

MEMO# 29836

April 14, 2016

IRS Issues Proposed Regulations on Deemed Distributions Under Section 305(c)

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TO: TAX MEMBERS No. 8-16

ICI GLOBAL TAX COMMITTEE No. 8-16 RE: IRS ISSUES PROPOSED REGULATIONS ON DEEMED DISTRIBUTIONS UNDER SECTION 305(C)

The Internal Revenue Service (“IRS”) and the Treasury Department have issued [proposed regulations](#) addressing deemed distributions under section 305(c) of the Internal Revenue Code. The Institute, the Managed Funds Association (MFA), and the Securities Industry and Financial Markets Association (SIFMA) previously requested guidance addressing various issues arising under section 305(c) with respect to convertible debt securities. [\[1\]](#)

The proposed regulations set forth rules that would address: (i) the amount and timing of deemed distributions under section 305(c); (ii) withholding under Chapters 3 and 4 of the Internal Revenue Code on such deemed distributions; and (iii) issuer reporting of such deemed distributions under section 6045B.

Amount and Timing of Deemed Distributions

The proposed regulations set forth rules regarding the amount and timing of deemed distributions under section 305(c). First, the proposed regulations would amend the definitions under Treas. Reg. § 1.305-1. The proposed regulations thus would provide that “stock” means actual stock (stock issued by a corporation) or a right to acquire stock. The term “right to acquire stock” would include, among other things, a right of a holder of a convertible instrument (including a debt instrument that is convertible into shares of stock) to convert the instrument into one or more shares of stock of the corporation issuing the instrument. A “deemed distribution” would mean a transaction or event, other than an actual distribution of cash or property, that constitutes a distribution under section 305(b) and (c).

The proposed regulations also would amend the regulations under Treas. Reg. § 1.305-7 to clarify when there has been an applicable adjustment that results in a deemed distribution. An “applicable adjustment” would mean an adjustment to a right to acquire stock,

including, among other things, an increase in the conversion ratio or a reduction in the conversion price of a convertible instrument. The proposed regulations then would amend the current regulations to clarify that an applicable adjustment is treated as a distribution of stock to which sections 305(b) and 301 apply if such transaction increases a shareholder's proportionate interest in the assets or earnings and profits of the corporation deemed to make such distribution, and the distribution has the result described in section 305(b)(2), (3), (4) or (5). The proposed regulations would provide that, with respect to a convertible instrument, an increase in the conversion ratio or the number of shares of stock to be received upon conversion or a reduction in the conversion price could have this effect on the deemed shareholder's proportionate interest. Additionally, a reduction in the conversion ratio or in the number of shares to be received upon conversion, or an increase in the conversion price, also could result in a deemed distribution of stock to an actual shareholder.

The proposed regulations would provide an exception to these rules. 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 which prevents dilution of the proportionate interest of the holders of actual stock or rights to acquire stock, would not result in a deemed distribution of stock. An applicable adjustment that is made to compensate for a cash or property distribution to another shareholder generally would not be made pursuant to a bona fide adjustment formula.

Amount of Deemed Distribution

The proposed regulations would provide that the amount of a deemed distribution to a deemed shareholder (e.g., the holder of convertible debt) due to an applicable adjustment is the excess of:

- A. The fair market value of the right to acquire stock held by the deemed shareholder immediately after the applicable adjustment, over
- B. The fair market value, determined immediately after the applicable adjustment, of such right to acquire stock as if no applicable adjustment had occurred.

In determining the fair market value of a right to acquire stock, any particular facts pertaining to the deemed shareholder, including the number of rights or shares such deemed shareholder owns, would be disregarded. Further, any value or reduction in value attributable to the possibility of future applicable adjustments that may result from actual or deemed distributions would not be taken into account.

Timing of Deemed Distribution

Under the proposed regulations, a deemed distribution would occur at the time that the applicable adjustment giving rise to the deemed distribution occurs, in accordance with the instrument that sets the terms of the right to acquire stock. In no event would the deemed distribution be treated as occurring later than the date of the distribution of cash or property that results in the deemed distribution. With respect to a right to acquire publicly traded stock, if the instrument setting forth the terms of such right does not provide a date and time for the applicable adjustment, the deemed distribution would be treated as occurring immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution. With respect to a right to acquire non-publicly traded stock, if the instrument does not provide a date and

time for the applicable adjustment, the deemed distribution would occur on the date that a holder is legally entitled to the distribution of cash or property that results in the deemed distribution.

Effective Date

The proposed regulations regarding the amount and timing of deemed distributions under section 305(c) would apply to deemed distributions occurring on or after the date that final regulations are published in the Federal Register. A taxpayer may rely upon these proposed regulations, however, for deemed distributions that occur prior to such date. For purposes of determining the amount of deemed distributions occurring prior to the final regulations, a taxpayer may determine the amount of the deemed distribution by treating such distribution either as a distribution of a right to acquire stock or as a distribution of the actual stock to which the right relates.

Withholding on Deemed Distributions

The proposed regulations would amend the regulations under section 1441 to clarify that a withholding agent has an obligation to withhold on deemed distributions under section 305(c). The proposed regulations would provide that an issuer of a security upon which a deemed distribution is made and any person that holds a security on behalf of the beneficial owner, directly or indirectly, or a flow-through entity that owns a security directly or indirectly, is considered to have custody of or control over the deemed distribution made on the security and thus is a withholding agent with respect to the distribution.

The proposed regulations also would provide that a withholding agent (other than the issuer of the specified security) would have an obligation to withhold on a deemed distribution only if, before the due date (excluding extensions) for filing Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, with respect to the calendar year in which the deemed distribution occurred, either: (i) the issuer meets its reporting requirements under section 6045B (as described below); or (ii) the withholding agent has actual knowledge that a deemed distribution has occurred. If the latter applies, the withholding agent's obligation would not arise until January 15 of the year following the calendar year of the deemed distribution.

Under the proposed regulations, a withholding agent would be required to satisfy its withholding obligation by withholding on the earliest of (1) the date on which a future cash payment is made with respect to the security; (2) the date on which the security is sold, exchanged, or otherwise disposed of (including a transfer of the security to another account not maintained by the withholding agent or a termination of the account relationship); or (3) the due date (not including extensions) for filing Form 1042 with respect to the calendar year in which the deemed distribution occurred.

The withholding agent generally would be able to satisfy its withholding obligation by withholding on future cash payments on the security. If the security is disposed of before sufficient cash payments to cover the withholding obligation have been made, the proposed regulations would require the withholding agent to withhold at the time of disposition. Generally, this could be accomplished by withholding on the proceeds from the disposal, liquidating other property held in custody for the beneficial owner, or obtaining other funds directly or indirectly from the beneficial owner.

If the withholding agent cannot timely satisfy its withholding obligation, either because

there are not sufficient future cash payments on the security or because the security has not been disposed of or transferred before the due date for filing Form 1042, the withholding agent would be permitted to apply the current rules under Treas. Reg. § 1.1461-2(b). Pursuant to these rules, the withholding agent can withhold on other cash payments made to the same beneficial owner or by liquidating other property held in custody for the beneficial owner over which it has control. The proposed regulations also would clarify that a withholding agent may obtain additional contributions directly or indirectly from the beneficial owner in order to withhold under these rules.

The proposed regulations would provide that a withholding agent may treat certain foreign entities as assuming primary Chapter 3 withholding responsibilities for a deemed distribution only if: (a) the withholding agent provides the foreign entity with a copy of the issuer statement described under section 6045B within 10 days of the issuer furnishing the statement to the holder of record or its nominee; or (b) the issuer has met the public reporting requirements under section 6045B. The foreign entity would have an obligation to withhold on the deemed distribution only if it receives a copy of the issuer statement or the issuer has met the public reporting requirements by the due date (not including extensions) for filing Form 1042 for the calendar year in which the deemed distribution occurred.

A withholding agent (other than the issuer of the specified security) would be permitted to rely on the information that an issuer provides under section 6045B to determine the proper amount of withholding on a deemed distribution, unless it knows that the information is incorrect or unreliable.

The proposed regulations would make similar changes to the regulations under Chapter 4 for withholding on a deemed distribution that is a withholdable payment.

Issuer Reporting

The proposed regulations would require an issuer to report any deemed distribution under section 305(c) that affects the basis of a specified security, including a deemed distribution resulting from an applicable adjustment, pursuant to section 6045B. Issuers would report such deemed distributions on Form 8937, Report of Organizational Actions Affecting Basis of Securities. Under current law, Form 8937 must be filed with the IRS by the earlier of 45 days after the organizational action or January 15 of the calendar year following the organizational action. The issuer also must send a written statement to holders of the specified security by January 15 of the calendar year following the organizational action. In lieu of filing the issuer return with the IRS and furnishing the written statement to holders, an issuer may post the required information on its public website by the due date for reporting the organizational action to the IRS. These requirements thus would apply to reporting of deemed distributions under section 305(c).

Current law contains an exception to section 6045B reporting for exempt recipients, such as corporations and foreign persons. Further, if an issuer determines that all of its holders are exempt recipients, it is not required to file an issuer return. To facilitate compliance with section 305(c) and the Chapter 3 and 4 withholding requirements, the proposed regulations would eliminate this exemption for section 305(c) deemed distributions only. Thus, an issuer would be required to report any such deemed distributions (either by filing Form 8937 with the IRS and sending statements to all holders, or by using the public reporting option), regardless of whether the holders of the specified security are exempt recipients.

Under the proposed regulations, an issuer would be required to provide, in addition to any other information required under section 6045B: (i) the date of the deemed distribution under section 305(c) as determined in accordance with the proposed regulations; and (ii) the amount of the deemed distribution under section 305(c) as determined in accordance with the proposed regulations.

The mandatory reporting requirement (requiring reporting to all holders, including exempt recipients) would apply to any deemed distribution under section 305(c) occurring on or after the final regulations are published in the Federal Register. [2] For deemed distributions occurring prior to the date of publication of final regulations, an issuer may determine the amount of the deemed distribution by treating such distribution either as a distribution of a right to acquire stock in accordance with the proposed regulations, or as a distribution of the shares of stock that would be received upon exercise of that right.

Securities Lending Transactions and Substitute Dividend Payments

The proposed regulations also would amend Treas. Reg. § 1.861-3 to provide that a deemed distribution under section 305(c) is a substitute dividend payment to which the owner of a transferred security is entitled during the term of a securities lending or sale-repurchase transaction.

Comments Requested

The IRS and the Treasury Department have requested comments on the proposed regulations no later than July 12, 2016. The IRS and the Treasury Department will hold a public hearing on the proposed regulations if they receive a request for one by that same date.

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endnotes

[1] See Institute [Memorandum](#) 28680, dated January 21, 2015.

[2] The IRS takes the position that reporting on deemed distributions under section 305(c) already is required under current law, for deemed distributions that occur after December 31, 2015. See Instructions for Form 8937 (<https://www.irs.gov/pub/irs-pdf/i8937.pdf>).