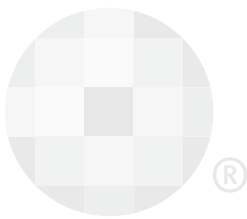


Deemed Dividends Without Cash—New IRS Proposed Code Sec. 305(c) Regs Trigger Outcry and Create Challenges for Convertible Debt, Stock and Rights

By Stevie D. Conlon*



Stevie D. Conlon analyzes the Proposed 305(c) Regulations. Also included in her article, is a simple conversion ratio adjustment example and a thoughtful discussion of the relevant legislative history and pre-existing IRS guidance.

Introduction

On April 13, 2016, proposed regulations under Code Sec. 305(c) were published (the “Proposed 305(c) Regs”).¹ The Proposed 305(c) Regs clarify that the holder of a convertible bond or stock, or a stock right issued by the issuer of the stock (each, a “stock right holder”), can have taxable dividend income as a result of an increase in such holder’s entitlement to shares of stock—a deemed dividend, even though such holder does not receive any payment of cash or property at such time. The Proposed 305(c) Regs also specifically require valuing such deemed dividend based on the fair market value *of the right to acquire stock*, rather than the *current value* of such stock.² The Proposed 305(c) Regs also clarify that such dividend generally occurs at the time the holder is legally entitled to additional stock. And although the Proposed 305(c) Regs would require withholding agents to withhold on deemed dividends arising for non-U.S. holders of stock rights (including certain convertible instruments), the Proposed 305(c) Regs try to minimize the

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burden by postponing withholding until after the issuer of the convertible bond, stock or stock right giving rise to a deemed dividend reports such information on Form 8937 pursuant to Code Sec. 6045B (or the withholding agent has actual knowledge of the deemed dividend). The Proposed 305(c) Regs also clarify that a holder of shares of actual stock can have taxable dividend income when others' entitlements to shares of that stock are reduced.

The Proposed 305(c) Regs are considered controversial for several reasons. Several industry groups had argued that it was inappropriate for the IRS to require issuers or withholding agents to track and take into account deemed dividends.³ Concerns were raised that withholding had not been required before and some argued that it was a change in law and practice to begin taxing deemed dividends now. Some argued that adjustments to the terms of convertible securities that were intended to simply make investors whole should not give rise to taxable income.⁴ Some raised further concerns that the amount of a deemed dividend was too difficult to determine.⁵ Others were unhappy with a perceived expansion of noncash or payment types of income beyond imputed interest, limited application of mark-to-market, embedded loans on certain notional principal contracts and dividend equivalent amounts under Code Sec. 871(m).⁶ Moreover, others have raised concern that delaying a withholding tax obligation until a Form 8937 or actual notice is provided raises potential problems with pro-active attempts to manage withholding tax risk.⁷

In response, the IRS indicated that it was simply clarifying an existing deemed dividend rule that was included in Treasury Regulations promulgated in 1973.⁸ Moreover, the legislative history set forth to the Tax Reform Act of 1969 relating to the 1973 regulation provides "... [t]he proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by methods such as increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock ..."⁹ It is also important to recognize that the IRS had issued both public and private letter rulings since the mid-1970's treating changes to conversion rates on convertible securities as giving rise to deemed dividends under Code Sec. 305(c).¹⁰

In summary, the IRS believes that it is clarifying long-standing guidance that is consistent with legislative intent, while many financial market participants and tax counsel are arguing that the IRS should not treat such adjustments as giving rise to deemed dividends.

This article focuses on analyzing the Proposed 305(c) Regs but begins with a simple conversion ratio adjustment example and discussion of the relevant legislative history and pre-existing IRS guidance.¹¹

Simplified Conversion Ratio Adjustment Example

Why do convertible debt securities and similar instruments include conversion ratio adjustment provisions? This simple example is illustrative.

Assume that Anna purchases 10 shares of Acme common stock for \$1,000. At the time of her purchase, each share has a value of \$100. Assume that Bob purchases a convertible bond with a face amount of \$1,000 that is issued by Acme on the same day. The bond is convertible into 10 shares of Acme.¹² Essentially, as part of the terms of the conversion privilege, Bob is a holder of a long-dated option to acquire 10 shares of Acme at a strike price of \$100 a share. The option is long-dated because, unlike typical publicly-traded options that often have a term of one year or less, Bob's option survives as long as the bond is outstanding. Accordingly, if the bond is newly issued and has a 20-year term, Bob's option can be exercised at any time over 20 years.¹³ The implicit strike price of the option is \$100 per share, since Bob would forgo the \$1,000 principal payment for the 10 shares of stock (\$100 multiplied by 10 shares) if exercised.

Now assume that 10 days after the stock and bond are purchased by Anna and Bob, respectively, Acme Corporation declares and pays a \$10 dividend per share of common stock. Anna receives a cash distribution on the 10 shares of \$100 in the aggregate. Because the company has distributed \$100 in cash, its value and the value of its stock fall by approximately the amount of the cash dividend. Accordingly, each share of stock has a fair market value of \$90 immediately after the cash dividend. As a result, the value of Anna's stock has been reduced from \$1,000 to \$900 (\$90 times 10 shares). However, Anna has not lost money because she also holds the \$100 received as a result of the cash dividend. Collectively, her investment related to Acme remains \$1,000 (10 shares worth \$90 and the cash in hand of \$100).

Without a conversion ratio adjustment provision for Bob's convertible bond, however, Bob's conversion option has declined in value. Instead of providing Bob with an option to acquire 10 shares of Acme stock worth \$100 each, the effect of the cash dividend distribution means that he would hold an option to acquire 10 shares of Acme stock worth \$90 each.

A conversion ratio adjustment provision is intended to adjust the conversion provision of convertible securities to offset reductions attributable to cash dividends, mergers (both taxable and nontaxable) and other types of events that can disproportionately affect the holders of such securities relative to actual shareholders.

For example, a simple conversion ratio adjustment formula might require a comparison of the fair market value of Acme stock before and after a cash dividend and require an increase in the number of shares to be received by (or reduce the conversion price implicitly paid by) the convertible bond holder on exercise of the conversion privilege. In our example, such a simplified conversion ratio adjustment formula would derive a new number of shares that Bob should be entitled to receive upon conversion to make him whole. In this simple example, Bob should receive 11.11111 shares of Acme stock instead of 10 after the cash dividend. If Bob receives 11.11111 shares of Acme stock by exercising his conversion privilege immediately after the conversion ratio adjustment occurs, the value of the Acme stock received would approximate \$1,000—essentially the same value of Acme stock that Bob would have received if only 10 shares were received and the value of such stock had remained at \$100 per share because the cash dividend was not paid, and the implicit strike price of Bob's option is reduced to \$90 per share.

The controversial tax question is, if the conversion ratio adjustment formula is intended to simply make Bob whole, why should Bob be taxed under Code Sec. 305(c) as the result of a deemed dividend? On one hand, Anna will be taxed on the cash dividend she receives—and Bob's conversion ratio will be changed to compensate for the dividend. However, she got the cash and Bob did not—there was simply an increase in his option right. Furthermore, the change was purely mechanical and not part of a renegotiation or change to the terms of the convertible instrument. However, other make-whole provisions can give rise to taxable income even though there may be potential contingencies, such as in the case of inflation-indexed debt instruments.¹⁴ Moreover, as discussed herein, the legislative history relating to Code Sec. 305(c) indicates that changes relating to convertible securities that increase such holders' interest in a corporation relative to other classes of shareholders give rise to taxable income.

The Relevant Law and Prior IRS Guidance

The Revision to Code Sec. 305 Under the Tax Reform Act of 1969

Code Sec. 305, enacted as part of the original Internal Revenue Code of 1954, addressed taxation of stock dividends. Stock dividends generally were not classified as income under the 1954 law, with the exception of dividends paid on preferred stock and dividends payable in cash or stock

at the option of the holder. Corporations routinely avoided triggering taxable dividends to shareholders under this version of Code Sec. 305 by issuing two classes of stock: one receiving stock dividends and the other receiving cash dividends where ready conversion of shares was allowed between the two classes.¹⁵ Leading up to the Tax Reform Act of 1969, corporations developed increasingly Byzantine structures to achieve tax-neutral changes in proportionate interest, including, for example, concurrent cash dividends and conversion rate changes, as well as at least one tactic involving systematic periodic optional redemptions.¹⁶

In response, the Tax Reform Act of 1969 overhauled Code Sec. 305 entirely. The revisions were not limited to just addressing conversion rate adjustments but attempted to remedy the perceived gaps in then-current legislative and regulatory treatment of stock dividends, which “... did not cover all of the arrangements by which cash dividends could be paid to some shareholders and other shareholders could be given corresponding increases in proportionate interest.”¹⁷

Code Sec. 305(c) in particular was intended to “... deal with transactions that have the effect of distributions, but in which stock is not actually distributed.”¹⁸ Prior law was ambiguous as to whether and to what extent an increase in proportionate interest due to methods other than explicit stock dividends should be treated as distributions, and this section of the Tax Reform Act of 1969 provided clarity.¹⁹ The legislative history provides that Code Sec. 305(c) grants the IRS regulatory authority to address transactions “... that have the effect of disproportionate distributions except for the fact that stock is not actually distributed ...” and that “... such methods as increasing the ratio at which his stock, convertible securities or rights to stock may be converted into other stock ...” were one of the specifically identified potential transaction types.²⁰ This provision and its focus, in part, on the impact of ratio adjustments, was enacted despite public commentary that it would be burdensome to corporations and holders of stock, convertible securities and rights to acquire stock.²¹

Reg. §1.305-7

The 1973 final regulations provided that “... a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated ... [as a taxable dividend], or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder may be treated as a distribution ...” to a shareholder whose proportionate interest in the corporation is increased as a result thereof.²² The regulations include an exception for

dividend treatment when a conversion ratio, conversion price of convertible preferred stock or bonds or exercise price of rights or warrants are made pursuant to a “*bona fide*, reasonable, adjustment formula.”²³ However, this exception does not apply if the adjustment is made in connection with a taxable distribution under Code Secs. 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b) or 857(b).²⁴

Rev. Rul. 75-513

Rev. Rul. 75-513 provided the first clear IRS guidance applying the 1973 final regulations to conversion ratio adjustments.²⁵ The ruling concerned a real estate investment trust (REIT) with outstanding shares of beneficial interest and convertible debentures. Under its facts, the convertible debentures include a conversion adjustment provision that adjusted the amount of underlying stock into which the debentures were convertible on January 31 of each year.

The ruling provides that pursuant to Code Sec. 305(d)(2) and Reg. §1.305-3(b)(5),²⁶ the holders of convertible debt instruments were considered shareholders, and the outstanding convertible debentures were treated as outstanding stock for purposes of the disproportionate distribution analysis. Rev. Rul. 75-513 states that because shareholders of the underlying stock received cash and the annual conversion rate adjustment resulted in an increase in the proportionate interest of the debenture holders in the company’s assets or earnings and profits, the conversion rate adjustment constituted a deemed distribution under Code Secs. 305(b)(2) and 305(c).

Several subsequent Revenue Rulings and Private Letter Rulings conclude that conversion ratio adjustments trigger deemed distributions.²⁷

Reason for New Guidance

In spite of the promulgation of the final regulations in 1973 and subsequent IRS guidance treating conversion ratio adjustments as giving rise to deemed dividends, as tax reporting and withholding rules and associated penalties changed in recent years, tax practitioners, brokers and custodians have become concerned regarding the compliance burdens relating to such deemed dividend treatment. In particular, a report released in 2013 by the Tax Section of the New York State Bar Association commenting on proposed regulations relating to Code Sec. 871(m) raised concerns regarding the potential interplay of competing withholding tax burdens on securities resulting from deemed dividends under Code Sec. 305(c) and dividend equivalent amounts under Code Sec. 871(m).²⁸ As concerns regarding compliance with

respect to potential deemed dividends from conversion ratio adjustments spread throughout the financial and tax advisory communities, letters were submitted to the Treasury arguing that such treatment was inappropriate and should not apply.²⁹ Concerns were also raised that treating the amount of a deemed dividend relating to a conversion ratio adjustment or stock right that is not immediately exercised as equal to the fair market value of stock overstated the value of a right compared to actual stock ownership. Further concerns were raised regarding who should be responsible for providing such valuations to shareholders, and if and how U.S. withholding taxes would apply to such deemed dividends.

The Proposed 305(c) Regs were published to respond to these requests and concerns.

The Scope of the Proposed 305(c) Regs

Code Sec. 305(c) applies to stockholders—both actual and deemed. Under the Proposed 305(c) Regs, an actual shareholder is defined as a holder of actual stock.³⁰ A deemed shareholder is defined as a holder of the right to acquire stock.³¹ A “right to acquire stock” is defined as one of four kinds: (1) a right of the holder of convertible instruments meeting certain requirements; (2) a warrant, stock right or option as defined below; (3) a right to acquire stock that is similar to (1) or (2); and (4) a right to receive an amount of cash or property “determined in whole or in part by reference to the value of a specified number of shares of stock (whether or not in lieu of such stock) of the corporation issuing the right.”³²

Applicability to Convertibles and Similar Instruments

The Proposed 305(c) Regs make it clear that classic convertible securities are within its scope by defining such instruments as follows: “[a] right of a holder of a convertible instrument (including a debt instrument that is convertible into shares of stock and stock that is convertible into another class of stock) to convert the instrument into one or more shares of stock of the corporation issuing the instrument.”³³ Moreover, just in case Wall Street or smart tax attorneys create financial instruments that skirt this definition, the Proposed 305(c) Regs further provide that a right to acquire stock similar to such rights is also included within the definition.³⁴ In addition, the Proposed 305(c) Regs apply—even if cash or property is distributed rather than actual stock—by further defining as a right

with respect to stock those instruments that constitute a right to receive an amount of cash or property “determined in whole or in part by reference to the value of a specified number of shares of stock (whether or not in lieu of such stock) of the corporation issuing the right.”³⁵

Applicability to Stock Rights and Warrants

A stock right or warrant subject to Code Sec. 305(c) is defined in the Proposed 305(c) Regs as “[a] warrant, subscription right, stock right, or other option to acquire shares of stock of the corporation issuing the instrument.”³⁶ The Proposed 305(c) Regs also explicitly apply to stock rights and warrants, and it should be noted that stock warrants may have conversion ratio adjustment provisions. As a result, conversion ratio adjustments relating to stock warrants (and potentially stock rights) issued by the issuer of the stock are also a concern. Is a forward contract whereby a person is obligated to take stock from the issuer (or be paid equivalent cash) that is part of a structured product a “stock right” for purposes of the Proposed 305(c) Regs? Note that a forward contract is economically very different from an option or typical stock right or warrant. Because such a forward contract participant is economically “long” the related stock, it would seem appropriate to treat such forwards as stock rights for this purpose.³⁷

Not All Convertibles and Stock Value-Related Instruments Are Ensnared

It is important to note that Code Sec. 305 and the Proposed 305(c) Regs do not apply to many derivative financial instruments that reference the value or right to referenced stock. For example, a convertible instrument issued by a broker or financial firm that provides for payments determined by reference to another company’s stock is not subject to this rule (because the rule only applies if the referenced stock is that of the corporation issuing the instrument). In addition, a convertible instrument issued by a corporation that references a stock or basket of stocks issued by entities other than the corporation would similarly not be subject to Code Sec. 305(c).³⁸

Determining When a Deemed Dividend Is Triggered

The Proposed 305(c) Regs define a “deemed distribution” as a “transaction or event, other than an actual distribution of cash or property, that constitutes a distribution under section 305(b) and (c).”³⁹ However, there is an exclusion

from this definition in the limited case of when “... the right to acquire stock is a nonqualified stock option without readily ascertainable fair market value ...” or “Section 83(a) applies to the right to acquire stock or the stock to which the right relates or the stock is subject to a substantial risk of forfeiture, and the holder of the right has not made an election under section 83(b).”⁴⁰

A deemed distribution can arise for both actual and deemed shareholders. For deemed shareholders, there is a two-step analysis: has an “applicable adjustment occurred” that increases such holders’ interest in the corporation, and does it have an effect described in Code Sec. 305(b)(2) through (5).

An applicable adjustment is defined as “an adjustment to a right to acquire stock,” including (1) for a convertible instrument and the holder of such instrument: “an increase in the conversion ratio or a reduction in the conversion price of such instrument,” (2) for a warrant, subscription right, stock right or option and the holder of such right or option: “an increase in the number of shares to be received by the holder upon exercise or a reduction in the exercise price,” (3) for a convertible instrument and an actual stock holder: “an increase in the conversion price or a reduction in the conversion ratio of such instrument,” (4) for a warrant, subscription right, stock right or option and an actual stock holder: “an increase in the exercise price or a reduction in the number of shares to be received by the holder upon exercise” and (5) an adjustment to the terms of a right to acquire stock having a similar effect to the effect of the adjustments described above.⁴¹

The Proposed 305(c) Regs provide that a deemed distribution occurs for a deemed shareholder and such distribution is subject to the Code Sec. 301 dividend distribution rules “... if an applicable adjustment has the effect of increasing a deemed shareholder’s proportionate interest in the assets or earnings and profits of the corporation, and if such increase has the effect described in section 305(b)(2), (3), (4) or (5) ...”⁴²

The Proposed 305(c) Regs explicitly provide that an increase in the conversion ratio or reduction in conversion price with respect to a convertible instrument is treated as deemed distributions.⁴³

A deemed distribution can also arise under the Proposed 305(c) Regs with respect to actual shareholders when an increase in such shareholders’ proportionate interest in the corporation occurs. The Proposed 305(c) Regs provide that a deemed distribution occurs for an actual shareholder and such distribution is subject to the Section 301 dividend distribution rules “[i]f an applicable adjustment has the effect of reducing a deemed shareholder’s proportionate interest in the assets and earnings and profits and thereby

increasing an actual shareholder's proportionate interest, and if such increase has the effect described in section 305(b)(2), (3), (4) or (5) ...⁴⁴

There is an exception from deemed distribution treatment for " ... an applicable adjustment that is made pursuant to a bona fide, reasonable, adjustment formula (including but not limited to an applicable adjustment made to compensate for a distribution of stock to another shareholder) and that has the effect of preventing dilution of the proportionate interest of the holders of the actual stock or rights to acquire stock ... " (the "bona fide reasonable adjustment formula" exception).⁴⁵ However, the Proposed 305(c) Regs further provide that "[a]n applicable adjustment that is made to compensate

The Proposed 305(c) Regs are considered controversial for several reasons. Several industry groups had argued that it was inappropriate for the IRS to require issuers or withholding agents to track and take into account deemed dividends.

for a cash or property distribution to another shareholder ... " that is taxable as a dividend under Code Secs. 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b) or 857(b) is not eligible for this exception.⁴⁶

The existing Section 305(c) regulations include two examples that are intended to make it clear that applicable adjustments give rise to potential dividends under Section 301—Examples (6) and (7).⁴⁷ The Proposed 305(c) Regs modify these two examples by adding sentences clarifying that the amount of the deemed distribution in both cases, as well as the date and time of such distributions, is determined in accordance with the Proposed 305(c) Regs.⁴⁸

Determining the Amount of a Deemed Dividend

A significant aspect of the Proposed 305(c) Regs is its new method for determining the amount of a deemed dividend distribution to a deemed shareholder that is triggered by an applicable adjustment. Under the proposed regulations, the amount of such a deemed distribution is " ... the excess of—(A) [t]he fair market value of the right to acquire stock held by the deemed shareholder

immediately after the applicable adjustment, over (B) [t]he fair market value, determined immediately after the applicable adjustment, of such right to acquire stock as if no applicable adjustment had occurred."⁴⁹

This approach, which focuses on the fair market value of a deemed shareholder's right to receive shares of stock inherent in a right to acquire stock—rather than the fair market value of the stock itself at the time of the deemed distribution—is a significant change over the approach of the existing final regulations, which focuses on the fair market value of the stock itself in all cases. This new approach also seems consistent with the economics of rights to obtain stock—when a holder of such a right receives right to additional shares as the result of an applicable adjustment, one simply measures the fair market value of the adjusted amount of the right, as compared to the value of such a right as if no applicable adjustment had occurred.⁵⁰ If the option represented by the right to obtain stock is deep in the money, the fair market value of the right should approximate the value of the related stock.⁵¹

The Proposed 305(c) Regs provide a separate rule for determining the amount of a deemed dividend distribution that applies to actual shareholders. Under this rule, the amount of a deemed distribution to actual shareholders is " ... the fair market value of the stock deemed distributed, determined in accordance with the method set forth in Sec. 1.305-3(e), Examples 8 and 9."⁵²

The Proposed 305(c) Regs also clarify aspects of the determination of fair market value. First, the proposed regulations provide that "[a]ny particular facts pertaining to the deemed shareholder, including the number of rights or shares such deemed shareholder owns, will be disregarded."⁵³ And second, "[a]ny value or reduction in value attributable to the possibility of future applicable adjustments that may result from actual or deemed distributions will not be taken into account."⁵⁴

Can rights to acquire stock be readily valued? Some industry participants and tax commentators suggest that such valuations cannot be made or are difficult. Some commentators have suggested alternative valuation methods, such as comparing the value of the entire convertible security before and after the conversion ratio adjustment, or comparing the value of the entire convertible security after the conversion ratio adjustment to that of a hypothetical, unadjusted bond (a "comparative total price change" method).⁵⁵ However, stock rights are essentially a type of financial derivative that can be generically described as long dated call options, and these options are in fact readily valued by many market participants in connection with their trading and investment activities. It appears that the right to stock inherent

in convertible debt and preferred stock can be readily valued as a call option by reference data providers and other market participants.⁵⁶

Note that one consequence of the adoption of the valuation methodology in the Proposed 305(c) Regs for deemed distributions with respect to deemed shareholders is that it may reduce the amount of deemed distributions for REITs that are of the type that were the subject of the prior public and private letter rulings mentioned earlier.⁵⁷

Determining the Date and Time of a Deemed Dividend

When should a deemed distribution triggered by an applicable adjustment be treated as having occurred? In general, the Proposed 305(c) Regs provide that “... the deemed distribution occurs at the time such applicable adjustment occurs, in accordance with the instrument setting forth the terms of the right to acquire stock, but in no event later than the date of the distribution of cash or property that results in the deemed distribution ...”⁵⁸ Presumably, the Proposed 305(c) Regulations applicable language: “... in accordance with the instrument setting forth the terms of the right to acquire stock ...” means the date on which the holder is legally entitled to the additional shares (or fraction of shares) provided for as a result of the change of the conversion ratio. Thus, the general rule requires a review of the actual terms of the conversion rate adjustment to determine the date and time of the deemed distribution. Such analysis may be considered burdensome, but precise legal terms are significant in assessing the taxation of financial instruments. The proposed regulations also provide a special rule applicable to rights relating to publicly-traded stock—“... if the instrument setting forth the terms of such right does not set forth the time the applicable adjustment occurs, the deemed distribution occurs immediately prior to the opening of business on the ex-dividend date for the distribution of the cash or property that results in the deemed distribution.”⁵⁹

Examples

The Proposed 305(c) Regs include three illustrative examples.⁶⁰ Example 1 involves a corporation with two classes of stock—A and B. B stock is convertible into A stock. The conversion price of the B stock is adjusted pursuant to a reasonable anti-dilution provision. The corporation sells A stock to the public at a price below the conversion price and, pursuant to the anti-dilution provision, the conversion price of the B stock is adjusted downward. The Proposed

305(c) Regs provide that although the adjustment to the conversion price is an applicable adjustment, it does not give rise to a deemed distribution due to the *bona fide* reasonable adjustment formula exception in the regulations.

Example 2 involves a corporation with one class of stock and outstanding convertible debt securities (convertible into the stock of the corporation) that it has issued. The terms of the convertible debt securities include a *bona fide*, reasonable anti-dilution provision, and the conversion ratio of the debt is increased for distributions of stock dividends or stock rights to the corporation’s stockholders. The Proposed 305(c) Regs first conclude that the convertible debt holders are treated as shareholders for purposes of Code Sec. 305, and the convertible debt securities are considered rights to acquire stock. And although the adjustment to the conversion price is an applicable adjustment, it does not give rise to a deemed distribution due to the *bona fide*, reasonable adjustment formula exception in the regulations.

Example 3 also involves a corporation with one class of stock and outstanding convertible debt securities (convertible into the stock of the corporation) that it has issued. The terms of the convertible debt securities include a conversion ratio formula that is not considered a *bona fide*, reasonable adjustment formula and the conversion ratio of the debt is increased for distributions of cash dividends to the corporation’s stockholders. The Proposed 305(c) Regs conclude that the conversion ratio adjustment is an applicable adjustment and further conclude that the change results in a deemed distribution taxable under Code Sec. 301 to the holders of the convertible debt securities.

Example 3 makes it clear that a conversion ratio adjustment formula that provides for adjustments relating to cash dividends paid to actual stockholders of the corporation does not qualify for the *bona fide*, reasonable anti-dilution exception. In other words, the exception does not apply to adjustments triggered as a result of taxable distributions to shareholders. This conclusion is consistent with the language of the exception contained in both the Proposed 305(c) Regs and the existing regulations, finalized in 1973.

Recapitalizations

The Proposed 305(c) Regs also include a special rule that treats certain recapitalizations as giving rise to deemed distributions.⁶¹ This rule is triggered in connection with recapitalizations if either (1) “... it is pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or earnings and profits of the corporation ...” or (2) “... a shareholder owning preferred stock with dividend in arrears exchanges his stock for other stock and as a result increases his proportionate interest in the assets

or earnings and profits of the corporation.”⁶² The amount of the deemed distribution under this special rule is the lesser of “... the amount by which the fair market value or liquidation preference, whichever is greater ... exceeds the issue price of the preferred stock surrendered, or ... the amount of the dividends in arrears.”⁶³

Practical Problems with Actual CRAs

An examination of the terms of many conversion ratio adjustment provisions applicable to convertible instruments reveals that in most cases, the calculation of ratio adjustment occurs immediately after the record date or ex-dividend date of the triggering cash dividend. Typically, the terms also provide that the amount of the dividend paid and the calculated adjustment are evaluated separately to see whether they exceed threshold amounts or percentages specified in the related documents. For many convertible instruments, dividends paid on the underlying equity below a certain cash threshold (which itself may be adjustable for a variety of other events affecting the underlying equity)

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do not result in a conversion rate adjustment calculation. For those that do result in a calculation, if the calculated adjustment exceeds its own, separate threshold, the ratio adjustment takes effect. Calculated adjustments below the threshold are sometimes carried forward and taken into account when performing the next adjustment calculation. However, provisions governing the instruments vary regarding the effective date of the ratio adjustment.

In addition, there may be a different methodology applied or terms required when a conversion ratio adjustment is triggered due to a corporate action such as merger, stock split or dividend, regardless of whether such corporate action is taxable or nontaxable.

Finally, although the terms of conversion ratio adjustments may provide that they are not generally applicable or announced by the issuer unless they exceed a specified threshold amount, it is typical that this limitation does not apply if a holder decides to exercise the conversion right immediately. In other words, the calculation adjustment threshold rule often seems to be for the convenience of

the issuer and indenture trustee, so that they can compute and announce ratio adjustment changes less frequently, while the terms of many convertible bonds commonly provide that the holder is entitled to the benefit of the conversion ratio adjustment almost immediately after the effective date by simply exercising that conversion right.⁶⁴

Note the significance of this last point—holders of such a convertible can benefit from a conversion ratio adjustment if they exercise their conversion right, even if the issuer of the security is not currently obligated under the related legal documents to notify holders of a conversion ratio adjustment because the specified threshold has not been crossed at such time. This economic right of holders to benefit by exercising a conversion right after such a conversion ratio adjustment could call into question the Proposed 305(c) Regs reliance on issuer reporting for withholding tax compliance. It is not clear if issuers will report conversion ratio adjustments for tax purposes on Form 8937 only on (a) the occurrence of a reporting obligation based on the indenture or (b) every time a dividend gives rise to a legal entitlement, even if that conversion ratio adjustment was not required by the security’s indenture terms to be reported to holders.

A relatively simple example of such an adjustment and deemed dividend might look as follows. The indenture governing the senior convertible notes provides that the conversion rate will adjust upon payment of any cash dividend greater than \$0.08 per share by multiplying the current rate by a fraction. The numerator of the fraction is the closing share price of Acme common stock on the trading day immediately preceding the ex-dividend date, and the denominator of the fraction is the same share price minus the amount by which the cash dividend exceeds the \$0.08 cash dividend threshold.⁶⁵

The indenture provides that the adjustment will be effective on the day following the record date for the dividend on the underlying stock. Any adjustment below one percent of the current value can be carried forward and made at the earlier of the next subsequent adjustment such that the total adjustments result in an aggregate change of one percent or more, or in connection with any conversion of the notes. Conversion rates are to be rounded to four decimal places. The current conversion rate is 21.1273.

Suppose Acme pays a \$0.20 dividend. The relevant share price on the date preceding the ex-dividend date is \$31.58. Therefore, the calculation is $(21.1273 \times 31.58) / [31.58 - (0.20 - 0.08)]$. This results in a new conversion rate of 21.2079, which does not cross the one-percent threshold; therefore, the issuer will likely not promulgate this adjustment into the marketplace. A holder who converts the day after the effective date, however, is entitled to the

full benefit of the adjustment. The converting holder will receive 21.2079 shares of Acme common stock per \$1,000 principal amount of notes converted. Suppose in the next quarter, Acme declares and pays a \$0.30 dividend. The relevant share price on the date preceding the ex-dividend date is now \$31.49. Therefore, the calculation is $(21.2079 \times 31.49) / (31.49 - 0.22)$. This results in a new conversion rate of 21.3571, which does cross the one-percent threshold; therefore, the issuer will likely promulgate this adjustment into the marketplace. Prior to the Proposed 305(c) Regs, how to value these adjustments was uncertain. While the two adjustments increase the potential conversion entitlement by a total of 0.2298 shares of underlying Acme common, the regulations were not explicit concerning how to calculate the value of the deemed distribution. Historical revenue rulings suggested valuing the deemed distribution as a distribution of actual stock; more simply, the increase in entitlement multiplied by the current value of that many shares of Acme common stock.

Despite the fact that the notes' governing documents only require the issuer to promulgate a change past the one-percent threshold, it seems counterintuitive to combine the two adjustments for Form 8937 issuer reporting purposes if the holder is entitled to the first below-threshold increase upon conversion of the note immediately after the first adjustment. If the dividends causing the adjustments are in different tax years, the deemed distribution from the first dividend could be shifted into the following year, despite what could be a taxable event for the holder in the preceding year. Alternatively, assume that a holder sells the convertible instrument after the first increase but before the second increase. If the conversion adjustment is not taxed at the time it occurs, presumably the buyer will be taxed on an adjustment that occurred before purchase.

Taxable Income and Information Reporting Implications

Much of the focus of commentary concerning the impact of deemed dividend treatment with respect to convertible instruments seems to focus on U.S. withholding tax consequences applicable to non-U.S. holders of such instruments. However, the implications of deemed dividend treatment are broader. Distributions that are taxable pursuant to Code Sec. 301, including deemed dividends, result in taxable income to taxpayers subject to federal income taxes. This can be a particular concern for mutual funds taxed as regulated investment companies (RICs) and REITs that are subject to special tax treatment under Subchapter M of the Code. Under both Sections 852 and 857, RICs and REITs must

distribute at least 90 percent of their taxable income each tax year.⁶⁶ It must also be determined whether deemed distributions are eligible to be treated as "qualified dividend income" under Code Sec. 1(h)(11) or for the dividends received deduction under Code Sec. 243.⁶⁷

For individuals, brokers and others with information reporting obligations, the related issue is whether deemed dividends must be reported as taxable dividends on IRS Form 1099-DIV under Code Sec. 6042. Although the Proposed 305(c) Regs do not include any proposed amendments to the regulations under Code Sec. 6042, the preamble to the proposed regulations provides that "[i]t is expected that similar principles would apply under section 6042 with respect to reporting of deemed distributions made to U.S. persons on Form 1099-DIV ..." and requests comments on the potential implementation of such reporting.⁶⁸

Determining the Timing of Withholding on a Deemed Dividend

As referenced, a key concern relating to applicable adjustments giving rise to deemed distributions is the potential U.S. withholding tax implications when deemed shareholders who are foreign persons hold the convertible security or right. Under the existing regulations, there was confusion regarding whether and when such a deemed distribution would give rise to a withholding event and the source of payment needed by the withholding agent to satisfy its withholding tax obligation.⁶⁹ In general, the Proposed 305(c) Regs clarify that withholding applies as more fully described hereafter.⁷⁰

The Proposed 305(c) Regs generally provide that a withholding agent has an obligation to withhold on "... a deemed distribution on a specified security only if: (A) The issuer of the specified security reports the information required under section 1.6045B-1 regarding the deemed distribution before the due date (not including extensions) for it to file Form 1042 for the calendar year in which the deemed distribution or the deemed payment occurred; or (B) The withholding agent has actual knowledge of the deemed distribution before the due date (not including extensions) for the withholding agent to file Form 1042 for the calendar year in which the deemed distribution or the deemed payment occurred, but in such case the requirements of this paragraph ... will not be considered to be met until January 15 of the year following the calendar year in which the deemed distribution or the deemed payment occurred."⁷¹ This rule shall be referred to as "the Notice or Actual Knowledge Withholding Trigger Rule."

“Specified security” is a term of art under the cost basis rules enacted in 2008⁷² and stock, stock rights, options and debt instruments (including convertible debt and preferred stock) are included within the definition.⁷³ An important aspect of the cost basis reporting law in this context is that Code Sec. 6045B and its regulation generally obligate issuers of specified securities to report to holders of such securities on IRS Form 8937 or post the information on the issuer’s website regarding any “organizational action” that has a “quantitative effect on basis.” Code Sec. 6045B and the applicable regulation require an issuer to provide such Form 8937 or post the information on its public website within 45 days of the date of the organizational action giving rise to a basis adjustment.⁷⁴ The Proposed 305(c) Regs would revise Reg. §1.6045B-1 by adding new paragraph (i) to (a) explicitly provide that deemed distributions occurring on or after January 1, 2016, that could affect the basis of a specified security⁷⁵ are subject to reporting by issuers under Code Sec. 6045B, (b) specifi-

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cally provide that the date of the deemed distribution and the amount of the deemed distribution (as determined under the Proposed 305(c) Regs) must be reported and (c) require mandatory reporting (either by providing holders with Form 8937 or providing public reporting as specified under such regulations) even if all the holders of the affected security are exempt recipients.⁷⁶

The Proposed 305(c) Regs also specify the time withholding on a deemed distribution or deemed payment occurs (the “Timing of Withholding Rules”).⁷⁷ First, the proposed regulations provide that the Timing of Withholding Rules is only applied after the Notice or Actual Knowledge Withholding Trigger Rule has been satisfied.⁷⁸ In general, withholding must be made on a deemed distribution “... on the earliest of: (A) The date on which a payment of cash is made with respect to the security or

the securities lending or sales-repurchase transaction; (B) The date on which the security is sold, exchanged, or otherwise disposed of (including a transfer of the security to a separate account not maintained by the withholding agent or a termination of the account relationship); or (C) The due date (not including extensions) for the withholding agent to file Form 1042 for the calendar year in which the deemed distribution or the deemed payment occurred.”⁷⁹

The Proposed 305(c) Regs provide special rules in the case of foreign entities such as qualified intermediaries, withholding foreign partnerships and trusts and U.S. branches treated as U.S. persons that assume primary Chapter 3 withholding responsibilities. These rules permit a withholding agent to treat such entities as assuming primary Chapter 3 withholding responsibilities for deemed distributions only if (1) the withholding agent provides the foreign entity with a copy of the issuer statement described in the cost basis regulations within 10 days of the issuer furnishing the statement to the holder of record or its nominee, or (2) the issuer has met the public reporting requirements of the cost basis reporting regulations.⁸⁰ Such foreign entities have an obligation to withhold on deemed distributions if they receive such copy or such public reporting has been made by the issuer by the due date (not including extensions) for filing Form 1042.⁸¹

Examples of the Proposed Withholding Rules

The Proposed 305(c) Regs include three examples to illustrate the application of the Notice or Actual Knowledge Withholding Trigger Rule and the Timing of Withholding Rules.

Example 1 involves a convertible bond held by a U.S. custodian on behalf of a foreign person. On March 1 of Year 1, a conversion ratio adjustment occurs that results in a deemed distribution under the Proposed 305(c) Regs. On March 15 of Year 1, an interest payment is made on the convertible bond. On April 1 of Year 1, the issuer of the convertible bond reports the deemed distribution on its public website in compliance with its reporting obligation under Code Sec. 6045B. On April 15, another interest payment is made. The example provides that the custodian’s withholding obligation does not begin until the issuer reports the deemed distribution on April 1 and the custodian must withhold on the deemed distribution on the payment of interest on April 15. Note that the custodian is not obligated to withhold on the March 15 interest payment that occurred before the issuer reported the deemed distribution.

Example 2 involves the same facts as Example 1, except that the convertible bond is transferred to a separate

account of the foreign person that is not maintained by the custodian on April 15 and an interest payment is not made on April 15. The example provides that the custodian must withhold on the deemed distribution upon the transfer of the convertible bond even though no cash payment was received on or after April 1, the date the issuer reported the deemed distribution.

Example 3 involves the same facts as Example 1, except that the convertible bond is transferred to a separate account of the foreign person that is not maintained by the custodian on March 30, in advance of the April 1 date that the issuer reported the deemed distribution. The example provides that the custodian must withhold on the deemed distribution upon the transfer of the convertible bond, even though the convertible bond is transferred before the date the issuer reported the deemed distribution. However, the custodian's obligation to withhold does not arise until April 1, the date on which the deemed distribution is reported. And because payments are not made, and the security was not sold after such notice date (April 1), the third prong of the Timing of Withholding Rules applies and the custodian must withhold as of the due date of Form 1042 for the calendar year in which the deemed distribution occurred. Note that this withholding obligation arises even though the convertible bond was transferred away *before* the custodian's obligation to withhold was triggered. The example further references Reg. §1.1461-2(b) as a means by which the custodian may collect the amount that should be withheld.

Note that Example 3 illustrates a subtle but critical nuance between the Notice or Actual Knowledge Withholding Trigger Rule and the Timing of Withholding Rules—issuer or actual notice that triggers the Notice or Actual Knowledge Withholding Trigger Rule triggers a “springing” obligation of the withholding agent to withhold on the deemed distribution to which such notice relates, even if the security has been transferred away (or presumably sold) after such deemed distribution date, but *before* the date of such notice.

Concerns with the Timing of Withholding

The springing obligation for a withholding agent to withhold on a deemed distribution when issuer or actual notice occurs after transfer or disposition creates a practical problem for withholding agents. This springing obligation, coupled with the Timing of Withholding Rules, creates a risk of under-withholding by withholding agents.⁸² The most prudent course would seem to be for such agents to

try to estimate the amount of a deemed dividend on the date the deemed dividend occurs and then protectively withhold that estimated amount so that it has adequate funds for withholding if the position is sold or transferred away before issuer or actual notice is made.⁸³ The IRS has previously issued proposed regulations that generally would permit withholding agents to escrow funds in connection with Code Sec. 302 distributions that could be classified as ordinary distributions, because at the time of such distributions each holder's respective ownership interest may be uncertain.⁸⁴

Modifying the Timing of Withholding Rules or Example 3 so that the withholding agent's obligation to withhold only arises with respect to positions held on or after the date notice is made would seem to create a risk of potential abuse. Holders with actual knowledge could avoid withholding tax by transferring or disposing positions giving rise to deemed distributions in advance of reported issuer notice or actual knowledge of the custodian (*i.e.*, a race to sell before issuer notice).⁸⁵

The Timing of Withholding Rules has also been criticized in commentary in several other respects. Unlike the Code Sec. 871(m) Regulations, if issuer or actual notice is received on or before January 15, the withholding agent must withhold on the related deemed dividends, regardless of whether there is a cash payment or disposition of the stock right or convertible that could be used to fund the withholding tax obligation.⁸⁶ Also, concerns have been raised that the withholding obligation can be triggered without any time to adequately prepare.⁸⁷

Concerns with Reliance on Form 8937 Reporting for Triggering Withholding

The reliance on issuer reporting of deemed distributions pursuant to Code Sec. 6045B of the cost basis reporting law seems like a neat and creative solution by the IRS. Moreover, this approach also provides a clear method by which brokers can make cost basis adjustments relating to such events. However, there are some notable concerns.

First, the IRS believes that there is an existing reporting obligation for issuers to report deemed distributions on specified securities because such distributions have a quantitative effect on the basis of such securities.⁸⁸ In other words, the IRS believes that issuers should *already* be reporting such events on Form 8937 and providing the quantitative effect on basis. A query of a database of Form 8937 information reported by issuers of specified securities on public websites results in just a few cases of deemed

distribution reporting since the Proposed 305(c) Regs were published on April 13, 2016.⁸⁹ Even for corporate actions involving stock, which have been subject to Code Sec. 6045B reporting since 2011, there is no comprehensive reporting in compliance with the cost basis rules.⁹⁰ It is unclear if such underreporting is due to lack of awareness or otherwise. Some might question whether or not issuer reporting under Code Sec. 6045B is required for deemed distributions under the existing cost basis regulations; the Proposed 305(c) Regs are not explicit in this regard.⁹¹

Issuers of specified securities regularly assess whether they are subject to Form 8937 reporting pursuant to Code Sec. 6045B and that in certain cases, issuers conclude that such reporting does not apply.⁹² Code Sec. 6045B is triggered in connection with the occurrence of an “organizational action.” It is possible that some issuers or their counsel have concluded that because conversion ratio adjustments generally occur pursuant to the original terms of the related security, that the actual adjustment event is not contempo-

However, it should be noted that similar concerns were raised prior to the enactment of Code Sec. 305(c) in 1969.

aneous with an organizational action that would give rise to a reporting obligation under Code Sec. 6045B.

Finally, it should be noted that the timing of Form 8937 reporting (typically by publication on the issuer’s website) creates challenges for brokers because the rules permit that such reporting can be made up to 45 days after the date of the event or organizational action.⁹³ In fact, Form 8937 reporting on public websites regularly occurs several weeks after the corporate action event date and as late as 45 days later.⁹⁴ There are also frequent occurrences of corrections and revisions to such reporting.

The lack of consistent and immediate reporting of cost basis adjustments by issuers already frustrates brokers. The significant potential financial consequences to withholding agents of timely assessing deemed distributions and withholding the necessary amounts would appear to put additional stress on reliance on issuer reporting.⁹⁵ As a practical matter, the potential triggering of an actual withholding obligation under the Proposed 305(c) Regs based on when the issuer reports a deemed distribution places pressure on all affected withholding agents to monitor and assess the consequences of such reporting the same day it is made.

Concerns with Actual Knowledge for Triggering Withholding

Under the Notice or Actual Knowledge Withholding Trigger Rule, a withholding agent’s withholding obligation for a deemed distribution can be triggered when “[t]he withholding agent has actual knowledge of the deemed distribution . . .”⁹⁶ This trigger necessitates scrutiny of the circumstances under which “actual knowledge” by the withholding agent can arise.

Concerns have been raised as to whether knowledge of a deemed distribution by a trader on a trading desk for convertible bonds at a global brokerage firm results in actual knowledge attributable to the firm’s custodial business for purposes of the taxpayer’s withholding obligation under the Notice or Actual Knowledge Withholding Trigger Rule.⁹⁷ Moreover, like many businesses, custodians and other financial intermediaries conduct a wide range of business activities organized into different departments that are often located in multiple geographic locations.

It seems inappropriate that a custodian who is more diligent or proactive than others should be treated as having actual knowledge that accelerates such custodian’s withholding obligation for a deemed distribution.⁹⁸ Such treatment would put a custodian at a competitive disadvantage in maintaining business with non-U.S. persons.

Treatment of Deemed Distributions for Substitute Dividend Payment Purposes

In securities lending or sale-repurchase transactions involving securities, the lender or transferor wants to be compensated for interest, dividend or other types of payments that could arise on the subject security while it is lent or held away, and the contract terms generally require equivalent amounts to such payments to be made to the lender or seller. These amounts are generally referred to as “substitute payments.” Reg. §1.861-3(a)(6) provides that substitute dividend payments are sourced the same as the related actual dividend on the lent or transferred security. The Proposed 305(c) Regs clarify that deemed distributions are also subject to this sourcing rule and are described as a “deemed payment.”⁹⁹

In other words, if a convertible debt or stock or stock right or warrant subject that can give rise to a deemed distribution is part of a securities lending or sale-repurchase transaction, and a deemed distribution arises during the term of such transaction, such

distribution gives rise to a deemed payment. Thus, a withholding agent could be responsible for withholding relating to such deemed payments. The Notice or Actual Knowledge Withholding Trigger Rule and the Timing of Withholding Rules specifically provide that they apply to deemed payments.¹⁰⁰

Reliance on Issuer Reporting, Control and Knowledge; Adjustments for Over- and Under-Withholding

In general, the Proposed 305(c) Regs provide that a withholding agent (other than the issuer of the specified security) may rely on the information reported by an issuer (for example, pursuant to providing Form 8937 on its public website) unless it knows that such information is incorrect or unreliable.¹⁰¹

The Proposed 305(c) Regs clarify the “control or custody and knowledge” requirement applicable to withholding agents under Code Sec. 1441.¹⁰² Importantly, the proposed changes provide that a withholding agent that directs another, such as a paying agent, to make payments to the withholding agent’s account holders, is considered as retaining control for purposes of such requirement.¹⁰³ The Proposed 305(c) Regs further provide that a withholding agent does not lack knowledge merely because it does not know the character or source of a payment for U.S. tax purposes.¹⁰⁴

The Proposed 305(c) Regs also make clear that a “... withholding agent may satisfy the tax from property it holds in custody for the beneficial owner, property over which it has control, or additional contributions of property from the beneficial owner.”¹⁰⁵ The proposed regulations also clarify that a withholding agent may adjust its under-withholding (and will not be subject to any related penalties or additions to tax) “... if it timely deposits the amounts that it withholds from future payments, proceeds from the liquidation of property, or additional contributions of property obtained directly or indirectly from the beneficial owner.”¹⁰⁶ It should be noted that although these clarifications are intended to provide the withholding agent with adequate funds to satisfy its withholding obligation on deemed dividends, it would seem that permitting the withholding agent to estimate and withhold amounts at the time of the deemed dividend (rather than waiting until issuer or actual notice) would provide a process that would benefit the fisc by increasing the likelihood of adequate withholding for withholding agents, given the risk of a springing withholding obligation as discussed earlier.¹⁰⁷

Coordination with Code Sec. 871(m)

The Proposed 305(c) Regs provide only one explicit point of interaction of their deemed distribution determination and withholding tax rules with the final Code Sec. 871(m) regulations published on September 18, 2015 (T.D. 9734, the “Final 871(m) Regs”) and their rules relating to “dividend equivalent amounts.”¹⁰⁸ As noted in the preamble to the Final 871(m) Regs, the IRS did not believe that rights to acquire stock that could give rise to Code Sec. 305(c) deemed distributions would generally be simultaneously subject to Code Sec. 871(m) because a simple contract governed by the Final 871(m) Regs is only included if it has a delta of 0.8 or greater “... when the ELI [equity linked instrument] is issued ...” and it is generally believed that convertible bonds, stocks and other rights to acquire stock have a delta that is much lower than this threshold at the time such bonds, stocks and rights are issued. Therefore, such instruments generally would not be subject to Code Sec. 871(m) as well as the Proposed 305(c) Regs.¹⁰⁹

The Final 871(m) Regs do contemplate that a convertible bond or other security could give rise to both a deemed dividend under Code Sec. 305(c) and a dividend equivalent under Code Sec. 871(m), as the regulations provide that a dividend equivalent amount (under the Final 871(m) Regs) is reduced by the amount of the deemed distribution (under the Proposed 305(c) Regs) relating to the same underlying dividend.¹¹⁰

Proposed Effective Date of the Proposed 305(c) Regs

In general, the Proposed 305(c) Regs provide that the regulations would be prospectively effective on or after the date on which final regulations are published.¹¹¹ Importantly, the Proposed 305(c) Regs permit a taxpayer to rely on the proposed regulations for deemed distributions before such final publication date and further permit deemed distributions to be calculated under either of two methods—1) by treating the distribution as a distribution of a right to acquire stock (and the amount of the deemed distribution would be based on the incremental fair market value of such right as provided under the proposed regulations) or 2) by treating the distribution as a distribution of the actual stock to which the right relates (and the amount of the deemed distribution would be based on the fair market value of such actual stock).¹¹² Explicit guidance on permitted methods prior to the publication of final regulations seems to make good sense because it provides clear

interim guidance that should minimize IRS and taxpayer disputes. However, there are concerns that some taxpayers may have been determining the amount of deemed distributions prior to the publication of the Proposed 305(c) Regs in manners that do not comport with either of the two permitted methods and that they may need to prospectively change their method to a permitted method under the proposed regulations.¹¹³

Conclusion

For financial industry participants that had advocated that the IRS exempt conversion ratio adjustments from deemed dividend treatment, the Proposed 305(c) Regs are distressing and there are continued requests and comments that the rules be withdrawn or that the rules should not apply to convertible bonds and stock. However, it should be noted that similar concerns were raised prior to the enactment of Code Sec. 305(c) in 1969. Comments and concerns continue to be expressed regarding the method

of valuing the amount of a deemed distribution with respect to a right to acquire stock. There are also mechanical concerns with the timing of withholding and notice of deemed distributions under the proposed regulations. There is concern that threshold-based issuer reporting of conversion ratio adjustments may not reflect the timing of legal entitlement for certain convertible instruments. It also does not seem fair that the actual knowledge trigger could result in a comparative disadvantage for diligent withholding agents. Arguably, the reliance on Form 8937 reporting is flawed. Some may see these new rules as simply another source of income and withholding burdens without cash, adding to the existing compliance burdens around dividend equivalent amounts under Code Sec. 871(m), while the IRS believes it is simply providing clarifying and appropriate revisions to long-standing guidance previously issued under Code Sec. 305(c) that is pursuant to an explicit legislative mandate. Regardless, there remain several thorny issues that must be resolved before final regulations are issued.

ENDNOTES

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¹ REG: 133673-15, 81 FR 21,795 (Apr. 13, 2016).

² The preamble to the Proposed 305(c) Regs notes the lack of clarity regarding the proper method of calculating the actual amount of a deemed dividend under the currently effective regulations. Therefore, until new final regulations have been published, the IRS will not challenge valuation that values the deemed distribution as a distribution of actual stock, following prior published letter rulings, or as a distribution of a right to acquire the stock, the method in the Proposed 305(c) Regs. REG: 133673-15, 81 FR 21,797 (Apr. 13, 2016).

³ See, e.g., *Firm Cites Need for Clear Guidance on Convertible Bonds*, 2016 TAX NOTES TODAY 3-15 (Jan. 6, 2016), *Firm Raises Issues With Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 149-19 (Aug. 3, 2016).

⁴ This argument is discussed in the New York State Bar Report. See, e.g., *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 11 (Aug. 11, 2016).

⁵ This argument has been raised in many comments on the Proposed 305(c) Regs. See, generally, *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 20 (Aug. 11, 2016), *JCI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 10 (Aug. 12, 2016).

⁶ See, e.g., discussion in *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16 (Aug. 11, 2016).

⁷ *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20 (July 6, 2016).

⁸ See, e.g., *Group Criticizes Treatment of Conversion Adjustments on Convertibles*, 2015 TAX NOTES TODAY 88-19, at 2 n.3 (May 7, 2015). In a letter dated January 15, 2015, replying to the December 18, 2014, letter from the U.S. Chamber of Commerce, the IRS stated that "[s]ection 305 and its regulations are one of the more static areas of corporate tax law. We issued the regulations on convertible securities over 40 years ago. They remain the current law and reflect our position." See CCMC-Economic Policy Joint Letter to the IRS on Potential Reinterpretation of Code Sec. 305(c), at 8, available online at www.uschamber.com/sites/default/files/documents/files/2015-9-8-irc-305-c-reinterpretation-letter.pdf. T.D. 7281, 38 FR 18,531 (July 12, 1973). The regulations were amended in 1974 (T.D. 7329, 39 FR 66134) and 1995 (T.D. 8643, 60 FR 66134). T.D. 8643 updated Reg. §§1.305-3, 1.305-5 and 1.305-7 with respect to treatment of redemption premiums for certain preferred stock and provided examples clarifying the same.

⁹ H.R. Rep. 91-413 (Part 1) at 114 (Aug. 2, 1969).

¹⁰ Some have argued that these rulings are distinguishable because the rulings related to real estate investment trusts, which are subject to special dividend distribution requirements under Section 856 but they all related to the application of rules of Subchapter C which apply more broadly. See, e.g., *Group Criticizes Treatment of Conversion Adjustments on Convertibles*, 2015 TAX NOTES TODAY 88-19, at 2 n.3 (May 7, 2015).

¹¹ The Proposed 305(c) Regs include a series of provisions that are generally intended to provide similar rules for the FATCA related withholding requirements of Chapter 4, but they are not discussed in this article. See Proposed Reg. §§1.1471-2(a)(4)(i)(A) through (D) and 1.1473-1(a)(2)(vii)(A) and (d)(7).

¹² This assumption is a simplifying convention because it is not common for convertible instruments to be issued with option valuations at or near the money.

¹³ The ability to exercise the conversion option without limitation throughout the 20-year term is a simplifying convention for this example. It should be noted that convertible instruments often have restrictions on exercise rights.

¹⁴ See Reg. §1.1275-7.

¹⁵ S. Rep. No. 91-552 at 150-151 (Nov. 21, 1969).

¹⁶ *Id.*, at 151.

¹⁷ *General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-172*, at 133. Washington: U.S. Government Printing Office. December 3, 1970. The amended Section 305(b) lists a variety of situations to be treated as dividends.

¹⁸ *Id.*, at 135.

¹⁹ *Id.* Sections 305(b) and (c), and the attendant regulations, have remained mostly unchanged until the recent proposed regulations. Successive rulings, both public and private, illustrate a consistent position regarding deemed dividends triggered by conversion rate adjustments.

²⁰ H.R. Rep. 91-413 (Part 1) at 114 (Aug. 2, 1969). Some methods of increasing the proportionate interest of a shareholder listed were "increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock, by decreasing the ratio at which other stock, convertible securities, or rights to stock can be converted into stock of the class he owns, or by the systematic redemption of stock owned by other shareholders."

²¹ During the legislative process leading to the enactment of the Tax Reform Act of 1969, the Senate committee received comments that included challenges to the propriety of treating conversion ratio adjustments as giving rise to deemed dividends to holders of convertibles or to holders of common. Testimony to be Received Thursday, September 18, 1969, on Tax Reform Act of 1969, H.R. 13270 Before the S. Committee on Finance, 91st Congress 149-183 (Statement of Glen McDaniel Opposing Certain Aspects of Section 421 of H.R. 13270). The idea of treating the holders of convertible bonds as actual shareholders was challenged, in part, because the embedded conversion right may never be exercised: "Although a strong case can be made against the reinstatement of the proportional interest test, it is argued by some that such reinstatement is justified as an effort to extend the exception in existing law which taxes a common shareholder on his stock dividend if he has an election between cash and stock. Section 421 [amending Sec. 305] would accomplish this by inhibiting the creation of two classes of common stock, one paying cash and the other stock but both participating alike in equity growth and equity decreases. Even if it is assumed that such an extension of the present law is desirable, Sec. 421 is a gross example of 'overkill' in treating convertible preferred stock and indebtedness as common stock. A preferred stock, or a bond, or a debenture, even if convertible into common stock, is not common stock and may never become common stock." *Id.*, at 155.

²² Reg. §1.305-7(a).

²³ Reg. §1.305-7(b)(1).

²⁴ *Id.*

²⁵ Rev. Rul. 75-513, 1975-2 CB 114 (Jan. 1, 1975).

²⁶ Section 305(d) has remained relatively unchanged since its addition to the Code as part of P.L. 91-172 in the Tax Reform Act of 1969. Reg. §1.305-3(d)(2) has remained unchanged since its amendment through T.D. 7281 in 1973.

²⁷ Rev. Rul. 76-186, 1975-2 CB 114 (Jan. 1, 1975) provided guidance as to the dividend characterization of a deemed distribution resulting from a corporation's annual January 31 conversion

rate adjustment with respect to outstanding convertible debentures. Rev. Rul. 76-186 holds that the deemed distribution was taxable as a dividend and further holds that a holder's basis in the debentures increased by the fair market value of the deemed distribution, as provided in Section 301(d)(1) and Reg. §1.301-1(h). Rev. Rul. 83-42, 1983-1 CB 76 (Jan. 1, 1976) clarifies the differing consequences of a conversion ratio adjustment versus an actual distribution of stock to holders of convertible preferred stock made as a result of a nontaxable stock dividend to common stockholders of the same corporation. Because the distribution of common stock to a preferred stockholder does not qualify as nontaxable pursuant to Section 305(b)(4), Rev. Rul. 83-42 holds that such distribution is a taxable dividend to the holders of convertible preferred stock—even though it was intended to provide anti-dilution protection to such holders (although a conversion ratio adjustment would have not resulted in a taxable distribution under the anti-dilution provision of Section 305(b)(4)). See also LTR 201247004 (letter ruling dated Aug. 22, 2012); LTR 201446013 (letter ruling dated Nov. 25, 2013); LTR 200615024 (letter ruling dated Jan. 10, 2006); LTR 7308310670A (letter ruling dated Aug. 31, 1973). Because these private letter rulings involved REITs, the taxpayers presumably wished to obtain certainty regarding the computation of their respective dividends paid deductions, or as in this case, a pre-REIT conversion required purging of pre-conversion earnings and profits.

²⁸ Proposed Reg. §§1.871-14, 15, 1.1441-1, 2, 3, 7, REG-120282-10, 78 FR 73,128 (Dec. 5, 2013). On the problem of the interaction, the NYSBA report stated, in part, "The [305(c)] Proposed Regulations provide that a payment pursuant to a section 871(m) transaction is not a dividend equivalent to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305. [citation omitted] The application of this rule raises many questions, as the circumstances giving rise to a deemed dividend under sections 305 and 871(m) are not the same. Among other matters, a section 305 dividend is equal to the value of the deemed distribution and is not determined by reference to delta; and in the case of a convertible bond or option with dividend adjustment provisions, a section 305 dividend arises at the time of an adjustment to the instrument's conversion ratio to reflect the payment of a dividend on the issuer's common stock, rather than on the record or ex-dividend date for the related dividend." *NYSBA Tax Section Comments on Proposed Dividend Equivalent Regs*, 2014 TAX NOTES TODAY 98-20 (May 21, 2014).

²⁹ *Group Criticizes Treatment of Conversion Adjustment on Convertibles*, 2015 TAX NOTES TODAY 88-19 (May 7, 2015), *Transparency Needed for Rules That Could Hurt Convertibles*, 2016 TAX NOTES TODAY 8-42 (Jan. 13, 2016).

Apparently, the IRS had recently begun examining whether withholding agents had been withholding on deemed distributions relating to convertible instruments.

³⁰ Proposed Reg. §1.305-1(d)(5).

³¹ Proposed Reg. §1.305-1(d)(6).

³² Proposed Reg. §§1.305-1(d)(3) and (d)(3)(iv).

³³ Proposed Reg. §1.305-1(d)(3)(i).

³⁴ Proposed Reg. §1.305-1(d)(3)(iii).

³⁵ Proposed Reg. §1.305-1(d)(3)(iv).

³⁶ Proposed Reg. §1.305-1(d)(3)(ii). This article intentionally omits a discussion of the historical expansion of Subchapter C concerning stock rights.

³⁷ See, e.g., discussion in *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 15 (Aug. 11, 2016).

³⁸ The NYSBA Report raises an excellent concern regarding the extent to which to definition of stock right for Section 305(c) purposes should be expanded to cover related entities. See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 17 (Aug. 11, 2016).

³⁹ Proposed Reg. §1.305-1(d)(7).

⁴⁰ Proposed Reg. §1.305-1(d)(7)(i) and (ii).

⁴¹ Proposed Reg. §1.305-7(a).

⁴² Proposed Reg. §1.305-7(c)(1).

⁴³ *Id.*

⁴⁴ Proposed Reg. §1.305-7(c)(2).

⁴⁵ Proposed Reg. §1.305-7(c)(3).

⁴⁶ Proposed Reg. §1.305-7(c)(3). Note that the limitation of the scope of the "bona fide adjustment formula" exception to exclude from eligibility adjustments for distributions taxable as dividends also exists under existing Reg. §1.305-7.

⁴⁷ Final Reg. §1.305-3(e).

⁴⁸ See Proposed Reg. §1.305-3(e), Examples (6) and (7).

⁴⁹ Proposed Reg. §1.305-7(c)(4)(i).

⁵⁰ Lee A. Sheppard, *No Safe Harbor Guidance on Deemed Distributions*, 2016 TAX NOTES TODAY 89-10, at 2 (May 9, 2016).

⁵¹ This conclusion was supported by an analysis of rights valuations relating to conversion rate adjustment events occurring during February, 2016. See also *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 8 (Aug. 12, 2016). This conclusion is consistent with a reference by Treasury Senior Counsel Karl Walli that mini-options would have values close to actual dividend amounts. See discussion in Sheppard, *No Safe Harbor Guidance on Deemed Distributions*, 2016 TAX NOTES TODAY 89-10, at 2 (May 9, 2016).

⁵² Proposed Reg. §1.305-7(c)(4)(ii).

⁵³ Proposed Reg. §1.305-7(c)(4)(iii)(A).

⁵⁴ Proposed Reg. §1.305-7(c)(4)(iii)(B).

⁵⁵ See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 20 (Aug. 11, 2016) and *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY

156-13, at 10 (Aug. 12, 2016). Note that the author raised the acceptability of such a method with government panelists in a discussion of the Proposed 305(c) Regs and they indicated that such a method was not acceptable. See discussion in Sheppard, *No Safe Harbor Guidance on Deemed Distributions*, 2016 TAX NOTES TODAY 89-10 (May 9, 2016).

⁵⁶ Stock volatility and other events such as corporate actions impact option valuations under all methods of option valuation, and yet simple and complex derivatives and structured products that involve embedded options or forward contracts are routinely issued and bought and sold in the financial markets. After the Proposed 305(c) Regs were issued, a team from the Wolters Kluwer Corporate Actions Suite obtained and compared valuations by reference data providers, and the valuations were generally comparable.

⁵⁷ See Sheppard, *No Safe Harbor Guidance on Deemed Distributions*, 2016 TAX NOTES TODAY 89-10, at 2 (May 9, 2016).

⁵⁸ Proposed Reg. §1.305-7(c)(5). Note that concerns have been raised that because the deemed distribution is treated as occurring "... in no event later than the date of the distribution of cash or property that results in a deemed distribution ...," this aspect of the timing of deemed distributions could be challenging for regulated investment companies. See *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 11 (Aug. 12, 2016).

⁵⁹ *Id.*

⁶⁰ Proposed Reg. §1.305-7(c)(6).

⁶¹ Proposed Reg. §1.305-7(d).

⁶² *Id.*

⁶³ Proposed Reg. §1.305-7(d)(2).

⁶⁴ For example, here is an excerpt from an actual conversion ratio adjustment provision: "No adjustment in the Conversion Rate shall be required unless such adjustment would require an increase or decrease of at least 1% in the Conversion Rate as last adjusted; *provided, however*, that any adjustments which would be required to be made but for this Section 13.08(a) shall be carried forward and taken into account in any subsequent adjustment *and any carry forward amount shall be paid to the Holder upon conversion regardless of the 1% threshold*" (*bold italics added for emphasis*). See Indenture to the Greenbrier Companies, Inc. 3.5 percent Convertible Senior Notes due 2018 at 58, dated April 5, 2011. See also, e.g., Indenture to Jarden Corporation 11/8% Senior Subordinated Convertible Notes due 2034 at 76, dated March 17, 2014 ("No adjustment pursuant to this Section 10.04 shall be made to the Conversion Rate unless such adjustment would require a change of at least 1% in the Conversion Rate then in effect at such time. However, any adjustments that are less than 1% of the Conversion Rate shall be carried forward and taken into account in any subsequent adjustment, regardless of whether the aggregate

adjustment is less than 1%, (i) annually on the anniversary of the first date of original issuance of the Notes and (ii) *otherwise (A) upon conversion of any Notes ...*" (*bold italics added for emphasis*); Indenture to Redwood Trust, Inc. 4.625 percent Convertible Senior Notes due 2018 at 26, dated March 6, 2013 ("If any adjustment of the Conversion Rate is less than 1% of the applicable Conversion Rate, such adjustment will be carried forward ... *provided, however*, that any carried forward adjustment will be made upon conversion of any Note ...").

Note that under the terms of some convertibles, cumulative carried forward adjustments under the one-percent threshold are instead applicable upon a specified date each year (such as the anniversary of issue) or under certain other limited conditions defined in the indenture documents (such as fundamental change make-whole clauses, observation periods for mandatory settlement, etc.).

⁶⁵ Note that in actual marketplace indentures, the cash dividend threshold and the relevant share price can be (and often are) more complicated to calculate. Complicating factors can include rolling averages of share prices over various time periods and annual or semi-annual cash dividend thresholds, or cash dividend thresholds that themselves reference averages of the share price of the underlying equity. Furthermore, while this is one common adjustment formula, there are others in use.

⁶⁶ See Sections 852(a)(1)(A) and 857(a)(1)(A). RICs must also generally timely distribute 98 percent of specified taxable income in order to avoid an excise tax under Section 4982. Note that the withholding tax rules of the Proposed 305(c) Regs that link a reporting obligation of a withholding agent to the receipt of issuer or actual notice do not apply for purposes of determining the timing of income recognition by U.S. taxpayers or for information reporting purposes. The timing of deemed dividends can be a significant concern for RICs and REITs. See, e.g., *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 10 (Aug. 12, 2016).

⁶⁷ See, e.g., *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 5-6 (July 6, 2016); *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 25-27 (Aug. 11, 2016); and *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 2-8 (Aug. 12, 2016).

⁶⁸ REG: 133673-15, 81 FR 21,800 (Apr. 13, 2016).

⁶⁹ REG: 133673-15, 81 FR 21,798 (Apr. 13, 2016).

⁷⁰ Proposed Reg. §1.1441-2(d)(1)(ii)(B) provides that the "control or custody and knowledge" exception from withholding does not generally apply to a deemed distribution of stock or a right to acquire stock, subject to a limited exception as described in the text of this article.

⁷¹ Proposed Reg. §1.1441-2(d)(4)(i). The Invest-

ment Company Institute has submitted comments to the IRS advocating a similar timing rule for income recognition. See *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 2-8 (Aug. 12, 2016).

⁷² P.L. 110-343.

⁷³ See Section 6045(g)(3)(B) and Reg. §1.6045-1(a)(14). The NYSBA recommends possibly expanding the scope of securities defined as specified securities under the cost basis reporting regulations to include derivatives that do not currently fall within the classic definition of a stock right. However, their report does not address whether such additional securities should also be subject to cost basis reporting and how brokers would compute cost basis (including addressing questions such as how the needed terms of such securities would be obtained or the certainty of applicable tax rules that would impact cost basis computations). See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 15 (Aug. 11, 2016).

⁷⁴ See generally, Reg. §1.6045B-1 and IRS Form 8937 and the related instructions.

⁷⁵ Although one of the holdings of Rev. Rul. 76-186 discussed above provides that there is a basis adjustment to a convertible debenture due to a conversion ratio adjustment, citing Section 301(d) and Reg. §1.301-1(h), the referenced authorities do not explicitly provide so. Nevertheless, it seems clear that such an adjustment should be made in order to prevent potential double taxation when such stock or right is sold. It should be noted, however, that under cost basis reporting regulations currently applicable to brokers, basis adjustments relating to deemed distributions are not explicitly required to be made if issuer reporting pursuant to Sec. 6045B was not made. See generally, Reg. §1.6045-1. See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 24 (Aug. 11, 2016).

⁷⁶ Proposed Reg. §1.6045B-1(i).

⁷⁷ Proposed Reg. §1.1441-2(d)(4)(ii).

⁷⁸ *Id.* A joint comment letter from the industry has suggested changes to the Timing of Withholding Rules, specifically requesting that "[w]ithholding agents should be permitted to withhold as soon as a deemed distribution or an 'approximate' deemed distribution ... is known, i.e., earlier than the earliest of the above dates." *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 2 (July 6, 2016).

⁷⁹ Proposed Reg. §1.1441-2(d)(4)(ii). Note that the proposed regulations provide an exception regarding the time to withhold for partnerships and trusts as cross-referenced to Reg. §1.1441-5.

⁸⁰ Proposed Reg. §1.1441-2(d)(4)(iii).

⁸¹ *Id.*

⁸² The requirement for withholding no later than the nonextended due date of Form 1042 for the

calendar year of the deemed distribution under the Proposed 305(c) Regs creates an earlier withholding obligation than can arise under the final Section 871(m) regulations (which do not include such a provision). Compare Proposed Reg. §1.1441-2(d)(4) with Reg. §1.1441-2(e)(8). This requirement creates a risk of underwithholding depending on the amount and timing of the deemed distribution relative to any annual cash payment on the right to acquire stock.

⁸³ As noted above, several financial institutions recommended that withholding agents be permitted to withhold as soon as an approximate deemed dividend is known. See *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 2-3 (July 6, 2016).

⁸⁴ See Proposed Reg. §1.1441-3(c)(5), REG: 140206-06, 72 FR 58,781 (Oct. 17, 2007).

⁸⁵ Making the withholding agent who receives a specified security giving rise to a deemed distribution responsible for withholding on a deemed distribution which occurs before such agent receives the position does not seem ideal either. This approach is one of the potential changes to the Proposed 305(c) Regs recommended in the NYSBA's comments concerning the Proposed 305(c) Regs. See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 38 (Aug. 11, 2016).

⁸⁶ See *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 3-4 (July 6, 2016).

⁸⁷ See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 33-34 (Aug. 11, 2016).

⁸⁸ See discussion of Rev. Rul. 76-186 at note 27. *But see* discussion at note 75.

⁸⁹ Wolters Kluwer offers a product called CISR 8937 that provides customers with access to this database. Through August 2016, a separate Wolters Kluwer product, called 305C Alert, has monitored over 700 potential deemed dividend events affecting underlying equities of convertible instruments that could give rise to conversion rate adjustments. The product shows roughly 335 conversion rate adjustments with potential associated deemed dividends as a result of these events for which only 10 associated Form 8937s have been located to date. It has also been suggested that a single person or repository should be responsible for making issuer reporting pursuant to Section 6045B publicly available. *NYSBA Members*

Submit Report on Deemed Stock Distribution Regs, 2016 TAX NOTES TODAY 155-16, at 30 n. 93 (Aug. 11, 2016). This recommendation was previously raised with regard to Section 6045B reporting when proposed regulations relating to cost basis reporting were released and was rejected by the IRS in connection with the promulgation of final cost basis reporting regulations. T.D. 9504, 75 FR 64,082 (Oct. 18, 2010).

⁹⁰ Wolters Kluwer's Capital Changes product comprehensively tracks corporate actions involving publicly held stock and has observed that Form 8937s are often not posted for corporate actions that would otherwise seem to require them.

⁹¹ REG: 133673-15, 81 FR 21,800 (Apr. 13, 2016). However, the instructions of Form 8937 explicitly state that conversion rate adjustments should be reported on this form (Rev. Sept. 2015).

⁹² This awareness is based on experience from many inquiries by the Wolters Kluwer CISR 8937 product team to issuers after corporate actions are reported in public news releases when they attempt to verify or obtain specific tax attributes of such events.

⁹³ Reg. §1.6045B-1(a)(2)(i). There are also concerns about the prompt "downstream" transfer of Form 8937 information from the recordholder of the security to the applicable withholding agent. *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 30 (Aug. 11, 2016).

⁹⁴ Based on the experience of the Wolters Kluwer CISR 8937 product team. In some instances, the forms are available later than the 45-day deadline.

⁹⁵ One industry comment letter from several large withholding agents noted the potential difficulty with a withholding obligation arising in January of the year following the event, particularly where the securities subject to the deemed distributions have been sold or transferred. See *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 4 (July 6, 2016).

⁹⁶ Proposed Reg. §1.1441-2(d)(4)(i)(B).

⁹⁷ The NYSBA echoes these concerns as to precisely what constitutes actual knowledge, particularly in the context of a large organization, and has requested further clarification from the IRS. See *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 155-16, at 33

(Aug. 11, 2016). See also *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 1-2 (July 6, 2016).

⁹⁸ See *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 4 (July 6, 2016).

⁹⁹ Proposed Reg. §1.861-3(a)(6).

¹⁰⁰ Proposed Reg. §1.1441-2(d)(4)(i) and (ii).

¹⁰¹ See Proposed Reg. §§1.1441-3(c)(5) and 1.1441-7(a)(4). Notably, this rule does not apply to the issuer of the specified security.

¹⁰² Proposed Reg. §1.1441-2(d)(1). The preamble to the Proposed 305(c) Regs explains that these revisions are intended to make these specific rules relating to Chapter 3 withholding " ... consistent with similar rules ... " for FATCA under Chapter 4. See REG: 133673-15, 81 FR 21,799 (Apr. 13, 2016).

¹⁰³ Proposed Reg. §1.1441-2(d)(1)(v).

¹⁰⁴ *Id.*

¹⁰⁵ Proposed Reg. §1.1461-2(b).

¹⁰⁶ *Id.*

¹⁰⁷ See *Financial Institutions Comment on Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 129-20, at 2 (July 6, 2016).

¹⁰⁸ Proposed Reg. §1.305-7(f). REG: 133673-15, 81 FR 21,804 (Apr. 13, 2016).

¹⁰⁹ See, e.g., Reg. §1.871-15(e)(1) and preamble discussion of the Final 871(m) Regs relating to convertible bonds, T.D. 9734, 80 FR 56,869 (Sept. 18, 2015). Note, however, that the reissuance of a convertible bond, stock or stock right or warrant would require a new analysis of delta as of the reissue date under Reg. §1.871-15 and upon such occurrence, there might be a greater risk that the delta as of such date would equal or exceed 0.8. See Reg. §§1.871-15(g)(2) and 1.871-15(a)(6).

¹¹⁰ Reg. §1.871-15(c)(2)(ii) and discussion in preamble to the Final 871(m) Regs. *Id.*

¹¹¹ See discussion in preamble to the Proposed 305(c) Regs, REG: 133673-15, 81 FR 21,800 (Apr. 13, 2016) and Proposed Reg. §§1.305-1(e), 1.305-3(f), 1.305-7(g), 1.861-3(d), 1.1441-2(f), 1.1441-3(c)(5)(ii), 1.1441-7(a)(5), 1.1461-2(d), 1.1471-2(c), 1.1473-1(f) and 1.6045B-1(i)(4).

¹¹² Proposed Reg. §1.305-7(g).

¹¹³ Concerns have been raised whether changing the manner of computing and reporting deemed distributions constitutes a change in accounting method for tax purposes. See *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 9 (Aug. 12, 2016).

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