timing of the consent payment) is dictated by those regulations (e.g., that for all purposes the payment reduces the adjusted issue price). It does, however, suggest that the appropriate treatment would be to treat the consent payment as another payment under the instrument, i.e., not a payment for services, but a payment in respect of the note itself.

b. Private Letter Ruling 9641001.

In PLR 9641001, the IRS ruled that consent fees made to bondholders to obtain their consent in connection with a stock redemption were nondeductible capital expenditures. The consent fee question in PLR 9641001 centered on whether expenses incurred for a consent solicitation and debt tender offer represented a deductible business expense, deductible interest or nondeductible capital expenditure under the Code. The expenses were incurred because the bond indentures contained a covenant prohibiting the issuer from making any payments in connection with the redemption, purchase or acquisition of the capital stock of the issuer, which made it necessary for the issuer to obtain the consent of the bondholders to amend the indenture agreements in order to redeem issuer stock. The corporate restructuring was expressly conditioned upon the issuer obtaining a certain number of consents in order to go forward with the redemption. The consent payments were offered to the bondholders as an inducement to make the necessary amendments. The taxpayer deducted the amount of the consent payments, but the IRS disallowed the deductions, concluding such payments represented nondeductible capital expenditures under Code Section 263.

The IRS agent asserted Code Section 263 applied to the consent payments and argued that the expenditures had their origin in the corporate restructuring, which was a capital transaction in nature. Specifically, the consent payment was an expense necessary to the redemption of the taxpayer's stock and, thus, like all expenses incurred in the redemption of stock, must be capitalized. The IRS agent also referenced the well established rule under the origin of the claim doctrine that if an expenditure has its origin in the acquisition, enhancement or disposition of an asset, the expenditure must be capitalized without regard to the motivation

for incurring the expenditure.[72] After a brief discussion of the applicable law, the IRS determined that the purchase of stock, including the purchase of the issuer's own stock, is to be considered a capital transaction for which no deduction is allowable, and the same treatment is to be given to any incidental expenses connected with such purchase.[73] In short, because the issuer incurred the consent payment costs in connection with the stock redemption, and the consent payments originated because of the acquisition of a capital asset, the payments were held to represent nondeductible capital expenditures. The IRS also noted the consent payments were so inextricably connected to the corporate restructuring that they must be considered as part of the restructuring expenses, citing to a case that disallowed expenses incurred in connection with obtaining the consent of its bondholders to an exchange of the debt.[74]

There are several troubling aspects to the holding in PLR 9641001. First, there is no discussion of the possibility that the consent fee could possibly result in, or may have been paid in connection with, a significant modification and what the consequences would be if that were the case. As it so happens, the IRS has concluded in FSA 001653 that a consent fee paid in connection with the significant modification of a debt instrument should be treated as a redemption premium paid on the "old" debt pursuant to Treasury Regulations promulgated under

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72 *See Woodward v. Commissioner*, 397 U.S. 572 (1970).

73 *Proskauer v. Commissioner*, 46 T.C.M. 679, 684 (1983).

74 *Denver & Salt Lake Ry. Co. v. Commissioner*, 24 T.C. 709, 719 (1955) (the expenses were not consent fees, but legal and other expenses).

Section 1001.[75] Under that analysis, any consent fee paid in connection with a significant modification (assuming it is a taxable exchange) would make the consent fee deductible.[76]

c. Private Letter Ruling 201105016.

In PLR 201105016, the IRS takes a different approach in its analysis of the proper tax treatment of consent fees. In this ruling, a restructuring transaction was conditioned on a tender offer to repurchase a certain portion of notes and a successful consent solicitation to permit the restructuring. The consent fee was paid to holders whose notes were tendered, with a portion treated as being paid to those whose notes were redeemed, and a portion paid to holders whose notes were tendered and amended but not redeemed.

With regard to the portion of the fee deemed paid in respect of the redeemed notes, the IRS treated the fee as part of the purchase price paid by the issuer for the notes, and thus the fee was not treated as a separate item although it was separately stated in the consent agreement. The IRS cited Treasury Regulations Section 1.163-7(c) as providing that such excess is repurchase premium and is therefore deductible as interest in the taxable year the notes were

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75 *See* FSA 001653 (July 24, 1995)

76 Ironically, the analysis in PLR 9641001 that was applied to redemption premiums paid for redeemed debt also concluded deductibility, so that a consent fee arguably gets a different result under the reasoning of PLR 9641001 in the case of a significant modification. It is also interesting that in footnote 3 of PLR 9641001, the IRS states that it does not rely upon Section 162(k), and notes the IRS view that it does not apply to the analysis of the expenses (including the consent fee). However, if the consent fee results in immediate or eventual interest deductions, by virtue of the redemption premium analysis or otherwise, Section 162(k) by its own terms would not require capitalization. Accordingly, the reasoning and analysis of PLR 9641001 appears to be rather flawed and is inconsistent with the IRS conclusions found in FSA 001653 and PLR 201105016, discussed below.

repurchased, and further stated that Code Section 263 would not affect the deductibility of the repurchase premium.[77]

The portion of the fee deemed paid in respect of the notes being amended, but not redeemed are treated as a payment under the debt instrument. In making this determination, the IRS discussed whether the payment of consent fees resulted in a significant modification, within the meaning of Treasury Regulations Section 1.1001-3, and relied on the taxpayer's representation that such payments did not cause the notes to be significantly modified. The IRS then determined that Treasury Regulations Sections 1.1001-3(e)(2)(iii) and 1.446-2(e)(1) applied treating such amounts first as payments of accrued and unpaid interest, and then as payments of principal on the note, which would reduce the adjusted issue price of the notes and eventually result in repurchase premium.

PLR 201105016 is interesting in several respects. First, it is helpful in that it does not treat the consent fee as a payment for services—in fact it never appears to consider it a possibility (and for that matter, neither did PLR 9641001 nor FSA 001653). Second, it does not appear to consider an origin-of-the-claim analysis relevant, which is also helpful and simplifying. What is perhaps most interesting, however, is that it does not simply consider the entire payment to be a payment of interest. The key to this aspect of the holding in PLR 201105016 rests on the conclusion that the interest payment constitutes a payment under the debt instrument, which then leads to the application of Treasury Regulations Section 1.446-2(e)(1). While the ruling in many respects is welcome, particularly for note holders that can defer tax on the receipt of the

[77] This aspect of the ruling is consistent with the rationale applied in FSA001653 to consent fees paid in connection with a significant modification of debt.

unexpected bump in yield, it is not clear that this is the most sensible way to treat the consent fee. For example, now the deductibility and income inclusion of a consent fee turns on whether it is paid in connection with (or causes) a significant modification. It is not clear that is necessarily sensible from a policy perspective, or that it reflects some substantively different underlying economic event; and it certainly complicates matters. Moreover, it is not clear that it really implements the intent underlying the rules. Arguably, Treasury Regulation, Section 1.446-2(e)(1) is best suited to addressing accelerated or otherwise already contemplated payments on a debt instrument—first they are applied to accrued and unpaid interest, and then to principal. However, to apply that rule to a payment that represents a self-contained increase in the yield on the instrument and, to sever the taxation of that accrued yield from the moment when it occurs, and to defer it until the end of the debt instrument's term, does not seem the most sensible approach. Whether that is a good result or a bad result, as is often the case with debt, depends on the eye of the beholder (i.e., the holder enjoying a deferral of income or the issuer suffering a deferral of a deduction).[78]

4. Implications of the Rulings.

(a) Deductibility and Character of a Consent Fee For Payers.

As evidenced by the above summaries of the rulings, PLR 9641001 is at odds with PLR 201105016, since each transaction consisted of a debt amendment coupled with a consent fee payment made in connection with a capital restructuring, yet different tax consequences were

[78] Note that while a repayment of principal is generally welcome to a holder, if the holder has market discount, the payment would trigger inclusion of the market discount.

held to apply with respect to the payers. As discussed, PLR 9641001 determined that the consent fee was a nondeductible capital expenditure, and noted that the consent payments were so inextricably connected to the corporate restructuring that they must be considered as part of the restructuring expenses. Given the passage of time since the issuance of PLR 9641001, the apparent conflict between PLR 9641001 and FSA 001653, and the more recent issuance of PLR 201105016, it would seem appropriate for payers of consent fees not to follow the approach set forth in PLR 9641001.

PLR 20110516 and FSA 001653 are similar in that they treat the consent fee as a payment in respect of the debt instrument, and not a separately paid fee that would be taxed independently. As mentioned above, the market practice does not follow the approach laid out in PLR 201105016; rather the market practice (based on SEC filings) treats the consent fees as separately paid fees that would be ordinary income to a holder (but without any further elucidation as to character or nature). The legal support for that position is unclear (although the commercial motive to the issuer is understandable).

Under the authority of Treasury Regulations 1.1001-3, as interpreted by PLR 201105016, the fee should be a payment of accrued and unpaid interest first and then a payment of principal. It is a bit unclear what the analysis should be if the fee is paid in connection with a significant modification of the debt. As mentioned above, the IRS concluded in FSA 001653 that a consent fee paid in connection with the significant modification of a debt instrument should be treated as a redemption premium paid on the "old" debt pursuant to Treasury Regulations promulgated under Section 1001. Under the reasoning in PLR 201105016, a significant modification

resulting in a taxable exchange might reach the same result, but through a different analysis, and possibly with different consequences. Under PLR 201105016, the fee would arguably be, first, a payment of accrued and unpaid interest, and then a payment of principal, all in respect of the old debt. Then, when that old debt (with a reduced adjusted issue price) is exchanged for the new debt, there would be a deemed payment of a repurchase premium in an amount equal to the excess of the new debt's issue price (face amount if not publicly traded and having adequate interest; fair market value if publicly traded) over the adjusted issue price of the old debt.

If the consent fee is paid in connection with a significant modification of the debt, and it is a deemed exchange of securities (i.e., a recapitalization under Section 368), the treatment of the consent fee also differs. Under PLR 201105016, one would argue there is a payment of accrued and unpaid interest, and then a payment of principal, thus reducing principal amount and adjusted issue price reduction, followed by an exchange of the old debt for the new debt, triggering gain to the extent the principal of the new debt exceeds that of the old debt.[79]

(b) Treatment for the Recipient of a Consent Fee.

While the rulings discussed above address the treatment of consent fees for the issuers of the debt, the rulings also provide guidance, or at least implications, for the holders. As stated above, PLR 9641001 is ambiguous about how it characterizes the consent fee. It does not indicate whether it is viewed as a payment for services or not, and it is difficult to tease out the implications for a recipient of the consent fee (except to the extent it is paid out as part of the redemption of the debt, in which case it is likely to be repurchase premium).

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[79] **[Section 354(a)(2)(A), 356(d)(2)(B).]**

Under the rationale in FSA 001653, the entire amount is repurchase premium if the fee is paid in connection with a significant modification of the debt. The same result applies under PLR 201105016 if the fee is paid in connection with a redemption of the debt. As discussed above, if the rationale of PLR 201105016 applies to the payment of a fee in connection with a significant modification, it likely results in repurchase premium if the deemed exchange is taxable (assuming the issue price of the new debt is equal to the face amount). If the consent fee is paid in connection with a significant modification of the debt that is a deemed exchange of securities (i.e., a recapitalization under Section 368), there would be gain. Under PLR 201105016, if the consent fee is paid in connection with a modification of the debt, but there is no redemption or significant modification, then the payment would be partially a payment of interest and partially a payment of principal.

For UBTI purposes, the treatment of consent fees for modifications to notes made with respect to U.S. tax-exempt investors could be viewed as amounts received for entering into an agreement to make the newly modified obligation, within the meaning of the Section 512(b)(1) of the Code. Alternatively, such consent fees may be viewed as a payment of accrued and unpaid interest, and then principal (following PLR 201105016), or as amounts realized upon the deemed exchange of the existing obligation, within the meaning of Section 512(b)(5) of the Code. In each case such amounts should presumably be excluded from the definition of UBTI. The treatment of gain from the retirement or other disposition of notes, e.g. pursuant to a significant modification under Treasury Regulations Section 1.1001-3 should also be excluded from the definition of UBTI under Code Section 512 (so long as the tax-exempt holder did not borrow money in connection with the acquisition of such notes).

The consequences of a consent fee paid to non-U.S. holders of debt should follow the same analysis as above, meaning that, depending on the circumstances, payment of interest, principal, repurchase premium or gain in a recapitalization could result from a consent fee under the analysis in PLR 201105016 or FSA 001653. All of those characterizations (other than interest) would generally be free from withholding, and in the case of interest, the same withholding that generally would apply to the interest payments would then apply to any portion of the consent fee treated as interest. What is interesting is that market practice for public debt appears to deviate from that approach. Most consent solicitations filed with the SEC state that the law is unclear, often mention the ruling, and then proceed to state the issuer's intent to treat the consent fees as a separately paid fee, which would result in ordinary income to the holder, and that the issuer, in the absence of clear guidance, will withhold 30% for non-U.S. holders unless the holder establishes the fee is ECI or can establish treaty relief (although what treaty relief would apply is unclear). Presumably, the payers of the consent fee take this position (i) to assure maximum deductibility right away, and (ii) eliminate risk of failure to withhold. It is unclear why the view is that the income would be subject to withholding, other than, perhaps, a concern that an analysis along the lines of that applied in *Bank of America* would apply, and the source would correspond to the jurisdiction of the obligor, and would constitute FDAP.

3. The Right Answer.

What is fairly surprising about the current state of the law respecting consent fees is that there is no formal guidance, and what little informal guidance exists appears to be ignored in market practice. Moreover, consent fees are one of the more common occurrences in the

commercial markets. Amendments to credit facilities and other debt instruments, for which a fee is paid, is virtually an everyday occurrence.

While the approach in 201105016 makes some sense, it does not seem to the author to be the best approach. The simplest approach, and the one that would be easiest to administer—and probably represents the most sound policy—would be treat consent fees as deductible interest payments in all cases, for both issuer and holders, and having no effect on issue price. That would apply in the case of a significant modification or not, and regardless of whether the significant modification qualified as a tax free recapitalization or not. While the author is somewhat sympathetic to the view that a repurchase premium or boot is perhaps a more appropriate treatment in the case of a significant modification, it would seem there is an equally or more compelling argument that, if a tax should be a neutral factor in how taxpayers make business decisions, then the treatment of a consent fee as interest in all instances is the right approach.

III. Comparing the Treatment of Fees.

Lending related fees are generally treated in one of three ways: as interest or principal (i.e., a payment on the debt), payment for services or payment for property. As shown above, the treatment is inconsistent as applied to guarantee fees because it is generally treated as a payment for services (e.g., *Tulia*, *Seminole*), but, except for the short-lived reign of *Container*, it is not treated as a payment for services for purposes of sourcing. For treaty purposes, it's even more confused because it is considered U.S. source income, and if not ECI, FDAP subject to

withholding and eligible for being re-sourced outside the United States under an "other income" provision, if such a provision exists in the relevant treaty.

Standby commitment fees are treated as the purchase of property, although different results depending on whether the taxpayer is the payer or the recipient. The payer is treated as purchasing an option (sort of), and would recover that cost as a loss if the loan is not made; and if the loan is made, treat the premium like a general financing cost (similar to legal fees incurred in the financing) through amortization. The lender, however, does not appear to have the same timing rules, but would have immediately taxable income upon receipt, regardless of whether the loan is made or not. The source of the standby commitment fees is also not entirely clear. If the option rules apply, or it is generally treated as the sale of property, it would generally be sourced to the residence of the fee recipient. However, one could view the *Bank of America* holding as suggesting that standby commitment fees should be sourced to the residence of the obligor.

The "law" on consent fees, if we are willing to treat the most recent IRS view in PLR 201105016 as law, would generally treat a consent fee as a payment under the debt instrument, i.e., either payment of interest or principal, and not as a payment for services. Its treatment in the event of a significant modification would differ. All of that being said, the market practice is to ignore this guidance.

What is interesting is that the law has developed in the area of these three types of fees largely independent of one another. Moreover, even when considering the taxation of one fee,

e.g. treatment of standby commitment fees, the law for one party seemed to develop independently of the law for the other. While that is understandable, and is a result of case law and IRS rulings addressing narrow questions as they are presented, it does create a mosaic of law that hardly seems coherent or desirable as a matter or policy or practice.

If one were to pick a comprehensive policy to govern the treatment of lending related fees, it would seem to make sense to treat fees that are separately charged, and that are clearly being paid for services (e.g., processing of paperwork), as payment for services, as is currently the case. All other fees related to the debt should be treated as interest for purposes of sourcing, character and timing, with one modification for standby commitment fees, which should be treated as payment of a premium for an option, and to the extent the loan is made, the premium would be treated like any other closing date fee not paid for services (i.e., reduce the issue price and create OID).

Treating guarantee fees as interest seems consistent with much of the best reasoning surrounding the appropriate treatment of guarantees, such as in *Bank of America*, because the pricing of interest is often directly related to credit support and risk, and paying a guarantor as a way to reduce the interest payment to the lender, supports the notion that the guarantee fee acts as a proxy of sorts for interest. Also, while interest is a charge for the forebearance of money, and a guarantee is not a charge for money actually being transferred to a borrower, the guarantee limits the ability of a guarantor to make full use of its money or assets during the period the guarantee is outstanding, which is similar to the forebearance notion.

If a lender receives a standby commitment fee, the borrower would be treated as purchasing an option, with the fee treated as the payment of an option premium for all parties concerned. It would be included in income (and deducted) upon lapse, or reduce the issue price if the loan is made (i.e., the option is exercised). The only real change here is to apply the rules for option purchases consistently to all parties to the transaction, including the consequences that would occur upon the making of the loan. It is interesting to consider whether this could be achieved now by having a lender and borrower change the form of the arrangement to an actual option, as sometime occurs in the case of equity purchases (using options in lieu of backstop fee arrangements).

Consent fees could also be treated as interest payments for purposes of source, character and timing. This is similar to the position outlined in PLR 201105016, although it would be simpler to treat any consent fee paid in respect of a debt instrument as an interest payment deductible and includible in income at that time. Treating all or part of it as a payment of principal, when it is a payment above and beyond what the debt instrument had ever called for does not seem like the most appropriate treatment of that additional payment—it is additional yield, previously unbargained for, pure and simple.