



Tax Topics: Sec. 305(c), Sec. 871(m), and Corporate Actions

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October 11, 2018



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Increased Activity in 2018

- Tax Cuts and Jobs Act of 2017
 - The corporate tax rate was lowered from 35% to 21%
 - Affects decision of whether to pursue a tax-free or taxable transaction
 - Mergers and acquisitions announced by U.S. acquirers so far in 2018 are running at the highest dollar volume since the first two months of 2000, according to Dealogic
- August showed the highest monthly volume of corporate CUSIP requests since CUSIP Global Services began tracking the data in 2010 (for the broad category of U.S. and Canadian corporate offerings, which includes equity and debt)
- U.S. issuance of convertible bonds has soared this year along with a rise in interest rates, as companies look for cheaper ways to raise capital – WSJ

Sec. 305(c) Deemed Distribution and Cost Basis Adjustment

How Does 305(c) Apply to Debt?

- Section 305(c) can trigger a taxable deemed dividend as a result of a change under a conversion ratio adjustment formula (CRA)
- A deemed dividend can be triggered for a convertible bond
- This creates compliance concerns because the convertible bond is not actually paying a dividend that would trigger normal operations reporting and compliance procedures
- Sec. 305(c) Applies to more than Debt
 - Section 305(c) can apply to convertible preferred stock, stock rights and warrants, a portion of an investment unit, and to contingent payment debt

Sec. 305(c) and Cost Basis

- A deemed dividend on convertible securities causes the basis to be increased under section 301(d)(1) of the Code and section 1.301-1(h) of the regulations by the fair market value of the deemed distribution (see Rev. Rul. 76-186)
- To value a distribution prior to final regs, proposed regs authorize taxpayers to use the FMV of either the conversion right/option (the Right) or the underlying stock
- Withholding agents can rely on proposed regs for deemed distributions occurring after December 31, 2015

Form 8937 Instructions

File Form 8937 when an organizational action affects the basis of holders of a security or holders of a class of the security. For example, you must file Form 8937 if you make a nontaxable cash distribution to shareholders or if you make a nontaxable stock distribution to shareholders, including a stock split. In addition, if a conversion rate adjustment on a convertible debt instrument results in a distribution under section 305(c) (for example, because of a cash distribution to shareholders), you must file Form 8937 if the adjustment occurs after December 31, 2015. Do not file Form 8937 if you

Cost Basis Regulations (1.6045-1(d)(6))

Adjusted basis

(i) *In general.*— For purposes of this section, the adjusted basis of a security is determined from the initial basis under paragraph (d)(6)(ii) of this section as of the date the security is acquired in an account, increased by the commissions and transfer taxes related to its sale to the extent not accounted for in gross proceeds as described in paragraph (d)(5) of this section. **A broker is not required to consider transactions or events occurring outside the account except for an organizational action taken by an issuer during the period the broker holds custody of the security (beginning with the date that the broker receives a transferred security) reported on an issuer statement (as described in §1.6045B-1) furnished or deemed furnished to the broker.** Except as otherwise provided in paragraph (n) of this section, a broker is not required to consider customer elections. For rules related to the adjusted basis of a debt instrument, see paragraph (n) of this section.

Pitfalls of Form 8937 Reliance

- Under Sec. 6045B and §1.6045B-1, an issuer must file an issuer return by the earlier of 45 days after the organizational action or January 15 of the calendar year following the organizational action.
- Many issuers do not meet the 45 day deadline. Many forms are issued months after the deadline. This leads to a risk of withholding agents being liable if the form is issued after the holder leaves the firm.
- Independent calculations of Sec. 305(c) events show that issuers fail to provide Forms 8937 in the majority of cases.
- Issuers often misinterpret their own security documents and make errors on Form 8937 that are only noticeable if the calculation is performed independently. Incorrect Form 8937 dates/amounts could lead to withholding from the wrong holder or over/underwithholding.

Some Deemed Divs Can Be Substantial!

Form **8937**

(December 2011)

Department of the Treasury
Internal Revenue Service

Part I Reporting Issuer

1 Issuer's name

Merrimack Pharmaceuticals, Inc.

8 Date of action

May 30, 2017

10 CUSIP number

590328AA8

Line 16 – Calculation of Change in Basis:

A holder of a Convertible Note has \$1,000 basis in a \$1,000 Convertible Note. A holder of a Convertible Note will increase its basis in such Convertible Note by \$182.0111 as a result of the inclusion of the dividend in gross income for U.S. federal income tax purposes.

Sec. 871(m) Recent Developments

Recent Developments

- On September 20, 2018, the IRS issued Notice 2018-72, which extends the previous delays for three key aspects of Sec. 871(m) regulatory compliance until January 1, 2021:
 - (1) the application of withholding to equity-linked instruments (“ELIs”) with a delta of between 0.8 and 1.0;
 - (2) the full “combination rule” set forth therein; and
 - (3) the related rules for Qualified Derivatives Dealers
- The good-faith effort provisions of Notice 2016-76 and 2017-42 are also extended for delta-one transactions; the IRS will take into account compliance efforts for delta-one transactions in 2019 and 2020 and non-delta-one transactions in 2021

Time For Some Real (Corporate) Action!

Time Warner Merger into AT&T

- Holders of Time Warner receive 1.437 shares AT&T Inc. common AND \$53.75 cash per share held
- Why is this transaction interesting?
 - The intended tax treatment was that of a tax-free reorg under Sec. 368.
 - Need “continuity of interest” – but whether transaction qualified depended on facts that were not known until transaction was completed.
 - Tax-free treatment required value of AT&T Inc. common received, determined as of completion of transaction, to represent at least minimum % of total consideration (40%).

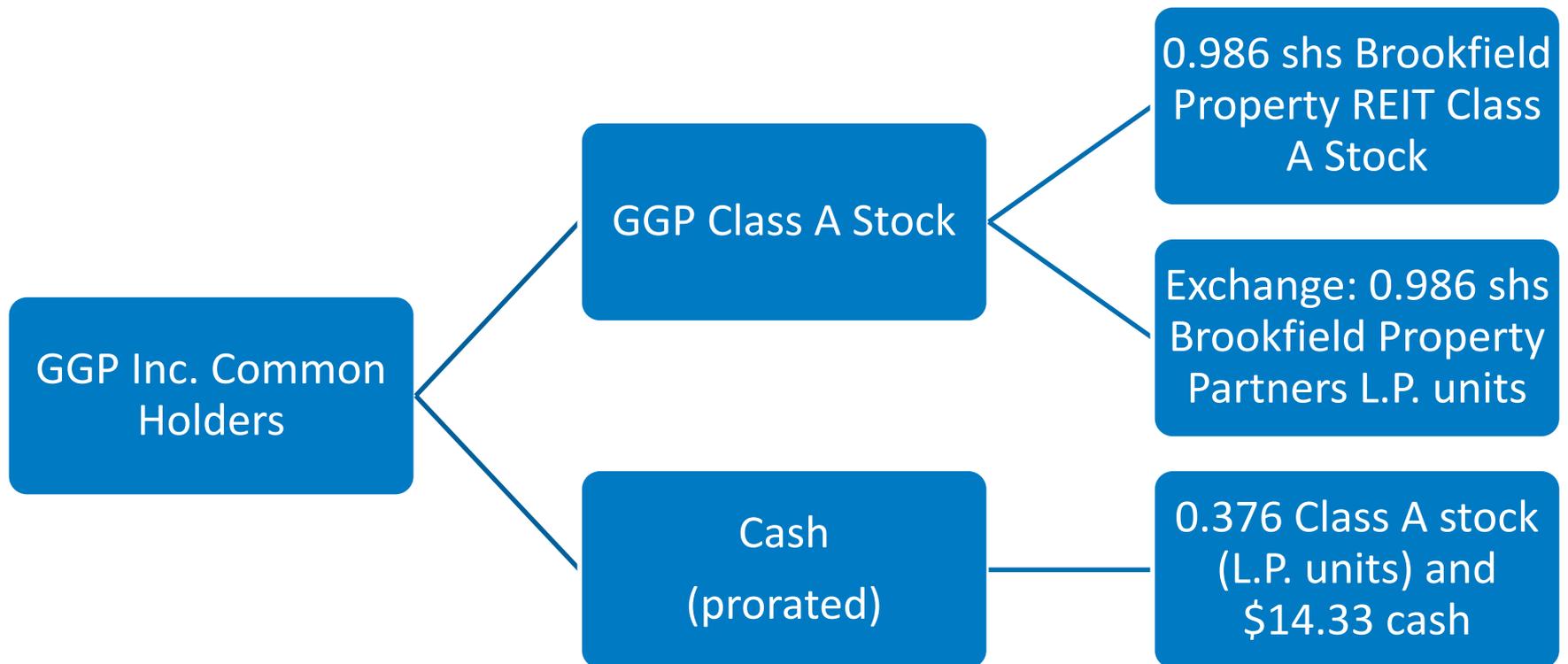
Keurig Green Mountain Merger into Dr. Pepper Snapple Group

- Holders of Dr. Pepper Snapple Group Inc. common stock received \$103.75 cash
- Why is this transaction interesting?
 - \$103.75 cash is a special cash dividend expected to be characterized as Sec. 301(a) distribution
 - Dr. Pepper Snapple Group Inc. shareholders will own 13% of Keurig Dr Pepper and former shareholders of Keurig Green Mountain, Inc. will own 87%
 - Company states that based on companies' estimate of their respective E&P, it is currently estimated that applicable E&P will be \$29.50 per share

GGP Inc. Takeover by Brookfield

- **Pre-closing dividend:** GGP Inc. declared special dividend payable to GGP Inc. shareholders who may elect to receive either (a) cash or (b) GGP Inc. class A stock.
 - Holders electing class A stock have option to exchange all (but not less than all) such shares for Brookfield Property Partners L.P. units (BPY unit exchange). Exchange is taxable.
- **Per share GGP Inc. common:**
 - *stock election:* 0.986 Class A stock or Brookfield Property Partners L.P. limited partnership unit
OR
 - *cash election (prorated):* 0.376 Class A stock or Brookfield Property Partners L.P. limited partnership unit and \$14.33 cash
OR
 - *non-election:* 0.376 Class A stock or Brookfield Property Partners L.P. limited partnership unit and \$14.33 cash.

Pre-closing Dividend Election (Pay 8/27)



GGP Inc. Merger (Effective 8/28)

- **Merger** - Per share GGP Inc. common: \$0.312 cash
- Exchange of GGP Inc. common for cash in merger will be a taxable sale resulting in recognition of gain or loss equal to the difference between merger consideration received and basis in GGP Inc. common after giving effect to the impact, if any, of the pre-closing dividend on GGP Inc. common stockholder's basis in its GGP Inc. common.
- Watch for return of capital due to pre-closing dividend