King & Spalding

Client Alert

Tax Practice Group

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IRS and Treasury Issue Proposed Regulations on Deemed Stock Distributions

Executive Summary

On April 12, 2016, the Internal Revenue Service ("IRS") and Treasury Department issued long-awaited proposed regulations (REG-133673-15, RIN 1545-BN07) (the "Proposed Regulations") regarding the constructive stock distribution rules of Section 305(c) of the Internal Revenue Code of 1986, as amended (the "Code"). The proposed rules clarify certain computational and timing issues associated with deemed distributions occurring under Section 305(c). The Proposed Regulations also provide guidance relating to the appropriate manner and timing of withholding on deemed distributions. Generally, the new rules should bring more certainty and uniformity to the treatment of common adjustments made to convertible debt instruments and similar securities.

Background

Section 305 of the Code governs the tax consequences of stock dividends to shareholders of corporations (or any other entities treated as corporations for U.S. federal income tax purposes). The general rule under Section 305(a) is that a stock distribution made by a corporation is not includible in gross income of the recipient shareholder. This general rule, however, is subject to various exceptions set forth in Section 305(b). For example, Section 305(b)(1) provides that where a shareholder has a right to receive either money (or other nonstock property) or stock, then the distribution will be taxable even where the shareholder elects to receive stock. Perhaps the most commonly applicable (and potentially most complex) exception is found in Section 305(b)(2), which provides for the taxability of a stock distribution that is part of a series of distributions pursuant to which some shareholders receive property and other shareholders benefit from an increase in their proportionate interests in the assets or earnings of the corporation.

Section 305(c) provides an overlay to the above rules, and governs transactions that are the economic equivalent of a stock distribution. These "deemed distributions" can take many forms, including the increase to the conversion ratio of convertible debt or other instruments convertible into stock.[1] When a transaction or arrangement gives rise to a deemed distribution under Section 305(c), the deemed distribution is tested under

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the Section 305(b) exceptions. In many cases, the distribution will be characterized as a taxable stock distribution under the "disproportionate distribution" provision of Section 305(b)(2), described above.

Section 305(c) looms large in the context of preferred stock, where such terms as "in-kind" or cumulative dividend rights, or liquidation preferences that exceed issue price, may be treated as deemed stock distributions to holders. In the context of convertible debt or similar securities, Section 305(c) will be implicated whenever a conversion rate adjustment is made to compensate the holders for what otherwise would be dilutive corporate transactions. For example, most convertible debt provides for conversion rate adjustments in the case of a cash dividend made to shareholders.[2] These adjustments fall squarely within the Section 305(c) rules and are made taxable via Section 305(b)(2). Under the applicable regulations, however, "an applicable adjustment made pursuant to a bona fide, reasonable adjustment formula that has the effect of preventing dilution of a shareholder's interest is not a deemed distribution of stock to which Sections 305(b) and 301 apply."[3] These adjustments are purely antidilutive and do not compensate holders of rights for taxable property distributions made to other shareholders.[4]

The taxable nature of a deemed distribution (at least in the context of an ameliorative adjustment to shareholder cash distributions) has been relatively clear since the Section 305 rules were first enacted in the 1970s. However, the quantification and timing of such distributions have been the subject of considerable uncertainty. The Proposed Regulations were issued to resolve these uncertainties.[5]

The Proposed Regulations also contain rules governing the withholding procedures applicable to deemed stock distributions under Section 305(c).[6] Constructive distributions under Section 305(c) have historically posed significant challenges to withholding agents. This is chiefly due to the fact that by its nature, a deemed distribution usually occurs (1) without a corresponding transfer of cash to the holder recognizing the income, and (2) without the withholding agent's knowledge of the adjustment giving rise to the deemed distribution. In the public debt markets, issuers regularly include risk factors and other disclosures in their offering documents, informing non-U.S. holders that in the case of a deemed dividend, withholding may be satisfied from any amounts owed to the holder, including interest payments or subsequent sales proceeds. In practice, however, the manner in which such withholding responsibilities have been discharged has been inconsistent and unpredictable. The withholding issue began to attract renewed attention in 2014 when the IRS and Treasury issued proposed regulations under the "dividend equivalent" rules of Section 871(m).

Summary of Proposed Regulations

The Proposed Regulations provide that where an actual distribution of cash or property to shareholders results in an increase to the number of shares to be received by the holder of a convertible instrument upon conversion, the adjustment is properly treated as a constructive distribution of additional rights to acquire stock (as opposed to a distribution of additional stock). Accordingly, the amount of the deemed distribution is equal to the increase in the fair market value of the right embodied in the convertible instrument resulting from the adjustment. Any facts pertaining to the particular holder (e.g., the size of the stock position held) are not taken into account for these purposes.[7] Similar treatment would apply to the reciprocal situation in which a holder of a convertible instrument receives property and suffers a concomitant *reduction* in the conversion ratio. In that case, the holders of the corporation's stock are deemed to receive a distribution of actual stock in an amount equal to the fair market value of the additional shares deemed to be received.[8] This valuation method is commonly referred to as the "delta" method.

The Proposed Regulations clarify that a deemed distribution occurs at the time the adjustment occurs (in accordance with the underlying instrument), but in no event later than the date of the property distribution giving rise to the deemed distribution.

With regard to withholding, the Proposed Regulations confirm that withholding agents do in fact have a responsibility to withhold on deemed distributions. For these purposes, a withholding agent includes the issuer of the security and any person who holds (directly or indirectly) a security on behalf of a beneficial owner. The Proposed Regulations create a new exception for withholding agents (other than the issuer) which provides that a withholding obligation is triggered only if, prior to March 15 of the year following the deemed distribution,[9] either (1) the issuer meets its reporting requirements under Treas. Reg. section 1.6045B-1,[10] or (2) the withholding agent has actual knowledge that the deemed distribution has occurred. The Proposed Regulations provide that once these requirements have been met, the withholding agent would be required to withhold on the next cash payment (for example, interest on the convertible bond) made with respect to the instrument (or, if earlier, the date on which the security is sold or exchanged), but no later than March 15 of the year following the deemed distribution. The Proposed Regulations state that in certain cases a withholding agent will need to rely on the current rules that apply to situations involving underwithholding. For example, existing law gives withholding agents the right to satisfy these obligations from property that it holds in custody for the beneficial owner or property over which it has control.

Conclusion

The Proposed Regulations are helpful in that they provide a formal imprimatur to positions that many practitioners and taxpayers assumed were proper under current law. The newly prescribed method of valuing deemed distributions has been well received, as most commentators believe that it is consistent with the economic realities of these instruments. Where a cash dividend is paid and a conversion rate is increased, treating the holder of the convertible instrument as having received an amount equal to the additional *stock* ignores the fact that he has only received an option on such additional stock.

While the rules expand the responsibilities of withholding agents, they also provide much needed relief by deferring the withholding obligation until such time as the agents have adequate information regarding the deemed distribution. The timing rules in the Proposed Regulations, however, are very nuanced and in many cases it may be difficult for brokers or other custodians to track the timing of withholding across different holders. Uncertainties also remain in the sense that a withholding agent may be in the difficult position of having to prove that it lacked actual knowledge of a deemed distribution prior to the liquidation of a convertible bond from an account it maintains. The Proposed Regulations also do not offer any guidance on the treatment of withholding deficiencies with respect to deemed distributions occurring prior to 2016, when issuer reporting for these instruments took effect. Commentators therefore expect additional guidance in this area.

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[1] Under Section 305(d), "stock" includes a right to acquire stock and "shareholder" includes a holder of such a right.

[2] Frequently, these adjustments are made only in connection with cash dividends that exceed a certain threshold.

[3] Treas. Reg. § 1.305-7(b)(1).

[4] The IRS has ruled that where the adjustment to the conversion ratio of convertible debt is in respect of a distribution to shareholders that is tax-free under Section 355, the antidilution exception applies and the adjustment is not subject to Section 305(c). Rev. Rul. 77-37, 1977-1 C.B. 85.

[5] In the words of the preamble (the "Preamble") to the Proposed Regulations, "These proposed regulations would amend the current regulations under section 305(b) and (c) only to clarify the amount and timing of such deemed

distributions, not the fact of their occurrence, which is clear under current law."

[6] The Proposed Regulations also contain new rules relating to an issuer's reporting obligations under Section 6045B in connection with a deemed stock distribution. This memorandum does not address this component of the Proposed Regulations.

[7] For deemed distributions occurring prior to the publication of final regulations, the Proposed Regulations allow withholding agents to calculate the deemed distribution based on the fair market value of the underlying stock, which the IRS believes is a "reasonable interpretation" of the current regulations.

[8] The current regulations under Section 305 provide guidance on how to value the additional shares deemed received. See Treas. Reg. § 1.305-3(e), Examples 8 and 9. These examples deal with the application of Section 305(c) to non-redeemed shareholders resulting from a plan to periodically redeem other shareholders, but the computational illustrations in the examples are instructive for other situations, such as those involving convertible instruments.

[9] This is the date that the IRS Form 1042 information reporting requirements are due with respect to deemed distributions to non-U.S. holders.

[10] Section 6045B was added to the Code in 2008 and requires issuers of certain securities to report "organizational actions" that affect holders' tax basis. Beginning in 2016, conversion rate adjustments that result in deemed distributions under Section 305(c) are reportable under this provision. The reporting is done by filing a return with the IRS and providing a written statement to holders. In lieu of these reports, the issuer may post the information on its website. Section 6045B contains an exception for "exempt recipients," which includes corporations. Another one of the changes introduced in the Proposed Regulations is to eliminate the "exempt recipient" exception with respect to Section 305(c) events. Like the rest of the Proposed Regulations, this change was prompted by the concerns expressed by brokers and withholding agents that they lacked the necessary information relating to a deemed distribution to allow them to discharge their withholding obligations.