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By Electronic Delivery

July 20, 2016

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Tax Legislative Counsel
U.S. Department of the Treasury
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RE: Proposed Regulations on Deemed Distributions under Section 305(c)

Dear Mr. Wilkins and Mr. West:

The Investment Company Institute[1] commends the Internal Revenue Service ("IRS") and the Treasury Department for issuing proposed regulations[2] (the "Proposed Regulations") addressing deemed distributions on convertible securities under section 305(c). The Proposed Regulations clarify several important questions that have arisen from the application of section 305(c) to convertible bonds. Namely, the Proposed Regulations provide guidelines on the amount and timing of deemed distributions, withholding on such distributions under Chapters 3 and 4 of the Internal Revenue Code, and issuer reporting of such deemed distributions under section 6045B.

The Proposed Regulations fail to address, however, two issues of importance to the mutual fund industry. First, the Proposed Regulations do not clarify whether deemed distributions on convertible securities can qualify as "qualified dividend income" ("QDI") or for the dividends received deduction ("DRD"). The Institute believes that deemed distributions should be eligible for treatment as QDI and for the DRD and ask the government to clarify this in the final regulations. Second, the Proposed Regulations do not specify whether a change in method of accounting has occurred when a taxpayer who has not been accounting for deemed distributions under section 305(c) on convertible securities begins to do so. We also urge the IRS and the Treasury Department to answer this critical question.

[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders.

[2] REG-133673-15, Apr. 13, 2016.

Additionally, we ask the government to address certain challenges that the Proposed Regulations present for holders in general, and mutual funds in particular, with respect to the determination of the amount of the deemed distribution and the timing of the inclusion of that deemed distribution in income. In particular, we suggest that the final regulations provide that:

(1) The amount of the deemed distribution is simply the fair market value of the right to acquire the additional shares provided by the conversion ratio adjustment;

(2) The holder of the convertible security is not required to recognize a deemed distribution as income unless and until the issuer reports such distribution on Form 8937 or the holder has actual knowledge that a deemed distribution has occurred;

(3) If the issuer provides a Form 8937, the holder may rely upon the issuer's valuation, so long as the holder does not have reason to believe that the issuer's valuation is unreasonable; and

(4) Any deemed distribution that properly would be recognized by a regulated investment company (a "RIC") as income during the portion of the calendar year after October 31 is treated as arising on January 1 of the following calendar year for purposes of determining the RIC's required distribution for excise tax purposes under section 4982.

Although we appreciate that the IRS and Treasury Department has issued proposed guidance on the application of section 305(c) to convertible securities, we do question whether, as a policy matter, that application is sensible. The rules in section 305(c) were meant to address earnings stripping, which generally is not an issue for the vast majority of convertible bonds in the market. It thus is not clear to us that there is a good policy rationale for requiring holders of convertible debt to take deemed distributions into income due to a conversion ratio change rather than waiting until a conversion actually takes place. We thus ask the government to reconsider whether such application makes sense. If the IRS and Treasury Department believe that the proposed guidance still should apply, we then ask that the final regulations include the changes we discuss below.

<u>Qualified Dividend Income and the Dividends Received Deduction</u>

The proposed regulations do not address whether a deemed distribution under section 305(c) can constitute QDI under section 1(h)(11) or give rise to a DRD under section 243. The Institute believes that a deemed distribution should be eligible for this favorable treatment because (i) the holder of the convertible debt is deemed to receive a taxable dividend;[3] and (ii) the holder of the convertible debt is treated as a shareholder for purposes of section 305(b) and (c).

We believe that section 1(h)(11) supports this conclusion. Section 1(h)(11) states that QDI means "dividends received during the taxable year from" domestic corporations and certain qualified

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[3] *See* Treas. Reg. § 1.316-1(c) defining the term dividend and referring to distributions of stock treated as distributions of property pursuant to section 305(b).

foreign corporations. Sections 243 and 246 similarly apply to "dividends" from a corporation. A taxpayer who receives a deemed distribution on a convertible security under section 305(c) is treated as receiving a taxable dividend. Therefore, the statute suggests that a deemed distribution can qualify as QDI and for the DRD.

There is some uncertainty, however, as to whether the holding period requirements in section 1(h)(11) and section 246 preclude such favorable treatment. Section 246 sets forth limitations on the availability of the DRD under section 243. The QDI rules in section 1(h)(11)(B)(iii) cross-reference the holding period requirements in section 246 to determine whether a dividend qualifies as QDI.

Pursuant to section 246(c)(1), DRD treatment is not permitted for "any dividend on any share of stock" unless the taxpayer holds the stock for at least 46 days around the ex-dividend date. Section 1(h)(11) similarly provides that QDI treatment does not apply to "any dividend on any share of stock" for which the holding period requirements of section 246(c) are not met, substituting a minimum of 61 days for 46 days. Under section 246(c)(4), a taxpayer's holding period for these purposes is reduced for any period in which the taxpayer has reduced its risk of loss in the stock by, for example, holding an option to sell, or being under a contractual obligation to sell, substantially identical stock or securities.

It is not clear how the holding period requirement of section 246(c)(1) and the related rules in section 246(c)(4) apply when the holder of a convertible debt instrument is treated as receiving a deemed dividend distribution pursuant to section 305. By their terms, sections 246(c)(1) and 1(h)(11)(B)(iii) apply with respect to "any dividend *on any share of stock*" (emphasis added). The holder of convertible debt, however, does not own shares of stock. Rather, it holds a debt instrument with an embedded warrant. One thus could argue that sections 1(h)(11) and 243 cannot apply to a deemed distribution under section 305(c) because the holder of the convertible debt does not own any "share[s] of stock" and therefore cannot meet the holding period requirements.

On the other hand, one could argue that the holding period requirements in section 246(c)(1) and 246(c)(4) simply do not apply to deemed dividends resulting from conversion rate adjustments on convertible debt because they apply *only* to dividends on actual shares of stock. As a holder of convertible debt does not hold shares of stock, one could read the statute to permit DRD treatment without the holding period requirements. Similarly, one could read the statute to permit the application of the QDI rules of section 1(h)(11)(B)(i) without the holding period rules of section 1(h)(11)(B)(iii).

We believe that both of these readings are incorrect; rather, the proper interpretation lies somewhere in between. The statutory language in sections 246(c)(1) and (4) and 1(h)(11) logically should apply to deemed distributions under section 305(c). We thus believe the proper interpretation is that the QDI and DRD rules should apply, provided that the taxpayer holds the convertible debt instrument for the same number of days that a shareholder must hold shares of stock, *i.e.* at least 61 days for QDI and 46 days for the DRD. Further, the taxpayer must do so without reducing risk of loss

with respect to the equity component of the convertible debt, by having an option to sell or a contractual obligation to sell the instrument.

We recognize that Revenue Ruling 94-28 raises some questions as to whether a holder of convertible debt can be viewed as reducing the risk of loss. For the reasons discussed below, however, we believe that the circumstances and rationale of that ruling are distinguishable. The revenue ruling addressed the application of section 246(c)(4) to certain instruments that are not in form equity for corporate law purposes but were found to be for federal income tax purposes. The instruments mature and pay a fixed amount of principal on a specified date, and holders have creditor rights with respect to the issuer's obligation to repay the principal due on the instrument. The ruling concludes that a holder's right to the principal upon retirement of the instrument at maturity is an option to sell or a contractual obligation to sell the instrument for purposes of section 246(c)(4)(A). As a result, a corporate holder of the instrument cannot accrue any holding period for purposes of section 246(c)(1) and will not be eligible for the DRD.

The ruling distinguishes these instruments from shares of mandatorily redeemable preferred stock that do not afford a holder creditors' rights.[4] The ruling notes the mandatory redemption feature might be viewed as an obligation to sell, but states that section 246(c)(4)(A) generally is interpreted as containing an exception for traditional mandatory redemption rights that are "common in the terms of many preferred stocks." The ruling goes on to say that this exception must be narrowly construed and does not extend to instruments, such as those that are the subject of the ruling, that afford holders creditor rights to receive a fixed payment on a specified date.

A broad reading of some of the language in Rev. Rul. 94-28 could suggest that holders of a convertible debt instrument cannot satisfy the holding period requirements for DRD or QDI treatment because they have creditor rights to receive the stated principal amount of the convertible debt instrument at maturity. We believe, however, that such a broad reading would be inappropriate for several reasons.

First, we note that convertible debt instruments fall outside the scope of instruments that are the subject of Rev. Rul. 94-28. By its terms, the ruling applies to instruments that are equity for federal income tax purposes. Convertible debt is not equity for federal income tax purposes. Rather, convertible debt instruments are debt for tax purposes, and interest payments with respect to convertible debt instruments generally are deductible by the issuer as interest expense and included by holders as interest income. The drafters of the ruling thus plainly did not have convertible debt in mind.

[4] The IRS and Treasury Department clarified this in Treas. Reg. § 1.246-5(b)(3), which provides that a "position" with respect to substantially similar or related property does not include traditional equity rights to demand payment from the issuer, as typically is provided by mandatorily redeemable preferred stock.

Second, Rev. Rul. 94-28 was one of three pieces of guidance issued together in response to tax-driven financial product innovation in the debt/equity area. The ruling was issued in the same week as Notice 94-47 and Notice 94-48. The two notices were directed at instruments and structures designed to qualify as equity for regulatory, rating agency, or accounting purposes but as debt for tax purposes. More specifically, Notice 94-47 was directed at a product known as MIPS, in which a corporation issues long-term, subordinated debt to a partnership, which issues "preferred securities" backed by the debt. The Notice cautioned that the IRS would look closely at instruments structured to qualify as equity for nontax purposes but as debt for tax purposes. The second notice, Notice 94-48, described a structure sometimes referred to as "reverse MIPS," in which a corporation issues preferred stock to a partnership, which in turn issues debt backed by the preferred stock. The Notice states that such structures will not be treated as debt for tax purposes. Rev. Rul. 94-28 rounded out the guidance by precluding the alternative approach of treating the instruments as credit-enhanced equity eligible for the DRD.

In contrast to new financial instruments designed to achieve tax benefits that were the subject of Rev. Rul. 94-28 and the two notices, convertible debt instruments have a long history as a standard means for corporations to raise capital.[5] For example, convertible debt was issued in the United States in the 19th century to finance the construction of railroads.[6] During a period running from the 1930's to 1960, over nine percent of all bonds offered by corporations were convertible debt.[7] Convertible debt thus is a traditional instrument of corporate finance, designed to accommodate the non-tax goals of both the issuing corporation and investors, rather than a new financial product with features dictated by tax considerations.

Third, unlike holders of the instruments that were the subject of Rev. Rul. 94-28, the holder of a convertible debt instrument does not have an obligation to sell. The taxpayers in the ruling held an instrument, treated as stock for tax purposes, with a stated maturity date, and these holders had an obligation to sell (redeem) the stock on that date (if not sold earlier). In contrast, the holder of a convertible debt instrument can exercise the conversion feature and convert the instrument into stock. This is what typically happens in the case of convertible debt.[8]

Similarly, and unlike holders of the instruments described in Rev. Rul. 94-28, the holder of a convertible debt instrument does not have an option to sell stock. Rather, the holder of convertible debt has an option to *acquire* stock (by virtue of the warrant embedded in the instrument), not an option to sell stock. The holder of convertible debt also holds a debt instrument, which is not an option to sell stock. An option to sell stock (*i.e.*, a put option) typically goes up in value when the stock

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[5] *See*, *e.g.*, Strnad, *Taxing Convertible Debt*, Stanford Law and Economics Working Paper No. 236, available at http://ssrn.com/abstract_id=311280, p. 9 ("convertible bonds have been a heavily used financing device for many years").

[6] *See* Fletcher and Cary, *The Taxation of Convertible Bonds and Stock*, 74 Harv. L. Rev. 473, 475 (1961) (also noting extensive issuances of convertible debt over the years by AT&T).

[7] *Id.* at 476.

[8] *See* Strnad, Taxing Convertible Debt, *supra*, at p. 3 (most convertible bonds end up being converted).

declines in value and vice versa. That is not true of the debt component of a convertible debt instrument, including the right to receive the stated principal amount at maturity. The value of that right is determined by interest rates and the creditworthiness of the issuer, not by changes in the value of the issuer's stock.

Also, the holder of a put option keeps any dividends paid on the stock while the stock is held and before the option is exercised. That is not true in the case of a convertible bond holder who redeems the instrument at maturity for the stated principal amount. All the holder receives in that event is the stated principal amount, without any adjustment for the dividends the holder may be deemed to have received under section 305. The holder of convertible debt also receives interest, includable in the holder's income and deductible by the issuer, which further differentiates the debt component of convertible stock from an option to sell stock. Accordingly, the holder of convertible debt does not have an option to sell stock within the meaning of section 246(c)(4)(A).

Finally, the holder of convertible debt should not be viewed as having diminished his or her risk of loss by holding one or more positions with respect to substantially similar or related property within the meaning of section 246(c)(4)(C). The analysis under section 246(c)(4)(C) and Treas. Reg. § 1.246-5, which implements that provision, is similar to the analysis above as to whether the taxpayer has an option to sell or is under a contractual obligation to sell. The scope is broadened to encompass additional types of risk reduction transactions relating to positions with respect to substantially similar or related property rather than substantially identical stock or securities.

Importantly, Treas. Reg. § 1.246-5 does not expand the types of instruments that are treated as stock for tax purposes. Rather, it expands the type of offsetting positions to stock that can trigger the limitations in section 246(c)(4) to include property that is substantially similar or related to, rather than substantially identical to, the stock in question. For instance, Example 2 in Treas. Reg. § 1.246-5(d)(1) describes a scenario in which the stock of each of two different companies primarily reflects the value of gold; it states that the stock of one company is substantially similar or related property with respect to stock of the other company.

Treas. Reg. § 1.246-5(b)(1) provides the rules for determining if property is substantially similar or related to stock. It provides that property is generally substantially similar or related to stock when --

> (i) The fair market values of the stock and the property primarily reflect the performance of –
>
> > (A) A single firm or enterprise;
> >
> > (B) The same industry or industries; or
> >
> > (C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(ii) Changes in fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property or a multiple of the fair market value of the property.

Pursuant to Treas. Reg. § 1.246-5(b)(2), a taxpayer has diminished the risk of loss on stock "by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely." Treas. Reg. § 1.246-5(b)(3) provides that a "position" with respect to property is an interest in property or any contractual right to a payment, whether or not severable from stock or other property.

The threshold question for analyzing the applicability of Treas. Reg. § 1.246-5(b) to a taxpayer who holds convertible debt is how convertible debt should be viewed for this purpose. As noted above, the holder of convertible debt holds a hybrid instrument consisting of two components: a debt component and a warrant. In the absence of some reason to view the component parts of convertible debt differently, these are the "properties" that should be analyzed under Treas. Reg. § 1.246-5(b) to determine if the convertible debt holder has reduced his risk in stock by holding a position with respect to substantially similar or related property.

The debt component of convertible debt, including the right to receive stated principal at maturity, is not property that is substantially similar or related to the warrant embedded in the convertible debt or to the stock into which the debt is convertible. The fair market value of the debt component primarily reflects interest rates and the creditworthiness of the issuer. The fair market value of the stock primarily reflects the performance of the company.[9] The fair market value of the warrant reflects a combination of factors, including primarily the performance of the company, the time remaining in which the conversion feature may be exercised, and the conversion price. In addition, changes in the fair market value of the debt component are not reasonably expected to approximate, directly or inversely, changes in the fair market value of the stock or of the warrant, or a faction or multiple of such changes. Accordingly, the debt component is not substantially similar or related property with respect to the warrant or the stock. Also, changes in the fair market values of the debt component and the stock or the embedded warrant are not reasonably expected to vary inversely. Thus, the risk reduction test in Treas. Reg. § 1.246-5(b)(2) is not satisfied.

Turning to the warrant component in a convertible debt instrument, the warrant is property that is substantially similar or related to the stock. The fair market value of the warrant component, however, and the fair market value of the stock are not reasonably expected to vary inversely because the

[9] While the creditworthiness of the issuer and the performance of the company (*i.e.*, the issuer) are related, the fair market value of the stock is much more dependent than creditworthiness on variations in the company's performance. For example, if the issuer is creditworthy at the time the convertible debt is issued, improvements in the company's performance will lead to increases in the fair market value of the stock/warrant but may have no effect on the issuer's creditworthiness. To the extent the company's performance affects the fair market value of both the stock/warrant and the debt component, the effects are directionally the same.

warrant is a long position in the stock, not a short position.[10] Thus, the warrant is not a risk-reducing position.

It would, of course, be possible to recast the rights of a convertible debt holder in such a way as to fall within Treas. Reg. § 1.246-5. Particularly when the conversion price becomes substantially in the money (*i.e.*, substantially below the fair market value of the stock into which the debt can be converted), changes in the fair market values of the convertible debt and the stock will tend to be closely related. In this situation, the embedded warrant (or the convertible debt instrument) could be recast as stock, and the ability to receive the stated principal amount at maturity could be characterized as a form of put option.

Even if such a recast were made, however, the right to payment at maturity generally should not be risk reducing. If the conversion feature is substantially less than the fair market value of the stock, the deemed put option would be substantially out of the money and therefore not risk reducing under the rule in Treas. Reg. § 1.246-5(c)(2)(i). This rule provides that a put option that is significantly out of the money does not diminish the risk of loss on the stock unless it is held as part of a strategy to substantially offset changes in the fair market value of the stock.

Moreover, while such a recast could be made, the analysis set forth above is straightforward and consistent with the components that comprise a convertible debt instrument. These components should be respected unless a recast should be made in light of the relevant tax policies and Congressional intent. As noted above, Treas. Reg. § 1.246-5 does not expand the types of instruments treated as stock, and thus the question of whether a recast is appropriate is the same under section 246(c)(4)(C) and Treas. Reg. § 1.246-5 as it is for the other parts of section 246(c)(4).

The analysis that respects the components of a convertible debt instrument leads to a conclusion that the fact that the holder of the instrument has creditor claims to repayment of principal is not a basis for denying QDI or DRD treatment to holders of the instrument. Further, denying QDI and DRD treatment for deemed dividends on convertible debt would be unduly harsh. There is no good tax policy rationale for requiring a holder of a convertible bond to recognize deemed distributions under section 305(c) while also denying QDI and DRD treatment, simply because the holder does not actually hold stock, but rather holds debt with typical creditor rights. We thus ask the IRS and the Treasury Department to confirm in the final regulations that deemed distributions under section 305(c) can qualify as QDI and for the DRD, so long as the holder satisfies the requisite holding periods in sections 1(h)(11)(B)(iii) and 246(c) with respect to the convertible debt.

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[10] Treas. Reg. § 1.246-5 contains special rules relating to convertible debt and convertible preferred stock. *See* Treas. Reg. § 1.246-5(c)(2)(ii)(B). Under the special rule relating to convertible debt, notwithstanding Treas. Reg. § 1.246-5(b)(1) and (2), a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if it enters into a short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock. These special rules for convertible instruments do not suggest that merely holding a convertible debt instrument, without more, precludes a taxpayer from accruing holding period for purposes of section 246.

Change in Method of Accounting

Another important issue to the mutual fund industry is whether tax accounting for deemed distributions under section 305(c) is a method of accounting under section 446. As noted in our previous letter, and as the IRS knows, many in the financial services industry were not aware that section 305(c) applied to convertible debt until the issue came to light in 2014. If a holder of a convertible security had not been taking into income such deemed distributions, but has begun to do so, it is unclear whether a change in method of accounting would arise. If it is a method change, then the taxpayer must seek permission from the IRS to make such a change.

The Proposed Regulations do not address this issue. We understand that some of our members have method change requests pending with the IRS. We thus ask the IRS to determine whether a taxpayer has a change in method of accounting if it begins to take into income any deemed distributions on convertible debt under section 305(c). Until the IRS clarifies this point, RICs and other taxpayers are left with substantial uncertainty regarding the amount and extent of their tax liabilities for prior years.

Valuation and Timing of Recognition of Deemed Distributions

The Proposed Regulations provide useful guidance addressing the amount and timing of deemed distributions under section 305(c), as well as an issuer's obligation to report such information. That guidance, however, presents certain challenges for mutual funds, and holders in general, with respect to the determination of the amount of the deemed distribution and the timing of the inclusion of that deemed distribution in income.

The Institute believes that the changes recommended below will ensure that holders of convertible securities, including RICs, will include, accurately and appropriately, deemed distributions in income under section 305(c). We thus ask the IRS and the Treasury Department to provide in the final regulations that:

(1) The amount of the deemed distribution is simply the fair market value of the right to acquire additional shares;

(2) The holder of the convertible security is not required to recognize a deemed distribution as income unless and until the issuer reports such distribution on Form 8937 or the holder has actual knowledge that a deemed distribution has occurred;

(3) If the issuer provides a Form 8937, the holder may rely upon the issuer's valuation, so long as the holder does not have reason to believe that the issuer's valuation is unreasonable; and

(4) Any deemed distribution that would be recognized by a RIC as income during the portion of the calendar year after October 31 is treated as arising on January 1 of the following

calendar year for purposes of determining the RIC's required distribution for excise tax purposes under section 4982.

Valuation of Deemed Distributions

The Proposed Regulations provide that under section 305(c) the conversion ratio adjustment should be treated like a distribution of a right to acquire additional shares of stock, and the amount of the deemed distribution is the fair market value of that right. If a conversion ratio adjustment will be treated as a distribution, then the Institute agrees with this conclusion. It does present certain challenges, however, which will be exacerbated for our members. The primary reason is that RICs must make certain determinations relating to the distribution requirements under section 4982 at times when the issuer reporting for a particular adjustment may not yet be available. The challenges stem from the fact that the right to acquire the additional shares does not trade separately from the bond and thus does not have a readily available market value. Holders and issuers will instead need to derive that value.

There are multiple approaches that could be used to value the right to acquire additional shares. One possibility is to extract the terms of the right to acquire additional shares (*i.e.,* number of shares, term, strike price, etc.) and determine a valuation for that right based on pricing models and/or market information with respect to similar options. Another approach is to use pricing models and market information to determine a valuation for a hypothetical bond that has the same terms of the bond in question, except that it does not and never will provide for the adjustment being made. One then would derive the value of the right to acquire additional shares based on the difference between the value of the bond post-adjustment and the value of the hypothetical bond. As a conceptual matter, both approaches generally should reach the same result. Reasonable minds, however, could reach different valuation results, even if applying the same general methodology, based on differences in the intricacies of the pricing models used.

The Proposed Regulations specify that the amount of the deemed distribution is the excess of the fair market value of the right to acquire stock immediately after the applicable adjustment, over the fair market value, determined immediately after the applicable adjustment, of such right to acquire stock as if no applicable adjustment had occurred. This phrasing apparently has led to some confusion as to how to arrive at the amount of the deemed distribution. We thus suggest that Treasury simply provide that the amount of the distribution is the value of the right to acquire the additional shares, and leave it to holders and issuers to consult with pricing and valuation experts to determine an appropriate model for determining the value of that right. As noted above, there are multiple ways to arrive at an appropriate valuation; we believe that because they generally should result in comparable valuations, each should be permissible. Therefore, we believe that the Proposed Regulations should specify what to value, without requiring a specific methodology for calculating that value.

Timing of Deemed Distributions

The Proposed Regulations also address the timing of deemed distributions under section 305(c). We believe that the proposed rules contain inconsistencies between the timing of the income recognition and the timing of the valuation, which should be addressed in the final regulations. Under the Proposed Regulations, the deemed distribution occurs at the time that the adjustment occurs in accordance with the terms of the instrument, but no later than the date of the distribution of cash or property that results in the deemed distribution.

The proposed rule effectively requires a holder to recognize a deemed distribution at the same time as the actual distributions that gave rise to the adjustment, even if the adjustment has not yet occurred. Presumably, the drafters thought that even though the adjustment formally has not been made, the holder immediately has a contractual entitlement to the adjustment and that receipt of the contractual entitlement constitutes income that should be recognized immediately. The determination of the amount of the deemed distribution under the Proposed Regulations, however, looks to the value of the right immediately after *the adjustment*. If the final regulations provide for the deemed distribution to be recognized prior to the time that the adjustment actually is made, then it seems odd to determine the amount of that distribution based on the value of the right when the adjustment is made. If holders are deemed to recognize the receipt of the additional right to acquire shares as income at the same time as the actual distribution to direct shareholders, the rules should not determine the value of that distribution based on the value of that right on a subsequent date. The valuation should be determined as of a date that is no later than the date on which income is recognized.

These timing inconsistencies could be corrected by requiring the amount of the deemed distribution to be both calculated and recognized on the date of the actual distribution, but that would be only a partial solution. Even with this change, the rule would not provide a clear and logical result with respect to an adjustment that results from the combination of multiple distributions or events, especially if the first distribution on its own would not entitle a convertible holder to an adjustment. For example, a convertible security may provide for an adjustment to occur only if the distributions paid to direct shareholders exceed a certain threshold; any distributions below the threshold are accumulated, and an adjustment occurs only if those cumulative amounts exceed the threshold. In such a scenario, if an adjustment is triggered based on a distribution paid in year 2 but the adjustment truly results from a combination of the year 1 and year 2 distributions, it is unclear when the taxpayer should recognize the income.

A more logical result would be for the deemed distribution to occur no later than the date of the distribution (or other event) that fixes the convertible security holder's right to the deemed distribution. In the example, if the year 1 distribution would not trigger an adjustment and the year 2 distribution (in combination with the year 1 distribution) does trigger the adjustment, then the deemed distribution would occur on the date of the year 2 distribution. Further, the amount of the deemed distribution would be determined based on the value of the right to acquire additional shares on the date of the year 2 distribution.

Issuer Reporting of Deemed Distributions

Even with these minor changes to the timing rules, a holder still could face significant challenges in recognizing that income on a timely basis. Holders may not know that a conversion ratio adjustment has been made and that the issuer has sufficient earnings and profits to support the deemed distribution. In many cases, holders must rely upon information reported by the issuer. If the issuer fails to satisfy its reporting obligations under section 6045B, the holder should not be held responsible for tax that it does not know it has. We thus ask that the final regulations provide that a holder's liability arises only when the issuer provides a Form 8937 or the holder has actual knowledge of the deemed distribution, whichever is earlier.[11]

In general, failure to receive a Form 1099 does not obviate a taxpayer's liability to pay tax on any gain or income it has received. This makes sense in the normal course, because the taxpayer actually has received a payment. In the context of section 305(c), however, the distributions are deemed to have occurred due to a change in a conversion ratio when other shareholders receive property. In this case, the holder of the convertible security has not received any actual payments and may not know that an actual distribution resulting in a change to the conversion ratio has been made. Therefore, the holder is not on notice that income must be recognized and some tax may be due. Of course, the holder should report and pay any applicable tax on such income if it knows that a deemed distribution has occurred, regardless of whether the issuer satisfies its reporting obligations, using the holder's own reasonable determination of value. Absent such knowledge, however, it would be unfair to hold the holder of a convertible security liable for such tax, because the holder has not received an actual payment.

The government already has proposed similar rules for withholding agents. Under the Proposed Regulations, a withholding agent is required to withhold upon a deemed distribution on a convertible security only if (i) the issuer meets its reporting obligation under section 6045B, or (ii) the withholding agent has actual knowledge that a deemed distribution has occurred. The same rules should be applied to a holder of a convertible security on which a deemed distribution has occurred.

In addition, when the issuer reports such a deemed distribution on Form 8937, the holder should be allowed to rely upon that value of the deemed distribution, unless the holder has reason to know that it is unreasonable. As discussed above, a holder of a convertible security that receives a deemed distribution under section 305(c) has not received actual payment. Therefore, one of the parties to the transaction must determine the value of this deemed amount using some methodology that looks at the value of the right to acquire additional shares of stock in the issuer. The holder of a

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[11] The preamble to the Proposed Regulations notes that the new rules are consistent with over forty years of IRS interpretation of sections 305(b) and (c). These rules thus predate the enactment of section 6045B in 2008. We believe that the addition of section 6045B demonstrates a recognition by Congress that the fair and accurate administration of the tax code requires, in some cases, an affirmative obligation on the part of issuers to provide notice of certain corporate-level events that affect holders of their stock or securities. Given that holders may not be aware that a deemed distribution has occurred, it would be equitable and appropriate to rely on the later-in-time statutory notification regime in section 6045B (unless the holder has actual knowledge of the distribution), notwithstanding the long history of section 305(c).

convertible security should be permitted to rely upon the information provided by the issuer on Form 8937, unless the holder knows that the issuer's valuation is unreasonable.

Recognition of Deemed Distributions for Excise Tax Purposes

The timing of deemed distributions raises special challenges for RICs. Section 4982 imposes a four percent excise tax on a RIC to the extent that the RIC does not satisfy certain minimum distribution requirements for its calendar year. This requirement is intended to encourage the RIC to make distributions equal to all or substantially all of the RIC's income in the calendar year in which the income arose. Under these rules, to avoid the excise tax, a RIC must distribute 98.2% of its net capital gains for the one-year period ending on October 31, and 98% of the sum of its (i) net specified ordinary income for the one-year period ending on October 31 and (ii) net non-specified ordinary income for the calendar year. This difference in timing for non-specified income versus gains and specified income recognizes that a RIC must estimate the required minimum distribution amount prior to the end of the calendar year in order to make the necessary distributions. It focuses on the types of income, gain or loss that would be difficult to estimate through the end of the calendar year. In particular, the timing and amount of gains and losses (capital or ordinary) from the sale, exchange or mark-to-market of an asset (referred to as "specified" items when the character is ordinary) are unpredictable and thus difficult to estimate. As a result, such gains and losses only are included for purposes of determining the required excise tax distribution amount if they arise on or prior to October 31 of the applicable calendar year.

Deemed distributions under section 305(c) are treated as dividends, a type of non-specified ordinary income that, absent additional guidance, would be calculated through December 31 for excise tax purposes. Given the challenges and complexity in identifying and calculating the amounts of the deemed distributions, we believe that an October 31 cut-off for excise tax purposes is appropriate. We note that the regulations already provide an October 31 cut-off for all items of income, gain or loss from contingent payment debt instruments (including interest and original issue discount accruals) because of the challenges and complexities associated with determining or estimating income on those securities.[12] We believe that the same rationale applies to deemed distributions on convertible securities and that an October 31-cut off for excise tax purposes is justified.

The excise tax-related challenges of identifying, calculating and including deemed distributions through December 31 would arise regardless of whether the final regulations adopt the timing rules in the Proposed Regulations or our suggestion that a holder not recognize a deemed distribution until the earlier of issuer notice or actual knowledge. If the timing rules in the Proposed Regulations are adopted and deemed distributions must be recognized as of the actual distribution date, a RIC would have to (i) monitor all of its convertible securities for deemed distributions through the end of the calendar year; (ii) quantify or estimate the value of those distributions prior to the end of the calendar year; and (iii) make appropriate distributions before the end of the calendar year.

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[12] Treas. Reg. § 1.1275-4(b)(9)(v).

Issuer reporting of deemed distributions on Forms 8937 will help with the identification and quantification, but even if issuers fully comply with their reporting obligations, those forms must be filed not later than the earlier of 45 days after the date of the action or January 15 of the year following the calendar year in which the action occurs. Thus, a timely Form 8937 for a deemed distribution that occurs in December may not be issued until after the RIC must make its excise distributions. Even if the Forms 8937 are issued in December, monitoring for publication of those forms through the end of the calendar year and factoring them into the distributions that must be paid prior to year-end would present significant administrative challenges.

Delaying income recognition of deemed distributions until the earlier of issuer notice or actual knowledge should provide relief to RICs in those cases where an adjustment arises before calendar year-end but the Form 8937 is not issued, and the RIC has no actual knowledge of the deemed distribution, until after December 31. Nevertheless, A RIC still would have to monitor continuously for deemed distributions and Forms 8937 through December 31, turning a potentially nuanced valuation exercise into a last-minute scramble to pay sufficient distributions to avoid the excise tax. This would create significant complexity and unpredictability late in the calendar year and is exactly the type of income that the October 31 cut-off rules are intended to address.

We thus request that any deemed distribution that would be recognized by a RIC as income during the portion of the calendar year after October 31 is treated as arising on January 1 of the following calendar year for purposes of determining the RIC's required distribution for excise tax purposes under section 4982.

We believe that these changes to the Proposed Regulations will ensure that holders of convertible securities, including RICs, will not be harmed unfairly if an issuer fails to comply with the requirements under sections 305(c) and 6045B and the regulations thereunder, and that RICs specifically don't encounter significant challenges in satisfying excise requirements.

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The Institute appreciates your consideration of our comments. If you have any questions or wish to discuss these issues further, please do not hesitate to contact me at (202) 371-5432 or kgibian@ici.org.

Sincerely,

/s/ Karen L. Gibian

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