NEW YORK STATE BAR ASSOCIATION
TAX SECTION

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")

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This report[1] provides suggestions regarding certain issues arising under the restrictions imposed by, and pursuant to, TEFRA on offers and sales of debt securities in bearer form (the "TEFRA restrictions"). The report focuses on certain issues addressed by Notice 2006-99[2] (the "Notice") relating to the characterization under TEFRA of certain securities issued in dematerialized form,[3] and suggests revisions in the framework for analyzing certain aspects of the TEFRA restrictions. The report also addresses certain other issues arising under TEFRA in the current market environment.

The classification of securities as in "bearer" or "registered" form has significant implications under TEFRA for issuers and other market participants. The terms "bearer" and "registered" are defined in regulations that were originally adopted in 1982.[4] Although these regulations have not been revised in more than 20 years, the evolution of the capital markets

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1 This report was written by S. Douglas Borisky, with substantial assistance from David Danon and David Miller. Helpful comments were received from Jean Bertrand, Peter Blessing, Peter Connors, Patrick Gallagher, Elizabeth Kessenides, Jiyeon Lee-Lim, Douglas McFadyen, Emily McMahon, John Narducci, Erika Nijenhuis, John Paton, Michael Schler, Andrew Walker and Kirk Wallace.

2 IRB 2006-46.

3 This report uses the term "dematerialized" broadly to refer to securities that are not held individually by holders in physical form. Thus, in addition to securities that are reflected solely by computer entries, this report generally also uses the term to refer to securities held by a nominee, custodian or clearing organization in "permanent global" form (whether such global security nominally is in bearer or registered form).

4 Treasury Regulation §5f.103-1.

since they were issued (in particular, the development of largely paperless systems that have been implemented to streamline the functioning of the capital markets) has made the application of the regulations uncertain, and even arbitrary, in certain respects.[5] The Notice addressed this uncertainty in one narrow situation, but in doing so left a number of questions unanswered and raised certain questions regarding the application of its principles in broader contexts.

This report sets forth two alternative proposals relating to the framework for determining whether dematerialized securities are in bearer or registered form. These proposals are intended to implement the policies underlying TEFRA in a manner that reflects the current state of the international capital markets and provides flexibility to address future market developments. One proposal suggests broadening the analysis of the Notice to apply to certain specific transaction structures that are commonly seen in the international capital markets. The other proposal more generally proposes that dematerialized securities should be treated as registered-form instruments unless a holder (or one or more holders acting collectively) has or will have a non-contingent right to request definitive securities in bearer form at one or more times prior to the maturity of the securities. The report also addresses a number of ancillary issues raised by the proposal, as well as additional issues arising under TEFRA and the withholding tax rules in the current market and regulatory environment.

Part I of this report discusses the background to the proposals, focusing on critical market and regulatory developments since the adoption of the TEFRA rules. Part II describes our two proposals and Part III provides a detailed discussion of the key issues that the proposals

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[5] As discussed below, private letter rulings have clarified certain limited issues in the application of these regulations. As a general matter, private letter rulings may be relied upon only by the taxpayer that obtained the ruling, limiting their value to other taxpayers, although they may provide informal guidance regarding the Service's analysis of issues.

address. Part IV then discusses an alternative means for addressing some of the policy considerations underlying TEFRA and the withholding tax rules in the context of the modern capital markets. Finally, Part V discusses a number of other issues arising under TEFRA and the withholding tax rules that we believe should be addressed by future guidance.

I. BACKGROUND

A. Original TEFRA Policies and Structure.

In 1982, Congress adopted restrictions on the issuance of debt instruments in bearer form, principally to enhance tax compliance by U.S. taxpayers and to restrict access to easily negotiable financial instruments that could be used to facilitate the "laundering" of funds derived from illegal activities.[6] Under these restrictions, issuers of debt instruments in bearer form generally are denied deductions for interest paid in respect of such instruments and are subject to an excise tax.[7] Holders of bearer-form debt instruments also generally are subject to sanctions – a denial of capital gains treatment in respect of gains realized, and a denial of deductions for losses realized, on disposition of such instruments – unless the instruments are held in a manner that allows the instruments to satisfy information reporting requirements.[8]

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6 *See* S. Rep. No. 97-494 ("TEFRA Senate Report"), at 242 (1982) ("The committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer instruments is issued. . . . [R]egistration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.") *See also, e.g.*, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, Joint Committee Print JCS-38-82 ("TEFRA Blue Book"), at 190; *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, Joint Committee Print JCS-41-84 ("1984 Blue Book"), at 391.

7 *See* Internal Revenue Code ("Code") sections 163(f), 312(m) and 4701. The Deficit Reduction Act of 1984 subsequently provided that debt instruments in bearer form would not qualify for the portfolio interest exemption unless they were issued in accordance with TEFRA. Unless otherwise indicated, all "section" references herein are to the Code.

8 *See* sections 165(j) and 1287; *see also* Treasury Regulation §1.165-12(c).

In adopting these restrictions, however, Congress also recognized the importance of not unduly restricting liquidity in the financial markets and allowing U.S. issuers to issue securities in the international capital markets in an efficient manner.[9] Thus, Congress reconciled these differing objectives by restricting the issuance of bearer-form debt instruments generally, but permitting their issuance outside the United States – *i.e.*, under circumstances in which the instruments were unlikely to be sold to United States persons.

The basic compromise adopted pursuant to TEFRA and the Deficit Reduction Act of 1984 created a system pursuant to which U.S. issuers were given a fundamental choice: (1) obtain the ability to issue securities globally by issuing them in registered form, subject to holder documentation requirements necessary to establish the identity of U.S. holders and the eligibility of non-U.S. holders for the portfolio interest exemption from U.S. withholding tax; or (2) minimize the need for holders to provide documentation by issuing the securities in bearer form, at the cost of not being able to issue those securities to U.S. investors. This fundamental dichotomy persists today, notwithstanding substantial regulatory and market developments over the past 25 years that have blurred the distinctions between registered- and bearer-form securities and that, in many cases, have lessened the practical significance of such distinctions.

The current Treasury Regulations, issued in 1982 and not revised since 1986, generally provide that an obligation is in "registered" form if (i) it is registered with the issuer (or an agent of the issuer) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance of the old instrument or the issuance of a new instrument by the issuer to the new holder and/or (ii) it may be transferred only through a book entry system

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[9] *See, e.g.*, TEFRA Senate Report, at 242; TEFRA Blue Book, at 190; 1984 Blue Book, at 391-92.

maintained by the issuer (or an agent of the issuer).[10] The regulations further provide that an obligation is not treated as in registered form (and thus is treated as in bearer form) as of a particular time if it "can be transferred" at that time or at any time until its maturity by any means not described in the preceding sentence.[11] Obligations that do not satisfy this definition are treated as in bearer form. These regulations do not elaborate on the meaning of the "can be transferred" language, raising questions regarding the proper application of the language in circumstances in which a holder has the right to transfer the obligation in bearer form (*e.g.*, by obtaining a definitive security in bearer form), but that right is subject to a precondition or constraint.

B. Developments Since Adoption of TEFRA.

1. Market Developments.

The international financial markets have evolved considerably in the 25 years since the adoption of TEFRA. As international financial institutions have grown and consolidated, their customer bases have grown progressively more international in character. As a result, both U.S. and non-U.S. financial intermediaries and advisers increasingly have a global client base. In addition, the growth of electronic commerce, in particular e-mail and other forms of electronic communication, has substantially facilitated the ability of market participants to conduct business and financial transactions quickly and efficiently across borders. Concomitant with this growth and internationalization in the capital markets has been a marked decline in the prevalence of, and investors' preference for, "true" bearer-form instruments – that is, instruments that exist in physical form that may be negotiated simply by delivery. Securities that formally

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[10] Treasury Regulation §5f.103-1(c)(1).

[11] Treasury Regulation §5f.103-1(e)(1), (2).

are denominated as in "bearer" form may be held in the form of a single global security, and an increasing number of securities trade in fully dematerialized form, where no physical securities exist and the only ownership records are in the books of financial intermediaries. These structures have been quite effective in reducing costs for market participants and facilitating holders' ability to collect payments and transfer securities securely and efficiently.

The measures that Euroclear and Clearstream, the principal European clearing organizations, have adopted to implement the European Union's Prospectus Directive, which entered into force in December 2003, exemplify this trend. Among other matters, the Prospectus Directive imposes a minimum denomination requirement as a prerequisite for issuers to obtain the benefits of certain relaxed disclosure requirements. This provision conditions eligibility for the new disclosure requirements on the relevant securities having a minimum denomination of €50,000 (or integral multiples of €1,000 in excess thereof). In implementing this restriction, the International Capital Markets Services Association has announced that Euroclear and Clearstream will accept securities intended to satisfy the minimum denomination requirement only if holders' ability to obtain definitive securities is restricted to circumstances that are thought to be unlikely to occur – specifically, (i) the closure of a clearing organization, (ii) an issuer default or (iii) upon the request of the issuer following an adverse change of tax law.[12]

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[12] *See* International Capital Markets Services Association, *Guide to the Treatment of Denominations and Related Exchange Conditions* (November 2006) and *Guidance Note on Denominations of €50,000 and Integral Multiples of €1,000* (both available on the International Capital Markets Services Association's website, http://www.capmktserv.com/Publications/default.asp).

These documents also contemplate the possibility of definitives being made available upon holder request, but only in narrower circumstances (*i.e.*, securities that are issuable only in a single denomination of €50,000 and integral multiples thereof). We understand that this restriction on the permissible denominations makes the inclusion of such an option infeasible in a substantial portion of transactions.

As the popularity of global bond and dematerialized structures has grown, the structural distinctions between securities that are in "bearer" form and those that are in "registered" form have diminished to the point where, in many circumstances, such structures are virtually indistinguishable from a practical perspective. Thus, a permanent global bond that nominally is in bearer form, but is expected to be held at all times by a designated clearing organization may be treated as in bearer form,[13] while an essentially identical permanent global bond that is held *in the name of* the clearing organization is treated as in registered form. Reconsideration of the boundaries between "bearer" and "registered" form securities is appropriate in an era in which virtually identical securities can be subject to substantially different treatment as a result of the presence or absence of features that have little, if any, real-world significance.

In addition, these issues have become more significant in recent years as a result of the increasing prevalence in the capital markets of certain non-traditional investment instruments, such as securitized mortgage loans and other receivables and liquid participations in syndicated loans, requiring the application of the TEFRA rules outside the traditional context of cross-border bond offerings.[14] Finally, increasing concern in Washington over issues affecting

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[13] The treatment of such securities may be unclear under current law unless the permanent global bond is freely exchangeable for definitive bearer-form securities. As a conservative matter, in the case of securities of U.S. issuers, U.S. tax counsel generally insist that a permanent global bond that nominally is in bearer form be exchangeable for definitive bearer-form securities in order to conclude that the securities are not in registered form for withholding tax purposes. In circumstances in which this may not be feasible, this lack of clarity regarding the classification of certain global bond arrangements could lead to situations in which issuers feel obligated to issue the securities pursuant to the TEFRA foreign-targeting rules *and* comply with the documentation requirements for registered-form obligations.

[14] Traditionally, a number of such instruments may have been viewed as not "of a type offered to the public" and thus as outside the normal TEFRA restrictions. *See* section 163(f)(2)(A)(ii) and Treasury Regulation §5f.103-1(b)(1). The increasing liquidity of such instruments may raise questions regarding this conclusion.

the "tax gap"[15] may increase the government's scrutiny of instruments that are said to be in bearer form.

2. U.S. Regulatory Developments.

In 1993, the Service released two private letter rulings that successfully reconciled foreign preferences for issuances of "bearer" bonds with TEFRA's requirements that offerings to U.S. investors be in registered form.[16] These rulings concluded that certain debt that was formally documented as in bearer form satisfied the definition of "registered form" because it was held through arrangements that did not permit the issuance of physical securities in bearer form *at any time*. (In general, the arrangements required that a bearer-form global instrument be immobilized by delivering the instrument permanently to a custodian and by the maintenance, by the issuer or its agent, of a book-entry system recording ownership interests in the immobilized instrument.) The rationale of the rulings was that, although the instruments were formally documented as bearer-form obligations, they nevertheless could be considered to be in registered form for U.S. tax purposes because they could be transferred only through a book-entry system maintained by the issuer or its agent. The transactions described in the rulings contemplated that the custodial arrangements might cease to exist at some future time, but provided that in any such circumstances, holders would receive definitive securities in *registered* form.[17]

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15 *See, e.g.*, Congressional Research Service, *Tax Gap and Tax Enforcement* (February 16, 2007); IRS Oversight Board, *Annual Report 2006*, at 3-4, 33-36.

16 One of the rulings involved a transaction structure adopted for a U.S. debt offering by a U.K. bank; the other involved a global debt offering by the World Bank. *See* PLRs 9343018 and 9343019, respectively. Both rulings dealt with circumstances in which foreign regulatory considerations created a need for bearer-form instruments: (i) in the United Kingdom, interest generally qualified for an exemption from U.K. withholding tax only if it was paid in respect of "quoted Eurobonds," which at the time of the rulings were required to be in bearer form; and (ii) in Germany, a good faith purchaser for value of securities was protected against defects in title only if the securities were in bearer form.

17 *See also* PLR 9613002 (applying the same analysis to a comparable structure for debt securities issued by a foreign building society).

In 1997, the Service finalized a far-reaching revision of the nonresident alien withholding tax rules issued under section 1441 (the "Withholding Tax Regulations").[18] The Withholding Tax Regulations were intended to rationalize the implementation of these rules, while also providing the Service with additional tools designed to enable it to monitor and enhance compliance.

We believe that the Withholding Tax Regulations have been successful in enhancing compliance. In particular, we believe that the revisions made by the Withholding Tax Regulations have significantly facilitated the Service's ability to monitor compliance with the U.S. tax rules relating to international financial transactions through the implementation of the "qualified intermediary" program. Under this program, several thousand non-U.S. financial institutions have entered into agreements with the Service pursuant to which such institutions have agreed to collect and maintain U.S. tax-related information and documentation from their customers, to comply with applicable U.S. tax information reporting requirements and otherwise to make relevant information and documentation available to the Service under appropriate circumstances. We believe that the enhanced compliance achieved through these measures reduces the risk of tax avoidance relating to U.S. taxpayers' offshore investment activities and this conclusion underlies a number of the proposals in this report.

C. Notice 2006-99.

On October 27, 2006, the Service issued the Notice. Like the 1993 private letter rulings and other prior guidance issued by the Service, the Notice concluded that securities that could be held only through a book-entry system were treated as in registered form. Unlike the

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[18] *See* T.D. 8734, 1997-2 C.B. 109.

prior guidance, however, in the facts described in the Notice, holders had the right to obtain definitive securities in *bearer* form under certain specified circumstances.

The Notice provides guidance, by way of example, with respect to a book-entry system operated in an unnamed foreign country (which we understand to be Japan). The example assumes that debt securities issued in the foreign country must be held through a designated clearing organization. The clearing organization operates an electronic book-entry system that reflects the holding of debt securities by the clearing organization's members and facilitates transfers of such securities among the clearing organization's member organizations. Debt securities held through the clearing organization's system do not exist in physical form, but are represented only by book entries maintained by the clearing organization, and holders of such securities do not have the ability to obtain physical certificates representing the securities that they hold. The only circumstance in which holders may obtain physical certificates representing their securities is if the clearing organization goes out of business without a successor that will continue to operate the book-entry system. In such circumstance, the physical securities will be in bearer form.

The Notice concludes that a debt security held through the book-entry system described in this example is 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 further observes that the cessation of the operation of the book-entry system would be "an extraordinary event" and thus concludes that the holders' right to obtain physical bearer-form certificates if 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 Notice's reasoning is not articulated in detail and its conclusion raises a number of technical questions. Treasury Regulation §5f.103-1(e)(2) provides that an obligation is not considered to be in registered form if it can be transferred "at any time until its maturity" in bearer form. The Notice specifically indicates that if the clearing organization ceases to exist and no successor is appointed, then holders will be able to obtain physical certificates in bearer form. The Service's statement that "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" is not explicitly reconciled with the regulations' "at any time" language. The Notice concludes that the clearing system's cessation of operations would be an "extraordinary event" and observes that the holders' right to obtain definitive securities is not the equivalent of a right to convert "in the ordinary course of business." It is not entirely clear, however, whether the Service's conclusion was that the note could not "be transferred" in bearer form because the triggering event that would be required to permit such transfers had not occurred – that is, drawing a distinction between a security that *is transferable* in bearer form, and one that *might become transferable in bearer form upon the occurrence of a future event* – or whether the Service simply concluded that the possibility that definitive securities in bearer form would ever be available was remote, allowing it to disregard the possibility that the securities ever would be convertible into bearer form. If the Service's conclusion was based on such a remoteness analysis, the Notice provides no standard for determining how unlikely an event must be before it may be disregarded for this purpose.

Because the Notice does not articulate in detail the technical basis for the Service's conclusion and the standard to be applied in evaluating dematerialized systems, it is difficult to apply the Notice's conclusions to other dematerialized systems in which definitive securities are available only in unusual circumstances, but in circumstances that are different than those described in the Notice, including (i) an issuer default, (ii) a change in law having adverse consequences for the issuer or holders or (iii) the request of some designated percentage of holders.

The Notice discusses only the treatment of bonds held in dematerialized form; thus, it does not address the treatment of the definitive bonds that will be released if the clearing organization ceases to exist (perhaps because the circumstances that would lead to such a release were thought to be remote). Treasury Regulation §5f.103-1(e)(2) would appear to provide that the definitives would be treated as in bearer form. Such treatment, however, raises significant issues for market participants. These issues are discussed in detail in Section III.B.2, below.

Finally, the Notice does not make clear whether the Service would treat the clearing system as the registered holder of the securities or as maintaining a book-entry system.[19] This distinction may not be significant in the context of the particular issues addressed in the Notice, since the Service concluded that the securities are in registered form. The identification of the "registered holder" of the securities may, however, be relevant in a number of other circumstances, including (i) the information reporting exemptions for commercial paper and

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[19] Treasury Regulation §5f.103-1 requires that a book-entry system be managed by the issuer or its agent. Thus, a clearing organization typically would not be treated as maintaining a "good" book-entry system within the meaning of this regulation because most clearing organizations do not function as the issuer's agent. Nevertheless, the Notice's analysis does not specifically address this issue, rendering the technical basis for the Notice's conclusions somewhat unclear.

certain bank deposits in Treasury Regulation §§1.6049-5(b)(10) and (11), and (ii) the foreign-targeted registered bond rules of Treasury Regulation §1.871-14(e).

II. OVERVIEW AND SUMMARY OF PROPOSALS

The Notice's implications are not entirely clear when applied to book-entry or other dematerialized systems that are similar to that described in the Notice but that provide for the delivery of bearer-form definitive securities in circumstances other than in the very narrow circumstance described in the Notice.[20] In addition, the market developments over the past several years discussed in Section I.B.1, above, call for more detailed current guidance than the Notice provides. The proper and efficient functioning of the capital markets require clear rules; the consequences to an issuer of an incorrect conclusion regarding the TEFRA status of an issuance may be very substantial (either the imposition of an excise tax and withholding tax and loss of interest deductions if an issuer incorrectly believes securities to be in registered form, or the imposition of a withholding tax if an issuer incorrectly believes securities to be in bearer form). In the absence of clear rules, a U.S. issuer's only effective alternative to ensure proper compliance – complying with both the TEFRA foreign-targeting rules (thereby waiving the ability to sell securities to U.S. investors) and W-8 requirements (thereby increasing the burdens on non-U.S. investors) – is likely to be untenable. Moreover, in issuing guidance in this area, the government should proceed carefully in taking steps that may disturb standard market practices that operate in compliance with prior guidance.

For the reasons outlined above, and discussed further in this report, we believe that any guidance in this area should satisfy a number of objectives, including the following:

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[20] The circumstance described in the Notice – the cessation of operations of a clearing organization without the appointment of a successor – would be likely to occur only in the context of an extraordinary disruption in a market.

- The rules should be clear and capable of being interpreted and applied effectively by market participants.

- The rules should be drafted in a manner that is designed to minimize the risk that taxpayers can manipulate them to evade taxes.

- The rules should implement the policies underlying TEFRA in a manner that is responsive to the structure and operations of modern capital markets and that does not unduly impede U.S. issuers' ability to access foreign markets, or unduly interfere with the normal operation of the international capital markets in contexts in which U.S. policies are not significant. We believe that the structures currently in use in the international capital markets work reasonably well, and the rules should seek to minimize the extent to which they upset reasonable and settled expectations that are based on prior guidance.[21]

We have outlined below two alternative approaches that would satisfy these objectives by broadening the circumstances in which securities held through dematerialized systems will be treated as in registered form, in a manner that is intended to provide clarity, preserve the government's compliance objectives and preserve the efficient functioning of the international capital markets.

In developing our proposed approaches, we felt that it was important that any proposal reflect a consistent conceptual approach grounded in the principles underlying TEFRA and the withholding tax rules. One significant threshold question that we considered is whether, and to what extent, the form of any definitive securities that may be released with respect to a dematerialized security should control the tax characterization of the dematerialized security – *i.e.*, whether a dematerialized security should be required to be treated as in bearer form merely because it provides for the delivery of definitive securities in bearer form under some circumstances. We also considered the related question of whether the characterization of the

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[21] In this regard, we note that the Notice provided a "grandfather" rule, protecting outstanding securities from potentially adverse implications of the Notice's guidance.

dematerialized securities as bearer- or registered-form securities for TEFRA and withholding tax purposes must be the same as that for the related definitive securities.

The current Treasury Regulations provide that the characterization of definitive securities generally dictates the characterization of any dematerialized securities with respect to which they are issued *if* the definitive securities are in bearer form.[22] Notwithstanding the literal text of the regulations, however, the Notice concludes that the form of definitive securities does not necessarily control the characterization of the related dematerialized securities, at least in one narrow context. Although we generally agree that the form of definitive securities that may be released in respect of a dematerialized security should not in all cases control the characterization of the dematerialized security, the Notice raises a question of exactly when such a de-linking is appropriate. As discussed in detail throughout this report, we generally believe that the tax characterization of dematerialized and definitive securities can be considered separately provided that two principal criteria are satisfied. First, consistent characterization should be required in circumstances in which such consistency is considered necessary or appropriate to ensure proper compliance – for example, the current-law rule that treats as a bearer-form security a book-entry security that may be converted at any time into a bearer-form definitive security.[23] Second, in circumstances in which dematerialized and definitive securities are characterized differently, it is important to confirm that market participants would be able to apply the rules in an effective

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22 *See* Treasury Regulation §5f.103-1(e)(2), which provides that obligations will be treated as in bearer form if they can be transferred in any manner other than those prescribed for registered-form obligations pursuant to Treasury Regulation §5f.103-1(c). If the dematerialized securities provide for definitive securities in *registered* form, the characterization of the definitive securities is not relevant to the characterization of the dematerialized securities.

23 Similarly, as discussed in greater detail in Sections III.A.3 and III.B.3, below, if the Service adopts the broader of the two approaches discussed in Section III.A, it may be appropriate to treat any definitive securities as in registered form to ensure the broadest potential applicability of the information reporting rules.

manner, including addressing the consequences of any change in characterization resulting from a delivery of definitive securities.

The members of our working group were in agreement regarding the basic need to clarify, and to some extent broaden, the holding of the Notice. We were, however, unable to reach a consensus on a single proposed approach. Thus, we have described below two alternative proposals, together with a discussion of the relative strengths of each proposal. We believe that either proposal would provide a clear and objective standard, expanding the definition of "book-entry system" to include the principal dematerialized systems in existence in the capital markets today in a manner that is consistent with the policies underlying TEFRA. One proposal (the "Identified Conditions Proposal") would expand the Notice's analysis beyond dematerialized securities that provide for the delivery of definitive securities only upon a clearing system's cessation of operations. Under this proposal, certain other events that are commonly provided for in capital markets documentation would be added to the list of events that permit the delivery of definitive securities without affecting the characterization of the dematerialized securities. Our other proposal (the "Unconditional Right Proposal") generally would treat any dematerialized security as a registered-form security, *unless* the security provides holders with a noncontingent right to obtain definitive securities in bearer form. More specifically, under the Unconditional Right Proposal, securities held through a book-entry system generally would be treated as in registered form unless (i) the holder (or holders as a group) may elect (individually or as a group) to obtain a physical security in bearer form at one or more times prior to the maturity date and (ii) such right is available without the occurrence of some triggering event that is beyond the holder or holders' control. In broad outline, the two proposals offer a choice between a limited approach that addresses certain particular transaction

structures that are common in the market today and a more comprehensive approach that provides greater flexibility to address changing market circumstances but requires the inclusion of an anti-abuse rule in order to be implemented properly.

In implementing either proposal, we believe 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 either case, the dematerialized security should be treated as in registered form if (but only if) the availability of definitive securities is restricted in the manner contemplated by the relevant proposal. 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.

We considered proposing a more general rule pursuant to which securities held through book-entry systems that provide for the delivery of definitive securities in bearer form would be treated as in registered form if such definitives were available only in situations that were reasonably thought to be "remote" (or some similar language indicating that the anticipated triggering events were unlikely to occur). We ultimately decided not to pursue such an approach because we believed that it would have involved difficult line-drawing exercises that ultimately would have had an element of arbitrariness. Moreover, we were concerned that a subjective test

of this nature would have been subject to considerable uncertainty – and inconsistency – when applied in actual circumstances.[24]

As the foregoing discussion suggests, adoption of either proposal would require that the Service address the characterization of any definitive securities released from a dematerialized system that is treated as in registered form. The Notice discusses only the treatment of dematerialized securities and does not address the characterization of any definitive securities that may be issued. As discussed in Section III.B.1, below, the existing regulations would treat such definitive securities as bearer-form securities, which may create withholding tax and TEFRA-related concerns for issuers and holders of such securities. Section III.B.2 discusses certain possible means of addressing these concerns, although the procedures discussed may in some respects be complex. Section III.B.3 thus discusses an alternative approach, pursuant to which definitive securities that are released in respect of dematerialized securities that are treated as in registered form should also be treated as in registered form. As discussed in greater detail below, we believe that, properly applied, either approach could be used to implement the withholding tax rules in an effective manner and minimize the potential adverse impact of the issuance of any such definitive securities in the market.

Because adoption of either of our proposals would change certain tax consequences of arrangements currently existing in the markets, we recommend that the Service first issue any guidance in proposed form and, when such guidance is issued in temporary or final form, that it have prospective effect only (*i.e.*, apply only to securities issued after the issuance of the guidance).

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[24] For example, if the terms of a securities offering permit holders to obtain definitive securities only upon an issuer default, that condition may be thought to be remote in the context of a AAA-rated issuer, but is far more likely to occur in the context of a sub-investment grade issuer.

III. DETAILED DISCUSSION OF PROPOSALS

A. Treatment of Book-Entry Securities.

1. Overview of Proposals.

For the reasons discussed in detail in this Section III.A, we believe that the definition of "registered form" as contemplated by the Notice should be broadened to provide that dematerialized securities that provide for the delivery of bearer-form definitive securities upon the occurrence of certain other events that are similar to the facts described in the Notice and that do not provide holders with an unconditional option to obtain definitive securities upon request will be treated as in registered form. We have set forth below, in Sections III.A.2 and 3, a discussion of two alternative approaches that may be used to implement this proposed revision to the definition of "registered form." Section III.A.4 then analyzes the two proposals and discusses their relative strengths and limitations.

Under either proposed approach, a conditional or unconditional holder option to obtain definitive securities in *registered* form would not adversely affect a dematerialized security's treatment as in registered form. Accordingly, this report generally focuses on dematerialized securities that provide for the delivery of definitive securities in bearer form under certain circumstances. Except where the context indicates otherwise, references in this report to definitive securities should be read as referring to definitive securities that are functionally in bearer form.

Finally, in evaluating the classification of instruments as in bearer or registered form under either proposal, actions taken by a person other than the issuer of those instruments generally should be disregarded, as is the case under current law.[25] Thus, for example, if a U.S.

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[25] *See, e.g.*, Treasury Regulation §5f.103-1(c)(1); *cf.* Treasury Regulation §1.163-5T(d).

corporation issues book-entry securities that do not permit the issuance of definitive bearer-form securities and those securities are acquired by a holder that places them into a custodial arrangement and issues bearer-form receipts representing the ownership of the securities held in custody, the issuer of the underlying book-entry securities should not be treated as having issued securities in bearer form.[26] Similarly, if a U.S. corporation issues definitive securities in bearer form (or interests in a dematerialized bond that are treated as in bearer form under the proposal) in accordance with TEFRA, but a holder places those bearer-form securities into a custodial arrangement subject to a permanent book-entry arrangement, the issuer of the underlying bearer-form securities should not be treated as having issued registered-form obligations that potentially are subject to the portfolio interest documentation requirements (although the custodian may be required to collect Forms W-8BEN in respect of the registered-form book-entry receipts).[27]

2. Identified Conditions Proposal.

As discussed in Section I.B.1, above, dematerialized securities frequently provide for the delivery of definitive securities only in limited circumstances, although those circumstances typically are somewhat broader than those contemplated by the Notice. Like the circumstance of a clearing system's cessation of operations, the additional triggering events provided in the terms of such securities generally are thought to be unlikely to occur. Thus we believe that the analysis of such securities should be comparable to that of the securities described in the Notice. The Notice does not discuss these securities, however, and thus it creates some uncertainty regarding their treatment.

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26 In such a transaction, the third-party custodian may be subject to issuer sanctions pursuant to Treasury Regulation §1.163-5T(d).

27 *See* Treasury Regulation §1.871-14(d).