New York State Bar Association

Tax Section

Report on Proposed Regulations under Section 305(c)

August 10, 2016

Contents

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This report ("**Report**")[1] of the New York State Bar Association Tax Section provides comments on regulations proposed on April 13, 2016 (the "**Proposed Regulations**")[2] concerning deemed distributions with respect to certain instruments under Section 305.[3] The Proposed Regulations provide guidance on the amount and timing for inclusion of a deemed distribution, an issuer's reporting responsibility with respect to a deemed distribution, and the obligations of withholding agents to withhold on these deemed distributions.

This Report is divided into three parts. Part I summarizes our recommendations. Part II provides background on the current law and the Proposed Regulations. Part III contains a more detailed analysis of our observations and recommendations.

I. Principal Recommendations

This report makes the following recommendations:[4]

1. In defining a Stock Right for purposes of Section 305, the final regulations should clarify whether derivative instruments other than options, convertible bonds and convertible stock are covered.

[1] The report was principally drafted by Lucy Farr. Helpful comments were provided by Daniel Breen, Kimberly Blanchard, Peter Connors, Simcha David, Michael Farber, Martin Hamilton, Robert Kantowitz, Stephen Land, David Miller, Michael Schler and Gordon Warnke. The assistance of Elina Khodorkovsky is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] Notice of Proposed Rulemaking, *Deemed Distributions under Section 305(c) of Stock and Rights to Acquire Stock*, REG-133673, 81 Fed. Reg. 21795 (Apr. 13, 2016).

[3] All Section references are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations thereunder.

[4] Capitalized terms used in this summary are defined in Part II below.

2. The final regulations should clarify whether the rules with respect to Deemed Distributions apply to exchangeable debt or other instruments issued by an entity related to the underlying stock issuer.

3. The final regulations should be revised so that the determination of the amount of a Deemed Distribution is based on the value of the entire instrument to which the Stock Right relates, not the embedded Stock Right alone.

4. A Deemed Distribution should not occur before the date of the Applicable Adjustment (or possibly the date the terms of the Applicable Adjustment become fixed).

5. The final regulations should confirm that a Deemed Shareholder has a single basis and holding period in the instrument containing the Stock Right.

6. The final regulations should clarify that Deemed Shareholders of convertible bonds can treat Deemed Distributions as qualified dividend income or as eligible for the dividends-received deduction.

7. Although the Proposed Regulations are relatively clear as to their application under Section 305(c) to substitute payments, as we stated in a recent report on regulations under Section 871(m),[5] Treasury should clarify how the Section 871(m) regulations are intended to apply to securities loans, repurchase transactions and other derivative transactions on convertible bonds.

8. The final regulations should clarify the effective dates of an issuer's reporting obligations under Section 6045B in the case of a security held in a clearing system.

9. The final regulations should clarify what constitutes "actual knowledge" of a Deemed Distribution for purposes of determining whether a withholding agent has an obligation to withhold.

10. Because, as written, the Proposed Regulations could result in issuer reporting at more than one time, the final regulations should implement a single mechanism by which issuers must satisfy their Section 6045B obligations in respect of Deemed Distributions. We recommend making Public Reporting the sole reporting method and allowing a delay between the issuer's satisfaction of the Public Reporting requirement and the time at which any related withholding obligation arises.

[5] N.Y. ST. BA. ASS'N, TAX SEC., *Report on Regulations under Section 871(m)* (Rep. No. 1340, Mar. 28, 2016).

11. If the relationship between a withholding agent and a Deemed Shareholder is terminated after the Deemed Distribution but before the issuer satisfies its reporting requirement, as well as in certain other situations in which the withholding agent has insufficient amounts from which to withhold, the final regulations should limit the liability of the withholding agent.

II. Summary of Current Law and Proposed Regulations

A. Background and Current Law

The federal government has struggled with how to treat distributions by a corporation of its own stock since the inception of the federal income tax. Under the Revenue Act of 1913, stock dividends were income in the amount of their cash value. The Supreme Court, in *Towne v. Eisner*, overturned this provision as a violation of the Sixteenth Amendment and held that stock dividends were not income because a *pro rata* stock dividend did not decrease the corporation's assets or change the proportionate interest of stockholders in the distributing corporation.[6] In the Revenue Act of 1921, Congress codified the *Towne* holding but later revised this provision in the Revenue Act of 1936, providing that a distribution of stock or stock rights was not treated as a dividend to the extent that it "does not constitute income to the shareholder within the meaning of the Sixteenth Amendment of the Constitution," causing confusion among courts as to how to apply the proportionate interest test from *Towne* to properly distinguish between taxable and nontaxable dividends.[7]

Congress enacted Section 305 in 1954 to clear up the confusion of the lower courts and essentially repeal the proportionate interest standard in favor of a simpler rule. The new test introduced by Congress provided that the distribution of stock or stock rights was not includible in gross income unless the distribution (1) discharged dividend arrearages on preferred stock or (2) was payable in either stock or property at the election

[6] *See* Towne v. Eisner, 245 U.S. 418 (1918) (holding that a stock dividend is not income because the "corporation is no poorer and the stockholder is no richer than they were before"); Eisner v. Macomber, 252 U.S. 189 (1920) (same).

[7] *See, e.g.*, Koshland v. Helvering, 298 U.S. 441 (1936) (holding that a distribution of preferred shares on common stock is taxable); Helvering v. Sprouse, 318 U.S. 604 (1943) (*pro rata* distribution of nonvoting common stock to holders of both voting and nonvoting common stock is not taxable); Strassburger v. Comm'r, 124 F.2d 315 (2d Cir. 1941) (distinguishing *Koshland* and holding that a distribution of preferred stock to the sole owner of common stock is not taxable).

of the shareholder. After Congress passed this new provision, corporations seeking to provide effective electivity for their shareholders changed their capital structures to include two classes of stock. The classes were identical except that one class of shares paid only cash dividends and the other class of shares paid only stock dividends, but was convertible into the cash-paying shares at any time, essentially providing stockholders with a choice between cash and stock. In response to this and other perceived abuses, Congress amended Section 305 in 1969 to tax these disguised shareholder elections and re-impose the proportionate interest standard from *Towne*.[8]

Current Section 305(a) generally exempts from gross income distributions by a corporation of its own stock to its shareholders. Section 305(b) enumerates exceptions to this general rule, including an exception for disproportionate distributions. Further, Section 305(c) directs the Treasury Department ("the **Treasury**") to prescribe regulations under which certain transactions that increase a holder's interest in the earnings and profits or assets of a corporation, including a change in conversion ratio, are treated as distributions to which Section 301 applies. The regulations state that if the change to the conversion ratio is made pursuant to a "bona fide, reasonable adjustment formula" that has the effect of preventing dilution (*i.e.*, an adjustment made to compensate for a non-taxable event, such as a stock split), it is not a deemed distribution of stock to which Section 301 applies.[9] However, an adjustment made to compensate for a taxable distribution of cash or property to other shareholders is not considered as made pursuant to such a bona fide, reasonable adjustment formula.[10] The regulations incorporate an example that addresses the exact capital structure discussed above, in which a corporation has two classes of common stock: class A and class B, with class B being convertible into class A. The corporation declares a cash dividend to class A holders and the conversion ratio of the class B stock is increased. Because the class B holders increase their proportionate interests in the corporation, and class A holders receive cash, the conversion ratio adjustment is a distribution to class B holders subject to Section 301.[11]

Under Section 305(d) and Treas. Reg. § 1.305-1(d), the right to acquire stock (*i.e.*, pursuant to a convertible debt instrument) is "stock" and a holder of rights or of convertible securities is a "shareholder." Thus, the Internal Revenue Service (the "**IRS**") has ruled that if a holder of common stock receives cash and there is a contemporaneous

[8] Section 305(b)(1), (2).

[9] Treas. Reg. § 1.305-7(b).

[10] *Id*.

[11] Treas. Reg. § 1.305-3(e), Ex. 6.

change in the conversion ratio of a convertible debt instrument with respect to that stock, the holder of the convertible debt instrument receives a distribution of stock, which is a disproportionate distribution under Section 305(b)(2).[12]

The preamble to the Proposed Regulations (the "**Preamble**") states the belief of the IRS and Treasury that it has been clear under current law, as described above, that an adjustment such as an increase in the conversion ratio of an instrument with respect to any right to acquire stock may be treated as a deemed distribution to the holder of the instrument. The Preamble states that, despite the clarity in the law, there has been confusion regarding the amount and timing of these distributions and the Proposed Regulations are intended to clarify various issues.[13]

B. Summary of the Main Provisions in the Proposed Regulations

Very generally, the Proposed Regulations do four things: (i) clarify the amount and timing for inclusion of a deemed distribution arising in connection with adjustments to stock rights; (ii) expand the definition of "substitute payment" to include deemed payments relating to a deemed distribution; (iii) require that issuers of specified securities satisfy information reporting requirements with respect to deemed distributions that result in a basis adjustment; and (iv) clarify and modify the obligations of withholding agents with respect to deemed distributions.

1. Regulations Under Section 305(c)

In order to effect the new guidance, Treasury introduced new definitions, some of which are described in this subsection and will generally be used in this Report. A "right to acquire stock" (a "**Stock Right**") means a right of a holder of a convertible instrument to convert the instrument into stock; a warrant, subscription right, stock right or other option to acquire stock; any other right to acquire stock similar to a conversion right or option; and a right to receive cash or property determined by reference to the value of a

[12] Rev. Rul. 75-513, 1975-2 C.B. 114 (applying Section 301 by reason of Section 305(b)(2) and 305(c) to a deemed distribution where the conversion ratio increased in connection with the payment of a cash dividend to other shareholders).

[13] Preamble, at 21796–97.

specified number of shares. In each case, the referenced stock must be of the corporation issuing the instrument.[14]

In addition, the Proposed Regulations distinguish between an "**Actual Shareholder**," who holds actual stock, and a "**Deemed Shareholder**," who holds a Stock Right, and define "**Deemed Distribution**" to mean an event, other than an actual distribution of cash or property, that constitutes a distribution under Sections 305(b) and (c).[15]

An "**Applicable Adjustment**" is an adjustment to a Stock Right, and includes an increase in the conversion ratio of a convertible debt instrument, an increase in the number of shares to be received by a holder of a warrant or option or decrease in the exercise price of a warrant or option, and any other adjustment that has an effect similar to one of the enumerated adjustments provided in the regulation.[16]

The Proposed Regulations treat a Deemed Distribution arising from an Applicable Adjustment as a distribution of additional Stock Rights, rather than a distribution of the actual stock to which the Stock Right relates.[17] Until the Proposed Regulations become final, a taxpayer may calculate the value of the Deemed Distribution as either the value of a distribution of a Stock Right (the amount of which is the fair market value of the Stock Right) or the value of the stock itself (the amount of which is the fair market value of the stock).[18]

Under the Proposed Regulations, the amount of a Deemed Distribution to a Deemed Shareholder resulting from an Applicable Adjustment is the excess of (i) the fair market value of the Stock Right after the Applicable Adjustment over (ii) the fair market

[14] Prop. Treas. Reg. § 1.305-1(d)(3).

[15] Prop. Treas. Reg. § 1.305-1(d)(5), (6), (7). In defining a Deemed Distribution, the Proposed Regulations exclude an Applicable Adjustment (as defined below) with respect to a Stock Right if either (i) the Stock Right is a nonqualified stock option without a readily ascertainable fair market value (citing Section 83(e) and Treas. Reg. § 1.83-7) or (ii) Section 83(a) applies to the Stock Right or the stock to which the Stock Right relates or the stock is subject to a substantial risk of forfeiture, and the holder of the Stock Right has not made a Section 83(b) election. Prop. Treas. Reg. § 1.305-1(d)(7).

Although the focus of the Proposed Regulations is on Deemed Distributions arising from Applicable Adjustments, the term "Deemed Distributions" is broader and would encompass, for example, Section 305(c) dividends arising from a redemption premium on preferred stock.

[16] Prop. Treas. Reg. § 1.305-7(a).

[17] *See* Preamble, at 21797.

[18] *Id.*, at 21800.

value, determined immediately after the Applicable Adjustment, of the Stock Right as if no Applicable Adjustment had occurred.[19] Facts specific to the Deemed Shareholder and the value attributable to the possibility of future adjustments are ignored in the calculation.[20]

There may also be a Deemed Distribution to an Actual Shareholder, for example, if there is a payment of cash or property to a Deemed Shareholder and a corresponding reduction in, say, the conversion ratio that increases the Actual Shareholder's proportionate interest in the assets or earnings and profits of the corporation.[21] In this event, the adjustment results in a Deemed Distribution to the Actual Shareholder equal to the value of the stock deemed distributed, determined in accordance with the methodology set forth in Treas. Reg. § 1.305-3(e), Examples 8 and 9.[22]

The Proposed Regulations provide that a Deemed Distribution occurs at the earlier of (i) the date of the actual distribution of cash or property that results in the Deemed Distribution and (ii) the time the Applicable Adjustment occurs, in accordance with the terms of the instrument.[23] If the terms of the instrument do not address the time of the adjustment, then for publicly traded stock, the Deemed Distribution occurs immediately before the opening of business on the ex-dividend date for the actual distribution that results in the Deemed Distribution.[24] For non-publicly traded stock, the Applicable Adjustment occurs on the date that a holder is legally entitled to the distribution of cash or property that results in the Deemed Distribution.[25]

2. Substitute Dividend Payments

Treas. Reg. § 1.861-3(a)(6), which applies to securities loans and repurchase agreements, provides that a substitute dividend payment is sourced in the same manner as a dividend on the relevant transferred security. The Proposed Regulations expand the substitute dividend payment rules to include "deemed payments," which are payments that are deemed to have been made in the amount of a Deemed Distribution that the own-

[19] Prop. Treas. Reg. § 1.305-7(c)(4)(i).

[20] Prop. Treas. Reg. § 1.305-7(c)(4)(iii).

[21] Prop. Treas. Reg. § 1.305-7(c)(2).

[22] Prop. Treas. Reg. § 1.305-7(c)(4)(ii).

[23] Prop. Treas. Reg. § 1.305-7(c)(5).

[24] *Id*.

[25] *Id.*

er of a transferred security is entitled to, calculated in the same manner as a Deemed Distribution.[26]

3. Issuer Reporting Requirements Under Section 6045B

Section 6045B generally requires that an issuer of a specified security[27] report information relating to organizational actions that affect the basis of a security to the IRS on Form 8937 and to holders of the security (the "**Issuer Statement**").[28] In lieu of reporting information on the basis adjustment to the IRS and holders, an issuer may post the required information on its public website ("**Public Reporting**").[29] Generally, issuers are not required to report under Section 6045B with respect to securities held by holders that are exempt recipients, such as C corporations.[30]

The Proposed Regulations state that an Applicable Adjustment is an organizational action that can affect the holder's basis in a security.[31] The Proposed Regulations require an issuer to report information related to a Deemed Distribution without regard to the exceptions in the current regulations for securities held by exempt recipients.[32] The issuer must provide the date of the Deemed Distribution and the amount of the Deemed Distribution, determined in accordance with the Section 305 regulations.[33]

4. Withholding Rules

Under current regulations, a withholding agent that is not related to the recipient or beneficial owner of a payment is required to withhold only to the extent that, at any time between the date on which the obligation to withhold would arise and the due date (including extensions) for filing Form 1042 with respect to the calendar year in which payment occurs, it has (i) control over, or custody of, money or property owned by the

[26] Prop. Treas. Reg. § 1.861-3(a)(6).

[27] "Specified security" is defined in Treas. Reg. § 1.6045-1(a)(14) and includes, *inter alia*, a share of stock, a debt instrument and an option.

[28] Treas. Reg. § 1.6045B-1(a)(1), (b)(1).

[29] Treas. Reg. § 1.6045B-1(a)(3).

[30] Treas. Reg. § 1.6045B-1(a)(4).

[31] Prop. Treas. Reg. § 1.6045B-1(i)(1).

[32] Prop. Treas. Reg. § 1.6045B-1(i)(2).

[33] Prop. Treas. Reg. § 1.6045B-1(i)(3).

recipient or beneficial owner from which to withhold and (ii) knowledge of the facts that give rise to the payment.[34] This limitation on the obligation to withhold does not, however, apply to distributions with respect to stock.[35] The Proposed Regulations clarify that this treatment of stock distributions applies to a Deemed Distribution (or a deemed payment under the portion of the Proposed Regulations expanding substitute payments).[36] Notwithstanding the foregoing, the Proposed Regulations limit the obligation of a withholding agent with respect to Deemed Distributions in the manner described below.[37]

Under the Proposed Regulations, a withholding agent other than the issuer of a specified security is generally required to withhold on a Deemed Distribution only if, before the due date (excluding extensions) for the withholding agent to file Form 1042 for the calendar year of the Deemed Distribution, (i) the issuer of the security meets its Section 6045B reporting requirements, as discussed above, or (ii) the withholding agent has actual knowledge of the Deemed Distribution.[38] The Proposed Regulations provide that a withholding agent does not lack knowledge merely because it does not know the character or source of the payment for U.S. tax purposes.[39] The withholding agent may rely on the information provided by the issuer regarding the amount of a Deemed Distribution unless it knows that the information is incorrect or unreliable.[40]

Once the issuer has satisfied its Section 6045B reporting requirements, the withholding agent must withhold on the earliest of (i) the date on which a cash payment is made on the security, (ii) 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 (iii) the Form 1042 filing date (excluding extensions).[41]

The Proposed Regulations provide that, notwithstanding the general rules under Section 1441 with respect to payments to qualified intermediaries, a withholding agent may treat a foreign entity as assuming primary withholding responsibility with respect to

34 Treas. Reg. § 1.1441-2(d)(1).

35 *Id.*

36 Prop. Treas. Reg. § 1.1441-2(d)(1)(ii)(B), (E).

37 Prop. Treas. Reg. § 1.1441-2(d)(4).

38 Prop. Treas. Reg. §§ 1.1441-2(d)(4)(i).

39 Prop. Treas. Reg. § 1.1441-2(d)(1)(v).

40 Prop. Treas. Reg. § 1.1441-3(c)(5).

41 Prop. Treas. Reg. § 1.1441-2(d)(4)(ii).

a Deemed Distribution only if the withholding agent provides the foreign entity with a copy of the Issuer Statement within ten days of the issuer furnishing the Issuer Statement to the holder of record or its nominee, or the issuer has satisfied its Section 6045B requirements through Public Reporting.[42] The foreign entity is obligated to withhold only if the above requirements are met by the Form 1042 filing date, and is permitted to rely on the information provided to it unless it knows the information is unreliable or incorrect.[43]

With respect to Deemed Distributions, the Proposed Regulations clarify that, in addition to the issuer of a security, any person that directly or indirectly holds the security on behalf of a beneficial owner is considered to have custody of or control over the Deemed Distribution, and therefore is a withholding agent with respect to it.[44]

If a withholding agent is required to withhold on the Form 1042 filing date, the withholding agent may satisfy its obligation by withholding on other cash payments made to the same Deemed Shareholder, or by liquidating other property held in custody for the Deemed Shareholder over which the withholding agent has control.[45] A withholding agent remains liable for any underwithheld amount with respect to a Deemed Distribution if the requirements of Treas. Reg. § 1.1441-2(d)(4)(i) are satisfied (*i.e.*, the issuer satisfies its reporting requirements or the withholding agent has actual knowledge of the Deemed Distribution) after a withholding agent has terminated its relationship with a Deemed Shareholder.[46]

The Proposed Regulations also amend the FATCA rules to correspond with these changes to the Section 1441 withholding rules.[47]

5. Effective Dates

The Proposed Regulations under Section 305 apply to Deemed Distributions occurring on or after the date of publication in the Federal Register of the Treasury decision under which they are adopted as final regulations.[48] Taxpayers may rely on the Proposed

[42] Prop. Treas. Reg. § 1.1441-2(d)(4)(iii).

[43] *Id*.

[44] Prop. Treas. Reg. §§ 1.1441-2(d)(1), 1.1441-7(a)(4).

[45] Prop. Treas. Reg. § 1.1461-2(b).

[46] *See* Preamble, at 21798–99.

[47] Prop. Treas. Reg. §§ 1.1471-2(a)(4)(i), 1.1473-1(a)(2)(vii), (d)(7).

[48] Prop. Treas. Reg. §§ 1.305-1(e),-3(f), -7(g).

Regulations for Deemed Distributions occurring before that date, and for purposes of determining the amount of a Deemed Distribution to a Deemed Shareholder may determine the amount of the Deemed Distribution by treating it either as a distribution of a right to acquire stock or as a distribution of the actual stock to which the right relates.[49]

The Proposed Regulations under Section 861 addressing substitute payments, as well as the Proposed Regulations affecting withholding, apply to payments made on or after the date of publication of the final regulations. However, a withholding agent may rely on those Proposed Regulations for all Deemed Distributions or deemed payments occurring on or after January 1, 2016 until the date of publication of the final regulations.[50]

We discuss below in Part III.C.2 the effective date rules for issuer reporting under Section 6045B.

III. Detailed Observations and Recommendations

A. Regulations Under Section 305(c)

1. Threshold Determination to Apply Section 305(c) to Applicable Adjustments

As a threshold matter, we observe that for many taxpayers, and even many tax practitioners, the notion that there is taxable income from Applicable Adjustments, such as conversion ratio adjustments, is not intuitive.

In the context of a convertible debt instrument, warrant or similar instrument, Applicable Adjustments are protective, generally operating to preserve the economic deal agreed to by the issuer and the holders. These adjustments are necessary as a commercial matter because the value of the stock—and therefore the conversion right—declines if cash or assets are removed from the corporation in the form of dividends or other distributions that were not incorporated into the original pricing. In that respect, they can be analogized to conversion ratio adjustments that are purchase price adjustments, which are expressly excluded from the purview of Section 305.[51] The expectation is that, after accounting for (i) the reduction in stock value arising from the dividend and (ii) the

[49] *Id.*

[50] Prop. Treas. Reg. §§ 1.861-3(d), 1.1441-2(f), 1.1441-3(c)(5)(ii), 1.1441-7(a)(5), 1.1461-2(d).

[51] Treas. Reg. § 1.305-1(c).

conversion ratio adjustment, the bondholder is left in economically the same position as it was before both events.[52]

And while the same economic point—that a taxpayer's wealth remains largely the same after accounting for both the stock dividends the taxpayer receives and the effect on the corporation of the cash dividends paid to other shareholders—might be true of many or even most of the arrangements that motivated the enactment of the disproportionate distribution rule of Section 305(b)(2) as well as its expansion through Section 305(c), the reasons why taxpayers created those arrangements were very different. Those arrangements typically provided the taxpayer with electivity to select between cash and stock dividends. They were also generally arrangements in which the economic features of the two relevant classes of stock (one dividend-paying and the other providing holders with an additional interest in the corporation) were otherwise identical. The rationale for treating both sets of holders as receiving dividends is more obvious when they have comparable economic interests. As a result, it is understandable why persons not steeped in the history of Section 305 would have difficulty seeing why the tax system views a Deemed Shareholder as having obtained wealth by virtue of a set of highly connected events intended to put it in a near neutral economic position in comparison with its position absent those events.

We note also that the consequences to non-U.S. taxpayers of Deemed Distribution treatment are particularly harsh, because the taxpayer may owe tax on a Deemed Distribution but may ultimately receive nothing (in the case of a warrant) or no cash beyond its interest and principal (in the case of a convertible debt instrument) and, unlike a U.S. taxpayer, derive no benefit from a corresponding basis increase. And, as a general matter, requiring withholding agents to perform withholding on income that does not generate cash has the potential for added complexities of the types described more fully below. So while treating Applicable Adjustments as potentially resulting in Deemed Distributions is consistent with the history of Section 305(c) and with the statutory language contained in Section 305(d) treating "stock" as including Stock Rights and "shareholder" as including a holder of rights or convertible securities, and therefore hardly surprising, we believe that there would be a significant policy basis for other approaches that excluded from

[52] Moreover, standard conversion ratio adjustments include anti-dilution adjustments that are not subject to tax by reason of Section 305(a), such as adjustments for stock splits and stock dividends. The purpose of those adjustments is the same as for adjustments to account for cash dividends, *i.e.*, to preserve the value of the bond, and viewed from the perspective of the bondholder there is little practical difference between the two. Yet under the Section 305(c) regulations the tax consequences of the two categories of adjustment are entirely different.

Section 305(c) treatment convertible debt instruments or warrants the economic profile of which diverged meaningfully from the underlying stock.

We appreciate that, in light of the long history of the application of the Section 305(c) regulations to convertible bonds, Treasury is unlikely to reverse course on the point in connection with the Proposed Regulations, and therefore we do not dwell on it further. Even so, we believe that it may inform the government's approach to past failures to withhold, since the somewhat debatable policy underpinnings, along with the lack of specificity in the existing regulations, were likely contributors to the widespread lack of awareness regarding current-law obligations. Another likely reason for the gap in compliance was the development of the convertible bond market: while historically conversion rate adjustments were rare events, because changes in ordinary dividend rates did not give rise to them, in the 2000s market norms changed. The result was that standard bond terms began to include adjustments for all such ordinary dividend rate changes.[53] The existing regulations were ill-equipped to address these market developments.

The Preamble addresses the fact that there has been a general lack of awareness among holders of convertible debt instruments, as well as withholding agents, that conversion ratio adjustments give rise to Section 305(c) deemed dividends, and a resulting failure to withhold or pay tax under the rules. It reiterates the view of Treasury and the IRS that, under the existing Section 305(b) and (c) regulations, it is clear that an Applicable Adjustment gives rise to a Deemed Distribution if it increases the proportionate interest of a Deemed Shareholder in the corporation's earnings and profits, the increase has a result described in Section 305(b), and the exception for "bona fide anti-dilution adjustments" does not apply. In support of this conclusion, the Preamble cites Revenue Ruling 75-513[54] and Revenue Ruling 76-186,[55] each of which finds a Deemed Distribution as the result of an Applicable Adjustment to a convertible debt instrument.[56]

We agree with the Preamble's conclusion that the current regulations, when read with the Revenue Rulings cited above, are clear that an Applicable Adjustment to a convertible debt instrument may give rise to a Deemed Distribution. However, as acknowledged by the Preamble, current law provides no rule or methodology for calculating the amount (or the timing) of a Deemed Distribution. In addressing the amount of a

[53] *See* Katy Burne, *Got Convertible Bonds? Prepare for New Taxes*, WALL ST. J. (July 15, 2016).

[54] 1975-2 C.B. 114.

[55] 1976-1 C.B. 86.

[56] *See also* Priv. Ltr. Rul. 201446013 (Nov. 25, 2013); Priv. Ltr. Rul. 201312028 (Dec. 20, 2012); Priv. Ltr. Rul. 201247004 (Aug. 22, 2012).

disproportionate distribution under current law, Treas. Reg. § 1.305-1(b)(3) does not provide an operative rule, but instead refers to examples set forth in the regulations.

Moreover, there has historically been no mechanism to provide to a Deemed Shareholder or a withholding agent information regarding the occurrence or amount of a Deemed Distribution. In order to comply with the rules, therefore, taxpayers and withholding agents would have been required to monitor an issuer's dividend announcements, calculate the amount of the Applicable Adjustment under a relevant bond indenture, and determine a valuation methodology to compute the amount of the Deemed Distribution. In light of these gaps in the current rules, the lack of compliance with them is not surprising, and therefore pursuing taxpayers (particularly withholding agents) for these failures may not represent the best use of enforcement resources.[57]

2. Definition of Stock Right

(a) General Comments

Under current law, there is little guidance as to the meaning of the term "right to acquire stock" for purposes of Section 305. In fact, the current regulations do not state explicitly that a conversion right embedded in a convertible debt instrument is within the term "right," although that interpretation is implied by the fact that the regulations (and the statute) define "shareholder" to include a holder of convertible securities.[58]

The Proposed Regulations define the term to mean a right of a holder of a convertible instrument to convert the instrument into stock of the corporation issuing the instrument; a warrant, subscription right, stock right or other option to acquire shares of stock of the corporation issuing the instrument; a right to acquire stock of the corporation issuing such right similar to the other types of rights included in the definition; and a right

[57] As a separate point, Treasury should clarify whether a switch from not reporting Deemed Distributions to reporting them in a manner permitted under the Proposed Regulations is a change in method of accounting that results in an adjustment under Section 481(a). For taxpayers, making a voluntary change to a method of accounting generally provides audit protection for all years prior to the year in which the change is made. Rev. Proc. 2015-13, 2015-5 I.R.B. 419. For the IRS, such a classification would permit adjustments to be recognized in relation to taxable years that would otherwise be closed under the statute of limitations. *See* Graff Chevrolet Co. v. Campbell, 343 F. 2d 568 (5th Cir. 1965) (holding that the IRS is permitted to make adjustments under Section 481 in respect of closed years).

[58] Section 305(d)(2); Treas. Reg. § 1.305-1(d)(2).

to receive an amount of cash or other property determined by reference to the value of a specified number of shares of stock of the corporation issuing the right.[59]

We believe that the addition of this definition provides significant clarity regarding the scope of the rules, which is welcome. However, the definition of Stock Right does not appear, at least in any clear way, to encompass derivative instruments other than those that resemble options, convertible bonds or convertible stock. In particular, it does not clearly cover equity forward contracts such as those addressed by Revenue Ruling 2003-97.[60]

The Preamble does not elaborate on the meaning of the Proposed Regulations' definition of Stock Right, nor does it explain the reasons for the line the Proposed Regulations appears to draw. The rationale for such a dividing line may be that Section 305 applies by its terms only to rights and not to other types of derivatives with respect to the issuer's own stock. Another reason for limiting the application of the Deemed Distribution rule to options and convertible debt or stock is to align it with the issuer reporting framework of Section 6045B through which the Proposed Regulations effect the Section 305(c) policies. Section 6045B only requires reporting with respect to specified securities, which include stock, debt, commodities and derivatives with respect to such commodities, and other instruments for which the Treasury determines adjusted basis reporting is appropriate.[61] While Treasury has authority to expand the "specified security" definition to cover other instruments, current regulations define it to mean stock, debt, certain options (including warrants and stock rights) and securities futures contracts.[62]

In considering where the line should be drawn as a general policy matter, different conclusions can be reached with respect to different equity derivative transactions that an issuer might enter into. On the one hand, there seems to be little or no general policy reason to exclude prepaid forward contracts issued by a corporation on its own stock. If anything, such instruments are economically closer to stock than options or convertible instruments, and therefore there is likely a stronger policy rationale for the Proposed Regulations to apply to them. Post-paid forward contracts of the type addressed in Revenue Ruling 2003-97 present a more mixed case: although closer in their economic return profile to stock than an option, they can function more like a liability than an asset when

[59] Prop. Treas. Reg. § 1.305-1(d)(3).

[60] 2003-2 C.B. 380.

[61] Section 6045B(d), defining specified security by cross-reference to Section 6045(g)(3)(B).

[62] Treas. Reg. § 1.6045B-1(a), defining specified security by cross-reference to Treas. Reg. § 1.6045-1(a)(14).

the underlying stock declines in value. As a result, a taxpayer that is a party to such a contract seems distinct from the type of corporate investor, with a proportionate interest in the corporation's earnings and assets, that Section 305 has historically addressed. Similarly, a taxpayer that issues a put option to a corporation under which the corporation has the right to sell its own stock to the taxpayer is also economically "long" the stock, but in a manner that is a pure liability to the taxpayer.[63] In addition to being very different from the paradigm Section 305 transaction, a non-prepaid derivative may have a "negative" basis if the taxpayer received cash in consideration for entering into the transaction, a fact that could give rise to additional complexities regarding the use of Section 6045B—a rule tied to basis—as the mechanism for issuer reporting of a Deemed Distribution.

In summary, the "correct" dividing line is unclear, but at least as a general policy matter it is hard to see a reason for prepaid forward contracts to be excluded. Whatever the scope determined by Treasury, it would be helpful to clarify whether or not the Proposed Regulations apply to forward contracts or other derivatives that are not similar in their return profile to options (including options embedded in bonds or stock).

It would also be helpful to clarify how the definition of Stock Right is intended to relate to the "specified security" definition applicable to Section 6045B and also cross-referenced in the withholding portions of the Proposed Regulations. Without such a clarification, there could be a mismatch in scope under which some instruments that are included in the definition of Stock Right are therefore subject to withholding as a general matter but not eligible for the Proposed Regulations' special withholding rules that apply only to specified securities. Such a result would be inappropriate and inconsistent with the Proposed Regulations' general approach of permitting withholding agents to rely on issuer information. Accordingly, if Treasury determines that the definition of Stock Right is broader than the current definition of "specified security," we recommend expanding the "specified security" definition for purposes of Section 6045B and the related withholding rules so that withholding agents' obligations are clear and reflect the information made available to them by issuers.

[63] In extreme cases, the economics of a written put option can, to the option writer, resemble those of the underlying stock. *See* Rev. Rul. 85-87, 1985-1 C.B. 268, treating a written put option as a "contract to acquire" the underlying stock for wash sale purposes when there is no substantial likelihood that the put option would not be exercised. Even in such a situation, however, the option would be a liability of the option writer rather than an asset.

(b) Instruments Issued by Related Entities

In addition, it would be helpful to confirm, at least as a general matter, that the Proposed Regulations do not apply to exchangeable debt or other instruments issued by a related entity such as a subsidiary. Although there does not appear to be any support for such a rule under Section 305, assuming that any such exchange right is only against the entity issuing the exchangeable debt and not against the underlying stock issuer, market participants have at times warned investors of Deemed Distributions in these situations, perhaps in light of concerns that the IRS could seek to apply such a rule on policy grounds. Where the related entity that issues the exchangeable debt is a clearly separate corporation, it is not clear to us how such a rule would even operate as a practical matter, because there would need to be a deemed transaction that explains how the deemed dividend is transmitted from the underlying stock issuer to the exchangeable debt issuer to the holder. In certain cases, however, when the division between the exchangeable debt issuer and the underlying stock issuer is less distinct, there would be a greater policy rationale for applying the Proposed Regulations. For example, the underlying policy of the Proposed Regulations should arguably apply in the event that an operating partnership in an "UPREIT" structure issues exchangeable debt that can be converted into shares of the real estate investment trust of the UPREIT. Similar arguments could be made with respect to a holding company or finance entity that, depending on its circumstances, could be viewed as an "alter ego" of the underlying stock issuer. Absent such special circumstances, however, we do not believe that the Proposed Regulations apply to instruments issued by a related entity, and confirmation of the point would be welcome.

(c) Stock Rights Subject to Contingencies

A different question arises in the context, most commonly, of convertible bonds. Often, these bonds are not immediately convertible, but instead are convertible only upon certain triggering events as well as for a brief time before maturity. The Proposed Regulations do not state whether contingencies of this type affect whether a right is treated as a Stock Right. We believe as a general matter that a contingency of this nature should not prevent an option or conversion right from being treated as a Stock Right. Even though the holder's ability to exercise the right is delayed, it will ultimately be entitled to exercise the right. A more difficult question might arise with respect to rights to acquire stock that are contingent upon the occurrence of a future event and that therefore may never become exercisable. Even in that case, we believe that such a right should be within the definition of a Stock Right, although the contingency would potentially affect the amount of the Deemed Distribution. We suggest confirming these points.

3. Amount of the Deemed Distribution

The main substantive decision made in the Proposed Regulations is to treat a Deemed Distribution arising from an Applicable Adjustment as a distribution of a Stock Right rather than a distribution of the full amount of stock reflected in the Applicable Adjustment.

We strongly agree with this approach, subject to the discussion below. An Applicable Adjustment is best analogized to the receipt of an additional Stock Right rather than the receipt of additional stock itself. The economic benefit to the Deemed Shareholder of the adjustment will only be realized if the Stock Right is ultimately exercised, and therefore its value at the time of the adjustment is effectively discounted to reflect the probability of exercise. In particular, if the Stock Right is "out of the money" at the time of the adjustment, the value of the adjustment is likely to be significantly less than the value of the underlying stock and should be taxed accordingly. The approach taken by the Proposed Regulations also brings the treatment of an Applicable Adjustment in line with the distribution of an actual stock right (*e.g.*, a warrant), which is taxed based on the right's fair market value.[64]

One negative consequence of this choice is the greater complexity for affected parties in calculating the amount of the Deemed Distribution. In the case of a public company, the valuation of a Stock Right is significantly more difficult—and subjective—than the valuation of a specified amount of stock.[65] However, by requiring the issuer to determine and report the amount of the Deemed Distribution, the Proposed Regulations at least minimize the burden for Deemed Shareholders and withholding agents.

The mechanism used in the regulations to calculate the Deemed Distribution applies a "with and without" approach, *i.e.*, comparing the value of the Stock Right immediately after the Applicable Adjustment against the hypothetical value of the Stock Right (also immediately after the Applicable Adjustment) if the adjustment had not been made.[66] By stating that each of these calculations is performed immediately after the Applicable Adjustment, the rule appears designed to require these two calculations to be performed as of the same moment in time and presumably, therefore, to hold constant the effects of the underlying dividend that gave rise to the Applicable Adjustment.

64 Treas. Reg. § 1.305-1(b)(1).

65 The Black-Scholes formula for valuing stock options, for example, requires a determination of the underlying stock's volatility, which may be calculated in various ways.

66 Prop. Treas. Reg. § 1.305-7(c)(4)(i).

In most cases, given the way in which the Proposed Regulations set the timing of the Deemed Distribution, as discussed in Part III.A.4 below, we would expect both the "with" and "without" calculations to be made using the lower underlying stock value that reflects the effect on the corporation of the underlying distribution that gave rise to the Applicable Adjustment. However, if the terms of the instrument provide for an Applicable Adjustment that takes effect before the corresponding distribution on the underlying stock, the Proposed Regulations would appear to require the relevant calculations to be made using a higher underlying stock value that does not yet reflect the effect on the corporation of the distribution on the underlying stock. We believe that calculating the amount of the Deemed Distribution using this higher stock value will overstate the economic benefit to the Deemed Shareholder of the Applicable Adjustment.[67] Accordingly, we recommend that the Proposed Regulations be revised to provide that the amount of the Deemed Distribution is calculated taking into account the effect of the underlying distribution in all cases, including the circumstance in which the Applicable Adjustment precedes the underlying distribution.

In some cases, the Applicable Adjustment may be calculated under the terms of the relevant instrument using the value of the underlying stock over an averaging period before the effective date of the Applicable Adjustment. In such a case, it would seem reasonable to use that same average stock value as an input for purposes of calculating the amount of the Deemed Distribution.[68]

[67] Consider, for example, a situation where a taxpayer holds a warrant that gives it the right to pay $100 in exchange for 9 shares of stock. Each share of stock is initially worth $11, and so the warrant is "out of the money" because upon exercise the taxpayer would receive only $99 worth of stock for the $100 exercise price. In connection with an expected future dividend of $1 per share, the number of shares for which the warrant is exercisable is increased to 9.9. (The original number of underlying shares (9) is multiplied by $11/$10 to get the new number of underlying shares.) If the decline in stock value resulting from the expected future dividend is ignored, the adjusted warrant would temporarily appear to be "in the money" because it would relate to shares of stock worth $108.90, and the Deemed Distribution would appear to reflect a net change in underlying stock value of $9.90 (0.9 shares worth $11 per share). On the other hand, if the expected decline is taken into account, the adjusted warrant would relate to shares of stock worth $99 (9.9 shares worth $10 per share), and the Deemed Distribution would reflect a net change in underlying stock value of $9.00 (0.9 shares worth $10 per share). The latter calculation seems a better reflection of the economic benefit to the taxpayer of the Applicable Adjustment in light of the overall circumstances giving rise to a Deemed Distribution.

[68] For example, convertible bond indentures often calculate the amount of an Applicable Adjustment arising from a spin-off based on the values of the underlying stock and the distributed stock over a

Although not entirely clear, it appears that the calculation of a Deemed Distribution is intended to be performed, in the case of convertible bonds or stock, on the embedded conversion right rather than the entire instrument. This conclusion follows from the Proposed Regulations' definition of a Stock Right as being "[a] right of a holder of a convertible instrument . . . to convert the instrument . . . " as opposed to the convertible instrument itself.[69] Assuming this reading of the Proposed Regulations is correct, we are concerned that this approach requires issuers and potentially other parties to value a financial instrument that does not actually exist. The conversion right contained in a convertible bond or convertible preferred stock can only be understood as the right to exchange the bond or preferred stock for the underlying stock, and therefore is not separable or capable of being separately valued in isolation. Moreover, although we do not have the expertise to say whether the two approaches would give meaningfully different results, it seems logical that, to the extent there is any difference, taking into account the actual instrument rather than a hypothetical embedded instrument would better reflect the net benefit to the taxpayer. Finally, we understand that, at least for convertible bonds, there are already commercial services that provide valuations of the bond as a whole and are widely used by market participants. Accordingly, we recommend revising the Proposed Regulations so that the valuation of the Stock Right deemed to have been received may be performed using the value of the actual convertible instrument as a whole (both with and without the Applicable Adjustment), not a hypothetical embedded instrument. If our interpretation of the Proposed Regulations is incorrect, we request a clarification of the point.

Under the Proposed Regulations, the amount of a Deemed Distribution to an Actual Shareholder is computed on the basis of the methodology described in Treas. Reg. § 1.305-3(e), Examples 8 and 9.[70] In those examples, some shareholders of a corporation receive cash in a redemption subject to Section 301, and the resulting deemed dividend to the other shareholders is computed by (i) calculating their increased percentage interests in the corporation, (ii) determining how many shares those shareholders would need to have received to achieve these higher percentage interests, if instead of a redemption

10-day averaging period beginning on the ex-dividend date for the distribution, with the adjustment being effective as of the last day of the averaging period. In the case of a taxable spin-off that gives rise to a Deemed Distribution, using the underlying stock value on the final day of the averaging period (which might be higher or lower than the average value) would seem likely to overstate or understate the economic benefit to the taxpayer of the Applicable Adjustment.

69 Prop. Treas. Reg. § 1.305-1(d)(3)(i).

70 Prop. Treas. Reg. § 1.305-7(c)(4)(ii).

there had been a stock distribution, and (iii) valuing those deemed received shares by reference to the aggregate value of the corporation's actual outstanding shares after the redemption. It is not clear how these steps are intended to be performed when there is an Applicable Adjustment instead of a simple change in number of shares outstanding of a single class. In particular, it is not clear whether the calculation of the Actual Shareholders' increased percentage interests in the corporation is performed by taking into account the changed value of the Stock Right due to the Applicable Adjustment or in some other manner. Accordingly, we recommend adding an example describing the required calculations.

4. Timing of the Deemed Distribution

The Proposed Regulations provide that a Deemed Distribution occurs at the earlier of (i) the date of the actual distribution of cash or property that results in the Deemed Distribution, taking into account Treas. Reg. § 1.305-3(b),[71] and (ii) the time the Applicable Adjustment occurs, in accordance with the instrument setting forth the terms of the Stock Right.[72]

The Proposed Regulations further provide a definition of when the actual distribution of cash or property is deemed to take place: before the opening of business on the ex-dividend date, for publicly traded stock; and on the date the holder is legally entitled to the distribution, for non-publicly traded stock.[73] The Proposed Regulations describe this definition as applying if the instrument setting forth the terms of the Stock Right does not say when the Applicable Adjustment occurs. However, even if the terms of the instrument do address the time of the Applicable Adjustment, the earlier of that time and the time of the actual distribution controls for purposes of ascertaining the time of the Deemed Distribution, and therefore it is necessary to determine when the actual distribution is deemed to occur. We recommend that the final regulations clarify that the rule regarding the timing of the actual distribution applies as a general matter and not only in circumstances in which the terms of the instrument fail to specify the time when the Applicable Adjustment occurs.

[71] This cross reference is to the "special rules" for determining whether a disproportionate distribution under Section 305(b) has occurred.

[72] Prop. Treas. Reg. § 1.305-7(c)(5).

[73] *Id.*

In indentures for convertible bonds on publicly traded stock, it is common for a conversion ratio adjustment to take effect as of the opening of business on the ex-dividend date for the dividend that gave rise to the adjustment. For these instruments, therefore, the timing of income under the Proposed Regulations will generally match the contractual timing of the Applicable Adjustment.

However, it is also common under these indentures for the timing of the Applicable Adjustment to be deferred under some circumstances, such as when the adjustment would give rise to a *de minimis* change in the conversion ratio (*e.g.*, a change of less than 1%). In those circumstances the adjustment is not forgone; rather, it is carried forward and applied to subsequent conversions or when further adjustments are made that, along with any adjustments carried forward, exceed the *de minimis* threshold. In these situations, it would appear that the timing rule under the Proposed Regulations would result in income to the Deemed Shareholder, and a corresponding reporting obligation for the issuer, as of the earlier date. As a result, the Proposed Regulations will likely impose an additional burden on the issuer, because it will be required to make calculations it would not otherwise have been required to make under the indenture in order to satisfy its Section 6045B reporting requirements. We considered whether an exception to Deemed Distribution treatment would be appropriate in these circumstances in order to align the issuer's reporting responsibilities under the Proposed Regulations with its non-tax obligations. On balance, however, given that the *de minimis* adjustments described in this paragraph essentially become part of the terms of the bond for purposes of any subsequent event (*e.g.*, conversion), it seems appropriate to us to treat them as occurring on the earlier date.

Outside of the typical convertible bond situation, it is possible to imagine scenarios in which there will be uncertainties about how to apply the timing rule under the Proposed Regulations. Because the regulations under Section 305(b) defining disproportionate distributions are extremely broad, an Applicable Adjustment may occur at a very different time from, and have little or even no connection to, the actual distribution.[74] For example, there may be an actual distribution in year one and an Applicable Adjustment in year three, under circumstances in which the two events are entirely unrelated to each

[74] Treas. Reg. § 1.305-3(b) applies if the result is that (i) some shareholders receive money or other property while (ii) others have an increase in their proportionate interest in the assets or earnings and profits of the corporation, whether or not as part of a plan. Other than a presumption against treating events separated by more than 36 months as giving rise to a deemed distribution, the rule generally mandates a deemed distribution if circumstances (i) and (ii) are present, whether they are in fact connected to each other.

other and there is no plan or agreement to make the Applicable Adjustment until year three. Under the Proposed Regulations, it would appear that the resulting Deemed Distribution is treated as occurring in year one, although it is hard to understand how to apply the Proposed Regulations in year one to tax an event not yet envisioned by the relevant parties. The amount of the Deemed Distribution could only be calculated in year three, in any event, because it is based on the value of the Stock Right immediately after the Applicable Adjustment. Finally, if the relevant instrument is transferred between the time of the actual distribution and the Applicable Adjustment, so that the holder in year one is not the same as the holder in year three, it is not clear how the rules are intended to operate.

In the case of the parallel situation under Section 305(b) (rather than Section 305(c)) involving a year one cash distribution to some shareholders and a year three actual distribution of Stock Rights to other shareholders, there does not appear to be an explicit rule regarding the timing of the resulting income to the shareholders receiving the Stock Rights. However, because the event giving rise to taxable income is the receipt of the Stock Rights, presumably the recipients of the Stock Rights would have income in year three. Given this fact, as well as the practical impossibility of applying the rules until the Applicable Adjustment occurs, we believe that the Proposed Regulations should be revised so that, if the Applicable Adjustment happens after the actual distribution, the Deemed Distribution occurs as of the date of the Applicable Adjustment.[75]

In the opposite situation, where the Applicable Adjustment is in year one while the (unconnected) actual distribution is in year three, it is similarly difficult to understand how the Proposed Regulations operate. Under our assumption that the two events are unconnected, the taxpayer has no knowledge of the actual distribution until year three, and therefore cannot properly report the income in year one (or year two). In the parallel case of an actual Section 305(b) distribution of Stock Rights where the cash distribution to other shareholders occurs two years later, it is similarly not clear how the rules operate, *i.e.*, whether the recipient of Stock Rights is supposed to recognize income in year three

[75] If the fact of the Applicable Adjustment is known as of the earlier date but its terms are not yet fixed, we believe there should be no Deemed Distribution until the terms are fixed. If the terms of the Applicable Adjustment are fixed in advance, but the Applicable Adjustment takes effect on a later date, it would seem reasonable to treat the Deemed Distribution as occurring on the date on which the Applicable Adjustment's terms become fixed. However, if this approach is taken, the method for calculating the amount of the Deemed Distribution might have to be reconsidered in light of the fact that, as currently drafted, it applies immediately after the Applicable Adjustment.

or year one (which, in the latter case, would mean filing an amended return). The Proposed Regulations should be revised to clarify their operation in this circumstance.[76]

5. Additional Issues Not Addressed by the Proposed Regulations

(a) Consequences to Holding Period and Basis

The Proposed Regulations do not address the effects of the Deemed Distribution on the Deemed Shareholder's basis in the instrument containing the Stock Right. Section 301(d) states that the basis of property received in a dividend distribution is the fair market value of the property, and Treas. Reg. § 1.301-1(h) provides, when relevant sections are read together, that the basis to a shareholder of a distribution of stock of the distributing corporation, or rights to acquire the stock, is the fair market value of the stock or rights if the stock or rights are treated as property under Section 305(b). In Revenue Ruling 76-186,[77] addressing adjustments on convertible debentures that were taxable under Section 305(c), the IRS cited these provisions in reaching a conclusion that the basis of the debentures was increased by the fair market value of the deemed distribution. We recommend confirming this conclusion in the final regulations.

Revenue Ruling 76-186 implies, but does not state explicitly, that the debentures have a single, unified basis; in other words, that the additional rights deemed received do not take a separate fair market value basis. If they did, the "original" instrument could have built-in gain or loss, in contrast to the rights deemed received.[78] This could matter,

[76] In clarifying this point, Treasury should consider the scope of Treas. Reg. § 1.305-3(b) and evaluate whether it should be narrowed, as the policy basis for applying it to two events that are factually unrelated and temporally distant seems weak. However, that topic is beyond the scope of this Report.

[77] 1976-1 C.B. 86.

[78] For example, if the instrument had a basis of $100 and a fair market value of $180 at the time of a Deemed Distribution of $10, under the bifurcated approach the "new" instrument would have a basis of $10 and a fair market value of $10 and the "original" instrument would have a basis of $100 and a fair market value of $170 (after accounting for the decline in value resulting from the actual cash distribution to other shareholders). Using the same facts but assuming that the corporation has no earnings and profits, the basis in the "original" instrument would decline to $90. In both scenarios, there is built-in gain on the "original" instrument but not on the "new" instrument deemed received. Each subsequent Deemed Distribution would require a further division of basis among the then-"existing" instruments and the then-"new" instrument.

for example, upon a conversion, as it could potentially result in shares of stock received with different bases and built-in gain.

As with basis, the Proposed Regulations do not address whether the Deemed Distribution has any effect on the Deemed Shareholder's holding period in the instrument containing the Stock Right. While there are valid conceptual arguments to be made to treat the additional Stock Rights deemed to have been received as taking a new holding period, as would be the case upon the actual receipt of a Stock Right, for administrability reasons we recommend against a split holding period approach. A Deemed Shareholder holds only a single, inseparable instrument, and may receive many Deemed Distributions over the course of the time it holds the Stock Right which, under a split holding period approach, would each be required to have a separate holding period. Furthermore, treating the relevant instrument as having a single holding period would be consistent with the implicit holding of Revenue Ruling 76-186 in that it would treat the instrument as a single item for both purposes. By analogy, the original issue discount rules do not require a bondholder to start a separate holding period for each item of original issue discount income; rather, the bond has a single holding period.

Accordingly, we recommend guidance indicating that a Deemed Shareholder has only a single, unified basis and holding period in the instrument containing the Stock Right.

(b) Dividends-Received Deductions and Qualified Dividend Income Treatment

Another issue that arises in the context of Deemed Distributions on convertible bonds is whether the Deemed Shareholder can treat the distribution as qualified dividend income or as eligible for the dividends-received deduction. As a preliminary matter, we note that Section 243 does not state explicitly that it applies to Deemed Distributions, in particular those arising with respect to convertible bonds or warrants as opposed to actual stock. However, Section 243(a) applies by its terms to "the amount received as dividends from a domestic corporation…" and the regulations under Section 243 reference Treas. Reg. §§ 1.301-1 and 1.316-1 to determine the amount of the dividend.[79] Section 305(b) states that a distribution under that section is a distribution to which Section 301 applies, and the same principle applies to a deemed dividend under Section 305(c).[80] Treas. Reg.

[79] Treas. Reg. § 1.243-1(a)(3).

[80] Treas. Reg. § 1.305-7(a).

§ 1.316-1(c), defining "dividend," references certain distributions of stock or stock rights treated as distributions of property under Section 305(b). Read together, these provisions support the conclusion that a Section 305(b) or 305(c) deemed dividend is eligible for a dividends-received deduction to the same extent as a regular dividend.[81] Accordingly, we believe that as a general matter Deemed Distributions are eligible for a dividends-received deduction or to be treated as qualified dividend income.

The primary reason for uncertainty regarding the treatment of convertible bonds in this context is Revenue Ruling 94-28,[82] which addressed an instrument that was stock for U.S. federal income tax purposes but debt for corporate law purposes and therefore provided holders with a creditor claim to the principal amount of the instrument at maturity. The ruling holds that the right to receive principal is an option to sell or contractual obligation to sell the stock for purposes of Section 246(c), and therefore suspends the taxpayer's holding period in the instrument.[83]

We recommend clarifying that the conclusion in Revenue Ruling 94-28 does not apply to Applicable Adjustments on convertible bonds. The concept underlying the Proposed Regulations is that convertible bondholders hold a Stock Right embedded in the bond, and are earning Deemed Distributions with respect to that Stock Right. Although the bondholder has a creditor claim to principal at maturity, that claim does not protect it from the decline in the value of the Stock Right embedded in the bond, which can become worthless if it is "out of the money" at maturity. In contrast, the stock described in the ruling had a fixed principal amount, and so the holder's creditor claim represented a form of protection against any loss with respect to the stock. As a result, Revenue Ruling 94-28 would seem to have little relevance to a Stock Right embedded in a convertible bond, and Treasury could provide welcome clarity by so stating.[84]

[81] In some private rulings, the IRS has treated deemed dividends under Section 305 as eligible for a dividends-received deduction, although those rulings related to stock rather than convertible bonds or warrants. *See, e.g.*, Priv. Ltr. Rul. 8451006 (Aug. 21, 1984) (corporation receiving deemed dividend on preferred stock is entitled to a dividends-received deduction).

[82] 1994-1 C.B. 86.

[83] The qualified dividend rules incorporate Section 246 principles for purposes of determining whether their holding period requirement is met. Section 1(h)(11)(B)(3).

[84] In contrast to Section 243, which refers to "dividends" but does not require that they be with respect to stock, Section 246(c) refers to "any dividend on any share of stock…" While the reference to stock in Section 246 could suggest that a dividends-received deduction under Section 243 is not available to bondholders or warrantholders in respect of Deemed Distributions, it could also imply that Section 246(c) (but not Section 243) applies only to stock positions and therefore

(c) Treatment of Contingent Payment Debt Instruments

Convertible bonds may be treated as contingent payment debt instruments within the meaning of Treas. Reg. § 1.1275-4 if they provide for contingencies other than the right to convert the bond into the issuer's stock.[85] A question not explicitly addressed by the Proposed Regulations is whether there is any difference in their treatment under the Section 305(c) rules as compared with the treatment of other convertible bonds, although the absence of any such special rule implies that there is no difference. It would be helpful to confirm that this is the case.[86]

B. Substitute Dividend Payments

The Proposed Regulations amend the definition of a "substitute payment," *e.g.*, arising under a securities loan or repurchase agreement, by providing that it includes a "deemed payment." A deemed payment is a payment deemed to have been made in the amount of a Deemed Distribution to which the owner of the transferred security is entitled during the term of the transaction.[87] The withholding portions of the Proposed Regulations are amended correspondingly to require withholding on these deemed payments.

that Revenue Ruling 94-28 is irrelevant to non-stock instruments. Perhaps the most plausible explanation is that the drafters of Section 246(c) simply did not consider Deemed Distributions. In any event, there is no evidence that Section 246(c) was intended to be read to exclude all convertible debt instruments from eligibility for a Section 243 dividends-received deduction.

85 *See* Rev. Rul. 2002-31, 2002-1 C.B. 1023.

86 On a contingent payment convertible debt instrument, interest accruals are based on projections of future payments on the instrument, including the value of stock to be delivered. When payments are made, a holder's interest income is adjusted to reflect the difference between the projections and the actual payments made. *See* Rev. Rul. 2002-31, 2002-1 C.B. 1023. In a sense, therefore, conversion ratio adjustments are already reflected in a holder's income on the bond, either in the initial projection regarding stock value to be delivered or in any ultimate adjustment to interest to reflect the actual value delivered. This leads to a question of whether taxing a conversion ratio adjustment under Section 305(c), in this context, results in double taxation with respect to a single item. We do not believe so, because the basis increase resulting from a Deemed Distribution would have the effect of reducing the ordinary interest income a U.S. taxpayer would ultimately recognize on the contingent payment debt instrument. *See* Treas. Reg. § 1.1275-4(b)(7), (b)(9)(i)(B).

87 Prop. Treas. Reg. § 1.861-3(a)(6).

We agree with this change, as it harmonizes the withholding tax treatment of convertible bonds with loans of those bonds, and therefore removes any incentive to loan out these bonds in order to avoid withholding tax.

In our report on regulations under Section 871(m),[88] we requested additional guidance with respect to the manner in which those regulations are intended to apply to securities loans and sale-repurchase transactions, as well as swaps, on convertible bonds. In particular, we requested clarification as to whether the "underlying security" in such a transaction is the convertible bond or the underlying stock (or both).[89] If finalized as drafted, the Proposed Regulations would seem to preempt the application of the Section 871(m) regulations in respect of any Deemed Distribution on a Stock Right, including a convertible bond, that is the subject of a securities loan or sale-repurchase transaction.[90] Section 871(m) might nonetheless apply if the underlying security were defined to be the underlying stock, or if the underlying security were defined to be the convertible bond and that bond gave rise to Section 871(m) dividend equivalents because it had been issued with a "delta" of at least 80%. Accordingly, while the Proposed Regulations, read in isolation, are fairly clear as to their application to substitute payments, it would nonetheless be helpful, as requested in our prior Report, to have additional guidance on the manner in which the Proposed Regulations and the Section 871(m) regulations are intended to operate in respect of derivative transactions on convertible bonds.[91]

C. Issuer Reporting Requirements Under Section 6045B

1. General Comments

A significant reason for past gaps in compliance with the Section 305(c) rules has been the lack of any mechanism to convey information to a Deemed Shareholder or with-

[88] *See* note 5 *supra.*

[89] Treas. Reg. § 1.871-15(a)(12) and (13), read together, define a Section 871(m) transaction to include a securities lending or sale-repurchase transaction with respect to an "underlying security." Underlying security is defined in Treas. Reg. § 1.871-15(a)(15) to mean "any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to §1.861-3…".

[90] Treas. Reg. § 1.871-15(c)(2)(ii).

[91] The Proposed Regulations do not address whether a domestic taxpayer has income as a result of a Deemed Distribution on a security the taxpayer has transferred in a securities loan or similar transaction.

holding agent regarding the amount and timing of Deemed Distributions. Without such a mechanism, there would likely be failures to comply with the Proposed Regulations (when final) as well. Because there is no cash or other property being transferred upon an Applicable Adjustment, there is generally no triggering event that would create awareness of the fact of a Deemed Distribution other than by contractual notification from the issuer. While in the convertible bond context issuers are often required to notify the holder of record (typically, The Depository Trust Company ("**DTC**") or its nominee) and the indenture trustee of a conversion ratio adjustment, this information may not always be transmitted promptly to beneficial owners and withholding agents. Moreover, given the Proposed Regulations' approach of calculating the Deemed Distribution as if it were the distribution of a Stock Right, different parties would likely calculate the value in different ways.

Accordingly, we support the requirement that a single party be responsible for providing information regarding the amount and timing of a Deemed Distribution, so that the treatment is consistent across taxpayers and withholding agents and so that information will be available regarding the Deemed Distribution, and we agree with the Proposed Regulations' choice of the issuer as that party. There is no other party that is certain to be involved in the transaction throughout its entire term.

One negative consequence of this choice, however, is the burden on issuers to perform this calculation. Many issuers will not be able to perform this calculation on their own and, as a result, will be required to hire investment banks or other valuation experts to perform these calculations for them. Nonetheless, the benefits of centralizing the determination in a single party and providing a mechanism for transmission of the information to other parties outweigh this negative consequence.

One odd aspect of the reporting rules is that the timing of reporting to holders and withholding agents will be very different depending on whether the issuer sends Issuer Statements to holders or satisfies its obligations using Public Reporting. While Issuer Statements are due on January 15 of the year following the calendar year of the Applicable Adjustment, Public Reporting must be done 45 days after the date of the Deemed Distribution.[92] For a Deemed Distribution occurring early in the calendar year, these divergent reporting times would mean very different times at which withholding would occur under the rules discussed in Part III.D below.

[92] Treas. Reg. § 1.6045B-1(a)(3), -1(b)(2);

Moreover, in the context of a security held in a clearing system, such as DTC, if the issuer provides the statement on January 15 to the holder of record (the clearing system or its nominee), the actual transmission of the statement may be delayed as the clearing system transmits it to its participants and it then gets transmitted to other withholding agents down the ownership chain. In fact, the Proposed Regulations do not contain a rule obligating the holder of record (or other withholding agents) to transmit the Issuer Statement to withholding agents further along the ownership chain. As a result, for securities held in a clearing system, we recommend making Public Reporting the sole issuer reporting method.[93]

2. Effective Dates

The current regulations, when read together with the Proposed Regulations, are not entirely clear as to the issuer's responsibilities before the date of publication of final regulations. The Proposed Regulations' effective date provision indicates that the part of

[93] Under the Proposed Regulations, although Issuer Statements are not due until January 15 of the following year, the issuer is nonetheless required to file Form 8937 with the IRS by the date that is 45 days after the Deemed Distribution. Therefore, requiring it to do Public Reporting by this same deadline would likely not increase the burden on it significantly.

For withholding agents, monitoring the websites of multiple issuers could be onerous and difficult to automate, and therefore it would be preferable to have a centralized repository at which this information would be made available to the public. However, in connection with the promulgation of other parts of the Section 6045B regulations, Treasury rejected requests from commentators to provide a centralized repository. *See, e.g.*, T.D. 9504, 75 Fed. Reg. 64072 (Oct. 18, 2010). In the convertible bond market, private sector solutions could emerge, such as contractual requirements that the issuer provide the information to a publicly available website maintained by, for example, DTC or another private sector vendor. In the Section 6045 regulations, brokers are permitted to rely on third party information sources under certain circumstances; we suggest consideration of a similar rule for withholding agents in this situation. *See* Treas. Reg. § 1.6045-1(d)(2)(iv)(B).

Finally, we note that there might be a question of whether Treasury has the authority under Section 6045B to make Public Reporting the exclusive reporting mechanism in these cases, since Section 6045B merely allows the Treasury to waive the return filing and Issuer Statement requirements if it does Public Reporting. In addition to the language of Section 6045B, the general grant under Section 7805(a) of authority to Treasury to prescribe all needful regulations for the enforcement of the Internal Revenue Code may provide support for Treasury's authority to create such a rule. If Treasury concludes it has insufficient authority to make Public Reporting the sole method in this context, it could at least minimize the difference between methods by requiring Issuer Statements to be provided 45 days after the Deemed Distribution.

the Proposed Regulations that explicitly mandates issuer reporting for a Deemed Distribution under Section 305(c) affecting basis applies to Deemed Distributions on or after the date final regulations are published.[94]

However, the current rules under Treas. Reg. § 1.6045B-1 already require reporting of any organizational action that affects the basis of a specified security, a description that fits an Applicable Adjustment, and for convertible bonds that requirement entered into force on January 1, 2016.[95] The Preamble confirms this reading of the current rules, and the IRS revised the instructions to Form 8937 in September 2015 to provide that reporting is required for a conversion rate adjustment on a convertible debt instrument that results in a Deemed Distribution under Section 305(c) if it occurs after December 31, 2015.

However, as noted in the Preamble, the current reporting requirement does not apply if the "holder" of the instrument is an exempt recipient, which would generally be the case for securities held by DTC,[96] given DTC's status as a corporation and a financial institution,[97] and the part of the Proposed Regulations that overrides the exception for exempt recipients applies prospectively only. Accordingly, it appears that there is no current reporting requirement for securities held through DTC or other exempt recipient intermediaries. We recommend that Treasury confirm this interpretation of the Proposed

94 Prop. Treas. Reg. § 1.6045B-1(i)(4).

95 Treas. Reg. §§ 1.6045B-1(j)(4), 1.6045-1(n)(3). For warrants, this requirement entered into force on January 1, 2014. Treas. Reg. § 1.6045-1(m)(2)(i)(C).

96 This reading of the regulation assumes that "holder" means "holder of record" as opposed to "beneficial owner." Such a reading is consistent with Treas. Reg. § 1.6045B-1(b)(1), requiring the issuer to furnish the Issuer Statement to each "holder of record."

97 Treas. Reg. § 1.6045B-1(a)(4), (b)(5), citing the list of exempt recipients in Treas. Reg. § 1.6045-1(c)(3)(i)(B) and stating that an issuer may treat a holder as an exempt recipient based on the applicable indicators in Treas. Reg. § 1.6049-4(c)(1)(ii)(A) through (M). Treas. Reg. § 1.6049-4(c)(1)(ii)(M) provides that a "financial institution" includes a clearing organization. The exemption for corporations requires that the issuer obtain from the holder an exemption certificate described in Treas. Reg. § 31.3406(h)-3 asserting that the holder is not an S corporation.

DTC ordinarily holds securities in the name of its nominee, Cede & Co. While Cede & Co. may not be a corporation (*see* https://www.dtcclearning.com/about-us/glossary/293-cede-co.html) or a financial institution, the Section 6045B regulations appear to distinguish between a "nominee" and a "holder," and so a nominee's status does not appear relevant for this purpose. *See, e.g.*, Treas. Reg. § 1.6045B-1(b)(1).

Regulations (or, in any event, provide further guidance on the point) so that issuers' current responsibilities are clear.

D. Withholding Rules

1. Special Exception to Withholding for Applicable Adjustments

A central feature of the Proposed Regulations is a special rule applicable to specified securities[98] that conditions the obligation of a withholding agent to withhold[99] in respect of an Applicable Adjustment on the issuer's Section 6045B compliance, and defers that obligation until cash payments are made or certain other events occur.[100] In addition, the Proposed Regulations provide a reliance rule under which a withholding agent may rely on the information provided by the issuer under Section 6045B unless it knows the information is incorrect or unreliable.[101] In these regards, Treasury was responsive to the concerns of withholding agents about carrying out withholding when there is no cash or other property being delivered in connection with the item of income and when there is a lack of information necessary to perform the withholding. We agree with this approach, subject to the points noted below.

Although generally withholding is required only once the issuer has satisfied its Section 6045B reporting obligations, withholding is nonetheless required if the withholding agent has "actual knowledge of the deemed distribution."[102] If the issuer of a convertible bond is a public corporation, its distributions are generally public infor-

[98] In this section, the instrument containing the Stock Right will generally be referred to as a "security," because the withholding rules apply generally to specified securities and also generally refer to the instrument subject to withholding as a "security."

[99] Prop. Treas. Reg. § 1.1441-2(d)(1)(iv) states that the special withholding limitation does not affect whether the item is subject to reporting under Treas. Reg. § 1.1461-1(b) and (c), addressing reporting on Form 1042 and statements on Form 1042-S. If intended, this would be a surprising result, as a withholding agent would be required to report a Deemed Distribution even if the issuer never reports it under Section 6045B (or reports it after the deadline for Section 1461 reporting), which would seem contrary to the Proposed Regulations' sensible approach of allowing withholding agents to rely on Section 6045B issuer information. We recommend providing an exception from Section 1461 reporting that is generally parallel with the exception from withholding, or at least clarifying the intended operation of this provision.

[100] Prop. Treas. Reg. § 1.1441-2(d)(4).

[101] Prop. Treas. Reg. § 1.1441-3(c)(5)(i).

[102] Prop. Treas. Reg. § 1.1441-2(d)(4)(i)(B).

mation, and its bond indentures may also be public in many cases. Accordingly, general knowledge of a Deemed Distribution, or at least the factual elements necessary to establish that a Deemed Distribution has occurred, may exist within a large financial institution that is a broker holding those bonds on behalf of investors. The fact that this information is available, and that such a financial institution could likely estimate the amount of the Deemed Distribution, should not mean that it has actual knowledge for this purpose, and it would be desirable for Treasury to clarify this point. The whole framework of the withholding sections of the Proposed Regulations appears aimed at providing a mechanism by which withholding agents may obtain consistent information regarding the amount and timing of a Deemed Distribution and therefore establish automated systems to withhold based on that information; the broad language regarding actual knowledge should not undermine this clear and practical approach.

2. Timing of Withholding Obligation

Once an issuer has reported a Deemed Distribution,[103] a withholding agent is required to withhold on the earliest of (i) the date of a cash payment with respect to the security, (ii) the date of disposition of the security (including the transfer of the security into an account not maintained by the withholding agent) and (iii) the due date (not including extensions) for filing Form 1042 (generally, March 15 of the subsequent year).[104] As noted above, we agree generally with Treasury's efforts to match the time of withholding to a time at which cash proceeds will be available to the withholding agent.

We note that the Proposed Regulations do not defer the withholding obligation beyond the due date for filing Form 1042, even if the withholding agent does not have cash proceeds from the security or the disposition thereof. This rule contrasts with the

[103] Under Prop. Treas. Reg. § 1.1441-2(d)(4), a triggering event for withholding arises when the issuer "reports the information required under §1.6045B-1." In the situation where the issuer sends Issuer Statements rather than doing Public Reporting, this presumably refers to the time at which the issuer has sent Issuer Statements as opposed to the date on which it has filed Form 8937 with the IRS, since the Issuer Statement would be the mechanism in that case for transmitting the required information to withholding agents. The Preamble confirms this interpretation by describing this event as occurring when "the issuer meets its reporting requirements under §1.6045B-1 (by furnishing an issuer statement or publicly reporting the information required under that section)…"

[104] Prop. Treas. Reg. § 1.1441-2(d)(4)(ii). Treas. Reg. § 1.6302-2(a) sets forth the timing rules (*e.g.*, monthly) under which a withholding agent must deposit amounts withheld under Section 1461. *See* Treas. Reg. § 1.1461-1(a)(1).

withholding rule applicable to dividend equivalents under Section 871(m), which can operate to defer withholding for multiple years, if no payment is made.[105] Subject to the discussion in Part III.D.3 below regarding circumstances in which the withholding agent no longer holds the security at the time when the withholding obligation arises or the security produces insufficient proceeds, this approach seems sensible to us because it limits the possibility of complications stemming from a withholding obligation arising long after the related income-generating event.

While we support the Proposed Regulations' approach to the timing of withholding as a general matter, we note that in some circumstances the rule may not provide the withholding agent with sufficient time in which to perform the required withholding. For example, if by coincidence an issuer reports a Deemed Distribution on its website on the very morning of the date on which a payment is made on the security, a withholding agent is required to withhold on that day even though its systems may not yet have become aware of, or processed, the updated information on the issuer's website. While we do not have the expertise to say whether withholding on such short notice is feasible, it seems to us likely that automated withholding systems will not be able to act in time to withhold in these circumstances.

In the case of an Issuer Statement in respect of a security held through a clearing system, there may be even greater delays because the statement would potentially need to be transmitted through a chain of multiple intermediaries to the one that will carry out the withholding. Assume, for example, that the issuer provides an Issuer Statement to the clearing organization ("CO") on January 15, which happens to be the date of an interest payment on the security. Assume also that the beneficial owner holds the security through a domestic broker that is not a direct participant in CO, but is rather a sub-participant ("SP") that has an account with another domestic broker that is a direct participant ("DP"). Under the Proposed Regulations, each of CO, SP and DP is a withholding agent, and their obligation to withhold arises on January 15. Generally speaking, SP would be the withholding agent that performs the withholding, because each of CO and DP is making payments to U.S. persons. However, even though its withholding obligation arises on January 15, SP may not actually receive the information until a later date unless CO is able to transmit the Issuer Statement to DP, and DP is able to transmit the information to SP, on a same-day basis. Accordingly, SP may fail to meet its withholding requirement through no fault of its own.

[105] Treas. Reg. § 1.1441-2(e)(8).

In the "reverse" situation where a Deemed Distribution is made to an Actual Shareholder of common stock rather than a Deemed Shareholder of a Stock Right (*e.g.*, because of a decrease in a conversion ratio), a withholding agent holding common stock on behalf of the Actual Shareholder would seem to face even greater challenges, given that it (as well as the Actual Shareholder) may have no knowledge of the existence or the terms of the Stock Right. In the case of a public corporation, a withholding agent holding a Stock Right will at least have access to public information about dividends declared on the corporation's common stock, and therefore may be able to anticipate the timing (if not the amount) of a related Deemed Distribution. On the other hand, a withholding agent holding common stock may lack access to information about both the Applicable Adjustment and any related taxable dividend, if they occur with respect to a different security. Take, for example, a situation where a corporation pays a cash dividend on a privately-held convertible preferred stock, and the conversion ratio of the stock adjusts downward. A withholding agent holding shares of the corporation's public common stock on behalf of customers likely has no way to obtain the necessary information from public sources. In this case, the withholding agent would be entirely dependent on issuer reporting under Section 6045B for its knowledge of the Deemed Distribution, and therefore should be given more time to withhold.

In summary, we recommend allowing a period of time between the date on which the issuer satisfies its Section 6045B reporting responsibilities and the date the related withholding obligation arises. We do not have a view regarding the specific time required, but would set it at a reasonable time necessary for typical payment systems to reflect that the Section 6045B reporting obligation has been met by the issuer and to adjust in time to perform the withholding.[106]

The issuer itself is not absolved of any withholding responsibilities under these provisions. As a result, its withholding responsibility arises as of the date of the Deemed Distribution, even though the responsibility of other withholding agents may never arise (if the issuer fails to meet its withholding responsibilities) or may be delayed (until the date on which the issuer does Public Reporting or the date on which it provides the Issuer

[106] Alternatively, particularly if our recommendation to require Public Reporting for cleared securities is adopted and so issuers would be obligated to report within 45 days of the Applicable Adjustment, a single date (*e.g.*, 60 days after the Applicable Adjustment) could be specified as the first date on which withholding is required, provided that the issuer has reported under Section 6045B before that time. Under such an approach, even if the issuer satisfied its reporting requirements early, withholding agents would have a better sense in advance of the date on which their withholding obligations will arise (even if they do not yet know the amount of the withholding).

Statement, which may be as late as January 15 of the following year). In the context of a security held through clearing systems and brokers, however, the issuer is generally not required to withhold if it can reliably associate the payment with a withholding certificate from a U.S. person.[107]

However, notwithstanding the general Section 1441 rules that exempt payments to U.S. persons from withholding, a withholding agent who has actual knowledge that a U.S. person receives a payment as an agent of a foreign person must treat the payment as made to the foreign person unless the U.S. person receiving the payment is a financial institution, and the withholding agent has no reason to believe the financial institution will not comply with its obligation to withhold.[108] In the context of a cleared security, the clearing system is obviously an agent, although the issuer may not know the tax residence of the ultimate beneficial owners at any given time. As a result, the issuer's obligations in such a situation are not entirely clear. To the extent an issuer does have an obligation to withhold in this scenario as a general matter, due to the clearing system's status as an agent, we recommend clarifying that the issuer is not required to withhold in advance of the date on which it must satisfy its Section 6045B reporting requirements. Put another way, if the issuer intends to satisfy its Section 6045B requirements, it should have reason to believe that other withholding agents will fulfill their withholding obligations. This seems desirable to us in order to avoid double withholding, and because brokers are better equipped than issuers to carry out the required withholding.

3. Obligation to Withhold After Account Closed or Where Cash Proceeds Are Otherwise Insufficient

While we agree generally with the approach of delaying withholding until Section 6045B reporting by the issuer occurs, that approach can have strange consequences in a situation in which the Deemed Shareholder closes its account after the date of the Deemed Distribution but before Section 6045B reporting.

In Example 3 of Prop. Treas. Reg. § 1.1441-2(d)(4)(iv), a Deemed Distribution occurs while a Deemed Shareholder holds a convertible debt instrument through a custodian. The sequence of events is: (1) Deemed Distribution occurs; (2) the Deemed Shareholder transfers the convertible debt instrument to an account not maintained by the custodian; and (3) the issuer reports the Deemed Distribution under Section 6045B. The

[107] Treas. Reg. § 1.1441-1(d).

[108] Treas. Reg. § 1.1441-1(b)(2)(ii).

example concludes that the custodian is a withholding agent with respect to the Deemed Distribution, because it held the convertible debt instrument on behalf of the Deemed Shareholder at the time of the Deemed Distribution, and therefore its obligation to withhold arises once the issuer reports under Section 6045B–even though the custodian no longer has custody of the convertible debt instrument at that later time.

The Preamble echoes this conclusion, stating, "[w]hen the [Section 6045B requirements] are satisfied after a withholding agent has terminated its relationship with the beneficial owner of the security, the withholding agent would remain liable for any underwithheld amount with respect to the deemed distribution. In order to avoid having to pay the tax due out of the withholding agent's own funds, before terminating an account relationship, a withholding agent should make arrangements with the beneficial owner to ensure that the withholding agent can satisfy any tax due, such as by retaining funds or other property of the owner."[109]

This rule would seem to create significant practical challenges for withholding agents. In order to protect itself upon an account termination, the withholding agent would need to reserve some amount to reflect Deemed Distributions that have occurred but have not yet been reported, potentially as far back as January of the prior calendar year. In order to have a rough estimate of the amount necessary to reserve, the withholding agent would have to rely on available public information to estimate the amount and timing of the Deemed Distribution. This may potentially be required for multiple securities that are held by the customer in its account over the course of the year.

Even if obtaining this information were feasible, requiring a withholding agent to take such a step seems inconsistent with, and undermines, the sensible approach of having a single source of information regarding withholding. The Proposed Regulations appropriately recognize that withholding agents need specific information about the amount and timing of income in order to carry out their withholding obligations properly, and create a general framework that provides withholding agents with that information before they are required to withhold. By making a withholding agent liable for amounts it becomes aware of only after it no longer has assets from which to withhold, the Proposed Regulations put withholding agents at risk of liability unless they perform what might be a large number of manual calculations or else simply hold back significant assets as a condition to their customers' switching brokers. Any of these outcomes seems undesirable as a policy matter.

[109] *See* Preamble, at 21798.

While we appreciate the desire of the government to make sure that a Deemed Distribution does not fall through the cracks or, worse, that Deemed Shareholders do not intentionally close out their accounts after a large conversion ratio adjustment in order to avoid withholding, we believe that the potential burdens and risks to withholding agents arising from this aspect of the rules warrant a change to the Proposed Regulations to relieve a withholding agent of liability in this situation. In most cases, the Deemed Shareholder will simply transfer its account—including the relevant security—to another financial institution. We recommend modifying the Proposed Regulations so that the transferee financial institution be the one to perform the withholding in that case.[110] This could be achieved by shifting withholding responsibility to the withholding agent holding the security as of the date on which the issuer reports under Section 6045B,[111] rather than the date of the Deemed Distribution. For such an approach to work, the transferee financial institution would need to know whether the taxpayer had held the security on the date of the Deemed Distribution. This information would generally be included on a transfer statement furnished by a transferor broker under Section 6045A,[112] although these statements are not required under the current Section 6045A regulations for securities held by certain foreign persons as well as exempt recipients.[113] As a result, changes to these rules might be necessary to effectuate our suggested approach.

If concerned about abuse, Treasury could provide an anti-abuse rule addressing cases where the transferor withholding agent fails to provide information to the transferee financial institution upon request, or has specific knowledge of the Deemed Sharehold-

[110] The Proposed Regulations do not address information reporting under Section 6042, nor do they address backup withholding under Section 3406. The Preamble indicates a general expectation that, for purposes of Section 6042 reporting, principles similar to those applicable to Section 6045B reporting will apply. While it makes sense to require Section 6042 reporting that would be consistent with an issuer's reporting under Section 6045B, it will be necessary to consider the corresponding backup withholding requirements in light of the fact that they reference Section 6042. *See* Section 3406(b)(2)(A)(ii). As is the case with Section 1441 withholding, it seems inappropriate to place a withholding obligation on a broker if the information necessary to withhold becomes available only after the broker no longer has custody of property from which to withhold.

[111] If our suggestion that the withholding obligation be delayed until a specified number of days after the issuer has reported under Section 6045B, or to a date that is a specified number of days after the Deemed Distribution, is adopted, that date could be used for determining which parties are withholding agents for purposes of the Deemed Distribution.

[112] Treas. Reg. § 1.6045A-1(b)(1)(vii).

[113] Treas. Reg. § 1.6045A-1(a)(1)(iii).

er's abusive purpose for the account closure. And even if no withholding occurs, the beneficial owner would remain liable for the tax under Section 871 or 881.[114]

A similar problem for withholding agents may arise if (i) the Deemed Shareholder sells the security in between the date of the Deemed Distribution and the date on which the issuer reports under Section 6045B or (ii) the security matures and fails to generate sufficient proceeds to cover the withholding tax (for example, in the case of an option that lapses). In these situations, unlike the account closure situation, the withholding agent may have control of cash or other property of the Deemed Shareholder from which it can withhold. Accordingly, we recommend that the withholding agent's obligation be limited to the value of cash or property of the Deemed Shareholder over which it has custody or control between the date the issuer reports under Section 6045B and the due date for Form 1042.

4. Foreign Withholding Agents

As described above, the treatment under the Proposed Regulations of qualified intermediaries and other foreign entities assuming primary withholding responsibility ("**foreign withholding agents**") is different from that of domestic withholding agents. A foreign withholding agent is responsible for withholding only if it receives a copy of the Issuer Statement or if the issuer performs Public Reporting under Section 6045B.[115] Moreover, another withholding agent may treat a foreign withholding agent as assuming primary withholding responsibility only if it provides a copy of the Issuer Statement to the foreign withholding agent within 10 days of the issuer providing the statement to the holder of record or if the issuer has performed Public Reporting.[116] The Preamble describes the purpose of this rule as being to ensure that foreign withholding agents have the Section 6045B information necessary to carry out their withholding responsibilities as these entities may not be holders of record.[117]

We do not believe such a distinction makes sense. Qualified intermediaries that have assumed primary withholding responsibility generally operate like domestic withholding agents, and treating them differently seems inconsistent with the qualified

[114] *Cf.* Treas. Reg. § 1.1441-3(b)(2) (no withholding required on interest accrued between payment dates, although the taxpayer remains liable for the tax under Section 871 or 881).

[115] Prop. Treas. Reg. § 1.1441-2(d)(4)(iii).

[116] *Id*.

[117] *See* Preamble, at 21799.

intermediary rules and unnecessarily burdensome to domestic middlemen in the chain of payments. Moreover, the stated rationale for the special rule could apply equally to a domestic broker that is a withholding agent, since for cleared securities the clearing system (or its nominee), rather than any broker, will be the holder of record. As we have discussed above, there is the potential for delay inherent in the transmission of an Issuer Statement down the chain of ownership of a security, to domestic withholding agents or foreign withholding agents. This issue could be mitigated more generally by either requiring a withholding agent to pass the Issuer Statement on to other withholding agents in the chain of ownership of the security, or in the context of cleared securities to require Public Reporting in lieu of an Issuer Statement. Whether our recommendations are adopted or not, the rationale for distinguishing between qualified intermediaries and domestic withholding agents seems insufficient to justify treating them differently.

5. Obligations of the Deemed Shareholder Under Section 871 or 881

While the regulations contain a number of special rules addressing the obligations of withholding agents, there are no special rules dealing with the Deemed Shareholder's liability under Sections 871 or 881. The special rules provided under Section 1441 to limit withholding responsibility make clear that they do not affect whether the relevant amounts are fixed or determinable annual or periodical income.[118] This is in contrast to, for example, the special rules under Treas. Reg. § 1.1441-2 relating to original issue discount, which affect both substantive taxation under Sections 871 and 881 as well as the corresponding withholding obligations.[119] The regulations regarding original issue discount reflect special statutory rules that defer the timing of inclusion until payments are made,[120] however, and there are no such corresponding rules for dividends.

Although in some instances a foreign Deemed Shareholder may be aware of the Deemed Distribution and be capable of estimating its value, in other cases it is not realistic to expect such a Deemed Shareholder to perform this task in the absence of issuer reporting under Section 6045B.[121] An Actual Shareholder holding common stock and re-

[118] Prop. Treas. Reg. § 1.1441-2(d)(1)(iv).

[119] Treas. Reg. § 1.1441-2(b)(3).

[120] Sections 871(a)(1)(C), 881(a)(3).

[121] Note that a parallel issue may arise in the case of domestic Deemed Shareholders (or Actual Shareholders) if the issuer simply does not comply with the Section 6045B rules, *e.g.*, if it is foreign and has limited connections with the United States. In that case, presumably a U.S. Deemed

ceiving a Deemed Distribution as a result of an event occurring with respect to a Stock Right with which it has no direct connection (*e.g.*, a downward conversion ratio adjustment on a convertible bond that the corporation has outstanding) would seem even less capable of complying with its obligations under Section 871 or 881 in the absence of issuer reporting.

Shareholder would still be required to estimate the value of the Deemed Distribution and pay tax on it.