Actual Withholding on Code Sec. 305(c) Deemed Distributions

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Last month's *M&A Tax Report* reviewed the proposed regulations under Code Sec. 305(c) that were released on April 12, 2016. [*See* Board, *Getting Stock Rights Right Under Section 305(c)*, Vol. 24, No. 11 (May 2016), at 1.] The proposed regulations not only clear up some ambiguities under current law, but also provide a much-improved framework for analyzing deemed dividends triggered by changes to the conversion ratios of convertible securities.

The proposed regulations are an excellent amplification of Subchapter C. Ironically, however, they owe their existence to an almost accidental encounter between Code Sec. 305(c) and the increasingly esoteric world of international finance.

"A Lack of Actual Withholding Tax"

In 2010, Congress was concerned that non-U.S. investors were using derivatives to obtain the equivalent of U.S.-source dividends. The big worry was that they were avoiding the 30-percent withholding tax that applies to real-world dividends under Code Secs. 871(a) and 881(a). The solution was Code Sec. 871(m), which treats certain "dividend equivalents" as actual dividends subject to withholding tax.

The Treasury followed up with proposed regulations that included a rule to prevent double withholding on transactions when Code Sec. 871(m) overlaps with Code Sec. 305. If a conversion rate adjustment ("CRA") results in a deemed dividend under Code Sec. 305(c), the deemed dividend is subtracted from the amount treated as a dividend under Code Sec. 871(m). After all, withholding agents were already withholding tax on deemed dividends under Code Sec. 305.

In 2014, however, the Tax Section of the New York State Bar Association (the "Tax Section") issued a report that suggested otherwise. [*See* NYBSA Tax Section, Report on Proposed Regulations Under Section 871(m) (May 20, 2014).] The influential body was commenting on the proposed regulations under Code Sec. 871(m). At one point, however, the report observed that the Treasury's assumption about withholding under Code Sec. 305(c) was something less than accurate:

> In practice, it is our understanding that although U.S. federal tax disclosure in a typical convertible debt offering document will indicate that section 305 may apply to changes in the instrument's conversion ratio, brokers and other withholding agents that would be required to do the reporting and withholding with respect to section 305 "deemed" dividends are not made aware of changes that have occurred in the instrument's conversion ratio or the amount of the resulting "deemed" dividend, leading to a lack of actual withholding tax.

One has to admire how candor and delicacy are combined in that final phrase—"a lack of actual withholding tax." The beans having been spilled, the Treasury set about revising the regulations to make withholding on Code Sec. 305(c) deemed distributions more than something tax lawyers write about in offering documents.

The proposed regulations try to get withholding agents to actually collect the applicable tax. We will focus on changes to the rules under Code Secs. 1441 (withholding) and 6045B (disclosure of certain "organizational actions").

Withholding on Actual Dividends

The proposed regulations do everything they can to maintain continuity with the current rules about withholding on *actual* dividends. So let us start with the traditional withholding scheme.

Code Secs. 871(a) and 881(a) impose a 30-percent tax on paid by nonresident aliens and foreign corporations from sources within the United States. The United States does not rely on these non-U.S. persons to file U.S. tax returns and pay tax on their U.S.-source dividends. Getting the money for the IRS before it leaves the United States is safer. Even assuming the best about non-U.S. taxpayers, withholding gets the money to the government sooner.

We need someone local to do the work, someone we can penalize if they do not. Thus, Code Secs. 1441 and 1442 require anyone

"having the control, receipt, custody, disposal or payment" of U.S.-source dividends, interest and similar income of a non-U.S. person (a "withholding agent") to "deduct and withhold" the applicable tax before passing the balance along to the non-U.S. person. The tax deducted and withheld is promptly sent to the Treasury.

Under Code Sec. 1461, withholding agents that fail to do their duty to the fisc are liable for any tax they fail to deduct and withhold. Withholding is serious business.

Discovering Deemed Dividends

Withholding on deemed dividends poses challenges. First, how is a withholding agent supposed to know that a deemed dividend has even occurred? With an actual dividend, the withholding agent will get a check, a wire transfer or *something* that looks valuable and can be traced back to the issuer of the stock.

Not so with a deemed dividend. As the Tax Section pointed out, withholding agents were not being made aware of changes to conversion ratios that can trigger deemed dividends. Typically, the only observable part of a CRA is the triggering event. That's usually the issuer's distribution of cash or stock to the holders of the stock into which the security may be converted. The adjustment to the conversion rate, in contrast, happens automatically under the terms of an anti-dilution clause buried deep in some corporate document.

Valuing Deemed Dividends

Suppose that a conscientious withholding agent has custody of some BigCo convertible debentures. Let's say this thoughtful withholding agent makes a point of tracking distributions on BigCo's common stock and calculating their consequences for the conversion ratio of the debentures. In that case, the withholding agent will discover that BigCo has paid, say, a $1.12 dividend on its common stock and will then calculate that the conversion ratio of BigCo's convertible debentures has increased from 2.61 to 2.88.

What then? The withholding agent understands that increasing the conversion ratio by 0.27 increases the debenture holders' proportionate interest in BigCo. It also knows that this increase in proportionate interest, combined with the cash payment to the common stockholders, is treated as a cash dividend to the debenture holders under Code Secs. 305(c) and 305(b)(2).

However, if the withholding agent is going collect the applicable tax, it needs to know *how much* cash the debenture holders are deemed to receive. Section 1.305-7(c)(4)(i) of the proposed regulations says the withholding agent that the amount is the excess of (a) the fair market value of the conversion right with the benefit of the CRA over (b) the fair market value the conversion right would have had if no CRA had occurred. This is theoretically sound, but it is not something that can be calculated on the back of an envelope.

Mandating Reliable Disclosure

As the issuer the convertible security, BigCo is obviously well positioned to know about the events that trigger a CRA and to calculate the actual adjustment. BigCo's finance people can then use an option-pricing model to translate the adjustment (here, 0.27 shares per debenture) into a dollar value for the deemed distribution.

The next step is getting this information into the hands of actual withholding agents. Under Code Sec. 6045B and current Reg. §1.6045B-1, U.S. issuers are already required to report "organizational actions" that affect a security holder's tax basis.

Issuers do this by filing Form 8937, *Report of Organizational Actions Affecting Basis of Securities*, by the earlier of 45 days after the organizational action and January 15 of the following calendar year. Issuers must also send written notice to security holders by January 15. (Issuers that want to go paperless can just post the required information on a public website.)

The proposed regulations piggyback on this existing system. Issuers are required to disclose not only the effect of a CRA on basis but also the date and amount of any deemed dividends under Code Sec. 305. Withholding agents (other than the issuer) may rely on this information pursuant to Proposed Reg. §1.1441-3(c)(5).

One large information services company is already offering a product that will collect all this information and make it available to subscribers who do not want to hunt through paper filings or nose around corporate websites. So the informational issues that have contributed to that "lack of actual withholding tax" appear to have been solved.

Withholding Agents for Actual Distributions

Under Code Secs. 1441 and 1442, a withholding agent is anyone with "control, receipt, custody, disposal or payment" of the income in question. That makes intuitive sense. If we are going to draft somebody to deduct and remit tax from an item of income, that person should have practical control of the funds.

That is the traditional model. Something of value passes from the issuer to an intermediary and then to the holder of the security. The intermediary is a withholding agent only if it has the practical ability to grab a portion of that valuable something before passing what is left to the security holder.

Withholding Agents for Deemed Distributions

The traditional model breaks down when we try to apply it to deemed distributions. If BigCo pays a dividend that triggers a favorable CRA to its convertible debentures, the debenture holders certainly benefit from the adjustment. But this modification to their contractual rights is not a reified lump of value that passes from issuer to intermediary to holder. The traditional concepts of "control, receipt, custody, disposal or payment" do not apply when nothing is actually distributed.

The proposed regulations do not develop an alternative to the traditional concepts. Proposed Reg. §1.1441-7(a)(4) simply declares without explanation that the issuer of the security upon which the deemed distribution is made, as well as any person holding that security on behalf of the beneficial owner, "has custody of or control over the deemed distribution." It follows under the general definition in Reg. §1.1441-7(a)(1) that they are withholding agents with respect to the deemed distribution.

Actual Withholding on a Deemed Distribution

Proposed Reg. §1.1441-2(d)(4)(i) states that a withholding agent "has an obligation to withhold on a deemed distribution." In the case of intermediaries, this cannot mean "withholding" in the traditional sense. Declaring that a person holding a security has custody or control of a deemed distribution does not make it so. Even with the best of intentions, a withholding agent cannot withhold value from a deemed distribution.

But existing law suggests a solution. Under current Reg. §1.1461-2(b), a withholding agent that has failed to withhold on an actual distribution is authorized to correct this omission by withholding against *future distributions* to the non-U.S. person. Alternatively, the withholding agent can satisfy its withholding obligation by liquidating other property that it holds for the non-U.S. person or over which the withholding agent has control.

Proposed Reg. §1.1441-2(d)(4)(ii) is relying on these powers when it requires a withholding agent to withhold on a deemed distribution on the earliest of: (a) the date on which a payment is made with respect to the security on which the deemed distribution was made; (b) the date on which the security is sold, exchanged or otherwise disposed of; and (c) the due date (not including extensions) for the withholding agent to file its Form 1042 for the year in which the deemed distribution occurred.

A withholding agent cannot literally withhold from a distribution that is only deemed to occur. But a deemed distribution has value. If it accrues in favor of a non-U.S. person, that person should bear the burden of the 30-percent tax.

While a withholding agent cannot withhold tax from a deemed distribution, we can require the agent to intercept some *other* value that does actually pass from the issuer to the non-U.S. person, or from a buyer to the non-U.S. person when the security is sold. The withholding agent must therefore be in a position to seize payments intended for the non-U.S. person. The issuer of the security can withhold on actual distributions. Someone who holds the security for the benefit of the non-U.S. person can withhold on actual distributions and on cash realized by selling the security.

So the proposed regulations correctly treat the issuer and a person who holds the security on behalf of a non-U.S. person as withholding agents for the tax due with respect to the deemed distribution. But this only makes sense because the issuer and the holder have actual control over *actual* distributions or sale proceeds.

The proposed regulations obscure this rationale by implying that a person is a withholding agent because he has custody or control of the *deemed* distribution. This maintains continuity with the

traditional model of withholding. But it would have been better to avoid reliance on this fiction, even at the price of admitting an innovation.

Private Arrangements for Special Cases

The new regime should work well, but there are some gaps. Proposed Reg. §1.14412(d)(4)(ii), described above, requires withholding on a deemed distribution if the security is sold, an event that generates cash for an intermediary to send to the Treasury.

But this same provision also requires withholding if the security is transferred to a separate account not maintained with the withholding agent or if the account relationship is terminated. This poses a problem because these transfers and terminations do not provide the withholding agent with cash.

In some transfer situations, the withholding agent can raise cash by exercising its right to sell *other* property of the non-U.S. person that happens to be in its custody or control pursuant to current Reg. §1.1461-2(b). But that self-help remedy will not be available if the non-U.S. person has completely terminated its relationship with the withholding agent.

The preamble to the proposed regulations acknowledges that this can put withholding agents in a bind. But instead of letting them off the hook, the preamble warns withholding agents that they need to figure something out:

> 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.

It seems rather optimistic to suppose that a non-U.S. person terminating an account will have any interest in leaving behind "funds or other property" to protect the withholding agent. If a withholding agent wants protection, it needs to build it into the initial documentation governing the account. But that is just one more paragraph in a dozen pages of boilerplate, so the proposed regulations' approach may not be unreasonable after all.

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