

REPORT ON REGISTERED DEBT FOLLOWING THE HIRE ACT

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REPORT ON REGISTERED DEBT FOLLOWING THE HIRE ACT

Part I.

EXECUTIVE SUMMARY¹

The Hiring Incentives to Restore Employment Act (the “HIRE Act”) enacted significant restrictions on U.S. issuers’ ability to issue debt securities in bearer form. Subject to certain exceptions, U.S. issuers will be subject to significant sanctions, including a denial of interest deductions, if they issue debt securities in bearer form after March 18, 2012, even if the distribution of those securities is targeted to non-U.S. investors.² The HIRE Act also repealed the applicability of the portfolio interest exemption to bearer-form debt.³ Thus, for debt securities issued after March 18, 2012, to qualify for the portfolio interest exemption, those securities will be required to be in registered form. The HIRE Act made related changes to the definition of “registered form”; in particular, the changes now clarify that debt securities that are in a dematerialized format will be treated as in registered form, although the new provisions provide no guidance regarding the meaning of the term “dematerialized.” Thus, there is a need for immediate guidance on how to interpret these new requirements.

In connection with the foregoing, we recommend the following:

¹ The principal authors of this report are Peter Connors and Matthew Welsh, with substantial assistance from Douglas Borisky, Stephen Fiamma and Stephen Land. Helpful comments were provided by Michael Schler and Elliot Pisem. Assistance was also provided by Stephen Lessard. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

² Section 163(f), as in effect for debt issued after March 18, 2012. All section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations issued thereunder.

³ Sections 871(h), 881(c).

1. In considering the circumstances under which debt will be treated as in registered or bearer form, we believe that, in borderline cases, the rules should tend to operate in a manner that is weighted towards treating the debt security as in registered form.

2. It would be helpful for the Internal Revenue Service (the “Service”) to confirm that the amendments made to section 163(f)(3) by the HIRE Act will not be interpreted in a manner that could negatively impact arrangements under which securities are regarded as being in registered form under current law.

3. We believe it would be helpful to provide guidance on the characteristics of an exchange or arrangement that would be viewed as a “dematerialized” system or otherwise as an approved book entry system under sections 149(a)(3) and 163(f)(3). In particular, we believe that an arrangement whereby a debt security is effectively immobilized with a custodial or other depository arrangement, and where beneficial ownership of the debt security is held and traded only through a book entry system, should be viewed as a “dematerialized” system or otherwise as such an approved book entry system, even if there are circumstances in which the debt security could be converted into definitive form. Under our proposal, securities that were either in a dematerialized system or immobilized in a clearing system would be treated as in registered form before the actual issuance of a definitive security.

4. Guidance should be provided on the extent to which debt securities would be considered issued in registered form even though physical bearer securities can be issued in limited circumstances. In particular, these circumstances should include (i) the cessation of clearing system operations without a successor, (ii) a default by the issuer, or (iii) a change in tax law that is adverse to the issuer.

5. We generally agree with the apparent conclusion of Notice 2006-99⁴ (the “Notice”) that an express legal agency relationship between an issuer and the party which maintains a book entry system is not required. However, in light of the uncertainty under current law as to whether the Notice can be applied in the absence of an actual and acknowledged agency relationship, the Service should confirm that no such agency relationship is required.

6. Definitive bearer securities may be required to be issued upon a clearing system shutdown or in certain other limited circumstances. In those circumstances, we recommend the debt security be treated as if it continued to be in registered form, so that no issuer or holder sanctions are triggered.

7. The regulatory paradigm under section 163(f)(2)(B) for foreign-targeted offerings by foreign issuers should be preserved for purposes of section 4701. To make it more useful, the regulations under Treasury Regulations section 1.163-5(c)(2)(i) (C) and (D) should be moved to section 4701.

8. Provisions of Treasury regulations relating to portfolio debt that is not issued in registered form should be updated to reflect the HIRE Act’s prohibition on such issuances. For example, consideration should be given to deleting an example in the conduit regulations that is affected by the statutory change.

Part II.

BACKGROUND

U.S. issuers generally may issue debt securities in bearer form provided the securities are issued under “arrangements reasonably designed” to ensure that the securities are sold only to non-United States persons. In addition, the portfolio interest exemptions of sections 871(h)(1)

⁴ 2006-2 C.B. 907.

and 881(c)(1) exempt from withholding tax qualifying interest payments to foreign persons that are not engaged in a U.S. trade or business. For this purpose, qualifying interest payments include interest paid on foreign-targeted bearer debt securities.

Section 502 of the HIRE Act, one of many provisions aimed at eliminating tax evasion through cross-border arrangements, effectively eliminates U.S. issuers' ability to issue debt securities in bearer form in the international capital markets. Subject to certain exceptions, U.S. issuers that issue debt securities in bearer form after March 18, 2012, will be disallowed interest deductions with respect to such issuance.⁵ In addition, the HIRE Act makes bearer debt ineligible for the portfolio interest exemption. Before this change, it was possible to issue bearer debt that was not subject to withholding tax if the debt was not a "registration-required" obligation under TEFRA.⁶ A registration-required obligation is any debt obligation other than one which: (1) is issued by an individual, (2) is not of a type offered to the public, (3) has a maturity of not more than one year, or (4) is targeted to non-United States persons on issuance pursuant to a provision frequently referred to as the "Eurobond exception."⁷ The HIRE Act repeals the fourth so-called "foreign-targeted exception" to the definition of registration-required obligation.

Interest paid on a registered-form debt security is eligible for the portfolio interest exemption only if the issuer receives a statement that the beneficial owner of the debt security is

⁵ Section 163(f). An excise tax could also be imposed under section 4701 but only if the debt securities were not foreign targeted.

⁶ P.L. 97-248 ("TEFRA").

⁷ Section 163(f)(2)(A). The Eurobond exception for foreign targeted obligations described in the text also is referred to as the TEFRA D exception, by reference to Treasury Regulations section 1.163-5(c)(2)(i)(D). A further exception is available under Treasury Regulations section 1.163-5(c)(2)(i)(C), referred to as the TEFRA C exception, but is of more limited application because of restrictions related to the type of issuer that may use it.

not a United States person.⁸ Treasury Regulations section 1.871-14(c) provides that for purposes of determining the application of the portfolio interest exemption, the conditions for an obligation to be in registered form are identical to the conditions described in Treasury Regulations section 5f.103-1. The HIRE Act also allows the Secretary to issue regulations under which the statement is not required.⁹

Under Treasury Regulations section 5f.103-1(c)(1), a debt security is in registered form if —

- (i) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or
- (ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) (as described in paragraph (c)(2) of this section).

(The obligation also is treated as in registered form if it can be transferred pursuant to both of the methods in (i) and (ii).) An obligation is considered to be in registered form at a particular time if it can only be transferred by a means described above at that time or any time until its maturity.¹⁰

⁸ Section 871(h)(2)(B)(ii); Treas. Reg. § 1.871-14(c)(1)(ii)(C). Typically, this statement is obtained on a Form W-8. However, it is also possible to comply with this requirement through other documentary evidence. That is, the United States person (or its authorized foreign agent) is permitted to use documentation so long as it can reliably treat the payment as made to a foreign beneficial owner in accordance with Treasury Regulations section 1.1441-1(e)(1)(ii), which cross-references Treasury Regulations sections 1.1441-6(c)(3) and (4), and 1.6049-5(c)(1). This last section includes the following general statement: “A payor may rely on documentary evidence if the payor has established procedures to obtain, review, and maintain documentary evidence sufficient to establish the identity of the payee and the status of that person as a foreign person (including, but not limited to, documentary evidence described in §1.1441-6(c)(3) or (4)); and the payor obtains, reviews, and maintains such documentary evidence in accordance with those procedures.”

⁹ Section 871(h)(2)(B)(ii)(II).

¹⁰ Treas. Reg. §§ 5f.103-1(c)(1), (e).

In the years since TEFRA was enacted, the practice of issuing individual physical bearer certificates to holders has largely been replaced by the practice of issuing only a physical global note or by not issuing any physical certificate at all. Under foreign law, there is often a preference for debt that is treated as bearer debt under local law. For example, in some jurisdictions, such as the United Kingdom, the use of bearer form instruments is necessary to avoid imposition of *ad valorem* taxes on certain issuances. This preference can typically be satisfied by use of a global bearer note.

In 1993, the Service issued two rulings relating to issuances that in form were bearer debt but which did not permit the issuance of individual physical securities in bearer form at any time.¹¹ The programs described required that the bearer debt in the form of a global instrument be immobilized by delivering the instrument permanently to a custodian and allowing transfers of interests in that instrument only to be made through a book entry system maintained by a party acting as an agent of the issuer. While formally documented as bearer securities, the debt issued under the program was considered registered because it could only be transferred by a book entry system maintained by the issuer or its agent.¹²

The Service dealt with a similar issue under the Notice. In the Notice, the Service and the Treasury addressed the development of dematerialized book entry systems for holding and transferring bonds. The Notice stated that in such systems, bonds are required to be represented only by book entries, and no physical certificates are issued or transferred. According to the Notice, such dematerialized book entry systems offer significant efficiencies for securities

¹¹ PLR 9343018, PLR 9343019.

¹² PLR 9613002 applied a similar analysis. This ruling dealt with debt issued by a foreign building society.

markets, and in order to capture those efficiencies, markets in certain foreign countries have adopted such systems.

The Notice described the laws of a foreign country, which we understand to be Japan, which require that, beginning on a certain date, bonds issued in that country must be held through the book entry system operated by a foreign country clearing organization (the “Foreign Country Clearing Organization”), which was an entity that was in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation. Within the book entry system, bonds were not represented by any physical certificates; they were represented only by book entries. Holders did not have the ability to withdraw bonds from the book entry system and obtain physical certificates representing the bonds. Holders could obtain physical certificates in bearer form only if Foreign Country Clearing Organization went out of business without a successor that would continue to operate the book entry system. Bonds that were issued before the book entry system became mandatory had to be transferred into the system by a specified date.

The Notice concluded that an obligation subject to a book entry requirement and held through the book entry system operated by Foreign Country Clearing Organization was an obligation in registered form because, within the book entry system, it may be transferred only by book entries and the holder of the obligation does not have the ability to withdraw the obligation from the book entry system and obtain a physical certificate in bearer form.

The Notice stated that the provision for the issuance of physical certificates in bearer form in the event that the book entry system goes out of existence is not the equivalent of a

provision conferring on the holder the ability to convert an obligation from registered form into bearer form in the ordinary course of business.

The HIRE Act included a provision that provided that “a dematerialized book entry system or other book entry system specified by the Secretary shall be treated as a book entry system described in” section 149(a)(3), which provides guidance regarding the definition of “registered form.” The legislative history to the HIRE Act specifically addressed the practice of issuing dematerialized obligations, after noting that the Service had adopted a flexible practice in applying the registered standard, stating:

The provision provides that a debt obligation held through a dematerialized book entry system, or other book entry system specified by the Secretary, is treated, for purposes of section 163(f), as held through a book entry system for the purpose of treating the obligation as in registered form. A debt obligation that is formally in bearer form is treated, for the purposes of section 163(f), as held in a book entry system as long as the debt obligation may be transferred only through a dematerialized book entry system or other book entry system specified by the Secretary.¹³

The revised version of section 163(f)(3) does not define “dematerialized book entry system.” While the Notice provides some helpful inferences, the legislation does not indicate that the guidance provided by the Notice, which leaves some questions unanswered, is the definitive word on this.

¹³ J. Comm. on Tax'n, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The “Hiring Incentives To Restore Employment Act,” Under Consideration by the Senate, JCX-4-10, at 53 (2010) (footnotes omitted).

Part III.

RECOMMENDATIONS

1. Bearer vs. Registered Form – General

Determining whether a debt security is in bearer or registered form for U.S. tax purposes is often not as straightforward as it initially would appear. As noted in our prior report on the TEFRA restrictions,¹⁴ there has been considerable uncertainty in this area, such as where debt securities are nominally in bearer form but are effectively immobilized in a clearing system such as Clearstream or Euroclear. Before the HIRE Act, U.S. issuers could manage this lack of certainty by incorporating terms in debt issuances that would ensure bearer treatment for U.S. tax purposes and ensuring that the issuance was properly foreign-targeted in compliance with TEFRA. Typically, U.S. issuers desiring to ensure that any debt issued was treated as in bearer form would provide holders with rights to demand definitive bearer certificates. Because the notes could in principle trade in bearer form if these definitive bearer certificates were issued (even though, generally, neither holders nor the issuer intended for definitive bearer certificates to be issued and considered the possibility of such an issuance to be unlikely) the debt would be treated as being in bearer form even during the period it was represented by a single global certificate that was immobilized in the clearing system. This conclusion is supported by Treasury Regulations section 5f.103-1(e)(2), which treats a security as being in bearer form “if it can be transferred at that time or at any time until its maturity by any means” other than by surrender to the issuer and reissuance by the issuer, or through a book entry system.¹⁵

¹⁴ N.Y. St. B. Ass’n, Rep. No. 1133, Report On Issues Relating To Restrictions Imposed on Offers and Sales of Bearer Bonds by The Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) 12 (2007) (the “2007 Report”).

¹⁵ See 2007 Report, Part I.A.

In light of the significant penalties associated with issuing most types of bearer debt, U.S. issuers must now be able to conclude with confidence that any debt they issue will be treated as in registered rather than bearer form for U.S. tax purposes. While issuers have generally been able to obtain a high level of certainty when they wished to issue bearer debt, reaching an equally high level of certainty that a security is issued in registered form under current guidance may not always be possible. Hence the need for the Service to provide additional guidance, as further discussed below.

In considering the circumstances under which debt will be treated as in registered or bearer form, we believe that the rules should tend to operate in borderline cases in a manner that is weighted towards treating the debt security as in registered rather than bearer form. The changes made by the HIRE Act, which significantly limit an issuer's ability to issue bearer debt, were enacted as part of an overall and ongoing policy of reducing tax avoidance and closing perceived avenues for that potential avoidance. We believe that such a bias towards a finding of registered form is consistent with Congressional intent in enacting the HIRE Act. Adopting this approach would further the overall goal of reducing tax avoidance, because it generally would require that withholding agents collect Forms W-8 with respect to the beneficial owners of the securities (or, where relevant, Forms W-9) in order to avoid the imposition of U.S. withholding tax¹⁶ and thus would result in an increase in information reported to the Service under the information reporting rules. Although the proposal potentially could result in an incremental increase in the number of definitive bearer form securities in the market, we believe that any concerns relating to that possibility are mitigated by the increased information reporting required

¹⁶ Although debt of non-U.S. issuers generally would not be subject to such requirements, the Service could require the provision of such forms in some circumstances, such as with respect to payments made in the United States, under the information reporting and backup withholding rules, as discussed in Section III.6, below.

with respect to such securities and the fact that such securities could exist only under very narrow circumstances following the occurrence of events beyond the control of the issuers or holders of such obligations.

2. Effect on Current Law and Arrangements

As an initial matter, it would be helpful for the Service to confirm that the amendments made to section 163(f)(3) by the HIRE Act will not be interpreted in a manner that could negatively impact arrangements under which securities are regarded as being in registered form under current law. For example, the Service could confirm that issuers may continue to rely on the types of arrangements contemplated by PLR 9343018 and similar rulings.¹⁷ Although those types of arrangements do not involve a “dematerialized” clearing system, we believe that debt securities issued under those types of arrangements should continue to be regarded as being in registered form for U.S. tax purposes. As noted above, an apparent purpose of the repeal of U.S. issuers’ ability to issue debt securities in bearer form was to improve information reporting to the Service in order to close avenues of perceived tax avoidance. Consistent with this purpose, the Service should confirm that arrangements that result in a debt security being in registered form under existing law and ruling practice will not be treated as resulting in a note in bearer form after the effective date of the HIRE Act provisions, merely because the arrangement is not formally a dematerialized book entry system.¹⁸

¹⁷ See also PLR 9343019 and PLR 9613002. As noted above, under those rulings, a physical global note in bearer form is issued and delivered to a custodian, and the custodian issues a registered receipt into a clearing system representing an interest in the underlying bearer note. In this manner the bearer note is effectively immobilized with the custodian, and beneficial ownership of the note is recorded in a book entry system maintained by the clearing system and its participants. See 2007 Report, Section I.B.2.

¹⁸ The text of section 163(f)(3) generally incorporates the definition of “registered” in section 149. In addition, the revised statutory language states that a dematerialized book entry system will also qualify. Thus, debt can be registered either in the way set forth in section 149, or in compliance with the dematerialized procedures—*i.e.*, that debt does not need to be “dematerialized” in order to be treated as in registered form.

3. Meaning of “Dematerialized” Book Entry System

The specific inclusion of dematerialized book entry systems as an approved form of book entry system in section 163(f)(3) appears to have originated from the facts of the Notice. Neither the legislative history of the HIRE Act nor the Notice provides a clear explanation or analysis of the specific characteristics of a book entry system that are relevant in determining whether that system qualifies as a “dematerialized” book entry system and, consequently, whether debt securities held and traded through that system are treated as being in registered form. Accordingly, there is continuing uncertainty with respect to debt securities held and traded through systems or under arrangements that, while not identical to the clearing and book entry system described in the Notice, are broadly similar, or at least the differences between which would not appear to be material to the tax analysis. Contrary to suggestions made by Service officials,¹⁹ we do not believe that the Notice provides enough guidance on issues relating to the use of dematerialized book entry systems. Indeed, we believe that the Treasury and the Service should issue a notice, and eventually proposed and temporary regulations, indicating how they will interpret the term “dematerialized book entry system.”²⁰

The following common fact pattern illustrates the three primary areas of uncertainty that arise in current market practice:

Example. Debt securities of Issuer A are issued to and cleared through Clearing System B. Clearing System B maintains a book entry system which records beneficial ownership of the underlying debt securities and through which all transfers of beneficial interest

¹⁹ See Letter of James Duensing of Caterpillar Financial Services Corp, dated September 30, 2011, *appearing in* 2011 TNT 193-18. See also Letter of Chris Ballinger of the Toyota Motor Credit Corp, dated September 28, 2011, *appearing in* 2011 TNT 197-23.

²⁰ See Letter of James Duensing of Caterpillar Financial Services Corp, dated September 30, 2011, *appearing in* 2011 TNT 193-18. See also Letter of Chris Ballinger of the Toyota Motor Credit Corp, dated September 28, 2011, *appearing in* 2011 TNT 197-23.

occur. However, unlike the clearing system described in the Notice, Issuer A actually issues a physical security in bearer form to the custodian of Clearing System B. Therefore, the first issue that arises is whether this type of arrangement is a “dematerialized” book entry system given the fact that a physical security is issued, as further discussed below in Part III.3.²¹

The physical security is deposited with and effectively immobilized with the custodian, and physical bearer securities can only be issued outside the clearing system in limited circumstances. The circumstances under which physical bearer securities can be issued are: (i) the cessation of Clearing System B’s operations without a successor, (ii) a default by Issuer A, or (iii) a change in tax law that is adverse to Issuer A. Although the occurrence of any of these events is thought to be unlikely, two of the three circumstances are not listed (and therefore not approved) in the Notice as events in which physical bearer securities can be issued to holders while still allowing the debt security to be treated as in registered form before that subsequent issuance. The second issue that arises, therefore, is whether the possibility for a release of definitive bearer certificates in circumstances beyond the single event listed in the Notice results in the debt securities being treated as bearer, as further discussed below in Part III.4.

A third issue relates to the requirement under the current Treasury Regulations that a book entry system be maintained either by the issuer or its agent. Although beneficial ownership in the underlying debt security is held and traded only through Clearing System B’s book entry system, Clearing System B does not maintain the book entry system as “agent” of Issuer A in the strict legal sense. The final issue is, therefore, whether the agency requirement of Treasury

²¹ As noted above, the securities potentially could be treated as in registered form even if not “dematerialized” but the procedures that market participants have had to adopt to ensure that securities are registered can be complicated and inefficient; thus, it would be useful to have some clarity as to whether these structures are to be treated as “dematerialized,” and thus registered, which may simplify the procedures that need to be adopted.

Regulations section 5f.103-1(c)(1)(i) continues to be relevant, as further discussed below in Part III.5.

Many clearing systems commonly encountered in the capital markets may not be regarded as fully dematerialized systems and, therefore, may not be addressed by either the Notice or new section 163(f)(3). Unlike the clearing system that was the subject of the Notice, securities that are cleared through many clearing systems, including, for example, Clearstream and Euroclear, are represented by a physical global security. The use of a physical global security is, in fact, the most commonly used format for debt offerings in the Eurobond markets. Although the security exists in physical form and therefore is not “dematerialized” in the literal sense, that physical global note is required to be delivered to a custodian of the clearing system and cannot be released by that custodian other than in limited and defined circumstances, as further discussed below in Part III.4. As noted in the 2007 Report,²² these types of systems, where physical bearer certificates are effectively “immobilized” with a custodian, are functionally equivalent to the type of dematerialized system that was the subject of the Notice. As a result, these types of systems should generally be treated in the same manner as “dematerialized” systems for purposes of section 163(f)(3). Alternatively, the Service could specify that these types of clearing systems or arrangements are to be treated as in registered form, pursuant to section 149(a)(3), as allowed by section 163(f)(3).

²² In the 2007 Report we stated that: “it would be helpful for the Service to clarify that securities that are required to be held in a book entry arrangement will be treated as ‘dematerialized’ securities that are included within the scope of the rules regardless of the formal structure of the arrangement. For example, a permanent global security that nominally is in bearer form but is required to be held through a clearing organization would be treated in the same manner as a permanent global security that is registered in the name of the clearing organization. In the absence of such a provision, small differences in form that have little or no substantive significance could have a substantial effect on the characterization of the relevant securities.”

Such a conclusion is consistent with the holdings in PLR 9343018 and similar rulings. In those rulings a definitive bearer note was immobilized with a custodian, and trading in the note took place only through a book entry system maintained by a clearing system. The Service concluded in the rulings that the immobilization of the bearer security with the custodian was tantamount to an issuance of a registered security to the custodian. In this context, a system where a security is immobilized by either the current practice of a number of clearing systems or by separate contractual arrangement, such as that in PLR 9343018, should be viewed as being “dematerialized,” or otherwise as a system described in section 149(a)(3) for purposes of section 163(f)(3). Unlike those rulings, however, in many cases in which securities are structured in the manner described in the example in Part III.3 above, the physical securities that are issued in the limited circumstances defined may be in bearer form.²³

Rather than listing approved clearing systems, we believe it would be helpful for the Treasury and the Service to provide guidance on the characteristics of an exchange or arrangement that would be viewed as a “dematerialized” system or otherwise as an approved book entry system under sections 149(a)(3) and 163(f)(3).

The characteristics of such an approved clearing system or book entry system are relatively straightforward. First, to the extent a physical obligation is issued in bearer form, that obligation must be effectively immobilized with a custodian or other depository. Immobilization is accomplished when the physical bearer obligation is issued to a custodian or depository, and the obligation cannot be released from the custodial or depository arrangement other than in limited circumstances. The particular circumstances under which the physical bearer obligation

²³ The issuance of such physical securities in bearer form may be required as a matter of local law or practice. This is consistent with the structure of the clearing system described in the Notice, which provided for bearer-form physical securities in the unusual circumstances in which such securities were issued.

could be released is an important and relevant consideration, and is discussed separately below in Part III.4.

Second, beneficial ownership of the underlying global debt security must be held and traded only through a book entry system. In most circumstances, we would expect this book entry system requirement to be relatively easy to satisfy, as we believe that most commonly encountered clearing systems currently maintain this type of book entry system.

4. Ability to Obtain Physical Certificates in Bearer Form

Although debt securities held and traded through a typical clearing system are either dematerialized or effectively immobilized, there typically are circumstances under which the security can be released from the clearing system and definitive bearer instruments issued to beneficial holders. The precise triggering events for the release of a security from the clearing system and the issuance of definitive bearer certificates will vary from deal to deal and across different clearing systems, and may be subject to local legal or regulatory constraints. However, as listed in the example in Part III.3, three commonly encountered circumstances in which this can occur are (i) in the event that the clearing system ceases to function without the existence of a successor, (ii) the occurrence of an issuer event of default, or (iii) a change in tax law adverse to the issuer. As discussed in the 2007 Report, as a technical matter, under current law the mere possibility that definitive bearer debt securities could be issued in these circumstances could be sufficient to cause the debt securities to be regarded as in bearer form from their issue date.²⁴

²⁴ As described below, the Notice provides that the potential issuance of definitive securities in bearer form does not prevent the securities from being treated as in registered form before the issuance of definitives, but under the terms of the securities described in the Notice, definitive securities may be issued only if the clearing system ceases to function.

In determining whether a security is to be treated as in registered or bearer form, Treasury Regulations section 5f.103-1 looks at the manner in which a security can be transferred at any time prior to maturity, apparently without requiring consideration as to the likelihood that the securities will ever be transferred in that manner.²⁵ Consequently, the mere possibility that physical bearer securities could be issued at some point in the future might cause the security to be regarded as in bearer form even while that security is either dematerialized or immobilized in the clearing system.

The clearing system described in the Notice required physical certificates in bearer form to be issued in the event that the clearing system ceased operations without a successor. Notwithstanding this possible release of physical bearer certificates, the Notice concluded that any debt securities held in the system were in registered form while within the system. While we agree with this conclusion, the precise reasoning relied upon for this conclusion continues to be unclear.

As set forth in the 2007 Report, the Notice's narrow factual setting leaves open questions concerning whether it would apply if physical certificates were made available in circumstances that are different from those in the Notice. In particular, it is unclear whether events that are unlikely but not as remote as a clearing system shutdown, such as an issuer default or an adverse change in tax law, qualify as events following which definitive bearer certificates can be permitted or required to be issued while still allowing the security to be treated as in registered form prior to any such issuance.

²⁵ The rules of many clearing systems will provide an issuer with some ability to specify the circumstances under which physical bearer certificates may be issued (although this flexibility may as a practical matter be constrained by local law or practice). This is in apparent contrast with the system addressed by the Notice, which seems to have mandated the issuance of bearer certificates in a clearing system meltdown scenario, and only in that circumstance.

The 2007 Report discusses this issue in some depth. In summary, the 2007 Report proposes analyzing the circumstances under which debt securities can be issued in definitive form while still maintaining registered form prior to that issuance under two alternative proposals. (The tax consequences to an issuer and to holders upon an actual issuance of definitive bearer certificates are also uncertain. The relevant issues were discussed in the 2007 Report and are discussed below in Part III.6).

Under the first proposal, the “Identified Conditions Proposal,” definitive bearer certificates that could be made available by an issuer only upon the occurrence of the following events would not cause dematerialized securities to be treated as in bearer form: (i) a cessation of clearing organization operation without a successor, (ii) an issuer default or (iii) an issuer option upon an adverse change in tax law. Under the second proposal, the “Unconditional Right Proposal,” definitive bearer certificates could be made available upon demand of the holders in broader circumstances, but only upon the occurrence of an event outside the control of the holders, other than the mere passage of time.²⁶ Under both of these proposals, securities that were either in a dematerialized system or immobilized in a clearing system would be treated as in registered form before the actual issuance of definitive securities. In each of these proposals, the event causing the issuance of the definitives is not in the control of either the holders or the issuer.

²⁶ As set out in the 2007 Report, our second alternative proposal would revise the concept of a “good” book entry system in Treasury Regulations section 5f.103-1(c)(1)(ii) to include in the definition of “registered form” securities that meet both of the following criteria: (i) the security may be held only in dematerialized form (including securities that nominally are in the form of a global security in registered or bearer form that is held by a clearing organization or a depository for a clearing organization) and (ii) a holder, or a group of holders acting collectively, does not have the right to obtain definitive securities in bearer form at one or more times on or prior to the maturity date except upon the occurrence of an event that is beyond the holders’ control, other than the mere passage of time.

As noted in Part III.1 above, we believe the rules generally should be interpreted in a manner that is weighted towards finding that notes are in registered rather than bearer form. Consequently, we believe that the rules should be sufficiently flexible to accommodate market practice (taking into account the requirements of particular clearing organizations or local legal or regulatory requirements) by permitting the issuance of definitive bearer securities in several instances other than those specified by the Notice, subject to the overall constraint that those situations are of a type that are unlikely and unexpected at the time the securities are issued and are beyond the control of the issuer or the holders at the time the securities are issued. Regardless of how these permissible conditions are defined, there appears to be no reason to have a distinction between transactions which are in fully “dematerialized” form and those in which there nominally is a physical security, but the physical security is immobilized.

5. Agency Requirement

As indicated in the 2007 Report, an additional area that has continued to create uncertainty relates to a provision in Treasury Regulations section 5f.103-1 that requires the book entry system to be maintained by the issuer or its agent. In practice, clearing systems maintaining book entry systems do not view themselves as acting as agents of the relevant issuer; in particular, they do not assume towards the issuer the fiduciary obligations that a true agent would owe to its principal. It can therefore be difficult to convince a non-U.S. entity maintaining a book entry system to acknowledge an agency relationship.

This issue has become particularly important in light of both the issuance of the Notice and amendments made by the HIRE Act with respect to bearer debt securities. The Notice does not make reference to an agency relationship; thus, some issuers of bearer debt through Clearstream, Euroclear and other clearing organizations have been inclined to conclude that the

characteristics of those systems are sufficiently similar to the system described in the Notice that the holding of the Notice can be relied upon for securities issued through those other systems, despite the fact that those systems may not technically be dematerialized.²⁷ Even though some issuers have been able to achieve some degree of comfort on this first issue, the lack of any express agency relationship between the issuer and the clearing system has represented an additional and unnecessary hurdle to full reliance on the Notice. Some issuers have been hesitant to rely on the holding in the Notice without establishing an agency relationship, which may not always be possible to achieve. The potential absence of an agency relationship is even more important in light of the amendments made by the HIRE Act and the consequential need for U.S. issuers to confidently conclude that debt securities they issue will be respected as being in registered form. The Notice appeared to disregard the technical requirement in Treasury Regulations section 5f.103-1 that the book entry system be maintained by an agent of the issuer, or it may have viewed the role of the clearing system as fulfilling the role of an agent for this purpose even though no agency relationship was established as a legal matter. Alternatively, the Notice may have analyzed the clearing system as equivalent to the registered holder of the securities, which would obviate the need for an agency relationship.²⁸ We generally agree with the apparent conclusion of the Notice that an express legal agency relationship should not be required. However, in light of the uncertainty under current law as to whether the Notice can be applied in the absence of an actual and acknowledged agency relationship, the Service should confirm that no such agency relationship is required.

²⁷ Issuers seeking to reach this conclusion will limit the circumstances under which definitive bearer certificates can be issued to the single circumstance mentioned in the Notice, namely the cessation of the clearing system and the inability to find a replacement.

²⁸ *See, e.g.*, PLR 9343018, which concluded that the custodial arrangement caused the global note to be the equivalent of a book entry on the issuer's books reflecting the custodian as the holder of the note.

6. Bearer Definitive Notes Upon Release from Book Entry System

A separate but related problem arises when definitive bearer securities are required to be issued under the circumstances described in the example in Part III.3 above. As noted in the 2007 Report, under current law the issuance of definitive bearer securities in respect of a dematerialized security could give rise to significant and unwarranted issues for U.S. issuers if those securities are subject to the bearer debt sanctions. Interest paid on these definitive bearer securities would no longer be deductible by the issuer, and would not be eligible for the portfolio interest exemption when paid to non-United States holders. The issuer could also be subject to an excise tax if the issuance of the definitive bearer securities were viewed as a new issue for purposes of section 4701. If the excise tax were not imposed, United States holders of a previously registered security could find themselves subject to sanctions under sections and 165(j) and 1287(a).

We believe that the mere conversion of a bond from dematerialized/book entry form to physical bearer form generally should not constitute a section 1001 event. Thus, as a technical matter, there may not be an “issuance” that would trigger the imposition of the issuer sanctions. Nevertheless, it would be helpful to have some clarity on this point.

While the issues raised in these circumstances require further attention, the resolution of these issues is less pressing than those discussed in Parts III.1 through III.5 above. Consequently, we do not discuss them further here, but refer to Part III.B. of the 2007 Report, which contains a detailed discussion and proposes alternative solutions. While certain elements of the discussion and proposals in the 2007 Report will need to be reconsidered in light of amendments made by the HIRE Act, the 2007 Report nonetheless provides an instructive analysis of the relevant considerations. In general, we believe that the definitive securities

should continue to be treated in registered form. A consequence of treating them as registered would be that holders would be required to deliver Forms W-8 in order to preserve the applicability of the portfolio interest exemption. In the case of foreign issuers, although Forms W-8 would not be required under the portfolio interest rule, the Service could require the provision of such forms in at least some circumstances (e.g., in the case of payments made in the United States) pursuant to the information reporting rules of section 6049 and the backup withholding rules.²⁹

7. Preservation and Renumbering of Section 163(f)(2)(B) Regulations

Following the enactment of the HIRE Act, under section 4701(b)(1), it will still be possible, for obligations issued after March 18, 2012, for non-U.S. issuers to rely on the TEFRA foreign-targeted procedures to avoid the excise tax.³⁰ The regulatory paradigm established under Treasury Regulations sections 1.163-5(c)(2)(i)(C) and 1.163-5(c)(2)(i)(D) should therefore be preserved for purposes of section 4701. To make it more useful, the regulations should be moved to section 4701.

8. Update of Treasury Regulations to Reflect Statutory Change

Changes will need to be made to the regulations to reflect the fact that debt can no longer qualify for the portfolio debt exemption if it is issued in bearer form. One change we wish to draw your attention to relates to the conduit regulations. Under those rules, which are contained in Treasury Regulations 1.881-3, an intermediary entity may be ignored in determining whether amounts paid by the financed entity are subject to withholding tax. Example 10 of Treasury Regulations section 1.881-3(e) addresses possible application of the conduit rules where debt is

²⁹ Treasury's regulatory authority under this area is very broad. See, e.g., sections 6049(b)(1)(G), 6049(b)(2)(B) and 6049(b)(2)(C).

³⁰ Section 4701(b)(1)(B) (as in effect after March 18, 2012).

issued by a foreign parent in bearer form and then lent to a U.S. affiliate. Example 10 states that because interest payments on the debt issued would not have been subject to withholding tax if the debt had been issued by the U.S. affiliate, there is no reduction in tax. Example 10 should be updated to reflect the fact that after March 18, 2012, debt may no longer be issued in bearer form. We note that the timing considerations for resolution of this issue are less pressing than for the other issues addressed in this report.