Unraveling the Timing and Character of Revolver Net-back Payments

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The humble revolving credit facility has become an increasingly popular investment for credit-orientated private investment funds. This trend has been driven by the growing liquidity in the bank loan market, the attractive yields and security of credit investments generally, and the economics of so-called "net-back" transactions, which pair nicely with the desired return profile of these investment funds.

This article begins with a brief overview of revolving credit agreements ("revolvers") and the economics of these net-back transactions, and then attempts to unravel the timing and tax character of net-back payments—an inquiry that is not as straight-forward as it might first appear.

I. Background

A. Revolver Mechanics and Economics

Financial institutions frequently enter into revolvers with borrowers and generally do so as part of broader lending transactions. Under the terms of a typical revolving credit agreement, the borrower has the right to borrow up to a fixed balance (the "commitment") and this right to borrow remains outstanding for a fixed duration (the "commitment period").

If the borrower exercises its right to borrow, the terms of the revolving credit agreement provide the loan's interest rate, maturity date, and other financial covenants governing the rights and obligations of the parties under the lending arrangement. That is, all is agreed to and fixed upfront. The borrower is not required to borrow the entire commitment at one time. Furthermore, if a borrower repays a loan, and the commitment period has not yet expired, the borrower can re-borrow the amount (up to the original undrawn commitment balance). Frequently, any outstanding loans under the revolving credit facility mature at the end of the commitment period.

In exchange for granting borrowers the aforementioned rights under a revolving credit agreement, borrowers typically pay the financial institution an upfront and nonrefundable fee (an "upfront commitment fee"). An upfront commitment fee generally is calculated based on the commitment balance and commitment period, as well as the credit quality of the borrower. Again, the borrower is not required to borrow under the revolving credit agreement, and if a borrower can receive more favorable financing from another financial institution or lender at the time it desires to borrow, the borrower can choose to do so.

In addition to the upfront commitment fee described above, borrowers typically pay an unused commitment fee over the term of the revolver (typically quarterly). The unused commitment fee is usually equal to the product of (i) an interest rate and (ii) the undrawn balance of the commitment. Unused commitment fees are sometimes referred to as "ticking fees" or simply "commitment fees."[1] While these unused commitment fees are an important part of the economics of a revolver, they are not the subject of this article and any references to the term "upfront commitment fee" herein are in reference only to the nonrefundable upfront fee described above, unless otherwise specified.

Many revolvers provide for a variable rate of interest (*e.g.*, indexed to Secured Overnight Financing Rate ("SOFR")) if drawn, such that the rate of interest fluctuates with market conditions. In addition, many revolvers are senior to other term loans and borrowings, and in this sense are fairly secure. Revolvers also typically provide for strong protections and financial covenants for financial institutions committing to lend.

B. Net-back Transactions

In so-called "net-back" transactions, an investment fund agrees to take on (in a secondary market transaction) a financial institution's place as lender under a revolving credit agreement (generally through a participation arrangement). In exchange for taking on a revolver commitment, the investment fund receives a nonrefundable payment (a "net-back payment") from the financial institution. In these transactions, the investment fund also is entitled to receive any interest on drawn balances as well as any ticking fees or unused commitment fees on undrawn balances. Because investment funds' economic performance is generally evaluated based on its return on capital, some funds seek to execute a "capital light" investment strategy, acquiring undrawn revolvers to minimize capital requirements. Therefore, in many cases these investment funds receive net-back payments without making an immediate cash outlay (and may in fact, never be required to make a cash outlay on account of a draw by the borrower).

By way of a simple example, assume that a financial institution has a pre-existing commitment under an unfunded revolver and that half-way through the term an investment fund agrees to take on the unfunded revolver in a secondary market transaction. Assume further that the financial wherewithal of the borrower has not declined since the time that the financial institution committed to the terms of the revolver. That is, if hypothetically the revolver had been fully drawn it would not trade in the secondary market at a discount. Assume further that the financial institution received an upfront commitment fee in connection with the revolver of $100x. In order to compensate the investment fund for assuming the funding obligation under the revolver, and the associated risk, the financial institution here might pay the investment fund a net-back payment of $50x (*i.e.*, pass-through half of the upfront commitment fee it received, given that half of the term of the revolver remains). This amount is nonrefundable; that is, even if the borrower ultimately repays any future advances under the revolver, or if the revolver expires unfunded, the investment fund is entitled to retain the $50x net-back payment as well as any ticking fees or unused commitment fees paid by the borrower prior to maturity.[2]

Most investment funds engaged in net-back transactions take the position that they are not engaged in a trade or business for U.S. federal income tax purposes[3] and accordingly also classify any revolvers acquired in these secondary market transactions as capital assets.[4]

C. Tax Questions Raised by Net-back Transactions

A significant tax issue for investment funds engaged in net-back transactions is determining the proper timing of income inclusion as well as tax character of the net-back payments received. In the investment fund context, this question is significant because capital gain income is favored by all investor classes. For example, foreign investors generally are not subject to U.S. net income tax on capital gain not derived in connection with a U.S. trade or business,[5] and capital gain (even if U.S. sourced) generally is exempt from U.S. withholding tax. [6] In addition, capital gain income generally is not unrelated business taxable income ("UBTI") to U.S. tax-exempt investors (unless debt-financed),[7] and taxable investors may benefit from favorable long-term capital gain rates as well as possible deferral of income/gain inclusion.

Often taxpayers and their tax advisors jump to conclusions here based on a cursory analysis of the relevant tax law. Some consider net-back payments as an immediate income inclusion, although this is probably a minority. Others accept that net-back payments should be treated as a basis adjustment, but consider any gain at maturity of an undrawn revolver as short-term capital gain because the payments are "similar to" option premiums, given that the Code provides for such result in the case of certain options (as discussed below).[8] For the reasons articulated below, however, it appears that net-back payments may be treated as producing long-term capital gain upon expiration of an undrawn revolver—a result favored by all investor classes.

II. Tax Analysis

There currently is no Internal Revenue Service ("IRS") guidance or judicial decisions directly addressing the treatment of net-back payments. In the absence of direct guidance, most practitioners (and the courts) look to the tax treatment of analogous transactions to inform the appropriate tax treatment of a given transaction.[9] Accordingly, the first step in determining the correct tax analysis here is finding the appropriate analogy.

In this regard, it appears that net-back payments are very similar to upfront commitment fees—in particular, both payments are made to compensate the relevant lender (be it the originating financial institution or the later investment fund) for the fact that it may be required to fund the revolver at unfavorable terms in the future given that the interest rate and other terms for draws under a revolver are fixed.[10] Whether a fee is paid upfront to the originating financial institution (*i.e.*, an upfront commitment fee), or paid later to the acquiring investment fund (*i.e.*, a net-back payment), the fees are similar in this regard. In fact, many market participants describe the net-back payments as a "passing through" of the upfront commitment fee economics to the revolver purchaser. Given the similarities between upfront commitment fees and net-back payments, it seems as if the tax authorities addressing upfront commitment fees are an obvious analogy and likely the first place one should look when determining the tax character and timing of net-back payments.

The upfront commitment fee analogy is also supported by the authorities governing the tax treatment of inducement payments, and the analysis below first examines this inducement payment authority and then analyzes the treatment of upfront commitment fees on revolvers under current law.

A. Inducement Payments

Net-back payments are made to induce investment funds to assume the future funding obligations of the selling financial institutions under the revolvers. Simply put, in this sense a seller (the financial institution) of property is paying a buyer (the investment fund) an amount in order to induce the purchase or acquisition of the property in question (the revolver). When the IRS and Treasury have considered situations where a third-party makes a payment to induce a buyer to acquire a specific asset or assume a liability, the inducement payments are generally treated as a purchase price or basis adjustment.

For example, in Rev. Rul. 73-559,[11] the taxpayer (Fannie Mae) agreed to purchase from the originator (a bank) loans that bore inadequate coupon interest at an above-market price, provided that a third party (Ginnie Mae) pay the taxpayer a "fee" at the time of purchase equal to the difference between the purchase price paid and the fair market value of the acquired loans. The IRS ruled that the amount received by the purchaser was not a separate item of income to the purchaser when received; rather, it functioned in substance as an adjustment to the purchaser's initial cost basis in the acquired loans.

In TAM 9726001,[12] a financial institution purchased a large portion of loans from a failing institution, assuming liabilities and receiving assets, and as compensation for assuming the various liabilities, the purchaser received certain "Federal financial assistance" payments. The IRS acknowledged that such payments would reduce the basis in the loan assets acquired.

The economic similarities between net-back payments and upfront commitment fees provide for a close analogy, such that the tax law governing upfront commitment fees should govern the tax treatment of net-back payments.

Relevant Treasury Regulations likewise do not provide for upfront taxation in the context of certain financial instruments. For example, Reg. §1.446-6(e)(2) allows taxpayers to treat an "inducement fee" paid to purchasers of a noneconomic residual interest in a REMIC to be treated in a manner similar to market discount (*i.e.*, essentially as a purchase price adjustment on the residual interest acquired). In addition, Reg. §1.446-3(h)(3) provides that payments made in connection with notional principal contract assumptions (including the assumption of underwater swaps) must be amortized over the term of such contract. Notice 89-21,[13] which was a precursor to

Reg. §1.446-3, reached a similar conclusion and specifically stated that immediate income recognition does not clearly reflect income.[14]

As a result, and when it comes to determining tax character, Code Sec. 1234(b)—a rule specific to option contracts—would not seem to apply to net-back payments. Instead, when an undrawn revolver expires it would appear that the net-back payments could be treated as long-term capital gain under Code Sec. 1234A. This is significant for U.S. taxable investors, who strongly prefer long-term capital gain treatment.

Case law also holds that certain payments made to the acquirer of property are not income but instead represent a reduction in the cost basis of such property. For example, in *Freedom Newspapers*,[15] the Tax Court held that a payment by a third party to a buyer that induced the buyer's acquisition of the property constituted a reduction in the basis of the acquired property as opposed to a taxable payment. In *Freedom Newspapers*, a broker agreed to pay a buyer a fee if a certain event subsequent to the buyer's purchase did not come to fruition. The broker intended to induce the buyer to make the purchase as offered by the seller because the broker would be entitled to certain commissions on the sale if sold in accordance with the seller's terms. The later event did not occur and the broker therefore ended up paying the fee to the buyer, which the buyer treated as a reduction to its basis in the property purchased. The IRS challenged the buyer's treatment asserting that the broker's payment should be ordinary income. The Tax Court found that the payment should reduce the buyer's adjusted basis in the purchased property as the purchase was induced by the broker's side agreement. The Tax Court also held alternatively that the payment should reduce the buyer's adjusted basis in the purchased property because the broker's subsequent payment was sufficiently tied to the actual purchase such that its characterization must be made by reference to the actual purchase transaction.

A common theme is clear—when inducement payments are made they are treated in a manner similar to a payment made in connection with the acquisition of the property in question. Thus, amounts received in connection with the acquisition of a loan are treated as an adjustment to the purchase price of the loan; amounts received to assume an underwater swap are treated in the same manner as an upfront payment on a swap; and amounts received from a seller in connection with the acquisition of property are treated by the buyer as a reduction in the cost basis of the property.

These inducement payment authorities support treating net-back payments in the same manner as upfront commitment fees. That is, as an inducement to the party assuming the revolver commitment to stand by and provide the loan at fixed and agreed-upon terms, even if that commitment occurs later by means of a net-back payment as opposed to simply at inception by means of an upfront commitment fee. This analogy is further supported by the fact that, as noted above, many parties view net-back payments as "passing through" the upfront commitment fee economics to the new funding party.

However, in situations where factually the net-back payment can be said to represent something *other* than an amount attributable to the original upfront commitment fee (*e.g.*, situations where the net-back payment is intended to compensate for service arrangements between the parties or a below-market ticking or unused commitment fee), the analogy to upfront commitment fees may be less clear.[16]

If the analogy to upfront commitment fees is correct, however, that then raises the question as to the proper tax treatment of such upfront commitment fees under current law.[17]

B. Upfront Commitment Fees

The tax treatment of upfront commitment fees is admittedly not entirely clear. In IRS guidance and judicial decisions, amounts labeled as "commitment fees" have been characterized either as (i) "similar to" an option premium or (ii) as a payment for services, depending on the context. For the reasons described below, however, characterizing upfront commitment fees as "similar to" an option premium seems to be most appropriate in the context of revolvers and, by extension, for net-back payments made in respect of the acquisition of existing revolvers. This treatment (at least with respect to upfront commitment fees) is consistent with prevailing market practice and appears to be the view of most tax practitioners.[18]

1. Characterization as "Similar to" an Option

a) Options, generally. In a traditional put option, the option writer provides the option holder the right to sell property to the option writer for a specified price (the "exercise price") at a future date.[19] The courts have defined an option contract as requiring the "following two elements: (1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until accepted; and (2) an agreement to leave the offer open for a specified or reasonable period of time."[20]

In exchange for the option writer agreeing to enter into the contract, the option writer will generally receive a payment (referred to as a "premium"). Under current tax law, a premium is not taxable when received. Rather, the option writer takes the premium into account when either the option holder exercises the option or the option expires unexercised.[21] If the option holder exercises a put option, and the option contract is not cash settled, the option holder must purchase the underlying property for the exercise price. The option holder's basis in the acquired property is equal to the exercise price minus the premium. Thus, the premium payment is taken into account by the option writer through a reduction in the acquired property's basis.[22] If the option lapses unexercised, the option writer recognizes income on the date of lapse.[23]

The policy rationale for treating a premium payment as an "open transaction" results from the uncertainty as to whether the option writer and holder will recognize gain or loss on the overall arrangement. For example, while the writer of a put option receives a premium payment on the date the parties enter into the contract, if the referenced property has depreciated significantly in value on the date the holder exercises the option, the option writer has recognized a loss on the overall transaction.[24] As the IRS stated in Rev. Rul. 58-234, "[s]ince the [option writer] assumes such obligation, which may be burdensome and is continuing until the option is terminated, without exercise, or otherwise, there is no closed transaction nor ascertainable income or gain realized by an [option writer] upon mere receipt of a premium for granting such an option."[25]

b) Freddie Mac. In *Freddie Mac*, the Tax Court supported the notion that a payment denoted as a "commitment fee" can qualify as a premium payment paid by an option holder to acquire a put option. The taxpayer entered into contractual agreements with loan originators in which the taxpayer agreed to purchase mortgage loans from the loan originators at a specified price. However, the loan originators were not obligated to sell the mortgage loans. In exchange for receiving the right (but not the obligation) to sell the mortgage loans, the loan originators paid the taxpayer a non-refundable commitment fee.

When concluding that the commitment fee should be treated as a premium payment, the Tax Court first answered the question of whether the arrangement between the loan originators and taxpayer qualified as an option contract for federal income tax purposes. When answering the question in the affirmative, the Tax Court's opinion looked to the fact that the loan originators had an unconditional right to sell the mortgage loans to the taxpayer, and the potential value to the loan originator (and future determinant to the taxpayer) depended on the uncertainty of future events (*e.g.*, changes in the value of the referenced mortgage loans). Thus, the Tax Court agreed that both the form of the transaction, as well as the transaction's economic substance, satisfied the requirements to be treated as an option contract. Given that the contractual agreement (in substance) qualified as an option contract, the taxpayer could treat the commitment fee as a reduction in the basis in the acquired mortgage loans, or if the contractual agreement expired unexercised, recognize the commitment fee as income on the expiration date. That is, open transaction treatment applies.

c) IRS guidance. The IRS has also addressed the treatment of commitment fees paid by a future borrower to a loan originator. Taking a slightly different approach from the court in *Freddie Mac*, the IRS guidance concludes these arrangements are "similar to" option contracts, such that open transaction treatment ought to be similarly applicable.[26] For example, in Rev. Rul. 81-160 the taxpayer entered into an agreement in which it would issue loans to a counterparty over a specified period of time.[27] As consideration for entering into the arrangement, the counterparty charged the taxpayer a commitment fee. The IRS concluded the commitment fee was:

> [S]imilar 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.... If the right is not exercised, the taxpayer may be entitled to a loss deduction under section 165 of the Code when the right expires.

This "similar to" language is also present in informal IRS guidance on commitment fees.[28] Shortly after the release of Rev. Rul. 81-160, the IRS concluded in a technical advice memorandum that the same analysis should apply to the recipient of the fee, stating:

> It is recognized that Rev. Rul. 81-160 is concerned with the treatment of a loan commitment fee to the borrower, while the instant situation is concerned with the lender's treatment. However, the character of the loan commitment fee should be the same on both the income and expenditure side. We therefore conclude that the annual fee which relates to the availability of money rather than its use, is payment for a property right and not for services.[29]

2. Characterization as a Service Payment

There are some court cases and IRS rulings, however, where commitment and similar fees have been characterized as income for services or have otherwise been required to be included into income upfront.

a) Chesapeake Fin. Corp. In *Chesapeake Fin. Corp.*,[30] the Tax Court held that amounts labeled as commitment fees paid to a mortgage banker using the accrual method of accounting should be included in income when due or received as service income. However, the transactions examined in *Chesapeake Fin. Corp.* are likely distinguishable from revolver commitments. In *Chesapeake Fin. Corp.*, the taxpayer was not the lender. Rather, the loans were funded by institutional investors and the taxpayer was paid a commitment fee to serve as a middleman between the institutional investors and the borrowers. In its capacity as a middleman, the taxpayer provided a variety of services when arranging the financing agreement, and was compensated for these services through the commitment fee. Therefore, the recipient of the commitment fee did not bear an economic risk associated with the value of the underlying property, and consequently the arrangement was not "similar to" an option contract. Instead, the payment appears to have been directly attributable to the services provided by the taxpayer in arranging the financing between the institutional investors and borrowers. In fact, the *Freddie Mac* opinion states "in *Chesapeake Fin. Corp.*, there was apparently no argument and certainly no consideration or discussion by the Court about whether the fees might constitute option premiums."[31]

b) YA Global. In *YA Global*,[32] the Tax Court concluded that the taxpayer, a Cayman Islands partnership, was engaged in a U.S. trade or business on account of its lending and underwriting activities, which were carried out through its U.S. manager, who was an agent of the Cayman Islands partnership. During the tax years at issue, the partnership invested primarily in convertible debentures, standby equity distribution agreements ("SEDAs"), and other securities of microcap and low-priced public companies trading on the over-the-counter public markets (investments like these sometimes are described as private investments in public securities). In a typical SEDA, the taxpayer committed to purchase a maximum dollar value of a company's stock over a fixed period (typically two years). The purchase price for the stock generally was discounted to 95–97 percent of the stock's market price *at the time of purchase*.

In concluding that the taxpayer was engaged in a U.S. trade or business, the Tax Court placed significant emphasis on the fact that the taxpayer was paid fees to enter into transactions with portfolio companies, such as the upfront payments that were made to enter into SEDAs. The taxpayer argued that the fees paid by the portfolio companies under SEDAs were premium paid for put options.[33] The Tax Court disagreed with the taxpayer's characterization, stating:

> … SEDA commitment fees can be readily distinguished from premiums paid in a typical put option. The premium paid for a put option generally compensates the writer for the risk that it will be called upon to purchase the subject property at a price that proves to be more than the property is worth when the option is exercised…By contrast, the price YA Global would pay for stock issued for a SEDA advance would almost certainly (and by apparent design) be at a discount to the market price. A SEDA would seldom, if ever, require the partnership to purchase stock for a price in excess of its value at the time of purchase.[34]

Notably, the Tax Court cited *Freddie Mac* with approval but distinguished YA Global's situation from that considered by the court in *Freddie Mac*:

> In *Freddie Mac*, we treated as option premiums commitment fees that originators of mortgages paid to the taxpayer for the option of selling it mortgages. Although the agreement between the taxpayer and originators provided a formula for determining the price the taxpayer would pay for a mortgage if an originator chose to sell it, the exact price could not be determined when the parties executed the agreement. Instead, that price would depend on the movement of interest rates between the execution of the agreement and any sale of the mortgage. But the formula had the effect of requiring the taxpayer to pay a minimum price…Therefore, the agreement protected the originator from declines in the value of the subject mortgage due to increases in interest rates beyond the specified yield…when YA Global entered into a SEDA, it did not have any exposure to price fluctuations prior to the time of \`exercise' (when it acquired stock from the issuer), because it always bought stock at a discount to the prevailing market price…[u]nlike a put option, SEDAs… did not protect issuers against the risk of a decline in their stock price (due to the floating purchase price)….

Unlike upfront commitment fees on a revolver, the SEDA payments considered by the court did not have one of the quintessential requirements of an option contract—that there be risk of loss to the option grantor. Therefore, *YA Global* is distinguishable from situations where such risk is present.[35]

c) Rev. Rul. 70-540

(i) Summary. Rev. Rul. 70-540,[36] Situation 3, describes a transaction in which a lender agreed to make a mortgage loan to a borrower in the amount of $20,000 with a term of 25 years at a stated annual interest rate of 8 percent. In consideration for the lender's agreement to make the loan at a specified date and at a specified rate of interest, the borrower paid the lender $200 (commitment fee) with funds not originally obtained from the lender. The commitment fee was not refundable in any event and would not be applied to reduce any other charge (*e.g.*, points, stated interest, or other fees).

The ruling states that, under the above circumstances, the commitment fee is a charge for agreeing to make funds available to the borrower rather than for the use or forbearance of money and, therefore, is not interest. The ruling then concludes that the commitment fee should be included into income by an accrual method taxpayer when the commitment fee is due or received, if earlier.

(ii) Distinguishable facts. The contract described in Rev. Rul. 70-540 is different than a typical option arrangement. With a traditional put option, the option writer provides the option holder the right, *but not the obligation*, to sell property to the option writer for a specified price at a future date.[37] Rev. Rul. 70-540 considers a payment made in consideration for an agreement to make a loan on a date certain, *i.e.*, "effective November 12, 1970." This phrase indicates that the making of a mortgage loan on November 12, 1970, was an obligation and therefore hardwired—not a transaction that could be undertaken at the option of the would-be borrower. As noted, in order to constitute an option for tax purposes the holder of a purported option cannot be required or compelled to exercise the option—the commitment fees described in Rev. Rul. 70-540 appear to lack this essential characteristic. Accordingly, the commitment fees described in Rev. Rul. 70-540 appear to be distinguishable from upfront commitment fees paid in respect of a typical revolver.

(iii) Ongoing validity. Revenue rulings are the IRS' position and are binding on the IRS (but not taxpayers) until revoked or made obsolete. A revenue ruling can become obsolete as a result of a regulation or court cases, even prior to it being formally revoked.[38]

Rev. Rul. 70-540 relied on Rev. Rul. 56-136 to support its conclusion. However, Rev. Rul. 56-136 was revoked by Rev. Rul. 81-160, which treated a commitment fee similar to a premium payment on an option contract. Because the technical underpinning of Rev. Rul. 70-540's commitment fee analysis was revoked, some practitioners question its ongoing validity in the context of commitment fees.[39]

It is also worth noting that in 1970 it was the IRS' position that an accrual method lender was required to recognize upfront lending fees into income when due or received if the funds to make the payment were not obtained from the lender (*e.g.*, they were not withheld from the proceeds transferred to the borrower).[40] In Rev. Rul. 70-540, the borrower paid the commitment fee with funds "not originally obtained from [the lender]." Therefore, in light of the IRS' overarching position on fees paid with funds that were not obtained from the lender at that time, it was reasonable for the IRS to conclude that the commitment fees considered in the ruling were required to be taken into account currently. However, this position was later obsoleted by the regulations finalized in 1994 dealing with original issue discount (the "final OID regulations") that treat fees incident to a lending transaction (other than payments for property or services) as OID that is subject to accrual over the term of a debt.[41] It is therefore possible that Rev. Rul. 70-540 was obsoleted by the final OID regulations even if it was not formally revoked.

Another possibility is that Rev. Rul. 70-540 is not obsolete, but its ongoing validity is limited to the holding that commitment fees are not a form of interest and, therefore, has no bearing on other tax principles including the open transaction doctrine that applies to options. As noted above, it is likely that the fact pattern in the ruling is not similar to that of an option, such that the option principles can be reconciled with a conclusion in the ruling (at least prior to the government's change in position with respect to the treatment of prepaid loan fees) applying the accrual method "all-events" test to the commitment fee at issue. More recent guidance supports this view. In particular, TAM 8543004 cites Rev. Rul. 70-540 as support for the proposition that commitment fees are not paid as consideration for the use of money and then notes that commitment fees should be accounted for similar to option premiums by both the lender and the borrower under Rev. Rul. 81-160. Nowhere in the guidance does the IRS suggest Rev. Rul. 70-540 might be a source of contrary authority.[42]

d) Reg. §1.1273-2(g)(2)(i). The final OID regulations also address certain commitment fees paid by a borrower to a lender. Reg. §1.1273-2(g)(2)(i) states:

> In a lending transaction to which section 1273(b)(2) applies, a payment from the borrower to the lender (*other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs*) reduces the issue price of the debt instrument evidencing the loan. However, solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under section 461(g)(2). (emphasis added)

While it is not entirely clear whether the italicized language refers to commitment fees as being an example of services or as a payment for property, the italicized text could be read consistent with the conclusion that commitment fees for loans where the funding is already committed are properly treated as a property right. In this regard, the language in a prior version of the proposed regulations is instructive as it provides, in contrast, as follows:

> In a lending transaction to which section 1273(b)(2) applies, a payment from the borrower to the lender (*other than a payment for services provided by the lender, such as commitment fees or loan processing costs*) shall reduce the issue price of the debt instrument evidencing the loan.[43] (emphasis added)

The proposed regulation clearly uses the term "commitment fee" to refer to a payment for services.[44] The change from the proposed to the final OID regulations was the addition of the term "property" to the phrase describing what is carved out of the definition of OID.[45] This can be seen as endorsing the view that commitment fees in situations where the funding of the loan is not a foregone conclusion are payments for a property right. At a minimum, and although perhaps not entirely clear, the parenthetical language of the final OID regulations could be interpreted consistent with treating upfront commitment fees as payments for property.

As can be seen, the term "commitment fee" has been used to describe payments made pursuant to a number of different, and highly dissimilar, financial contracts.[46] Substance and context matter, such that the term may have different meanings depending on the exact situation involved. The foregoing highlights the fact that certain commitment fees can be characterized, in appropriate circumstances, as a payment for services. In *Chesapeake Fin. Corp.*,[47] the term "commitment fee" was used to refer to fees received in exchange for services in arranging loans for the construction and permanent financing of commercial projects. The taxpayer was never the lender, and the commitment fees there were not consideration for agreeing to make funds available to the borrower. In addition, the final OID regulations already contemplate that commitment fees can be treated as a payment for services. In this regard, even if the addition of the term "property" to the final OID regulations was not intended to directly relate to the reference to commitment fees, as noted above an alternative explanation is that the IRS and Treasury may have intended for the fees described in Reg. §1.1273-2(g)(2)(i) to represent fees similar to the fees at issue in *Chesapeake Fin. Corp.*[48] In appropriate circumstances, the IRS has used the term commitment fee to describe payments, "charged for making money available for a loan, regardless of whether money is actually borrowed, rather than a fee for any of the enumerated services."[49] Therefore, even under an interpretation that Reg. §1.1273-2(g)(2)(i) uses the term "commitment fee" as an example of a service payment, the regulation would not preclude treating the commitment fees in a manner similar to option premium payments in appropriate circumstances. Rather, under this interpretation the regulation is best viewed consistent with other IRS guidance on items labeled commitment fees, as standing for the proposition that certain types of fees described as commitment fees (but are very different from upfront commitment fees on a revolver) could represent payments for services.

3. Conclusion as to the Appropriate Characterization of Revolver Commitment Fees

Under a typical revolver, the financial institution is required to lend to a borrower at specified terms and is paid an upfront commitment fee for agreeing to do so. The borrower, however, is given the right, but not the obligation, to borrow. The borrower may never elect to borrow pursuant to the revolver, which therefore may expire unused. When a financial institution enters into a revolver, it is therefore not possible to ascertain whether profit/gain or loss will be realized (overall) by the financial institution on the transaction. An upfront commitment fee is paid on the date the financial institution and the borrower enter into a revolving credit agreement, and is generally based on the credit quality of the borrower (among other factors) at that time. The borrower's credit worthiness, however, is subject to change, and if the revolver specifies a fixed rate of interest, market interest rates likewise are subject to change. Accordingly, the set terms at which the financial institution agrees to lend may be below-market when a later borrowing, if any, occurs. For example, if a borrower's credit worthiness declines from the date the parties entered into the revolver, and the borrower exercises its right to borrow, the financial institution will have purchased property (a loan) for less than its fair market value.[50] Similarly, if the revolver provides for a fixed rate of interest and interest rates move upward, the financial institution will have purchased property (*i.e.*, provided a loan) at a below-market rate of interest. However, if a revolver expires unexercised, the financial institution will realize a profit/gain in the amount of the upfront commitment fee (which is nonrefundable). Therefore, it is not possible to determine the financial institution's overall profit/gain or loss with respect to such commitment fee until the expiration of the commitment period.

The reason for the open transaction doctrine, as first annunciated in *Burnet v. Logan*,[51] is to delay the taxation of a transaction for which the amount of gain or loss is uncertain. The open transaction doctrine is a "rule of fairness designed to ascertain with reasonable accuracy the amount of gain or loss realized upon an exchange, and, if appropriate, to defer recognition thereof until the correct amounts can be accurately determined."[52] Since its inception, the open transaction doctrine has been applied to a wide variety of contracts and transactions for which the amount of gain or loss cannot be ascertained.[53]

To summarize, the economics of the upfront commitment fees on a revolver are similar to those of a put option writer. If the underlying property's value declines by more than the option premium and the option is exercised, the writer of the option will have purchased property for less than its fair market value, and the writer would realize a taxable loss if it sold the property.[54] However, if the put option expires unexercised, the option writer would realize a gain in the amount of the option premium. Because gain or loss on a revolver cannot be ascertained until the option to borrow is exercised or the commitment period expires, upfront commitment fees should be afforded open transaction treatment either under an analogy to option transactions (to which they are similar) or by looking to general tax principles underlying the open transaction doctrine.

The situations in which commitment fees were characterized by the courts and IRS as a payment for services are factually distinguishable from upfront commitment fees paid in respect of a revolver and are either of questionable ongoing validity or able to be reconciled with the conclusion stated above on the basis of factual differences.

4. Tax Consequences of Treating Commitment Fees as "Similar to" Option Payments

a) Timing. Under an approach analogizing upfront commitment fees to the general taxation of options, such fees should be subject to open transaction treatment and therefore should be taken into account only when/if there is a draw on the revolver or when/if the commitment period expires. For example, if a borrower exercises its right to borrow under a revolver, the upfront commitment fee would reduce the lender's basis in the loan and be taken into account over the life of the loan.[55] To the extent the upfront commitment fee is not allocated to a draw under the revolving credit facility, however, such a fee appears to result in profit/gain only when the commitment period expires.

b) Tax character

(i) Financial instrument character, generally. Generally, the tax character of gain or loss realized upon termination of lapse of a financial instrument is determined by reference to the character of the underlying reference asset.[56] Therefore, if loans to be made under a lending commitment (such as a revolver) would be capital assets, the character of the gain realized with respect to an upfront commitment fee upon the lapse of a commitment period should be capital. In the context of revolvers, there are two separate provisions of the Code that could provide for this result: Code Secs. 1234A and 1234(b).

Code Sec. 1234A provides:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.[57]

Revolvers and other lending commitments are "obligations" with respect to property (*i.e.*, loans that would be made under the lending commitment).[58] Assuming the loans acquired pursuant to a draw under a revolver would be capital assets in the hands of the revolver funder, Code Sec. 1234A would apply in the absence of another controlling character provision. In situations where Code Sec. 1234A applies, the character of such gain or loss as long term or short term is determined by reference to the holding period of the contract.[59]

Code Sec. 1234(b) provides:

> In the case of the grantor of the option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as gain or loss from the sale or exchange of a capital asset held not more than 1 year.

For this purpose, property is defined to mean "stocks and securities (including stocks and securities dealt with on a "when issued" basis), commodities, and commodity futures."[60]

Code Secs. 1234A and 1234(b) could both be applied to options on property (as defined). If the revolver commitment were held for more than one year and expired undrawn, Code Sec. 1234A would generally result in long-term capital gain and Code Sec. 1234(b) would result in short-term capital gain. For tax-exempt and foreign investors, this distinction is relatively unimportant. However, U.S. taxable investors strongly prefer long-term capital gain treatment.

Under general principles of statutory construction, Code Sec. 1234(b), if applicable, should control over Code Sec. 1234A because it is the more specific provision.[61] However, for the reasons discussed below, good arguments can be made that Code Sec. 1234(b) is not applicable to upfront commitment fees paid in respect of revolvers.

(ii) Legislative history of Code Sec. 1234(b), Code Sec. 1234A, and related provisions. In 1976, Congress amended Code Sec. 1234 to include special rules for determining the character of gain or loss from a closing transaction for a grantor of an option on property.[62] These rules are similar to what is now Code Sec. 1234(b). At the time of the 1976 legislative change, the IRS had ruled that income from the lapse of an option was ordinary income. The legislative history indicates that the new rule was intended to prevent taxpayer character electivity.[63] The legislative history also provides examples of various straddle strategies and includes examples of option transactions that would be addressed by the legislation.[64] In each of the examples provided, the options reference publicly traded stock (IBM and Ford Motor Company stock) and are listed on an exchange (Chicago Board Options Exchange, American Stock Exchange, Philadelphia-Baltimore-Washington Stock Exchange).[65] The genesis of the change in law appears to be the growth of options markets, which provided taxpayers with a low-cost means of entering into options and the ability to enter into closing transactions to terminate them.[66]

As part of the same legislation, Congress amended Code Sec. 856(c) to change the manner in which "amounts received or accrued as consideration for entering into agreements to make loans secured by mortgages on real property or on interests in real property" were treated for real estate investment trust purposes.[67] The title of this legislative amendment was "commitment fees."[68]

In 1981, Congress enacted Code Sec. 1234A to limit the scope of the extinguishment doctrine.[69] Congress stated that "a change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain depositions of capital assets, which if sold at a gain, would produce capital gains."[70] Congress considered the ordinary loss inappropriate because it believed that the settlement of a contract to deliver a capital asset is economically equivalent to a sale or exchange of the contract.[71]

In 1993, Congress amended Code Sec. 512(b)(1) to exclude from the definition of UBTI "amounts received or accrued as consideration for entering into agreements to make loans."[72] Similar to the amendments to Code Sec. 856 described above, the title of this legislative amendment was "commitment fees."[73] As part of this same legislation, Code Sec. 512(b)(5) was amended to change the treatment of option transactions. As amended, Code Sec. 512(b)(5) excludes from the definition of UBTI "all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) …" Prior to the legislation, the provision read as follows: "There shall also be excluded all gains on the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) written by the organization in connection with its investment activities." Note that Code Sec. 1236(c) defines the term "securities" extremely broadly so as to include in effect any loan.[74]

(iii) Analysis. Code Sec. 1234A applies to a variety of financial instruments and contracts—its only requirement is that the underlying instrument be a capital asset in the hands of the taxpayer. Assuming that loans made pursuant to a revolver would be capital assets, this requirement should be met.

By contrast, Code Sec. 1234(b) applies only to contracts that are "options" that reference "stocks and securities (including stocks and securities dealt with on a 'when issued' basis), commodities, and commodity futures." In the case of revolvers, it does not appear that either of these requirements are met.

With respect to the requirement that the contract be an "option," it should be noted that the IRS has consistently described lending commitments as "similar to" options and as "property rights" as opposed to "option rights" or "option contracts." This suggests that while the IRS believes there are sufficient similarities to invoke open transaction principles, the IRS has purposely stopped short of treating the lending commitments as actual options for all purposes. This view is unsurprising given the economic differences between lending commitments and typical option arrangements. For one, prior to the exercise of a lending commitment the property underlying the arrangement does not exist—that is, the property referenced by the lending commitment (*i.e.*, the loan) is created *via* exercise. This is unlike a typical option arrangement, where the property that is the subject of the option is currently in existence.[75] This distinction explains why the court in *Freddie Mac* described purchase commitments as options without the "similar to" qualifier. In that situation, the purchase commitment provided for the acquisition of loans that had already been originated by a third party (the lenders)—thus, the exercise of those commitments did not create the property subject to the option. Another economic difference arises from the fact that options are typically unilateral contracts that can be exercised upon demand, whereas lending commitments are generally subject to conditions precedent that must be met before there is a requirement to lend.[76] The economic differences between lending commitments and options are further magnified in the context of revolvers, where there exists the ability to borrow, repay, and re-borrow. We are not aware of traditional option arrangements that provide for similar rights.

The conclusion that lending commitments are not actual options is also strongly supported by the legislative history described above. For example, the legislative history has consistently labeled "amounts received or accrued as consideration for entering into agreements to make loans" as "commitment fees."[77] When Congress amended Code Sec. 512 in 1993 to treat commitment fees as excluded from UBTI, it did so under Code Sec. 512(b)(1), rather than clarifying the existing rules for option transactions under Code Sec. 512(b)(5). For two reasons, this suggests that Congress did not believe that commitment fees were payments pursuant to an option transaction. First, the need to change the statute suggests that commitment fees were not already covered by Code Sec. 512(b)(5), which prior to the legislation read as follows: "There shall also be excluded all gains on the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) written by the organization in connection with its investment activities." As noted above, essentially all loans are Code Sec. 1236(c) securities, such that Code Sec. 512(b)(5) would have already excluded commitment fees from UBTI if they were properly regarded as option premiums. Courts have been clear that, where possible, "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." [78] Because the change to Code Sec. 512(b)(1) would not have been needed if lending commitments were options, the basic rules of statutory interpretation indicate they are not appropriately characterized as option contracts. Second, and relatedly, had Congress believed that lending commitments were option contracts but thought that the question was in need of clarification, one would have expected commitment fees to be addressed in Code Sec. 512(b)(5) (the rule for options) rather than Code Sec. 512(b)(1). Therefore, the position of the commitment fee rule in the statutory text also suggests that commitment fees are not option premiums.

Even assuming the revolver commitment could be considered an option, there is the separate requirement in Code Sec. 1234(b) that the option reference "stocks and securities (including stocks and securities dealt with on a 'when issued' basis), commodities, and commodity futures." Here, the only category in which revolver loans could reasonably be placed is "securities." The term security has been given various definitions, and some (but not all) would include within that term any loans made under a revolver. For example, the definition of a security under Code Sec. 1236(c) would include any debt instrument. However, the term "securities" was not defined in Code Sec. 1234(b) by cross-reference to this broad definition, which suggests an intentional act on the part of Congress to use the more colloquial definition of that term, which would be consistent with an interpretation requiring exchange trading.[79] The intention to use the term "security" consistent with its commonly understood meaning, rather than a particular tax definition, is underscored by the fact that Code Sec. 1236(c) is in an adjacent statute and numerous other provisions do include a specific cross-reference to Code Sec. 1236(c).[80] This interpretation is also supported by examples in the legislative history, which all involve liquid publicly traded instruments. Loans under revolvers are not liquid or widely traded assets (*i.e.*, assets commonly considered securities). In addition, although we do not practice securities law, we understand that revolver draws are also not "securities" for securities law purposes or commonly considered securities by market participants.[81] Although not controlling for tax purposes, this suggests that revolver loans are not "securities" in the colloquial sense of the word, which as noted, is presumably the meaning Congress intended when enacting Code Sec. 1234(b),

In light of the foregoing, it appears that Code Sec. 1234A, and not Code Sec. 1234(b), should be controlling in the context of upfront commitment fees and similar payments (such as net-back payments).[82] If that is correct, and circling back to the simple example above where the original financial institution paid an investment fund a $50x upfront net-back payment to assume an existing revolver in a secondary market transaction, it appears that this amount could produce long-term capital gain to the investment fund if the remaining commitment period was over a year and if the revolver expired at the end of such period undrawn, with such gain deferred until expiration.[83]

C. Implications for Net-Back Payments

The economic similarities between net-back payments and upfront commitment fees provide for a close analogy, such that the tax law governing upfront commitment fees should govern the tax treatment of net-back payments. Although not entirely clear, most tax practitioners (and the authors of this article) believe that upfront commitment fees should be treated in a manner similar to options and subject to the open transaction doctrine. It therefore follows that from a timing perspective similar treatment should be afforded to net-back payments—that is, held open until the earlier of a draw on the revolver or expiration of the commitment period.[84]

But a transaction "similar to" an option is not the same as an option. As described above, there are significant differences between revolvers and traditional option contracts and the legislative history supports an interpretation that lending commitments are not synonymous with options. As a result, and when it comes to determining tax character, Code Sec. 1234(b)—a rule specific to option contracts—would not seem to apply to net-back payments. Instead, when an undrawn revolver expires it would appear that the net-back payments could be treated as long-term capital gain under Code Sec. 1234A. This is significant for U.S. taxable investors, who strongly prefer long-term capital gain treatment.

ENDNOTES

* The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

1 For a discussion of these fees and fees generally in the lending context, *see* New York State Bar Association, *Report on Certain Fees*, Report #1500 (Sep. 13, 2024); Shapiro, Yaghmour, Schneider, *A Tax Field Guide to Debt-Related 'Fee' Income*, 106 TAX NOTES 8 (June 3, 2014); and Dunn, *How Could This Possibly Be? We Don't Know What to Do with a Fee*, THE TAX CLUB (May 21, 2014).

2 For purposes of this article, and for simplicity, it assumed that (i) the investment fund is acquiring an unfunded revolver in full (*i.e.*, no amount has been drawn under the revolver at the time of acquisition), (ii) at the time of the purchase, the financial wherewithal of the borrower has not declined at the time of the secondary market acquisition, such that no portion of the net-back payment is attributable to any increased assumed credit risk, (iii) at the time of the purchase, the interest terms and unused commitment fee terms are "at market," such that no portion of the net-back payment is attributable to previous interest rate movements. Instead, it is assumed that the net-back payment is essentially a "pass-through" in full to the investment fund of some portion of the original upfront commitment fee received by the originating financial institution.

3 In our experience revolver funds generally take the position that they are not engaged in a trade or business because the funds are not involved in the negotiation or origination of the revolvers and any loans made under the revolvers are non-discretionary. Much ink has already been spilled on the lending trade or business topic, and for purposes of this article we will assume that the determination that the fund is not engaged in a trade or business is appropriate.

4 *See* Code Sec. 1221(a)(4); *Burbank Liquidating Corp.,* 39 TC 999, Dec. 26,025 (1963), *affirmed in part and reversed in part on other grounds*, CA-9, 64-2 USTC ¶9676, 335 F2d 125 (loans must be acquired in the context of a lending trade or business to constitute ordinary assets).

5 *See* Code Secs. 871(b) and 882(a).

6 *See* Reg. §1.1441-2(b)(2)(i).

7 *See* Code Secs. 512(b) and 514.

8 *See* Code Sec. 1234(b).

9 *See, e.g.*, *Bank of America*, CtCls, 82-1 USTC ¶9415, 680 F2d 142, 147 ("When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes."); *Container Corp.*, 134 TC 122, 131, Dec. 58,131 (2010), *aff'd*, CA-5, 2011-1 USTC ¶50,351 ("caselaw tells us to proceed by analogy"). *See also* Notice 2004-52, IRB 2004-32 (outlining possible tax treatments of credit default swaps by reference to analogous transactions); Paul Kunkel, *Reverse Convertibles*, 7, 2 J. TAX'N FIN. PRODS. 15 (2008) (describing reversible convertibles and the possible ways that they could be taxed by making analogy to other financial instruments).

10 In some scenarios interest rates (or interest margins) may have increased and/or the credit quality of the borrower may have declined since the date the revolving credit agreement was entered into, such that the lender's economic return may no longer be "market." It is assumed for purposes of this article that the terms of the revolver are "at market" when it is purchased by the investment fund (although future changes might render the terms above or below market). In situations where terms are not market, and although beyond the scope of this article, perhaps an analogy could be made to inducement payments made by an existing lessee to a new lessee to assume a lease where rental payments are above market. *See, e.g.,* Rev. Rul. 55-675, 1955-2 CB 567, and *Oxford Paper Co.*, CA-2, 52-1 USTC ¶9178, 194 F2d 190. *See also* Cummings, *Paying for Assumption*, TAX NOTES, April 29, 2014, and New York State Bar Association, *Report on Tax Treatment of 'Deferred Revenue' Assumptions by the Buyer in Taxable Asset Acquisitions*, Report #1281 (Jan. 7, 2013).

11 1973-2 CB 299.

12 June 27, 1997.

13 1989-1 CB 651.

14 In Notice 89-21, 1989-1 CB 651, the IRS specifically indicated that the premise underlying *M.E. Schlude*, SCt, 63-1 USTC ¶9284, 372 US 128, 83 SCt 601 and *American Automobile Association*, SCt, 61-2 USTC ¶9517, 367 US 687, 81 SCt 1727 does not apply in the context of notional principal contracts. This suggests that in the context of financial instruments, those cases are generally not applicable or clearly reflective of income.

15 36 TCM 1755, Dec. 34,798(M), TC Memo. 1977-429 ("*Freedom Newspapers*").

16 *See* the assumptions made in endnote #2.

17 In various situations, the IRS has analogized payments that were not described as "commitment fees" to the treatment of commitment fees based on their economic similarity. *See, e.g.,* TAM 8537002 (May 22, 1985); TAM 8543004 (Jul. 18, 1985). In the discussion below, all such fees (*i.e.*, nonrefundable upfront fees paid to acquire the right to borrow) are referred to as "commitment fees" for the sake of simplicity, but analogizing other types of fees to commitment fees based on their economic similarity is an approach applied by the IRS in similar situations.

18 *See* New York State Bar Association, *Report on Certain Fees*, Report #1500 (Sep. 13, 2024) ("A substantial majority of the Executive Committee of the Tax Section believes that Capital Providers and issuers should treat Commitment Fees like option premiums, with 'Commitment Fees' defined as payments for a commitment to provide capital or purchase a Security, if the funding or issuance of the Security is at the election of the issuer as opposed to the Capital Provider (whether labeled commitment fees, ticking fees, unused fees, backstop fees, standby fees or some other term)."). *See also* Shapiro, Yaghmour, Schneider, *A Tax Field Guide to Debt-Related 'Fee' Income*, 106 TAX NOTES 8 (Jun. 3, 2014); Dunn, *How Could This Possibly Be? We Don't Know What to Do with a Fee,* The Tax Club (May 21, 2014).

19 *See* Rev. Rul. 58-234, 1958-1 CB 279, *clarified by* Rev. Rul. 68-151, 1968-1 CB 363 ("The option rights and obligations here concerned generally are relatively simple options, usually assignable, to sell (generally termed 'puts'), or to buy (generally termed 'calls'), certain property … granted by the writer (issuer or optionor) to the holder (optionee) for a consideration, usually a cash payment (generally termed 'premium')).").

20 *Federal Home Loan Mortgage Corporation*, 125 TC 248, at 259, Dec. 56,199 (2005) ("*Freddie Mac*"), *citing Old Harbor Native Corp.,* 104 TC 191, at 201, Dec. 50,452 (1995). *See also* J. Walker Johnson & Bridget Kelly, *Tax Restrictions Can Impede the Use of Options to Manage Risk*, TAX NOTES, Oct. 6, 2014 ("the three aspects [of an option] are (i) a unilateral agreement entered into for consideration (ii) that binds [the option writer] to buy or sell property and (iii) gives [the option holder] the right, but not the obligation, to sell or buy that property.").

21 *See Freddie Mac*, at 260 *citing Kitchin*, CA-4, 66-1 USTC ¶9104, 353 F2d 13, at 15 (1965), *rev'g*. 22 TCM 1738, Dec. 26,439(M), TC Memo. 1963-332 ("Option payments are not includable in income to the optionor until the option either has lapsed or has been exercised.").

22 Rev. Rul. 58-234, 1958-1 CB 279.

23 Rev. Rul. 78-182, 1978-1 CB 265; Code Sec. 1234(b).

24 The option writer's loss on a put option will generally equal the exercise price minus the fair market value of the property minus the premium payment.

25 *See also Virginia Iron Coal & Coke Co.*, CA-4, 38-2 USTC ¶9572, 99 F2d 919, at 921 ("[A]t the time the payments were made it was impossible to determine whether they were taxable or not. In the event the sale should be completed, the payments became return of capital, taxable only if a profit should be realized on the sale. Should the option be surrendered it would then become certain, for the first time, that the payments constituted taxable income. Thus it will be readily seen that it was impossible to

tax these payments in the year in which they were made."); *Freddie Mac*, at 258 ("The policy rationale for the tax treatment of an option as an open transaction is that the outcome of the transaction is uncertain at the time the payments are made. That uncertainty prevents the proper characterization of the premium at the time it is paid."); *C.E. Koch*, 67 TC 71, at 86, Dec. 34,062 (1976) ("[I]t [is] impossible to tell when the payments were received whether they would ultimately represent income to the taxpayer or a return of capital.").

26 Although not explicitly stated, it appears that the use of the qualifier "similar to" in the IRS guidance was intended to indicate that the arrangements were not actually options because they were paid in respect of a commitment to lend. In this respect, the commitment fees considered in the IRS guidance are distinguishable from the commitment fees considered in *Freddie Mac*, where the fees were paid by lenders (not the borrowers) for the right to sell existing loans to Freddie Mac (a third party that was not a party to the original lending arrangement). In a similar vein, the IRS has consistently referred to the lending commitment being acquired as a "property right" rather than "an option." *See* discussion, *infra.*

27 1981 CB 312. Admittedly, the parties in the revenue ruling did not appear to have the right to repay and re-borrow under the terms of the arrangement. However, credit card annual fees were treated as similar to option premiums to the lender in TAM 8543004 (Jul. 18, 1985) and GCM 39434 (Oct. 25, 1985), which both cited Rev. Rul. 81-160 as support for the position. Similar to the revolvers that are the subject of this article, credit card contracts provide a borrower the right to borrow, repay, and re-borrow. Accordingly, the analysis in Rev. Rul. 81-160 seems equally applicable to arrangements that allow the customer the right to repay and re-borrow under the terms of the arrangement.

28 More recently, in FSA 200037034(Jun. 15, 2000) the IRS referenced Rev. Rul. 81-160, 1981-1 CB 312 and stated that a nonrefundable commitment fee was "similar to" the cost of an option.

29 TAM 8537002 (May 22, 1985). *See also* TAM 8543004 (Jul. 18, 1985); GCM 39434 (Oct. 25, 1985); Tax Management Portfolio 6620: Source of Income Rules, Section XV.B.1.c. ("While Rev. Rul. 81-160 addressed the treatment of a standby loan commitment fee to the borrower, the character of the fee should be the same on both the income and expenditure sides.").

30 78 TC 869, Dec. 39,059 (1982) ("*Chesapeake Fin. Corp.*").

31 *Freddie Mac*, at 269.

32 161 TC No. 11, Dec. 62,306 (2023) ("*YA Global*").

33 *YA Global*, at 14 ("Because the SEDA gave the portfolio company the right, but not the obligation, to sell its stock to YA Global during a fixed period, petitioners reason, it was a purchase by the company (and a sale by YA Global) of a put option. Petitioners assert: The Code makes clear that transactions in options are capital transactions, not fees for services. They conclude: It is clear, then, that any commitment fees that portfolio companies paid to YA Global when they entered into a SEDA were not compensation for services. Rather, they were income from capital assets, namely YA Global's investments in the portfolio companies." (internal quotations omitted)).

34 The Tax Court cited the description of a put option given by the court in *Freddie Mac*: "[I]n a typical put option, the optionee is willing to pay a premium to the optionor for the right to sell a security to the optionor at an agreed price sometime in the future. If the market value of the security falls below the exercise price, the optionee can sell the security to the optionor at a price greater than its value on the exercise date. That potential opportunity is what the optionee paid for. Likewise, the premium received by the optionor is compensation for accepting the potential risk of having to purchase at an unfavorable price. If the market value of the security rises above the exercise price, the option will not be exercised, and the optionor keeps the option premium for having accepted the risk associated with uncertainty." *Freddie Mac*, at 119.

35 The case is also notable for the fact that it cited *Freddie Mac* with approval, which suggests that the Tax Court was not of the view that lending commitments are never similar to options.

36 1970-2 CB 101.

37 *See C.T. Franklin Est.,* 64 TC 752, 762, Dec. 33,359 (1975), *aff'd,* CA-9, 76-2 USTC ¶9773, 544 F2d 1045 ("[An option] gives the optionee no present estate … and imposes on him no obligation to consummate the transaction. He has the choice of exercising the option or allowing it to lapse."); *U.S. Freight Co.*, CtCls, 70-1 USTC ¶9244, 422 F2d 887, 895 (optionee must have the "truly alternative choice" of exercising an option or allowing it to lapse); *W.E. Halle*, CA-4, 96-1 USTC ¶50,250, 83 F3d 649, 654, *rev'g and remanding Kingstown LP*, 68 TCM 1497, Dec. 50,307(M), TC Memo. 1994-630 ("The would-be purchaser of the property thus pays a premium for the choice of whether to proceed with the purchase of the property. Inherent in that choice is the absence of any obligation to proceed."); *Old Harbor Native Corp.*, 104 TC 191, 201, Dec. 50,452 (1995) ("The primary legal effect of an option is that it limits the promisor's power to revoke his or her offer.").

38 *See* Reg. §601.601(d)(2)(v)(e) (parties seeking to rely on a revenue ruling "should consider the effect of subsequent legislation, regulations, court decisions, and revenue rulings").

39 *But see* FSA 200037034 (Jun. 15, 2000) (citing both Rev. Rul. 70-540, 1970-2 CB 101 and Rev. Rul. 81-160, 1981-1 CB 312).

40 Rev. Rul. 70-540, 1970-2 CB 101, Situation 1. The deferral of loan fees was made a coordinated industry issue. *See Industry Specialization Program—Savings and Loan Association*, *Deferred Loan Fees—Composite Method*, and *Deferred Loan Fees—Loan Liquidation*. The position papers were then rendered obsolete by the adoption of the original issue discount regulations. Prior to the finalization of the regulations, the IRS' position was upheld by the Tax Court in *Bell Fed. Sav. & Loan Ass'n & Subsidiary*, 62 TCM 376, Dec. 47,527(M), TC Memo. 1991-368, *rev'd sub nom. Bell Fed. Sav. & Loan Ass'n*, CA-7, 94-2 USTC ¶50,598, 40 F3d 224.

41 59 FR 4799-01.

42 *See also* TAM 8543004 (Jul. 18, 1985); TAM 8537002 (May 22, 1985); FSA 200037034 (Jun. 15, 2000).

43 51 FR 12022-01.

44 The same language was retained in the 1992 version of the proposed regulations. *See* 57 FR 60750-01.

45 It is possible that this change was made in response to practitioner comments. *See* New York State Bar Association, *Report on Proposed Original Issue Discount Regulations*, Report #767 (Jul. 1, 1993) ("We believe that payments from the borrower to the lender for property (not just services) should not reduce issue price.").

46 The lack of a fixed definition for the various types of lending related fees routinely results in fees being paid for very different types of property or services while being described using the same term. The term "commitment fee" is no exception. *See* Shapiro, Yaghmour, Schneider, *A Tax Field Guide to Debt-Related 'Fee' Income*, 106 TAX NOTES 8 (Jun. 3, 2014); Dunn, *How Could This Possibly Be? We Don't Know What to Do with a Fee,* THE TAX CLUB, May 21, 2014.

47 78 TC 869, Dec. 39,059 (1982).

48 *See* New York State Bar Association, *Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations*, Report #555 (Dec. 30, 1986) ("[P]ayments for services provided by the lender, such as commitment fees or loan processing costs, do not reduce the issue price of a debt instrument. Section 1.1273-2(f)(2). Instead, they are treated under principles of tax law outside the context of OID (generally as service income to the lender and as a non-deductible capital expenditure amortizable over the life of the loan by the borrower). We believe that this treatment is appropriate.").

49 TAM 8543004 (Jul. 18, 1985) and TAM 8537002 (May 22, 1985). *See also Freddie Mac.*

50 Courts have consistently held that below-market loans can be valuable assets to the borrower. *See, e.g., Citizens and Southern Corp.*, 91 TC No. 35, 91 TC 463, Dec. 45,036 (1988), *Peoples Bancorporation and Subsidiaries*, 63 TCM 3028, Dec. 48,226(M), TC Memo. 1992-285 (1992), and *Federal Home Loan Mortg. Corp.*, 121 TC No. 13 (2003) (each holding that favorable financing is an asset); *E.C. Dickman,* SCt, 84-1 USTC ¶13,560, 465 US 330, 337, 104 SCt 1086, 79 L.Ed.2d. 343 ("The right to use money is plainly a valuable right, readily measurable by reference to current interest rates."); Code Sec. 7872 (related party below market loans are a form of disguised compensation). Therefore, the holder of a revolver might realize an economic gain by exercising its right to borrow at below market rates, and conversely the financial institution might realize an economic loss.

[51] SCt, 2 USTC ¶736, 283 US 404, 51 SCt 550 (1931). *See also Inaja Land Co., Ltd.,* 9 TC 727, at 736, Dec. 16,085 (1947) ("Apportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it cannot be determined that petitioner has, in fact, realized gain in any amount. Applying the rule as above set out, no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of petitioner's cost basis."); *A.J. McKelvey Est.,* 148 TC No. 13, at 8, Dec. 60,879 (2017) *rev'd and remanded* No. 17-2554, CA-2, 2018-2 USTC ¶50,424, 906 F3d 26 ("Certain transactions ... are afforded 'open' transaction treatment because either the amount realized or the adjusted basis needed for a section 1001 calculation is not known until contract maturity. In these instances, the component that is known is held in suspense and gain or loss is not realized until the missing component is determined and the transaction is properly closed"); *F.B. Farr, Exr.*, 33 BTA 557, at 562, Dec. 9150 (1935) ("The gain or loss from a short sale is ascertained by matching the short sale price against the cost or other basis of the stock used to close the transaction.").

[52] *C.O. Dennis*, CA-5, 73-1 USTC ¶9181, 473 F2d 274, at 285, *aff'g* 57 TC 352, Dec. 31,107 (1971).

[53] *See, e.g.*, Rev. Rul. 78-182, 1978-1 CB 265 (option contracts not subject to tax until the option lapses or is exercised); Rev. Rul. 2003-7, 2003-1 CB 363 (variable prepaid forward contracts not subject to tax until shares are delivered); Reg. §§1.483-4 Ex. 1 and 1.1275-4(c) (contingent payment debt instruments and contingent payment contracts are not included in the amount realized on a transaction or in the purchaser's basis until the contingency is resolved); Reg. §1.1233-1(a) ("[F]or federal income tax purposes a short sale is not deemed to be consummated until the delivery of property to close out the short sale."); Rev. Rul. 81-160 (commitment fees that were similar to option premiums were provided open transaction treatment); *Federal Home Loan Mortgage Corporation, Petitioner*, Respondent., 125 TC 248, Dec. 56,199 (2005) (asserting Freddie Mac commitment fees would be open transactions even if the contracts to purchase mortgages were characterized as rebate-like payments or forward contracts instead of options).

[54] It bears mentioning that the treatment of an option is the same regardless of whether the acquired property is sold or retained by the writer of the put option. For example, in *Freddie Mac* it was an agreed upon fact that, "[o]nce [Freddie Mac] acquired a mortgage, it sometimes retained the mortgage for its own account." *See Federal Home Loan Mortgage Corporation, Petitioner*, Respondent., 125 TC 248, Dec. 56,199 (2005).

[55] The treatment of commitment fees in the event of a draw is beyond the scope of this article. However, we understand that taxpayers generally allocate the fee proportionally to draws under the revolver and amortize over such allocated fees over the term of the loan. Because revolvers can be drawn, repaid, and redrawn, taxpayers will often establish a "high water mark" of drawn commitment that must be exceeded before additional commitment fees to begin amortization. *See* New York State Bar Association, *Report on Certain Fees*, Report #1500 (Sep. 13, 2024) (describing a "Market Discount Approach").

[56] One requirement for the realization of capital gain or loss is the existence of a "sale or exchange." *See* Code Sec. 1222. Under the so-called "extinguishment doctrine" various courts have treated gain or loss realized in connection with the termination or lapse of a financial instrument as ordinary gain or loss, on account of the termination or lapse not being a "sale or exchange." *See D. Fairbanks*, SCt, 39-1 USTC ¶9410, 306 US 436, 59 SCt 607; *Starr Brothers, Inc.*, CA-2, 53-1 USTC ¶9410, 204 F2d 673; *Pittston Co.*, CA-2, 58-1 USTC ¶9284, 252 F2d 344; *M.D. Leh*, CA-9, 58-2 USTC ¶9889, 260 F2d 489, 260 FSupp 489; *General Artists Corp.*, CA-2, 53-2 USTC ¶66,060, 205 F2d 360. Over time, the scope of the extinguishment doctrine has been narrowed considerably by the enactment of Code Secs. 1234, 1234A, 1234B, 1241, and 1271. The discussion in this article focuses on whether Code Sec. 1234A or 1234(b) should control, and it will not further consider the extinguishment doctrine or the other character provisions that limit that scope of that doctrine.

[57] Code Sec. 1234A also applies the same character rule to Code Sec. 1256 contracts that are capital assets in the hands of the taxpayer, and states that the rule does not apply to the retirement of any debt instrument.

[58] *See, e.g.,* FSA 199935017 (Sep. 3, 1999) (contracts to acquire debt are derivative financial instruments that reference the underlying loan).

[59] Congress enacted Code Sec. 1234A to deem certain non-sale or exchange dispositions to be sales or exchanges to ensure that gain or loss from such dispositions had the same character as a gain or loss from selling the contract. *See* House Report 97-201, at 212 (1981). Thus, it necessarily follows that the long-term/short-term nature of the gain or loss should look to the holding period of the contract (*i.e.*, in this case, the revolver).

[60] Code Sec. 1234(b)(2)(B). Reg. §1.1234-3(c) provides exclusions for broker-dealers that references Code Secs. 1236(a) and 1236(b). However, the flush language indicates that the definition of property is not defined by reference to Reg. §1.1234-3(b)(2) (which is identical to Code Sec. 1234(b)(2)(B)) rather than Code Sec. 1236(c).

[61] *Hobbs v. U.S. ex rel. Russell*, CA-5, 2000-1 USTC ¶50,403, 209 F3d 408, 412 (2000).

[62] P.L. 94-455, Sec. 2136 (Oct. 4, 1976).

[63] House Report 94-1192 (May 26, 1976). For example, in the case of a call option with an economic loss, the writer would enter into a closing transaction, which would result in an ordinary tax loss. Conversely, with an economic gain the writer would exercise the option, and could then sell the stock underlying the option for a capital gain.

[64] *Id.*

[65] *Id.*

[66] *Id.* ("The growth of options exchanges has greatly increased the option investor's flexibility and enables the sophisticated taxpayer to adjust his risks quickly and frequently according to market fluctuations in order to reduce his risks, to protect his investment, and to maximize his return.").

[67] P.L. 94-455, Sec. 1604(c) (Oct. 4, 1976).

[68] *Id.*

[69] Code Sec. 1234A was enacted as part of the as part of the Economic Recovery Act of 1981, Pub. L. 97-34, §507(a).

[70] *See* House Report 97-201, at 212 (1981); Senate Report 97-144, at 170 (1981); Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, JCS-71-81, at 313 (1981).

[71] *Id.* The example given in the legislative history is the following: A taxpayer simultaneously enters into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks declines, then the taxpayer will assign the contract to sell marks for a gain (treating that gain as sales proceeds) and cancel the obligation to buy marks by paying an amount to settle the contract and treating that payment as an ordinary loss.

Absent an election under Code Sec. 988, Code Sec. 1234A no longer applies to over-the-counter contracts involving foreign currency because the character of gain or loss with respect to foreign currency and contracts made with respect to foreign currency is ordinary under Code Sec. 988. The election provision under Code Sec. 988 was enacted as part of the Tax Reform Act of 1986 (§1261(a), Pub. L. 99-514).

[72] P.L. 103-66, Sec. 13148 (Aug. 10, 1993).

[73] *Id.* The legislative history also states: "[T]he House bill excludes loan commitment fees from UBTI. For purposes of this provision, loan commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. These charges are to compensate the lender for the risk inherent in committing to make the loan (*e.g.*, for the lender's exposure to interest rate changes and for potential lost opportunities)." Conference Report 103-213 (Aug. 4, 1993), at 552.

[74] Code Sec. 1236(c) provides that: "the term 'security' means any share of stock in any corporation, certificate of stock or interest in any corporation, *note, bond, debenture, or evidence of indebtedness*, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." (emphasis added).

[75] Note, this does not mean that the revolvers are not derivative interests or contracts with respect to the underlying loans. *See, e.g.,* FSA 199935017 (Sep. 3, 1999) (contracts to acquire

debt are derivative financial instruments that reference the underlying loan).

[76] Commentators have noted that in order for a financial arrangement to qualify as an option, it must generally not be subject to contingencies that cause the transaction to differ from a traditional option arrangement. *See* J. Walker Johnson & Bridget Kelly, *Tax Restrictions Can Impede the Use of Options to Manage Risk*, Tax Notes, Oct. 6, 2014 ("Although the inclusion of various types of terms and conditions is frequently prudent from an economic and risk management standpoint, it can jeopardize an agreement's qualification as an option for tax purposes … [w]hen a condition exists that may impel or impede exercise of the option, the determination [of whether the contract is an option] should consider whether the arrangement preserves the economic bargain struck by the parties while comporting with the economic substance of an option.").

[77] For example, the statutory provisions addressing such payments were labeled "commitment fees." Although, Code Sec. 7806(b) provides that "[n]o inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title, nor shall any … descriptive matter relating to the contents of this title be given any legal effect" courts have held that a title may be used to help resolve ambiguity. *Montero-Martinez v. Ashcroft*, CA-9, 277 F3d 1137 (2002); *Buculei*, CA-4, 262 F3d 322 (2001); *Emery Worldwide Airlines, Inc.*, 49 FedCl 211 (2001), *aff'd*, CA-FC, 264 F3d 1071 (2001). In addition, the Conference Report for P.L. 103-66 indicates that the provision applies to commitment fees and describes that term in a way that would fit revolver commitment fees.

[78] *Duncan v. Walker*, SCt, 533 US 167, 174, 121 SCt 2120 (2001); *C.J. Sophy*, 138 TC 204, 211, Dec. 58,965 (2012).

[79] Courts generally assume that Congress has acted intentionally or purposely in the disparate inclusion or exclusion or words or phrases. *Russello*, 464 US 16, 23 (1983) (quoting *Wong Kim Bo*, CA-5, 472 F2d 720, 722 (1972)) ("'[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.'"). Thus, a specific definition (*e.g.*, the Code Sec. 1236(c) definition) should not be imported into Code Sec. 1234(b). In addition, a word that is not statutorily defined should generally be interpreted using its ordinary, contemporary, common meaning. *See Ltd., Inc.*, CA-6, 2002-1 USTC ¶50,353, 286 F3d 324, 332. This view is also consistent IRS interpretations in other areas of the Code where the term "securities" is not defined. *See, e.g.*, GCM 39511 (1986) ("this division has concluded that other definitions of 'security' used in Code should not be relied upon but rather that general Congressional intent that can be gleaned from the Code generally and section 1091 in particular should determine whether an instrument is a security within the meaning of section 1091.").

[80] *See, e.g.,* Code Sec. 512(b)(5). In other words, if Congress wished to define a security by reference to Code Sec. 1236(c), it could have done so. *Cf. PSB Holdings, Inc.*, 129 TC 131, Dec. 57,159 (2007) (noting that evidence of Congressional intent was present when Congress required a certain result in one portion of the statute but not another).

[81] *See Kirschner v. JPMorgan Chase Bank, N.A.*, CA-2, No. 21-2726 (2023).

[82] In the context of net-back payments, a third reason Code Sec. 1234(b) might not apply is that the provision by its terms only applies to the "grantor" of an option. Reg. §1.1234-3(b)(3) defines a "grantor" as "the writer or issuer of an option." The use of this language, as opposed to, for example, the "obligor" could be interpreted as indicating the initial option counterparty is subject to Code Sec. 1234(b) and that future parties to the option might otherwise fall within the general tax treatment (*e.g.*, treatment under Code Sec. 1234A).

[83] Presumably the financial institution is not required to report the upfront commitment fee of $100x as immediate income, but as discussed herein can defer such amount until there is a draw or until expiration of the commitment period. However, in the example, half-way through the commitment period there is a sale/transfer to the investment fund with a net-back payment of $50x. Here, presumably this is a tax trigger to the financial institution, requiring an acceleration of $50x of the upfront commitment fee.

[84] We acknowledge that, unlike upfront commitment fees, net-back payments are sometimes made over the duration of the lending commitment. We do not believe that this precludes open transaction treatment. Although option premiums are typically paid at the outset, the premiums can be paid upon exercise or failure to exercise (a post-paid option) or paid over the term of the option contract. *See, e.g., Virginia Iron Coal & Coke Co.*, CA-4, 38-2 USTC ¶9572, 99 F2d 919 (taxpayer granted an option with premiums due at intervals).