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Section 305(c)

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Background – Conversion Ration Adjustments

It has become common in the convertible bond market over the last 10 years for issuers to include a provision in the bond that allows for conversion ratio adjustments ("CRA").

— CRAs are typically anti-dilutive provisions designed to equalize bond holders in certain situations, for example, where there is a dividend payment on the underlying equity.

— In some cases the adjustment takes place upon any dividend payment, while in other cases the adjustment only takes place where the distribution is above a certain threshold (i.e. in the case of regular dividend payers, a certain base dividend may be factored into the convertible bond pricing).

Background – Conversion Ration Adjustments

Section 305(c) is a longstanding provision in the Internal Revenue Code which causes a deemed distribution to holders of convertible securities who receive the benefit of a conversion ratio adjustment.

— The taxable amount would be the value of the incremental shares into which the bond is convertible and the income inclusion typically is on the date of the adjustment.

— The distribution would only be considered a dividend (as opposed to a return of capital) to the extent that there is sufficient current or accumulated earnings and profits in the corporation.

— **Section 305(c) is applicable regardless of whether or not the convertible feature is in the money, or whether or not the bond is ever converted.**

— Provision is directed toward long holders of the securities and does not take into consideration any of the economics of a hedge or short-side position that may be part of a larger convertible bond arbitrage investment strategy.

— **As there is no actual cash distribution, the amount of the deemed taxable dividend increases the holder's tax basis, ultimately reducing any capital gain or increasing any capital loss on disposition.**

— These deemed dividends therefore can result in both a potential timing mismatch in the income, as well as a character mismatch.

Effect on U.S. Investors

Regarding the character mismatch, domestic investors will generally be taxed on dividends at ordinary income rates.

These rates are the same rates applicable to short term capital gains (although the netting rules for capital gains could provide a different result).

Longer term investors will often be eligible for the qualified dividend income rate (20%) on the dividend which is the same rate applicable to long term capital gain/loss.

Accordingly, in many situations, despite the character differences, the rates applicable to both sides of the transaction may often be the same.

Effect on Non-U.S. Investors

General Rule:

Dividend income is considered FDAP income and taxed at a 30% gross rate in the case of US issuers (without offset for expenses).

Capital gains, however, are typically not subject to US tax and, accordingly, capital losses provide no benefit.

The result is not merely timing and additionally results in an increased tax liability.

U.S. Withholding

Non-US investors typically pay US taxes through a withholding mechanism.

— Withholding agents, most commonly prime brokers, withhold taxes where applicable and have joint and several liability for the tax where they fail to properly withhold.

— However, no major prime broker has been withholding on deemed dividends resulting from CRAs.

— It appears that the lack of withholding was a result of error and/or uncertainty as to the fact that the conversion adjustments existed, the fact that section 305(c) applied in this instance, or that the cashless nature of the deemed distribution created operational concerns about how to effect withholding.

— It appears that at least some withholding agents concede that withholding tax was due as a technical matter and have been considering whether there is an exception to the withholding tax rules that might relieve them of withholding liability despite the ultimate tax being due.

— Alternatively, if the withholding agent is liable for the tax, they typically have contractual reimbursement rights to collect the tax from clients. There will likely be considerable issues with collecting this reimbursement, especially in the case of customers such as funds which may no longer exists.

The failure to withhold or the conclusion that withholding is not required does not relieve a non-US investor of liability for any tax due on income subject to U.S. taxation.

U.S. Withholding

Withholding agents are now becoming aware of this issue, it is expected that they will begin to comply with the withholding requirements, at least on a go-forward basis.

— The majority of bank withholding agents have begun withholding beginning with the 2015 tax year.
  - Many banks withheld for the entire 2015 tax year in March of 2016, in coordination with the 2015 1042 filing deadline.
  - Some have employed as delta standard while others have not.

— Most bank withholding agents have been withholding for 2016 and forward.
  - More withholding agents have moved toward a delta standard.

Application of Delta Standard?

Question arises whether 305(c) should also employ a Delta standard?

— The real value of the conversion rate adjustment is largely dependent on whether or not the bond is likely to convert (i.e. a conversion rate adjustment has little value of the bond will likely never be in a position to convert).

- Delta is a mathematical formula detailing the relationship between a derivative and an underlying security, which is widely viewed as a surrogate for likelihood of exercise of option embedded in a convertible debt instrument.

— Issue was brought to light by NYSBA comment letter regarding 871(m) implementation, since 871(m) uses a Delta standard.

— Prop Reg § 1.305–7 (April 2016)

Amount of deemed distribution—

(i) *Deemed distribution to deemed shareholder.* For a deemed distribution under section 305(b) and (c) that is made to a deemed shareholder and is an applicable adjustment, the amount of the deemed distribution is the excess of—

(A) The fair market value of the **right** to acquire stock held by the deemed shareholder immediately after the applicable adjustment, over

(B) The fair market value, determined immediately after the applicable adjustment, of such **right** to acquire stock as if no applicable adjustment had occurred.

- Preamble: The current regulations are unclear, however, as to the amount of a deemed distribution to a deemed shareholder. The current regulations may reasonably be interpreted as providing either that such a deemed distribution is treated as a distribution of a **right** to acquire stock (the amount of which is the fair market value of the **right**), or that such a distribution is treated as a distribution of the actual stock to which the right relates (the amount of which is the fair market value of the stock). **Accordingly, for deemed distributions to deemed shareholders occurring before final regulations are published, the IRS will not challenge either position.**

— Valuation of the right, as opposed to the stock, is consistent with the delta standard.

Statute of Limitations

The statute of limitations on the assessment of taxes is typically 3 years from the date of filing of the tax return.

Statute increases to 6 years in the case of a substantial omission (25% of taxable income reported).

In the case of non-US persons, they are often not required to file US tax returns and thus, the statute of limitations remains open indefinitely.

Some non-US investors will file “protective” US tax returns with zero income for the primary purpose of starting the statute of limitations to run.

- In instances where this is the only income taxable in the US, any income will be considered a substantial understatement and the statute of limitations is effectively 6 years from the date of filing.

ASC 740/FIN 48

As part of the financial statement audit and confirmation of NAV, the tax issue should be analyzed to determine if there is an ASC 740/FIN 48 reserve required for all years still open under the statute of limitations.

Current year issue or prior period adjustment.

May also amount to a change in accounting method and require certain tax filings and income adjustments to be taken in over the time period prescribed by Section 481.

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