

Current Developments

Proposed Regulations Address Applicable Adjustments to Stock and Stock Rights Under Code Sec. 305(c)

By William R. Pomierski



In an apparent response to coordination questions raised by comments to proposed regulations under Code Sec. 871(m) (relating to certain cross-border dividend equivalent payments),¹ the Treasury issued proposed regulations on April 12, 2016 (the “Proposed Regulations”) addressing *deemed distributions* of stock and stock rights under Code Sec. 305(c). Among other stated goals, the Proposed Regulations attempt to “resolve ambiguities concerning the amount and timing of deemed distributions that are or result from adjustments to rights to acquire stock.”

The Proposed Regulations also provide guidance to withholding agents regarding the current withholding and information reporting obligations under chapters 3 and 4 with respect to such deemed distributions.

This column outlines the Proposed Regulations, describing the types of transactions, including adjustment events, giving rise to deemed distributions with respect to stock rights, as well as describing the amount and timing thereof. A companion article in this issue of the JOURNAL addresses the related withholding and information reporting considerations.

Before describing the Proposed Regulations, a brief summary of Code Sec. 305(c) and the current regulations relating to deemed distributions is in order.

Background

Code Sec. 305 and its regulations potentially apply to actual and deemed distributions by a corporation of its own stock and *stock rights*. For purposes of Code Sec. 305, the term stock right refers simply to rights to acquire stock, as opposed to a current position in stock itself.²

Code Sec. 305(a) sets out the general rule that the receipt of stock and stock rights distributions is not included in the gross income of the recipient, meaning that such distributions generally do not result in taxable dividends. Code Sec. 305(b) then provides exceptions to the general rule. If an exception applies, an actual or deemed distribution of stock or stock rights is treated as a

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distribution of property to which Code Sec. 301 applies.³ The exceptions generally involve situations in which the effect of a stock or stock right distribution is to increase the proportionate interests of some—but not all—of the shareholders of the distributing corporation. For example, under Code Sec. 305(b)(2), if a distribution (or series of distributions) by a corporation results in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the distributing corporation, such distributions will be treated as distributions of property to which Code Sec. 301 applies.

Code Sec. 305(c) authorizes the Secretary to prescribe regulations treating changes in the conversion ratio of instruments convertible into stock—and other events having similar effects—as distributions to shareholders whose proportionate interests in the assets or earnings and profits of the corporation increase by reason of such events.⁴ These events are referred to as *deemed distributions*.⁵

Among other stated goals, the Proposed Regulations attempt to “resolve ambiguities concerning the amount and timing of deemed distributions that are or result from adjustments to rights to acquire stock.”

Current Reg. §1.305-7 sets forth the criteria under Code Sec. 305(c) for determining when certain adjustment events and similar transactions are characterized as deemed distributions. Under subsection (a) of the regulation, a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption that is treated as a distribution to which Code Sec. 301 applies or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder may be treated as a distribution with respect to shareholders whose proportionate interests in the earnings and profits or assets of the corporation increases by reason of such change, difference, redemption or similar transaction. The current regulations provide that a deemed distribution results in a distribution under Code Secs. 305(b) and 301 when (1) the proportionate interest of any shareholder in the assets or earnings and profits of the corporation is increased and (2) the deemed distribution has a result described in any of subsections (2), (3), (4) or (5) of Code Sec. 305(b).

To the extent any such change, difference, redemption or similar transaction is treated as a distribution, such distribution will be deemed made with respect to any shareholder whose interest in the earnings and profits or assets of the distributing corporation is increased. Under current Reg. §1.305-1(b)(1), when a distribution of a stock right results in a distribution of property to which Code Secs. 305(b) and 301 apply, the amount of the distribution is the fair market value of the stock or stock right that is distributed, measured on the date of the distribution.⁶

The Proposed Regulations

Although the deemed distribution rules of Code Sec. 305(c) and Reg. §1.305-7 have been in place for a number of years, questions regarding the proper application of such provisions arose recently in connection with proposed regulations under Code Sec. 871(m). In particular, commentators addressing Code Sec. 871(m) requested guidance relating to the coordination between the withholding implications and obligations under such provision and Code Sec. 305(c) relating to deemed dividends with respect to convertible instruments.⁷ In addressing these coordination issues, some commentators also pointed out that the current regulations are unclear as to whether and when a deemed distribution results from various adjustment events, including in particular changes in the conversion ratio with respect to convertible bonds.⁸ In light of the perceived uncertainties under current law, other commentators suggested that regulations under Code Sec. 305(c) should be clarified to apply—if at all—to deemed distributions only on a prospective basis.⁹

According to the Preamble to the Proposed Regulations, however, the Treasury and the IRS are of the view that under Code Secs. 305(b) and (c) and the current regulations thereunder, an *applicable adjustment*—as described below—results in a deemed distribution to which Code Sec. 301 applies, if: (1) the applicable adjustment increases the proportionate interest of an actual shareholder or a deemed shareholder in the corporation's assets or earnings and profits; (2) such increase has a result described in one of the exceptions set out in Code Sec. 305(b); and (3) the anti-dilution exception of Reg. §1.305-7(b)(1) does not apply. The Preamble goes out of its way to note—apparently in response to questions regarding the past application of the deemed distribution rules—that it has been the position of the Treasury and the IRS “for over forty years that, under section 305(b) and (c) and the regulations thereunder, an increase in the conversion ratio of a convertible debt instrument may be treated as a deemed distribution to the deemed shareholder that holds the instrument, and, if so

treated, section 301 applies to the deemed distribution.”¹⁰ As such, the Treasury and the IRS view the Proposed Regulations as simply amending “the current regulations under section 305(b) and (c) only to clarify the amount and timing of such deemed distributions, not the fact of their occurrence, which is clear under current law.”¹¹

Applicable Adjustment Events

As noted in the Proposed Regulations, a corporation may issue stock rights in a number of different forms, including warrants, subscription rights, options, convertible instruments (debt and preferred stock), which give the holder a right to convert the instrument into shares of stock in the issuing corporation, and similar instruments.¹² In any of these forms, such stock rights may provide the holder (referred to as a “deemed shareholder”) with *applicable adjustments* that provide such deemed shareholders with economic benefits that correspond to distributions of stock, cash or other property made to actual shareholders. Stock rights may also provide for adjustments designed to prevent actual shareholders’ interests from being diluted as a result of distributions of stock, cash or other property to deemed shareholders. As noted below, however, *bona fide* anti-dilution adjustments do not result in deemed distributions for these purposes.

The consequences of an applicable adjustment will vary depending on the underlying transaction giving rise to the adjustment. For example, an *applicable adjustment* relating to a convertible instrument may consist of an increase in the number of shares of stock a deemed shareholder will receive upon conversion.¹³ Similarly, an applicable adjustment to a warrant, subscription right, stock right, option or similar right to acquire stock may consist of an increase in the number of shares the deemed shareholder will receive upon exercise. In any such event, the applicable adjustment may have the effect of increasing the deemed shareholders’ proportionate interests in the assets or earnings and profits of the corporation.

Under the general rule of the Proposed Regulations if, as a result of an applicable adjustment event, there is an *increase* in the deemed shareholders’ proportionate interests in the assets or earnings and profits of the corporation, and such increase has a result described in Code Sec. 305(b), the applicable adjustment will result in a deemed distribution to the deemed shareholder, and Code Sec. 301 will apply.¹⁴ A *deemed distribution* is defined for these purposes as “transaction or event, other than an actual distribution of cash or property, that constitutes a distribution under section 305(b) and (c).” An exception is provided, however, in the case of certain rights to acquire stock governed by Code Sec. 83.

Note that under Proposed Reg. §1.305-7(c)(3), an applicable adjustment made pursuant to a *bona fide*, reasonable adjustment formula that has the effect of preventing dilution of a shareholder’s interest does *not* result in a deemed distribution to which Code Secs. 305(b) and 301 apply. Unfortunately, this exception appears to be limited. The Proposed Regulations provide that an applicable adjustment that compensates deemed shareholders for a distribution of cash or (nonstock) property to actual shareholders, where such distribution of cash or property is taxable under Code Secs. 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b) or 857(b), is *not* considered as made pursuant to a *bona fide*, reasonable adjustment formula. As such, an applicable adjustment that compensates deemed shareholders for a taxable distribution of cash or (nonstock) property to actual shareholders may be a distribution to which Code Secs. 305(b) and 301 apply.

The consequences of an applicable adjustment will vary depending on the underlying transaction giving rise to the adjustment.

Examples of the application of these rules in the case of applicable adjustment events relating to convertible debt securities are provided in the Proposed Regulations¹⁵:

Example 2. Corporation X has outstanding one class of actual common stock and convertible debt securities. The convertible securities have a *bona fide*, reasonable antidilution provision that provides for an increase in conversion ratio in the event stock dividends or rights to acquire stock are distributed to the common shareholders. *Corporation X distributes an actual stock dividend to the common shareholders that results in an increase in the conversion ratio of the convertible securities. Pursuant to the antidilution provision, the conversion ratio is increased.*

Under Code Sec. 305(d) and Reg. §1.305-1(d)(4), the holders of convertible securities are shareholders for purposes of Code Sec. 305(b) and (c). The convertible securities are rights to acquire stock and are stock for purposes of Code Sec. 305. The increase in conversion ratio caused by the distribution of the stock dividend to the common shareholders is an applicable adjustment event. Because the applicable adjustment is made pursuant to a *bona fide*,

reasonable adjustment formula within the meaning of paragraph (c)(3) of this section, *the applicable adjustment is not a deemed distribution* under Code Sec. 305(c) of rights to acquire stock.

Example 3. Corporation X has outstanding one class of publicly-traded common stock and convertible debt securities. The terms of the convertible securities provide for an increase in the conversion ratio in the event stock, cash or property is distributed to the holders of the common stock. *Corporation X distributes cash to the holders of the common stock*, and the distribution results in an increase in the conversion ratio of the convertible securities.

Under Code Sec. 305(d) and Reg. §1.305-1(d)(5), holders of the convertible securities are shareholders for purposes of Code Sec. 305(b) and (c). The conversion rights in the convertible securities are rights

It will be interesting to see whether the regulations are finalized in their current form or will be subject to extensive comments and potentially re-proposed.

to acquire stock (as defined in Reg. §1.305-1(d)(3)) and are stock for purposes of Code Sec. 305. The increase in conversion ratio resulting from the cash distribution to the holders of common stock is an applicable adjustment. *Because the applicable adjustment is not made pursuant to a bona fide, reasonable adjustment formula within the meaning of paragraph (c)(3) of this section, it is a deemed distribution to the holders of the convertible securities of rights to acquire stock under Section 305(c) and paragraph (c)(1) of this section.* Because the proportionate interests of these deemed shareholders in the assets or earnings and profits of Corporation X are increased by the change in conversion ratio, the distribution has the result described in Code Sec. 305(b)(2) and is treated as a distribution to which Code Sec. 301 applies. The amount of the deemed distribution is determined in accordance with paragraph (c)(4)(i) of this section, and the date and time of the deemed distribution are determined in accordance with paragraph (c)(5) of this section.

Recapitalizations

Specific rules are provided in the case of deemed distributions resulting from recapitalizations. Under Proposed Reg. §1.305-7(d), a recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which Code Sec. 305(c) and Proposed Reg. §1.305-7 apply if (1) it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation, or (2) a shareholder owning preferred stock with dividends in arrears exchanges such stock for other stock and, as a result, increases the shareholder's proportionate interest in the assets or earnings and profits of the corporation.

For these purposes, an increase in a preferred shareholder's proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the preferred stock surrendered.

Amount of Deemed Distributions

The Preamble to the Proposed Regulations notes that the current regulations under Code Secs. 305(b) and (c) are unclear as to the amount of a deemed distribution to a deemed shareholder. According to the Treasury and the IRS, 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 itself), 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)." In the case of a deemed distribution to deemed shareholders occurring before final regulations are published, the IRS will not challenge either position.

The Proposed Regulations, however, reflect the view of the Treasury and the IRS that a deemed distribution of a stock right is more accurately viewed as a distribution of additional rights to acquire stock, the amount of which is the fair market value of the right. This is in contrast to potentially treating a deemed distribution of a stock right as a distribution of the stock to which the right relates. Accordingly, the amount of the deemed distribution with respect to the holder of a stock right (a deemed shareholder) is measured by the excess of (i) the fair market value of the stock right immediately after the applicable adjustment event over (ii) the fair market value of the right without the applicable adjustment.¹⁶ In determining the fair market value of a stock right, any particular facts pertaining to

the deemed shareholder's rights, including the number of actual shares of stock or rights to acquire stock held by such deemed shareholder, would be disregarded.¹⁷ In addition, any value or reduction in value attributable to the possibility of future applicable adjustments that may result from actual or deemed distributions will not be taken into account.¹⁸

As noted above, under the terms of a convertible instrument or other stock right, a payment of cash or property to the holder of such convertible instrument or right may cause a reduction (negative adjustment) in the number of shares the deemed shareholder would receive upon conversion or exercise. Such a reduction can be considered an applicable adjustment with respect to actual shareholders to the extent the negative adjustment increases the actual shareholders' proportionate interests in the assets or earnings and profits of the corporation. Under the Proposed Regulations, the amount of a deemed distribution to an actual shareholder in such event is the fair market value of the stock deemed distributed, determined in accordance with Proposed Reg. §1.305-3(e), *Examples 8 and 9*.¹⁹

Finally, in the case of a deemed distribution resulting from a recapitalization under Proposed Reg. §1.305-7(d) (1), the amount of the deemed distribution under Code Sec. 305(c) is the lesser of (1) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered or (2) the amount of the dividends in arrears.²⁰

Timing of Deemed Distributions

The Preamble to the Proposed Regulations indicates that the current Code Sec. 305(c) regulations are unclear as to the timing of a deemed distribution to a deemed shareholder.

The Proposed Regulations attempt to provide clarity to the timing issues by providing that if an applicable adjustment results in a deemed distribution under Proposed Reg. §1.305-7(c), the deemed distribution occurs at the time such applicable adjustment occurs, as determined in accordance with the instrument setting forth the terms of the stock right, but in no event later than the date of the distribution of cash or property that results in the deemed distribution (taking into account Proposed Reg. §1.305-3(b)).²¹ If, however, the instrument setting forth the terms of such right does not set forth the date and time the applicable adjustment occurs, the time at which the deemed distribution occurs depends on whether or not the underlying stock is publicly-traded, as follows:

- In the case of an applicable adjustment relating to a right to acquire *publicly-traded stock*, if the instrument

setting forth the terms of such right does not set forth the date and time the applicable adjustment occurs, 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.

- In the case of an applicable adjustment relating to a right to acquire *nonpublicly traded stock*, if the instrument setting forth the terms of such right does not set forth the date and time the applicable adjustment occurs, the deemed distribution occurs on the date that a holder is legally entitled to the distribution of cash or property that results in the deemed distribution.

Effective Date

Finally, the Proposed Regulations would, by their terms, apply only to deemed distributions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.²² A taxpayer, however, may rely on the Proposed Regulations for deemed distributions under Code Sec. 305(c) that occur prior to such date. Special effective date rules relating to the withholding and reporting implications of the Proposed Regulations are not addressed herein.

As noted above, for purposes of determining the amount of a deemed distribution to a deemed shareholder occurring prior to the date of publication of final regulations, a taxpayer may determine the amount of the deemed distribution by treating such distribution either as a distribution of a right to acquire stock or as a distribution of the actual stock to which the right relates. The Proposed Regulations state that the IRS will not challenge either position.

Observations

As indicated above, the Proposed Regulations, while not answering all pertinent questions, attempt to provide clarity on the question of whether certain adjustments with respect to stock rights result in deemed distributions for purposes of Code Secs. 305(b) and 301. It will be interesting to see whether the regulations are finalized in their current form or will be subject to extensive comments and potentially re-proposed. It is worth noting that a number of comments to the Proposed Regulations have already been submitted, largely seeking clarifications on certain aspects of the Proposed Regulations. However, some of the comments submitted to date suggest that the regulations are inappropriate and should not be adopted, based largely on the notion that the adjustments at issue do not result in

an accretion to wealth in many instances, and thus should not result in taxable income.²³ A critical question regarding the timing and content of final regulations may ultimately

depend on the views of withholding agents as to the withholding and reporting provisions, which are described in detail in a companion article in this issue of the JOURNAL.

ENDNOTES

¹ 2016-18 IRB 697; REG-133673-15. Unless otherwise indicated, all references to "Code Sec." and "§" are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations promulgated thereunder.

² Code Sec. 305(d)(1) provides that for purposes of Code Sec. 305, "the term 'stock' includes rights to acquire such stock."

³ Code Sec. 305(b) provides that distributed stock is property subject to inclusion under Code Sec. 301 if the distribution:

- is, at the election of any of the shareholders, payable either in its stock, or in property;
- results in (a) the receipt of property by some shareholders and (b) an increase in the proportionate interests of other shareholders in the assets or earnings of the corporation;
- has the result of (a) the receipt of preferred stock by some common shareholders and (b) the receipt of common stock by other common shareholders;
- is with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock into which such stock is convertible; and
- is a distribution of convertible preferred stock, unless it is established to the satisfaction of the Secretary that such distribution will not result in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.

⁴ Code Sec. 305(c) was first enacted as part of the Tax Reform Act of 1969.

⁵ Code Sec. 305(c) provides as follows:

For purposes of this section and section 301, the Secretary shall prescribe regulations under which 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 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, difference, redemption, or similar transaction. Regulations prescribed under the preceding sentence shall provide that—

(1) where the issuer of stock is re-

quired to redeem the stock at a specified time or the holder of stock has the option to require the issuer to redeem the stock, a redemption premium resulting from such requirement or option shall be treated as reasonable only if the amount of such premium does not exceed the amount determined under the principles of section 1273(a)(3),

(2) a redemption premium shall not fail to be treated as a distribution (or series of distributions) merely because the stock is callable, and

(3) in any case in which a redemption premium is treated as a distribution (or series of distributions), such premium shall be taken into account under principles similar to the principles of section 1272(a).

⁶ Reg. §1.305-1(b)(1) provides that "where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), *the amount of the distribution*, in accordance with section 301(b) and §1.301-1, *is the fair market value of such stock or rights* on the date of distribution."

⁷ See, e.g., *ABA Tax Section Comments on Proposed Regs on Dividend Equivalents From U.S. Sources*, May 15, 2012, 2012 TNT 95-27:

Finally, we note that the currently proposed definition of "equity linked instrument" is broad enough to apply to many transactions that would also be within the scope of section 305. Consider a physically-settled convertible note in which the conversion ratio adjusts to compensate the holders for a payment of an extraordinary cash dividend on the issuer's common stock. While such a payment would constitute a "dividend equivalent" within the meaning of the Proposed Regulations, it would also constitute a deemed dividend under section 305(c) and (b)(2). In order to avoid the possibility of double taxation, we recommend that the final regulations provide that no amount treated as a dividend under Subchapter C will be treated as a dividend equivalent. Additionally, we recommend that consideration be given to whether, and under what circumstances, an ELI, such as a convertible note, might provide for a dividend equivalent in an amount greater than the amount of the dividend deemed paid on such instru-

ment. [Citations omitted].

See also *NYSBA Tax Section Comments on Proposed Dividend Equivalent Regs*, May 20, 2014, 2014 TNT 98-20, commenting on proposed regulations under Code Sec. 871(m), where the NYSBA noted, in reference to potential overlap issues, as follows:

Under section 305, a distribution made by a corporation to its shareholders in the form of its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under section 305(c). Under section 305(c), a change in the conversion ratio or conversion price of a convertible security may give rise to a deemed distribution of stock where other shareholders receive a distribution of cash or other property. Thus, an increase in the conversion ratio of a convertible security can be treated as a taxable distribution of stock to the securityholder, before it has converted the security. Withholding is required on these deemed distributions. In addition, the amount of a corporate distribution (whether actually or deemed paid) to a foreign payee is subject to reporting on Form 1042-S. 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. For the same reason, it appears that section 305 deemed dividends are commonly not reported to domestic investors that are non-exempt recipients, leading to under-taxation of those amounts as well. [Citations omitted.]

⁸ See Lee A. Sheppard, *News Analysis: Dividend Equivalent Withholding on Convertibles*, 2015 TNT 124-6, in addressing adjustments to conversion ratios with respect to convertible debt securities when the issuer pays cash dividends to shareholders, noting the uncertain application of Reg. §1.305-7:

The question is what happens when adjustments are made to the conver-

sion ratio. Section 305(c) is crystal clear. Under section 305(c), pursuant to regulations, a change in the conversion ratio or conversion price is considered a deemed distribution in the form of shares when other shareholders receive a distribution of cash or property. So when a dividend is paid on common shares, an increase in the conversion ratio could be treated as a taxable distribution to investors in convertibles, even when it occurs according to the terms of the debt instrument.

But a change in the conversion ratio that merely prevents convertible investors from having their inchoate equity interest diluted is not a deemed distribution. The adjustment must be made pursuant to a "bona fide, reasonable, adjustment formula . . . which has the effect of preventing dilution of the interest of the holders" (reg. section 1.305-7(b)(1)).

So what's the problem? The regulation seems self-contradictory. The first sentence clearly says that anti-dilutive adjustments to the conversion ratio are not taxable. But the second sentence says that adjustments that "compensate" for taxable distributions are taxable because they are not deemed to be made pursuant to a bona fide adjustment formula.

At this point readers may well wonder what the difference is between anti-dilutive and compensatory adjustments. There is no way to know, but the drafters seem to have had in mind that an anti-dilutive adjustment merely makes the convertible holders whole for the temporary loss in value of their securities, while a compensatory adjustment somehow overcompensates and gives holders something they ought to be taxed on (*Eisner v. Macomber*, 252 U.S. 189 (1920)).

As a mathematical matter, all conversion ratio adjustments are arguably anti-dilutive and no more, because issuers have pricing formulae that enable them to return convertibles to the market price pre-dividend. Readers

understand that common shares take a value hit ex-dividend. Convertibles also take a value hit when a dividend is paid on the underlying common. But the conversion ratio adjustment never equals the dividend in amount.

⁹ See *Potential Reinterpretation of IRC Section 305(c)*, Chamber of Commerce letter to Commissioner Koskinen, dated September 8, 2015, available online at www.uschamber.com/letter/ccmc-economic-policy-joint-letter-irs-potential-reinterpretation-irc-section-305-c.

¹⁰ The Preamble cites to distribution where the conversion ratio of convertible debentures was increased due to payment of cash dividend to common shareholders); and Rev. Rul. 76-186, 1976-1 CB 86 (concluding that an increase in the conversion ratio of convertible debentures following the issuing corporation's payment of a cash dividend to its common shareholders results in a deemed distribution of property to the debenture holders to which Code Sec. 301 applies by reason of Code Secs. 305(b)(2) and (c)). deemed distribution because anti-dilution exception of Reg. §1.305-7(b) applied where distribution to actual shareholders was tax-free under Code Sec. 355).

¹¹ With respect to the coordination issues relative to Code Sec. 871(m), the Proposed Regulations refer only to Reg. A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction."

¹² Under the Proposed Regulations, a "right to acquire stock" is defined as:

- (i) a right of a holder of a convertible instrument (including a debt instrument that is convertible into shares of stock and stock that is convertible into shares of another class of stock) to convert the instrument into one or more shares of stock of the corporation issuing the instrument;
- (ii) a warrant, subscription right, stock right or other option to acquire shares of stock of the corporation issuing the instrument;
- (iii) a right to acquire stock of the corporation issuing such right similar to the rights described in

paragraphs (d)(3)(i) and (ii) of this section; and

- (iv) a right to receive an amount of cash or other property determined in whole or in part by reference to the value of a specified number of shares of stock (whether or not *in lieu* of such stock) of the corporation issuing the right.

See Proposed Reg. §1.305-1(d)(3).

¹³ See Proposed Reg. §1.305-7(a)(1)-(5).

¹⁴ See Proposed Reg. §1.305-1(d)(7), providing that an applicable adjustment to a right to acquire stock is not and does not result in a deemed distribution if either (1) the right to acquire stock is a nonqualified stock option without a readily ascertainable fair market value (as determined under Code Sec. 83(e) and Reg. §1.83-7) or (2) Code Sec. 83(a) applies to the right to acquire stock or the stock to which the right relates, or the stock is subject to a substantial risk of forfeiture and the holder of the right has not made an election under Code Sec. 83(b).

¹⁵ Examples of the application of these rules to other forms of stock rights and/or adjustment events are provided in Proposed Reg. §§1.305-3(e) and 1.305-7(c)(6).

¹⁶ See Proposed Reg. §1.305-7(c)(4)(i).

¹⁷ See Proposed Reg. §1.305-7(c)(4)(iii).

¹⁸ *Id.*

¹⁹ See Proposed Reg. §1.305-7(c)(4)(ii).

²⁰ See Proposed Reg. §1.305-7(d)(2). For these purposes, in the case of stock issued before July 12, 1973, the term issue price of the preferred stock surrendered shall mean the greater of the issue price or the liquidation preference (not including dividends in arrears) of the stock surrendered.

²¹ See Proposed Reg. §1.305-7(c)(5).

²² See Proposed Reg. §1.305-7(g).

²³ See, e.g., *SIFMA Asks for Changes to Deemed Distribution Regs*, Sept. 26, 2016, 2016 TNT 189-16; *Funds Group Recommends Changes to Deemed Stock Distribution Regs* (Managed Funds Association), July 12, 2016, 2016 TNT 156-15; *ICI Seeks Changes to Proposed Regs on Deemed Distributions of Stock*, July 20, 2016, 2016 TNT 156-13; and *NYSBA Members Submit Report on Deemed Stock Distribution Regs*, Aug. 20, 2016, 2016 TNT 155-16. See also *U.S. Chamber Raps Proposed Regs on Deemed Distributions* (Chamber of Commerce), July 12, 2016, 2016 TNT 156-16.

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