Introduction


Background

The Code imposes various sanctions on issuers and holders of bearer debt obligations, other than in the case of certain limited categories of bearer debt that are not “registration-required.” In the case of bearer debt of U.S. issuers, the sanctions include denial of any deduction for the interest on the bearer debt and loss of the portfolio interest exemption from withholding. U.S. investors who acquire bearer debt generally lose the ability to deduct losses on the debt and cannot treat gains from the debt as capital gains subject to preferential tax rates. A non-U.S. issuer of bearer debt may be subject to a substantial excise tax. An exception to these sanctions was available for “foreign-targeted” bearer debt. The procedures required to satisfy the foreign-targeted exception were contained in the so-called “TEFRA C” and “TEFRA D” rules.

Bearer debt is broadly defined for these purposes to mean any obligation that is not in “registered form.” An obligation is treated as in registered form only if (1) the instrument is registered as to both principal and interest with the issuer and a transfer can be effected only by surrender of the old instrument and reissuance of a new instrument or (2) the right to principal and stated interest may be transferred only through a book entry system maintained by the issuer or its agent, or any combination of (1) and (2).
If it is possible to convert an obligation into a form that is not “registered,” then the obligation is considered to be a bearer obligation from inception (the “convertible-to-bearer” rule).

In practice, debt issued through clearing systems is transferred only through book entries despite the issuance of a global “bearer” note to the clearing system. In the past, issuers and their advisors took the view that the possibility that a global bearer note held by a clearing system could be exchanged for definitive bearer notes, albeit in very limited circumstances like the clearing system going out of business, meant that under the convertible-to-bearer rule above the debt obligation was not in registered form.

In 2006, the IRS issued Notice 2006-99\(^2\) (the “JADEC Notice”) suggesting that the remote possibility of an exchange into definitive bearer notes did not convert a global obligation that is otherwise transferable only through a book entry system into bearer debt. However, the precise parameters of the JADEC Notice were unclear.

**The HIRE Act and Notice 2012-20**

The Act repealed the “foreign-targeted bearer” exemption for U.S. issuers by eliminating that provision from the Code. Thus, after the effective date of these new provisions (March 18, 2012, two years after the Act was signed into law), U.S. issuers may no longer rely on the “TEFRA D” regulations to issue bearer debt instruments. However, in the case of non-U.S. issuers, the Act provided that any instrument that met the requirements of the “foreign-targeted bearer” exemption would not be subject to the excise tax. Notice 2012-20 clarifies that the IRS intends to promulgate rules substantially identical to the former “TEFRA C” and “TEFRA D” to further define the exemption.

The Act also codified the conclusion that an obligation issued under a dematerialized book entry system is “registered” for federal income tax purposes. A dematerialized book entry system is one where there are no physical certificates issued for bonds and the bonds are only transferable by book entry through a clearing organization. Bonds may be dematerialized notwithstanding they are labeled “bearer” for business and regulatory reasons in non-U.S. markets such as the European market.

Notice 2012-20 provides additional guidance in several areas related to the Act. In particular, the Notice provides that obligations will be considered to be in registered form if issued through a dematerialized book entry system or a clearing system in which the obligation is effectively immobilized. An obligation is effectively immobilized if the only holder of physical global form (bearer) certificates is a clearing organization, the physical certificates can only be transferred to a successor clearing organization and the beneficial interests in the underlying obligation are only transferrable on a book entry system maintained by the clearing organization. The obligation may be considered to be in registered form even if a physical certificate is available in certain circumstances. Those circumstances are limited to termination of the clearing organization’s business, 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 unless securities are issued in physical bearer form.

**Consequences for Issuers**

Various information reporting requirements were premised on foreign-targeted bearer bond status and issuer documentation was typically drafted to satisfy the former rules. As a result of the Act, Notice 2012-20 and the JADEC Notice, many obligations issued by non-U.S. issuers in global form that were formerly considered “bearer” obligations may now properly be considered “registered form” obligations. **Documentation used by non-U.S. issuers (such as medium-term note program documentation) may contain “TEFRA C” and “TEFRA D” selling restrictions and information reporting provisions premised on a “bearer” status of the obligations issued that is no longer appropriate. Issuers should therefore consider undertaking a comprehensive review of any such programs or documentation to ensure it appropriately addresses U.S. federal income tax withholding and information reporting considerations in light of the changes to the law described above.**