

US Inbound Newsalert

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*IRS provides guidance on repeal of
portfolio interest exemption for bearer
bonds and the expanded scope of
registered obligations*

Overview

Section 502 of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (the "HIRE Act") repealed the application of the portfolio interest exemption for bearer bonds issued after March 18, 2012. The legislation also: (1) expanded the scope of obligations that will be considered to be in registered form by generally treating dematerialized obligations issued pursuant to a book entry system, or obligations issued under any other book entry system specified by the Secretary of the Treasury, as obligations in registered form and (2) authorized the Secretary to waive the requirement of obtaining Forms W-8BEN from beneficial owners in appropriate cases. Notice 2012-20, issued March 7, 2012, implements these changes by defining when an obligation will be considered to be issued pursuant to a dematerialized or immobilized book entry system and providing for a waiver of the need to obtain Forms W-8BEN from beneficial owners under specified circumstances. The Notice also addresses the continued availability of the exception under section 6049 from reporting of interest or original issue discount for certain foreign-targeted short-term debt obligations and clarifies the procedures required to comply with the foreign-targeting rules of section 4701(b).



Background

Prior to the application of the HIRE Act, issuers of bearer debt obligations) generally were subject to the following U.S. federal income tax treatment except in the case of bearer debt that complied with the foreign-targeting rules of section 163(f)(2)(B) Treas. Reg. § 1.163-5(c)(2)(i)(D) ("TEFRA D"):

- Interest deductions under section 163(f) could be disallowed to the issuer;
- Excise tax could be imposed under section 4701;
- Gain on the sale or disposition of certain bearer obligations could be treated as ordinary income rather than as capital gain;
- A deduction under section 165(j) could be disallowed for any loss sustained on certain bearer obligations; and
- The section 871(h) and 881(c) exception from U.S. federal income tax for U.S.-source portfolio interest received by a nonresident alien or foreign corporation (the "portfolio interest exception") did not apply.

While most obligations intended to qualify for the portfolio interest exemption are issued in traditional registered form, another common method of issuing portfolio debt is for the obligation to be distributed through clearing houses in either immobilized form or dematerialized form, with distribution through the clearing house system conforming to the TEFRA D foreign targeting rules. A common example is where the issuer of the debt provides a "global certificate" in bearer form to the clearing house which holds the global certificate and, through its members and dealers, distributes interests in the obligation through a book entry system. Notice 2006-99 describes a "dematerialized" system of distribution, similar to the above common example except that there is no global certificate. The Notice generally treats such obligations as being in registered form.

Pursuant to the HIRE Act, the portfolio interest exception no longer applies with respect to U.S.-source interest on bearer obligations issued after March 18, 2012, regardless of whether such bearer obligations are "foreign-targeted obligations" described in section 163(f)(2)(B) and TEFRA D. As a result of this change in law, with respect to obligations issued after March 18, 2012, the portfolio interest exception applies only to obligations issued in registered form; the exception no longer applies with respect to any obligations issued in bearer form.

When obligations are considered to be in registered form

Prior to the issuance of Notice 2012-20, an obligation could qualify as a registered obligation if, *inter alia*, (1) transfer of the obligation could be effected solely by a surrender of the old instrument and an issuance (or reissuance) of the instrument to a new holder, or (2) the obligation was transferable only through a book entry system maintained by the issuer or its agent.

Observation: The determination of whether an obligation meets the portfolio interest criteria can be challenging, particularly for holders of the obligation. There are several criteria that must be met and there is limited guidance on how to interpret the rules. Questions often arise as to whether the issuer's registration rules meet the registration requirement, whether any or all of the interest is in the disqualified category of contingent interest, and

whether the holder of the obligation has a 10% or greater interest in the issuer, such that the portfolio interest exemption is inapplicable.

In response to comments expressing concern that the Notice 2006-99 reference to a dematerialized book entry system might create uncertainty regarding obligations issued in a manner other than the dematerialized book entry system described in the Notice (such as "immobilized" obligations), Notice 2012-20 states that the Treasury and IRS intend to issue regulations providing that an obligation will be considered to be in registered form if it is issued through (i) a "dematerialized" book entry system in which beneficial interests are transferable only through a book entry system maintained by a clearing organization, or (ii) a clearing system in which the obligation is "effectively immobilized." For this purpose, an obligation will be considered to be effectively immobilized, and therefore treated as a registered obligation if: (1) the obligation is represented by one or more global securities in physical form that are issued to and held by a clearing organization or its agent for the benefit of purchasers of interests in the obligation under arrangements that generally prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms, and (2) beneficial interests in the underlying obligation are transferable only through a book entry system maintained by the clearing organization or its agent.

In general, an obligation is not "registered" for purposes of the portfolio interest exception if it can be converted at any time in the future into a bearer obligation. Notice 2006-99 provided a limited exception to this rule such that an obligation would be treated as "registered" in the specific case of a dematerialized book entry system that provided for the issuance of physical certificates in bearer form in the "extraordinary" event that the book entry system went out of existence.

Notice 2012-12 extends this exception to immobilized obligations as well as dematerialized obligations, and broadens the range of extraordinary events under which a bearer obligation may be issued to include the termination of the clearing organization's business without a successor, default by the issuer, or issuance of definitive securities at the issuer's request upon a change in tax law that would be adverse to the issuer but for the issuance of physical securities in bearer form.

Temporary extension of the portfolio interest exception to certain foreign-targeted registered obligations issued after March 18, 2012 and before January 1, 2014

The portfolio interest exception generally is available for holders of registered obligations only if a U.S. withholding agent receives a statement, typically provided on a Form W-8BEN, that the beneficial owner of the obligation is not a U.S. person. The foreign targeting rules that applied to bearer bonds eliminated the need for Forms W-8BEN and facilitated the issuance of portfolio debt in certain foreign markets. In light of comments noting that it may be difficult for withholding agents to obtain such statements in certain foreign markets where Forms W-8BEN traditionally have not been required, Notice 2012-20 provides a temporary rule waiving the Form W-8BEN requirement for obligations issued after March 18, 2012 and before January 1, 2014. For such obligations, the foreign-targeted registered obligation rules of Treas. Reg. § 1.871-14(e) may be applied. Those rules require that the withholding agent receive certification from the financial institution receiving the interest payment that interests in the obligations are not held by U.S. persons under procedures detailed in Treas. Reg. § 1.871-14(e).

Observation: The temporary nature of the waiver, described as a "limited transition rule," leaves open the question of whether all obligations issued on or after January 1, 2014 will require that withholding agents obtain Forms W-8BEN from the beneficial owners of the interest, a requirement that could prove troublesome in the future. It is presently anticipated that the FATCA rules, also added by the HIRE Act and intended to police tax evasion by U.S. persons holding financial interests through foreign financial institutions, will be largely in effect. Since it is expected that every major clearing house will be compliant with the FATCA rules, requiring Forms W-8BEN for obligations distributed through those clearing houses would seem redundant and unnecessary.

Exception from section 6049 reporting for certain foreign-targeted short-term obligations

Treas. Reg. § 1.6049-5(b)(10), which relates to information reporting of interest paid with respect to certain "jumbo" (over \$500,000) short-term original issue discount ("STOID") instruments, currently requires information reporting with respect to the payees unless the instruments meet the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (describing the requirements for foreign-targeted obligations). Although the HIRE Act has removed the concept of foreign-targeted obligations from section 163(f)(2)(B), Notice 2012-20 confirms that the section 6049 STOID exception from information reporting requirements continues to be available. According to Notice 2012-20, it is anticipated that future regulations will allow this exception to apply if the requirements for "foreign-targeted obligations" in Treas. Reg. 1.163-5(c)(2)(i)(D) are satisfied.

Notice 2012-20 guidance on compliance procedures for section 4701(b) foreign-targeting rules

Section 4701 imposes an excise tax on the issuer of a registration-required obligation that is not in registered form." Prior to enactment of the HIRE Act, the term "registration-required obligation" under the excise tax provision of section 4701(b) had the same meaning as when used in section 163(f), except that the term did not include any obligation required to be registered under section 149(a), which relates to certain obligations that are exempt from U.S. federal income tax. Under the HIRE Act, registration also would not be required for obligations issued after March 18, 2012 that meet criteria similar to the foreign targeting rules under pre-HIRE Act section 163(f)(2)(B). Notice 2012-20 states that under future regulations, for purposes of determining when an obligation is "registration-required" for excise tax purposes, rules identical to those that apply under pre-HIRE Act section 163(f)(2)(B) and the corresponding regulations will apply to obligations issued after March 18, 2012.

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