

IRS Proposed Regulations Under Section 305(c)

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In April, the IRS issued proposed regulations interpreting deemed distributions under Section 305(c). Specifically, the proposed regulations would clarify the amount and timing of deemed distributions that result from an adjustment to the right to acquire stock. These regulations will generally apply to deemed distributions occurring after they are finalized, but may be relied upon for deemed distributions occurring on or after January 1, 2018.

Section 305 governs situations where a corporation distributes its own stock or rights to acquire such stock. Although stock dividends are generally not taxable to the shareholders of such a corporation, Section 305(b) includes five exceptions to this general rule. Under Section 305(c), Congress specifically provided the Treasury Department the ability to promulgate regulations to expand the exceptions to the general rule to certain changes to warrants, options, instruments convertible into stock and other rights to acquire stock. Although the Treasury Department believes the current regulations are clear as to what constitutes a change that will be considered a taxable deemed distribution, it felt that they are unclear as to the amount and timing of the deemed distribution. The proposed regulations address these two areas. In addition, the proposed regulations provide guidance as to when and how a withholding agent must withhold on the deemed distribution.

Amount of deemed distribution

The proposed regulations state that “the amount of the deemed distribution¹ is the excess of (1) the fair market value of the right to acquire stock immediately after the applicable adjustment² over (2) the fair market value of the right to acquire stock without the applicable adjustment.” This clarifies that the deemed distribution amount is determined by the increase in the fair market value of the right held by the holder of the instrument. There was a concern that current regulations could be interpreted as the distribution being treated as a distribution of the actual stock to which the right relates.

In contrast, the amount of the deemed distribution to an actual shareholder from an applicable adjustment is determined by reference to the fair market value of the stock deemed to be distributed. In determining the fair market value of a right to acquire stock, any particular facts pertaining to the deemed shareholder’s rights are disregarded and any possible future applicable adjustments are not

taken into account.

Timing of deemed distribution

Under the proposed regulations, the deemed distribution occurs contemporaneously to the applicable adjustment, but in no event later than the date of the distribution of cash or property that results in the deemed distribution. The applicable adjustment is determined by looking at the applicable instrument setting forth the rights to acquire stock.

There are two default rules if the relevant instrument does not set forth the date of upon which the applicable adjustment takes effect. If the right is to acquire publicly traded stock, the deemed distribution occurs immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution. If the right is to acquire non-publicly traded stock, the deemed distribution occurs on the date that the actual shareholder or deemed shareholder is legally entitled to the distribution of cash or property that results from the deemed distribution.

Withholding agent's obligation

The proposed regulations also provide rules and information for withholding agents with respect to deemed distributions to foreign holders, imposing withholding obligations even in situations where there is no cash payment. The requirements are somewhat more relaxed in the event the withholding agent is a foreign entity or is not the issuer of the security. There are also information reporting obligations for the issuer of the instrument.

1 A "deemed distribution" is defined as a transaction or event, other than an actual distribution of stock, money or other property, that is considered a distribution under section 305(b) or (c).

2 An "applicable adjustment" is defined as an adjustment to a right to acquire stock, including an increase or reduction in the conversion ratio, conversion price, option price or number of shares the holder would receive upon conversion or exercise.

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