

Capital Changes 305C Alert Service

Withholding tax and mutual fund reporting of
IRC Sec. 305(c) deemed dividends



The Challenge

Updated guidance

On April 13, 2016, proposed regulations under Code Sec. 305(c) were published (the “Proposed 305(c) Regs”). The Proposed 305(c) Regs clarify that the holder of a convertible bond or stock, or a stock right issued by the issuer of the stock (each, a “stock right holder”), can have taxable dividend income as a result of an increase in such holder’s entitlement to shares of stock – a deemed dividend, even though such holder does not receive any payment of cash or property at such time. The Proposed 305(c) Regs also specifically require valuing such deemed dividend based on the fair market value of the right to acquire stock, rather than the current value of such stock. The Proposed 305(c) Regs also clarify that such dividend generally occurs at the time the holder is legally entitled to additional stock.

The Solution

At Wolters Kluwer, we live and breathe the Internal Revenue Code and we understand the needs of corporate action and tax reporting professionals. Our subject matter experts have carefully studied the challenges raised by Sec. 305(c) and based on their research, we have designed a service that, we believe, addresses the key compliance issues industry participants face.

Capital Changes 305C Alert Service at-a-glance

- ✓ Self-service web application
- ✓ Access to entire database or limit alerts to user’s securities of interest (SOI)
- ✓ Leverages data from leading sources including Capital Changes
- ✓ Provides:
 - Early notification of potential deemed dividends
 - Reminders of upcoming dividends
 - Estimated dividend calculations prior to effective date
 - Exact amount of deemed dividend on effective date (based on bond indenture formula) using two methodologies
 - Exportable search results



Capital Changes 305C Alert

Capital Changes 305C Alert tracks convertible debt, preferred securities, stock rights, and warrants that are convertible into common stock of the issuer. Users may access our entire database or limit alerts to their specific SOI.

The product determines and displays the amount of a deemed dividend in two ways:

1. Based on the actual value of shares
2. Based on the excess of:

A		B
The Fair Market Value of the right to acquire stock immediately after the conversion ratio adjustment	over	The Fair Market Value immediately after the adjustment as if no adjustment had occurred



This service delivers two critical alerts: (1) early notice of all cash dividends and corporate actions that could result in a CRA; and (2) calculation of the exact amount of any deemed dividend on effective date based on the specific formula provided in the bond indenture. When no bond indenture is available, we use a calculation model that best approximates industry practice.

In addition to these core features, this service provides reminders of upcoming dividends, estimated dividend calculations prior to effective date, and post-effective date revisions, if necessary.

What is Sec. 305(c)?

Section 305 generally governs the tax treatment of stock dividends, stock splits, and the distribution of stock rights. Among other things, it provides that distributions, where some shareholders receive cash and others receive stock, are fully taxable. One variation on this theme occurs when shareholders receive a cash dividend while convertible bondholders receive a conversion ratio adjustment (CRA) that entitles them to receive more of the same stock on which the cash dividend was paid. Essentially, some shareholders receive cash while other (potential) shareholders are entitled to receive more stock. Subsection (c) authorizes the IRS to prescribe regulations under which such CRAs are treated as taxable dividends to the bondholder.

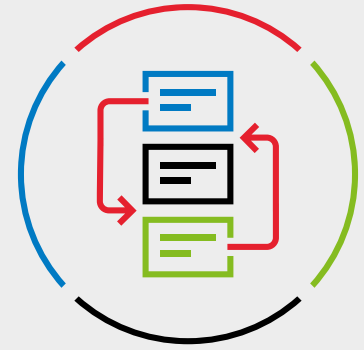
Holders of convertible bonds, convertible preferred stock, stock rights, and warrants may be deemed to receive a dividend, under Sec. 305(c) of the Internal Revenue Code, due to a dividend or a corporate action affecting the underlying common stock.

The difficulty is identifying when these deemed dividends occur and determining the exact amount of the dividend. Renewed attention to this issue has exposed withholding agents and mutual funds to significant liability for failure to correctly account for these dividends deemed.

How does Sec. 305(c) apply to convertible debt?

Convertible debt is typically issued under an indenture that specifies how the bond may be converted into stock, how many shares the holder is entitled to receive, and under what circumstances the conversion ratio may be adjusted. For example, a cash dividend paid on stock (into which the bond is convertible), or a corporate action, may trigger a CRA if it exceeds a specified threshold. The CRA, in turn, may result in a deemed dividend equal to the fair market value of the increase in the conversion privilege.

For withholding agents and mutual funds, this scenario presents two problems: (1) correctly identifying which events may trigger a CRA, and (2) correctly calculating the amount of the deemed dividend. The solution requires someone to track all dividends and corporate actions affecting every stock into which all outstanding bonds are convertible, and then correctly applying the specific formula spelled out in each bond indenture on the effective date of the conversion. There are ancillary concerns, such as estimating the amount of the deemed dividend in advance of the effective date, and obtaining funds to pay the withholding tax when no cash is actually distributed to bondholders, but the bottom line is that Sec. 305(c) presents real compliance challenges.



Flexible Deployment

Choice of:

- Web application.
- On demand responses using product UI. Exportable to flat or XML format.
- Automated file delivery.
- Data delivered through SFTP (MoveIT). Data communication can be sent using flat or XML formats.

About Wolters Kluwer Financial & Corporate Compliance

Wolters Kluwer (EURONEXT: WKL) is a global leader in information, software solutions and services for professionals in healthcare; tax and accounting; financial and corporate compliance; legal and regulatory; corporate performance and ESG. We help our customers make critical decisions every day by providing expert solutions that combine deep domain knowledge with technology and services.

Wolters Kluwer reported 2023 annual revenues of €5.6 billion. The group serves customers in over 180 countries, maintains operations in over 40 countries, and employs approximately 21,400 people worldwide. The company is headquartered in Alphen aan den Rijn, the Netherlands.

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