

Proposed Regulations Address Withholding on Distributions in Redemption of Publicly Traded Stock*

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On October 16, 2007, the U.S. Internal Revenue Service (“IRS”) released proposed regulations which, if finalized in their current form, would significantly revise the withholding procedures for certain distributions in redemption of publicly traded stock. These proposed regulations could impose significant compliance and reporting burdens on foreign shareholders, U.S. financial institutions acting as withholding agents, and qualified intermediaries.

Transactions Affected. The new regulations are generally targeted at transactions in which a publicly traded corporation offers to purchase stock from its shareholders (a “self-tender”). In this type of transaction, a corporation may purchase stock from some or all of its shareholders, depending on each shareholder’s willingness to sell its stock under the terms of the offer.

Because not all shareholders may choose to participate, and may not participate equally if they do, each shareholder’s percentage ownership interest in the corporation may increase, decrease, or remain unchanged following the transaction. This can have significant tax implications, because if a shareholder’s interest increases, remains unchanged, or has not been sufficiently reduced, the distribution may be taxed as a dividend, rather than as a payment in exchange for stock.

Section 302. Whether these distributions are taxable as a dividend or as a capital gain from sale or exchange of the stock is determined under section 302.¹ Whether these distributions will be dividends or gain from sale of the stock can be difficult to ascertain until after the entire redemption transaction is completed. Upon completion of the redemption transaction, it is possible to determine how other shareholders’ interests have changed and calculate the relative change in each shareholder’s percentage ownership interest, also taking into account the constructive attribution of ownership.

Withholding Under Section 1441 and 1442. A person who makes a payment to a foreign beneficial owner of an “amount subject to withholding” is required to deduct and withhold tax on that distribution. The regulations clarify that these amounts subject to withholding include FDAP income, such as dividend distributions, but do not include distributions that constitute payments from the sale or exchange of stock. Therefore, whether section 302 would characterize a distribution as a dividend or as a payment in exchange for stock can, in this situation, affect whether withholding is required. Where applicable, the withholding tax rate generally is 30%, subject to being reduced by an applicable income tax treaty.

Effect of these Rules

At present, there is a measure of flexibility allowed to withholding agents with respect to section 302 distributions. The effect of these proposed regulations, should they be adopted in their present form, would be additional clarity and certainty at the cost of an increased reporting burden for U.S. financial institutions, qualified intermediaries, withholding partnerships and trusts, and the foreign beneficial owners of the stock of publicly traded U.S. corporations.

¹ Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended.

The certification requirement should be of particular concern to foreign owners of U.S. stock and their advisors. These regulations would require that foreign beneficial owners make what could be relatively complicated determinations of the extent of the percentage change of their ownership interests, including constructive ownership, every time they participate in the redemption of stock of a U.S. corporation, or risk having the entire amount placed in escrow treated as tax.

Although there are procedures that would allow recovery of this amount in the event of a late certification, and potential adjustments for over or under withholding should an owner make an incorrect certification, these procedures can be complicated. Failing to make a timely and correct certification could therefore be costly and time consuming. The principal aspects of the new rules are as follows.

- **“Escrow Procedure.”** The proposed regulations require a U.S. financial institution acting as a withholding agent to set aside 30% (or, where applicable, the dividend rate under a treaty) of the distribution in an escrow account. The withholding agent must then provide information to the foreign beneficial owners regarding the distribution, such as the total number of shares of stock outstanding prior to and following the distribution, and an explanation of the conditions under which section 302 would treat the distribution as a dividend or a payment in exchange for stock. The withholding agent must then request that the foreign owner certify within 60 days whether the distribution is a dividend or a payment in exchange for stock. If the withholding agent does not receive this certification within 60 days, or if the agent has reason to know that the certification is incorrect, it is required to treat the amount held in escrow as tax and deposit that amount on the 61st day.
- **Certification from the Beneficial Owner.** The foreign beneficial owner of the stock must identify his name and account number, list the number of shares owned before and after the distribution, and certify under the penalties of perjury whether the distribution is a dividend or a payment in exchange for stock.
- **Qualified Intermediaries.** These regulations also would affect qualified intermediaries and withholding foreign partnerships and foreign trusts. Although qualified intermediaries may, and withholding foreign partnerships and trusts must, generally assume primary withholding responsibility, they would not be permitted to do so with respect to these section 302 distributions. The regulations stipulate that this withholding must be done by U.S. financial institutions, such as brokers. Therefore, qualified intermediaries must instead follow this procedure and provide certifications to the U.S. institutions, as described above. Where there is a chain of intermediaries, this procedure must be followed at each level of that chain.

It is not clear that these proposed regulations will be implemented in their current form. A public hearing for comments has been scheduled for February 8, 2008, on which date there will be further opportunity to discuss the proposed changes.

As proposed, these regulations would apply to stock redemptions after December 31, 2008. However, some withholding agents may elect to rely upon these regulations and follow this procedure for redemptions occurring prior to January 1, 2009.

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