

## Recent US Bills would Affect Certain "Foreign Targeted" Bearer Bonds

January 29, 2010

On December 9, 2009, the U.S. House of Representatives passed H.R. 4213, the Tax Extenders Act of 2009 (the "Tax Extenders Bill"),<sup>1</sup> which incorporates and modifies certain provisions of the Foreign Account Tax Compliance Act (the "Foreign Account Bill"), a bill proposed on October 27, 2009. Included in the Foreign Account Bill and the Tax Extenders Bill is a set of rules designed to discourage tax evasion, including provisions that would affect certain obligations issued in bearer form by both US and non-US issuers. The provisions of the Tax Extenders Bill still need US Senate and White House approval.

Bearer bonds, which lack formal registration identifying their holders, allow investors to remain anonymous, potentially providing non-compliant US beneficial owners with an opportunity for tax avoidance.

Current US tax law significantly restricts the issuance of bearer bonds. In order to avoid detrimental US tax implications, a debt obligation is required to be in registered form (a "Registration-required Debt Obligation") unless it 1) is made by a natural person, 2) matures in one year or less, 3) is not of a type offered to the public, or 4) is a "foreign-targeted obligation."<sup>2</sup> A foreign-targeted obligation is a debt obligation that 1) is designed to be sold (or resold in connection with the original issue) only to non-US persons, 2) only pays interest outside the United States, and 3) has a legend stating that US persons who hold the obligation will be subject to limitations under US income tax laws, including the limitations in Sections 165(j) and 1287(a) (the "Statutory TEFRA Exception Requirements").<sup>3</sup>

Regulations implementing the Statutory TEFRA Exception Requirements introduced two alternative procedures, known as "TEFRA C" and "TEFRA D," to ensure that a debt obligation will be treated as foreign-targeted. Under the so-called "TEFRA D" rules, the legend described above must be included on the debt obligation and 1) the issuer and distributor cannot offer or sell the obligation during a restricted 40-day

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<sup>1</sup> The text of the Tax Extenders Bill is available [here](#).

<sup>2</sup> An obligation generally is treated as issued in registered form if the right to the principal of and stated interest on the obligation can be transferred only through a book-entry system maintained by the issuer or its agent. See Sections 163(f)(3) and 149(a); see also Treas. Reg. § 5f.103-1(c). Unless otherwise noted, all references to sections herein are to sections of the Internal Revenue Code of 1986, as amended, and all references to regulations are to the U.S. Treasury Department regulations (the "Regulations") issued or proposed thereunder.

<sup>3</sup> Section 163(f)(2)(B); Treas. Reg. § 1.163-5(c)(1)(ii)(B).

period to a person within the United States or to a US person, 2) during such restricted period, neither the issuer nor any distributor may deliver the obligation in definitive form within the United States, and 3) certain certifications must be produced on the earlier of the date of the first payment of interest on the obligation or the date of delivery by the issuer of the obligation in definitive form.<sup>4</sup> Under the "TEFRA C" rules, generally no legend is required if a bearer bond is issued only outside the United States by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such bond and interest on such bond is payable only outside the United States.<sup>5</sup>

A Registration-required Debt Obligation that is not in registered form is subject to substantial sanctions. US and non-US issuers of such an obligation are subject to an excise tax equal to one percent of the principal amount of the obligation multiplied by the number of calendar years from the issuance date until maturity.<sup>6</sup> If the issuer does not pay the excise tax, 1) gain on the sale or other disposition of the debt obligation by a US holder will be treated as ordinary income, and 2) any loss on such transaction will not be deductible.<sup>7</sup>

In addition to the one percent excise tax, a US issuer of such an obligation is denied a deduction for interest paid or accrued thereon.<sup>8</sup> From a foreign holder's perspective, interest paid or accrued on a Registration-required Debt Obligation issued by a US person that is not in registered form is subject to a 30 percent withholding tax (subject to reduction under an applicable income tax treaty). This interest does not qualify for the portfolio interest exception.<sup>9</sup>

The Foreign Account Bill would potentially foreclose the use of bearer bonds as a viable financing alternative by completely repealing the exceptions for foreign-targeted obligations, thereby imposing the one percent excise tax on all US and non-US issuers of bearer bonds. The bill also would repeal a provision in Title 31 of the U.S. Code that currently permits the US government to issue foreign-targeted obligations in bearer form.

The Tax Extenders Bill mitigates the excise tax result prescribed in the Foreign Account Bill for all issuers by preserving an exception to the registration requirement for excise tax purposes provided, generally, that the current Statutory TEFRA Exception Requirements are satisfied. In the

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<sup>4</sup> Treas. Reg. § 1.163-5(c)(2)(i)(D).

<sup>5</sup> Treas. Reg. §§ 1.163-5(c)(1)(ii)(A), 1.163-5(c)(1)(ii)(B), 1.163-5(c)(2)(i)(C).

<sup>6</sup> Section 4701.

<sup>7</sup> Sections 165(j), 1287(a). Treas. Reg. § 1.165-12(a).

<sup>8</sup> Section 163(f). Although this limitation also technically applies to a foreign issuer, it would only have an adverse tax effect if such issuer were engaged in a US trade or business to which this expense could be allocated.

<sup>9</sup> Sections 871(h)(2), 881(c).

absence of further guidance, the Tax Extenders Bill would require all bearer bonds (including bonds issued by non-US issuers to non-US investors) to comply with all Statutory TEFRA Exception Requirements, including the legend requirement. Since there would appear to be no enforcement reason not to allow TEFRA C compliant bonds (which, among other things, do not carry a legend) to qualify for the excise tax exception, further revision or guidance to do so under this provision would be justified.

Relevant to US issuers, the Tax Extenders Bill retains the proposed repeal of the foreign-targeted obligation exception as applied to the denial of interest deductions for bonds not issued in registered form. It also would continue to deny the benefit of the portfolio interest exception to interest paid by US issuers on bearer obligations, irrespective of whether the obligations are offered only to foreign persons. This requirement would appear to compel US persons only to issue registered bonds and collect IRS Forms W-8 from holders to meet the requirements for 0 percent withholding on US-source interest under the portfolio interest exception. The Tax Extenders Bill, however, authorizes the Secretary of the Treasury to waive the obligation to collect forms when it is "not required in order to carry out the purposes" of the provision. The Technical Explanation of the Tax Extenders Bill anticipates that the Secretary of the Treasury may waive this requirement in circumstances where there is a low risk of tax evasion and there are adequate documentation standards in the beneficial owner's country of tax residency. This is a welcome grant of additional authority to the Treasury Secretary.

Apparently as a means to decrease the impact of these measures pertaining to bearer bonds, the Tax Extenders Bill confirms that a "dematerialized" book-entry system will be treated as a book-entry system that satisfies the registration requirements. Under such a system, a debt obligation that is formally issued in bearer form will nonetheless be treated as issued in registered form (and hence will avoid the detrimental tax consequences described above) as long as the debt obligation may be transferred only by book entry 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 in the ordinary course of business.<sup>10</sup> It appears, however, that further clarification of this rule may be needed. Recently, commentators, including the Tax Section of the New York State Bar Association, have pointed out that the use of the term "dematerialized" by the Tax Extenders Bill may be technically incorrect. Based on the Technical Explanation of the Tax Extenders Bill, it is apparent that the rule was intended to cover a structure involving a "global

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<sup>10</sup> See Joint Committee on Taxation, Technical Explanation of H.R. 4213, the "Tax Extenders Act of 2009," as Introduced in the House of Representatives on December 7, 2009 (JCX-60-09), December 8, 2009, at 142 (citing IRS Notice 2006-99, 2006-2 CB 907), available [here](#).

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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note" issued in "physical," bearer form and traded through a clearing house, although such an obligation is not fully "dematerialized." It should be made clear that such an obligation also would be treated as issued in registered form.<sup>11</sup>

The bearer bond provisions would be effective for debt obligations issued two years after the date of enactment of the Tax Extenders Bill (rather than after 180 days, as specified in the Foreign Account Bill). The revised effective date under the Tax Extenders Bill is a welcome relief as it would give issuers additional time to conform to the new requirements and revise their debt programs.

*For more information, please contact Julio Castro at +44 20 7459 5374 or [jcastro@dl.com](mailto:jcastro@dl.com); Todd McArthur at +1 202 346 7830 or [tmcArthur@dl.com](mailto:tmcArthur@dl.com); Tamara W. Ashford at +1 202 402 8017 or [tashford@dl.com](mailto:tashford@dl.com); Walburga Kullmann at +49 69 3639 3320 or [wkullmann@dl.com](mailto:wkullmann@dl.com); Gordon Warnke at +1 212 259 6070 or [gwarnke@dl.com](mailto:gwarnke@dl.com); or your Dewey & LeBoeuf relationship attorney.*

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<sup>11</sup> See New York State Bar Association Tax Section, *Comments on the Foreign Account Tax Compliance Legislation* (Report No. 1199, Jan. 11, 2010), available [here](#).