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Changes to U.S. Income Tax Withholding on Convertible Bonds (IRC § 305(c))

On March 7, 2016, SIFMA sponsored a webinar discussing the taxation of conversion ratio adjustments on convertible debt under section 305(c). The presenters were: Payson Peabody, Managing Director & Tax Counsel, SIFMA; Keith Anzel, Managing Director, Citigroup; Elissa Shendalman Johnson, Managing Director & Senior Tax Executive, Bank of America; and Erika Nijenhuis, Partner, Cleary Gottlieb Steen & Hamilton LLP.

The webinar presenters first covered the background. A convertible debt instrument may provide for a conversion rate adjustment if certain dilutive events occur. The instrument will specify the relevant dilutive events but typical ones include a dividend payment or an increase in the dividend payable on common stock. A conversion rate adjustment to a convertible debt instrument is a deemed distribution, regardless of whether the conversion right is in or out of the money or the conversion right is never exercised. If the issuer/borrower has earning and profits, then the deemed distribution would be a taxable dividend and potentially subject to withholding for non-US investors.

The presenters reported that they expect the Internal Revenue Service to issue proposed regulations within the last two weeks of March. The presenters are hopeful that the proposed regulations will address a number of issues. One issue is how to determine the amount of the dividend; SIFMA is advocating for the amount to be equal to the change in the value of the conversion option, and not the additional value of shares that a holder could become entitled to receive on exercise. Another issue involves how U.S. issuers report the dividend to investors, and the scope of detail that the issuer would have to provide. Regarding brokers and custodians, it is hoped that the proposed regulations will address when they must withhold.

The Service and Treasury have rejected SIFMA's proposal to begin withholding as of January 1, 2017. Accordingly, withholding agents are generally expected to begin withholding for 2015. (Note that Form 1042 returns for 2015 are due March 15, 2016.) Some withholding agents have indicated that they will use a change in

conversion value or delta-like approach for 2015, even prior to the issuance of the anticipated proposed regulations; others have indicated that without guidance they will withhold using an amount based on the additional value of the shares due to the conversion rate adjustment. If the proposed regulations do adopt a delta-like approach for determining the dividend amount, then presumably those for whom the withheld amounts were in excess of the amounts as calculated under any such guidance could file for a refund.

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