



July 12, 2016

**Via Electronic Filing:**

Internal Revenue Service  
CC:PA:LPD:PR (REG-133673-15)  
Room 5203  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

**Re: Managed Funds Association Comments on Proposed Rules -- Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock**

Dear Ladies and Gentlemen:

Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to respond to proposed regulations on deemed distributions under Section 305(c)<sup>2</sup> of stock and rights to acquire stock (the “Proposed Rules”). MFA continues to believe that a conversion ratio adjustment on convertible securities should not, as a matter of tax policy, be treated as a distribution subject to withholding tax. Nevertheless, we appreciate the release of the Proposed Rules to provide taxpayers with greater clarity with respect to issues on how withholding taxes should be applied.

MFA agrees with the proposal that any amount subject to withholding tax under the final rules should be based on the increase in fair market value of the right to acquire stock after the adjustment. As discussed in more detail below, we also believe that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “IRS” or the “Service”) should: (i) provide an exemption from withholding for taxpayers that have offsetting hedged positions; and (ii) provide greater guidance regarding coordination between the Section 305(c) rules and the contingent debt payment instrument rules.

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<sup>1</sup> The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

<sup>2</sup> Unless otherwise indicated, any references to a “Section” or “Sections” are references to a “Section” or “Sections” of the Internal Revenue Code of 1986, as amended, or the regulations issued under the Code by Treasury and the IRS.

### **Withholding Tax on Increase in the Fair Market Value of Right to Acquire Stock**

We agree with the Proposed Rules that the amount of any deemed distribution attributable to a conversion ratio adjustment should be the increase in fair market value of the right to acquire stock after the adjustment compared to the fair market value of the right to acquire stock if no adjustment were made. This approach reflects the fact that the anti-dilution protection received by a convertible bond holder as a result of a conversion ratio adjustment is fundamentally different than the economic value received by a shareholder who receives a cash dividend or a shareholder who receives a stock dividend in lieu of a cash dividend. In the vast majority of circumstances, a convertible bond holder receives less than a ratable amount of the economic value that is received by shareholders who are paid the dividend on the underlying stock. We believe that Treasury's recognition of this distinction, as well as questions regarding the proper method to value the deemed distribution (discussed in the paragraph below), highlight the policy concerns with treating a conversion ratio adjustment as a taxable distribution.

As noted above, because the economic effect of a conversion adjustment to a convertible bond holder, which in many cases could be zero, is significantly less than the value of the stock to which the conversion adjustment relates, we support the proposed approach of applying any withholding tax on the change in value of the right to acquire stock. This approach does, however, raise concerns regarding the proper method to value the amount of any deemed distribution. Because the change in value of the embedded option in a convertible bond (which will be what taxpayers have to value to determine their tax liability) is based on an analysis of various factors and assumptions that will vary from taxpayer to taxpayer, we encourage the IRS and Treasury to provide guidance that would help clarify how taxpayers should calculate the deemed distribution amount subject to withholding tax. Absent further guidance, we believe that there is a significant likelihood that taxpayers, withholding agents, issuers, and the IRS will reach different conclusions about the proper amount subject to withholding, creating significant uncertainty for taxpayers as to their tax obligations.

### **Application of Rules to Hedged Positions**

As noted in the proposing release, Section 305(c)

authorizes the Secretary to prescribe regulations to treat 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 are increased by such events. [emphasis added]

We believe that Treasury and the IRS should provide an exemption from withholding taxes under the rules to the extent a convertible debt holder hedges its convertible securities with short positions in the underlying equity. In these situations, the value of any conversion ratio adjustments to the taxpayer typically is entirely or substantially

offset by the substitute dividend payments made on the taxpayer's short equity positions. As such, a taxpayer that has entered into an offsetting position with respect to substantially similar or related property that has substantially diminished the risk of loss with respect to the equity position of the convertible instrument<sup>3</sup> is not in a similar economic position as a shareholder who receives a distribution. Further, in the similar context of a Qualified Derivatives Dealer ("QDD") receiving a payment subject to Section 871(m) and making a related 871(m) payment to a U.S. person, the IRS has acknowledged the need to consider clarifying how withholding tax rules apply.

Accordingly, we encourage Treasury and the IRS to provide an exemption from Section 305(c) withholding if either: (i) the taxpayer has implemented QDD-type procedures; or (ii) the taxpayer has entered into hedging transactions that substantially offset the economic value of any conversion ratio adjustment (for example, by providing an election to integrate convertible debt and an offsetting equity derivatives position into a single debt instrument or to qualify for an exemption for identified hedged positions). Because, in these circumstances, a taxpayer that has not received a similar economic effect to a distribution, we believe such an exemption is consistent with the underlying policy intent of Section 305.

#### **Coordination with Contingent Payment Debt Instrument ("CPDI") Rules<sup>4</sup>**

We also believe it is important for Treasury and the IRS to address concerns about potential conflicts between the Proposed Rules and the CPDI rules, as applied to conversion ratio adjustments. Under the CPDI rules, a conversion ratio adjustment contingency is priced into the value of a convertible bond, and is part of the value that the holder of the bond is accruing as original issue discount from the time of the purchase of the bond. Under the Proposed Rules, however, a contingent conversion ratio adjustment also would be taxed as a deemed distribution. As such, the same economic value would be taxed twice prior to the maturity or sale of the convertible bond, once under the original issue discount rules and then a second time as a deemed distribution under Section 305(c). We encourage Treasury and the IRS to address these inconsistencies to avoid creating confusion and uncertainty for taxpayers that own convertible bonds subject to the rules under Section 305(c) and the CPDI rules.

#### **Guidance on Qualified Divided Income ("QDI")<sup>5</sup> Treatment**

Given the determination that conversion ratio adjustments on convertible instruments should be treated as deemed distributions, we believe Treasury and the IRS should confirm that such deemed distributions are eligible for QDI treatment. Because the taxpayer does not own the underlying stock directly, Treasury and the IRS should issue

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<sup>3</sup> We note that this approach is similar to language elsewhere in the Code and related guidance regarding dividend received deductions (section 246(c) and 1.246-5), qualified dividend income (section 1(h)(11)(B)(iii), which references section 246(c)) and the straddle rules (Section 1092(c)(2), defining an offsetting position).

<sup>4</sup> Treasury Regulation §1.1275-4.

<sup>5</sup> As defined in Section 1(h)(11)(B) and IRS publication 550.

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guidance that would permit taxpayers to determine QDI status based on the holding period of the convertible instrument giving rise to the deemed distribution.

MFA appreciates the willingness of Treasury and the Service to consider the issues discussed above. If you have any questions regarding any of MFA's suggested amendments to the Proposed Rules, or if we can provide further information with respect to the issues raised in our letter, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

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