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Re: Section 163(f)(3) Guidance

Ladies and Gentlemen:

On behalf of the Securities Industry and Financial Markets Association,[1] I am writing to draw your attention to the urgent need for guidance under Section 163(f) of

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

the U.S. Internal Revenue of Code of 1986 (the "Code") as amended by the Hiring Incentives to Restore Employment (HIRE) Act of 2010 (enacted March 18, 2010, the "Hire Act").

Section 163(f)(3) provides that "a dematerialized book-entry system or other book-entry system specified by the Secretary shall be treated as a book-entry system". Guidance is needed as to whether notes in global bearer form deposited with an international central securities depositary will be treated as held in a "dematerialized book entry system" within the meaning of Section 163(f)(3, or whether such a system needs to be specified by the Secretary as a system that "shall be treated as a book-entry system". Guidance is also needed as to the circumstances under which a note that, although treated as held through a book-entry system, will or will not be treated as being in "registered form" by reason of the ability of holders to receive bearer definitive securities upon extraordinary circumstances. This guidance is urgently needed because issuers of bearer debt need sufficient time to update program documents before Section 163(f) becomes fully effective on March 18, 2012 (i.e., when the existing U.S. tax rules relating to bearer debt issuances expire in many instances). A failure to provide timely guidance could result in significant confusion and market dislocation in the global debt markets as issuers, clearinghouses, and withholding agents struggle to differentiate grandfathered obligations from non-grandfathered obligations.

Background

In 1982, Congress passed the Tax Equity and Fiscal Responsibility Act ("TEFRA"), which establishes U.S. tax rules with respect to the issuance of debt instruments in bearer form. Under TEFRA, issuers of debt instruments in bearer form generally are denied deductions for U.S. federal income tax purposes for interest paid with respect to such debt instruments and are subject to an excise tax (equal to 1% of the principal amount of the bonds times the number of years to maturity). Various sanctions also apply to holders. The aforementioned sanctions, however, do not apply with respect to bearer debt instruments that are issued under circumstances in which they are unlikely to be sold to U.S. persons. These circumstances include an issuance of foreign-targeted bearer debt instruments that complies with Treasury regulations referred to as "TEFRA C" and "TEFRA D."

The U.S. imposes a 30% withholding tax on all U.S. source interest paid to non-resident aliens and foreign corporations. In 1984, however, Congress exempted "portfolio interest" from the U.S. withholding tax. Portfolio interest is any U.S. source interest other than interest received from certain related parties, or interest earned by a bank on an extension of credit in the ordinary course of its lending business. In addition, debt instruments in bearer form do not qualify for the portfolio interest exemption (with the result that interest paid on such instruments is generally subject to the 30% U.S. withholding tax) unless such instruments are issued in compliance with TEFRA C or TEFRA D.

Many U.S. issuers have medium-term note or other foreign-targeted programs under which they issue bearer notes in compliance with TEFRA C or TEFRA D. In addition, many non-U.S. issuers include TEFRA restrictions in their debt offerings outside the U.S. to ensure that they are not subject to the TEFRA excise tax.

Sanctions on Issuances of Bearer Bonds

For notes issued after March 18, 2012 the Hire Act ends the practice by U.S. issuers of selling bearer debt instruments to foreign investors under TEFRA C and TEFRA D. Thus, with respect to U.S. issuers of foreign-targeted bearer debt instruments, the Act repeals the exception to a denial of interest deduction for interest on bearer debt instruments. In addition, interest paid on such instruments will no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% withholding tax, and any gain realized by a holder of such bonds would be treated as ordinary income. As a result, U.S. issuers will have to revise their existing issuance programs to prohibit bearer debt instruments after March 18, 2012.

Committee Report

In connection with the repeal, the Hire Act also amended Section 163(f) to provide that "a dematerialized book-entry system or other book-entry system specified by the Secretary shall be treated as a book-entry system". The Joint Committee's technical explanation of the Hire Act (the "Committee Report")[2] explains that "the provision provides that a debt obligation held through a dematerialized book-entry system, or other book-entry system specified by the Secretary, is treated, for purposes of section 163(f), as held through a book-entry system for the purpose of treating the

[2] Joint Committee on Taxation Publication, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN SENATE AMENDMENT 3310, THE HIRING INCENTIVES TO RESTORE EMPLOYMENT ACT, UNDER CONSIDERATION BY THE SENATE, JCX-4-10 (23 February 2010).

obligation as in registered form. A debt obligation that is formally in bearer form is treated, for the purposes of section 163(f) as held in a book-entry system as long as the debt obligation may be transferred only through a dematerialized book-entry system or other book-entry system specified by the Secretary." The Committee Report continues that "in applying this requirement, the IRS has adopted a flexible approach that recognizes that a debt obligation that is formally in bearer (*i.e.*, not in registered) form is nonetheless "in registered form" for these purposes where there are arrangements that preclude individual investors from obtaining definitive bearer securities or that permit such securities to be issued only upon the occurrence of an extraordinary event." The Committee report cites to Notice 2006-99, 2006-2 C.B. 907, noting that in that notice the IRS held that that the registration requirement may be satisfied by "dematerialized book-entry systems" developed in some foreign countries, even if, under such a system, a holder is entitled to receive a physical certificate, tradable as a bearer instrument, in the event the clearing organization maintaining the system goes out of existence, because "cessation of operation of the book-entry system would be an extraordinary event."

Guidance Request

It is clear from 163(f)(3) that debt instruments cleared through a system where a physical security is never issued (for instance, JASDEC in Japan) will be treated as held through a dematerialized book-entry system. However, in many markets, a global note is issued in bearer form and this note is held (and is effectively immobilized) by a depositary for a clearing organization. In these cases, bearer form is, for various reasons and aside from any potential local legal requirements, the commonly accepted or sole form for debt issuance in some non-U.S. markets. It is not certain without Treasury guidance, though, whether a system where a global bearer certificate is issued and held by a depositary will be treated as a "dematerialized book-entry system" for purposes of Section 163(f)(3), or whether such a system needs to be specified by the Secretary as a system that "shall be treated as a book-entry system".

In cases where a permanent global note is issued and held through a clearing system, the ownership of interests in the global note will be shown on, and transfers of such ownership will be effected only through, the clearing organization's computerized book-entry system. The same is generally true (i.e., the note may be transferred only by the clearing organizations' book-entry system) in cases where a note is issued through a dematerialized book-entry system. Accordingly, there should not be any reason to distinguish between cases where no permanent global note is issued (such as JASDEC) and cases where a permanent global note in bearer form is issued (such as Euroclear Bank and Clearstream) but held effectively immobilized by a depositary as there are no

obvious real world distinctions between the two cases. In fact, the IRS has issued private letter rulings that treat bearer instruments that have been immobilized in a trust as effectively registered.[3]

SIFMA therefore requests that Treasury clarify that notes in global bearer form deposited with an international central securities depositary will be treated the same as if held in a "dematerialized book-entry system" within the meaning of Section 163(f)(3), or that such notes will otherwise be treated as held in a book-entry system, provided that the global bearer note may not be transferred by a depositary prior to maturity or early retirement and the ownership of beneficial interests in such global note may be transferred only through the book-entry system.

SIFMA further requests that Treasury clarify that debt instruments held through such systems will continue to be treated as in registered form for U.S. federal income tax purposes notwithstanding the possibility that investors, in very limited circumstances, could get definitive bearer certificates.

In particular, as confirmed in Notice 2006-99, 2006-2 C.B. 907 for dematerialized book-entry systems, debt instruments held in a book-entry system should be treated as in registered form notwithstanding the possibility that investors could get definitive bearer certificates in the remote event a clearing system goes out of existence. For similar reasons, debt instruments held in a book-entry system should be treated as in registered form notwithstanding the possibility that investors could get definitive bearer certificates in the event that the issuer files for bankruptcy or becomes insolvent. Under local law, investors may need definitive bearer certificates to prove entitlement upon making a claim.

Some non-US issuers may wish to retain treatment of their debt instruments as bearer form for U.S. federal income tax purposes. In this regard, it would be helpful to clarify that the unfettered right of a holder to request a definitive bearer certificate (whether or not the holder is required to pay the cost of printing the certificate) is sufficient to cause the issuance to be treated as in bearer form.

We finally wish to underline the necessity for issuers, arrangers and advisors to bring the required modifications to their issuance documentation well ahead of implementation date, a process which may take several months considering the size of this market after the guidance requested in this letter is provided. Therefore, we

[3] Private Letter Rulings 9343018 and 9343019 (July 29, 1993).

request that Treasury urgently issue the requested guidance in order that issuers have sufficient time to adjust documentation prior to March 18, 2012.

At your convenience, SIFMA members would be pleased to meet with you to discuss these requests. We would also support discussions between yourselves and the international central securities depositaries.

Sincerely,

Kenneth E. Bentsen, Jr.
EVP, Public Policy and Advocacy
Securities Industry and Financial Markets Association

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