Wolters Kluwer

The M&A Tax Report

JUNE 2016 VOLUME 24, NUMBER 11

The Monthly Review of Taxes, Trends & Techniques

Getting Stock Rights Right Under Code Sec. 305(c)

By Donald P. Board • Wood LLP

Long before the spawning and proliferation of limited liability companies, there were corporate taxes. LLCs and the other flow-through entities began dominating choice-of-entity menus after the 1986 repeal of the *General Utilities* doctrine. But before that, the staples were all about corporate taxes. And despite the changes of the last three decades, some things remain the same.

Code Sec. 305 governs distributions of stock and stock rights. And with the steadfastness of Bernie Sanders, the core provisions of this vaunted code section stand pretty much where Congress left them when they were installed in 1969. Subsequent legislation has addressed special topics, but the basic features of Code Sec. 305(a), (b) and (c) remain virtually unchanged. The same goes for the regulations.

The rules that the Treasury issued in 1973 to govern the fundamental provisions of Code Sec. 305 have hardly been touched in over 40 years. So, the issuance on April 12, 2016 of proposed regulations dealing with deemed distributions under Code Sec. 305(c) might be considered at least something of an event. The Treasury and the IRS, however, are downplaying the changes.

They say the proposed regulations simply resolve two technical "ambiguities" concerning the amount and timing of deemed distributions triggered by adjustments to rights to acquire stock. Anything that resolves technical ambiguities is always welcome, of course. But the Treasury and the IRS are being too modest.

The proposed regulations do not revolutionize the substantive law governing deemed distributions, but they significantly improve how the rules are formulated. The drafters have abandoned the gnomic phrasing of current Reg. §1.305-7 in favor of a much more explicit conceptualization. Now they try to say what "happens"—and to whom—when adjustments to stock rights are re-characterized as corporate distributions under Code Sec. 305(c).

The payoff is that the proposed regulations significantly clarify Code Sec. 305(c)'s interaction with Code Sec. 305(b). This is a provision that can turn an apparently innocent stock distribution into a taxable dividend. The main "ambiguity" that the proposed regulations are supposed to resolve is responsible for some misguided analysis in a key example involving changes to conversion ratios.

This faulty analysis (discussed below) has been sitting in the regulations for decades. The proposed regulations finally correct the example. And beyond that, they provide terminology that would have prevented the confusion if it had been available in 1973.

So the Treasury and the IRS should take credit for more than just a pair of technical adjustments. The reformulated rules under Code Sec. 305(c) will make life easier for tax advisers, withholding agents and anyone else who needs to work out the consequences of changing the terms of a right to acquire stock.

Twice-Deemed Distributions Under Code Sec. 305

Code Sec. 301(a) and (c) requires a stockholder to include in gross income the portion of any corporate distribution of property that constitutes a dividend as defined in Code Sec. 316. Code Sec. 317(a), however, says that the term "property" does not include stock of the corporation making the distribution or rights to acquire such stock. This means that those familiar distributions known as "stock dividends" are not directly taxable as dividends under Code Sec. 301.

Code Sec. 305 steps in to fill the statutory gap. It begins, in Code Sec. 305(a), by reaffirming that distributions of stock (broadly defined in Code Sec. 305(d)(1) to include rights to acquire stock) are not includible in gross income. This general rule of exclusion is immediately subjected to the exceptions listed in Code Sec. 305(b), which treats five types of stock distribution as distributions of *property*.

Distributions of property are taxable under Code Sec. 301, so a stock dividend can be as taxable as cash if it runs afoul of Code Sec. 305(b). Code Sec. 305(c) adds another layer of deemed distributions. It instructs the Treasury to prescribe regulations that will treat certain "transactions" as distributions of stock even though there is no observable distribution of shares.

Code Sec. 305(c) provides the following list of candidates for re-characterization:

> [A] change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder.

If the mandated regulations treat one of these transactions or events as a distribution of stock pursuant to Code Sec. 305(c), the deemed distribution must be examined under Code Sec. 305(b). The latter is supposed to determine whether it should be further re-characterized as a distribution of property subject to Code Sec. 301.

Coming to Terms

Stated schematically, the cascade of deemed distributions through Code Sec. 305(b) and (c) is not hard to follow. The difficulties arise when one tries to decide whether a transaction that triggers a deemed distribution of stock also triggers a deemed distribution of property

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

under a particular provision of Code Sec. 305(b). Part of the problem is the technical nature of the underlying financial transactions. That is pretty much unavoidable.

Another source of difficulty, though this one is entirely avoidable, is a matter of terminology. The current regulations, following the statute, generally use a single term—"stock"—to refer to both stock and rights to acquire stock. This is probably not as bad as defining "apples" to mean both apples and oranges. Still, it certainly does not make analysis any easier for those of us in the trenches. As we shall see, the proposed regulations adopt new terms that remove this impediment.

Options and Convertibles

Currently, Reg. §1.305-7(a) says that the transactions or events listed in Code Sec. 305(c) "may be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction."

The following discussion will focus, as the proposed regulations do, on changes to conversion ratios and similar adjustments to rights to acquire stock from a corporate issuer. These rights to acquire stock fall into two groups. The first consists of such familiar instruments as warrants, options and subscription rights.

Options and similar rights entitle their holders to purchase stock from the issuer for cash at a particular price—the option's "exercise price." The lower the exercise price per share, the more valuable the option. The second group consists of convertible securities. These are financial instruments with independent economic significance—usually preferred stock or debentures, but also common stock.

However, like options, convertibles also give their holders the right to acquire stock from the issuer. Convertible preferred stock and convertible debentures typically convert into common stock. Convertible common stock may convert into preferred stock or another class of common.

The rights to acquire stock that are part of these instruments are exercised not by a fresh payment of cash but by "converting" the instrument directly into the target stock—in effect, a tax-free exchange. Usually, the critical feature is the "conversion ratio." It will determine how many shares of stock the holder of a convertible security will receive if he or she exercises the conversion right. The higher the conversion ratio, the more valuable the conversion right and the convertible security that includes it.

In other convertibles, the key feature is the "conversion price." This is the price that must be "paid"—using the face value of the security, not cash—to acquire shares. A lower conversion price is equivalent to a higher conversion ratio.

Anti-Dilution and Proportionate Interests

The indentures, option agreements and corporate charter provisions that lay out the terms of rights to acquire stock almost always include provisions designed to protect their holders from one or more forms of dilution. Suppose that the holder of a debenture is entitled to convert the instrument into two shares of the issuer's common stock. If the issuer declares a one-on-one stock dividend or executes a two-for-one stock split, the number of outstanding shares will double.

A debenture that formerly entitled the holder to convert into, say, six percent of the issuer's outstanding common stock will now be convertible into only three percent. The total value of the issuer's outstanding common stock, like the size of a pie, is unaffected by the number of slices it is divided into. Nevertheless, a transaction that reduces the debenture holder's *proportionate interest* in the corporation from six percent to three percent will reduce the economic value of the conversion right by 50 percent.

To maintain the "buying power" of the conversion right, the debenture holder's contract with the issuer will include an anti-dilution provision that adjusts the conversion ratio to take account of any stock splits or stock dividends. To compensate for a one-on-one stock dividend, the conversion ratio should be doubled. That way, the holder's original right to convert the debenture into six percent of the issuer's common stock remains unimpaired.

This kind of anti-dilution adjustment does not increase the holder's "proportionate interest in the earnings and profits or assets of the corporation" as described in Code Sec.

305(c). It is designed to maintain the *status quo*. So it is not surprising that both current Reg. §1.305-7(b)(1) and Proposed Reg. §1.305-7(c)(3) say that changes to conversion ratios resulting from the operation of a "bona fide, reasonable adjustment formula" will not be treated as distributions that must be scrutinized under Code Sec. 305(b).

A Different Anti-Dilution Tactic

A second kind of an anti-dilution provision is more problematic. Suppose that a corporation whose common stock is worth $100 per share pays an extraordinary dividend of $60 per share. All things being equal, the corporation's stock price should drop to $40.

A holder of a convertible debenture who could have converted into one share of stock worth $100 before the dividend still has a right to convert into one share of stock after the dividend. Payment of the cash dividend does not change the number of shares outstanding, so the debenture holder's proportionate interest in the corporation is also unaffected. But that share of stock is worth only $40, because cash was distributed to the existing shareholders.

The dilution is purely economic, but that does not make it any less of a problem. To avoid this unhappy result, holders of convertible instruments often demand provisions to protect against dilutive property distributions. The drafting can get complicated, but the goal is plain enough.

The conversion ratio should be increased by an amount that makes up for the economic effect of the distribution. In the example above, the conversion ratio would be increased so that each debenture would still be convertible into common shares worth $100, despite the $60 distribution. The conversion ratio would therefore be increased to 2.5-to-1, because it takes 2.5 shares of stock worth $40 to equal the value of one share worth $100.

This second kind of anti-dilution provision simply aims to preserve the economic *status quo*. Nevertheless, it operates by increasing the debenture holder's proportionate interest in the corporation. That sets off sirens under Code Sec. 305(c).

Protecting investors from dilution sounds admirable or at least harmless. However, current Reg. §1.305-7(b)(1) and Proposed Reg. §1.305-7(c)(3) have dual warnings. They both caution that anti-dilution provisions that compensate holders of stock rights for the effects of cash or property distributions to shareholders are not "bona fide, reasonable adjustment formulas" of the sort the regulations endorse in connection with stock splits and stock dividends.

As a consequence, a conversion rate adjustment (known on Wall Street as a "CRA") triggers a deemed distribution of stock (including rights to acquire stock) under Code Sec. 305(c). This deemed distribution must then be examined under Code Sec. 305(b) to determine whether it should be treated as a distribution of property. That, of course, opens the door to taxing the adjustment as a dividend under Code Sec. 301.

Disproportionate Distributions

Code Sec. 305(b) has five separate tests for determining whether a distribution of stock must be treated as a distribution of property. We can limit ourselves to Code Sec. 305(b)(2). This subsection is captioned "Disproportionate distributions."

It treats a distribution of stock (or rights to acquire stock) as a distribution of property if the distribution has the result that some shareholders receive property while other shareholders increase their "proportionate interests … in the assets or earnings and profits of the corporation." Since an increase in proportionate interest is also what triggers Code Sec. 305(c), deemed stock distributions must always be reviewed under Code Sec. 305(b)(2).

Applying Code Sec. 305(b)(2) to a deemed distribution of corporate shares is straightforward, at least in principle. Assuming that the distribution results in some shareholders increasing their proportionate interests in the corporation at the expense of others, Code Sec. 305(b)(2) applies if any of the other shareholders receive property. This test is not hard to satisfy, because the other shareholders' receipt of property need not have any obvious connection to the stock distribution.

Suppose, for example, that a corporation distributes additional shares to the holders of its Class A common stock, increasing their proportionate interests at the expense of holders of Class B common. Under Reg. §1.305-3(b)(4), the stock distribution to the Class A shareholders will trigger Code Sec. 305(b)(2) if the corporation pays (or has paid) anything—even a normal cash dividend—to the Class B shareholders at any time within *three years* before or after the stock distribution. Even if the receipt of property falls outside the six-year window, it will trigger Code Sec. 305(b)(2) if it was made pursuant to a plan that involved the deemed distribution.

Getting Rights Wrong

Applying Code Sec. 305(b)(2) to a deemed distribution resulting from the adjustment of a stock right presents an additional challenge. The current regulations use a single term—"stock"—to refer to both stock and rights to acquire stock. This promotes economy of expression, but it makes it harder to understand how the rules are supposed to work.

In fact, it is responsible for the principal "ambiguity" that the proposed regulations are supposed to resolve.

To illustrate the problem, suppose that a $100 debenture is convertible into one share of the issuer's common stock. The debenture has an anti-dilution provision that protects the holder from the effect of cash dividends paid on the common stock.

The common stock is currently trading at $90 per share, so the conversion right is out-of-the-money. Converting the $100 debenture into a share worth $90 would lose the holder $10.

The corporation declares a $10 dividend, causing the value of its shares to fall to $80. The anti-dilution provision kicks in, increasing the conversion ratio so that the debenture is now convertible into 1.125 shares of common. With the stock trading at $80, 1.125 shares are worth $90. So the anti-dilution provision is a roaring success. Despite the $10 dividend, there is no change in the total value of the shares into which the debenture can be converted.

Terms and Consequences

What are the tax consequences? Under current Reg. §1.305-7(a), a change in a conversion ratio that increases the proportionate interest of "any shareholder" will be deemed a distribution of "stock" to that shareholder if it has the result described in Code Sec. 305(b)(2).

Current Reg. §1.305-1(d) defines "stock" to include rights to acquire stock and "shareholder" to include holders of convertible securities. So we can read current Reg. §1.305-7(a) as saying that a change in conversion ratio that increases the proportionate interest of the holder of a convertible security to compensate for a property distribution to shareholders will be treated as a distribution of additional *rights to acquire stock* to the holder of the convertible security.

However, the definition of "stock" just says that stock includes rights to acquire stock. It does not tell us when "stock" means stock and when it means rights.

So it is also possible to read current Reg. §1.305-7(a) as saying that a change in conversion ratio that increases the proportionate interest of a holder of a convertible security will be treated as a distribution of *stock* to the holder of the convertible security.

This reading is more than a hypothetical possibility. Current Reg. §1.305-3(e) includes several examples that are supposed to illustrate the application of Code Sec. 305(b)(2) in conjunction with Code Sec. 305(c). Example 6 imagines a corporation with two classes of common stock—Class A and Class B. The Class B stock is initially convertible into Class A shares on a one-to-one basis.

The corporation pays a cash dividend to the Class A shareholders. A year later, an annual adjustment clause automatically increases the conversion ratio so that one share of Class B stock is now convertible into 1.05 shares of Class A. Example 6 explains that, as a result of the increase in the conversion ratio,

> a distribution of *0.05 shares of class A stock* is deemed made under section 305(c) with respect to each share of class B stock, since the proportionate interests of the class B shareholders in the assets or earnings and profits of [the corporation] are increased and the transaction has the effect described in section 305(b)(2). [Emphasis added.]

Example 6, in other words, treats the deemed distribution of "stock" under Code Sec. 305(c) as a distribution of actual shares of stock, not rights to acquire shares. This interpretation has unfortunate consequences for the holder of the $100 convertible debenture described above.

Under Example 6, increasing the conversion ratio to 1.125 will be treated as the distribution of 0.125 shares of common stock. With the stock trading at $80 per share, this deemed distribution under Code Sec. 305(c) will be worth $10 ($80 times 0.125). Code Sec. 305(b)(2) will treat the deemed distribution as a distribution of property worth $10.

By any reckoning, this is an unreasonable result. Increasing the conversion ratio of an out-of-the-money conversion right has stuck the debenture holder with a $10 dividend. It is true that increasing the conversion ratio means that the debenture holder would get stock worth an extra $10 if he or she immediately opted to convert. But that fact is hardly relevant when the conversion feature is under water and converting the debenture makes no economic sense.

What the debenture holder is *really* getting is an increase in the number of shares that he or she has the *right to purchase* by exercising the conversion right. The right to acquire an additional 0.125 shares will always make the conversion right more valuable by some positive amount. But what that amount is will vary enormously depending on circumstances.

When the conversion right is significantly out-of-the-money, as in the example, the right to get an additional 0.125 shares may be worth very little—much closer to 10 cents than to $10. On the other hand, if the stock is trading for a price well above the value of the debenture, the right to get an additional 0.125 share will be worth quite a bit. The point is that one cannot simply equate the value of an increase in a conversion ratio with the value of the additional stock that the adjusted conversion right can buy.

The proposed regulations have deleted the questionable "stock" analysis from Example 6 and replaced it with a cross reference to Proposed Reg. §1.305-7(c)(4)(i). If an adjustment to a right to acquire stock is treated as a distribution, the proposed regulation declares that it is a deemed distribution of *a right to acquire stock*, not a deemed distribution of stock. The value of this deemed distribution is equal to the increase in the value of the holder's right resulting from the adjustment.

Under Proposed Reg. §1.305-7(c)(4)(i), this is the excess of (a) the fair market value of the right to acquire stock determined with the benefit of the adjustment over (b) the fair market value that the right to acquire stock would have had if the adjustment had not been made. It may require a rocket scientist and the latest option-pricing model to figure out just what those real and hypothetical values are. But the proposed regulations are finally aiming at the right target.

Reformed Framework for Analysis

To their joint credit, the Treasury and the IRS have not just corrected a misguided example. The proposed regulations provide a conceptual framework that recognizes, as it should, the significant difference between stock and rights to acquire stock. This is reflected primarily in the new terminology in Proposed Reg. §1.305-1(d).

The term "rights to acquire stock" is defined in the usual way to include conversion rights and options. But now rights to acquire stock are clearly distinguished from "actual stock." That means shares of stock actually issued by a corporation, period. It specifically does *not* include rights to acquire stock.

The same distinction is reflected in the new terms "actual shareholder" (a holder of actual stock) and "deemed shareholder" (a holder of a right to acquire stock). "Apples" means apples, and "oranges" means oranges.

Naming Rights?

Proposed Reg. §1.305-7(d) adopts the colorless term "applicable adjustment" to refer to any adjustment to a right to acquire stock.

An umbrella term is useful because these adjustments are among the most common ways to trigger a deemed distribution under Code Sec. 305(c) and (b)(2). But the best thing about the new definition is that it explicitly identifies some leading situations to which the term applies, as well as the person to whom it applies. Although one can extract this information from the current regulations through patient study of the many pages of examples, it is never systematized.

Nor would it be easy to do so, given the current regulations' use of "stock" to mean both actual stock and rights to acquire stock.

The proposed regulations come right out and say that an increase in the conversion ratio of a convertible instrument (or, equivalently, a reduction in the conversion price) is an applicable adjustment with respect to the holder of the *instrument*. [Proposed Reg. §1.305-7(a)(1).] A decrease in the conversion ratio (or an increase in the conversion price) is an applicable adjustment with respect to a holder of *actual stock* of the kind into which the instrument may be converted. [Proposed Reg. §1.305-7(a)(3).]

Similarly, an increase in the number of shares to be issued upon exercise of an option is an applicable adjustment with respect to the holder of the *option*. In contrast, a decrease is an applicable adjustment with respect to a holder of *actual* stock of the kind that would be issued if the option were exercised. [Proposed Reg. §1.305-7(a)(2) and (a)(4).]

Thanks to this basic orientation, anybody trying to determine the tax consequences of these common adjustments is half way home. This is a vast improvement compared with the current regulations. For over 40 years, they have done little more than invite readers to search through the examples for a fact situation that seems to fit.

Deemed Distribution of What, Exactly?

Once an applicable adjustment has been identified, it will be treated as a distribution under Code Sec. 305(c) if it increases the proportionate interest of the holder of the right to acquire stock or a holder of actual stock (as applicable) *and* it has one of the effects described in Code Sec. 305(b)(2), (3), (4) or (5). The current regulations label this a deemed distribution of "stock" and leave it at that. Proposed Reg. §1.305-7(b)(1), in contrast, clearly distinguishes deemed distributions of actual stock from deemed distributions of rights to acquire stock.

Suppose that a corporation distributes cash to the holder of a convertible security, which triggers a *reduction* in the conversion ratio. Reducing the ratio is an applicable adjustment with respect to the holders of the corporation's actual stock. The adjustment increases the proportionate interest of the actual shareholders in their capacity as shareholders, so they are deemed to receive a distribution consisting of *actual stock*. [Proposed Reg. §1.305-7(c)(2).]

In the mirror-image case, the corporation distributes property to its actual shareholders. This triggers an *increase* in the conversion ratio applicable to the outstanding rights to acquire stock. Increasing the ratio is an applicable adjustment with respect to the holders of the rights. The adjustment increases the right-holders' proportionate interests in the corporation, so they are deemed to receive a distribution of *rights to acquire stock*. [Proposed Reg. §1.305-7(c)(1).] (This does away with the dubious analysis of Example 6 of current Reg. §1.305-3(e), discussed above.)

The proposed regulations thus straighten out what happens in the two kinds of deemed distributions (and to whom). After that, the rules for determining the amount of the deemed distribution are exactly what one would expect. If there is a deemed distribution of actual stock, the amount of the deemed distribution is the fair market value of the stock deemed distributed. [Proposed Reg. §1.305-7(c)(4)(ii).]

If there is a deemed distribution of rights to acquire stock, the amount deemed distributed is the fair market value of the rights deemed distributed. [Proposed Reg. §1.305-7(c)(4)(i).]

When Is a Deemed Distribution Made?

Timing matters. The second of the two ambiguities identified in the preamble to the proposed regulations concerns the time when deemed distributions resulting from adjustments to rights are deemed to occur. Proposed Reg. §1.305-7(c)(5) starts by treating a deemed distribution as occurring at the time of the applicable adjustment, assuming that it is specified in the instrument setting forth the terms of the right to acquire stock.

If the indenture says that an event will cause the conversion ratio of a debenture to increase or decrease as of some particular date, that is when the deemed distribution occurs. But sometimes not. As we have seen, adjustments to conversion ratios that result in deemed distributions are frequently triggered by distributions of property either to actual shareholders or to holders of rights.

Suppose that a corporation's preferred stock is convertible into common stock. The conversion ratio is adjusted annually in January to take account of cash distributions to holders of the common stock during the preceding calendar year to the extent that the distributions exceeded, say, $2 per share. The proposed regulations treat the deemed distribution to the preferred shareholders as occurring on the *earlier* of the date of the adjustment and the date of the property distribution that triggered the subsequent adjustment.

So the preferred shareholders can end up with dividend income in the tax year preceding the favorable adjustment of their conversion ratio. The governing documentation may not specify a date for an applicable adjustment, and the right may be a right to acquire publicly traded stock. In that case, the proposed regulations treat the deemed distribution as occurring immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that triggered the deemed distribution.

If the right is a right to acquire nonpublicly traded stock, the proposed regulations use the date when the recipient of the cash or property became legally entitled to the distribution.

Concluding Observation

Anyone who works through even half the examples in the current regulations under Code Sec. 305 will be struck by the ingenuity of the drafters. The regulations may not be the *Magna Carta*, but they are still pretty impressive. Yet every couple of decades, it is worth stepping back, as the proposed regulations have done, and taking a new look at the existing edifice.

A judicious bit of remodeling—widening an entrance way, installing a skylight and removing a wall or two—can honor the original architects while better accommodating those who come after them.

Wolters Kluwer

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH