

## *Recent IRS Guidance on Repeal of Bearer Bond Exception: Notice 2012-20*

BY KRISTEN CHANG WINCKLER & MARCIA N. PERSAUD

As a result of the repeal of the foreign targeted bearer bond exception by the "Hiring Incentives to Restore Employment Act" (the "HIRE Act"), U.S. bonds issued after March 18, 2012 generally must be in registered form in order for the issuer to benefit from deductibility of interest payments and for foreign holders to obtain "portfolio interest" payments exempt from U.S. withholding tax.<sup>1</sup> On Wednesday, March 7, 2012, the Internal Revenue Service (the "IRS") released [Notice 2012-20](#) (the "Notice") which provided guidance (i) clarifying when an obligation will be treated as being in registered form under U.S. tax principles, particularly with respect to dematerialized book entry systems, (ii) creating a transition period that temporarily extends a foreign-targeted registered obligation exception to the withholding certification requirements of the portfolio interest exemption and (iii) addressing the application of the foreign targeted exception to the issuer excise tax.

### **Clarification of Bonds in Registered Form**

Bonds are in registered form for purposes of these rules if ownership of the bond, i.e., the right to principal and interest on the bond, is reflected on, and may only be transferred through, a book entry (record of ownership) system maintained by the issuer or its agent. Generally, an obligation will not be considered registered if it can be converted at any time to bearer form. IRS Notice 2006-99 permitted an exception for bonds held in a dematerialized book entry system maintained by a clearing house and notwithstanding the possibility that such bonds could be converted to bearer form upon termination of the clearing house without a successor.

The HIRE Act codifies the treatment of obligations held through a dematerialized book entry or other book entry systems specified by the Treasury as being in registered form. However, the HIRE Act failed to provide guidance on what would constitute a dematerialized book entry system. The Notice clarifies this issue by providing that an obligation will be considered to be in registered form if such obligation is issued through:

- a dematerialized book entry system in which beneficial interests are transferable only through a book entry system maintained by a clearing organization,<sup>2</sup> or by an agent of such clearing organization, or
- a clearing system in which such obligation is effectively immobilized.

An obligation is effectively immobilized if two requirements are satisfied:

- the obligation is represented by one or more global securities in physical form that are issued to and held by a clearing organization, or by a custodian or depository acting as an agent of such clearing organization, for the benefit of purchasers of interests in the obligation under

arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms and

- the beneficial interests in the underlying obligation are transferable only through a book entry system maintained by the clearing organization or an agent of the clearing organization.

The Notice provides that beneficial interests in obligations will be treated as being transferable only through a book entry system, and thus be in registered form, notwithstanding that holders of such obligations may obtain physical certificates in bearer form in the following situations:

- 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 such issuer but for the issuance of physical securities in bearer form.

However, if one of the above mentioned situations occurs and a holder, or a group of holders acting collectively, has the right to obtain a physical certificate of an obligation in bearer form, such obligation will no longer be treated as being in registered form at such time. This is true regardless of whether the holder has actually exercised any option to obtain a physical certificate in bearer form.

### **Temporary Extension of the Foreign-Targeted Registered Obligation Exception**

As stated above, the HIRE Act eliminated the foreign targeted bearer bond exception with respect to the portfolio interest exemption for U.S. withholding tax. Thus, in order to claim the portfolio interest exemption on bonds issued after March 18, 2012, the bond must be in registered form. Generally, to qualify for the portfolio interest exemption on a registered bond, the applicable withholding agent must receive a statement, typically on IRS Form W-8, from the beneficial owner or a securities clearing organization, bank or other financial institution that holds customers' securities in the ordinary course of its trade or business ("qualifying financial institutions"), that such beneficial owner is not a U.S. person. This certification requirement was not applicable to foreign targeted bearer bonds.

Due to public concern expressed over the transition to the rules applicable to registered bonds, the Notice provides temporary, alternative certification procedures for obligations that are "foreign-targeted registered obligations" issued after March 18, 2012 and before January 1, 2014.<sup>3</sup>

Generally, a "foreign-targeted registered obligation" is an obligation that is sold only to foreign persons in accordance with procedures similar to those that qualified an obligation for the foreign targeted exception to registration. Interest paid on such a bond outside of the U.S. to certain qualifying financial institutions may qualify for the portfolio interest exemption if such institution certifies to the withholding agent that the beneficial owner will not be a U.S. person and that the financial institution will provide notification to the withholding agent of any U.S. beneficial ownership with respect to the applicable holding period of the obligations.<sup>4</sup>

The Notice adds that a financial institution may make such certification if such financial institution has determined the non-U.S. status of such beneficial owner, as required by the applicable certificate, by obtaining either (a) an IRS Form W-8 (or substitute form) or (b) documentary evidence that satisfies the U.S. information reporting rules for payments to offshore accounts under Treasury Regulation §1.6049-5(c).

### Foreign Targeted Exception for Issuer Excise Tax

The HIRE Act retains the foreign targeted bearer bond exception with respect to the issuer excise tax. Without such exception, an issuer would be subject to an excise tax equal to 1% of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) between the issue date and the maturity date of such obligation. The Notice clarifies that for purposes of this issuer excise tax, the rules of the foreign targeted bearer bond exception for obligations issued after March 18, 2012 will be identical to those rules and regulations currently applicable to foreign targeted bearer bonds.

### Effective Date

The Treasury and the IRS intend to issue regulations implementing the guidance in the Notice, which will be effective for obligations issued after March 18, 2012.



*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

#### New York

Marcia N. Persaud  
1.212.318.6741  
marciapersaud@paulhastings.com

Kristen Chang Winckler  
1.212.318.6047  
kristenwinckler@paulhastings.com

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<sup>1</sup> For additional information regarding the general repeal of the foreign targeted bearer bond exception, refer to our [March 2012 Client Alert](#).

<sup>2</sup> For this purpose, a clearing organization is 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.

<sup>3</sup> Notice 2006-99, 2006-2 C.B. 907 had previously provided that the foreign-targeted registered obligation exception would be eliminated for obligations issued after December 31, 2006, except in limited circumstances.

<sup>4</sup> Treas. Reg. §1.871-14(e).