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January 18, 2018

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Re: *Proposed Regulations Providing Guidance on the Definitions of Registration-Required Obligation and Registered Form*

Dear Messrs. Kautter and Paul:

This letter[1] of the New York State Bar Association Tax Section ("Tax Section") provides comments on the recently proposed regulations

[1] This letter may be cited as New York State Bar Association Tax Section Report No. 1385, *"Proposed Regulations Providing Guidance on the Definitions of Registration-Required Obligation and Registered Form*" (Jan. 18, 2018). The principal drafter of this letter was John T. Lutz with contributions from Douglas Borisky, Bora Bozkurt, Peter Connors, Lucy W. Farr, Stephen B. Land, Jiyeon Lee-Lim, Leah Li, Jeffrey Maddrey, John Narducci, James Peaslee, Joseph Riuley, Michael Schler and Jason Schwartz. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

providing guidance on the definitions of registration-required obligation and registered form (the "Proposed Regulations").[2]

The Proposed Regulations are intended to address both changes in market practice and the statutory repeal of the foreign-targeted bearer obligation exception to the registered form requirement.[3] We thank the Department of the Treasury ("Treasury") and Internal Revenue Service (the "IRS") for adopting many of the recommendations of the Tax Section and other commentators. This letter discusses the Proposed Regulations and provides several comments that we hope will be considered when the Proposed Regulations are promulgated as final.

Summary of Proposed Regulations

Registration-Required Obligation. Section 163(f) denies an issuer a deduction for interest on a registration-required obligation that is not in registered form.[4] Section 163(f)(2) defines "registration-required obligation" as any obligation other than (1) an obligation issued by a natural person; (2) an obligation not of a type offered to the public; or (3) an obligation that has a maturity at the date of issue of not more than one year. The Proposed Regulations clarify that an "obligation" for this purpose includes pass-through certificates and participations.[5] In addition, the Proposed Regulations significantly narrow the scope of the phrase "an obligation not of a type offered to the public" by providing an obligation is not of a type offered to the public only if the obligation is "traded on an established market" as determined under the Section 1273 regulations, without regard to the $100 million exception for the small debt issues.

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[2] Guidance on the Definition of Registered Form, 82 Fed. Reg. 43,720 (Sept. 19, 2017). All "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code") or the Treasury Regulations promulgated thereunder.

[3] The Hiring Incentives to Restore Employment Act (The "HIRE Act") repealed Section 163(f)(2)(B) (relating to foreign-targeted bearer obligations). Foreign-targeted bearer obligations issued after March 18, 2012 are subject to the special rules for bearer obligations set forth in Sections 149(a), 163(j), 165(f), 312(m) and 1287. The HIRE Act revoked the portfolio interest exception for foreign-targeted bearer obligations issued after March 18, 2012. The HIRE Act did not repeal the foreign-targeted bearer obligation exception to the Section 4701 excise tax.

[4] In addition to Section 163(f), the Code imposes adverse tax consequences on issuers and holders of registration-required obligations that are not in registered form. Section 4701 imposes an excise tax on the issuer of certain registration-required obligations that are not in registered form. Interest on a registration-required bond is not tax exempt unless the bond is in registered form. *See* Section 149(a). Sections 871(h) and 881(c) exempt from income tax portfolio interest only if the obligation with respect to which the interest is paid is in registered form. Section 165(j) generally denies holders a deduction for losses sustained on a registration-required obligation that is not in registered form. Section 312(m) provides that an issuer's earnings and profits cannot be decreased by interest paid on a registration-required obligation that is not in registered form. Finally, Section 1287 generally treats a holder's gain on the sale of a registration-required obligation not in registered form as ordinary income.

[5] The Proposed Regulations also add regular interests in a REMIC to the definition of "obligation." We have no comments to the REMIC provisions of the Proposed Regulations.

The Proposed Regulations define a "pass-through certificate" as an instrument evidencing an interest in a grantor trust or a similar fund that principally holds debt instruments. For this purpose, a similar fund includes a disregarded entity or an entity classified as a partnership, but not an entity classified as a corporation, for federal tax purposes. As we noted in a prior letter,[6] prior guidance was ambiguous as to whether an entity classified as a partnership constituted a "similar fund." The Proposed Regulations are consistent with the IRS's position set forth in two recent Private Letter Rulings.[7]

Under the Proposed Regulations, a participation interest in a debt obligation is analyzed separately from the underlying debt obligation. The Proposed Regulations state that a participation interest that evidences ownership of some or all of one or more obligations and that is treated as conveying ownership of a specified portion of the obligation or obligations (and not ownership of an entity) is a registration-required obligation if the participation interest itself meets the definition of registration-required obligation without regard to whether any obligation to which the participation relates is a registration-required obligation.

Finally, the Proposed Regulations provide that an obligation held by a trust or fund in which ownership interests are represented by pass-through certificates is considered to be in registered form or to be a registration-required obligation if the obligation held by the trust or fund is in registered form or is a registration-required obligation, without regard to whether the pass-through certificates are in registered form or are registration-required obligations.

Registered Form. The Proposed Regulations make very few changes to the definition of registered form.[8] Except for the temporal limitations discussed below, an obligation is in registered form if a transfer of the right to receive both principal and any stated interest on the obligation may be effected only (1) by surrender of the old obligation and either the reissuance of the old obligation to the new holder or the issuance of a new obligation to the new holder; (2) through a book entry system maintained by the issuer of the obligation (an agent of the issuer) or by a clearing organization; or (3) through both (1) and (2). An obligation will be considered transferable through a book entry system, including a dematerialized book entry system, if ownership of the obligation or an interest in the obligation is required to be recorded in an electronic or physical register maintained by the issuer (or its agent) or by a clearing organization.

An obligation represented by one or more physical certificates in bearer form will be considered to be in registered form if the physical certificates are effectively immobilized. A certificate is effectively immobilized only if (1) the physical certificate is

[6] New York State Bar Ass'n Tax Section, *Systems for Holding Consumer and Privately Negotiated Loans in Registered Form to Qualify for the Portfolio Interest Exemption* (Letter No. 1320, Mar. 25, 2015).

[7] See Priv. Ltr. Rul. 201504004 (Jan. 23, 2015) Priv. Ltr. Rul. 201610015 (Mar. 4, 2016).

[8] *Compare* Prop. Reg. § 1.163-5(b) *with* Temp. Reg. § 5f.103-1(c).

issued to and held by a clearing organization for the benefit of the purchasers of interests in the obligation under arrangements that prohibit the transfer of the physical certificates except to a successor clearing organization subject to terms that effectively immobilize the physical certificate; and (2) ownership of the obligation or an interest in the obligation is transferable only through a book entry system maintained by the clearing organization. A "clearing organization" means an entity that is in the business of holding obligations for or reflecting the ownership interests of member organizations and transferring obligations among such member organizations by credit or debit to the account of the member organization without the necessity of physical delivery of the obligation.

The Proposed Regulations provide that, in general, an obligation is not considered to be in registered form as of a particular time if the obligation may be transferred at that time or at a time or times on or before the maturity of the obligation, except an obligation transferrable through a dematerialized book entry system is not in bearer form solely because a holder has a right to obtain a physical certificate in bearer form upon the occurrence of one or both of the following events: (1) the clearing system that maintains the book entry system ceases business without a successor; or (2) the issuance of physical securities at the issuer's request upon a change in tax law that would be adverse issuer but for the issuance of physical securities in bearer form. Upon the occurrence of (1) or (2), any obligation with respect to which a holder may obtain a physical certificate in bearer form will no longer be in registered form, regardless of whether a physical certificate in bearer form has actually been issued. This exception from bearer form treatment is consistent with Notice 2012-20[9] except that the Proposed Regulations do not permit a holder to have a right to obtain a physical security in bearer form if the issuer defaults. As discussed below, we recommend that the issuer default exception be retained when the Proposed Regulations are finalized.

Corresponding Changes. The Proposed Regulations centralize the definitions of registration-required obligation and registered form in one regulation. The Proposed Regulations make corresponding changes to other relevant Code Sections by amending Treasury Regulations section 1.165-12 (related to denial of losses on registration-required obligations not in registered form), Treasury Regulations section 1.860D-1 (related to regular interests in REMICs), Treasury Regulations section 1.871-14 (relating to the inapplicability of the portfolio interest exception to registration-required obligations not in registered form), Treasury Regulations section 1.1287-1 (relating to the denial of capital gains on the sale or exchange of registration-required obligations not in registered form), Temporary Regulations section 1.149(a)-1 and 5f.103-1 (relating to tax-exempt bonds) and Treasury Regulations section 46.4701-1 (relating to the excise tax imposed on registration-required obligations issued in registered form).

Section 881. The Proposed Regulations remove examples 10 and 19 of Treasury Regulations section 1.881-3(e). The preamble indicates that the examples were removed to

[9] Notice 2012-20 adopted many of the recommendations set forth in New York State Bar Ass'n Tax Section, *Report on Registered Debt Following the HIRE Act* (Report No. 1250, Dec. 15, 2011).

address the repeal of the foreign-targeted bearer obligation exception. As discussed below, we recommend that example 19 be retained in the final regulations.

Effective Dates. To coordinate with the repeal of the foreign-targeted bearer obligation exception under the HIRE Act, the Proposed Regulations generally will apply to obligations issued after March 18, 2012. The rules related to pass-through certificates, participation interests and obligations "not of a type offered to the public" will apply to obligations issued after the Proposed Regulations are adopted as final.

Comments

1. Registration-Required Obligations.

The Proposed Regulations adopt the Section 1273 regulations to determine whether an obligation is of a type offered to the public and thus a registration-required obligation. The preamble provides that, "[c]onsistent with the 1993 proposed regulations, Treasury and the IRS continue to believe that it is appropriate to determine whether an obligation is of a type offered to the public by reference to whether the obligation is "traded on an established market." Although a number of Code and regulation sections refer to and define that phrase (for example, sections 453, 1092, 1273 and 7704, as well as regulations promulgated under those sections), Treasury and the IRS have concluded that the definition provided in [Treasury Regulations section] 1.1273-2(f) is the most appropriate for purposes of defining a registration-required obligation." We disagree with the Proposed Regulations' adoption of Section 1273.

Treasury Regulations section 1.1273-(f) attempts to ascertain a ***value*** for an instrument ***not*** to determine whether it is (or is of a type) "offered to the public." Under Treasury Regulations section 1.1273-2(f), property is traded on an established market if, at any time during the 31-day period ending 15 days after (including a debt instrument) the issue date, there is a sales price,[10] a firm quote,[11] or an indicative quote[12] for the property.[13]

[10] A sales price exists if the price for an executed purchase or sale of the property within the 31-day period described in Treasury Regulations section 1.1273-2(f)(1) is reasonably available within a reasonable period of time after the sale. Treas. Reg. § 1.1273-2(f)(2). The price of a debt instrument is considered reasonably available if the sale price (or information sufficient to calculate the sales price) appears in a medium that is available to issuers of debt instruments, persons that regularly purchase or sell debt instruments (including a price provided to only certain customers or to subscribers) or persons that broker purchases or sales of debt instruments. Treas. Reg. § 1.1273-2(f)(2)(ii).

[11] A firm quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the quoted price is substantially the same as the price for which the person receiving the quoted price could purchase or sell the property. Treas. Reg. § 1.1273-2(f)(3).

[12] An indicative quote is considered to exist when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote. Treas. Reg. § 1.1273-2(f)(4).

[13] Treas. Reg. § 1.1273-2(f)(1).

Under this standard, trade claims, vendor receivables, privately negotiated loans, bank loans and other receivables (not issued by a natural person) will be treated as registration-required obligations if brokers and dealers provide indicative quotes for these obligations. Even a related-party loan could be a registration-required obligation if a broker provided an indicative quote for it.

The Section 1273 regulations are too broad to apply for registration-required obligation purposes. The standard for registration-required obligations should relate to whether the obligation is "of a type" offered to the public, and should not turn merely on whether a dealer may have quoted a price (and not even necessarily a "firm" price). We recommend that the Proposed Regulations, when finalized, adopt the relevant provisions of the Section 7704 regulations to determine whether a debt obligation is traded on an established market and thus, a registration-required obligation.[14] In determining whether partnership interests are "readily tradable on a secondary market or the substantial equivalent thereof," the Section 7704 regulations set forth a facts-and-circumstances analysis that focuses on liquidity; not just whether there is some (*any*) even arguably determinable value.[15] Under this approach, related party loans, bank loans and privately negotiated loans should not be treated as "of a type offered to the public" unless, in fact, such loans are readily tradable.

2. Pass-Through Certificates.

As previously noted, we welcome the expansion of pass-through certificates to disregarded entities and partnerships. We have two observations that Treasury and the IRS should consider prior to finalizing the Proposed Regulations. First, a pass-through certificate is an instrument evidencing an interest in an entity that *principally holds* debt. Thus, a partnership interest in a hedge fund or similar investment fund that principally owns debt obligations qualifies as a pass-through certificate. It would be helpful for Treasury and the IRS to clarify that an entity "*principally holds*" debt obligations even if it is trading them actively.

Second, Treasury and the IRS should clarify whether a foreign person holds bearer debt (that is not a registration-required obligation should be permitted to hold that debt through a domestic disregarded entity the sole membership interest in which is in registered form and claim the portfolio interest exemption. This seems to be permitted under the Proposed Regulations; however, it is unclear how the foreign person could demonstrate to the withholding agent that withholding does not apply. The final regulations should clarify that a withholding agent that receives an IRS Form W-8 indicating that an obligation is held through a domestic disregarded entity may rely on the Form W-8 if the provider

[14] Alternatively, Treasury and the IRS could refer to the definition of "personal property" in Section 1092(d) and the Treasury Regulations promulgated thereunder. The Section 1092(d) Regulations, like the Section 7704 Regulations, focus on the liquidity of the instrument. We recommend referring to the Section 7704 Regulations because the guidance under Section 7704 is more developed than that under Section 1092(d).

[15] *See* Treas. Reg. § 1.7704-1(c).

demonstrates that the sole membership interest is in registered form. This may require a substantive rule in Treasury Regulations section 1.871-14 to address the application of the portfolio interest exception to these facts.

3. Participations.

A participation interest in a debt obligation is analyzed separately from the underlying debt obligation. Section 4701 imposes an excise tax on the issuer of a registration-required obligation that is not in registered form. For Section 4701 purposes, the Proposed Regulations provide the "issuer" is the person who receives the proceeds from issuing the participation (the sponsor).[16]

The same result would occur if a lender deposited a debt obligation (or a pool of debt obligations) in a grantor trust, partnership or disregarded entity and issued pass-through certificates to investors. For purposes of Section 4701, a pass-through certificate is considered to be issued by the recipient of the proceeds from the issuance of the pass-through certificates.[17] Thus, the sponsor (here, the lender) is liable for any Section 4701 excise tax if the pass-through certificate is a registration-required obligation not in registered form. The Proposed Regulations, when finalized, should clarify that our interpretation is accurate and that the issuer of the underlying debt obligation (if it is in registered form) cannot be denied an interest deduction or be liable for the Section 4701 excise tax if the sponsor fails to comply with the registration requirements.

4. Retain Example 19 of Treasury Regulations section 1.881-3(e).

The preamble to the Proposed Regulations states that example 19 of Treasury Regulations section 1.881-3(e) was removed at the request of commentators to take into account the repeal of the foreign-targeted bearer obligation exception. We do not understand why the example was removed. Example 19 relates to the application of the conduit entity regulations in the context of related party debt, not the repeal of the foreign-targeted bearer debt rules.

Treasury Regulations section 1.881-3(e) Example 19 provides:

> Assume that FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

[16] Prop. Reg. § 46.4701-1(b)(5)(ii).

[17] *See* Temp. Reg.§ 1.163-5T(d)(3); Prop. Reg. § 46.4701-1(b)(5)(ii).

> (i) On February 1, 1995, FP issues debt in Country N that is in registered form within the meaning of section 881(c)(3)(A). The FP debt would satisfy the requirements of section 881(c) if the debt were issued by a U.S. person and the withholding agent received the certification required by section 871(h)(2)(B)(ii). The purchasers of the debt are financial institutions and there is no reason to believe that they would not furnish Forms W-8. On March 1, 1995, FP lends a portion of the proceeds of the offering to DS.
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> (ii) The FP debt and the loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(l) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The owners of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Interest payments on the debt issued by FP would be subject to withholding tax if the debt were issued by DS, unless DS received all necessary Forms W-8. Therefore, the participation of FP in the financing arrangement potentially reduces the tax imposed by section 881(a). However, because it is reasonable to assume that the purchasers of the FP debt would have provided certifications in order to avoid the withholding tax imposed by section 881, there is not a tax avoidance plan. Accordingly, FP is not a conduit entity.

This example reflects a common fact pattern—a U.S. subsidiary borrows from its foreign parent and the foreign parent borrows from third parties. Foreign issuers (and their advisers) rely on this example to determine whether the foreign parent should collect Forms W-8 from its debt holders. If a foreign parent can reasonably assume that the purchasers of the foreign parent's debt would provide all necessary Forms W-8, the example concludes that no tax avoidance plan exists and, therefore, the foreign parent is not a conduit entity. We recommend that Treasury and the IRS retain example 19 in the final regulations or otherwise confirm the non-applicability of the conduit entity regulations to this fact pattern.

5. Clearing Organizations.

The Proposed Regulations provide that an obligation represented by a physical certificate in bearer form will be considered to be in registered form if the physical certificate is effectively immobilized. Notice 2012-20[18] provided that an obligation is considered to be effectively immobilized if: (1) The obligation is represented by one or more global securities in physical form that are issued to and held by a clearing organization (*or by a custodian or depository acting as an agent of the clearing organization*) for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms; and (2) beneficial interests in the underlying obligation are transferable only through a book entry system maintained by the clearing organization (or an agent of the clearing organization).

[18] 2012-1 C.B. 574.

To be effectively immobilized under the Proposed Regulations, the physical certificate evidencing an obligation must be issued to and held by a clearing organization.[19] The Proposed Regulations do not allow a custodian or depository acting as an agent of the clearing organization to qualify for purposes of meeting the registered-form requirement. We request that the final regulations clarify that a custodian or depository acting as an agent of a clearing organization qualifies as a clearing organization, consistent with Notice 2012-20.

6. Issuer Default Exception.

Notice 2012-20 allows a holder to obtain physical certificates in bearer form in the event that the issuer defaults on the obligation. The Proposed Regulations eliminate this exception. The preamble states that Treasury and the IRS understand in certain situations holders may be required to obtain physical certificates to pursue claims against the issuers, but in such instances it would be appropriate to expect those physical certificates to be issued in registered form.

We recommend that Treasury and IRS retain the issuer default exception in the final regulations. Upon a default, a clearing organization may require holders to withdraw the physical certificates or the holder may need to obtain physical securities in bearer form to enforce the holder's legal rights. In these circumstances, it is not possible for the physical securities to be issued in registered form and utilizing a pass-through certificate that is in registered form in order to avoid the issue may not be possible or practical. Further, we understand that some foreign jurisdictions, require physical certificates to be issued in bearer form. For these reasons, we recommend that the Proposed Regulations, when finalized, retain the issuer default exception set forth in Notice 2012-20.

7. Effective Dates.

We generally agree that the effective date of the Proposed Regulations should correspond to the effective date of the repeal of the foreign targeted bearer obligation exception (*i.e.*, March 18, 2012). The definition of "registration-required obligations" (as well as the rules related to pass-through certificates and participation interests) apply to obligations issued after the Proposed Regulations are adopted as final. We believe that the reference to the Section 1273 regulations will cause many newly issued obligations to become registration-required obligations. Accordingly we recommend that Treasury and the IRS delay the effective date of the Proposed Regulations, when finalized, to give taxpayers (and their advisers) adequate time to comply with the final regulations. Issuers must determine whether newly issued obligations will be registration-required obligations and holders of registration-required obligations that are in bearer form must consider whether a pass-through certificate should be utilized to mitigate adverse tax consequences or benefit from the portfolio interest exemption.

[19] Prop. Reg. § 1.163-5(b)(2).

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

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