

The Odd Couple: Code Sec. 305(c) and Make-Whole Fundamental Changes

By Michael E. Bauer, Y. Bora Bozkurt, and Matthew H. Brown*

Michael E. Bauer, Y. Bora Bozkurt, and Matthew H. Brown examine the interaction between the deemed distribution rules under Code Sec. 305(c) and the make-whole-fundamental change (“MWFC”) provisions that are found in many modern convertible debt agreements.



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The tax code and regulations contain numerous provisions requiring taxpayers to take into account “deemed” payments. Some are more well-known than others. Despite having been enacted in 1969,¹ Code Sec. 305(c) (and its application to convertible bonds) has yet to become the household name that some other provisions have become. If not to make it a household name, this article at least aims to remind readers of the importance of Code Sec. 305(c) and the complications in its interpretation using a real-life example.²

Congress added Code Sec. 305(c) to the tax code in 1969 to address arrangements that taxpayers had developed to avoid Code Sec. 305’s primary exception to the tax-free treatment of stock dividends—taxing stock dividends that a shareholder could elect to receive in cash.³ The concern at the time was that the exception could be easily avoided with the economically similar transaction of paying cash dividends to common stockholders and increasing the conversion rate on convertible bonds that may be converted into the same common stock.⁴ Treasury issued regulations in 1973 that, among other things, were meant to identify when a change to a convertible bond’s conversion rate should be treated as akin to a stock distribution.⁵ For much of the subsequent 45-year period, the tax community appears to have struggled with the application of these regulations to convertible bonds and put off examining the possibility of a taxable deemed dividend as a result of a conversion rate adjustment under a convertible bond.⁶ Only recently, the government and taxpayers (in part as a result of proposed regulations issued in 2016) have focused on the scope (and potential tax implications) of Code Sec. 305(c), which has become generally known ... and criticized (by some).⁷

MICHAEL E. BAUER is a director, and **MATTHEW H. BROWN** is a senior associate, in the International Tax group in PwC’s Washington National Tax practice. **Y. BORA BOZKURT** is a partner with Latham & Watkins LLP.

This article focuses on a conversion rate adjustment that is found in most convertible bonds but which does not always fit neatly into Code Sec. 305(c): the conversion rate adjustment for a make-whole fundamental change (MWFC).

MWFC Conversion Rate Adjustments

A number of events are typically classified as an MWFC, including cash mergers and other business combinations (typically excluding business combinations where the bonds become convertible into consideration 90% or more of which consists of listed stock of another issuer). In addition, the redemption of the bonds or the delisting of the underlying common stock are often MWFC events.⁸

MWFC events can significantly reduce the value of the convertible bond, primarily by devaluing the embedded conversion right. For example, a delisting of the underlying common stock erodes value by reducing the liquidity of the consideration received upon conversion. Similarly, a cash merger, which will cause the convertible bonds to become convertible solely into cash, can erode value by eliminating the volatility of the value of the consideration payable upon conversion. Finally, since a conversion right is generally more valuable the longer the exercise period is, a redemption of the convertible bond will reduce value by effectively cutting short the exercise period. MWFC provisions are designed to compensate for this lost value by increasing the conversion rate applicable to bonds that are converted within a specified window surrounding the MWFC (typically, within 35 trading days after an MWFC or, in the case of a redemption, at any time after the bonds are called for redemption and before they are redeemed). While the MWFC provisions sometimes refer to “additional shares” being added to the conversion rate, in a cash merger, for example, in which the underlying stock is to be exchanged for cash, the bonds will become convertible into cash, and, upon conversion in circumstances in which the conversion rate is increased, the additional consideration resulting from the increase will be paid in the form of cash, if delivered after the cash merger’s effective date.⁹

The MWFC adjustment is commonly calculated by reference to a table in the indenture that determines the amount of the adjustment by taking into account the trading price of the stock (or, in the case of a cash merger, the amount of cash given per share of common stock in the merger) and the remaining term of the bond. Although the conversion rate increases for those bondholders who elect to convert within the applicable window, it “resets”

to the pre-MWFC rate thereafter (such that bondholders who do not convert are not entitled to the conversion rate increase).¹⁰

Consistent with the regular conversion option, if a bondholder converts in connection with an MWFC, the issuer often can, at its option, settle in cash, stock, or a combination thereof (except, as described above, in the case of an MWFC arising from a cash merger where the ability to settle in stock upon conversion is replaced with the ability to settle with the merger consideration—*i.e.*, cash).

Code Sec. 305(c)’s Application to Convertible Bonds

Before considering how Code Sec. 305 might (or might not) apply to conversions in connection with an MWFC, some basics are in order. Indeed, why would a Code Sec. captioned “Distribution of stock and stock rights” apply to a conversion rate adjustment under a convertible bond?

To begin with, despite its caption, Code Sec. 305 provides by its terms that: (1) “stock” includes the rights to acquire stock; and (2) “shareholder” includes a holder of such rights or of convertible securities.¹¹ Thus, perhaps counterintuitively, Code Sec. 305(c) applies to convertible bonds and their holders (who are “shareholders” for this purpose).¹² In the same vein, Code Sec. 305(c) says: “For purposes of this Code Sec. and Code Sec. 301, the Secretary shall prescribe regulations under which a change in conversion ratio ... shall 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.” The 1969 legislative history to Code Sec. 305(c) indicates that Congress expected such regulations would provide that certain changes in the conversion rate of convertible bonds would be treated in a manner similar to a stock distribution (another action that can cause a shareholder’s proportionate interest in the E&P or assets of a corporation to increase).¹³

Regulations under Code Sec. 305 provide that a deemed distribution under Code Sec. 305(c) “will be deemed to be a distribution of the stock” of the corporation made by the corporation to the shareholder whose interest in the E&P or assets of the corporation is increased thereby.¹⁴ The regulations clarify that a change in conversion rate is treated as a distribution to which Code Secs. 305(b) and 301 apply where a shareholder’s proportionate interest in the E&P or assets of the corporation is increased by

the change and, recognizing that any such distribution is generally non-taxable under Code Sec. 305(a), the deemed distribution has the result described in Code Sec. 305(b) (2), (3), (4), or (5). Therefore, as with any other stock distribution, a deemed stock distribution is only taxable if it fits within one of the Code Sec. 305(b) exceptions to Code Sec. 305(a).¹⁵

The four exceptions under Code Sec. 305(b) that could make a deemed stock distribution under Code Sec. 305(c) taxable (assuming sufficient E&P) are as follows:

1. The deemed stock distribution has the result of (i) the receipt of property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or E&P of the corporation¹⁶;
2. The deemed stock distribution has the result of (i) the receipt of preferred stock by some common shareholders, and (ii) the receipt of common stock by other common shareholders¹⁷;
3. The deemed stock distribution is with respect to preferred stock (other than an increase in the conversion rate of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock in which such convertible stock is convertible)¹⁸; or
4. The deemed stock distribution is of convertible preferred stock (unless it is established that the distribution will not result in the receipt of property by some shareholders and the increase in the proportionate interest of others in the assets or E&P of the corporation).¹⁹

There is an exception to Code Sec. 305 for conversion rate adjustments made pursuant to “antidilution provisions.”²⁰ If a change in conversion rate is made pursuant to a *bona fide*, reasonable adjustment formula (e.g., a “market price” or “conversion price” formula) that has the effect of preventing dilution of the interest of the holders of such stock, the change will not result in a deemed distribution of stock.²¹ Accordingly, if a conversion rate adjustment is made pursuant to an antidilution provision, no deemed stock distribution occurs under Code Sec. 305(c) (and, therefore, it is not necessary to consider whether one of the Code Sec. 305(b) exceptions to Code Sec. 305(a) apply). There is no deemed distribution and thus no taxable event.

Whether or not Code Sec. 305(c) applies to an MWFC could be a high-stakes question. The application of Code Sec. 305(b) means that, assuming sufficient E&P, the holder of the convertible bond will receive a dividend instead of what would otherwise be a tax-free transaction (such as in the case of a conversion entirely into stock)

or a transaction resulting in capital gain recognition.²² While the dividend would increase the bondholder’s basis in the convertible bond,²³ that may be poor consolation for a U.S. taxpayer. In the case of a conversion into cash, the bondholder would recognize gain or loss in any event, but the application of Code Sec. 305(c) to an MWFC adjustment could then result in ordinary dividend income followed by a reduced capital gain or increased capital loss (the deductibility of which may be limited). For a foreign investor in convertible bonds issued by a U.S. corporation, the tax consequences of a deemed dividend are even more drastic, as most foreign investors are subject to at least some dividend withholding tax (whereas the conversion of the convertible bond would have been otherwise tax-free or would result in a capital gain that is normally not taxable in the United States).

Application of Code Sec. 305(c) to an MWFC Conversion Rate Adjustment for Converting Bondholders

As noted above, a threshold question in determining whether Code Sec. 305(c) could apply is whether the change in the conversion rate increased the bondholder’s proportionate interest in the E&P or assets of the corporation. If not, the change in conversion rate could not result in a deemed stock distribution to the bondholder under Code Sec. 305(c), let alone a *taxable* deemed stock distribution under Code Secs. 305(b) and 301.

When applied to more complicated fact patterns—such as conversion rate adjustments in response to MWFC events—Code Sec. 305(c) becomes truly difficult to apply.

Whether a converting bondholder’s proportionate interest in the corporation increased ought not to depend on whether they ultimately received cash or shares (or a combination thereof) on conversion (which would be determined by the issuer or, in certain cases, the consideration received by underlying stockholders in the MWFC, and not the holder). In any event, on account of the MWFC,

there was an adjustment to the conversion rate that entitled them to additional shares in the corporation. As a result, the converting bondholder's proportionate interest in the corporation necessarily increased (relative to that of the other shareholders, whose proportionate interest in the corporation necessarily decreased). Whether this increase in their ownership ultimately manifests itself in additional shares or a larger cash retirement price, the converting bondholder (as a result of the conversion rate adjustment) is entitled to a larger share of the E&P or assets (in the case of a cash payment²⁴) of the corporation relative to the other shareholders immediately prior to the transaction.

An MWFC adjustment to the conversion rate also does not appear to satisfy the exception for a *bona fide* antidilution provision. As noted above, the MWFC conversion rate adjustment compensates converting bondholders primarily for the lost value of the embedded conversion option in their convertible bond—thus, it is not intended to prevent converting bondholders from being diluted. Therefore, the MWFC conversion rate adjustment is unlikely to be viewed as a *bona fide* antidilution provision.

Assuming there is a deemed stock distribution under Code Sec. 305(c) (*i.e.*, there was an increase in the bondholder's proportionate interest in the E&P or assets of the company), the distribution will only be taxable (if at all) to the extent that the distribution satisfies an exception to Code Sec. 305(b)(2)–(5).²⁵

The main candidate in this context is probably Code Sec. 305(b)(2).²⁶

Under Code Sec. 305(b)(2), if the adjustment to the conversion rate results in an increase in the converting bondholder's proportionate interest in the E&P or assets of the corporation, it will be treated as a distribution of property to which Code Sec. 301 applies (and, thus, potentially a taxable dividend) if it has the result of the receipt of property by other shareholders. Regulations under Code Sec. 305(b)(2) clarify that there is no requirement for both elements of Code Sec. 305(b)(2) to occur in the form of a distribution or series of distributions so long as the result of the deemed stock distribution is that some shareholders' proportionate interests increase and others received cash or property.²⁷ Reg. §1.305-3(b)(4) provides, if there are more than 36 months between the receipt of cash or property by some shareholders and a distribution (or series of distributions) of stock to other shareholders, the distribution is not a disproportionate distribution, unless the receipt of cash or property and the distribution of stock or stock rights are made pursuant to a common plan. The inverse is also true—a series of distributions

within the 36-month period may be considered part of a single disproportionate distribution whether or not in fact made pursuant to a common plan. In the convertible bond context, Treasury also added the following parenthetical language to Reg. §1.305-3(b)(3) in 1974: “[T]he payment of interest to a holder of a convertible debenture is treated as a distribution of property to a shareholder for purposes of Code Sec. 305(b)(2).” Reg. §1.305-3 demonstrates the impact of these rules by a simple example:

Example (4). (i) Corporation W has one class of stock outstanding, class A common. The corporation also has outstanding interest paying securities convertible into class A common stock which have a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. Corporation W distributes to the class A shareholders rights to acquire additional shares of class A stock. During the year, interest is paid on the convertible securities.

(ii) The stock rights and convertible securities are considered to be outstanding stock of the corporation and the distribution increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation. Therefore, the distribution is treated as a distribution to which section 301 applies. [...]

If the underlying common stockholders have been receiving cash dividends within the 36 months leading up to the MWFC event or receive cash dividends within the 36 months following the MWFC event, it would indicate that “the receipt of property by some shareholders” prong would be met.

In the absence of such cash distributions—assuming an MWFC event occurs pursuant to which half the bondholders convert at a rate subject to the MWFC adjustment and half the bondholders hold on to their bonds and continue to receive interest—it is not clear whether the same class (*i.e.*, convertible bonds) should be bifurcated into holders benefiting from the MWFC adjustment and holders receiving the interest payments, thereby satisfying both prongs of Code Sec. 305(b)(2).²⁸

Under Reg. §1.305-3(b)(3), “a distribution of property incident to an isolated redemption of stock (for example, pursuant to a tender offer) will not cause section 305(b)(2) to apply.” The question is whether this rule can provide relief from an MWFC conversion rate adjustment being treated as a deemed dividend? The issue with that, however,

is that Reg. §1.305-3(b)(3) seems to envision an increase in the E&P of the entity by other shareholders due to the redemption, and the redemption in this instance (*i.e.*, the conversion of the bonds) is not necessarily what increases the E&P of the convertible bondholders—it is instead the conversion rate adjustment itself. And the conversion rate adjustment—a deemed distribution of the corporation’s stock—is likely not a “distribution of property” within the meaning of this regulation, which addresses “the receipt of money or other property by some shareholders” (*i.e.*, not stock) and the “increase in the property interests of other shareholders in the assets or [E&P] of the corporation” (*i.e.*, stock or its equivalent). It therefore appears that the exception for certain isolated or incidental transactions in Reg. §1.305-3(b)(3) is not intended to provide safe haven in the case of an MWFC conversion rate adjustment, despite the fact that it is undoubtedly an isolated and incidental transaction.

Is There Even an Adjustment?

Stepping back, an important question that we have not posed is whether an MWFC conversion rate adjustment event is a “change in conversion ratio” within the meaning of Code Sec. 305(c) in the first place. The quintessential adjustment captured by Code Sec. 305(c) is the change in conversion rate that results from a cash dividend with respect to the underlying shares. In that case, the change in conversion rate is permanent for all holders of securities and it impacts any future conversion. In the case of an MWFC, the change in conversion rate is either immediately put into use by an imminent conversion or forever lost by non-converting holders. If that is the case, can an MWFC conversion rate adjustment be more appropriately seen as a built-in feature of the conversion function?

Such a position has fundamental support in the tax code. Assume the convertible bonds were converted to cash entirely—in effect, terminated. The conversion in this case terminated the instrument; after conversion, the converting bondholder has only cash and no interest in any bond or stock issued by the corporation. As such, it appears that the cash conversion (or termination) ought to generally be governed by Code Sec. 1271(a), which provides that any amount received in retirement of a debt instrument shall be considered as an amount received in exchange therefor. But if the cash conversion triggers a taxable deemed stock distribution, the converting bondholders would essentially recognize ordinary income on the conversion.²⁹ To

add, in a cash settlement scenario, if one focuses on the ultimate economic result (as opposed to viewing the steps separately), it is difficult to argue the bondholder has experienced an increase in the E&P or assets of the corporation at the expense of the common stockholders if the taxpayer ends up solely with cash at the end of the day.

Arguably, the result should not differ if the conversion were entirely in return for stock. Generally speaking, the conversion of a convertible bond into the stock of the issuing corporation has long been considered a tax-free event in most circumstances.³⁰ Taxpayers should not be required to disaggregate into steps what’s essentially a single event and to tease a dividend out of it. The converting bondholder normally takes a carryover basis in the common stock and any built-in gain or loss is deferred. This all prompts the question: Was Code Sec. 305(c) meant to convert a longstanding tax-free (or capital) transaction outside of Code Sec. 305 into a taxable and ordinary one? If so, Congress appears to have failed to say so.³¹

Putting aside bondholders who convert and benefit from the conversion rate adjustment, it would be a particularly unexpected result if the bondholders who do not convert had a taxable deemed stock distribution. Code Sec. 305(c) and the underlying regulations can cause a converting bondholder to have a taxable deemed stock distribution as a result of a change to the conversion rate only if the bondholder’s *pro-rata* interest in the E&P or assets of the corporation is increased by such change.³² Congress instructed Treasury to issue regulations to clarify when such a deemed distribution occurs, but the Code Sec. 305(c) regulations simply restate the language of Code Sec. 305(c). Taxpayers thus have very little to go on when considering a conversion rate adjustment with an expiration date. As a practical matter, though, it seems that Congress and Treasury must have envisioned Code Sec. 305(c) to cover a conversion rate adjustment that the bondholder either benefitted from or retained the ability to benefit from. In that regard, it is at least arguable that Code Sec. 305(c) should not apply to a conversion rate adjustment that expires within a certain period of time if a bondholder does not actually convert during that period. Put differently, if a bondholder does not convert and the conversion rate snaps back to normal after a certain period of time, how could one argue that the non-converting bondholder has experienced an increase in the E&P or assets of the corporation as a result of the adjustment to the conversion rate? The non-converting bondholder has the same interest in the E&P or assets

of the corporation after the conversion period lapses as it did before the MWFC.

This view of the rules appears to be proven out by the surprising knock-on consequences that could arise if a non-converting bondholder is deemed to have a taxable deemed stock distribution under Code Sec. 305. For instance, the non-converting bondholder would increase its basis in the convertible bond by the amount of the taxable deemed stock distribution. Because the conversion rate returns to normal after the conversion period lapses, although the basis of the bond has been increased, the fair market value of the bond is likely unchanged. If the holder acquired the convertible bond right before the MWFC at its fair market value, would Code Sec. 305 result in a deemed dividend followed by a built-in capital loss in a convertible bond going forward?²³³

Also, if the temporary upward adjustment to the conversion rate results in a taxable deemed stock distribution to the non-converting bondholder, could the adjustment down at the end of the conversion period result in a taxable deemed stock distribution to the common stockholders under Code Sec. 305(c)? If the non-converting bondholders are deemed to have received an increase in their interest in the E&P or assets of the corporation at the expense of the common stockholders, it would seem possible that the common stockholders are deemed to receive an equal

and opposite increase when the conversion rate returns to normal at the end of the MWFC conversion period. These seemingly unintended results suggest that Code Sec. 305(c) should at the very least not apply to the bondholders who do not elect to benefit from the temporary change in conversion rate as a result of the MWFC. Although, as described above, the current unclear state of the law leaves a bit to be desired.

Parting Thoughts

The application of Code Sec. 305(c) is complicated when applied to the simplest of fact patterns. It first requires determining whether a deemed stock distribution has occurred (for example, as a result of a conversion rate adjustment) and then requires taxpayers to compute the amount of the deemed distribution.³⁴ When applied to more complicated fact patterns—such as conversion rate adjustments in response to MWFC events—Code Sec. 305(c) becomes truly difficult to apply. Although MWFC events are relatively uncommon, the potential application of Code Sec. 305(c) in such cases can lead to very different (and painful) tax consequences, leaving taxpayers and tax practitioners alike searching for answers in regulations that have been around for more than 45 years, but may still creak when opened.

ENDNOTES

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¹ See Tax Reform Act of 1969, P.L. 91-172, §421, 83 Stat. at 614.

² Due to the challenges (and frustrations) that can arise in applying Code Sec. 305(c), one of the authors had considered titling this article Grumpy Observations: Code Sec. 305(c) and Make-Whole Fundamental Changes as a tribute to the late Dale Collinson, one of his early mentors. See, e.g., Dale S. Collinson, *Grumpy Observations on Reality in Financial Instruments*, 107 TAX NOTES 1587 (June 20, 2005).

³ See H. Rep. No. 91-413, at 112 (1969).

⁴ *Id.* This is economically similar to one shareholder receiving a stock dividend and another receiving cash because one investor increases its interest in the E&P or assets of the corporation (via the increased conversion rate) and the other gets cash.

⁵ See Code Sec. 305(c); 38 FR 18,531 (July 12, 1973). Although the regulations under Code Sec. 305(c)

use the term “conversion ratio,” practitioners commonly refer to such changes as “conversion rate adjustments,” so we refer to “conversion ratio adjustments” as “conversion rate adjustments” in this article.

⁶ After four decades of quiescence, in 2014 the New York State Bar Association raised general awareness about the issue in its report on proposed Code Sec. 871(m) rules that require U.S. withholding tax on dividend-equivalent payments—interrelated, in part, with the deemed dividend rules under Code Sec. 305(c). See generally New York State Bar Association, *Report on Proposed Regulations Under Section 871(m)* (May 20, 2014), available at www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2014/Tax_Section_Report_1306.html.

⁷ See, e.g., NYSBA Members Submit Report on Deemed Distribution Regs, 2016 TAX NOTES TODAY 155-16 (Aug. 11, 2016) (recognizing that treating conversion rate adjustments as deemed distributions is consistent with the legislative history of Code Sec. 305(c) and the language of Code Sec. 305(d), but at the same time arguing “that there would be a significant policy basis for

other approaches that excluded from Code Sec. 305(c) treatment convertible debt instruments or warrants the economic profile of which diverged meaningfully from the underlying stock”); *Firm Raises Issues with Deemed Stock Distribution Regs*, 2016 TAX NOTES TODAY 149-19 (Aug. 3, 2016) (proposed regulations under Code Sec. 305(c) “require the current payment of tax on deemed income that does not represent an accretion to wealth and that may never be realized by the holder of the convertible obligations”); *Firm Cites Need for Clear Guidance on Convertible Bonds*, 2016 TAX NOTES TODAY 3-15 (Jan. 6, 2016) (Code Sec. 305(c), “if applied to produce imputed dividends at the time of a conversion ratio adjustment, will be virtually unadministrable since it will be very difficult to value such adjustments accurately when made”); *Group Criticizes Treatment of Conversion Adjustment on Convertibles*, 2015 TAX NOTES TODAY 88-19 (May 7, 2015) (“we believe, as a matter of tax policy, that Conversion Adjustments for dividends do not present an appropriate occasion for taxation of Convertible holders who have not exercised their conversion rights in the first place”).

⁸ For an excellent discussion of MWFCs and the mechanics of the MWFC conversion rate adjustment provisions, please refer to Gregory P. Rodgers and Arash Aminian Baghai, *Demystifying Modern Convertible Notes*, available at <http://documents.jdsupra.com/cbd08f1e-9ea8-4c28-bb46-67a9b8e4c463.pdf>.

⁹ *Id.*

¹⁰ Convertible bonds generally will also permit holders to “put” their debt to the issuer (*i.e.*, the issuer will be required to prepay the debt) on the occurrence of a “fundamental change” for a cash amount equal to the unpaid principal amount together with any accrued but unpaid interest (referred to as a “Fundamental Change Put”). There is often an overlap between events that constitute a “fundamental change” and events that constitute an MWFC such that a holder will also have a Fundamental Change Put right upon an MWFC.

¹¹ Code Sec. 305(d).

¹² The Service has also made this clear in sub-regulatory guidance on the subject. See, *e.g.*, Rev. Rul. 75-513, 1975-2 C.B. 114.

¹³ See, *e.g.*, S. Rep. No. 91-552, at 153 (1969) (the “purpose of [Code Sec. 305(c)] is to give the Secretary authority to deal with transactions that have the effect of distributions, but in which stock is not actually distributed”) (emphasis added).

¹⁴ Reg. §1.305-7(a) (depending on the facts, it will be either a deemed distribution of common stock or a deemed distribution of preferred stock).

¹⁵ For this purpose, though, the regulations specifically exclude the exception under Code Sec. 305(b)(1). Reg. §1.305-7(a)(2).

¹⁶ Code Sec. 305(b)(2).

¹⁷ Code Sec. 305(b)(3).

¹⁸ Code Sec. 305(b)(4).

¹⁹ Code Sec. 305(b)(5).

²⁰ Reg. §1.305-7(b)(1).

²¹ *Id.* (a conversion rate adjustment that is made to “compensate for cash or property distributions to other shareholders that are taxable under Code Sec. 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) will not be considered as made pursuant to a bona fide adjustment formula”).

²² This would not necessarily be an unusual result under the regulations, and is in fact a result that Treasury contemplated with respect to certain recapitalizations that may otherwise be tax-free transactions. See Reg. §1.305-7(c) (a recapitalization (whether or not an isolated transaction) results in a deemed distribution to which Code Sec. 305(c) applies if (i) it is pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or E&P of the corporation, or (ii) a shareholder whose preferred stock has a dividend arrearage exchanges the preferred stock for other stock and, as a result, increases their proportionate interest in the assets or E&P of the corporation).

²³ Rev. Rul. 76-186, 1976-1 C.B. 86.

²⁴ Although it seems odd that Code Sec. 305(c) could apply in this scenario, it is at least arguable that the converting bondholder did experience an increased proportionate interest in the E&P or assets of the corporation as compared to the common stockholders. The common stockholders’ interest in the E&P or assets of the corporation necessarily decreases if the converting bondholder converts into a greater amount of common stock; and it does seem that the converting bondholder did in fact benefit from an increased interest in the corporation’s E&P by converting.

²⁵ Reg. §1.305-7(a)(2).

²⁶ While this article focuses on convertible debt, certain convertible preferred stock in the market also have MWFC conversion mechanics. For such stock, Code Sec. 305(b)(4) could be the basis under which a deemed distribution may arise.

²⁷ Reg. §1.305-3(b)(3).

²⁸ In particular, it is unclear how Reg. §1.305-3(b)(6) applies (if at all) in this circumstance. Reg. §1.305-3(b)(6) provides that, “[i]n cases where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a shareholder has increased his proportionate interest in the assets or earnings and profits of a corporation,” and “[t]he individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation.” If the class as a whole (*i.e.*, convertible bonds) experiences an increased interest in the E&P or assets of the corporation, can the same class satisfy the receipt of property prong?

²⁹ Authorities like *Waterman Steamship Corp.*, 50 TC 650, Dec. 29,070 (1968, *rev’d* CA-5, 430 F2d 1185 (1970)), that focus on the use of the dividends-received deduction under Code Sec. 243 for any dividends received by stockholders of a company prior to the company’s acquisition do not appear to be directly on point assuming deemed dividends on a convertible debt are not eligible for the dividends-received deduction (which is a point subject to significant doubt in its own right, see, *e.g.*, *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, 2016 TAX NOTES TODAY 156-13, at 10 (Aug. 12, 2016)).

³⁰ See Rev. Rul. 72-265, 1972-1 C.B. 222 (“conclusion that no gain or loss is realized upon the conversion of a corporate debenture into stock of the obligor corporation [initially stated long ago in Treasury regulations] remains applicable except where provisions of the Code specifically require that gain be recognized”); Reg. §1.1001-3(c)(2)(ii) (not a significant modification and thus not taxable if, at the holder’s option, there is an alteration that results in an instrument that is not debt).

³¹ *But cf. supra* note 22.

³² See Code Sec. 305(c); Reg. §1.305-7(a).

³³ A similar phenomenon arises in a scenario where common shareholders receive stock rights if the receipt of such rights is treated

as a Code Sec. 301 distribution under the rules of Code Sec. 305 and a particular shareholder lets those stock rights expire without exercising them. From the distribution date to the expiry date, the common shareholders will have received ordinary income in the form of dividend income and a corresponding capital loss. However, that fact pattern seems distinguishable—since stock rights are separately tradable, it makes sense that they obtain a separate basis and trigger a subsequent loss upon expiry. Such a concern would not arise in the context of an MWFC conversion rate adjustment with respect to the convertible bonds.

³⁴ This article purposefully avoids any questions around how to value a taxable deemed stock distribution, focusing instead on whether an MWFC conversion rate adjustment can cause a taxable deemed stock distribution in the first place. As one might expect, valuation issues in these circumstances are also tricky, though Treasury did try to clear them up with proposed regulations in 2016. See 81 FR 21,795 (Apr. 13, 2016). Under Proposed Reg. §1.305-7(c)(4)(i), the value of the taxable deemed stock distribution can be calculated as the excess of (i) the fair market value of the right to acquire stock (*i.e.*, the convertible bond’s embedded option) immediately after the applicable conversion rate adjustment, over (ii) the fair market value of the convertible bond’s embedded option without the applicable conversion-rate adjustment.

Unfortunately, even with the proposed regulations, there are still open valuation questions. Although Proposed Reg. §1.305-7(c)(4)(iii) attempts to clarify the bounds of the fair-market-value standard—ignoring particular facts pertaining to the shareholder or any increased or reduced value attributable to possible future adjustments that may result from the actual or deemed stock distribution—questions still abound, particularly in the context of an MWFC conversion rate adjustment where some bondholders may convert to cash and/or stock. For instance, is the value of the embedded option after the conversion rate adjustment affected by how much stock is outstanding (or deemed outstanding) following any conversions? Presumably, prior to the MWFC and related conversion rate adjustment, a valuation of the embedded option would take into account stock issued and outstanding as well as the number of shares to which convertible bondholders could convert. Is the value of the embedded option after the MWFC and related conversion rate adjustment affected not only by the conversion rate adjustment itself but also by how many bondholders converted to stock and/or cash as a result of the MWFC?

These valuation questions and others mentioned in this article’s footnotes could be fodder for another article altogether.



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