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")

October 1, 2007

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Report No. 1133

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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).

The principal concerns discussed in Section I.C, above, could be addressed by a rule that defines "book-entry system" in a manner that includes a dematerialized system so long as bearer-form definitive securities are available only upon certain events that are specified in the regulations (or pursuant to a notice). In particular, we recommend that the regulations provide that the availability of definitive bearer-form securities upon the occurrence of the following events not cause dematerialized securities to be treated as in bearer form: (i) a cessation of clearing organization operation, (ii) an issuer default or (iii) an issuer option upon an adverse change in tax law.[28] If the Service decides to adopt this Identified Conditions Proposal, however, we recommend that the Service request comments regarding the circumstances that should be included in the list of events that permit holders to obtain definitive securities without causing the dematerialized securities to be treated as in bearer form, in order to minimize the risk that the regulations would inadvertently exclude triggering events that should be included.

We believe that the Identified Conditions Proposal would be consistent with the Notice and would provide added clarity by expanding the reach of the Notice to address other structures that may be similar to, but not identical to, the facts described in the Notice. In addition, by requiring that the relevant triggering events be designated by the Service, the proposal would allow the Service to restrict the applicability of the rule to circumstances that were not thought to create a substantial risk of noncompliance.

By expanding the list of events that would permit the delivery of definitive securities without causing dematerialized securities to be treated as in bearer form, the Identified

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[28] We also understand that dematerialized securities occasionally provide for the delivery of definitive securities if the securities, or other securities into which the securities in question are convertible, are de-listed from a securities exchange. If the Service decides to follow the approach described in the text, it should consider including de-listing as another circumstance in which the potential delivery of definitive securities would not affect the classification of the dematerialized securities.

Conditions Proposal would provide added guidance and comfort to market participants in a manner that would be clear in its application. The specificity of the proposal, however, raises the possibility that the proposal, when implemented, may fail to include certain specific transaction structures that are comparable to those identified in the implementing regulations but are not identified prior to the issuance of such regulations or that are developed subsequent to the issuance of the regulations. If the Service adopts the Identified Conditions Proposal, we recommend that the regulations provide that the Service may update the list of triggering events by issuing a notice or announcement, in order to facilitate the Service's ability to update the list if changes in market practice or other factors make it desirable to do so. Nevertheless, the process of updating the list of triggering events in this manner is likely to be somewhat more time-consuming and cumbersome than would be the case under a more flexible standard that would by its terms accommodate changing market conditions. The Unconditional Right Proposal, described in Section III.A.3, below, is intended to address this issue.

3. Unconditional Right Proposal.

Our second alternative proposal for clarifying the classification of dematerialized securities would revise the concept of a "good" book-entry system in Treasury Regulation §5f.103-1(c)(1)(ii) to include in the definition of "registered form" securities that meet both of the following criteria:

i) Except to the extent permitted pursuant to clause (ii), 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 depositary for a clearing organization).

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 holder or holders' control, other than the mere passage of time.[29]

Under this proposal, a bond held through a dematerialized system that permits holders to obtain definitive bearer-form securities only upon the occurrence of certain specified events that are set forth in the terms and conditions of the securities and that would not be under the control of the holders would be treated as in registered form. Thus, for example, the availability of definitive securities upon a cessation of operations of the relevant clearing system, a default by the issuer, or a change in law would not cause the dematerialized bonds to be treated as in bearer form.

The terms of securities currently in the market that allow holders to obtain definitive securities only upon the occurrence of a specified event generally involve events that are thought to be highly unlikely to occur, such as a clearing system's cessation of operations or an issuer default. If the Service were concerned that a broad rule of the type described herein nevertheless could be subject to manipulation, we propose (i) a limitation on the ability of an *issuer* to cause or permit the issuance of definitive securities and (ii) a broader anti-abuse rule, each as described below.

In implementing the Unconditional Right Proposal, special consideration should be given to the treatment of *issuer* options to cause or permit the issuance of definitive securities. Although securities permitting definitive securities to be issued at the issuer's discretion would

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[29] As is the case currently under Treasury Regulation §5f.103-1(e), a provision permitting holders to request definitive securities only at certain specified times or during a specified period of time prior to maturity would not be treated as an event beyond the holders' control for purposes of clause (ii). Thus, such securities would be treated as in bearer form under the proposal. The proposal also would not change the current-law rule providing that if a security provides holders with an option to obtain definitive securities that lapses prior to the maturity date, the securities are treated as in registered form after the option lapses. *See* Treasury Regulation §5f.103-1(e)(3).

As discussed below, we also contemplate the inclusion of a special rule limiting the circumstances in which an *issuer's* right to make definitive securities available would be covered by this rule.

not provide holders with an unconditional option to obtain such securities, a rule treating all such securities as in registered form would increase the possibility that securities that functionally are in bearer form may become available to U.S. taxpayers. Although we believe that treating such securities as in registered form would be unlikely to create substantial compliance concerns,[30] on balance we believe that it would be appropriate to adopt a somewhat narrower rule in the context of issuer options in order to minimize the risk that U.S. taxpayers would obtain the ability to hold bearer-form securities in inappropriate circumstances. We understand that the securities in the market that provide for an issuer option to cause book-entry securities to be exchanged into definitive form typically do so only in change-of-law circumstances. Thus, we suggest restricting the issuer option rule so that an issuer's option to cause or permit definitive securities to be issued would not cause dematerialized securities to be treated as in bearer form provided the circumstances in which the option could be exercise were limited to avoiding adverse tax or regulatory considerations relating to the issuance of dematerialized securities.[31]

Under the Unconditional Right Proposal, a holder should be treated as having an option to obtain definitive bearer-form securities notwithstanding that an issuer may impose a charge for providing the definitive securities. The current regulations do not specifically address the question of whether an obligation "can be transferred" in bearer form, within the meaning of Treasury Regulation §5f.103-1(e)(2), if the holder is obligated to incur substantial costs in order

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30 Any such securities that are treated as in registered form would be fully subject to U.S. information reporting requirements and, in the case of securities of U.S. issuers, Form W-8 requirements. Moreover, it has been our experience that issuers typically reserve the right to cause dematerialized securities to be converted into definitive bearer form only in unusual circumstances, such as a change in law that adversely affects issuers of securities in book-entry form, and, more generally, that issuers seldom wish to incur the cost and inconvenience of issuing definitive securities.

31 We recommend that this standard not be limited to a *change* in law to provide protection to issuers that may become subject to the laws of a jurisdiction after the issuance of the relevant securities, such as pursuant to an acquisition or restructuring, in circumstances in which existing tax or regulatory constraints may subject it to adverse treatment as the issuer of dematerialized securities.

to convert a security into bearer form. Under the bright-line test provided by the proposal, a holder would be viewed as having an option to obtain a bearer-form definitive security, notwithstanding the fact that the holder may be disinclined to incur the cost of obtaining the security. The consequence of this rule is that certain securities that holders would be unlikely to convert into bearer form nonetheless would be treated as in bearer form, and thus could be offered, sold and held only in compliance with TEFRA. As a result, this bright-line standard should not raise potential compliance concerns for the Service.[32]

One significant benefit that would result from the adoption of the Unconditional Right Proposal would be the clear application of its objective standard. Inherent in the use of an objective standard is that issuers may be seen as having some electivity in applying the standard. Thus, the Service may be concerned that the proposal creates the potential for market participants to exploit the rules to avoid otherwise-applicable requirements (such as the TEFRA restrictions or the portfolio interest documentation requirements) in some circumstances.[33] For the reasons discussed in the following two paragraphs, we do not believe that adoption of the Unconditional Right Proposal would create undue compliance concerns. We do believe, however, that the proposal should include an anti-avoidance rule (as discussed below) to provide further assurances that the proposal would not undermine the government's policy objectives.

Although the Unconditional Right Proposal may be seen as providing issuers with some element of electivity, any such electivity should be viewed as representing a choice

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[32] If the Service is concerned that issuers could impose excessive charges as a means of inappropriately manipulating the bearer- or registered-form classification of an instrument, those concerns could be addressed through the anti-abuse rule discussed below.

[33] For example, dematerialized securities that permit the delivery of definitive bearer-form securities to holders only upon the occurrence of a condition that is expected to occur shortly following the issuance of the securities could be viewed as providing U.S. taxpayers with inappropriate access to bearer-form securities.

between two effective, long-standing regulatory regimes. If securities are treated as in bearer form, they may be issued only in accordance with the TEFRA restrictions, which are designed to prevent their initial distribution to United States persons. If the securities are treated as in registered form, they will be fully subject to U.S. information reporting requirements to the same extent that such securities are under current law. Thus, the promulgation of more objective standards that permit issuers to make a clearer choice between bearer- and registered-form classification should not be viewed as creating the potential for inappropriate avoidance of the requirements of the TEFRA restrictions, the information reporting rules or the withholding tax rules.

The Unconditional Right Proposal is principally intended to provide issuers and other market participants with clearer standards delineating the circumstances in which alternative regulatory regimes apply to existing (and future) transaction structures. As discussed in Part I, above, a number of legal, regulatory and other factors affect the structure of securities offerings in the markets today. If the Service were to adopt the Unconditional Right Proposal, we believe that issuers would continue to structure offerings of their securities in accordance with the requirements of the principal clearing organizations, the EU Prospectus Directive and other similar constraints on the structure of such offerings. Nevertheless, even if issuers do change in some manner the structure of their offerings in response to the adoption of the proposal, any such changes would simply reflect a choice between the currently applicable regimes for bearer- and registered-debt – a choice that exists for issuers today.

Notwithstanding the foregoing considerations, we believe that regulations adopting the Unconditional Right Proposal should include an anti-abuse rule that would provide further protection against the actions of market participants who might otherwise implement the

literal rules in a manner that is designed to have a distortive effect. For example, the Service should consider adopting a rule providing that, notwithstanding the broad definition of "book-entry system," any issuer that structures an arrangement with a principal purpose of permitting U.S. taxpayers to acquire, directly or indirectly, debt securities in bearer form without compliance with the TEFRA rules would be treated as having issued securities in bearer form (and therefore potentially would be subject to an excise tax, loss of interest deductions and withholding tax).[34]

The regulations also could address any such concerns by specifically designating a particular dematerialized system, or systems or transaction structures having particular features, as in registered or bearer form, as appropriate, or could reserve the Service's authority to provide such guidance by future notices or other action. Finally, if the Service adopts the Unconditional Right Proposal, the Service may conclude that it is appropriate to treat any definitive securities that may be issued as registered-form securities in order to broaden the applicability of various information reporting rules,[35] which may further reduce the risk of non-compliance.

In adopting any anti-abuse rule, we recommend that the Service clearly articulate the circumstances in which the rule would be applied, through the specific language of the

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[34] The Unconditional Right Proposal also may permit issuers to structure securities to qualify as bearer-form securities, even under circumstances in which the securities are expected to be held in dematerialized form at all times. This result is no different than that resulting from the application of the current regulations in many cases. Such a result does not seem to present a policy or compliance problem. Issuers clearly have the ability to issue physical securities in bearer form in compliance with TEFRA and thus avoid the obligation to collect Forms W-8 from the holders of the securities. Securities that are issued pursuant to the same restrictions and differ only in that it is not certain that holders will exercise their option to obtain securities that can be negotiated anonymously should not be viewed as creating a more significant compliance concern.

[35] The potential applicability of these information reporting rules to definitive securities that are treated as in registered form is discussed in greater detail in Section III.B.3, below.

regulations or illustrative examples, in order to minimize the risk that such an anti-abuse rule would create uncertainty in the application of the general rules.

We have set forth below several examples that illustrate how the Unconditional Right Proposal would work in certain common scenarios.

> **Example 1**: Securities are issued in the form of a permanent global security that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization.[36] Holders of beneficial interests in the permanent global security are entitled to obtain definitive securities in bearer form, but only upon the occurrence of one of the following events: (i) the clearing organization ceases operation and no successor can be found or (ii) an event of default by the issuer.

Because the two circumstances in which holders can obtain definitive securities are not within the holders' control, the proposal would treat the securities as in registered form while held in permanent global form.[37] (The result would be the same under our Identified Conditions Proposal.) This example is comparable to the structure described in the Notice, but expands the facts described in the Notice to add a second condition permitting holders to obtain definitive securities.

> **Example 2**: The facts are the same as in Example 1, but the issuer also has the right to cause the global security to be exchanged for definitive bearer-form securities if there is a change in tax law that adversely affects it as the issuer of securities in global form.

The analysis of this transaction would be the same as that in Example 1, notwithstanding the inclusion of somewhat broader triggering events permitting the holders to obtain definitive securities. (The result would be the same under our Identified Conditions

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[36] The Unconditional Right Proposal's treatment of the securities described in these examples generally would be the same if the securities are held in the form of a permanent global security that is registered in the name of the clearing organization or its depositary.

[37] The treatment of any definitive bearer-form securities that may be delivered upon the occurrence of either of the two triggering events is discussed in Section III.B, below.

Proposal.) We believe that this example includes the most common triggering events in existence in the international capital markets, other than a conventional unconditional holder option to obtain definitive securities at any time.[38] Moreover, this example generally describes the terms of securities that are intended to comply with the requirements of the European Union's Prospectus Directive.[39] Thus, we believe that it is particularly important that the Service provide clear guidance regarding the treatment of such structures.

> **Example 3**: Securities are issued in the form of a permanent global bond that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization. Holders of beneficial interests in the permanent global bond are entitled to obtain definitive securities in bearer form at any time, but only if holders of 25 percent or more of the securities (measured by outstanding principal amount) so request.

Because a group of holders, acting collectively, has a non-contingent right to cause the global bond to be exchanged for definitive bearer-form securities at any time, the bonds would be treated as in bearer form under the Unconditional Right Proposal, even while held in global form, notwithstanding the fact that no individual investor may have the right, acting alone, to obtain definitive securities.

In developing the proposal, we considered a standard that would have provided that, if a dematerialized security was exchangeable for definitive bearer-form securities only upon the request of a substantial percentage of the holders, and such percentage was set at a sufficiently high level that the likelihood of an exchange was thought to be remote, the

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38 *See* International Capital Markets Services Association, *Guide to the Treatment of Denominations and Related Exchange Conditions* (November 2006) at 4-5 (available on the International Capital Markets Services Association's website, http://www.capmktserv.com/Publications/default.asp). This report identifies four "principal events currently documented" in the terms and conditions of securities in the market: (i) the closure of a clearing organization, (ii) an issuer default, (iii) an exchange at the option of the issuer due to adverse tax consequences and (iv) an exchange at any time at the option of either the noteholder or the issuer.

39 *See* Section I.B.1, above.

possibility of such an exchange should be disregarded (*i.e.*, it should not be treated as giving holders an option to obtain definitive securities), allowing the dematerialized security to be treated as in registered form. Adopting such an approach inevitably would involve difficult line-drawing exercises regarding the relevant threshold percentage, however, and the appropriate place to draw such a line could differ depending on the circumstances of a particular transaction. More important, we were concerned that such an approach could inappropriately permit holders of a substantial portion of an issue to obtain definitive bearer-form securities without restriction while nonetheless treating the securities as in registered form.[40] Thus, notwithstanding that the likelihood that small investors would ever have the right to obtain definitive securities under such an approach could be remote, we concluded, on balance, that the policies underlying the TEFRA restrictions were best served by a bright-line standard providing that any unconditional option permitting any holder or holders, acting together, to obtain definitive bearer-form securities should cause the relevant dematerialized security to be treated as in bearer form.

> **Example 4**: On July 15, 2007, an issuer issues five-year securities in the form of a permanent global bond that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization. Holders of beneficial interests in the permanent global bond are entitled to obtain definitive securities in bearer form at any time upon the occurrence of one of the following events: (i) if the clearing organization ceases operation and no successor can be found or (ii) if there is an event of default by the issuer. In addition, holders have an unconditional option to exchange their interest in the global bond for definitive bearer-form securities at any time after July 15, 2011 (*i.e.*, during the final year before maturity).

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[40] For example, the proposal could have provided that a holder right to cause a dematerialized security to be exchanged into definitive securities would be disregarded – *i.e.*, would not be treated as the type of right that caused the dematerialized security to be treated as in bearer form – if it required that holders of 25 percent or more of the securities (measured by outstanding principal amount) so request. In such a case, a United States person holding 30 percent of the issue would effectively have the unrestricted right to obtain definitive bearer-form securities at any time and yet there would be no restriction on the holder's ability to acquire or hold such securities.

Because the holders have an unconditional option to obtain definitive bearer-form securities during a period of time prior to the securities' maturity date, the global bond would be treated as in bearer form under the proposal. This is the same as the result that Treasury Regulation §5f.103-1(e)(2) currently mandates.

> **Example 5**: Securities are issued in the form of a permanent global bond that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization. Holders of beneficial interests in the permanent global bond are entitled to obtain definitive securities in registered form at any time. The terms of the securities do not provide for the possible issuance of definitive securities in bearer form.

The proposal would treat the permanent global bond in this example as a registered-form security, because it does not permit any holder or holders to obtain definitive securities in bearer form. (The result would be the same under our Identified Conditions Proposal.) This result is generally consistent with the treatment of book-entry securities under Treasury Regulation §5f.103-1, although under current law, the analysis of the structure would be clear only if affirmative steps were taken to immobilize the permanent global bond and create a formal registry or book-entry system that is maintained by the issuer or its agent.[41]

> **Example 6**: Securities are issued in the form of a permanent global security that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization. Holders of beneficial interests in the permanent global security are entitled to obtain definitive securities in bearer form if, and only if, the issuer's credit rating is below A- (or the equivalent) for any period of 30 consecutive days. On the date of the securities' issuance, the issuer's credit rating is BBB+ and the parties to the transaction do not expect such credit rating to be increased in the immediate future. The provision relating to definitive securities is not intended to satisfy any legal or regulatory requirements or the rules of any clearing organization or securities exchange, but is intended to provide holders with the option to obtain bearer-form securities.

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41 *See, e.g.*, PLRs 9343018 and 9343019.

Because the holders' ability to obtain definitive securities requires the occurrence of a condition that is not within the holders' control, the proposal potentially would treat the permanent global security as in registered form. In such a case, the issuer's ability to offer and sell the securities to U.S. investors would not be restricted. However, the contingency that would permit the holders to obtain definitive securities would be expected to be satisfied shortly following the securities' issuance, permitting U.S. investors to obtain definitive securities in bearer form in a manner that is not consistent with the principles of the TEFRA rules. Thus, the offering should be treated as having been structured with a principal purpose of permitting U.S. taxpayers to acquire debt securities in bearer form without compliance with the TEFRA rules. Under the anti-abuse rule described above, the permanent global security should be treated as in bearer form, requiring that it be issued in accordance with the TEFRA restrictions.[42]

> **Example 7**: An issuer issues ten-year securities in the form of a permanent global security that nominally is in bearer form, but is expected to be held at all times through a designated clearing organization. Holders of beneficial interests in the permanent global security are entitled to obtain definitive securities in bearer form if, and only if, the issuer's credit rating is below investment grade (BBB- or the equivalent) for any period of 90 consecutive days. On the date of the securities' issuance, the issuer's credit rating is BBB+. The parties to the transaction do not expect the downgrade criterion to be met, although the possibility that such an event would occur at some point during the securities' ten-year term is not thought to be remote. The provision relating to definitive securities is intended to facilitate the holders' ability to pursue their rights under the securities under local law if the issuer's credit standing deteriorates.

Because the holders' ability to obtain definitive securities requires the occurrence of a condition that is not within the holders' control, the proposal would treat the permanent global securities as in registered form, provided the anti-abuse rule does not apply. The offering

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[42] The analysis in this example generally should be the same even in a case in which the option to obtain definitive securities is not expected to be immediately available, although the likelihood that such a right will be exercisable and the time at which it is expected to be exercisable may be relevant in assessing whether the issuer has a principal purpose of permitting U.S. taxpayers to acquire debt securities in bearer form without compliance with the TEFRA rules.

should not be treated as having been structured with a principal purpose of permitting U.S. taxpayers to acquire debt securities in bearer form without compliance with the TEFRA rules because (i) the holders are not expected to have the right to obtain definitive securities and (ii) the issuer has structured the provision relating to definitive securities in order to satisfy certain considerations under local creditors' rights law. Thus, the anti-abuse rule should not apply and the book-entry securities should be treated as in registered form.

4. Analysis of Proposals.

We believe that the standards incorporated in the two proposals outlined above provide a clear, substantive difference between "registered-form" and "bearer-form" debt, in a manner that is consistent with existing guidance and market practice. Although the proposals' basic approaches are consistent with the Notice's treatment of dematerialized securities as registered-form securities (and similar analyses under certain earlier rulings issued by the Service[43]), the proposals address certain ambiguities that the Notice leaves unanswered, in either case providing issuers and other market participants with a viable choice between two effective regulatory regimes.[44]

The two alternative proposals are intended to accomplish comparable objectives, which is to clarify the treatment of dematerialized securities in a manner that provides guidance to market participants regarding the TEFRA and withholding tax status of the structure of common securities offerings, while preserving the government's tax compliance objectives. In practice, as the above examples illustrate, we believe that the two proposals generally would

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43 *See, e.g.*, PLRs 8842051, 9343018, 9343019 and 9613002.

44 As discussed in Part II, above, we rejected a more general "remoteness" standard because it would have involved difficult line-drawing exercises and would have been subject to considerable uncertainty – and inconsistency – when applied in actual circumstances.

produce comparable results, although the two proposals balance the relevant policy considerations in somewhat different ways. The Identified Conditions Proposal, which would explicitly identify certain types of triggering events that do not cause dematerialized securities to be treated as in bearer form (and implicitly exclude other such events) would provide somewhat greater certainty in some circumstances than the more general approach taken by the Unconditional Right Proposal. That greater clarity would, however, create a risk of inappropriately treating certain dematerialized securities as in bearer form. Global financial markets, and applicable market conventions, are diverse and evolving. Limiting the applicability of these rules to a specific list of triggering events would risk excluding structures in some markets that are analogous to those on the official list, but perhaps had not come to the Service's attention, or had been developed after the regulations were issued. Although the Service would have the power to modify the list of the relevant events to reflect changing market practices, the Service may not always be able to do so in a timely and efficient manner.

The Unconditional Right Proposal, which would classify securities according to the general nature of the rights of the holders (rather than a specific itemized list of rights), potentially would provide issuers and other market participants with greater flexibility to adapt their financing structures to accommodate evolving market practices and would reduce the risk that market structures would inadvertently be excluded simply because they had not been identified. This greater flexibility, however, may increase the possibility that market participants would be able to devise transaction structures that produce results that are not intended by the regulations. As a result, we believe that regulations implementing the Unconditional Right Proposal should include an anti-abuse rule, which may complicate the application of the proposal in practice. For the reasons discussed elsewhere in this Section III.A, we believe that either the

Identified Conditions Proposal or the Unconditional Right Proposal would provide helpful guidance in a manner that is consistent with the government's compliance objectives, but we believe that the Service should determine which of the two proposals best balances the relevant objectives.

The principal benefit of both proposals is to create clarity with respect to certain transaction structures that are not clearly addressed by existing guidance. Thus, except in unusual cases the application of either proposal should not produce substantially different results than exist (or would be expected to exist) under current law and practice. In the context of dematerialized securities that provide for definitive securities (i) in registered form or (ii) in bearer form upon the request of the holder, the analysis under either proposal would be the same as that under Treasury Regulation §5f.103-1. However, the treatment of dematerialized securities that provide holders with the right to obtain definitive securities in bearer form but only subject to specified conditions is not entirely clear under current law (other than in the narrow fact situation described in the Notice). It is in this context that the proposals' more comprehensive approaches represent the most significant departure from current law. The practical effects of such differences, however, may not be significant in most cases. The lack of clarity under current law generally has led issuers to take the most conservative approach in cases that are not clearly addressed by existing guidance, by assuming that such securities could be treated either as in bearer form subject to the TEFRA restrictions or as in registered form subject to withholding tax documentation requirements (in the case of U.S. issuers). Thus, the principal substantive result of either proposal's treatment of dematerialized securities as in registered form is likely to be a reduced number of securities that are issued under the TEFRA foreign-targeting procedures. A related consequence may be an increase in the number of

securities held by U.S. investors that can be converted into definitive bearer-form securities, albeit subject to conditions that are not within the investors' control. The potential compliance implications of this are discussed in detail below.

Both proposals have been structured in a manner that is intended to be consistent with the government's tax compliance objectives. In the context of debt of U.S. issuers, the application of the existing information reporting rules and the documentation requirements imposed on non-United States persons as a prerequisite to claiming the portfolio interest exemption should provide the Service with sufficient information regarding the holders of the debt to allow it to satisfy its compliance concerns. Debt of non-U.S. issuers would not be subject to withholding tax documentation requirements, but the information reporting requirements imposed pursuant to sections 6045 and 6049 would apply to any sales effected, or payments made, in the United States or by U.S. financial intermediaries or certain non-U.S. financial intermediaries that have a connection to the United States.[45] In either case, the information collected and transmitted to the Service would equal or exceed the information that would be available if the debt were to be treated as in bearer form.[46] More generally, the proposals attempt to create a regime in which the applicable sanctions for noncompliance conform as closely as possible to the underlying tax policies. Thus, the proposals provide for registered-form treatment for securities that are held, and are expected to be held, in recorded form and reserves the

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45 *See* Treasury Regulation §1.6049-5(c)(5).

46 The Service has previously indicated that it believes that information relating to the identity of the beneficial owners of registered-form securities ultimately would be available, for example, as a result of the provisions of an exchange of information agreement between the United States and the jurisdiction in which a book-entry system is located. *See, e.g.*, PLR 9343019. The current regulations, however, do not require that a book-entry system be operated by a person that is located in a treaty jurisdiction or otherwise provide specific assurances that such information will be readily available, such as requiring that the book-entry agent be a qualified intermediary. Our proposals follow the approach of Treasury Regulation §5f.103-1(c) and do not impose restrictions of this nature.

application of the TEFRA issuer and holder sanction rules to securities that allow holders to collect income and transfer the securities anonymously.

Current law's requirement that a registry or book-entry system be maintained by either the issuer or its agent can create some uncertainty when securities are held in dematerialized form through an intermediary (such as a clearing organization) that operates its own book-entry system and arguably does not act as the issuer's agent. In many cases, the intermediary properly should be viewed as the registered holder of the securities, but this issue has created uncertainty in some contexts. The proposals' functional approaches provide a measure of certainty regarding this issue by minimizing the significance of the agent vs. registered holder issue.[47]

Notwithstanding the advantages of the proposals discussed above, we recognize that the proposals involve some tradeoffs. By defining "registered form" more broadly than does the Notice, the proposals reduce the circumstances in which issuers can issue securities under the TEFRA foreign-targeting procedures and avoid the need to collect withholding tax documentation, which may be problematic in some jurisdictions in which it is difficult to obtain Forms W-8 from investors. Similarly, the proposals may increase the burdens on non-U.S. investors who would be required to provide withholding tax documentation (or, perhaps, would feel a need to become qualified intermediaries). We do not believe, however, that these are significant concerns, principally because the proposals are intended as a clarification of rules that are in many respects unclear now. In other words, securities that would be treated as in

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[47] Questions relating to identifying the registered holder of an obligation may continue to be relevant in other contexts, including the foreign-targeted registered bond rules of Treasury Regulation §1.871-14(e) and the information reporting exemption in Treasury Regulation §1.6049-5(b)(10).

registered form under the proposals generally would be treated as in registered form, or, at least, as not clearly being in bearer form, under current law.

Because the proposals would allow dematerialized securities to be marketed freely to U.S. investors, even though those securities would provide for the delivery of definitive securities in bearer form in unusual circumstances, they could be seen as increasing the likelihood that U.S. taxpayers ultimately may hold physical securities that are in bearer form. As discussed in greater detail in Section III.B, below, however, we believe that a number of factors mitigate the likelihood that this would be a significant source of concern. First, any such securities that are transferred or paid in the United States or through a U.S. or U.S.-related financial intermediary will be subject to the existing information reporting rules. Second, holders will not have a non-contingent right to obtain definitive securities in bearer form, and the circumstances in which such a right will exist are expected to be unusual. Third, the compliance risks with respect to such definitive securities are not significantly different than those that exist in the secondary market today. For example, foreign-source interest on securities in *registered* form generally is not subject to information reporting if paid outside the United States by a non-U.S. payor. More generally, we believe that the current withholding tax and information reporting regulations generally effect a reasonable balance between ensuring compliance, on the one hand, and permitting market participants to conduct their activities in an efficient manner, without being subject to unreasonable constraints, on the other. We believe that either of our proposed treatments of dematerialized securities is consistent with these considerations.

5. Other Considerations Relating to Implementation of Proposals.

In some cases, the proposals may have the effect of treating securities that, as a matter of local law, are in bearer form as registered-form securities for the purposes of TEFRA and the U.S. withholding tax rules. Although this issue exists under current law, the adoption of

either of the proposals may have the effect of increasing the number of securities that are subject to such hybrid classification. This may raise a practical issue in connection with the implementation of either proposal. To the extent U.S. issuer securities are treated as in registered form under the proposals, market participants will be required to comply with U.S. withholding tax documentation requirements. In such cases, it will be important for there to be mechanisms for holders, paying agents and other market participants to be able to distinguish dematerialized securities that are subject to Form W-8 requirements from those that are treated as in bearer form that qualify for the portfolio interest exemption without documentation. For example, issuers could provide legends on definitive securities that are subject to portfolio interest documentation requirements, notifying potential holders of the applicability of such requirements. Paying agents could be required (contractually) to disseminate information regarding the securities that are subject to documentation requirements, perhaps by maintaining lists of securities that are subject to certification requirements on their websites. Similarly, a means for identifying securities subject to certification requirements in computerized trading systems could be developed.[48]

B. Treatment of Definitive Securities.

1. General Considerations.

As discussed above, the Notice did not address the treatment of definitive securities that might be issued under the facts described therein. Definitive securities would only be issued under these facts if the clearing organization through which the book-entry system was

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[48] The securities markets may be able to develop identification mechanisms of the type described in the text without a formal regulatory requirement to do so. The Service may, however, wish to impose a requirement that issuers adopt some means of identifying securities subject to Form W-8 requirements in order to facilitate the market's implementation of any new rules. In such a case, we would recommend that the Service request comments regarding means of identification that could be readily adopted by the markets.

maintained were to go out of business without a successor. Since local law in the foreign country described in the Notice required securities issued in the foreign country to be held through a designated clearing organization, the likelihood that definitive securities would actually be issued under these facts would appear to be very remote. Thus, the Service may have believed that resolution of the treatment of definitive securities was not essential to resolving the principal concerns addressed by the Notice. Even in circumstances in which it is highly unlikely that definitive securities will be issued, however, in structuring an offering, it will be necessary to address the documentation and procedural issues that issuers, clearing organizations and financial intermediaries will be required to implement. Thus, it is important to address the potential treatment of definitive securities even if the possibility of their being issued is thought to be remote. Moreover, the proposals discussed in this report will broaden the definition of "registered-form" securities somewhat, by permitting debt securities to be treated as in registered form in circumstances in which there may be more than a remote possibility that holders will obtain definitive bearer-form securities at some point in the future. Since adoption of either proposal would lead to an increased likelihood of the release of definitive securities that are functionally in *bearer* form in circumstances in which the securities initially were treated as in *registered* form, we believe that it is important to discuss the potential treatment of such definitive securities as a part of the overall discussion of the proposals.

Under Treasury Regulation §5f.103-1(e)(2) as currently in effect, if definitive securities in bearer form are obtained upon the termination of a book-entry arrangement (either under the facts of the Notice or under the broader proposals discussed in this report) they would

be treated as in bearer form.[49] Thus, bearer-form treatment would be the "default" classification for such definitive securities unless the regulations were altered to provide different treatment. As discussed in this Section III.B, treatment of definitive securities released from a dematerialized system as in bearer form raises potential withholding tax and TEFRA-related concerns for issuers and holders. Accordingly, we believe that a comprehensive proposal relating to the treatment of dematerialized securities should address the treatment of such definitive securities, either by addressing these withholding tax and TEFRA issues or by concluding that the definitive securities should be treated as registered-form securities.

For the reasons discussed in this Section III.B, we believe that it should be possible to treat definitive securities issued in respect of dematerialized securities that are treated as in registered form under either of the proposals discussed in Section III.A, above, as either bearer- or registered-form securities in a manner that not only addresses the Service's compliance objectives but also may be implemented effectively by market participants.[50] Each alternative raises certain technical and practical considerations, which are discussed in detail in this Section III.B. We believe that the Service should consider these issues carefully and choose the alternative that it believes best balances the government's compliance concerns and market participants' ability to implement the rules effectively.

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[49] Under Treasury Regulation §5f.103-1(e)(2) securities that can be transferred at any time before their maturity in bearer form will be treated as in bearer form. This treatment would have the result of causing the form of the securities to change (from registered to bearer) upon the issuance of definitive bearer-form securities. Although this consequence may seem unusual, the existing regulations provide some precedent for changed circumstances resulting in a change in the bearer/registered classification of an outstanding security. *See* Treasury Regulation §5f.103-1(e)(3).

[50] As discussed in Section III.A, above, definitive securities in registered form do not raise the issues addressed in this report. As a result, the treatment of such securities as registered-form securities would be unaffected by our proposal.

In implementing this portion of the proposal, it is important to note that, although the treatment of definitive securities is complex and, as a result, the discussion of the treatment of such securities occupies a significant portion of this report, we view the specific resolution of this issue as somewhat ancillary to our proposals regarding the treatment of dematerialized book-entry securities. We believe that our proposals regarding the treatment of securities held through dematerialized book-entry systems would be an effective means of clarifying the treatment of such securities regardless of the treatment of definitive securities that might be issued in certain circumstances under the proposals.

2. Possible Classification of Definitives as Bearer-Form Securities.

As discussed above, definitive securities that are functionally in bearer form but that are issued in respect of a dematerialized security will be treated as bearer-form securities for TEFRA and withholding tax purposes if the Service does not alter the treatment of such securities under current law (or if the Service affirmatively concludes that such definitive securities should be so treated). Unless the Service issues further guidance, however, this treatment would create significant and unwarranted withholding tax problems for U.S. issuers and the holders of debt securities of U.S. issuers. Under the proposals discussed in Section III.A, above, as well as under the Notice, securities represented by a dematerialized arrangement generally would be treated as in registered form prior to any release of such securities in definitive form. As a result, the issuer would not be required to issue them under the TEFRA foreign-targeting procedures. Since interest paid on bearer-form debt securities is eligible for the portfolio interest exemption only if the securities are issued under those procedures, however, interest paid by U.S. issuers with respect to definitive securities that are released from a dematerialized system generally would be subject to withholding tax if those definitive securities

are treated as in bearer form, absent modification of this rule.[51] In most cases, U.S. issuers would be required to bear the cost of any such tax as a result of an obligation to pay additional amounts in respect of U.S. withholding tax pursuant to a standard "gross-up" provision. In the case of instruments that do not provide for a conventional "gross-up" obligation, holders would suffer the economic consequences of a withholding tax imposed on interest paid with respect to securities on which interest was previously paid free of withholding tax, as a result of events over which the holders had no control. In either case, the prospect of the imposition of withholding tax on the release of definitive securities in bearer form could affect the ability of U.S. issuers to access foreign capital markets.

It may be possible to address this withholding tax problem through the creation of special rules that would allow securities released in definitive form from a dematerialized arrangement to be treated as foreign targeted. For example, a definitive security could be treated as foreign targeted, and therefore interest on the security would qualify for the portfolio interest exemption, if holders were required to provide a certificate comparable to that required under the TEFRA D regulations (*i.e.*, the certification required by Treasury Regulation §1.163-5(c)(2)(i)(D)(*3*) upon the earlier of the date the securities are released in definitive form or the date the first interest payment is made).[52]

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51 Sections 871(h)(2) and 163(f)(2)(B); Treasury Regulation §1.163-5(c).

52 Under Treasury Regulation §1.163-5(c)(2)(i)(D)(*3*) a holder is required to certify that the beneficial owner of the security is (i) a non-United States person; (ii) a United States person that is, or holds the obligation through, a foreign branch of a U.S. financial institution that agrees to comply with the restrictions of the holder sanction rules of section 165(j); or (iii) a financial institution holding the security for purposes of resale to a non-United States person outside the United States.

This rule could operate in conjunction with the present foreign-targeting rule. Thus, securities that were issued in accordance with the TEFRA D foreign-targeting procedures in connection with their initial issuance generally should be treated as having been foreign targeted (as under present law) when released in definitive form. Alternatively, the Service could require the delivery of the certification at the time of

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Although the approach outlined above may address issuers' withholding tax concerns to some extent, it would not provide a practical solution for U.S. investors. Because the dematerialized securities would have been treated as in registered form, there would have been no restriction on U.S. investors' ability to acquire or hold the securities. Such holders generally would be unable to provide a TEFRA D-type certification, however, unless they were foreign branches of U.S. financial institutions or held the securities through such foreign branches. We believe this problem could be addressed in several ways. The most effective way might be to provide that a United States person could satisfy this special foreign-targeting rule by agreeing to hold the securities only in accordance with Treasury Regulation §1.165-12(c). This would allow United States persons to hold the securities in a manner that is consistent with the U.S. government's tax compliance objectives while preserving fungibility with the securities held by non-U.S. investors. This approach may, however, be somewhat burdensome for U.S. investors who may be required to change the manner in which they hold their investments or the financial institutions through which they hold the investments.

There are other potential means of addressing the withholding tax concerns relating to bearer-form classification of definitive securities if some of the securities are held by United States persons, but those alternatives raise additional collateral consequences; in particular, they are likely to result in securities initially released to U.S. holders not being fungible with those initially released to non-U.S. holders. For example, an issuer could provide that U.S. holders would be entitled to receive only definitive securities in *registered* form (or securities that are held through custodial arrangements that would cause the definitive securities

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issuance of the definitive securities in respect of all securities, regardless of the manner of their initial issuance.

to continue to be treated as in registered form). Although such an approach could allow the definitive securities held by non-U.S. investors to qualify for the portfolio interest exemption, it would result in U.S. investors holding registered-form securities that would not be fungible with the bearer-form definitive securities that are initially released to non-U.S. holders. Moreover, it is not clear that issuers would have the flexibility to provide for registered-form definitives in all circumstances.[53]

Furthermore, while these suggestions would help to provide a solution to the withholding tax issues described above, they would not address a potential concern relating to the holder sanction rules that would confront U.S. holders who held definitive securities. Holders of dematerialized securities that would be treated as in registered form under the Notice or under either the Identified Conditions Proposal or the Unconditional Right Proposal typically would not have held such securities in accounts that complied with the technical requirements of Treasury Regulation §1.165-12(c). Thus, if the holders' interest in the dematerialized securities were to be exchanged for definitive securities that are treated as in bearer form, the holders generally would become subject to the holder sanctions unless they changed the manner in which they held the securities prior to any disposition of the securities. Although holders may be able to mitigate these concerns by transferring their securities to a custodial arrangement of the type described in Treasury Regulation §1.165-12(c), this requirement could be burdensome and could result in a U.S. holder being denied the ability to realize a loss in a non-abusive situation that arises as a result of circumstances that are outside of the holder's control.

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[53] In circumstances in which, as a result of a regulatory or other restriction, the issuer could not issue definitive securities in registered form, it could permit (or compel) U.S. investors to receive bearer-form definitive securities. In order to preserve the ability of definitive securities initially held by non-U.S. investors to qualify for the portfolio interest exemption, however, the definitives issued to U.S. investors could not be fungible with the securities initially held by non-U.S. investors. In addition, such U.S. investors potentially could be subject to the holder sanctions, as described above.

In addition to addressing the withholding tax issue, if the Service were to treat the definitive securities as in bearer form, it should revise the existing regulations to confirm that a release of definitive bearer-form securities would not be treated as a new issuance for purposes of section 163.[54] This would provide the proper framework so that issuers would not be subject to issuer sanctions as a result of a release of definitive securities.

Notwithstanding the complexity of the approaches outlined above for addressing the withholding tax and other consequences of bearer-form classification of the definitive securities, there may in fact be certain advantages to such treatment. Under this approach, issuers would generally have considerable flexibility to choose to provide for definitive securities that would be treated as in registered form, either through the issuance of definitive securities in registered form or by establishing custodial arrangements that would permit the definitive securities to be classified as registered-form securities.[55] Thus, absent compelling market constraints or foreign regulatory restrictions, U.S. issuers in many cases would be able to avoid the possible imposition of withholding tax through arrangements to ensure registered-form treatment. Withholding tax would only be imposed if an issuer provided for the issuance of bearer-form definitive securities and was unable to establish custodial arrangements that would result in registered-form treatment, or otherwise declined to do so.[56] We do not, however, believe that this would represent a complete resolution of the withholding tax issues described

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54 In addition, as discussed in Section III.C.1, below, the Service should modify the a convertibility rule in Treasury Regulation §5f.103-1(e)(2) to reflect the proposal and preserve the registered-form status of the dematerialized securities.

55 *See, e.g.*, PLRs 9343018 and 9343019.

56 In essence, although there are potential adverse consequences to the treatment of the definitive securities as in bearer form, in many cases issuers would have the ability to mitigate those consequences. Moreover, because the proposals discussed in this report broaden the circumstances in which dematerialized securities would be treated as in registered form, the circumstances in which issuers would have this flexibility would be broadened.

above because it may not always be feasible for issuers to provide for registered-form definitive securities. For example, we understand that the book-entry system in Japan, which was the subject of the Notice, requires that any definitive securities be in bearer form. Similar restrictions exist in other markets, either as a result of legal constraints or compelling market demand.

Furthermore, bearer-form treatment of the definitive securities would be consistent with the underlying principles of the TEFRA and information reporting rules. The potential application of the section 165 and 1287 holder sanction rules could reduce the potential for non-compliance arising from the ownership of definitive securities by U.S. investors. We note, however, that the information reporting rules that would apply if the definitive securities were to be treated as registered-form securities, discussed in Section III.B.3, below, would effect compliance measures that are comparable to those that would be achieved through the potential applicability of the holder sanction rules. As a result, bearer-form treatment of the definitive securities would arguably be more effective in furthering compliance only with respect to the narrow class of non-U.S. issuer securities held outside the United States in accounts with financial intermediaries that do not have substantial connections to the United States (and in those circumstances, it seems fair to question the extent to which the holder sanction rules are effective as a compliance measure).

3. Possible Classification of Definitives as Registered-Form Securities.

The Service may be able to avoid addressing the complex issues discussed in Section III.B.2, above, if it were to treat definitive securities issued in respect of dematerialized securities as in registered form, regardless of whether such definitive securities are functionally in registered or bearer form. Although this suggestion may seem somewhat counter-intuitive, and may seem to raise compliance concerns, we believe that such treatment may provide an

effective means of addressing the concerns raised by the potential issuance of definitive securities, from both a compliance and a practical perspective.

First, we note that registered-form classification would avoid the withholding tax and holder sanction problems inherent in bearer-form classification and, therefore, would avoid the need for complex solutions to that problem. Furthermore, as discussed in greater detail below, treating the definitive securities as in registered form generally should help to implement the government's compliance objectives, which may be particularly important if the Service adopts the Unconditional Right Proposal. In the context of debt securities of U.S. issuers, Forms W-8BEN (or other comparable documentation) would continue to be required for non-U.S. holders to qualify for the portfolio interest exemption, and the section 6045 and 6049 information reporting rules generally would apply to U.S. holders. In addition, the information reporting requirements of sections 6045 and 6049 generally would apply in most cases to securities of non-U.S. issuers.[57]

A number of issues would, however, need to be addressed under this approach. Under this treatment, interest paid on the securities generally would qualify for the portfolio interest exemption only if the holders and beneficial owners provide Forms W-8 or similar documentation.[58] Holders who receive definitive securities upon the exchange of the dematerialized securities would have held the securities while they were in registered form and

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[57] In accordance with the provisions of sections 6045 and 6049 and the regulations issued thereunder, information reporting generally is not required with respect to payments made to exempt recipients. In the context of the securities covered by the proposal, however, this is no different than the treatment of any other registered-form securities.

[58] Because the securities would functionally be in bearer form, a paying agent generally would not have access to information regarding the owners of the securities. As a consequence, we anticipate that a withholding agent would require the delivery of the appropriate Forms W-8 on each payment date in respect of definitive securities presented for payment (unless the presumption rules of Treasury Regulation §1.1441-1(b)(3)(iii) allow the withholding agent to presume that the holder of the securities is a United States person).

therefore would have already been complying with the certification requirements for registered-form securities. Since these holders would have been subject to certification requirements at the time they purchased their securities, it seems likely that imposing an obligation for such holders to continue to satisfy these certification requirements after the securities are issued in definitive form should not be viewed as unduly burdensome or otherwise problematic. In the case of potential secondary-market purchasers of the definitive securities, however, there is a risk of confusion since such holders likely would not expect to be required to provide such certifications. This risk of confusion may also raise concerns regarding potential confusion in the broader market if some, but not all (or even many) U.S. issuer definitive bearer-form securities become subject to Form W-8 requirements. To the extent any such market confusion does exist, it could affect U.S. issuers' ability to market "true" bearer-form debt securities that are issued in accordance with TEFRA.

Because market participants are not accustomed to providing U.S. withholding tax documentation in respect of securities that are functionally in bearer form, classification of the definitive securities as in registered form may cause practical implementation difficulties. As discussed in Section III.A.5, above, in connection with the implementation of our proposals, it will be critical for the securities markets to develop mechanisms for holders, paying agents and other market participants to be able to distinguish definitive securities that functionally are in bearer form but are subject to Form W-8 requirements from those that were issued in compliance with TEFRA that qualify for the portfolio interest exemption without documentation.[59]

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[59] As discussed above, such measures might include legends on the definitive securities, information posted on paying agents' websites or other similar procedures.

We believe that the circumstances in which definitive securities that functionally are in bearer form will be subject to Form W-8 requirements will be sufficiently unusual that such possibility should not adversely affect the market for "true" bearer-form debt securities that are issued in accordance with TEFRA D and thus are eligible for the portfolio interest exemption without requiring the provision of documentation. Nevertheless, we believe that it is critical to the efficient operation of the markets that the Service assess this risk of confusion prior to adopting in temporary or final form regulations implementing registered-form treatment for definitive securities that functionally are in bearer form.

We recognize that treating the definitive securities as in registered form may result in an increase in the number of United States persons that hold securities that functionally are in bearer form but that were not issued, and are not required to be held, in compliance with TEFRA. In particular, treating the definitive securities as in registered form would mean that the holder sanction rules would not apply to holders of such securities. We believe, however, that such treatment would not pose a significant compliance risk for several reasons. First, we note that the existing withholding tax and information reporting rules generally would require reporting with respect to (i) interest paid on definitive securities issued by U.S. issuers, (ii) interest paid on securities of non-U.S. issuers if such payments are made within the United States or through a U.S. or U.S.-related financial institution and (iii) the gross proceeds of dispositions of such securities in the United States or through a U.S. or U.S.-related broker.[60] Thus, these

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[60] *See* sections 871(h)(2)(B)(ii) and 881(c)(2)(B)(ii) (portfolio interest documentation requirements); Treasury Regulation §§1.6049-5(a)(1) (interest on obligations in registered form generally subject to information reporting); 1.6049-5(b)(6) (foreign-source interest exempt from information reporting only if paid outside the United States by a non-U.S. payor or a non-U.S. middleman); 1.6045-1(a)(1) (defining the term "broker" for purposes of the gross proceeds reporting rules as generally including all U.S. and foreign brokers except with respect to sales effected outside the United States by persons that are not U.S. payors or U.S. middlemen).

rules would largely replicate the reporting required by the holder sanction rules. Second, although it is possible that there would be an increase in the volume of definitive securities held by United States persons as a result of the implementation of our proposal, any definitive securities that are available to United States persons as a result of either of our proposals would be released only in unusual circumstances that should not be seen as presenting an opportunity for abuse. For example, a provision permitting the release of securities in definitive form as a result of an issuer default clearly should not be viewed as facilitating a holder's ability to avoid U.S. tax and would not appear to present a substantial risk of increased non-compliance. We believe that the risk of taxpayer non-compliance in such circumstances is not substantially different than the risk of non-compliance that currently exists through United States persons' ability to acquire definitive bearer-form securities in non-U.S. markets. U.S. taxpayers generally would be able to avoid U.S. tax by holding definitive securities released with respect to dematerialized securities only by holding non-U.S. issuer securities in accounts with non-U.S. financial institutions outside the United States. Thus, we do not believe that there is a substantial risk that the small volume of additional definitive securities that may be released into the U.S. market under our proposals would measurably increase non-compliance by U.S. taxpayers.

The Service may question whether it has the authority to treat securities as in registered form solely on the basis that they were issued in respect of registered-form securities.[61] Although we believe that the Service's authority in this area is sufficiently broad to permit it to reach this result,[62] any such concerns about this issue may lead the Service to

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[61] See Part IV, below, for a further discussion of potential limits on the Service's authority to determine the form of securities.

[62] It should be noted that Notice 2006-99 permitted securities that previously were issued in bearer form in compliance with TEFRA to continue to be treated as in bearer form after their conversion into

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conclude that the definitive securities should be treated as in bearer form. In such a case, the Service should carefully consider the issues discussed in Section III.B.2, above. Finally, if the Service concludes that there is a substantial risk that classifying the definitive securities as in registered form would cause confusion that would jeopardize U.S. issuers' ability to issue conventional bearer-form securities under TEFRA D, the Service should consider classifying the definitive securities as in bearer form.

4. Possible Hybrid Approaches.

At a conceptual level, it would seem that the Service's compliance objectives would best be advanced by adopting a hybrid approach, treating definitive securities as in bearer form for TEFRA purposes, thus retaining the applicability of the holder sanction rules with respect to the definitive securities, while still treating the securities as in registered form for withholding tax purposes, retaining the obligation for holders to provide Forms W-8 or comparable documentation with respect to securities of U.S. issuers. As discussed in Section III.B.2, above, however, U.S. holders of dematerialized securities who received definitive securities on an issuer default or similar event could be subject to adverse consequences if the definitive securities were treated as in bearer form for purposes of the holder sanction rules, forcing holders to change the arrangements through which they hold the securities (including, in some cases, changing the financial institutions through which they hold the securities). In some cases, these consequences could be significant and, we believe, unwarranted. For example, in the context of an issuer default, in which a holder's ability to sell securities quickly may be critical, the holder could effectively be denied the ability to recognize a loss, notwithstanding

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dematerialized form. This conclusion would seem to suggest that the Service believes that its authority in this area is quite broad.

that the holder initially purchased registered-form dematerialized securities in a non-abusive situation.

As discussed above, we do not believe that our proposals would create significant additional compliance risk. Nevertheless, if the Service is concerned that treatment of the definitive securities as either bearer- or registered-form securities fails to address its compliance concerns, we believe that it would be preferable to address this concern through targeted amendments to the present information reporting rules.[63] In addition, we believe that the Unconditional Right Proposal's anti-abuse rule (discussed in Section III.A.3, above) could address any lingering concerns that the Service may have regarding the potential risk of non-compliance.

In exploring how to address both TEFRA compliance goals and continued issuer access to non-U.S. bearer markets within the framework of our proposal, we also considered another hybrid approach to the treatment of the definitive securities. Under this approach, definitive securities issued in respect of U.S.-issuer dematerialized securities would have been treated as in registered form and definitive securities issued in respect of non-U.S. issuer dematerialized securities would have been treated as in bearer form. This approach would maximize the extent to which existing U.S. compliance rules would apply to both U.S.- and non-U.S. issuer securities, albeit at the cost of added complexity. Under this approach, since U.S. issuer definitive securities would be treated as in registered form, they would be subject to withholding tax documentation requirements. Since non-U.S. issuer securities would be treated as in bearer form, holders of such securities would be subject to the section 165 and 1287 holder

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[63] If the Service decides to amend the information reporting rules to address these concerns, we would recommend that any such amendments be issued initially in proposed form, to allow the Service to ensure that they do not create unintended adverse consequences.

sanction rules. We ultimately decided not to adopt this proposal principally as a result of two concerns. First, we thought that there was a substantial risk that treating U.S. issuer and non-U.S. issuer securities differently would create market confusion. We felt that this risk was particularly significant with respect to hybrid branches of U.S. issuers that are treated as U.S. issuers for U.S. tax purposes but non-U.S. companies for non-tax purposes. Second, we question whether the Service's authority is sufficiently broad to permit it to define "bearer" and "registered" securities differently for U.S. and non-U.S. issuers.

C. Other Issues.

1. Conforming Changes to Convertibility Rule.

Under either of the proposals discussed in Section III.A, above, securities held through a dematerialized system would not be treated as in bearer form merely because of the possibility that they might be exchanged into definitive form at a future time, unless this possibility was the result of a non-contingent right of holders to demand securities in definitive form. However, under Treasury Regulation §5f.103-1(e)(2), securities will be treated as in bearer form if they may be transferred through non-book-entry means at any time prior to their maturity. If either of our proposals is adopted, conforming changes will be required to this "convertibility" rule. The modified regulations should provide that securities that would otherwise be treated as registered-form book-entry securities will be treated as in bearer form only if holders have, or will have, the right to obtain the securities in bearer form and either (i) the right is not specified pursuant to the regulations as one that does not cause dematerialized securities to be treated as in bearer form (under the Identified Conditions Proposal) or (ii) the right does not require the occurrence of an event outside the holders' control, other than the passage of time (under the Unconditional Right Proposal).

2. Diminished Role for "Agent of the Issuer" Concept.

As discussed above, the present regulations' requirement that a registry or book-entry system be maintained by either the issuer or its agent creates uncertainty when securities are held in dematerialized form through an intermediary. Under the more objective functional approach taken by the proposals described in this Part III, securities generally will be treated as in registered or bearer form based on whether holders have a non-contingent right to obtain definitive securities in bearer form. Thus, one effect of the proposals is to minimize the significance of agency concepts in defining whether dematerialized securities are in registered form. Under the proposals, securities held through a book-entry system or other dematerialized system that is maintained by a person that is acting on behalf of the issuer and that satisfies the other requirements of the relevant proposal will be treated as in registered form, as is the case under current law. The proposals also provide, however, that securities held through similar systems that are maintained by clearing organizations will also be treated as in registered form, without reference to agency concepts or to whether the clearing organization is treated as the registered holder of the securities.[64] Accordingly, the provisions of the Treasury Regulations reflecting the "agent of the issuer concept" should be modified to reflect the nature of the proposals.

IV. ALTERNATIVE PROPOSAL.

As discussed in detail in Part I, above, as the financial markets have modernized over the last two decades, investors' appetite for securities in physical form has declined markedly and securities in dematerialized form (including "permanent" global securities) have

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[64] Notwithstanding this general revision, questions relating to identifying the registered holder may still be relevant in other contexts, including the targeted-registered bond rules and Treasury Regulation §1.6049-5(b)(10).

become increasingly prevalent. The regulatory definitions of "registered" and "bearer," however, have remained largely unchanged since 1986. As a result of this evolution in the capital markets and the static state of the relevant Treasury Regulations, the functional differences between securities that are in "bearer" form and those that are in "registered" form have diminished substantially and, in many cases, such securities are virtually indistinguishable.

Notwithstanding the subtlety of the distinctions between the forms of these two categories of securities in the modern markets, the tax consequences of the differing classifications may be very significant. In particular, holders of interests in a registered-form permanent global security generally will be required to comply with Form W-8 certification requirements in order to establish their entitlement to the portfolio interest exemption from withholding tax. No such documentation is required in respect of a similar security that is treated as in bearer form, although the issuer is subject to restrictions on its ability to distribute the security in the United States or to United States persons.

One consequence of the increasing internationalization of the capital markets and investors' decreased interest in the specific forms of securities being offered is that securities offerings tend to be structured and documented based on constraints or investor expectations particular to the market or markets in which securities are offered. That is, differences between targeted local offerings and broad global offerings tend to drive the structure of transactions more than somewhat arbitrary concepts regarding the technical form of the securities (except to the extent that form is required by the application of U.S. tax or other applicable regulatory principles). Because of this, and because the TEFRA and withholding tax rules already incorporate foreign-targeting concepts, we believe that a more workable operating framework would be one that distinguishes between securities that are targeted to foreign markets in

connection with their initial issuance and those that are sold in the United States or globally, rather than on the basis of whether the securities are in "bearer" or "registered" form.

We have set out below a general outline of a proposal that would incorporate this concept for purposes of the withholding tax rules. As discussed below, the proposal is intended principally as a modernization of these rules. Because this proposal relaxes the distinctions between bearer- and registered-form securities, it may create the potential for avoidance if applied for purposes of the TEFRA issuer and holder sanction rules. Thus, the proposal would not affect the treatment of the securities under TEFRA. In implementing this proposal, however, the recommendations made elsewhere in this report regarding the definitions of "bearer" and "registered" form would continue to be relevant to the extent not superseded by this proposal.

Under this alternative proposal, the withholding tax rules would be applied by reference to whether the securities were offered for sale in the United States or whether they were foreign targeted in connection with their initial issuance; for *withholding tax* purposes, form (*i.e.*, whether the securities are in bearer or registered form) would not matter. Thus, if bearer- or registered-form debt securities are initially distributed under procedures comparable to the current-law TEFRA D restrictions, they would qualify for the portfolio interest exemption without more. This treatment would correspond to the current treatment of foreign-targeted bearer-form debt securities. Although this treatment would represent a relaxation of the current treatment of foreign-targeted registered-form debt securities, we perceive no policy reasons to subject debt securities to more stringent withholding tax rules simply because it is easier to identify the holders of the securities, provided those securities are initially distributed in

compliance with the same foreign-targeting rules that apply to bearer-form debt securities.[65] In particular, the increase in effective information reporting resulting from the implementation of the Withholding Tax Regulations in 1997, including the qualified intermediary regime, should reduce any compliance-related concerns related to this aspect of the proposal.

Debt securities that are not issued in accordance with the TEFRA D foreign-targeting rules would be eligible for the portfolio interest exemption only if the holders complied with the documentation requirements currently applicable to debt securities in registered form. Although this rule theoretically would apply to debt securities in either registered or bearer form, because the TEFRA issuer sanctions would continue to apply to bearer-form debt securities that are not issued in accordance with the foreign-targeting rules, we anticipate that, as a practical matter, this latter rule would apply only to registered-form debt securities and thus would be consistent with the current-law treatment of such securities.

Sections 871(h) and 881(c) prescribe different withholding tax rules for obligations that are in "registered" and "bearer" form. We believe that the Service has broad discretion to define these terms. If, however, the Service has any concern regarding its authority to interpret the terms differently for TEFRA and withholding tax purposes, or to interpret them in a way that preserves portfolio interest treatment for obligations in registered form without the

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[65] We note that the implementation of this proposal will result in circumstances in which securities that are treated as in bearer form under local law will be subject to the U.S. withholding tax documentation requirements applicable to registered-form securities. Although this issue exists under current law – in particular in the case of securities subject to depositary arrangements that are intended to cause bearer-form obligations to be treated as in registered form for TEFRA purposes – adoption of the alternative proposal described in this Part IV would increase the prevalence of such hybrid structures. In adopting such an approach, therefore, the Service should consider carefully means by which the potential risk of confusion for market participants can be mitigated.

provision of a Form W-8 or similar documentation,[66] and therefore believes that this alternative proposal may require legislation to amend sections 871 and 881, we would be happy to further develop this proposal toward that objective.

V. OTHER ISSUES

A. Offers and Sales of Bearer-Form Debt Securities to U.S. Investment Advisers.

Section 163(f) generally permits issuers of debt securities in bearer form to claim deductions for interest paid or accrued with respect to such securities if, and only if, the securities are issued under "arrangements reasonably designed to ensure that such [securities] will be sold (or resold in connection with the original issue) only to a person who is not a United States person."[67] Prior to the adoption of the TEFRA D rules in 1990, Treasury Regulations provided that the "arrangements reasonably designed" standard generally would be satisfied if the security were offered for sale or resale, and delivered, only outside the United States and the distribution of the security was exempt from the registration requirements of the Securities Act of 1933 (the "Securities Act") because it was intended for distribution only to non-United States persons.[68] Under the securities laws in effect at that time, sales of securities to U.S. fiduciaries acting on behalf of non-U.S. investors generally were deemed to be in accordance with such procedures because the beneficial owner of the securities was not a U.S. citizen or resident.[69]

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66 Sections 871(h)(2)(B)(ii) and 881(c)(2)(B)(ii) require that documentation meeting the requirements of section 871(h)(5) be provided in respect of obligations in registered form. It may, however, be possible to interpret section 871(h)(5) in a manner that includes the certification required pursuant to Treasury Regulation §1.163-5(c)(2)(i)(D)(*3*).

67 Section 163(f)(2)(B)(i). Failure to comply with this restriction also generally results in sanctions under sections 312(m), 871(h)(2)(A) and 4701.

68 Treasury Regulation §1.163-5(c)(2)(i)(A).

69 *See* Securities Act Release No. 33-4708 (1964); Baer Securities Corp., SEC No-Action Letter, 1979 SEC No-Act. LEXIS 3573 (October 12, 1979).

We are not aware of any specific tax compliance problems that were caused by market participants' ability to offer and sell bearer-form debt securities to non-U.S. investors through U.S. investment advisers. The TEFRA D rules, however, adopted an independent set of procedures that generally must be followed to ensure compliance with the "arrangements reasonably designed" requirement of section 163(f). Thus, although offers and sales of bearer-form debt securities that are not registered with the Securities and Exchange Commission ("SEC") to such non-U.S. investors continue to be permissible under the SEC's Regulation S,[70] such offers and sales now violate the regulations implementing section 163(f) unless the requirements of the TEFRA D rules independently are satisfied.

The TEFRA D rules generally require, inter alia, that neither the issuer nor any distributor offer or sell a bearer-form debt security during an initial restricted period "to a person who is within the United States or its possessions or to a United States person."[71] The TEFRA D rules also provide that an offer or sale is deemed to be made to a person who is within the United States or its possessions "if the offeror or seller of the obligation has an address within the United States or its possessions for the offeree or buyer of the obligation with respect to the offer or sale."[72] Because these rules impose a geographical restriction in addition to the restriction on offers and sales to United States persons, and because a transaction is deemed to violate that geographical restriction in a case in which the relevant offeree has a U.S. address related to the transaction, market participants generally have read the TEFRA D rules conservatively as prohibiting direct contact between a distributor and an investment adviser representing a person

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70 Securities Act Rules 901-905, 17 C.F.R. §230.901-.905.

71 Treasury Regulation §1.163-5(c)(2)(i)(D)(*1*)(*i*), (*ii*)(*A*).

72 Treasury Regulation §1.163-5(c)(2)(i)(D)(*1*)(*iii*)(*A*).

that is a non-United States person located outside the United States, if that investment adviser is physically located in the United States.

As discussed in Section I.B.1, above, as the financial markets have grown and internationalized in the years since the adoption of TEFRA and the TEFRA D rules, the customer bases of U.S. financial intermediaries and advisers have become substantially more global in scope. In addition, the growth of electronic commerce and communication has substantially facilitated the ability of market participants to conduct business transactions quickly and efficiently across borders. Paralleling this evolution in the financial markets has been a substantial increase in the information available to the Service relating to such cross-border transactions, in particular as a result of the implementation of the qualified intermediary program pursuant to the Withholding Tax Regulations.

The adoption of the Withholding Tax Regulations in 1997 represented a successful attempt to modernize the manner in which the withholding tax rules apply in the context of the global financial markets of the twenty-first century. The TEFRA D rules' reliance on geographic distinctions has not been modified, however, and, as a result, these rules have become an increasingly outmoded method of regulating these markets. In particular, given the speed and facility of modern telecommunications, the location of the recipient of a telephone call or e-mail can be somewhat arbitrary, and may be unknown to the person placing the call or sending the message. While some market participants have been able to develop arrangements to allow them to comply with the restriction on offers and sales to non-U.S. investors through

U.S. investment advisers,[73] these arrangements are quite formalistic and create inefficiencies that do not appear to promote any substantial compliance objective.

Section 163(f)(2)(B)(i) proscribes offers and sales of bearer-form debt securities to *United States persons* (rather than offers and sales *in the United States*). In this context, we believe that the information reporting provisions of the Withholding Tax Regulations, including, in particular, the qualified intermediary procedures, as well as the related Treasury Regulations issued under chapter 61 of the Code, provide a better means of ensuring that bearer-form debt securities are distributed only to non-United States persons than regulations that rely on formalistic geographical restrictions. Accordingly, as described below, we believe that it should be possible to facilitate non-U.S. investors' ability to invest in bearer-form debt securities while at the same time using the qualified intermediary procedures to protect the Service's interest in ensuring that such securities are not distributed to United States persons. The procedures described below are intended only to facilitate the acquisition by non-United States persons of bearer-form debt securities under appropriate safeguards. By relying on the documentation and information reporting rules applicable to qualified intermediaries (and United States persons), these proposed procedures should be viewed as providing equivalent safeguards to those implemented pursuant to section 165(j)(3), which permits *United States persons* to hold bearer-form debt securities acquired in the secondary market under appropriate circumstances.

We have set out below the text of a proposed revision to the TEFRA D rules. This proposal is intended to facilitate the sale of bearer-form debt securities to non-U.S. investors

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[73] Such arrangements typically involve a U.S. investment adviser engaging an employee or agent located outside the United States that is authorized to receive offers for the sale of bearer-form debt securities for such investment adviser's non-U.S. customers. In some cases, these offshore employees and agents do not have independent discretion to accept such offers, but rather must consult with the investment adviser prior to accepting such an offer.

that may have U.S.-based investment advisers, while adopting safeguards to ensure that the "arrangements reasonably designed" standard is not compromised. In general, under the procedures described below, contacts (including telephone calls and e-mails) between a distributor and an investment adviser located in the United States in respect of offers and sales of bearer-form debt securities would be permitted if, and only if:

i) the investment adviser agrees with the distributor on a general basis that it will acquire bearer-form debt securities only for the accounts of customers that are non-United States persons that do not have U.S. addresses with respect to the offer or sale;

ii) in order to confirm the ongoing validity of the general agreement described in (i), the investment adviser provides to the distributor of a particular security a certificate acknowledging that bearer-form debt securities will be sold to it only for the account of customers described in clause (i); and

iii) the investment adviser agrees with the distributor to hold the bearer-form debt securities, or cause them to be held, through an account with either a United States person or a qualified intermediary that has agreed[74] that it will hold such securities only for the account of such non-United States persons.[75]

More specifically, we would amend Treasury Regulation §1.163-5(c)(2)(i)(D)(*1*)(*iii*) to include the following new paragraph (*D*):

> *(D)* An offer or sale of an obligation will not be treated as made to a person within the United States or its possessions or to a United States person if the person to whom the offer or sale is made is a financial institution that satisfies each of the following conditions:
>
> (I) the financial institution agrees with the offeror or seller that all debt securities in bearer form that it acquires pursuant to this paragraph (c)(2)(i)(D)(*1*)(*iii*)(*D*) will be acquired only for the account of one or more customers (x) that are not United States persons and (y) with respect to which

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74 The United States person or qualified intermediary's agreement would be with the relevant investment adviser. The agreement with the investment adviser would be on a blanket basis, renewable periodically.

75 The investment adviser's agreement described in clauses (i) and (iii) would be on a blanket basis, renewable periodically.

the financial institution does not have an address or addresses in the United States or its possessions with respect to the offer or sale;

(II) the financial institution provides to the seller, with respect to the sale, a certificate from such financial institution acknowledging that debt securities in bearer form are being sold to it in such transaction only for the account of one or more customers that are described in paragraph (c)(2)(i)(D)(*1*)(*iii*)(*D*)(I); and

(III) the financial institution agrees with the offeror or seller to hold all securities described in this paragraph (c)(2)(i)(D)(*1*)(*iii*)(*D*), or cause such securities to be held, through one or more accounts with persons each of which (x) is either a United States person or a qualified intermediary and (y) has agreed with the financial institution that it will hold such securities only for the account of such non-United States persons. [76]

A financial institution may satisfy the requirements of paragraphs (c)(2)(i)(D)(*1*)(*iii*)(*D*)(I) and (III) by delivering a blanket certificate to the issuer or distributor offering or selling the obligation. A United States person or qualified intermediary may satisfy the agreement requirement of paragraph (c)(2)(i)(D)(*1*)(*iii*)(*D*)(III) by delivering a blanket certificate to the applicable financial institution. In the case of a qualified intermediary, such agreement may be provided only if and to the extent permitted pursuant to its qualified intermediary agreement with the Internal Revenue Service. Any such blanket certificate must be (x) received by the relevant issuer, distributor or financial institution on or prior to the date of the sale, in the year of the sale or in either of the preceding two calendar years, and (y) retained by the applicable issuer, distributor or financial institution for at least four years after the end of the last calendar year to which it relates.

We believe that these procedures, coupled with the existing restrictions on deliveries of bearer-form debt securities in the United States, would substantially safeguard the Service's interest in preventing the distribution of such securities to United States persons while facilitating investment activities that are important to non-U.S. investors, U.S. investment advisers and other participants in the global capital markets.

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[76] The qualified intermediary's agreement with the investment adviser would be pursuant to procedures set forth in the qualified intermediary's agreement with the Service.

B. Expansion of Rules Permitting Bearer-Form Debt Securities to be Held Through Financial Institutions.

A United States person is permitted to hold bearer-form debt securities without being subject to the holder sanction rules if such taxpayer is a financial institution, or holds the securities through an account at a financial institution, and the financial institution complies with information reporting requirements that are intended to provide the Service with sufficient information to permit it to ensure compliance.[77] In addition, a United States person is permitted to acquire bearer-form debt securities in connection with their initial distribution if such person acquires and holds the securities through a foreign branch of a *U.S.* financial institution that complies with these reporting requirements.[78]

Since the adoption of the TEFRA D rules, the Service has implemented the qualified intermediary rules (and similar rules relating to withholding foreign partnerships and trusts). Under these rules, a substantial number of foreign intermediaries have entered into agreements with the Service pursuant to which they have agreed to comply with U.S. information reporting requirements, and be subject to audits to ensure their compliance with these requirements. The Service therefore should be able to obtain information relating to bearer-form debt securities held by U.S. taxpayers through qualified intermediaries (or withholding foreign partnerships or trusts) to the same extent as those held through foreign branches of U.S. financial institutions. Accordingly, we recommend that Treasury Regulation §1.163-5(c)(2)(i)(D)(*6*)(*ii*) be modified to permit United States persons to acquire bearer-form debt securities in connection with their original issuance through accounts with qualified

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77 *See* Treasury Regulation §1.165-12(c).

78 *See* Treasury Regulation §1.163-5(c)(2)(i)(D)(*1*)(*iii*)(*C*), (*6*)(*ii*).

intermediaries. In addition, the definition of "financial institution" in Treasury Regulation §1.165-12(c)(1)(iv) should be revised to include qualified intermediaries, withholding foreign partnerships and withholding foreign trusts, to the extent that such entities do not otherwise qualify as "financial institutions."

More generally, securities that are held through accounts described in Treasury Regulation §1.165-12(c) are fully subject to information reporting and may only be resold subject to constraints intended to ensure that U.S. taxpayers cannot hold bearer-form securities in a manner that raises compliance concerns.[79] Therefore, the Service might consider expanding the principles discussed in Section V.A, above, by permitting bearer-form debt securities to be offered and sold to United States persons, provided such securities are required to be held in accordance with arrangements that satisfy the requirements of Treasury Regulation §1.165-12(c).

C. Relaxation of Holder Sanction Resale Restriction.

Treasury Regulations issued under section 165 permit U.S. taxpayers to hold bearer-form debt securities without being subject to the holder sanctions if they (i) are financial institutions holding the securities in connection with the conduct of a non-U.S. trade or business or for their own investment account or (ii) hold through an account at a financial institution and, in any such case, satisfy certain additional requirements.[80] If the holder is a financial institution holding the securities for investment or a person holding through an account at a financial institution, compliance is assured by requiring that any interest (including original issue

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79 Such securities generally cannot be resold in the United States except in very narrow circumstances, although in Section V.C, below, we recommend that this rule be broadened somewhat.

80 *See* Treasury Regulation §1.165-12(c).

discount) received on, and gross proceeds from any disposition of, the securities be reported to the Service.[81]

In addition to the reporting requirements described above, securities held through such arrangements are subject to resale restrictions that generally prohibit their subsequent sale to another U.S. taxpayer, even if the purchaser holds the securities through an account at a financial institution that agrees to comply with the reporting rules described above.[82] This further constraint on resale can be burdensome for U.S. taxpayers. As noted above, all income on bearer-form debt securities held through the arrangements described in the section 165 regulations is fully reportable to the Service. Thus, we see no compliance advantage in the resale restriction. Moreover, the resale restriction applies only to securities that are resold in the United States. Thus, the restriction may be seen as hindering compliance because income relating to securities held outside the United States is substantially less likely to be reported to the Service.

Because the restriction on resales imposes burdens on U.S. taxpayers and serves no apparent compliance objective, we recommend that Treasury Regulation §1.165-12(c)(2)(iii) and (3)(iii) be broadened to permit resales of bearer-form debt securities to persons that will hold the securities in accordance with Treasury Regulation §1.165-12(c).[83]

D. Extending Pass-Through Certificate Treatment to Obligations Held Under Treasury Regulation §1.165-12(c).

Treasury Regulation §1.871-14(d) provides a broad rule that is intended to increase liquidity in the financial markets by facilitating repackagings and similar transactions.

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81 *See* Treasury Regulation §1.165-12(c)(2)(i), (ii), (3)(i) and (ii).

82 *See* Treasury Regulation §1.165-12(c)(2)(iii) and (3)(iii).

83 This proposal contemplates that any broadening of the definition of "financial institution" pursuant to the proposal described in Section V.B, above, would also apply for this purpose.

Under this provision, the determination whether interest paid on a pass-through certificate qualifies for the portfolio interest exemption is made by treating the pass-through certificate as the relevant obligation. Thus, for example, interest paid on a registered-form pass-through certificate generally will qualify for the portfolio interest exemption if the beneficial owner provides a Form W-8BEN, even if the underlying obligations are bearer-form mortgage loans that were not issued in accordance with the TEFRA foreign-targeting procedures.

Treasury Regulation §1.871-14(d) has been a very useful tool in the securitization market. Its application to "pass-through certificate[s]," however, may limit its potential effectiveness. For example, a U.S. bank may wish to sell a participation in a loan that is in bearer form but is not a registration-required obligation (and thus would not have been issued under the TEFRA foreign-targeting procedures) to a non-U.S. investor. In the absence of further guidance regarding the meaning of "pass-through certificate," it is not entirely clear whether the participation would be eligible for the portfolio interest exemption. The procedures in Treasury Regulation §1.165-12(c) represent a successful attempt to facilitate investing and trading activities in a manner that is consistent with preserving the tax policies underlying TEFRA. Because the information reporting required by these procedures provides the Service with information equivalent to the information available with respect to registered-form obligations, there would seem to be no policy obstacle to extending the principles of the pass-through certificate rules to instruments held in an account satisfying the requirements of Treasury Regulation §1.165-12(c). Therefore, we recommend expanding Treasury Regulation §1.871-14(d) to provide, in addition to the current rule relating to pass-through certificates, that interest paid on an obligation held in an account satisfying the requirements of Treasury Regulation §1.165-12(c) also will qualify for the portfolio interest exemption, as long as the beneficial

owner of the account satisfies the portfolio interest documentation requirements applicable to obligations in registered form.

E. Proposed Revisions to Treasury Regulation §§1.6049-5(b)(10) and (11).

Treasury Regulation §1.6049-5(b)(10) provides that U.S.-source original issue discount on an obligation that has a maturity at issue of 183 days or less is exempt from information reporting (and backup withholding) if certain specified requirements are met. Treasury Regulation §1.6049-5(b)(11) provides a similar rule for interest paid with respect to certain U.S. bank deposits. One of the requirements for exemption under these regulations is that the obligation have a face amount of not less than $500,000 (determined based on the spot rate of exchange, if the obligation is denominated in foreign currency). Presumably, the $500,000 minimum denomination requirement is intended to ensure that these obligations are not purchased by U.S. individuals. However, these regulations also generally require that such obligations be issued in accordance with section 163(f)(2)(B) and the regulations thereunder. The portfolio interest rule does not impose a corresponding restriction on the denomination of bearer-form obligations with an original maturity of more than 183 days, which must be issued in accordance with the requirements of section 163(f)(2)(B). It therefore is unclear why any minimum denomination is necessary to ensure that original issue discount obligations described in Treasury Regulation §§1.6049-5(b)(10) and (11) are not sold to United States persons.[84]

In our experience, the $500,000 minimum denomination rule has impeded access by U.S. issuers to foreign commercial paper markets, putting them at a competitive disadvantage. In the absence of any clear compliance benefit, we would recommend its elimination.

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[84] The fact that the holder sanction rules of sections 165(j) and 1287(a) do not apply seems irrelevant, since the holder sanctions are equally inapplicable to obligations having a maturity of more than 183 days but not more than one year.

Additionally, there is a technical problem relating to the application of the $500,000 requirement for foreign currency-denominated obligations. Treasury Regulation §§1.6049-5(b)(10) and (11) require that the face amount of the obligation be at least $500,000 as of the date of issue. Typically, in connection with the issuance of instruments in the capital markets, the price of an obligation is set several days prior to the actual issuance of the obligation. By the time an offering has priced, market participants have arranged their affairs in reliance on the offering, and the issuer typically will have earmarked the proceeds for use in its business. In addition, market participants may have arranged hedges and other transactions relating to the offering, in particular in respect of obligations issued in foreign currency. In cases in which the $500,000 test is met as of the pricing date, but is not met as of the issue date due to fluctuations in exchange rates during the intervening few days, market participants will be forced to cancel an offering, revise its terms or issue the instruments on a different basis than that initially anticipated (*i.e.*, as subject to reporting under section 6049). Allowing the $500,000 requirement to be satisfied as of the date that the terms of a transaction are set should not be viewed as providing the potential for manipulation or abuse. Thus, if the $500,000 requirement is retained, we recommend revising the regulations to provide that, with respect to obligations denominated in a currency other than U.S. dollars, compliance may be measured as of the obligation's pricing date.

F. Legending Requirement for Long-Term Commercial Paper.

Interest paid on bearer-form obligations having a term to maturity that is greater than 183 days is exempt from withholding tax under the portfolio interest exemption only if the obligation is issued in accordance with the TEFRA restrictions applicable to bearer-form debt

having a term to maturity of greater than one year.[85] One of the requirements imposed under the TEFRA regulations is that the obligations bear a legend that notifies holders that the obligation is subject to the holder sanction rules of sections 165(j) and 1287(a).[86] These sanctions, however, do not apply to obligations having a term to maturity of one year or less. Thus, the required legend is incorrect as a matter of law. We therefore recommend that Treasury Regulation §1.871-14(b)(1) be revised to eliminate the requirement that the incorrect legend be placed on the face of the obligations.[87]

G. Legending Dematerialized Securities.

As discussed in Section I.B, above, securities issued in the international capital markets increasingly are taking the form of dematerialized securities. A number of technical rules under TEFRA, the withholding tax rules and the information reporting and backup withholding rules, however, continue to operate on the assumption that securities exist in physical form in some manner. For example, Treasury Regulation §1.163-5(c)(1)(ii)(B) requires that bearer-form debt securities bear a specified legend. This regulation includes a special rule for book-entry securities, but provides no guidance for securities that are in fully dematerialized form in which there may be no conventional "book entry," as the term is commonly understood. Similarly, the information reporting exemptions for commercial paper and certain bank deposits in Treasury Regulation §§1.6049-5(b)(10) and (11) require that the obligation bear a specified

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85 *See* Treasury Regulation §1.871-14(b)(1), which requires that the obligation be described in section 163(f)(2)(B) and the regulations thereunder.

86 Treasury Regulation §1.163-5(c)(1)(ii)(B).

87 Treasury Regulation §1.6049-5(b)(10)(i) addresses a similar issue in connection with the information reporting exemption for obligations having a term to maturity of 183 days or less. Unlike Treasury Regulation §1.871-14(b)(1)'s cross-reference to section 163(f)(2)(B), however, the information reporting exemption cross-references sections 163(f)(2)(B)(i) and (ii)(I), excluding the legend requirement in section 163(f)(2)(B)(ii)(II).

legend on its face. The lack of guidance regarding the application of these legending requirements to securities that do not exist in physical form creates a risk that issuers will fail to comply with the relevant requirements because they are unable to answer correctly the metaphysical question of how to place a legend on a security that does not exist in physical form.

In other contexts, legending requirements apply only to physical securities. For example, the foreign-targeted registered obligation rules require that such obligations bear a specified legend, but only if the securities are evidenced by a physical document.[88] We recommend that a similar rule be adopted for dematerialized securities that are issued pursuant to TEFRA D[89] and for securities issued under the information reporting exemptions in Treasury Regulation §§1.6049-5(b)(10) and (11). Alternatively, we request that the Service provide issuers with guidance regarding how they may implement the legending requirements for securities that do not exist in physical form or through a conventional "book entry."

H. Clarification of Information Reporting Requirements Applicable to Certain Guaranteed Debt.

Foreign-source interest generally is exempt from information reporting if it is paid outside the United States by a non-U.S. payor.[90] Thus, information reporting would not apply in the ordinary course to interest paid with respect to foreign-targeted debt of a non-U.S. issuer. If the debt is guaranteed by the non-U.S. issuer's U.S. parent corporation (or any other U.S. guarantor), however, an information reporting problem may arise. Interest paid by a U.S.

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88 *See* Treasury Regulation §1.871-14(e)(2). *See also* Treasury Regulation §1.1275-3(b)(1), (2) (original issue discount legend required only when security is issued in physical form).

89 Although dematerialized securities normally would be treated as in registered form under current law (and under the proposal discussed in Parts II and III of this report), dematerialized securities that provide holders with an option to obtain definitive securities in bearer form generally would be treated as in bearer form.

90 Treasury Regulation §1.6049-5(b)(6).

guarantor in respect of a guarantee of debt of a non-U.S. borrower is treated as foreign-source interest.[91] Because the guarantor would be treated as a U.S. payor, however, the general information reporting exemption for foreign-source interest would not apply.[92] The potential imposition of information reporting in these circumstances would be particularly problematic in the context of bearer-form debt securities, where information relating to the holders of the securities may not be available. Moreover, we believe that the situations in which a United States person is making a payment pursuant to a guarantee of a non-U.S. issuer obligation is not a context that raises a significant risk of non-compliance. Therefore, we believe that it would be appropriate to extend the principles of the general section 862 rule (treating payments made by a guarantor as payments with respect to the guaranteed obligation) to the information reporting exemption for foreign-source interest, thereby permitting a U.S. guarantor to make payments with respect to such debt outside the United States without being subject to the risk that it would be unable to satisfy the information reporting requirements.

I. Clarification of Foreign-Targeted Registered Bond Rules.

The Notice provides that the special documentation regime for foreign-targeted registered-form obligations[93] ("FTROs") will not apply with respect to securities issued after 2008. However, we anticipate that the Notice's conclusion that securities held through certain dematerialized systems are treated as in registered form will increase the significance of the FTRO rules over the next few years. Those rules have not been updated in a number of years,

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91 Treasury Regulation §1.862-1(a)(5).

92 The information reporting exemptions for portfolio interest in Treasury Regulation §§1.6049-5(b)(7) and (8) do not apply to foreign-source interest.

93 *See* Treasury Regulation §1.871-14(e).

raising certain technical issues regarding their implementation in the context of dematerialized systems currently in use in the international capital markets.

Treasury Regulation §1.871-14(e)(1) provides that the special FTRO documentation rules apply to foreign-targeted obligations in registered form "if the interest is paid by a U.S. person, a withholding foreign partnership, or a U.S. branch . . . to a registered owner at an address outside the United States, provided that the registered owner is a financial institution described in section 871(h)(5)(B)." This language raises a couple of technical questions. First, interest on foreign-targeted obligations typically is paid through a paying agent that is not a United States person. The literal language of the regulations quoted above could be read as suggesting that, although a U.S. issuer may be eligible for the benefits of the FTRO rules, any foreign paying agents are not so eligible and thus must collect Forms W-8. This interpretation clearly is at odds with the purpose of the FTRO rules and would serve no apparent compliance objective, but it would be helpful if the rules clearly provided that a non-U.S. paying agent for a U.S. issuer also could rely on the rules.

Second, as discussed elsewhere in this report, in some circumstances it may be unclear whether the registered holder of dematerialized securities is the clearing organization through which the securities are held or the clearing organization's participants. Moreover, in some – but not all – dematerialized systems, payments are not made through the clearing organization, but rather are made directly to the clearing organization's participants. Because the FTRO rules technically require that the payment be made to the "registered owner," it is important that market participants be able to identify that person. Thus, it would be helpful if the FTRO rules were clarified to provide explicitly that, in the context of securities held through a

clearing organization, the payment may be made either to the clearing organization or to its participants.

Finally, the FTRO rules define "clearing organization" as "an entity which is 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."[94] It is our understanding that, under the local law applicable to some clearing organizations, such organizations are not treated as "holders" of securities. More generally, in the context of dematerialized securities, the clearing organization may in fact not "hold" an instrument of any type. Thus, we believe that it would be helpful if the language quoted above were clarified to provide that a clearing organization is an entity that is in the business of "holding obligations for, or reflecting the ownership interests of, member organizations. . . ."

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94 Treasury Regulation §1.871-14(e)(3)(i)(B).