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Welcome to the inaugural issue of TaxTruths. This publication highlights developments in areas of tax law of interest to our clients.

PROPOSED REGULATIONS HIGHLIGHT PHANTOM INCOME AND OTHER ONEROUS CONSEQUENCES TO HOLDERS AND ISSUERS OF CONVERTIBLE NOTES AND OTHER SECURITIES

By Saba Ashraf and Wayne R. Strasbaugh

The Internal Revenue Service (IRS) and the Treasury Department issued proposed regulations in April of this year addressing certain open issues under Section 305(c) of the Internal Revenue Code of 1986, as amended (Code). The proposed regulations[1] are noteworthy for the guidance that they would provide. However, they are also noteworthy because they serve as a reminder of how unexpected, counterintuitive, and potentially burdensome the obligations imposed by Section 305(c) can be for issuers and holders of convertible debt, warrants, and other rights to acquire stock. Perhaps because the rules do at times seem counterintuitive, taxpayers often seem unaware of the rules and quite surprised when they learn that they must comply with them.

Existing Law: Deemed Distributions on Convertible Notes, Warrants, and Other Securities

An adjustment to the conversion ratio or conversion price of convertible securities can be treated as a distribution to the holder of the convertible securities, resulting in taxable income to the holders. Yes, really. This isn't a newly promulgated rule, or one suggested by the proposed regulations. This is existing law.

Take as an example a corporation that has a class of common stock outstanding, as well as notes outstanding, which are convertible into shares of common stock. Pursuant to the terms of the notes, the conversion ratio is adjusted each time a cash dividend is paid on the common stock to increase the number of shares of common stock into which the notes are convertible.

1 REG-133673-15, 81 Fed. Reg. 21795 (April 13, 2016).

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In year one, a $1 cash dividend is paid on the shares of common stock. Pursuant to the terms of the notes, the conversion ratio of the notes is increased at this time. Under the existing regulations under Section 305, this increase in conversion ratio is deemed to be a distribution to the holders of the notes.[2] The deemed distribution results in a taxable dividend to the holders of the notes assuming the corporation has sufficient "earnings and profits."[3] Such a deemed distribution is mandated by the rules under Section 305(c) where the adjustment to conversion ratio of the notes and the receipt of the dividend on the common stock take place within 36 months.[4]

In summary, holders of convertible securities of any corporation that pays regular dividends on its stock may have taxable income even when they don't receive any actual distribution from the corporation. There are criticisms of the rules under Section 305(c)—specifically that they tax convertible ratio adjustments that are simply a loss recovery mechanism and not an accretion to wealth. Be that as it may, these are the clear, existing rules under Section 305(c).[5]

2 Section 305(c) of the Code directs the Treasury Department to prescribe regulations under which certain transactions that increase a holder's interests in the earnings and profits or assets of a corporation, including a change in conversion ratio, are treated as distributions to which Section 301 applies (which provides rules for inclusion of distributions in taxable income of a shareholder). The term "stock" is defined to include the right to acquire stock (i.e., including pursuant to a convertible debt instrument) and the term "shareholder" is defined to include a holder of rights to acquire stock, or of convertible securities. Code Section 305(d). Changes in conversion ratio can result in a taxable distribution where the distribution (or a series of distributions of which such distribution is one) has the result of (i) the receipt of property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Code Section 305(b)(2).

3 A distribution by a corporation is a taxable dividend to the extent the corporation has current or accumulated "earnings and profits" (a term similar to the financial accounting concept of "retained earnings" – but often with many key differences in computation).

4 Treas. Reg. § 1.305-3(b).

5 See NYSBA Report No. 1351 on Proposed Regulations under Section 305(c), Aug. 10, 2016 ("[I]t is understandable why persons . . . would have difficulty seeing why the tax system views a Deemed Shareholder as having obtained wealth by virtue of a set of highly connected events intended to put it in a near neutral economic position in comparison with its position absent those events . . . We appreciate that, in light of the long history of the application of the Section 305(c) regulations to convertible bonds, Treasury is unlikely to reverse course on the point in connection with the proposed Regulations, and therefore we do not dwell on it further. . . We agree with the Preamble's conclusion that the current regulations, when read with the Revenue Rulings cited above, are clear that an Applicable Adjustment to a convertible debt instrument may give rise to a Deemed Distribution.")

Existing Law: Withholding and Reporting Obligations Relating to Distributions

Deemed distributions give rise to withholding and reporting obligations on the part of issuers and withholding agents. For example, under the current Treasury regulations that have been promulgated under Section 6045B of the Code, issuers of stock, debt instruments, options, and other securities are required to report information relating to organization actions that affect the basis of a security to the IRS and to holders of the security. An issuer may alternatively post the required information on its public website.

> *An adjustment to the conversion ratio or conversion price of convertible securities can be treated as a distribution to the holder of the convertible securities, resulting in taxable income to the holders. Yes, really.*

In certain cases—particularly where the deemed distribution is made to a foreign holder of the convertible securities—withholding obligations on the part of issuers and other withholding agents arise with respect to the phantom income of the security holder. This can be a particularly harsh obligation on the withholding agent given that there is no actual cash distribution from which it may withhold.

Aim of Proposed Regulations

One of the main aims of the IRS and Treasury in issuing the proposed regulations likely was to close the compliance gap that currently exists with respect to deemed distributions pursuant to Section 305(c). While the rule that there are deemed distributions to holders of convertible securities is clear, many holders, issuers, and other withholding agents do not fulfill their obligations under the rules. This likely is partly because they are unaware of the rules, and partly because compliance with the rules is difficult given certain gaps in the rules. For example, while the existing rules are clear

that there is a deemed distribution upon particular adjustments of conversion ratios, they are not clear as to how the amount of the deemed distribution should be computed, and the time that it should be included in income. Similarly, the existing rules make it difficult for withholding agents to be aware that a deemed distribution took place unless the withholding agents closely monitor all corporate distributions of the issuing corporation. The proposed regulations fill some gaps that would make compliance with and enforcement of the rules easier.

> *[The obligation to withhold] can be a particularly harsh obligation on the withholding agent given that there is no actual cash distribution from which it may withhold.*

Helpful Clarifications in Proposed Regulations

The proposed regulations contain needed clarifications. In light of the current ambiguity as to whether a deemed distribution is a distribution of a right to acquire stock or a distribution of the stock itself, the proposed regulations clarify that the amount of the deemed distribution is the fair market value of the additional rights to acquire stock that are deemed to be distributed, rather than the fair market value of the underlying stock to which the rights relate. The proposed regulations clarify that the timing of the deemed distribution that results from a conversion adjustment is the time the adjustment occurs, in accordance with the term of the instrument, but in no event later than the actual distribution that triggers the adjustment. Further, they clarify and modify the obligations of withholding agents with respect to deemed distributions. They clarify who is considered a withholding agent with respect to a distribution and explain when and how to withhold on a deemed distribution. In addition, they provide that withholding agents will not be required to withhold on deemed distributions unless, before the due date of the annual withholding tax return, either the issuer of the instrument satisfies its reporting obligations with respect to the deemed distribution (for example, by providing notice to holders or by posting information on its public website) or the withholding agent has actual knowledge of the deemed distributions. Finally, they require issuers to provide an issuer return to the IRS and a written statement to each holder of record of a security (or to the holder's nominee) of the date and amount of a deemed distribution under Section 305(c), without regard to the general exceptions in the existing regulations requiring information reporting for organizational actions.

Effective Date

The proposed regulations apply to deemed distributions occurring on or after the date of publication of the final regulations. However, generally, taxpayers may rely on the rules contained in the proposed regulations for reporting and withholding with respect to deemed distributions before the date that the final regulations are adopted.

The current regulations as well as the proposed regulations are complicated and nuanced, but taxpayers are nonetheless subject to monetary penalties for non-compliance. The above discussion is only a summary. We urge you to contact us for guidance on additional details or specific aspects of the rules.

TAX WHISTLEBLOWERS MAY RECOVER EVEN GREATER AWARDS: U.S. TAX COURT RULES THAT "COLLECTED PROCEEDS" SUBJECT TO TAX WHISTLEBLOWER AWARDS INCLUDE CIVIL FORFEITURES

By Peter D. Hardy

The U.S. Tax Court recently issued an important decision regarding tax whistleblowers and expanded the ability of successful whistleblowers to maximize their awards. On August 3, 2016, the Tax Court rejected the arguments of the IRS and held in *Whistleblower 21276-13W v. Commissioner, 147 T.C. No. 4 (2016)*, that IRS whistleblowers can collect awards for whistleblowing not only with respect to situations in which tax, interest, and civil tax penalties are recovered by the government under the Internal Revenue Code of 1986, as amended

(codified at Title 26 of the U.S. Code, IRC), but also in which criminal fines and civil forfeitures are collected under Title 18 of the U.S. Code (the general criminal code). Specifically, the Tax Court interpreted the statutory term "collected proceeds," which are the revenues collected due to a specific whistleblower tip and the amount comprising the pool of money from which a tax whistleblower award is made, to include more than just sums collected under the IRC. The ruling in this case, widely reported to have arisen out of the prosecution of now-defunct Swiss bank Wegelin & Co. (which collapsed after having been convicted for conspiring to assist U.S. taxpayers in hiding accounts offshore), made a meaningful difference to the whistleblowers in the case. The parties had agreed that the award should equal 24 percent of the total amount of "collected proceeds." The final award amount leapt from about $4.8 million to about $17.8 million once the total amount of "collected proceeds" reached more than $74.1 million due to the inclusion of the criminal fine and civil forfeiture sums.

IRS Whistleblower Basics

The IRS whistleblower program provides for two types of awards. First, there is a regime for mandatory awards under IRC § 7623(b): if the taxes, penalties, interest, and "additional amounts" in dispute exceed $2 million, the IRC requires the IRS to pay 15 percent to 30 percent of the "collected proceeds," assuming that certain conditions are met. If the case involves an individual target, his or her annual gross income must be more than $200,000. Further, if the whistleblower "planned and initiated the actions" resulting in the underpayment of tax, then the IRS may reduce the award; if the whistleblower's information is not the sole and original source of an IRS action, then the award may not exceed 10 percent. If the whistleblower disagrees with the outcome of a claim under § 7623(b), he or she can appeal to the Tax Court. This mandatory program was at issue in *Whistleblower 21276-13W*, in which the Tax Court found that the plain language of § 7623(b)(1) defining "collected proceeds" was clear and expansive, and was not limited to money collected only under the tax code.

Second, for whistleblowers who do not meet the dollar threshold of $2 million in dispute or for cases involving individual taxpayers with gross income of less than $200,000, IRC § 7623(a) provides for discretionary awards, with a maximum award of 15 percent, up to $10 million. Because the awards are discretionary, the whistleblower cannot appeal the outcome of the claim to Tax Court. Of course, neither the mandatory nor the discretionary version of the whistleblower program is limited to cases resulting in criminal proceedings. The vast majority of cases involve purely civil tax resolutions with the target of the whistleblower's information.

> *Ultimately, the decision . . . could breathe new life into a program that has struggled to date.*

Inclusion of Bank Secrecy Act Collections in "Collected Proceeds"

The *Whistleblower 21276-13W* opinion also contains an important footnote which may expand future awards in another way. In footnote 15, the Tax Court strongly suggests that "collected proceeds" also would include fines and penalties collected under 31 U.S.C. § 5314, the provision of the Bank Secrecy Act which pertains to the Foreign Bank and Financial Account Report (FBAR). U.S. taxpayers—whether individuals or entities—with an interest in, or signatory authority over, offshore accounts with a value above $10,000 at any point in the year must file an accurate and complete FBAR, and disclose the account(s) on federal income tax returns. Because a violation of the FBAR requirement carries potentially onerous civil and criminal penalties, the FBAR has been the engine of the government's extended enforcement campaign against offshore accounts. The government's enforcement has involved numerous prosecutions of taxpayers, professionals, and financial institutions, and has led to an extensive program involving many Swiss banks entering into non-prosecution agreements in exchange for paying heavy monetary penalties and cooperation with the U.S. government regarding their former U.S. clients. Due to this enforcement campaign, the IRS has collected

billions of dollars, and more than 38,000 U.S. taxpayers who had neglected their compliance requirements—including citizens, green card holders, and other permanent U.S. residents—have entered the various versions of the IRS Offshore Voluntary Disclosure Program since 2009. The apparent inclusion of the potentially steep monetary penalties under the Bank Secrecy Act in the pool of "collected proceeds" clearly should motivate would-be whistleblowers to approach the IRS regarding individuals and financial institutions involved in undisclosed offshore accounts.

Future of the IRS Whistleblower Program

Ultimately, the decision in *Whistleblower 21276-13W* could breathe new life into a program that has struggled to date. The IRS established its centralized Whistleblower Office only in 2007, and since has been criticized by some for its slow pace in assessing and paying out awards. For example, the IRS Whistleblower Office's Annual Report for Fiscal Year 2015 (the Report) reflects that, in FY 2015, only 10,615 total claims had been resolved, whereas more than 12,078 claims had been received that year, and 35,670 claims still remained open. Moreover, the Report reflects that, for claims paid out in FY 2015, the average length for resolution of mandated awards was more than six years, and the average length for resolution of discretionary awards was almost nine years. Finally, the government sent a decidedly mixed motivational message to potential tax whistleblowers in the case of the most famous tax whistleblower, Bradley Birkenfeld, a former banker for Swiss bank UBS. He came to the IRS in 2007 and exposed a massive scheme of international tax evasion, and thereby set in motion the enforcement campaign by the IRS and the Department of Justice against undisclosed foreign accounts described above, which is still going strong and which has altered forever global bank secrecy. For his efforts, Birkenfeld eventually received an impressive whistleblower award of $104 million—but only after he received a federal sentence of 40 months in prison for his own role in the same scheme which he brought to the attention of the tax authorities.

Nonetheless, the program—which collected more than $500 million in FY 2015—appears to be gaining traction, despite certain efforts by the IRS which seem to undermine its own program through foot dragging and fighting claimants. All employers and corporations are subject to federal taxes—and therefore all are subject to potential claims by would-be whistleblowers seeking a payday from the IRS that might be slow in coming but which could be substantial.

P3 PROJECTS AND TAX-EXEMPT BOND FINANCING: HOW DOES THE PUZZLE WORK?

By Vicky Tsilas* and Edith Brashares

Reports of our nation's aging infrastructure and our need to provide additional investment to support its modernization have revived discussions in Washington about what the best source of financing is and which parties are most suitably equipped to pay for it. The talk about infrastructure is not just limited to Washington; even comedian John Oliver did a segment on financing infrastructure on his HBO show (John Oliver, 2015). The federal government's contribution to infrastructure investment comes in the form of grant and loan programs as well as federal subsidies provided through the tax system. Increasingly, the debate has focused on the role of the private sector and whether federal government initiatives should encourage more private sector funding.

This paper describes infrastructure spending by state and local governments and the traditional methods for funding these assets. Investment in our bridges, highways, utility systems, and water and sewage facilities has come from both the public and the private sectors. Given the importance of transportation investment, we first discuss the experience with highway projects. Highway projects have been one of the main areas where the public-private partnership (P3) structure has been used.

You can read the remainder of this article, originally published in the *Municipal Finance Journal* here.

** Special thanks to our former colleague Vicky Tsilas who was recently appointed Branch Chief for the Tax Exempt Bond Branch at the IRS.*

IN THE NEWS

September 14, 2016

Linda B. Schakel and **Vicky Tsilas** presented "*Understanding the New IRS Management Contract Guidance*," a Ballard Spahr webinar. Webinar slides and recording available here.

October 10, 2016

Saba Ashraf will present "*Tax Issues Every Person Working With Start-Ups Should Know*," a Ballard Spahr webinar, on October 10, 2016. Click here for more information.

October 17, 2016 and November 15, 2016

Peter D. Hardy will be a panelist on "*Ethical Issues During a Criminal Tax Trial,*" at 2016 Emerging Ethical Issues in Tax Practice presented by the New Jersey Institute for Continuing Legal Education, in Mount Laurel, New Jersey (October 17), and Fairfield, New Jersey (November 15). Click here and here respectively for more information.

November 11, 2016

Peter D. Hardy will serve as moderator of "*The United States as a Potential Tax Haven: Foreign Assets and Potential Money Laundering Exposures for Lawyers and Other Gatekeepers*," at the Pennsylvania Association of Criminal Defense Attorneys White Collar Seminar in Philadelphia. Click here for more information.

November 17-18, 2016

Peter D. Hardy will be a panelist on "*The Office of Professional Responsibility Hearing, and Criminal Investigation & Prosecution of Tax Preparers*," at The New England IRS Representation Conference, at Foxwoods Casino in Mashantucket, Connecticut. Click here for more information.

December 9, 2016

Peter D. Hardy will be a panelist on "*Offshore Enforcement: How Will They Prove It?*" at the ABA 33rd Annual National Institute on Criminal Tax Fraud and 6th Annual National Institute on Tax Controversy in Las Vegas. Click here for more information.

CONTACTS

The above articles address the relevant tax issues and structuring at a high level only. Please consult members of the Ballard Spahr Tax Group for further discussion.

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