Bearer or Registered?
Lingering Issues under TEFRA

For many years my practice required me to advise on numerous debt offerings, mostly, but not exclusively, for foreign issuers. Frequently these securities were offered in bearer form to investors outside the United States. Even a foreign offering for a foreign issuer requires U.S. tax advice, since the U.S. tax law imposes significant tax penalties on issuers of bearer debt securities, unless the securities are properly targeted to offshore investors in compliance with U.S. tax regulations.

Two oddities struck me when dealing with this area of the law. First, for U.S. issuers, the law seemed to favor bearer debt, since U.S. issuers were required to obtain withholding tax forms from investors only if the securities were in registered form. This advantage seemed at odds with the policy of discouraging the issuance of bearer debt generally. Second, there was a remarkable lack of clarity regarding when debt was considered to be in bearer form for tax purposes, and some of the most common arrangements for issuing public debt securities fell right in the gray zone.

Except for a helpful summary of the bearer debt restrictions written by Michael Schler, there was virtually nothing written about these rules. This paper was intended to fill that gap, and to address in particular the mysterious lack of clarity regarding whether a particular debt instrument would be treated as bearer or registered. As I wrote the paper, it became clear that what might have been thought of as a dull backwater in the tax law was rich in interpretive issues of practical significance. And in the absence of other in-depth commentary, the

1 See infra note 53.
paper became a widely consulted resource for practitioners in the field.

There have been several important developments in this area since the paper was published in 2005. The paper was not been updated to reflect those developments, so I briefly summarize them here:

(1) In Notice 2006-99, the IRS stated that dematerialized obligations would be treated as registered, even though they would be converted into physical bearer instruments if there was a “meltdown” of the relevant clearing system. This Notice was issued in response to a request for guidance from the Japanese Securities Depository Center (JASDEC). I represented JASDEC in connection with that request.

(2) In 2010, Congress finally eliminated the tax advantage to U.S. issuers of bearer debt, by limiting the portfolio interest exemption from U.S. withholding tax to debt issued in registered form.

(3) In Notice 2012-20, the IRS stated that securities issued in global bearer form would be treated as registered for tax purposes, if bearer instruments would be issued to holders only in cases of clearing system meltdown, issuer default, or adverse change in tax law affecting the issuer.

These developments largely resolve the conundrums that originally motivated this paper. Yet the paper remains of continuing relevance to U.S. issuers, who need to avoid issuing debt in bearer form, as well as to foreign issuers, who can continue to issue debt in bearer form, but need to understand when U.S. tax restrictions apply.

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3 This Notice was issued in response to a request for guidance from the Japanese Securities Depository Center (JASDEC). I represented JASDEC in connection with that request.


5 2012-13 I.R.B. 574.
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I. INTRODUCTION

The tax law imposes sanctions on U.S. persons who hold bearer debt securities, and on issuers of bearer debt to U.S. persons. Sanctions on the holder include disallowance of deductions for any losses on sale, taxation of any gains at ordinary rates, loss of the withholding tax exemption for portfolio interest, and, in the case of municipal debt, loss of the tax exemption. Sanctions on the issuer include disallowance of the deduction for interest and an excise tax on the


7 The relevant provisions of tax law usually refer to these debt securities as “obligations.” They are often colloquially called “bearer bonds,” perhaps for alliterative reasons, regardless of whether they are secured. Here, I use the terms “debt,” “security,” “bond” and “obligation” interchangeably to refer to investments that are treated as indebtedness for tax purposes; and I use the terms “note” and “instrument” (and sometimes “security”) to refer to the piece of paper, if any, that evidences this indebtedness.

8 I.R.C. § 165(j).
9 I.R.C. § 1287(a).
10 I.R.C. §§ 871(h)(2), 881(c)(2).
11 I.R.C. § 149(a).
12 I.R.C. § 163(f). § 312(m) contains a similar restriction on the deductibility of this interest for earnings and profits purposes, unless the issuer is a foreign corporation that is neither a controlled foreign corporation nor a foreign personal holding company, and the issuance did not have as a purpose the avoidance of these restrictions on deductibility.
issuance.\textsuperscript{13} These are serious consequences, and therefore much depends on whether a particular debt instrument is in registered or bearer form.

In the easy cases, it is obvious whether an obligation is bearer or registered. An obligation is bearer if it is evidenced by a note made payable to “bearer,”\textsuperscript{14} so that legal title can be transferred by physical delivery of the note. An obligation is registered if it is evidenced by a note made payable to a specific holder, and title can be transferred only by surrendering the note to the issuer and having a new note issued in the name of the new holder. Sadly, the easy cases have no relevance to modern securities markets. Securities are traded through clearing systems, with layers of custody, depositary, and brokerage arrangements. Buyers and sellers of these securities rarely see the underlying notes, if any.\textsuperscript{15}

The tax law has struggled to keep up with these evolving arrangements. As a result, in many common circumstances the determination whether a particular issue of debt securities is bearer or registered is not a straightforward exercise. The situation is complicated by the fact that, for offerings by U.S. issuers outside the United States, the U.S. tax law actually favors bearer debt by exempting it from reporting requirements that require holders to disclose their identity to the issuer.\textsuperscript{16} In other cases, conflicting provisions of U.S. and foreign law require that an issue be treated as registered under U.S. law but bearer under foreign law.\textsuperscript{17}

\textsuperscript{13} I.R.C. § 4701(a).
\textsuperscript{14} Yogi Berra recalls, “After doing a radio show with Jack Buck in St. Louis, a check was handed to me made out to ‘Pay to Bearer.’ I turned to Jack and said, ‘You’ve known me all this time and you still can’t spell my name!’” YOGI BERRA, THE YOGI BOOK 89 (1998).
\textsuperscript{15} Uncertificated or dematerialized notes, which are not evidenced by any physical instrument, are discussed infra in Part VI (p. 533).
\textsuperscript{16} I.R.C. §§ 871(h)(2), 881(c)(2); Treas. Reg. § 1.6049-5(b)(7).
\textsuperscript{17} See infra Part V (p. 526).
This article explores the puzzles that arise when trying in a coherent manner to classify debt as bearer or registered under a variety of arrangements for their issuance and trading. It also addresses a few related issues under the rules restricting the issuance and holding of bearer debt.
II. BACKGROUND

A. The Adoption of the Bearer Bond Restrictions

In 1980, after a decade of economic stagnation and periodic high inflation, Ronald Reagan was elected President on a platform that included major tax reductions and increased defense spending. The tax reductions were swiftly enacted as the Economic Recovery Tax Act of 1981, but within a year it was apparent that the federal deficit would grow unacceptably large unless some of these tax reductions were rolled back. The result was the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which repealed or scaled down some of the investment incentives in the 1981 Act, and contained a long list of miscellaneous revenue raisers. The Treasury Department had recently completed a study of the underground economy, which claimed that billions of dollars in tax revenues were lost because of unreported income. A number of measures were proposed to combat

22 For example, TEFRA repealed the safe harbor leasing rules (§ 209, 96 Stat. 442), and reduced depreciable basis by one-half of the investment credit (§ 205(a), 96 Stat. 427).
23 The most significant, by revenue gain, were the repeal of safe harbor leasing, the adjustments to depreciation and the investment credit, and the taxpayer compliance provisions. H.R. Rep. No. 97-760, at 691–93 (1982).
this problem, including expanded information reporting and withholding on investment income.25

Measures to enhance tax enforcement had some political appeal, notwithstanding the Republican Party’s traditional disdain for the IRS,26 because they provided needed revenues without actually increasing taxes. And no one was going to stand up for tax cheats. Bearer bonds are an ideal vehicle for tax evasion because payments are made to the bearer of the instrument without any proof of identity.27 Any measures that restricted the ownership of bearer bonds by United States taxpayers would make it easier for the IRS to track down unreported income.

Two circumstances complicated the implementation of these restrictions. First, the United States by that time had become a debtor nation, and both the federal government and corporate borrowers were hooked on foreign capital.28 That capital was raised in the Euro-markets, which relied principally on bearer securities. Second, the tax committees in Congress wished to control any legislation that was

25 See House Hearings, supra note 24, at 61, 80–84 (statement of Richard Fogel); Joint Hearing, supra note 24, at 9, 11 (statement of Jerome Kurtz).

26 Introducing legislation titled, “The Taxpayers’ Bill of Rights,” Sen. Jesse Helms (R-N.C.) declared that “the harassment of taxpayers by agents of the Internal Revenue Service” is “one of the most blatant civil rights abuses of all times.” 22 TAX NOTES 632 (Feb. 1, 1984). More recently, hearings on the IRS were described as “a central element in a campaign by Congressional Republicans to demonize the tax agency.” John M. Border, Demonizing the IRS: Is an Overhaul Needed, Or Just Less Posturing?, N.Y. TIMES, Sept. 20, 1997, at D1.

27 The topic has even acquired some Hollywood glamour, since bearer bonds were the sought-after contraband in the Eddie Murphy movie BEVERLY HILLS COP (Paramount Pictures 1984). But then, Eddie Murphy could run with a story line based on commodity futures. See (really!) TRADING PLACES (Paramount Pictures 1983).

drafted to address this issue,\footnote{For the growing power of the tax committees during this period, see C. Eugene Steuerle, The Tax Decade 77–78 (1991)} and the Treasury Department wished to control its implementation. As a result, the restrictions adopted in TEFRA do not actually prohibit United States taxpayers from holding bearer bonds. Instead, the sanctions are limited to loss of tax benefits, such as the deduction for losses on sale, capital gains rates for gains on sale, the tax exemption for municipal bond interest, the issuer’s deduction for interest, and the portfolio interest exemption from withholding tax; plus the excise tax on the issuer.\footnote{See supra notes 8–13 and accompanying text.}

The bearer bond restrictions that were adopted as part of TEFRA are commonly referred to as the “TEFRA” restrictions, even though they comprise only a small part of TEFRA, which is itself a comprehensive piece of tax legislation that runs for nearly 400 pages.\footnote{Specifically, 96 Stat. 324–707. The bearer bond rules, TEFRA § 310, take up only 6 of these pages: 96 Stat. 595–600.} These restrictions apply to any “registration-required obligation,” which is any debt obligation other than one which:

1. is issued by an individual,
2. is not of a type offered to the public,
3. has a maturity of not more than one year, or
4. is targeted to non-U.S. persons on issuance.\footnote{I.R.C. § 163(f)(2)(A).}

The Treasury is given authority to issue regulations that would extend these restrictions, on a prospective basis, to obligations in these last three excluded categories,\footnote{I.R.C. § 163(f)(2)(C).} but this authority has not yet been exercised.
B. Issuer Sanctions

If an issuer issues a registration-required obligation in bearer form, TEFRA imposes two sanctions on the issuer. First, no deduction is allowed for interest paid on the obligation.\(^{34}\) This sanction has no effect on foreign or tax-exempt issuers. Second, the issuer is subject to an excise tax upon issuance equal to one percent of the principal amount times the number of calendar years, or portions thereof, during the period from issuance to maturity.\(^{35}\) Because the excise tax is determined by reference to calendar years, it is possible for the excise tax to be three percent of the principal amount of an obligation with a maturity of only slightly more than one year, such as an obligation issued in December 2004 that matures in January 2006.

The excise tax has an extraordinarily broad reach,\(^{36}\) and is a classic case of the extraterritorial application of United States law. A foreign issuer of a bearer security can become subject to tax even if the issuer has no connection whatsoever with the United States, since a sufficient jurisdictional nexus can arise based merely on marketing efforts of its underwriters involving persons situated in the United States.\(^{37}\) As a result, issuers and underwriters worldwide have had to develop procedures and documentation to comply with the TEFRA restrictions. Even transnational organizations, which enjoy complete

\(^{34}\) I.R.C. § 163(f).

\(^{35}\) I.R.C. § 4701(a).

\(^{36}\) The only issuers that are explicitly exempt from the excise tax are issuers of municipal tax exempt obligations. I.R.C. § 4701(b)(1). Instead, a registration-required municipal obligation issued in bearer form loses its tax exemption. I.R.C. § 149(a). Although this is technically a holder sanction, the economic burden falls on the issuer, which must offer a higher interest rate on a taxable obligation.

\(^{37}\) See infra note 42 and accompanying text.
exemption from United States taxation based on multinational treaties,\(^{38}\) have made it a practice to comply with TEFRA.\(^{39}\)

For issuers, compliance with TEFRA means targeting the issuance to non-U.S. persons. More precisely, a bearer obligation will not be a registration-required obligation if:

1. there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with its original issue) only to persons who are not United States persons;
2. interest on the obligation is payable only outside the United States and its possessions; and
3. on the face of the obligation there is a statement that any United States person who holds the obligation will be subject to limitations under the United States income tax laws.\(^{40}\)

The regulations state that the last requirement will be satisfied if, on the face of the obligation, there appears the legend, “Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations...


\(^{39}\)See, e.g., Prospectus, Asian Development Bank U.S.$20,000,000,000 Global Medium-Term Note Program 57 (July 16, 2001); Prospectus, International Finance Corporation Global Medium-Term Note Program 46 (Nov. 17, 1999); Prospectus, International Bank for Reconstruction and Development Global Debt Issuance Facility 49 (Oct. 7, 1997). While this practice may simply be a matter of comity, a practical benefit to these organizations of complying with TEFRA is that their tax exemptions may not extend to their paying agents, and the paying agents can rely on the TEFRA compliance of these issuers to avoid information reporting and backup withholding obligations. See infra Part II.D (p. 496). One of these organizations, the World Bank, has gone so far as to obtain a ruling from the IRS regarding its compliance with TEFRA. See infra note 151 and accompanying text.

provided in sections 165(j) and 1287(a) of the Internal Revenue Code.”\textsuperscript{41}

The regulations provide two sets of rules for satisfying the requirement that there be arrangements reasonably designed to ensure that the obligation will be sold only to persons who are not United States persons. These rules are known as the “C” rules and the “D” rules, based on the paragraphs of the regulations in which they appear. (There are also “A” rules and “B” rules, but these only apply to obligations issued before September 7, 1990.)

To satisfy the C rules, the obligation must be “issued only outside the United States and its possessions by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such obligation either directly or through its agent, an underwriter, or a member of the selling group.”\textsuperscript{42} Although as a matter of United States constitutional law the term “interstate commerce” has come to have an extremely broad meaning,\textsuperscript{43} the regulations take a narrower view that is more closely aligned with the purposes of the TEFRA restrictions.

In particular, the regulations state that for this purpose, “interstate commerce” means “trade or commerce in obligations or any transportation or communication relating thereto between any foreign country and the United States or its possessions.” The regulations further clarify that interstate commerce does not include “activities of a preparatory or auxiliary character that do not involve communication between a prospective purchaser and an issuer, its agent, an under-

\textsuperscript{41} Treas. Reg. § 1.163-5(c)(1)(ii)(B).

\textsuperscript{42} Treas. Reg. § 1.163-5(c)(2)(i)(C).

\textsuperscript{43} U.S. CONST. art I, § 8, cl. 3. Although the Commerce Clause by its terms only confers power on the federal government “[t]o regulate commerce with foreign nations, and among the several States, and with the Indian tribes,” the Supreme Court has interpreted it to support, among many other things, federal regulation of agricultural production “not intended in any part for commerce but wholly for consumption on the farm.” Wickard v. Filburn, 317 U.S. 111, 118 (1942).
writer, or member of the selling group if either is inside the United States or its possessions.” The regulations provide examples of these permitted sorts of preparatory or auxiliary activities, and also give examples of the types of marketing-related communications that are not covered by this safe harbor.

Obligations that comply with C rules are sensibly excused from the legending requirement. An issuer that issues obligations without the legend in circumstances that have no United States nexus at all will not commit an inadvertent violation of the TEFRA restrictions, since such an issue will satisfy the C rules.

The C rules, though helpful in some cases, have serious drawbacks. They can be used by U.S. issuers only in very limited situations involving overseas bank branches, and controlled foreign corporations cannot use the C rules if the obligations are (i) guaranteed by a United States shareholder, (ii) convertible into debt or equity of a United States shareholder, or (iii) substantially identical to obligations issued by a United States shareholder. More fundamentally, compliance with the C rules depends on strict adherence by the issuer and the underwriters to a complete absence of involvement in the selling effort by people in the United States: a single telephone call by or to a person in the United States can trigger the excise tax.

The D rules can be used by any issuer, but require some care in the documentation of the issue. The D rules have three principal requirements:

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45 Treas. Reg. § 1.163-5(c)(2)(ii). For this purpose, a United States shareholder is limited to those who are treated as such under the Subpart F rules; that is, only United States persons that own, directly or with attribution, at least a 10 percent voting interest. I.R.C. § 951(b). It appears that for this purpose an issuer can have a United States shareholder even if it is not a controlled foreign corporation for Subpart F purposes. Controlled foreign corporations that are engaged in the banking business, however, are subject to constraints similar to those that apply to overseas bank branches. Treas. Reg. § 1.163-5(c)(2)(i)(C).
(1) the issuer and underwriters must observe restrictions on the offer and sale of the obligations in the United States or to United States persons;

(2) the obligation must not be delivered in definitive form in the United States or its possessions; and

(3) before the first payment of interest or delivery of the obligation in definitive form, the issuer must obtain a certificate (a “TEFRA D certificate”) from the holder stating that it is either not a United States person or falls within a category of United States persons who are exempt from the holder sanctions.  

An advantage of the D rules is that there is less of a chance that a mistake by an underwriter will land the issuer in the soup. The regulations provide that the first requirement will be satisfied by an underwriter if it covenants with the issuer to observe the selling restrictions, and it has internal procedures in place that are reasonably designed to ensure that the restrictions will in fact be observed by its employees and agents.  

Underwriting agreements for obligations intended to comply with the D rules normally contain the paragraphs set out in Appendix I in order to satisfy this first requirement. An actual lapse by an underwriter in observing these covenants will not trigger the excise tax, provided that the underwriter at least has the internal procedures in place that would presumably cause such a lapse to be rare. Although the selling restrictions generally prohibit sales to United States holders, they do permit sales to United States holders that are exempt from the holder sanctions, as discussed more fully in Part II.C below.

The TEFRA D certificate must be signed by its owner or a financial institution holding the obligation on the owner’s behalf, but it need not state the identity of the owner. This form of certification provides assurance that the obligation is not being sold to United States persons, without threatening the anonymity that the bearer


bond markets require. The certification can be provided by a clearing organization such as Euroclear or Clearstream based on statements received from its member organizations, and is normally given in the form set out in Appendix II. The form of certification allows for the possibility that the holder is a United States person that is exempt from the holder sanctions. The certificate must be retained for four calendar years after the year in which the certificate is received, and can be provided electronically by an institution that maintains adequate records over this four-year period.

C. Holder Sanctions

If a United States person should acquire a registration-required obligation that was issued in bearer form in accordance with the TEFRA restrictions, losses on a sale of the obligation will not be deductible, and gains from the sale will be subject to tax at ordinary rates. For this purpose, an obligation is considered to be a registration-required obligation even if, from the issuer’s point of view, it is not treated as such because it complies with the exception for foreign targeted issuance. This is why the legend on a D rules issue states that United States holders will be subject to the holder sanctions even though the issuer sanctions are avoided.

49 These exempted holders include the persons “described in Sections 165(j)(3)(A), (B) and (C) of the Internal Revenue Code” in the form of clearing system certification. See infra notes 55–58 and accompanying text.
51 I.R.C. § 165(j).
52 I.R.C. § 1287(a).
Oddly enough, if an issuer fails to comply with the TEFRA requirements and incurs the excise tax, then the holder sanctions will not apply. Thus, for any bearer obligation that is not issued by an individual and has a maturity for more than one year, either the issuer sanctions or the holder sanctions will apply, but not both.

Not all United States holders are subject to the holder sanctions. TEFRA authorizes regulations exempting any holder that:

1. holds the obligation in connection with a trade or business outside the United States;
2. holds the obligation as a broker-dealer (registered under Federal or State law) for sale to customers in the ordinary course of its trade or business;
3. complies with reporting requirements with respect to ownership, transfers and payments as required by the regulations; or
4. promptly surrenders the obligation to the issuer for the issuance of a new obligation in registered form.

As noted above, an issuer can sell bearer obligations to these exempted holders without incurring the issuer sanctions. Curiously, these rules do not permit “offers” to these exempted holders, and there is no guidance as to how a sale can be accomplished without an offer. Presumably such a sale could only follow a “reverse inquiry,” in which the prospective holder contacts the issuer or an underwriter, having somehow learned of the offering even though it was targeted offshore.

Arguably, to avoid the holder sanctions, the excise tax must actually be paid. See Michael L. Schler, Issuing Bonds to Non-U.S. Investors: Finding the Path Through the Tax Maze, PRACTISING LAW INSTITUTE, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, RE-ORGANIZATIONS & RESTRUCTURINGS 975, 1004–05, n. 20 (2003).

A third holder sanction is the loss of the tax exemption on a municipal obligation. Unlike the other holder sanctions, this sanction does apply (in lieu of the excise tax) when the issuer fails to comply with the TEFRA requirements. See supra note 36.

I.R.C. § 165(j)(3).
Regulations implementing these exemptions permit financial institutions to hold for their own account, or for the account of others if they report to the IRS the amount of interest and gross proceeds received on behalf of the beneficial owner. The financial institution can offer, sell or deliver the obligation in the United States only to another exempt holder. The term “financial institution” is defined broadly to include not only banks, insurance companies and broker-dealers, but also mutual funds, investment advisers and non-bank finance companies. These regulations make it possible for any United States person to hold bearer obligations, but only under conditions that preclude anonymity.

D. Information Reporting and Backup Withholding

At the time TEFRA was under consideration by Congress, the Treasury Department had recently completed a study of underreported income, which found that taxpayers paid tax on 99% of wage income that was subject to income tax withholding, 85-89% of dividend and interest income that was subject to information reporting but not withholding, but only 68% of capital gain income that was subject to neither information reporting nor withholding. Accordingly, as part of the same compliance initiative that gave rise to the bearer bond restrictions, TEFRA included provisions that extended income tax withholding to interest and dividend income, and extended information reporting to proceeds of sales of securities. The

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56 Treas. Reg. § 1.165-12(c)(2) and (3).
57 Treas. Reg. § 1.165-12(c)(1)(ii) and (iii). Exempt holders include tax-exempt organizations, which are effectively exempt from the holder sanctions anyway.
58 Treas. Reg. § 1.165-12(c)(1)(iv).
withholding provisions encountered strong opposition from the securities industry, and a compromise was fashioned the following year which repealed these provisions before they became effective, in favor of narrower rules under which withholding would be required only on income of taxpayers who did not provide sufficient information to permit proper information reporting, or who were otherwise failing to report their income. Thus the “backup withholding” regime was born.

The backup withholding rules require payors of interest and dividends to withhold federal income tax at a 28% rate if any of the following conditions are present:

1. the payee has failed to give his or her taxpayer identification number to the payor;
2. the payor has been notified by the IRS that the taxpayer identification number given by the payee is incorrect;
3. the payor has been notified by the IRS that backup withholding is required because the payee has failed to report all of his or her interest and dividend income; or
4. the payee has failed to certify under penalties of perjury that the taxpayer identification number given is correct.

In addition, backup withholding applies to other “reportable payments,” including gross proceeds of sales of securities, if either of the first two conditions listed above are present.

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63 I.R.C. § 3406(a)(1) prescribes that the backup withholding rate shall be the fourth lowest rate of tax applicable under § 1(c), which gives the income tax rates for single individuals. The fourth lowest rate specified in § 1(c) is 36%, but § 1(i)(1) adds an additional 10% rate bracket, which makes 36% the fifth lowest rate, and causes the fourth lowest rate to be 31%; and § 1(i)(2) substitutes 28% for this 31% rate for taxable years beginning in 2003 and thereafter. Jobs and Growth Tax Reconciliation Act of 2003, Pub. L. No. 108-27, § 105(a), 117 Stat. 752, 755 (2003). There must be a simpler way to express this rate.

64 I.R.C. § 3406(a)(1).
Needless to say, these rules are incompatible with the anonymity expected by holders of bearer debt. United States holders of bearer debt are not the problem here, since they are permitted to hold bearer debt only under conditions that effectively waive anonymity. But many foreign holders will, if disclosure of their identity is demanded, simply choose to invest elsewhere. Bearer bonds are often subject to mandatory redemption if disclosure of the holder’s identity is required, although the issuer can instead choose to gross up payments if disclosure can be avoided that way.

Foreign issuers are generally not subject to the backup withholding rules. These rules apply only to “reportable payments”; although payments of interest and principal on debt securities are generally treated as reportable payments, there is an exception for foreign source interest or original issue discount paid outside the United States by a non-U.S. payor or middleman. A further exemption applies to payments of principal other than original issue discount, if the payor has documentation that the payee is a non-U.S. person.

Under the original version of the regulations, the exemption for foreign source interest (including original issue discount) applied regardless of whether the payment was made by a U.S. payor or middleman. The definition of U.S. payor or middleman is broad enough to include foreign branches and subsidiaries of U.S. banks, who are commonly used as paying agents for bearer securities issued by both U.S. and foreign issuers. Backup withholding can be avoided in these cases without disclosure of the owner’s identity by making the

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65 I.R.C. § 3406(a)(2).
66 See supra Part II.C (p. 494).
68 Treas. Reg. § 1.6049-5(b)(6).
69 Treas. Reg. § 1.6045-1(g)(1).
70 Temp. Treas. Reg. § 5f.6045-2(b)(vi) (as added by T.D. 7853 (Nov. 15, 1982)).
payments through foreign clearing organizations, who are themselves exempt recipients\(^{71}\) and are able to forward these payments without any further reporting requirement.

U.S. issuers, however, cannot take advantage of the exception for foreign source interest. Instead, they must rely on a separate exception from the definition of reportable payments, which applies to interest paid on bearer obligations issued in compliance with TEFRA.\(^ {72}\) To take advantage of this exception, the TEFRA rules must be followed even if the obligation has a maturity of one year or less and is therefore not a registration-required obligation. Taken literally, such an obligation must even include on its face the standard legend warning of holder sanctions under TEFRA,\(^ {73}\) even though for such a short-term obligation the legend is patently false.\(^ {74}\)

\section*{E. Portfolio Interest Exemption}

The burgeoning deficits of the early 1980s had a further consequence beyond the need to improve tax compliance: America became dependent on foreign capital.\(^ {75}\) The 30-percent withholding tax on U.S. source interest paid to foreign persons acts more as a deterrent than as a source of revenue, since suppliers of debt capital can redirect their investments to instruments not subject to withholding tax. U.S. borrowers at that time could circumvent the withholding tax by issuing debt obligations through Netherlands Antilles finance subsidiaries while incurring only a modest Netherlands Antilles tax.\(^ {76}\) The Service

\(^{71}\) Treas. Reg. \(\S\) 1.6049-4(c)(1)(ii)(M).

\(^{72}\) Treas. Reg. \(\S\) 1.6049-5(b)(7).

\(^{73}\) See supra note 40 and accompanying text.


\(^{75}\) See Ammendola, supra note 28, at 13–14.

\(^{76}\) Although the Netherlands Antilles Profits Tax Ordinance allowed finance companies a 90-percent reduction in its normal tax rates of between 24% and 30%, a
was ambivalent about this technique: it was indefensible as a matter of tax policy to allow such blatant treaty shopping, but without it U.S. issuers would be shut out of the overseas bearer bond markets.\(^77\)

To avoid the costs to U.S. borrowers associated with the Netherlands Antilles financings,\(^78\) Congress, with Treasury support, repealed the U.S. withholding tax on “portfolio interest,” broadly defined to include nearly all interest other than interest paid on bank loans or to related parties.\(^79\) There are two key restrictions on portfolio interest that are relevant for our purposes:

1963 protocol to the Netherlands tax treaty (as extended to the Netherlands Antilles) allowed an exemption from withholding tax on interest only for companies that did not benefit from these lower rates. Convention with Respect to Taxes on Income, Apr. 29, 1948, U.S.-Neth., 62 Stat, 1757, T.I.A.S. No. 1855 (extended to the Netherlands Antilles by Protocol, June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366; amended by Protocol, Oct. 23, 1963, 15 U.S.T. 1900, T.I.A.S. No. 5665; modified by Convention, Dec. 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051). These Netherlands Antilles finance companies typically earned a spread of at least 1% in order to avoid characterization as a conduit for United States tax purposes. See N. Ind. Pub. Serv. Co. v. Comm’r, 115 F.3d 506 (1997). But see Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383. The Netherlands Antilles, however, was willing to grant rulings applying transfer pricing rules that reduced the deemed taxable spread for Netherlands Antilles tax purposes to 0.50% on any loans above $40 million made during a fiscal year; if the obligations were issued to a bank or financial institution, the deemed spread could be as low as 0.125%. Letter of H. Henriquez, Hoofdinspecteur der Belastingen [head tax inspector] (Curaçao), dated Jan. 30, 1978; D.E. Cijntje, Belastingen in de Nederlandse Antillen 47 (1990).

\(^77\) See Ammendola, note 28, supra p. 487, at 25–28. Although tax treaties with many of our principal trading partners (e.g. France, Germany and the United Kingdom) eliminate U.S. withholding tax on interest, treaty benefits are unavailable as a practical matter to anonymous holders of bearer instruments.


(1) Interest on a registered obligation will not qualify as portfolio interest unless the holder provides an IRS Form W-8 certifying as to the holder’s identity and non-U.S. status; and

(2) Interest on a bearer obligation will not qualify as portfolio interest unless the obligation was issued in accordance with TEFRA.

The first restriction might seem nearly redundant in light of the backup withholding rules, which require backup withholding at close to the 30-percent source withholding rate if a non-U.S. holder fails to provide a Form W-8. In 1984, however, when the portfolio interest exemption was enacted, the backup withholding rate was only 20 percent. It seems odd in any case to require certification of non-U.S. status to avoid source withholding, since U.S. status is sufficient to avoid source withholding as well. The real purpose appears to be to strengthen the backup withholding regime for U.S. source interest, since the requirement of a Form W-8 in the portfolio interest context cannot be avoided by paying through a foreign intermediary.

The second restriction adds another issuer sanction to TEFRA, since interest on bearer bonds issued by a U.S. issuer in violation of TEFRA will not qualify as portfolio interest. This might seem to be a holder sanction since the withholding tax is technically imposed on the holder, but in practice it acts as an issuer sanction whenever gross-up clauses place the burden of this tax on the issuer. Moreover, unlike the holder sanctions that are imposed only when the issuer complies with the TEFRA rules for targeting the issue to foreign holders, the loss of the portfolio interest exemption occurs only when the issuer fails to comply with those rules.

The portfolio interest exemption, like the backup withholding rules, has the effect of requiring U.S. issuers to comply with TEFRA

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82 See supra notes 68–72 and accompanying text.
even for short-term bearer bonds that are not registration-required obligations. There has long been a separate exemption from withholding tax for obligations with a maturity of 183 days or less, and this exemption does not require compliance with TEFRA. The difficulty arises for obligations with a maturity of more than 183 days but not more than one year: obligations with a maturity within this time frame must comply with TEFRA to obtain the withholding tax exemption even though TEFRA does not itself apply to these obligations. Initially, the Treasury Department interpreted the portfolio interest exemption as being completely unavailable for these obligations, the reasoning presumably being that Congress could not have intended to extend TEFRA restrictions to these obligations in such a backhanded manner. A somewhat more common-sense view prevailed, and now these obligations can qualify for the exemption by going through the (otherwise unnecessary) TEFRA motions, including applying the (false) legend that U.S. holders will be subject to the TEFRA holder sanctions.

Since obligations with a maturity of 183 days or less enjoy an exemption from withholding tax that does not depend on compliance with TEFRA, the only reason that TEFRA compliance would be nec-

83 I.R.C. § 871(g).
86 T.D. 8111 (Dec. 19, 1986). This rule has since been moved to Treas. Reg. § 1.871-14(b)(1). T.D. 8734 (Oct. 6, 1997).
ecessary for these obligations would be to avoid the backup withholding rules. Those rules provide a bit of further flexibility for these obligations, since interest on these obligations will not be a reportable payment if the following requirements are met:\textsuperscript{87}

(1) The interest is paid outside the United States;
(2) The interest is not paid by a U.S. intermediary acting as agent of the payee;
(3) The face amount of the obligations is not less than $500,000;\textsuperscript{88}
(4) The TEFRA D rules are followed, but without regard to the certification requirement; and
(5) A substitute legend is placed on the face of the obligation in lieu of the usual TEFRA legend.

The substitute legend states,

“By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder).”

The deemed representation in this legend substitutes for the TEFRA D certification.

Even this modified form of TEFRA compliance is unnecessary in cases where holders of these short-term bearer obligations are prepared to disclose their identity. The terms of the obligations can simply require presentation not only of the note or coupon but also of

\textsuperscript{87} Treas. Reg. § 1.6049-5(b)(10).

\textsuperscript{88} Or its equivalent in other currencies. The dollar threshold coincides with IPMA’s minimum denomination for Euro commercial paper, although the corresponding IPMA minimums in other currencies are stated in terms of those currencies rather than as a dollar-equivalent amount. IPMA RECOMMENDATIONS, supra note 67, Recommendation 5.1.
a properly completed Form W-8 (for non-U.S. holders) or Form W-9 (for U.S. holders).
III. Definition of “Registered”

Given the significance and breadth of consequences that turn on whether an obligation is bearer or registered, it is surprising that no definitions of the terms “bearer” or “registered” appear in the Code, although the Code does state that a “book-entry” bond shall be treated as registered “if the right to the principal of, and stated interest on, such bond may be transferred only through a book entry consistent with regulations prescribed by the Secretary.”

The regulations do contain a definition of “registered,” which provides that an obligation is in registered form if either:

1. The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder, or

2. The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent).

These are the only permissible methods for transferring a registered obligation; any obligation that can be transferred by any other means is considered to be in bearer form. Thus, the term “bearer” is de-

89 I.R.C. § 149(a)(3)(a). Although this provision by its terms applies only to the holder sanction disallowing the exemption for municipal bond interest, it is cross referenced by the Code provisions dealing with the issuer’s interest deduction (§ 163(f)(3)), the excise tax (§ 4701(b)(2)), the portfolio interest exemption (§ 871(h)(7)), the holder’s loss deduction (§165(j)(2)(B)), and capital gains treatment (§ 1287(b)(2)).

90 Temp. Treas. Reg. § 5f.103-1(c)(1). The regulations also treat as registered an obligation that can be transferred by either method.

91 Temp. Treas. Reg. § 5f.103-1(c)(2). See also infra Part III.A (p. 507).
fined negatively: it sweeps up any obligation that is not expressly within the scope of the term “registered.” Defining the term “bearer” in this fashion causes it to be potentially broader than its colloquial meaning of an obligation that can be transferred by physical delivery of an instrument evidencing its ownership.

There is something nearly circular about a definition of “registered” that requires the obligation to be “registered as to both principal and interest.” Yet it seems that what is meant here is that there must be a registry, maintained by the issuer or its agent, of record ownership of the principal and interest. Under the first option for transfer of registered notes, the transfer is effected by the issuance of a note to the new holder; under the second option, the transfer on the register itself is sufficient to transfer ownership.

There is no specific form that a book entry system for a registered obligation must take, provided that entries in the system are required to effect a transfer, and these entries identify the owners of an interest in the obligation. The regulations specifically provide that no physical securities need be issued at all, and therefore dematerialized obligations, which exist only in book entry form, can qualify as registered.

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93 The Uniform Commercial Code (the “UCC”) treats a certificated security as in bearer form only if “the security is payable to the bearer of the security certific ate according to its terms but not by reason of an indorsement.” UCC § 8-102(a)(2) (1995). The requirement that the certificate be payable to the bearer by its own terms rather than by reason of an indorsement is to prevent other types of instruments, such as negotiable instruments governed by Article 3 of the UCC, from being brought within the scope of Article 8 (dealing with investment securities) by reason of a blank indorsement. UCC § 8-102(a)(2), Official Comment 2 (1995).
94 Although nearly unheard of today, it is possible to have a bond registered only as to principal. Such a bond’s principal is payable to a registered holder, but it has interest coupons attached payable to bearer. See ROBERT I. LANDAU, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 95 (3d ed. 1985).
95 Temp. Treas. Reg. § 5f.103-1(e)(2).
96 Dematerialized obligations are discussed further in Part VI infra (p. 533).
The current regulations require that the obligations be registered “with the issuer (or its agent)” and that a book-entry system be “maintained by the issuer (or its agent).” The original regulations did not contain these quoted phrases, and therefore did not explicitly say with whom the obligation had to be registered or who should maintain the book-entry system. This requirement was presumably added so that the status of bonds as bearer or registered would be determined by what the issuer or its agent did, as opposed to any actions by others who might acquire the obligations and issue interests in those obligations that could be traded in a manner different from that of the obligation itself. For example, an trust might acquire registered obligations and issue bearer certificates evidencing interests in those obligations. If the trust is acting independently of the issuer, this is no reason to charge the issuer with the excise tax. Instead, the regulations treat the trust as an issuer of bearer obligations and impose the excise tax on the trust if it fails to abide by the TEFRA restrictions when issuing the bearer certificates.

A. Definition of “Transfer”

The distinction between bearer and registered obligations hinges entirely on how the obligation may be transferred. Yet the meaning of “transfer” in this context is far from obvious. At first it might seem that it is a transfer of ownership of the obligation that matters here. There are two problems with this approach. First, the commercial law applicable to the rights of holders may permit transfers between holders that are binding between them even if the issuer or third parties are not yet aware of these transfers. Second, in some cases the tax law

97 Temp. Treas. Reg. § 5f.103-1(c)(1).
Definition of “Registered”

recognizes a transfer of ownership even though there has been no such transfer as a matter of commercial law.

In the context of United States law dealing with certificated securities, obligations evidenced by certificated securities can be transferred without the involvement of the issuer even where the obligations purport to be registered. If a seller executes an instrument of conveyance to a buyer, that buyer may be treated as the owner of a certificated security in any dealings between the buyer and seller even if the issuer is not required to treat the buyer as the owner until the certificated security has been duly presented to the issuer for registration of transfer. At most, the restrictions on transfer embodied in the underlying documentation can dictate who the issuer is entitled to treat as the owner. Until due presentment of the certificated security to the issuer for registration of transfer, the issuer is entitled to treat the person on the registry as the owner, even if that person has disposed of the obligation to someone else. If the issuer is presented with an effective endorsement of the certificated security and other requirements are met, the issuer will have a duty to register

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100 Article 8 of the Uniform Commercial Code has separate rules for certificated securities, uncertificated securities, and securities held through a financial intermediary. UCC Article 8, Prefatory Note (1995). Although most securities in the United States are held through financial intermediaries, holders are typically given the right to hold their security certificates directly. Since, as discussed infra in Part III.C (p. 514), an obligation is treated as in bearer form if it can trade as a bearer obligation at any time until maturity, the treatment of certificated securities is generally relevant even for obligations held through financial intermediaries.

101 In this discussion, I will use the term “issuer” to include the issuer’s agents.

102 See UCC §§ 8-104(a)(1), 8-301(a) (1995). Acquiring an interest in a certificated security that is not held or transferred through a clearing account is achieved by “delivery,” within the meaning of UCC Article 8, which does not require registration in this context. Re-registration may be required, however, in certain instances to transfer interests in uncertificated securities or securities held in a securities account.


104 Id.
the transfer, regardless of whether these items are presented by the current registered holder or a third party claiming ownership as a purchaser or other transferee of the registered holder. At that point, even the issuer is required to treat someone other than the registered holder as having rights in the certificated security.

Then there is the question of what governing law applies to the transfer. The nationalities of the buyer and seller, the locus of the sale, the nationality of the issuer, the governing law of the obligation, or the choice of law, if any, given in the obligation itself or in the instrument of transfer might conceivably play a role in determining which jurisdiction’s laws will govern the transfer. Yet it would be madness to expect the issuer to ascertain its liability for the TEFRA penalties by reference to the governing law that might apply to future transfers by yet-to-be-identified holders. The regulations consider an obligation to be in bearer form at a particular point in time if *at any time* from then until maturity it can be transferred by any means other than those specifically set out in the regulations for transfers of registered obligations. Thus the mere possibility that a transfer by a non-permitted means could occur is sufficient to cause the obligations to be treated as bearer even if such a transfer never in fact occurs.

The sensible resolution is to count only those transfers that the issuer is required to respect. If the issuer is entitled to treat as the owner


106 In most cases involving foreign issuers, the governing law will not be U.S. law. The UCC of a particular state applies to transfers of investment securities of an out-of-state (including a foreign) issuer only if the issuer affirmatively elects the law of that state, and the law where the issuer is organized permits such an election. UCC § 8-110 (1995).

107 For example, under the UCC’s choice of law rules in § 8-110, the local law of the issuer’s jurisdiction governs, *inter alia*, the rights and duties of the issuer with respect to registration of transfer, the effectiveness of registration of transfer by the issuer, and whether the issuer owes any duties to an adverse claimant to a security. The “issuer’s jurisdiction” is defined as the jurisdiction under which the issuer is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer.
the person who is the owner of record, then a payment of principal or interest to that person will discharge the issuer’s liability for that payment. 108 This determination will presumably be a matter of the governing law of the instrument, and whatever governing law might apply to non-registered transfers or purported transfers among holders is irrelevant.

This approach disconnects the concept of a “transfer” from that of a change in ownership for tax purposes. In many contexts the tax law recognizes that the owner of an asset for tax purposes may be someone other than the registered holder. For example, in the case of repurchase arrangements involving tax-exempt debt securities, a number of cases hold that the seller-repurchaser is the owner for tax purposes, treating the registered holder as owning debt of the seller-repurchaser rather than the underlying security. 109 Indeed, it is likely that any holder who unconditionally sells a particular debt obligation for future delivery, and who is contractually required to retain that specific obligation for delivery, will be treated as having made a present sale. Until delivery occurs, the seller will remain the registered holder even though the purchaser is the owner for tax purposes. The fact that the transfer of tax ownership can occur by a means other

108 U.C.C. § 8-207, Official Comment 1 (1995). The issuer is entitled, indeed obligated, to treat the registered owner as the owner even if it has notice of another person claiming to be the transferee of the registered owner. See Kerrigan v. Am. Orthodontics Corp., 960 F.2d 43 (7th Cir. 1992); UCC § 8-404, Official Comment 3 (1995).

109 Union Planters Nat’l Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 1970); Am. Nat’l Bank of Austin v. United States, 421 F.2d 442 (1970); New Mexico Bankcorp. & Subsidiaries v. Commissioner, 74 T.C. 1342 (1980). The practical consequence in these cases is that the registered holder is not entitled to exclude the interest that it receives on the obligation: instead, this interest is deemed to be paid over to the seller-repurchaser and then paid over as taxable interest to the registered holder. Although the seller-repurchaser can exclude the interest that it is deemed to have received, the benefit of doing so is wiped out by a disallowance of the deduction for the interest deemed paid to the registered holder. I.R.C. § 265(a)(2).
than those specified in the regulations for registered obligations should not cause the obligation to be treated as bearer.

In at least one context the Service has acknowledged that a registered obligation can be transferred by means other than those permitted for registered obligations, even though the definition of “registered” states that a registered obligations can be transferred only by those means. Proposed regulations issued 15 years ago cause such a transferor to be subject to the TEFRA excise tax,\textsuperscript{110} computed as if the obligation had been newly issued on the date of transfer.\textsuperscript{111} They are set out within a larger body of regulations dealing with pass-through certificates, but the terms of the proposed regulations can apply to any transfer of a registered obligation that is not reflected on the issuer’s registry, regardless of whether any pass-through certificates are involved. Although these regulations have never been issued in final form, they purport to apply to transfers occurring after August 17, 1988. This rule may come as a surprise to someone who makes an “off the books” transfer of a registered obligation, without any intention of creating a bearer pass-through interest.

**B. Obligations Not of a Type Offered to the Public**

Although TEFRA itself applies only to registration-required obligations, the portfolio interest exemption has had the effect of extending the TEFRA rules to obligations not otherwise subject to TEFRA. The consequences of this extension to short-term obligations has already been discussed.\textsuperscript{112} More troubling, however, is the extension of TEFRA rules to obligations that are not of a type offered to the public.


\textsuperscript{112} See supra notes 83–86 and accompanying text.
Under TEFRA itself there is no need to determine whether an obligation that is not of a type offered to the public is bearer or registered, because such an obligation is not a registration-required obligation. It is not surprising, therefore, that the definition of “registered” for TEFRA purposes was drafted with regard only to obligations that are offered to the public. Indeed the phrase “in registered form or with interest coupons attached” has been used as a means of designating obligations of a type offered to the public in numerous tax contexts long before TEFRA was enacted. Yet in order to determine whether the portfolio interest exemption applies to an obligation of a U.S. issuer that is not of a type offered to the public, a determination must be made whether that obligation is registered or bearer.

The trouble is that the regulations define “bearer” to include every obligation that is not “registered.” The definition of registered looks to whether transfers are made by issuance of a note in the name of the new holder, or by a transfer on a registry maintained by the issuer or its agent. As a consequence, the current definition could be read to treat as bearer just about any obligation that is not of a type offered to the public. These obligations will rarely have a registry, and often will not be evidenced by a note.

Some of these obligations should be regarded as bearer. For example, if the obligation is evidenced by a negotiable instrument, transfer can occur by endorsement; and even though the instrument is not expressly payable to bearer, the holder must present the instrument in order to receive payment. But for most of these obligations,

\[113\] Some of these contexts predate the income tax itself, relating instead to documentary stamp taxes that were imposed on notes of this type. See ABA Report, supra note 85, at 703–04, for an excellent summary of the pre-TEFRA usage of the phrase “in registered form.” For examples of current contexts, see I.R.C. § 165(g)(2)(C) (deduction for worthless securities) and § 1402(a) (exclusion of interest from self-employment earnings).

\[114\] In one instance, the IRS seized on the presence of negotiability language “pay to the order of…” to declare a note to be in bearer form, even though the note al-
the “bearer” label is problematic. For example, an ordinary contractual claim or even a judgment claim is typically assignable without any formalities of registry or even notice to the issuer.\textsuperscript{115} Some types of debt may result from characterizations under U.S. tax law, such as deemed loans that result from front- or back-loaded payments in swaps\textsuperscript{116} and rental agreements.\textsuperscript{117} Those documents, which legally are not debt instruments at all, may not have been drafted with a view to qualifying them as “registered” for purposes of the portfolio interest exemption.

The difficulty here is similar to that faced by any obligation that is registered in the classic sense, but is subject to transfer outside the registry. The proper resolution is likewise similar: if the issuer can discharge its obligation by payment to the person to whom it is expressly obligated under the terms of the obligation, then the obligation should be treated as registered. In a sense, the terms of the obligation itself can be viewed as a sort of registry. The IRS has issued some private letter rulings\textsuperscript{118} that treat as registered some obligations, such as judgment claims, that are not capable of registration in the classic sense; but the IRS will not ordinarily rule on this issue in the case of interest paid on contracts that fail to meet tests for qualification as annuities or life insurance contracts.\textsuperscript{119}

\textsuperscript{115} Even if the terms of the contract restrict assignability, damages for its breach may be assignable. \textit{See} Restatement (Second) of Contracts § 322 (1981).

\textsuperscript{116} Treas. Reg. § 1.446-3(g)(4).

\textsuperscript{117} Treas. Reg. § 1.467-1(e)(3).


Even if the definition of “registered” in this context is liberalized along the lines suggested here, there will still be instances where careful attention will need to be given in order to avoid jeopardizing the portfolio interest exemption. For example, a loan to a U.S. borrower by a foreign financial institution that is not a bank can benefit from the portfolio interest exemption, but if the loan is evidenced by a negotiable promissory note the TEFRA restrictions may apply. In the meantime, the conservative approach for any note that is intended to qualify for the portfolio interest exemption as a registered note is to put express language in the note to the effect that it is registered as to principal and interest. The remainder of this article, however, will focus on the distinction between bearer and registered obligations that are of a type offered to the public.

C. Conversion between Registered and Bearer Form

The TEFRA rules allow a simultaneous issue of registered obligations in the United States and otherwise identical bearer obligations overseas, and issuers in global offerings frequently do so. In a typical arrangement, the issuer will issue a global bearer note overseas under Regulation S, and issue a global registered note in the United States

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120 A similar suggestion is reflected in a draft revenue ruling that an ABA committee has proposed to deal with this issue. ABA Report, supra note 85, at 734–35.

121 In I.R.S. Field Serv. Adv. 1999-662 (released Mar. 12, 1992), the taxpayer amended an installment note from the sale of U.S. real property to cause it to be registered on the issuer’s books, and the IRS accordingly treated it as a registered note eligible for the portfolio interest exemption.

under Rule 144A. These can trade separately in their separate markets, but greater liquidity for holders can be achieved if the notes are made effectively fungible. The securities laws accommodate this desire even though distinct groups of holders are entitled to hold the Reg S and Rule 144A components. A non-US holder who wishes to sell a given principal amount of notes to a US purchaser can surrender that principal amount of its interest in a global Reg S note, and cause a corresponding principal amount of a global Rule 144A note to be given to the US purchaser, and *vice versa*, at least as far as the securities laws are concerned.

If both the Reg S and Rule 144A notes are registered, the tax law has no problem with this kind of fungibility. Interests in the global notes can flow back and forth between US and non-US holders, and the relative principal amounts of the Reg S and Rule 144A global notes are adjusted accordingly. Nothing in the tax law restricts the simultaneous issuance of a bearer Reg S note and a registered 144A note that are otherwise identical. In this case, allowing free conversion of bearer obligations into registered obligations and *vice versa* would run afoul of the TEFRA rules, because those rules treat an otherwise registered obligation as being in bearer form if at any future time it can be transferred by any means other than those permitted for registered obligations. A registered note that can be converted into a bearer note is treated as bearer from the outset.

The original regulations expressly reserved on the status of registered bonds that could be converted to bearer form. Shortly thereafter, proposed regulations on the issuer’s sanction regarding the

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123 Rule 144A sets forth the circumstances in which unregistered (in the securities law sense) securities can be offered and sold to “qualified institutional buyers” in the United States. 17 C.F.R. § 230.144A. The considerations discussed in this Part would also apply if the notes offered in the United States were registered with the Securities and Exchange Commission.


125 Temp. Treas. Reg. § 5f.103-1(e) (as originally added by T.D. 7852 (Nov. 15, 1982)).
loss of interest deductions provided that, for purposes of that sanction, such a bond would be treated as registered before conversion, provided that upon conversion a certification was delivered that the holder either was not a U.S. holder, or was a permitted U.S. holder.\textsuperscript{126} This provision was dropped from the final regulations, on the grounds that “this conversion rule would have created a substantial market of bearer paper that would be more readily available to U.S. persons.”\textsuperscript{127} When the regulations defining “registered” were changed to their current form in 1986,\textsuperscript{128} no further comment was given other than that the amendment “clarifies and amplifies” the definition of “registered” in the original regulations. The current rule, although a hindrance to fungibility, does make sense in light of the purposes of the bearer bond rules. The conversion of a registered obligation to a bearer obligation creates a new bearer instrument. The TEFRA rules closely regulate the creation of bearer instruments to ensure that they are targeted to non-US holders on issuance. No similar restrictions apply to secondary trades, so that the bearer obligation created on conversion of a registered obligation could be offered and sold in the United States. While nothing prevents holders of already outstanding bearer obligations from also offering and selling those obligations in the United States, at least those obligations, unlike interests in registered notes, will have been targeted offshore in their original issuance.


\textsuperscript{127} T.D. 7965 (Aug. 22, 1984)

\textsuperscript{128} T.D. 8111 (Dec. 19, 1986).
IV. MAKING DEFINITIVES AVAILABLE

A. Bearer Bonds in an Electronic Age

Today’s bearer bond is unlikely to be found in the safe deposit box of a Belgian dentist. Bearer securities, like debt and equity securities of all kinds, are normally held through brokerage accounts, and trading is more a matter of electronic recordkeeping than physical delivery of paper. Indeed, the cost of printing and delivering individual bearer instruments is a cost most issuers would prefer to avoid. Instead, a single global note, representing the entire principal amount of the issue, is issued in bearer form to a depositary acting for one or more clearing agencies such as Euroclear or Clearstream. Participants in the clearing system hold interests in the bearer note for their customers, who may themselves be financial intermediaries holding for others, and so on.

It can hardly be said that interests in such a bearer obligation pass by delivery. Unless the clearing systems go out of business, the bearer note itself is staying put. Transfers of interests in the obligation are made on the books of the clearing agency. Even those books, however, are not sufficient to identify ownership, since the participants are financial institutions who will generally be holding for others. Tracking ownership requires the combined books of the entire pyramid of financial intermediaries through whom interests in the obligation are held.

As we have seen, transfers on book-entry systems are one of the two permitted ways to transfer a registered obligation. If the bearer obligation above can only be transferred on the book entry systems of the clearing agencies and their direct and indirect participants, is there any reason not to treat the obligation as in registered form? To be sure, the note by its terms is payable to “bearer.” But the tax regulations do not make reference to the stated payee on the note; they only
look to how interests are transferred. Yet there are two possible reasons to treat the obligation as in bearer form. First, the clearing system is not normally acting as “agent” of the issuer; it acts on behalf of its participants. The clearing agency is nothing more than a place where securities can be deposited for more efficient trading. This answer, however, may be too glib in cases where the issuer itself has arranged for the entire issue to be deposited with the clearing system, and there are provisions in the bond documentation that discourage or even prohibit bonds from being held in any other way. In this circumstance, the clearing system is plausibly acting as agent for the issuer even if the bond documentation does not expressly use agency terminology.

Second, the bond documents will deal with the possibility, however remote, that the clearing system does go out of business, or is otherwise unable to continue its role. If no successor clearing system takes over the job, then individual bearer notes will be issued to holders. In some cases the documents will also provide for individual notes to be issued upon a default by the issuer, since under applicable law there may be procedural obstacles to enforcement by the holders unless they actually hold the notes.\textsuperscript{129} Such a clause, however, may be

\textsuperscript{129} Under New York law, for example, in several recent cases claims by beneficial owners of registered bonds were dismissed on the grounds that only the holder of the global note could sue. MacKay Shields LLC v. Sea Containers, Ltd., 300 A.D.2d 165, 751 N.Y.S.2d 485 (1st Dep’t 2002); Caplan v. Unimax Holdings Corp., 188 A.D.2d 325, 591 N.Y.S.2d 28 (1st Dep’t 1992). In those cases, the registered holder was Cede & Co., as nominee for The Depository Trust Company (“DTC”). DTC itself will bring suit on behalf of holders, but only under arrangements satisfactory to it, including broad indemnities from its participants, who will presumably seek similar indemnities from the beneficial owners.

Elsewhere, there may be no need to supply individual notes for this purpose. In the United Kingdom, for example, beneficial owners of interests in a global note can bring claims against the issuer under a deed poll. The use of a deed poll arose because English law did not confer third-party beneficiary rights before the enactment of The Contracts (Rights of Third Parties) Act 1999. A deed poll can confer rights on third parties without any need for contractual privity. Chelsea & Walham Green Bldg. Soc’y v. Armstrong, [1951] Ch. 853.
of limited use in a default context unless the holder of the global note already has a supply of individual notes to deliver, since the cooperation of the issuer at that time cannot be assumed.

As discussed in the preceding section, a bond will be treated as bearer if at any future time it can trade by any means other than the means prescribed for registered obligations. Even if the bonds would otherwise be treated as registered, the possibility that they could be converted to bearer form could be enough to cause them to be treated as bearer all along. Under this view, any possibility, however remote, that the bonds could trade in a non-registered fashion is sufficient to cause them to be treated as bearer. But the regulations could be read to treat a bond that is convertible into bearer form only upon the happening of a contingency as being in registered form until the contingency occurs. To be sure, the literal terms of the regulations can be seen to support the reading that any possibility, however remote, of conversion to bearer form is sufficient to cause the bonds to be treated as bearer from the outset. Yet it is troubling to have the classification of a bond as registered or bearer turn entirely on the existence of a remote contingency.130

Now imagine a bond issued under exactly the same arrangements, except that the global note is made payable to the depositary (but equally immobilized), and any definitives that are issued if the clearing system ceases to function are in registered form. The only differences, therefore, are the stated payee on the note, and the outcome of a remote contingency. Bonds of this type are routinely issued, and they are routinely regarded by market participants as being in registered form. It is hard to dispute this conclusion; but it is equally hard to see

the differences between this case and the preceding case involving a
global bearer instrument that justify such different treatment under
TEFRA.

B. Definitives under the D Rules

Two of the requirements of the D Rules relate to obligations that
are in “definitive” form. First, in connection with the sale of the obli-
gation during an initial 40-day restricted period, neither the issuer nor
any distributor may deliver the obligation in definitive form within the
United States. The TEFRA D certification must be provided
before the earlier of the first payment of interest or the delivery of the
obligation in definitive form. The regulations do not define what is
meant by “definitive form,” except to say that, for purposes of these
two requirements, a temporary global security is not considered to be
in definitive form.

The term “temporary global security” is defined, but in a way that
is not entirely helpful, since it uses the term “definitive”:

[T]he term “temporary global security” means a security which is
held for the benefit of the purchasers of the obligations of the is-
suer and interests in which are exchangeable for securities in
definitive registered or bearer form prior to its stated maturity.

The practice of using temporary global securities comes from the
United States securities laws, which impose restrictions on the offer
and sale of unregistered securities in connection with their initial issuance. Even before it became relevant for securities law compliance,

133 Although the registration requirements of the Securities Act of 1933 could liter-
ally apply to any offer or sale of a security involving interstate commerce, the
Securities and Exchange Commission has long taken the position that those re-
quirements are primarily to protect American investors, and has therefore not
taken action for failure to register offshore offerings. Securities and Exchange
Commission, Release No. 4708, 29 Fed. Reg. 9828 (July 9, 1964). After the re-
a temporary global security was a convenient way to evidence an obligation until it could be replaced by instruments produced by a financial printer.

A temporary global security does not normally carry any rights to payments of principal and interest, but is exchangeable into a permanent global security, which does carry these rights. In addition, interests in the permanent global security are sometimes, but not always, exchangeable into separate instruments for each holder. Maddeningly, the regulations do not answer the basic question whether a permanent global security is considered to be in definitive form. If a permanent global security is not considered to be in definitive form, then presumably the issuer could deliver it in the United States without running afoul of the D Rules, and if no individual instruments were provided, the TEFRA D certification could be delayed until the first payment of interest, which could be as late as maturity in the case of a zero-coupon obligation. It is doubtful that the IRS would countenance this result, however. In Revenue Ruling 89-9, the IRS ruled that a purported temporary global security would not be treated as

peal of the Interest Equalization Tax in 1974 made foreign securities attractive to U.S. investors, the SEC began to require, as a condition to issuing no-action letters, the use of a temporary global certificate that would be exchangeable for definitive securities only upon a certification of non-United States beneficial ownership. See Andre W.G. Newburg, Financing in the Euromarket by U.S. Companies: A Survey of the Legal and Regulatory Framework, 33 Bus. Law. 2171, 2186 (1978). Offshore offerings are now governed by Regulation S, which requires a temporary global certificate only for “Category 3 issuers,” which in the case of debt offerings include only U.S. issuers that are not reporting issuers under the Securities Exchange Act of 1934. 17 C.F.R. § 230.903.

134 In the context of these offerings, it is perfectly natural to speak of exchanging interests in a permanent global note for definitive notes, and this usage would imply that a permanent global note is not itself a definitive note. See, e.g., IPMA RECOMMENDATIONS, supra note 67, Recommendation 1.10.

135 1989-1 C.B. 76.
such under the predecessor to the TEFRA D Rules, where the security was not promptly replaced after issuance but remained outstanding for the entire seven-year term of the issue; such a security could not plausibly be regarded as “temporary” even though it was labeled as such. Consequently, as a matter of conservatism issuers treat the permanent global security as in definitive form in this context, so that it is delivered only outside the United States, and only after the TEFRA D certifications have been received.

The question is further complicated by a provision in the regulations stating that an issuer will fail to meet the TEFRA D certification requirement unless it makes the obligation available for delivery in definitive form within a reasonable time after the end of the restricted period. This provision was apparently added to ensure that the TEFRA D certifications are provided shortly after issuance. Treating the permanent global security as in definitive form satisfies this purpose, since the issuer cannot then deliver the permanent global security until the TEFRA D certifications have been received. But an issuer that fails to make individual definitive instruments available to holders will not be in compliance with the D Rules if the permanent global security is not considered to be in definitive form. The most conservative practice therefore, would be to treat the permanent global security as in definitive form for purposes of the delivery restriction and the timing of the TEFRA D certificates, but not for purposes of the requirement that definitive instruments be made available to holders within a reasonable time after the end of the restricted period. Yet this inconsistent stance cannot be right, since the regulations purport-

136 The so-called “B” rules contained in Treas. Reg. 1.163-2(c)(2)(B) applied to obligations issued before September 7, 1990, and were then superseded by the D Rules.


edly apply the same definition of “definitive form” for all of these purposes.

C. Concerns of U.S. Issuers

Foreign issuers often issue securities under the D Rules without making individual definitive instruments available to holders except in the remote circumstance of the clearing system ceasing to perform its role. Since they are obtaining timely TEFRA D certificates, and are not delivering any instruments at all in the United States, they regard this practice as good faith TEFRA compliance, and are not deterred by a theoretical extraterritorial imposition of the TEFRA excise tax. United States issuers are far more risk averse on this point, for three reasons. First, the TEFRA sanctions they face include not only the excise tax but also the potential loss of both interest deductions and the portfolio interest exemption. Second, these issuers are more directly under the audit scrutiny of the IRS. Third, the failure to provide definitive instruments raises the question whether the bonds should have been treated as registered, in which case the failure to obtain Forms W-8 from holders would also trigger the loss of the portfolio interest exemption.\(^\text{139}\)

Some bearer bond documentation allows the issuer to avoid a gross-up obligation if the holder fails to provide tax certifications on request; in other cases, the need for a tax certification forces the issuer to gross-up or redeem the bonds. While a careful US issuer can avoid some gross-up risk by using the former type of documentation,\(^\text{140}\) this

\(^{139}\) Such a bond would in effect be a “foreign-targeted” registered bond. The rules governing foreign-targeted registered bonds modify the holder certification requirements for payments to financial institutions, but they do not dispense entirely with the need for certification. Treas. Reg. § 1.871-14(c).

\(^{140}\) Even without a gross-up clause, the issuer bears the risk that the IRS will seek to collect the withholding tax some time after the interest has been paid, by which time the issuer will be unlikely to be able to recover the tax from the holder.
approach merely shifts the risk to the holder. To deal with the risk more directly, steps are needed to provide added assurance that the bonds will be treated as bearer. An effective approach is to give holders the right to receive individual definitive bearer notes on demand at any time. This right is unlikely to be of any practical consequence, since investors generally prefer to hold their securities through the clearing systems. Many issuers, however, are reluctant to expose themselves to the costs and practical complications of having to deal with a potential exercise of this right. Moreover, some clearing systems have an “all or nothing” rule, whereby if any portion of an issue is converted from global to definitive form, then the entire issue must be so converted, and individual notes must be printed for everyone.\(^{141}\)

The reason for such a rule is that the clearing systems generally operate on the principle that all obligations of an issue that they hold on behalf of participants must be absolutely fungible, so there can never be a question of which obligations are held for which participant. A definitive note can differ from an interest in a global note in some ways, such as the procedure for enforcing remedies, and this difference can be enough to violate the fungibility principle.

The all or nothing rule can be addressed by requiring holders who demand definitives to withdraw their notes from the clearing system, since in that case the clearing system should be willing to hold the balance of the issue in pure global form. The forced withdrawal should be enough of a disincentive in most cases to assure issuers that the practical risk of conversion is unlikely, but other disincentives could

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\(^{141}\) See, e.g., Joint Statement of IPMA, the International Securities Market Association, Cedel Bank and Morgan Guaranty Trust Company of New York, Brussels Office as Operator of the Euroclear System (January 27, 1995). See also IPMA RECOMMENDATIONS, supra note 67, Recommendation 1.10: “If the issue is to be in semi-permanent global form and to clear in Clearstream Banking and/or Euroclear then, in order to maximise the fungibility of the issue, for bearer securities the whole issue should be converted to definitive form (but not at the expense of the investors) when an investor gives due notice that he wishes to hold his part of the issue in definitive form.”
be considered. For example, definitives could be made available only if some percentage (e.g., 20%) of the holders request them. This approach will ensure that definitives are available whenever circumstances make sense for holders to have them, but prevents a single holder, on a whim, from calling for definitives. Another approach would give the holders the right to demand definitives, but only during a window of a week or so immediately after the end of the restricted period. There would still have to be a second window just before maturity, to preserve the bearer characterization, since the regulations provide that a bearer bond that ceases to be transferable by other than registered means will thenceforth be treated as registered.\footnote{Temp. Treas. Reg. § 5f.103-1(e)(3).} The arrangements for these windows, however, are highly artificial, and clarifications to the meaning of definitives as well as the distinction between bearer and registered in this context would make these arrangements unnecessary.
V. HYBRID OBLIGATIONS

Bearer bonds dominated the Eurobond market long before the TEFRA restrictions were enacted, and not surprisingly features of European law and practice evolved in a manner that reflects this dominance. The restrictions on sales of bearer bonds to United States persons were adopted just as a massive globalization of financial markets was getting under way. When features of local law conferred advantages on bearer obligations, issuers faced an unpleasant choice of either forgoing those advantages or losing access to the U.S. capital markets.

For example, the United Kingdom has for many years provided relief from withholding tax under its “quoted Eurobond” exemption. To qualify for this exemption, debt securities had to be listed on an exchange and be in bearer form. The listing part is easy, since there are few restrictions to obtaining a Luxembourg listing. But the requirement that the obligations be in bearer form meant that they could not be offered in the United States. Nor was it attractive to offer registered obligations in the United States alongside a foreign offering of bearer securities. The registered obligations would have been subject to a withholding tax of 20%, which holders would not have been willing to absorb and which, if grossed up, would have been a prohibitive cost for the issuer.


145 Income & Corporation Taxes Act 1988 §§ 1A, 4(1A), 349(2). While U.S. holders could presumably claim an exemption from this withholding tax under the tax treaty with the United Kingdom, the obligations could not freely trade in global markets on the basis that they were not subject to withholding tax.
The quoted Eurobond exemption has since been amended, and it is now available for registered obligations. Yet in some circumstances UK tax law still favors the issuance of bearer obligations. For example, convertible debt obligations may attract stamp duty reserve tax unless issued in bearer form. Other countries may also have legal and tax requirements that are best satisfied by issuing obligations in bearer form.

A. IRS Rulings

The dilemma can be resolved by issuing a “hybrid” obligation that is in registered form for US tax purposes but in bearer form for foreign tax and legal purposes. It might seem difficult to design such an obligation: after all, the obligation either trades in a manner characteristic of registered obligations, or it does not. Yet it has proven possible to do so in a number of foreign countries, by taking advantage of the more formal approach used by those countries to classify obligations as bearer or registered.

For example, such a hybrid obligation, when issued by a United Kingdom issuer, takes the form of a single global bearer instrument

146 Income & Corporation Taxes Act 1988 § 349(4) (as amended by Finance Act 2000 § 111(2)(b)).

147 Finance Act 1986 § 79(2) contains a blanket exemption from stamp duty reserve tax for bearer debt instruments. The corresponding exemption for registered debt instruments in § 79(4) is made inapplicable to convertible instruments by § 79(5). Under recent legislation even a bearer debt instrument may attract stamp duty reserve tax, if it is not sterling-denominated and is convertible into stock of a UK issuer. Finance Act 1996 §§ 95(2) and 97(3) (as amended by Finance Act 1999 § 116).

148 For example, convertible bonds issued under Japanese law must be issued in bearer form. SHÔHÔ [COMMERCIAL CODE], Art. 341-8(3) states, “Shinkabu yoyakukan-tsuki shusaiken wa mukimeishi to su.” [“The debenture certificates with the rights to subscribe for new shares shall be uninscribed.”] (Eibun-Horei Sha trans.) The term “inscribed” in this context means “registered.” BLACK’S LAW DICTIONARY 936–37 (rev. 4th ed. 1968). See also infra text accompanying note 151.
covering the full amount of the issue. The terms of the note are those of a classic bearer obligation: it is payable to bearer, and under English law ownership of the obligation can be transferred by delivery of the instrument. This bearer note is held by a depositary (or in some cases by a custodian acting for a depositary). In documentation that is separate (in the sense of appearing in separate contracts) from the note documentation, the depositary immobilizes the note by agreeing not to transfer it to anyone other than a successor depositary acting in the same role. The depositary then issues receipts that evidence interests in the bearer note; those receipts are issued in registered form. The receipts can be held by a clearing system, and interests in the receipts trade in the normal way. If the clearing system should cease to perform its role, the definitive notes that are issued to holders will be in registered form. (This last provision, under the earlier terms of the quoted Eurobond exemption, was unwelcome to a United Kingdom issuer, since it meant that a withholding tax would have been imposed if definitive notes were issued to holders, and the documentation would have provided for a gross-up of this withholding tax.)

For United Kingdom tax purposes, such a note is bearer while it remains in the clearing system, because the documentation extraneous to the note is disregarded. Arguably the TEFRA regulations could have been read to reach the same result for United States tax purposes. The IRS, however, issued a series of rulings in the mid 1990s that look to the substance of the overall arrangements to conclude that the notes should be treated as registered. Two of these rulings follow


150 I.R.S. Priv. Ltr. Ruls. 1993-43-018 (July 29, 1993), 1996-13-002 (Mar. 29, 1996). In the first ruling, the custodian itself issued receipts to the clearing system, but in the second ruling a separate depositary issued the receipts. Although the parties are not disclosed in the publicly available versions of these rulings, the issuer in the first ruling is widely known to be Barclays Bank.
the fact pattern described above in order to achieve a withholding tax exemption in the issuer’s home country.

A third ruling\(^\text{151}\) involves an issue by the World Bank that was represented by two global notes: one in registered form, which was held by a custodian for a United States clearing system; and one in bearer form, which was held by a custodian for Frankfurter Kassenverein AG, the predecessor to the German clearing system Clearstream AG. The ruling holds that the entire issue will be treated as registered. Because interests in the note held through the United States clearing system could be exchanged for interests in the note held through the German clearing system, and \textit{vice versa}, the status of the foreign notes as registered was essential for the domestic notes to be treated as registered as well. Since the issue included a note that was by its own terms registered, there does not appear to have been a withholding tax problem that was motivating the issuance of a bearer note to the German clearing system. Instead, the ruling states that the foreign note had to be in bearer form to be eligible for safekeeping and clearing by the German clearing system.\(^\text{152}\) In addition, the ruling stated


\(^{152}\) The German statute authorizing the deposit of securities with a clearing system requires that they be \textit{vertretbare Wertpapiere} [fungible securities]. \textit{Depot Gesetz} [Depot Act] § 5(1): “Der Verwahrer darf vertretbare Wertpapiere, die zur Sammelverwahrung durch eine Wertpapiersammelbank zugelassen sind, dieser zur Sammelverwahrung anvertrauen…” [“The custodian may accept fungible securities for general deposit, which are accredited by a security collecting bank for general deposit…”] The requirement of fungibility effectively requires that the instrument be transferable by delivery or endorsement. \textit{Handelsgesetzbuch} [Commercial Code] § 1 Depot Gesetz VI 303 (Ebenroth, Boujong & Joost ,2001): “Vertretbar sind nach § 91 BGB Sachen, die im Verkehr nach Zahl, Maß oder Gewicht bestimmt werden. Wertpapiere können nach Zahl oder ihrem Nennwert bestimmt werden, wenn innerhalb einer Wertpapierart jedes einzelne Wertpapier die gleichen Rechte verkörpert...Namenswertpapiere sind vertretbar, wenn sie mit einem Blankoindossament versehen sind.” [“In accordance with § 91 of the Civil Code, fungible items are those that can be accounted for in commerce according to number, measure or weight. Securities can be accounted for according to number or their nominal value, if within a kind of security each individual security embodies the same right...Registered securities are fungible, if they provide a blank endorsement.”]
that foreign law provided that a good faith purchaser for value of securities was protected against defects in title only if the securities were in bearer form. Presumably the hybrid arrangement, even though it caused the securities to be registered for United States tax purposes, did not hinder the application of this German-law rule.

B. Relevance of Agency

The documentation of a hybrid bond issue will normally make clear that the custodian and depositary are acting as agents of the issuer. This language may be there at the request of the tax lawyers, who want to be clear that these parties are acting as “agents” of the issuer in carrying out their responsibilities for tracking ownership, as required by the regulatory definition of “registered.” The corporate lawyers may accommodate the request, even if the language serves no other commercial or legal purpose. Curiously, however, none of the rulings dealing with hybrid securities expressly states that these parties are acting as agents for the issuer.

What is going on here? A bearer note held by a custodian who issues a receipt to a clearing system is treated as registered. Yet non-hybrid bonds often take the form of a bearer note held by a custodian for a clearing system, and the participants treat these bonds as bearer. Does some meaningless agency language make all the difference? Or is it just the nature of the instruments issued in the remote circumstance that the clearing system ceases to function?

Clearly a closer look is needed at what it means to be an agent of the issuer in this context. The most sensible approach is to tie the concept of “agency” to that of “transfer” discussed above: a regist-

153 See supra note 90 and accompanying text. The regulations also contain an example dealing with an obligation issued to a bank that keeps records of ownership interests, which states that the bank keeps these records as agent for the issuer. Temp. Treas. Reg. § 5f.103-1(f), Ex. (2).

154 See supra Part III.A (p. 507).
trar is acting as agent for the issuer if the issuer is bound to treat the person designated by the registrar as the owner of the debt, and can discharge its payment obligations by making payment to whomever the registrar designates as the owner. This approach appears to be the one adopted by the IRS in two of its rulings on hybrid instruments. For example, in one of those rulings, the IRS states,

Custodian will be the sole owner of each Global Note. However, under the Custody Agreement, the economic and other rights to which the holder of the Global Note would otherwise be entitled are conferred on the registered owners of the Global Receipt and any Certificated Receipts. Thus, all payments of principal and interest on the Global Note that are due to the Custodian are paid by the Depositary at the Custodian’s direction to Clearing Organization as holder of the Global Receipt and, if applicable, to any registered owners of Certificated Receipts.155

Here, the depositary is effectively acting as the issuer’s agent in maintaining the register, even though the ruling does not expressly refer to the depositary as an agent. The issuer has agreed with the depositary that payments are to be made to holders of the registered receipts issued by the depositary, which in the first instance are held by the clearing organization, but might also be held by owners outside the clearing system.

By contrast, an ordinary non-hybrid bearer global note is held by a custodian acting for the clearing system. The issuer is required to pay the clearing system by virtue of the fact that its custodian holds the physical note. The clearing system and its participants track ownership up the chain, but the issuer’s sole responsibility is to pay the clearing system; what happens after that is up to the clearing system and its participants. The distinction between this and a hybrid note arrange-

ment is barely perceptible in practice, but it can spell the difference between bearer and registered.\textsuperscript{156}

The IRS drew the line even finer in the World Bank ruling.\textsuperscript{157} In this case, there was no registered certificate issued by a depositary; instead, a bearer note was issued directly to the custodian for the German clearing system. Here, the IRS relied on the fact that the bearer note was immobilized to conclude that the issuer itself was maintaining a register of ownership that showed the clearing organization as the sole owner. Under this view, no other person was acting as agent for the issuer since the issuer was maintaining a register of ownership itself. While such a register is necessarily short, showing only one entry, this is exactly what happens when an issuer issues a global registered note to a clearing system.

\begin{itemize}
  \item \textsuperscript{156} A more flexible approach to bearer/registered hybrids may be possible using pass-through certificates or other repackaging arrangements, as discussed \textit{infra} in Part VII.C (p. 551).
  \item \textsuperscript{157} I.R.S. Priv. Ltr. Rul. 1993-43-019 (July 29, 1993).
\end{itemize}
VI. Dematerialized Obligations

Although obligations trading in U.S. markets are almost always certificated,\(^\text{158}\) uncertificated or “dematerialized” obligations have been introduced in a number of European countries. A dematerialized obligation is not represented by any sort of physical instrument, global or otherwise. Ownership of a dematerialized obligation is determined through records maintained by a clearing system authorized by a statute in the issuer’s home country under which the dematerialized obligations are issued.

It is hard to see how any dematerialized obligation could be regarded as bearer in the colloquial sense of allowing title to pass by delivery: in the absence of a physical note, there is nothing to deliver. But the question here is whether they might be bearer in the technical sense as defined in the regulations. The situation is complicated by the fact that some countries actually use the term “bearer” to describe certain dematerialized obligations.\(^\text{159}\)

A. Issuer Access to Records

Is a “dematerialized bearer” obligation an oxymoron? Take the example of French law, which provides for two types of dematerialized obligations: titres nominatifs and titres au porteur. In both cases,

\(^{158}\) As it became apparent in the late 1960’s that growing trading volumes could be accommodated only by electronic trading, it was thought that certificated securities would gradually be replaced by uncertificated securities. Instead, in the United States (with a few exceptions such as Treasury securities and mutual fund shares) most securities continue to be issued in certificated form, but the certificates are held by a clearing system such as DTC, and trades are settled electronically on the books of the clearing system and its participants. UCC Art. 8, Prefatory Note Part I.B (2002).

\(^{159}\) By contrast, under the UCC the term “bearer” is used only for certificated securities. See supra note 93.
ownership of the obligations is determined by records maintained by Euroclear France SA, a French clearing system. The only difference is that the issuer can see these records if the obligations are nominatifs, but not if the obligations are au porteur.

The terms nominatif and au porteur are also used in French to indicate a “registered” and “bearer” bond respectively, where a physical note is issued. The French have no problem referring to an obligation as being both au porteur and dématérialisée. The question is whether we should properly translate au porteur as “bearer” in this context. And the answer, presumably, turns on whether Euroclear France can be regarded as an agent of the issuer in maintaining a book-entry register of ownership.

Nothing in French law expressly refers to Euroclear France as an agent of the issuer; rather it is performing a statutorily prescribed role with regard to dematerialized bonds. 160 Admission to Euroclear France is automatic upon listing of the obligations on a regulated French stock exchange. In this role Euroclear France is not seen under French law as the “agent” of any private party, although in some cases it has been willing (at the request of U.S. tax lawyers) to sign an acknowledgement that it is acting as the issuer’s agent. In any event, the duties of Euroclear France as an authorized intermediary correspond precisely to those of an agent as described in the preceding section, and indeed are identical to those for a dematerialized nominatif obligation. Under French law, the issuer must treat as the owner the person identified as such in the records of Euroclear France. 161 Pay-

160 CODE MONETAIRE ET FINANCIER [MONETARY AND FINANCIAL CODE] art. L.211-4 provides, “Les valeurs mobilières émises en territoire français et soumises à la législation française, quelle que soit leur forme, doivent être inscrites en comptes tenus par l’émetteur ou par un intermédiaire habilité.” [“Securities issued in France and under French law, regardless of their form, must be registered in accounts maintained by the issuer or an authorized intermediary.”]

161 CODE DE COMMERCE [COMMERCIAL CODE] art. L.228-1 provides, “Les valeurs mobilières émises par les sociétés par actions revêtent la forme de titres au porteur ou de titres nominatifs. Ces valeurs mobilières, quelle que soit leur forme, doivent être inscrites en compte
ments of principal and interest are made to Euroclear France, which is obligated to forward the payments to the owners that appear on its records. Even if the issuer does not know who those owners are, it is using Euroclear France to track ownership and to discharge its payment obligations. So there is no oxymoron: a “dematerialized bearer” obligation is properly regarded as registered.

The concept of agency fits more comfortably with some systems than with others. For example, Swedish law authorizes VPC AB to operate a book-entry system for dematerialized securities.\textsuperscript{162} Registration of an issue in VPC can occur, however, only if the issuer has entered into an agreement with VPC that specifically appoints VPC to act as registrar.\textsuperscript{163} Although the Swedish documentation makes this agency explicit, there does not appear to be any relevant difference between the role played by VPC and that played by Euroclear France in maintaining a registry for dematerialized bonds.

\textit{au nom de leur propriétaire…”} [Securities issued by corporations take the form of bearer securities or registered securities. These securities, regardless of their form, must be registered in the name of their owner…”]

\textsuperscript{162} Lag (1998:1479) om kontoföring av finansiella instrument [Financial Instruments Accounts Act] Ch. 4, § 4: ”Registrering enligt 2 eller 3 §§ sker enligt avtal mellan den centrala värdepappersförvararen och emittenten. Om de finansiella instrumenten har utfärdats i ett annat land än Sverige, får sådan registrering också ske enligt avtal mellan den centrala värdepappersförvararen och företag med motsvarande uppgifter i det landet, om de finansiella instrumenten har avskilt för sådant ändamål.” [”Registration pursuant to § 2 or § 3 shall take place pursuant an agreement between the central securities depositary and the issuer. If the financial instruments have been issued in a country other than Sweden, this registration may also take place pursuant to an agreement between the central securities depository and an entity with the corresponding tasks in that country, provided that the financial instruments have been separated for those purposes.”].

\textsuperscript{163} Id. VPC’s standard agreement for Swedish issuers states, “Emittenten uppdrar åt VPC att för Emittentens räkning kontoföra nedan angivna Finansiella Instrument i Avstämningsregister.” [”The Issuer hereby on its behalf appoints VPC to register the securities specified below in a securities account.”] For non-Swedish issuers, VPC’s standard agreement is in English, and includes the clause, “VPC shall be appointed by the issuer as registrar and shall as such establish and maintain a VPC Register for the Securities in accordance with the Financial Instruments Accounts Act.” Standard Agreement, VPC’s Rules for Issuers, 2002:1, App. 1.
B. Government Access to Records

Even if the issuer lacks the right to view the register on a dematerialized obligation, the local government may have this right: for example, the records of Euroclear France and of VPC are available to the French\textsuperscript{164} and Swedish\textsuperscript{165} governments, respectively, for the administration of their revenue laws. Moreover, the United States tax treaties with France and Sweden both contain exchange of information clauses that in principle make this information available on an as needed basis to the United States government.\textsuperscript{166} In this context, it is hard to imagine why the Service would have any objection to treating dematerialized obligations as registered.

\textsuperscript{164} See \textit{Livre des procédures fiscales} [Tax Procedure Book] art. L94, which provides, “Les personnes dont le commerce habituel consiste à recueillir des offres et des demandes de valeurs de bourse doivent communiquer à l'administration, sur sa demande, les registres constituant le répertoire de leurs opérations.” [“People whose regular business consists in collecting offers and requests of stock exchange values must provide to the tax authorities on request the registers constituting their operations’ index.”]

\textsuperscript{165} See \textit{Skattebetalningslagen} (1997:483) [Tax Payment Act] ch. 14, § 4, which provides, “Skatteverket får förelägga den som är eller kan antas vara bokföringsskyldig enligt bokföringslagen (1999:1078) eller som är annan juridisk person än dödsbo att lämna uppgift, visa upp handling eller lämna över en kopia av handling som rör rättshandling mellan den som föreläggs och den med vilken han har ingått rättshandlingen (kontrolluppgift). Föreläggande får meddelas, om kontrolluppgiften har betydelse för beskattning enligt denna lag. Om det finns särskilda skäl, fär även någon annan person än som avses i första stycket föreläggas att lämna kontrolluppgift.” [“The Tax Authority may order a person who is obliged to prepare financial accounts pursuant to the financial accounts act (1999:1078) or who is a legal entity, other than an estate of a deceased person, to provide information, present documents or deliver a copy of documents relating to a transaction between the party so ordered and the party with whom the ordered party made the transaction (tax verification). An order may be given, provided the tax verification has relevance for taxation under this act. If there are particular reasons, also other persons than the persons mentioned in the first paragraph may be ordered to provide the tax verification.”]

Indeed, the legislative history to the TEFRA rules makes clear that the bearer bond restrictions were enacted to backstop the information and withholding provisions that were enacted at the same time. 167 In authorizing book-entry systems for Treasury obligations, the TEFRA Blue Book stated,

When necessary, the Secretary may provide for maintenance of such book entries by an agent of the issuer or through a chain of one or more nominees, so long as such a system of book entries provides an audit trail through which the Commissioner could determine the ultimate owner of the interest or principal of any obligation at any particular time. 168

Similar book entry-systems were contemplated for non-Treasury obligations, it being anticipated that “the Secretary will require that such book-entry systems be maintained in a manner that would permit examination of the entries by the Secretary in connection with enforcement of the internal revenue laws.” 169

In one of the rulings dealing with hybrid bonds, the IRS noted the existence of exchange of information agreements between the United States and the countries where the issuer and custodian were organized and, in the case of the custodian, subject to banking regulation. 170 In that ruling, the clearing organization was domestic; in another ruling with a German clearing organization, the IRS noted the existence of an exchange of information agreement between the United States and the country where the clearing organization was


168 TEFRA Blue Book, at 191. This sentence also appears in the Senate report, but only up to the word “nominees.” TEFRA Senate Report, at 243.

169 TEFRA Senate Report, at 244; TEFRA Blue Book, at 193.

organized and subject to banking regulation.\textsuperscript{171} In the third hybrid bond ruling, both the custodian and the clearing organization were domestic.\textsuperscript{172} In each case, the IRS had the means to track registered ownership through the clearing organization.

It thus appears that as a matter of ruling practice the IRS has respected the idea set out in the Blue Book that a book entry system should permit the IRS to track ownership. Yet nothing in the regulations states that a book entry system must be implemented in a

\textsuperscript{171} I.R.S. Priv. Ltr. Rul. 1993-43-019 (July 29, 1993). The treaty with Germany contains an exchange of information clause that requires each party to provide tax information to the other to the extent available to it under its own revenue laws. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-Ger., Art. 26, TAX TREATIES (CCH) ¶ 3249.53. German law gives the tax authorities the power to examine bank records. Abgabenordnung [Fiscal Code] § 97: “Die Finanzbehörde kann von den Beteiligten und anderen Personen die Vorlage von Büchern, Aufzeichnungen, Geschäftspapieren und anderen Urkunden zur Einsicht und Prüfung verlangen.” [“For review and examination, the tax authority can require from the parties and other persons books, records, business documents and other certificates.”] This power, however, is restricted in two ways. First, the tax authorities are required to approach the taxpayer before approaching third parties. Second, the tax authorities are not entitled to troll through accounts generally or in connection with a tax audit of the bank itself. Abgabenordnung § 97 Abs. 2: “Die Vorlage von Büchern, Aufzeichnungen, Geschäftspapieren und anderen Urkunden soll in der Regel erst dann verlangt werden, wenn der Vorlagepflichtige eine Auskunft nicht erteilt hat, wenn die Auskunft unzureichend ist oder Bedenken gegen ihre Richtigkeit bestehen.” [“The submission of books, records, business papers and other documents is only to be demanded if the taxpayer does not provide the necessary information, or if the information is insufficient or doubts exist in regard to the correctness of the information.”] Abgabenordnung § 30a: “Die Finanzbehörden dürfen von den Kreditinstituten zum Zweck der allgemeinen Überwachung die einmalige oder periodische Mitteilung von Konten bestimmter Art oder bestimmter Höhe nicht verlangen. Die Guthabenkonten oder Depots, bei deren Errichtung eine Legitimationsprüfung nach § 154 Abs. 2 vorgenommen worden ist, dürfen anlässlich der Außenprüfung bei einem Kreditinstitut nicht zwecks Nachprüfung der ordnungsmäßigen Versteuerung festgestellt oder abgeschrieben werden.” [“For purposes of general monitoring, the tax authority is not allowed to demand one-time or periodic information about certain types of accounts or accounts with certain amounts. During a tax audit of a financial institution, bank accounts or deposits shall not be identified or copied in order to determine their proper taxation, if when these accounts or deposits were opened, the verification procedure set forth in § 154 ¶ 2 was carried out.”]

manner that provides access to the IRS. While in the French case this access appears to be available, the situation may be less clear in other countries.

Portugal, for example, provides for the issuance of dematerialized bonds that clear through the Portuguese clearing agency Central de Valores Mobiliários (“CVM”). As under French law, a Portuguese dematerialized bond is considered to be bearer or registered depending on whether the issuer has the right to be informed of the identity of the holders.173 Bonds are considered to be registered unless the issuer affirmatively decides that they should be bearer.174 While there is an exchange of information agreement between the United States and Portugal,175 that agreement is effective only to the extent that Portugal itself has access to the relevant information in the books of CVM or its participants.176 Those records are protected by bank secrecy laws, but the protection is not absolute, since government access can be obtained with judicial authorization. In addition, government access can be obtained even without judicial authorization where certain objective indicia of tax avoidance are present, such as suspiciously low reported income or evidence of tax fraud. There is no indication in the regulations, the legislative history, or the IRS rulings whether this form of qualified access is sufficient.

173 **CODIGO DOS VALORES MOBILIARIOS** [SEcurities CODE] Art. 52 (1): “Os valores mobiliários são nominativos ou ao portador, conforme o emitente tenha ou não a faculdade de conhecer a todo o tempo a identidade dos titulares.” [“Securities are registered or bearer, depending on whether the issuer has the ability at all times to be informed of the identity of the respective holders.”]

174 **CODIGO DOS VALORES MOBILIARIOS** Art. 52 (2): “Na falta de cláusula estatutária ou de decisão do emitente, os valores mobiliários consideram-se nominativos.” [“In the absence of a company bylaw clause or of a decision of the issuer, the securities are considered to be registered.”]


176 A curious wrinkle arises for sovereign issues of dematerialized bearer obligations. In its capacity as issuer, the sovereign has no right to inspect the book-entry register, but in its capacity as tax collector, it may have such a right.
Even if the dematerialized bonds are cleared through a system that operates in full sunshine, the records up the chain may be shrouded in darkness. The principal European clearing systems are Clearstream and Euroclear, whose records are protected by bank secrecy laws in Belgium and Luxembourg respectively. Euroclear, for example, is itself a participant in CVM. If the ultimate owner holds Portuguese dematerialized bonds through an account with a participant in Euroclear, CVM's records will simply show that the bonds are held by

177 CODE DES IMPÔTS SUR LES REVENUS [INCOME TAX CODE] Article 318, 1° provides: “Par dérogation aux dispositions de l'article 317 et sans préjudice de l'application des articles 315 et 316, l'administration n'est pas autorisée à recueillir, dans les comptes, livres et documents des établissements de banque, de change, de crédit et d'épargne, des renseignements en vue de l'imposition de leurs clients.” [As a limitation on the provisions of Article 317, and without affecting the application of Articles 315 and 316, the [tax] administration is not authorized to collect information from the accounts, books and records of banking, exchange, credit and savings institutions in connection with the taxation of their customers.”] The principle of bank secrecy is not absolute, however, and bank records can be inspected if there is evidence of tax fraud (Article 318, 2°), or a tax protest has been filed by a taxpayer against a tax assessment (Article 374, 2°). Moreover, the Belgian tax treaty contains an exchange of information clause. Convention for the Avoidance of Double Taxation, July 9, 1970, U.S.-Belg., Art. 26(1), TAX TREATIES (CCH) ¶1,303.27.

178 Loi du 5 avril 1993 relative au secteur financier telle qu'elle a été modifiée [Law of April 5, 1993 regarding the financial sector, as amended] Article 41 provides, “Les administrateurs, les membres des organes directeurs et de surveillance, les dirigeants, les employés et les autres personnes qui sont au service des établissements de crédit, des autres professionnels du secteur financier, des organes de règlement, des contreparties centrales, des chambres de compensation et des opérateurs étrangers de systèmes agréés au Luxembourg visés à la partie I de la présente loi, sont obligés de garder secrets les renseignements confiés à eux dans le cadre de leur activité professionnelle. La révélation de tels renseignements est punie des peines prévues à l'article 458 du Code pénal.” [“Directors, members of the management and supervisory boards, officers, employees and any other person in the service of credit institutions, other professionals within the financial sector, settlement agents, central counterparties, clearing houses and foreign operators of the clearing systems authorized in Luxembourg that are referred to in Part I of this Law, have an obligation to keep confidential the information obtained in the course of their professional activity. Disclosure of this information is subject to the penalties provided by Article 458 of the Penal Code.”] The only exception is for investigations of criminal activity. CODE D'INSTRUCTION CRIMINELLE [CODE OF CRIMINAL PROCEDURE] Arts. 63–67.
“Euroclear,” and that is the only information that will be available to the Portuguese tax authorities (or to the United States tax authorities under the exchange of information route). Given this possibility, it is hard to see how government access merely to the records of CVM should be given much weight in determining whether the dematerialized bonds should be treated as bearer or registered.

Indeed, the same issue crops up outside the context of dematerialized bonds. Take the common example of a global registered note that is deposited with Cede & Co. on behalf of DTC, which operates a clearing system in the United States. The IRS has ruled that an issuer may treat bonds issued in this fashion as registered, even though the clearing system’s own records will simply identify the amounts held by its direct participants and will therefore not identify beneficial owners. While in principle ultimate beneficial ownership can be traced through DTC’s participants, those participants include foreign clearing systems such as Euroclear and Clearstream, whose records are not open to the IRS. The situation is even more stark where the global registered note is not deposited with DTC but instead is deposited with a common depositary for Euroclear and Clearstream. The only notation on the issuer’s register will show that the entire issue is held by the common depositary; the real ownership records are those of the clearing organizations and their participants. But there is no assurance that those records will be available to the governments of their host countries, much less to the IRS.

Given the ubiquity of Euroclear and Clearstream in the European capital markets, there is a huge volume of registered obligations outstanding with ownership that cannot be readily traced by the IRS. The Blue Book’s assertion that a book entry system must allow such tracing cannot be taken at face value; if it were, those obligations would be treated as bearer, and there would be in the aggregate an astro-

onomic excise tax liability. This excise tax would not be imposed on the issuers of these obligations, since they are properly in registered form. Instead, the excise tax would be imposed on the clearing organizations, since it is their systems that would, under this view, be allowing transfers in a fashion other than those approved for registered obligations.\footnote{180} Given the critical role these clearing systems play in raising capital for issuers in the United States and elsewhere, it is impossible to imagine the IRS seriously attempting to collect such a tax from the clearing systems, other than as a ploy to attack the relevant secrecy laws.

C. Transfers Outside the Register

Even with a dematerialized obligation it is possible for transfers to occur that are not reflected in the register. For example, under Swedish law a purchase and sale agreement between two parties can be held valid as between the parties to the agreement even if that agreement is not valid towards third parties.\footnote{181} If the sale involves

\footnote{180} See supra note 99 and accompanying text.

\footnote{181} Lagen (1998:1479) om kontoföring av finansiella instrument [Financial Instruments Trading Act] ch. 6 § 6: "Den som på förfallodagen eller på fastställd avstämmingsdag är antecknad på ett konto i avstämmningsregistret som ägare eller i andra fall berättigad att ta emot betalning för en skuldförbindelse skall anset ha rätt att ta emot betalningen. Betalningen är dock inte giltig, om gäldenären insåg eller borde ha insett att betalningsmottagaren inte var berättigad att ta emot betalning för skuldförbindelsen." ["The person who on the maturity date or on the determined record date is registered as owner of an account in the relevant securities account or in other instances is authorized to receive payment in respect of a debt security shall be deemed to be authorized to receive the payment. The payment is however not a valid discharge if the debtor realized or should have realized that the recipient of the payment was not authorized to receive payments in respect of the debt security."] Under Swedish law this same rule applies to physical notes payable to bearer. Lagen (1936:81) om skuldebrev [Act on Promissory Notes] § 19: "Har skuldebrev som är ställt till innebäraner infriats hos den som hade det i besittning, och visar sig sedan att han var i konkurs eller att han icke var rätte borgenären eller behörig att å dennes vägnar uppbära beloppet, vare betalningen ändock gill, utan så är att gäldenären visste att beloppet kom i orätt-a händer eller äsidosatt den aktansambet som, efter omständigheterna, skuligen bort iakttagas."
dematerialized bonds that clear through VPC, the buyer can enforce the agreement and require the seller to have the transfer registered, even though the issuer would otherwise be entitled to continue to treat the seller as owner. If, however, the issuer has actual knowledge of the transfer, then the issuer may have an obligation to pay the buyer, and the issuer can no longer treat the seller as the owner. (As a practical matter, the issuer would deposit the funds with a public body until the question of ownership is settled.) The possibility of such transfers outside the register should not preclude a dematerialized obligation from being treated as registered, any more than the similar possibilities that exist for an obligation evidenced by a note.182

[If a promissory note, which is payable to the bearer, has been discharged to the person who had it in its possession and who subsequently turns out to have been in bankruptcy or not the right creditor or authorized to receive the amount on the creditor’s behalf, the payment is still a valid discharge, provided that the debtor did not know that the amount was paid to the wrong person or that the debtor had not neglected to observe proper care that, depending on the circumstances, reasonably should have been taken.]

182 See supra Part III.A (p. 507).
VII. LAYERS OF OWNERSHIP

An obligation is generally viewed as a two-party arrangement between an issuer and a holder. But the reality is rarely this simple. Obligations are held through layers of ownership arrangements. At their simplest, these arrangements may consist of an account with a broker through which the obligation is held; the broker in turn has an account with a clearing system, or perhaps with another broker that has such an account. In such a case, the broker is merely acting as a custodian for the securities: it has possession, but no beneficial interest. Legal title is usually held by a nominee who lacks any other attribute of ownership or possession. In these cases, the ultimate holder is considered for tax purposes to own directly an interest in the underlying obligation.183

Even where the holder is considered to directly own an obligation of the issuer, a custodian, nominee or depositary can be considered the “issuer” for purposes of the TEFRA excise tax if it causes interests in a registration-required obligation to trade in bearer form.184 A trust arrangement produces essentially the same results, since under the grantor trust rules the owners of the trust interests are considered to directly hold their respective shares of the trust’s assets.185

Other forms of indirect holding of debt securities take the form of securitizations where a separate entity acquires the securities with the proceeds of its own obligations. The taxonomy of the myriad forms

183 For UCC purposes, a beneficial owner who holds a financial asset though a securities intermediary is considered to have acquired a “security entitlement” from the securities intermediary. UCC § 8-501(b) (1995). Such a security entitlement represents more than a personal claim against the securities intermediary, since the financial asset is considered to be the property of the entitlement holder, not the securities intermediary. UCC § 8-503(a) (1995).

184 See supra note 99.

185 I.R.C. § 671 et seq.
of securitization is beyond the scope of this article, but a few broad categories of these arrangements are worth noting because of their implications for the application of the bearer bond restrictions.

**A. Debt or Equity?**

In some cases the obligation issued by an offshore securitization vehicle is itself debt for tax purposes, and such an obligation, if issued in bearer form, will need to comply with TEFRA. This will be the case if the vehicle has substantial equity, such as a significant tranche of junior securities, which may take the form of debt but would likely be treated as equity for tax purposes if the vehicle has nominal stated equity. Also, the obligation may be issued, or backed, by a financial institution or other creditworthy party, which will normally ensure that the obligation will be treated as debt. Finally, the obligation may be treated as debt by statutory fiat, as under the REMIC or FASIT rules.\(^{186}\)

In other cases the obligation issued by the securitization vehicle will be treated as equity, either because it takes the form of equity, or because the vehicle has only a nominal amount of stated equity and has no other junior security outstanding. If the vehicle is a corporation for tax purposes (usually an elective matter under the check the box rules),\(^{187}\) then it will almost always be passive foreign investment company (a “PFIC”).\(^{188}\) Since the TEFRA rules only apply to obligations that are treated as debt for tax purposes, presumably TEFRA does not

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\(^{186}\) A fixed or floating rate security issued by a real estate mortgage investment conduit (a “REMIC”) or a financial asset securitization interest trust (a “FASIT”) is treated as debt for tax purposes, even if it takes the form of preferred stock. I.R.C. §§ 860B(a), 860H(c)(1).

\(^{187}\) Treas. Reg. § 301.7701-3 permits a wide spectrum of business entities to elect whether to be treated as a corporation or a partnership for US tax purposes, by filing an election form with the IRS.

\(^{188}\) See I.R.C. § 1297(a).
restrict obligations that take the form of equity or are otherwise treated as such.

Yet there are good reasons why repackaging debt as bearer corporate equity is not a particularly attractive idea. First, if the obligation takes the form of debt, it puts the parties in a position of arguing against the form of the transaction. Second, the Service might treat the whole arrangement as a device to circumvent TEFRA, and impose the excise tax on the vehicle for having provided an indirect way to trade bearer interests in the underlying obligation.189 Perhaps that attack can be forestalled by paying careful attention to the corporate formalities,190 but it is one more thing to worry about. Most important, however, is that from the holder’s point of view, the cure is probably worse than the disease. Gains realized on the disposition of PFIC shares are taxed at the highest rates applicable to ordinary income, and there is also an interest charge imposed on a deemed deferral of tax compared with the tax that would have been paid had the gain accrued ratably over the holder’s holding period.191 While this result can be avoided if the holder makes a “qualified electing fund” election to be taxed annually on the holder’s share of the vehicle’s income,192 this approach probably raises the risk of the Service’s asserting the application of TEFRA, and in any event is likely to be difficult to administer in a manner that preserves the holder’s anonymity.193

189 Existing regulations already impose sanctions on persons who attempt to transfer registered obligations through means outside the registry (see supra note 99), but if the vehicle is respected as a separate entity then transfers of its equity should not be viewed as transfers of the obligations that it owns.

190 Even if the formalities are followed, the Service might argue that the vehicle should be treated merely as a collection agent for its owner. Cf. Aiken Indus., Inc. v. Commissioner, 51 T.C. 925 (1971).

191 I.R.C. § 1291.

192 I.R.C. § 1293.

193 The PFIC rules do, however, permit a qualified electing fund election to be made for bearer shares. Treas. Reg. § 1.1295-1(d)(1).
Outside the securitization context, there is little concern that TEFRA applies to bearer equity. Although bearer shares are not a feature of domestic corporate law, the corporate laws of many European countries authorize the issuance of bearer shares, and even a domestic issuer could issue bearer equity in the form of debt with strong equity features such as a perpetual term and deferrable payments. Bearer shares may be issued with dividend coupons attached to, or issued with, the share certificate, and surrendered in order to receive a dividend. Although the share itself is unquestionably equity, query whether the right to receive a dividend, as evidenced by the dividend coupon, is a bearer debt obligation once the board of directors has declared the dividend. In any event, however, the question is of little practical import, since the dividend obligation,

194 See, e.g., Del. Code Ann. tit. 8, § 158, which prohibits the issuance of bearer share certificates.

195 See, e.g., Aktiengesetz [Stock Corporation Act] § 10(1) (F.R.G.): “Die Aktien können auf den Inhaber oder auf Namen lauten.” [“Share certificates may be in bearer or registered form.”] English companies cannot issue bearer shares because they are required to maintain a register of share ownership, but they can issue bearer warrants for shares, which can carry rights to dividends. Companies Act §§ 188, 352.

196 In the U.S. context, a declared dividend can create a debtor-creditor relationship between a shareholder and the corporation. Wilmington Trust Co. v. Wilmington Trust Co., 25 Del. Ch. 193, 15 A.2d 665 (1940). This is the case even though a corporation can declare a dividend only out of available capital, surplus and profits. See, e.g., Del. Code Ann. tit. 8, § 170. Moreover, a shareholder normally has no right to compel a corporation to declare a dividend or to redeem shares even if a dividend and redemption schedule is provided for under the terms of the shares. See Alco Prod. Inc. v. White Motor Corp., 1978 U.S. Dist. LEXIS 14479 (S.D.N.Y. 1978).

A shareholder of a German corporation also has a creditor’s claim to a declared dividend. See Adler/Düring/Schmalz, Rechnungslegung und Prüfung der Unternehmen, ann. 55 to § 174 AktG (6th ed. 1997). “Mit der Beschlussfassung über die Gewinnverwendung, die eine Verteilung an die Aktionäre vorsieht, entsteht ein entsprechender Anspruch des Aktionärs auf Auszahlung der Dividende. Der Anspruch ist ein reines Gläubigerrecht.” [“A resolution declaring a dividend to shareholders gives them an entitlement to the payment of the dividend. This entitlement is purely that of a creditor.”]
even if separately viewed as debt, will almost always have a maturity of not more than one year, and therefore will not be a registration-required obligation subject to the TEFRA restrictions.197

If the securitization vehicle is classified as a partnership for United States tax purposes, and it issues obligations that are treated as equity, those obligations will be treated as partnership interests. Although the idea of bearer partnership interests is slightly odd as a legal matter, these obligations could easily take the legal form of corporate bearer debt. With a partnership vehicle, the PFIC rules are no hindrance.

Consider, for example, a Cayman Islands limited liability company with nominal stated equity that elects to be treated as a partnership, and issues a single class of bearer notes, the proceeds of which are used to purchase an entire issue of registered obligations of a non-U.S. issuer. The issuer of those obligations simply shows the Cayman Islands company as the sole owner of the registered issue. The holders of the bearer notes are happily anonymous. Could the Cayman Islands issuer offer and sell those notes in the United States, on the grounds that the notes are equity and TEFRA does not restrict the issuance of bearer partnership interests? (Such a partnership, because it earns no U.S. source income, would have no U.S. tax filing obligations, and would therefore not need to know who its noteholders are for U.S. tax compliance purposes.)

Of course, some of the caveats mentioned above in connection with notes treated as corporate equity would also apply here. The Service already has some authority to expand the categories of registration-required obligations as necessary to give effect to the purposes of the TEFRA rules,198 and it would no doubt seek some basis

197 The dividend obligation might also be regarded as not registration-required because it is not of a type offered to the public, although this would be less clear if the underlying shares were publicly held.

198 I.R.C. § 163(f)(2)(C) authorizes the issuance of regulations on a prospective basis to treat obligations as registration-required even if they are not of a type offered to the public, have a maturity of not more than one year, or are targeted off-
on which to apply those rules here.\textsuperscript{199} Indeed, if the issuer were characterized as a grantor trust rather than a partnership, the Service would be empowered under existing regulations to treat the interests in the trust as registration-required obligations, and to impose sanctions on the issuer of the underlying obligations as well as on the trustee if the issuer set up the arrangement.\textsuperscript{200}

**B. Underlying Obligations That Are Not Registration-Required**

Some securitizations are essentially repackagings of underlying obligations that are not registration-required, and which can themselves be issued in bearer form without running afoul of TEFRA. The TEFRA rules, for example, do not apply to obligations issued by individuals. A home mortgage loan is ordinarily considered to be in bearer form for TEFRA purposes, since the bank can transfer the loan without the issuance of a new note or a notation on a registry maintained by the borrower or her agent.\textsuperscript{201} If a home mortgage issued by an individual is not a registration-required obligation, then presumably a

\textsuperscript{199} Possibly the Service might use the partnership anti-abuse rules to treat the partnership as an aggregate for this purpose, so that transfers of interests in the partnership would be viewed as transfers of the underlying obligations. \textit{See} Treas. Reg. § 1.701-2(c)(1). \textit{See also infra} note 208.

\textsuperscript{200} Treas. Reg. § 1.163-5T(d)(4). Arguably the rules applicable to trusts extend to partnerships as well, and members of an ABA committee have proposed that the IRS issue a revenue ruling to that effect. ABA Report, \textit{supra} note 85, at 710–13, 736–37.

\textsuperscript{201} I, for one, would be hard pressed to maintain a register of ownership of my home mortgage loan, which has changed hands at least once since issuance, although the servicing bank is careful to tell me where to send my monthly payments.
certificate representing an interest in such a mortgage would not be registration-required either, and could be issued in bearer form.

The regulations, however, prevent this result by treating interests in a pool of mortgage loans as registration-required obligations even though the underlying loans will not typically be registration-required. At the same time, the Regulations allow the certificates to be treated as targeted to non-U.S. persons on issuance, and therefore in compliance with TEFRA, even if the underlying obligations were not so targeted. In general, the regulations completely disconnect the TEFRA status of the pass-through certificates from that of the underlying obligations. For example, the status of the certificates as being in registered form or targeted to non-U.S. persons on issuance will not be affected by whether the underlying obligations are registered or so targeted, and any TEFRA excise tax triggered by the issuance of bearer certificates is imposed on the sponsor rather than the borrowers on the underlying obligations.

A regular interest in a REMIC is considered to be a separate debt security rather than an ownership interest in the underlying mortgage pool. The TEFRA regulations treat these regular interests in the same fashion as mortgage pass-through certificates, so their status under TEFRA is disconnected from that of the underlying mortgages. The regulations do not expressly deal with FASITs, but these are still a fairly recent invention, and there is no reason to treat them any differently from REMICs in this regard.

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205 I.R.C. § 860B(a).
207 The FASIT rules were added by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188 § 1621(a), 110 Stat. 1755, 1858 (1996). The days of FASITs are probably numbered. In the Jobs and Growth Tax Reconciliation Act of 2003, Pub. L. No. 108-27, the Senate version contained a provision to repeal the
Bank loans are generally not registration-required obligations, since they are not of a type offered to the public. This is perhaps just as well, since bank lenders will often reserve the right to transfer their interest in the loan without the consent of the borrower, and any such loan would be treated as bearer for TEFRA purposes. A transfer may take the form of a loan participation, where the originating bank will act as agent for the others in dealing with the borrower, but the ownership of the loan will be shared by the participating banks.

These loan participations can be, and often are, securitized. The resulting collateralized loan obligations might well be of a type offered to the public, and if characterized as debt for tax purposes would then be registration-required obligations. If, however, the collateralized loan obligations were treated as equity in a vehicle that was classified as a partnership or grantor trust, then absent the application of the pass-through rules, those obligations could be issued in bearer form without compliance with TEFRA. Although the regulations dealing with pass-through certificates deal primarily with pools of mortgage loans, they contain an anti-abuse rule broad enough to capture securitizations of other obligations that are not registration-required, such as bank loans.²⁰⁸

C. Repackaging Bearer Obligations as Registered

If the underlying obligation is in bearer form but is issued to a securitization vehicle in accordance with the TEFRA D Rules, query whether that vehicle could issue registered securities backed by the

²⁰⁸ Treas. Reg. § 1.163-5T(d)(4). Although the example discussed in this rule deals with certificates backed by a registered obligation, the same principles would presumably apply to certificates backed by a bearer obligation that was not registration-required.
bearer obligation. The registered securities would not be issued in compliance with TEFRA, and indeed might be offered in the United States. The vehicle itself would be organized offshore, and would provide the TEFRA D certificate as a non-U.S. person. These arrangements resemble the hybrid bonds discussed earlier, and serve the same purpose: to enable the issuer to issue bearer bonds while allowing United States investors to acquire registered interests in those bonds.

If the registered securities issued by the vehicle are respected as debt of the vehicle distinct from the bearer obligations issued to the vehicle, then it should be possible for these arrangements to comply with TEFRA even though the United States holders will have acquired an indirect interest in a bearer obligation. If instead the registered securities take the form of certificates of beneficial interest in a trust, then those securities will themselves represent ownership interests in the bearer obligation and will not be treated as a distinct obligation. Yet even in this case it may be possible to comply with TEFRA. As noted above, the regulations dealing with pass-through certificates state that the status of pass-through certificates as in registered form or as foreign-targeted on issuance will be determined independently from the status of the underlying obligations. It should therefore be possible to treat the underlying obligations as foreign-targeted bearer obligations, while treating the securities issued by the vehicle as registered. These regulations by their terms deal with pooled funds and trusts, raising the question whether they can be applied to a “pool” that consists of only a single obligation. While such a solitary instrument is plainly not a pool, it is not clear that the regulations were intended to apply only to pass-through certificates with a large number of underlying obligations, and the IRS has issued a ruling that applies these regulations to a pass-through arrangement backed by a

209 See supra Part V (p. 526).

210 See supra note 203 and accompanying text.
single loan.\textsuperscript{211} Pass-through certificates backed by a large number of underlying obligations can be more easily seen as having characteristics distinct from those underlying obligations;\textsuperscript{212} but otherwise it is hard to see why the rules that apply to pass-through certificates backed by many obligations should not also apply to certificates backed by only a few, or even one; nor is there any logical place to draw the line should one choose to do so.

In some circumstances it may be desirable to be able to distribute the underlying bearer obligations to the holders of the registered securities. For example, if the underlying obligations are in default the holders may find it easier to enforce payment if they hold those obligations directly.\textsuperscript{213} If the registered securities are regarded as a form of ownership of the underlying obligations, then this possibility might be viewed as an impermissible conversion to bearer form, which would cause the registered securities to be treated as bearer from the outset.\textsuperscript{214} By contrast, if the registered securities were a distinct debt obligation of the issuer, then a distribution of the underlying obligations would be viewed as a payment in redemption of those securities rather than a conversion of those securities to bearer form. Because of uncertainties in the characterization of these arrangements, it will often be prudent to avoid any possibility that the underlying obligations will be distributed in bearer form to holders of the registered securities.

Although these arrangements resemble the hybrid bond arrangements discussed earlier, the analysis here sidesteps two of the issues that feature in the hybrid bond rulings. First, the underlying bearer obligation might not be “immobilized,” but it would clearly be intend-
ed to rest with the vehicle in connection with its initial issuance. The vehicle could in theory be given the right to sell the bearer obligation at some later time and substitute other assets to provide cash flows to service the registered securities, although as a commercial matter the parties would not ordinarily allow this flexibility. Second, the securitization vehicle might not be acting as the issuer’s agent. Instead, the issuer’s obligations would be discharged by making payments to the vehicle, and the issuer would have no responsibility to the holders of the registered securities. Indeed, it could be argued that the rulings are too strict in requiring immobilization and agency in the hybrid bond context. These requirements can be loosened without undermining the purposes of the TEFRA rules, since the only interests offered to U.S. persons are in registered form.

This relatively relaxed view of hybrid arrangements could create a trap for the unwary. If pass-through certificates are issued in registered form backed by a bearer obligation of a U.S. issuer, then interest paid on those certificates to non-U.S. holders will be exempt from U.S. withholding tax only if a Form W-8 is received from the holder. Similarly, if a U.S. issuer issues a bearer debt obligation to a foreign clearing system without giving holders the right to definitives, arguably the clearing system has issued registered interests backed by the bearer obligation and is obligated to collect Forms W-8, which would come as a surprise to all concerned. The potential for such a strange outcome is a feature of a system that favors bearer over registered bonds for U.S. debt issued offshore.

D. U.S. Government-Backed Securities

U.S. Treasury securities are the ultimate registration-required obligation, since the Treasury refuses to issue them in bearer form.215

215 Treas. Dep’t News Release R-2816 (Aug. 16, 1984). This release followed a resolution expressing the sense of the Senate that the Treasury Department should
Although the repeal of the withholding tax on portfolio interest made it practicable for the Treasury to issue bearer securities in offshore markets, it decided at the time the repeal took effect not to avail itself of this opportunity. At the same time, the Treasury applied this prohibition to securities issued by or guaranteed by U.S. government-owned agencies and U.S. government-sponsored enterprises.\footnote{\textit{Treas. Dep’t News Release R-2816} (Aug. 16, 1984). See also \textit{Treas. Reg. § 1.163-5(c)(1) (stating that any such bearer securities, even if they could be issued, would not satisfy TEFRA’s foreign-targeting rules).}

At that time, there was already a lively market in pass-through certificates on Treasury obligations. This market grew enormously following the adoption of another provision in TEFRA, which provided for the taxation of stripped bonds and coupons on a basis that reflected the economic accrual of income.\footnote{\textit{I.R.C. § 1232B(a), as added by Pub. L. No. 97-248, § 232(a) (now codified at I.R.C. § 1286(a)).}} Although the coupon-stripping rules were aimed at perceived abuses,\footnote{S. Rep. No. 79-494, Vol. I, at 215–16 (1982).} they had the effect of facilitating stripping by clarifying the law in this area, even if there was no longer a tax advantage.\footnote{\textit{See Merrill Offers New Zero Issue, N.Y. TIMES, Aug. 10, 1982, at D11.}} The big non-tax advantage of stripped Treasury instruments is that they function as synthetic zero-coupon obligations with no default or reinvestment risk. Until the Treasury put in place arrangements to allow the direct stripping of Treasury securities through its STRIPS program,\footnote{31 C.F.R. § 356.31.} the stripping was done synthetically by investment banks, who deposited Treasury securities with a custodian and issued receipts for individual interest prevent the issuance, sale, or resale of Treasury-backed securities in bearer form. See \textit{Senate Adopts Resolution, Stark Introduces Bill, Prohibiting Issuance of Bearer Bonds, 84 TAX NOTES TODAY} 170–71 (Aug. 14, 1984).}
payments, and for the principal payment together with any interest payments due after the first possible call date.221

The Treasury’s refusal to issue bearer securities could have added further appeal to the market for Treasury pass-throughs, if those certificates were issuable in bearer form.222 Overseas investors that preferred bearer securities would presumably accept a lower yield for them, and the difference between that yield and the return paid on the underlying Treasuries would benefit the intermediaries doing the repackaging. Partly in order to prevent this benefit from inuring to the intermediaries, the Treasury determined that it would not permit securities backed by U.S. government obligations to be issued in bearer form.223

The decision is odd in a couple of respects. The stated rationale is that the benefit of the lower yield would accrue to the intermediaries rather than the U.S. government. True enough, but why should the government care? Once it has decided not to issue bearer securities itself, it has already decided to pay the (presumably) higher rate demanded for registered obligations. If the bearer repackaging of U.S. government securities simply transfers wealth from investors to the intermediaries, that should not be of public concern.

A more serious issue would arise if the presence of bearer certificates actually increased the rate demanded on the underlying registered obligations. This is an empirical question, but it does not

221 Merrill Lynch, for example, offered deposit receipts representing interests in Treasury coupons called “Treasury Investment Growth Receipts” or TIGRs. Offering Circular, Treasury Investment Growth Receipts (Feb. 6, 1986); See also Paul Taylor, Merrill Lynch Zero Coupon, FIN. TIMES, Aug. 9, 1982, at I-16.

222 Shortly before Treasury stopped the practice, Salomon launched a $7 billion offering of “certificates of accrual on Treasury securities (CATS), which included Treasury-backed bearer instruments. See Lee A. Sheppard, Treasury Reassures Foreign Investors but not Congress about Targeted Issue, 24 TAX NOTES 1103 (Sept. 17, 1984).

Bearer or Registered?

seem to be a likely outcome. The return on the registered obligations is set by the forces of supply (the Treasury’s need for funding) and demand (the desire of investors to hold these securities). That demand would be created not only by investors (such as U.S. holders) that hold the registered securities, but also by investors in the bearer certificates, since those certificates could only be issued by acquiring registered obligations to back them. It is hard to see why this aggregate demand should be reduced by making investments in these obligations available in both registered and bearer form.

The other stated reason is that the policy reasons that led to the refusal to issue bearer instruments directly also justified refusing to allow these instruments to be issued in bearer form indirectly. To the extent that the Treasury decided not to issue bearer securities because it did not want to be a party to arrangements that facilitated tax evasion, then that same concern could also relate to repackaged securities that benefited from U.S. government credit.

Even if the decision not to allow U.S. government backed bearer securities is defensible on the merits, the way the decision was implemented is bizarre. The relevant rules are set forth in a letter by Donald Regan, then Treasury Secretary, to Bob Dole, then Chairman of the Senate Finance Committee. The letter refers to the Treasury’s decision not to allow itself or other U.S. government agencies to issue bearer securities, and states the intention of the Treasury Department to issue regulations prohibiting private issuers from issuing bearer securities that are backed by U.S. government obligations.

The trouble is that nearly twenty years have elapsed and no such regulations have been issued or even proposed. One might suppose that the Treasury Department had forgotten the issue, except that the

224 In a letter to Treasury Secretary Regan, Senator Dole stated, “A perceived collusion by the U.S. Treasury with tax evaders is of even greater concern to me than a similar potential use of private U.S. corporate securities by such persons.” Letter from Robert Dole to Donald Regan (July 16, 1984) (reprinted at 84 TNT 156–49).
prohibition on U.S. government-backed bearer securities is alluded to in the regulations dealing with pass-through certificates. Those regulations do not address the issue squarely; instead, they pointedly avoid it, stating that the treatment prescribed for pass-through certificates:

“does not affect the determination of whether bearer obligations that are issued or guaranteed by the United States Government, a United States Government-owned agency, a United States Government sponsored enterprise … or that are backed (as described in the Treasury Department News Release R-2385 of September 10, 1984 and Treasury Department News Release R-2847 of September 14, 1984) by obligations issued by the United States Government, a United States Government-owned agency, or a United States Government sponsored enterprise comply with the requirements of [the TEFRA bearer bond restrictions].”

The first of the news releases mentioned by the regulations contains the rules referenced in the Regan letter; the other release announces an intended September 7, 1984 effective date for these rules.

The jurisprudential status of this prohibition is murky to say the least. If a bold taxpayer were to blatantly disregard the prohibition and repackage Treasury securities in bearer form, on what authority would the IRS base its challenge? Such a repackaging would presumably be in compliance with the TEFRA rules generally. The regulations quoted above do not assert the prohibition; they simply say that they have no bearing on it. The Treasury news releases and the letter merely state an intention to issue regulations. They certainly lack the presumption of validity generally enjoyed by regulations. They might not even constitute “substantial authority” for purposes of the accuracy-related penalties: those rules treat IRS press releases as substantial

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225 Treas. Reg. § 1.163-5T(d)(5).

226 The courts have treated Treasury regulations as presumptively valid so long as they are reasonable. Cottage Savings Ass’n v. Comm’r, 449 U.S. 554 (1991); Goulding v. United States, 957 F.2d 1420 (7th Cir. 1992).
authority,\textsuperscript{227} but these releases were issued by the Treasury Department, not the IRS.

There are good reasons to accord little or no weight to a decades-old letter quoted in a press release.\textsuperscript{228} There was no opportunity for public comment, as would arise if this rule were actually proposed as a regulation, and there is no evidence that the rule received even the sort of technical Internal Revenue Service review that would accompany the issuance of a revenue ruling.\textsuperscript{229} Worse yet, the letter purports to define the circumstances when a security will be treated as U.S. government-backed, but fails to address many of the practical issues that arise in the administration of such a rule.

For example, what is the relevant testing date for determining whether an obligation is U.S. government-backed? Just the issue date? Or does a problem arise if the obligation is government-backed at any time while it is outstanding? Just applying the test on the issue date would be consistent with the foreign-targeting requirements of the TEFRA C and D rules, but it would not prevent the possibility of bearer obligations becoming government-backed after issuance. Of course, it should not be possible to avoid the restriction by issuing obligations with the express intention of securing them with U.S. gov-

\textsuperscript{227} Treas. Reg. § 1.6662-4(d)(3)(iii).

\textsuperscript{228} The substantial authority regulations state that a private letter ruling, technical advice memorandum, general counsel memorandum or action on decision that is more than ten years old “generally is accorded very little weight.” Treas. Reg. § 1.6662-4(d)(3)(ii). There are two private letter rulings (each more than ten years old) that refer to the restrictions on government-backed securities, each holding that post-September 7, 1984 modifications to pre-September 7, 1984 arrangements would not cause a reissuance that would bring those restrictions into play. I.R.S. Priv. Ltr. Ruls. 1987-31-045 (Aug. 4, 1987), 1987-31-046 (Aug. 4, 1987).

ernment obligations shortly after issuance, so at the very least the implementing regulations would have to cover cases of this sort. An even broader rule may be needed: if the government’s concern is keeping obligations of this type out of the market, it should make no difference whether they become government-backed on issuance or afterwards.

Yet applying the test at all times while the securities are outstanding creates some potential traps for the unwary. For example, many bond indentures contain an “in substance” defeasance clause that provides for a release of financial covenants if high-quality securities are pledged to secure the remaining payments of principal and interest.²³⁰ Quite frequently these securities are, and may even be required to be, U.S. government obligations. If the bonds had been originally issued in bearer form, the defeasance itself could run afoul of the restrictions on government-backed securities, if those restrictions are considered to apply at all times.

The news release also fails to define what is meant to have the obligations “supported” by government-backed income or collateral. Is an actual pledge required, or merely an expectation that the funds will be available? Suppose a startup company does a private placement of convertible bonds in bearer form,²³¹ and places the proceeds in U.S. government securities until needed for the business. If those securities account for more than half of the company’s assets, then the bonds could be regarded as U.S. government-backed, even if they genuinely bear the credit risk of the business. The news release states that an obligation will be covered if more than 50 percent of the collateral is government-backed, but it is unclear whether this percentage is meas-

²³⁰ Such an in substance defeasance would not be regarded as a reissuance of the bonds under the Cottage Savings regulations. Treas. Reg. § 1.1001-3(d), Ex. (5). See also Rev. Rul. 85-42, 1985-1 C.B. 36.

²³¹ There can be valid local law reasons for issuing convertibles in bearer form. See supra notes 147–148.
ured by book value or fair market value. The assets of many startup companies consist of intangibles or goodwill that have little or no value on their balance sheets. These assets are real, so it makes sense to take them into account, but their values are notoriously volatile, which could make it difficult to ensure ongoing compliance if the test is applied after issuance.\textsuperscript{232} This problem might go away, however, if absent a pledge the government securities were not considered to “support” the company’s obligations in this context.

The restriction extends to obligations backed by “U.S. government-sponsored enterprises”, but the term is nowhere used in the Code, and there are only two uses of the term in the regulations outside the TEFRA context.\textsuperscript{233} The TEFRA regulations merely list some examples of U.S. government-sponsored enterprises\textsuperscript{234} but provide no comprehensive list or definition.

This discussion is not so much intended to push for any particular interpretation of the restriction on government-backed securities as to point out that serious issues of interpretation exist. The press release states that the regulations will apply to obligations issued after September 7, 1984.\textsuperscript{235} In this circumstance, 20-year retroactivity is absurd, except perhaps in the most obvious cases that would clearly be covered by any rule of this sort.

\textsuperscript{232} A foreign startup company faces an analogous problem in seeking to avoid classification as a PFIC, which will occur if more than half of its assets produce passive income. I.R.C. § 1297(a)(2). In most cases asset value can be determined based on fair market values, I.R.C. § 1297(f), but PFIC status must be determined annually, and a decline in the value of the company’s intangibles or goodwill can cause it to become a PFIC even if there is no other change in its business or the composition of its assets.

\textsuperscript{233} Treas. Reg. § 6041-7(b)(2) (filings on magnetic media) and § 301.7701-7(d)(iv)(I)(1) (definition of a domestic trust).

\textsuperscript{234} Treas. Reg. §1.163-5(c)(1) lists, as examples, the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Loan Mortgage Corporation, and Farm Credit Administration, and the Student Loan Marketing Association.

\textsuperscript{235} Treas. Dep’t News Release R-2847 (Sept. 14, 1984).
E. **Conduit Regulations**

The Treasury has express authority to issue regulations characterizing any multiple-party financing transaction as a transaction directly among any two or more of those parties if appropriate to prevent tax avoidance.\(^{236}\) Every pass-through arrangement is a multiple party financing transaction, since there are always at least three parties (the vehicle, the holders of the securities issued by the vehicle, and the issuer of the securities owned by the vehicle). The Treasury has exercised this authority twice:\(^{237}\) for fast-pay preferred stock,\(^{238}\) and for “conduits” in the withholding tax context;\(^{239}\) but only the latter is relevant here. Under the conduit regulations as they apply to pass-through arrangements, a pass-through vehicle will be disregarded only if all of the following tests are met:

1. The participation of the vehicle reduces the U.S. withholding tax from that applicable to a direct payment from the issuer of the securities held by the vehicle to the holders of the securities issued by the vehicle;
2. The participation of the vehicle is pursuant to a plan to avoid this withholding tax; and
3. The vehicle would not have participated in the arrangement under the same terms without having obtained the financing from the holders of its securities.\(^{240}\)

The third test is ordinarily satisfied by a pass-through vehicle, which presumably has no other resources to acquire securities other than the

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\(^{236}\) I.R.C. § 7701(1).


\(^{238}\) Treas. Reg. § 1.7701(1)-3.

\(^{239}\) Treas. Reg. §1.881-3.

\(^{240}\) Treas. Reg. § 1.881-3(a)(4)(i).
proceeds of its own issuance, and the terms of the securities issued are generally tailored to fit with the terms of the securities acquired (taking into account any swaps or similar arrangements).

The conduit regulations are of concern only if securities of U.S. issuers are acquired by the vehicle, since otherwise there is no U.S. withholding tax to avoid, and neither of the first two tests would be met. Moreover, treaty qualification is usually irrelevant, since the vehicles do not ordinarily qualify for treaty benefits. Thus, the only way a pass-through arrangement can be affected by the conduit regulations is if the participation of the vehicle reduces withholding tax on U.S. securities that it acquires, by reason of a statutory exemption such as the portfolio interest exemption.

As discussed above, the requirements of the portfolio interest exemption depend on whether the obligation on which the interest is paid is registered or bearer. If registered, the holder must provide a Form W-8; if bearer, the obligation must have been issued in accordance with TEFRA. If both the obligations acquired by the vehicle and the obligations issued by the vehicle are in bearer form, then there is no U.S. withholding tax to avoid, assuming that both sets of obligations have been issued in accordance with TEFRA, since a direct issuance would also have been eligible for the portfolio interest exemption. Complications arise only if either set of obligations is in registered form.

Suppose that both the obligations acquired by the vehicle and those issued by the vehicle are in registered form. (This will always be the case if the acquired obligations are U.S. government securities.) If the vehicle is a corporation, it will provide its own Form W-8 to the issuers of the underlying obligations, but the holders of its obligations

241 See supra notes 80–81 and accompanying text.

242 And assuming, as is generally the case in this context, that the limitations on the portfolio interest exemption for bank loans, contingent interest and related parties do not apply. See I.R.C. § 871(h)(3) and (4), and § 881(c)(3) and (4).
do not need to provide a Form W-8 to the vehicle since the vehicle is not paying U.S. source interest. If, however, the holders had held the underlying obligations directly and failed to provide a Form W-8, a U.S. withholding tax would have been imposed. So in this case at least, the participation of the vehicle actually does reduce U.S. withholding tax, and the first test for applying the conduit regulations will be satisfied. In a case like this, the potential application of the conduit regulations hinges on the second test; that is, whether a principal purpose of the participation of the vehicle is to avoid this withholding tax.

The conduit regulations offer a helpful example dealing with this situation. In the example, a foreign parent issues obligations in registered form to financial institutions and lends the proceeds to its U.S. subsidiary. The parent resides in a country with a treaty that eliminates withholding tax on interest, so interest payments by the subsidiary are free of U.S. withholding tax under the treaty, and interest payments by the parent to the financial institutions are free of U.S. withholding tax because they are not U.S. source. Had the obligations been issued directly by the U.S. subsidiary to the financial institutions, they would have qualified for the portfolio exemption (presumably the exception for bank loans does not apply here), but only if Forms W-8 were received from the holders. The example makes the further assumption that there is no reason to believe that the financial institutions would not furnish Forms W-8 if that were necessary; i.e., these are not individuals trying to hide their identity from the IRS. Based on this further assumption, the example concludes that there is no tax avoidance plan, since on a direct issuance the financial institutions would presumably provide Forms W-8 and so there is no plan to avoid U.S. withholding tax by routing the financing through the foreign parent.

243 Treas. Reg. § 1.881-3(e), Ex. (18).
Consequently, the second test is not met, and the conduit regulations do not apply.\textsuperscript{244}

U.S. tax counsel are often asked to provide an opinion that no U.S. withholding tax will be imposed on the obligations owned by the vehicle.\textsuperscript{245} If those obligations generate U.S. source income, and the obligations owned and issued by the vehicle are all in registered form, then the opinion will need to contain an assumption to negate the presence of tax avoidance under the second test, like the assumption in the example that the holders are all financial institutions who would provide a Form W-8 if asked. This assumption would of course need to be appropriate in the circumstances,\textsuperscript{246} but if it is reasonable to conclude that the holders would be willing to provide a W-8, it is not necessary for them actually to do so. The curious result is that a Form W-8 is actually required from the holders only if it is not reasonable to believe that they would be willing to provide one!

Now suppose that the obligations owned by the vehicle are bearer but the obligations issued by the vehicle are registered. In comparing actual results with those of a hypothetical direct issuance, the conduit regulations provide that the character of these hypothetical direct payments shall be determined by reference to that of the payments actually received by the holders of the obligations issued by the vehi-

\textsuperscript{244} The conduit regulations contain an alternate third test, which is satisfied if the party in the middle is related to either of the others. Treas. Reg. \textsection 1.881-3(a)(4)(i)(C)(2). In the example, the foreign parent is clearly related to its own subsidiary, so the application of the conduit regulations hinges on whether the second test is satisfied.

\textsuperscript{245} If a withholding tax were imposed under the conduit regulations, it is almost certain that the issuer of those obligations would not be required to gross-up for the withholding tax, since gross-up clauses for registered obligations customarily contain an exception for withholding taxes that can be avoided by filing withholding tax forms. Since the vehicle itself would normally have no other resources to pay the tax, the burden would likely fall on the holders of its own obligations. If those obligations are rated, the rating agency will often ask for the tax opinion.

Presumably this means that in this circumstance the hypothetical direct payments would be treated as payments on a registered obligation, and the same considerations as those discussed in the example above would apply. Yet the conduit regulations go on to state that this characterization does not extend to qualification of a payment for exemption from withholding tax if the qualification depends on the terms of, or other similar facts or circumstances relating to, the obligations issued by the vehicle that do not apply to the underlying obligations owned by the vehicle. Here, the qualification for the portfolio interest exemption on the obligations issued by the vehicle depends on getting a Form W-8, but if the underlying obligations are bearer there would have been no reason to provide a Form W-8 to the issuers. Possibly the vehicle could offer a Form W-8 anyway, but many repackagings occur without the involvement of the issuers, and it would be peculiar in that circumstance for the vehicle to volunteer a Form W-8. Happily, in the example discussed above the regulations make no assumption about whether the underlying obligation is registered or bearer, so it should be possible to avoid the conduit regulations regardless of whether the underlying obligation is bearer or registered, if the holders would have been willing to provide Forms W-8 if asked.

Now consider the reverse situation, where the obligations owned by the vehicle are registered but the obligations issued by the vehicle are bearer. Here, a hypothetical direct obligation would be in bearer form, so the exemption from withholding tax would require compliance with the TEFRA restrictions. But if the underlying obligations are registered, it will be likely that they were not issued in compliance with those restrictions, since there would have been no need to do so outside the context of the repackaging, and indeed it would not have been possible to do so if the obligations were offered in the United

248 Id.
States. Under a strict reading of these rules, therefore, a hypothetical
direct obligation would have been subject to withholding tax, and
therefore the first test will be satisfied. Yet since the obligation pre-
sumably could have been directly issued in bearer form in compliance
with TEFRA, and therefore it should generally be possible to con-
clude that there was no tax avoidance purpose. In that case, the
second test will not be met, and the conduit regulations should not
apply. An example in the conduit regulations\textsuperscript{249} glides over this issue: a
foreign parent issues bearer debt and lends the proceeds to its U.S.
subsidiary. The loan to the subsidiary is presumably not a registration-
required obligation, and the example does not say whether it is bearer
or registered. The example simply concludes that there is no reduction
in tax since the subsidiary could have issued the bearer debt itself
without triggering any U.S. withholding tax.

\textsuperscript{249} Treas. Reg. § 1.881-3(e), Ex. (9).
VIII. REISSUANCES

The issuer’s responsibilities under the TEFRA rules relate only to its original issuance, since an obligation is not a “registration-required” obligation if its issuance is foreign-targeted under the TEFRA rules.\(^\text{250}\) After the dust settles, bearer obligations can, and do, find their way back to the United States. Although the holder sanctions apply to these obligations,\(^\text{251}\) those sanctions may not deter outright tax evaders, and, more benignly, U.S. tax-exempt organizations are unaffected by the holder sanctions.\(^\text{252}\) But the issuer can go about its business without regard to this secondary market activity.

The issuer, however, may need to deal with TEFRA if it seeks to amend the terms of its outstanding bearer obligations. For example, the issuer might offer a higher interest rate in exchange for a longer maturity and a waiver of some financial covenants. The amendment may occur by way of an exchange offer, or the issuer may seek the votes of a sufficient percentage of the outstanding holders to approve a modification. In either case, if the modification or exchange is tantamount to the issuance of a “new” obligation it will be subject to the

\(^{250}\) See supra Part II.B (p. 489).

\(^{251}\) See supra Part II.C (p. 494).

\(^{252}\) Private foundations subject to the 1- or 2-percent tax on investment income could potentially be affected by the nondeductibility of losses on bearer obligations, since capital losses can generally be used to offset capital gains for this purpose. I.R.C. § 4940(c)(4). Oddly, a technical (but probably unsuccessful) argument could be made that gains on bearer obligations that are taxed as ordinary income under I.R.C. § 1287(a) are not subject to this tax because they are not included either in the definition of net investment income (which does not include gains from sales of assets) or in the definition of capital gain net income (which only includes net capital gains). See Treas. Reg. §§ 53.4940-1(c), (f).
TEFRA restrictions, and the issuer will have to comply with the C rules or the D rules.  

The difficulty in applying the TEFRA restrictions to a modification is that, in contrast to a new issuance for cash, the issuer has no choice over who the holders are. Because the original obligations will have been trading in bearer form, there will have been no effective restriction on secondary trading. As a result, some of these obligations could be held by U.S. persons, which will make it impractical for the issuer to avoid the instrumentalities of interstate commerce in connection with the modification or exchange (as required by the C rules) or to obtain a certification of non-U.S. beneficial ownership (as required by the D rules).

In this case, what is the issuer to do? The harsh answer would be that it must forgo the modification altogether, but that would be an extraordinary extraterritorial imposition of a U.S. law constraint in a case where the issuer and the initial holders are all foreign. A more practical answer would be that U.S. holders must be excluded from the modification. Yet this approach could create a potential legal problem if the issuer is required under applicable law to treat all holders equally, and it would leave some portion of the original obligations outstanding, which may be contrary to the issuer’s commercial objectives (such as relief from covenants). Other approaches that may be feasible in some cases would be to cash out U.S. holders entirely, or to issue the modified bonds in registered form or as a “hybrid” issue that is treated as registered for U.S. tax purposes.

Unfortunately, the problem is made worse by the fact that the TEFRA regulations largely adopt the standards of the Cottage Savings

\[253\] In this Part I will use the term “modification” to include any modification that is treated as a reissuance for TEFRA purposes, without regard to whether there is an actual exchange of instruments.

\[254\] See supra Part V (p. 526).
regulations\textsuperscript{255} for determining when a change in a debt instrument is a reissuance for tax purposes.\textsuperscript{256} Under those regulations, even a relatively slight modification (such as a change in yield of more than 25 basis points) can trigger a reissuance.\textsuperscript{257} The only relief offered by the TEFRA regulations is that an exchange will not be treated as a reissuance for TEFRA purposes if the issuer changes but the obligation remains identical in all other respects. The requirement, however, that the terms of the obligation remain identical apart from the change in issuer makes this exception of limited value.

\textsuperscript{255} Treas. Reg. § 1.1001-3. These regulations specify when a change to an obligation is to be treated as an exchange for a new obligation for purposes of realizing taxable gain or loss. They elaborate on the result reached in Cottage Savings Ass’n v. Comm’r, 449 U.S. 554 (1991), which treated an exchange of mortgage portfolios as triggering gain or loss, even though the portfolios as a group had substantially identical economic characteristics (and for that reason the exchange did not trigger gain or loss for financial accounting purposes), because the mortgages in the exchanged pools had different issuers.

\textsuperscript{256} Treas. Reg. § 1.163-5(e)(2)(i).

\textsuperscript{257} Treas. Reg. § 1.1001-3(e)(2)(ii).
IX. REOPENINGS

A “reopening” of an issue is the issuance of additional obligations with terms that are identical to a series of outstanding obligations of that issuer. The intent is for the new obligations to be completely fungible with the outstanding obligations, thereby enhancing the trading liquidity of the enlarged issue. While this fungibility can be assured as a pre-tax matter by the use of identical terms for the new obligations, the new obligations will not be truly fungible if they are treated differently for tax purposes.

For U.S. holders, this lack of fungibility arises if the new obligations are issued below par at an issue price which is lower than the adjusted issue price of the old obligations. In that case, discount which is market discount on the old obligations will be original issue discount on the new obligations. Since U.S. holders generally treat market discount and original issue discount differently, a U.S. purchaser of an obligation after the reopening will be treated differently depending on whether the obligation purchased was part of the original issue or the reopening. As a result, the obligations will not be fungible to that holder, and since the U.S. holder will be unable to

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258 If both the original and the additional obligations are issued at or above par, the treatment of holders will be unaffected by the reopening, since a holder’s accrual (if elected) of original issue premium is the same as the accrual of market premium. I.R.C. § 171(b).

259 Similar problems can arise if the new obligations are issued at a price which is higher than the adjusted issue price of the old obligations, but still less than par. In such a case, a market purchaser of the old obligations will be entitled to reduce the accrual of original issue discount by its acquisition premium, I.R.C. § 1271(a)(7), but the timing of the accrual of this reduced original issue discount will not be the same as the timing of the accrual of original issue discount on the new obligations.

260 A U.S. holder can, if it wishes, elect to treat market discount in the same manner as original issue discount, but it is not required to do so. Treas. Reg. § 1.1272-3(a).
prove that the obligation acquired was part of the original issue, it will have to assume it was part of the reopening. If U.S. holders are sufficient in number to have an effect on trading prices, this adverse tax assumption could affect the trading price of the entire issue, to the detriment of the original purchasers.\textsuperscript{261}

The original issue discount regulations offer limited relief from this problem by treating the reopening as part of the original issue if it occurs within six months of the original issue and the yield on the reopening date is no more than 110\% of the yield on the original issue date.\textsuperscript{262} In such a case, the additional obligations are treated for purposes of the original issue discount rules as having the same issue date and the same issue price as the original obligations. This special rule, when it applies, enables holders to treat the original and the additional obligations as fungible for U.S. tax purposes.

Reopenings of bearer bonds are a different story. Those bonds will not have been issued in the U.S. market, so the disparate treatment of the original obligations and the additional obligations under the original issue discount regulations is relevant only if the bonds find their way into the hands of U.S. holders.\textsuperscript{263} But TEFRA compliance can delay true fungibility for some time after the additional obligations are issued. If the additional obligations are issued under the D rules, there will be a 40-day restricted period after issuance, during which the issuer and distributors may not offer or sell those obligations in the United States or to U.S. persons.\textsuperscript{264} The original ob-

\textsuperscript{261} Although the original purchasers can continue to benefit from the more favorable tax treatment accorded the original issue (since they know they did not purchase in the reopening), they will nonetheless suffer if they realize a lower sale price on account of the reopening.

\textsuperscript{262} Treas. Reg. § 1.1275-2(k)(3)(ii).

\textsuperscript{263} This disparate tax treatment is also relevant for a U.S. issuer that redeems some but not all of the outstanding obligations, since the issuer’s repurchase premium will be different for the original and new obligations.

\textsuperscript{264} Treas. Reg. § 1.163-5(c)(2)(i)(D)(1).
ligations, however, will have already been seasoned for this purpose if they have been outstanding for more than 40 days on the date the original obligations are issued. While the issuer might collect TEFRA D certifications on the new issue before the end of the 40-day period, and indeed possibly as early as the date of issue, the restrictions on offers and sales would remain in effect for the balance of the 40-day period.

To be on the safe side, a distributor can apply the TEFRA selling restrictions to the original bonds as well as the additional bonds during the restricted period for the additional bonds. This may require some effort, since affiliates of the issuer may be dealing with the original bonds on the basis that they are already seasoned under TEFRA. Moreover, such a restriction could at least in principle affect trading prices for the issue during this period, and the reopening, which was intended to increase liquidity, may temporarily decrease it.

A distributor will, however, be in a position to know that an obligation that it is selling is part of the additional issue, when it gets those bonds directly from the issuer or from another distributor. If the parties are prepared to defer true fungibility until after the restricted period for the new bonds, the distributors could apply the selling restrictions only to the additional bonds during their restricted period. This approach should work for sales, although it is somewhat problematic to say that the obligations being “offered” are only original obligations when all of the obligations have identical terms. The securities laws, however, have made their peace with this concept, since it is possible to offer substantively identical securities under Regulation S and Rule 144A, and offer only the Rule 144A securities in the United States.  

See supra note 122.
X. Conclusion

Should the rules change? The status quo works, after a fashion. Issuers and underwriters have become habituated to the TEFRA rules, and rarely do these rules present a serious impediment to accessing the bearer bond markets. While tax evasion remains an ever-present problem, there does not seem to be any evidence of widespread holdings of bearer bonds by U.S. persons. The distinction between bearer and registered may hinge on fine distinctions, but well-advised issuers can navigate the rules to design instruments that are either bearer or registered, depending on their needs. Blessedly, the law has been relatively stable since the last round of regulations in 1990, giving market participants ample time to absorb the rules and adapt their practices to them.

And yet the current situation is not entirely satisfying. For holders, the current holder sanctions are a trap for the honest but unwary investor who purchases an obligation that happens to be evidenced by a global bearer security. A committed U.S. tax evader, however, can acquire definitive bearer securities perfectly legally, and the only consequences are losing a loss deduction or treating gains as ordinary income.266 These are unlikely to be a significant deterrent for purchasers of bonds with floating interest, or with a short- to medium-term maturity during a period of stable interest rates. And of course a tax evader who is hiding the income from the bonds is hardly going to report gains or losses anyway.

There has been little visible evidence of enforcement of the bearer bond restrictions. The most noteworthy instance was in response to a

266 The loss of the portfolio interest exemption is only relevant for securities with a U.S. issuer, and in any event has no effect on a U.S. holder. (By contrast, the holder sanction that treats bearer tax-exempt bonds as taxable is completely effective in eliminating these bonds from the market.)
blatant effort by the government of Pakistan to market bearer notes in the United States.\textsuperscript{267} This case appears to have been the result of ignorance of U.S. rules rather than a knowing attempt to flout them.\textsuperscript{268} After the IRS took notice,\textsuperscript{269} Pakistan promptly withdrew the proposed issue, and subsequent issues into the United States have been in registered form.\textsuperscript{270}

The Pakistan episode illustrates one of the principal drawbacks of the current regime. Like many areas of U.S. tax law, the bearer bond restrictions have developed a significant degree of subtlety and complexity. Unlike most of these other areas, however, the bearer bonds rules are to a large extent applied to foreign activities of foreign persons. These persons and their foreign advisors are unlikely to have more than a passing familiarity with U.S. rules, and apart from compliance with Regulation S of the securities laws, there may be no reason for the parties to pay any attention to U.S. law at all. While sophisticated issuers have avoided Pakistan’s blooper, the potential for inadvertent violations is great. In a situation like this, it is particularly desirable for the rules to be simple and clear, at least in the cases that come up most often. Unfortunately, the common cases are just those

\textsuperscript{267} Thomas Petzinger, Jr., \textit{We Clean Cash! Pakistan Pitches Money-Laundering in the U.S.}, \textit{Wall St. J.}, Mar. 18, 1992, at C1:

For an official briefing on the purpose of the five-year, government-backed bonds, a reporter called the securities department of the Pakistani central bank in Karachi. “This is a way to launder the black money,” explained Munir Ahmad, an official of the bank.

Who would buy these bonds? “Anybody having some black money, if they want to make it white,” Mr. Ahmad replied. “Do you understand now?”

\textsuperscript{268} Yet Pakistan’s U.S. attorney, who presumably should have known better, neglected to register the issue with the Securities and Exchange Commission, thereby earning a Cease and Desist Order from that body. \textit{In re} Jeffry L. Feldman, Securities Act Release No. 33-7014, 55 SEC Docket, No. 1 (Sept. 20, 1993).


\textsuperscript{270} See, e.g., Prospectus, Islamic Republic of Pakistan, U.S.$150,000,000 11\frac{1}{2}\% Notes due 1999 (Dec. 16, 1994).
in which the distinction between bearer and registered can be hardest to discern.

Indeed, the modern bearer bond, which is evidenced by a global security that can be exchanged for definitives only in remote circumstances, if at all, is hardly the kind of obligation that prompted the enactment of the bearer bond restrictions in the first place. There is no clandestine passing of pieces of paper that transfers ownership with no audit trail. While obligations may be held in or through accounts in countries with bank secrecy laws, those laws apply equally where the underlying obligations is evidenced by a note in registered form and issued to the nominee of a clearing system. In short, the distinction between bearer and registered, as applied today under the TEFRA rules, has little to do with whether an obligation is held in a manner that promotes tax evasion.

This article is been primarily descriptive rather than prescriptive, but it is hard to think in depth about the bearer bond restrictions without having ideas for their improvement. While acknowledging the virtues of stability in law, and therefore not urging haste in whole-sale revision, I can at least observe some promising directions that future developments in this area might take:

1. There is no point in applying the TEFRA restrictions to bearer bond issues that are locked up in global form. If the bonds trade solely through the accounts of clearing systems and their participants, it makes no practical difference whether the global instrument is bearer or registered. While it might be appropriate to maintain a rule that would treat registered bonds as bearer if they can be freely converted into definitive bearer instruments, such a rule should not apply if such a conversion can take place only upon events that are not reasonably anticipated at the time of issue, such as the termination of the clearing system arrangements or a default by the issuer. One could require cer-

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271 But cf. GEORGE CARLIN, BRAIN DROPPINGS xii (1997): “[I]f you think there’s a solution, you’re part of the problem.”
tifications of non-U.S. ownership at the time of any such conversion, but even that would not be necessary in a default context if the rules were changed to permit U.S. persons to hold bearer instruments after a default when needed to enforce remedies.

2. Holder sanctions need to be strengthened if they are to act as a meaningful deterrent. The issuer sanctions do not prevent bearer bonds from flowing back into the U.S. through secondary market trades; and as noted above, the holder sanctions will often have a minor effect and will likely be scoffed at by tax evaders. In particular, the bite of the holder sanctions should not depend on how much the bond goes up or down in value. Instead, there should be a penalty tax based on the amount of bearer bonds held. The tax could be tiered along the lines of the penalty taxes on various exempt organizations and trusts, where a relatively modest first-tier tax is followed by a significantly higher second-tier tax if the holder fails to take appropriate remedial steps.\footnote{These first- and second-tier taxes are imposed at varying rates, as shown in the following table:}

<table>
<thead>
<tr>
<th>Code §</th>
<th>Target of Tax</th>
<th>1st-Tier Rate</th>
<th>2nd-Tier Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>4941</td>
<td>Self dealing (private foundations)</td>
<td>5%</td>
<td>200%</td>
</tr>
<tr>
<td>4942</td>
<td>Failure to distribute income</td>
<td>15%</td>
<td>100%</td>
</tr>
<tr>
<td>4943</td>
<td>Excess business holdings</td>
<td>5%</td>
<td>200%</td>
</tr>
<tr>
<td>4944</td>
<td>Jeopardizing charitable purpose</td>
<td>5%</td>
<td>25%</td>
</tr>
<tr>
<td>4945</td>
<td>Taxable expenditures</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>4951</td>
<td>Self-dealing (black lung trusts)</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>4952</td>
<td>Taxable expenditures</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>4955</td>
<td>Political expenditures</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>4958</td>
<td>Excess benefits</td>
<td>25%</td>
<td>200%</td>
</tr>
<tr>
<td>4971</td>
<td>Failure to meet minimum funding</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>4975</td>
<td>Prohibited transactions</td>
<td>15%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Both tiers of tax should be no higher than necessary to serve their deterrent purpose: the second-tier taxes that result in a
complete forfeiture (or more) appear draconian in this context (and in their own contexts as well). But even a significantly lesser tax would be far more meaningful than the current holder sanctions.

3. If, as intimated by TEFRA’s legislative history, the evil of bearer bonds is that ownership cannot be traced, the same can be said of bonds (registered or bearer) held through secret offshore accounts. A logical extension of the holder sanctions would be to apply them to all bonds held in this manner. Closing off access to the U.S. capital markets for arrangements in countries that provide for secret records would provide an incentive for those countries to offer arrangements that are not subject to such secrecy. U.S. holders should also be permitted to hold these bonds under arrangements similar to those now permitted for bearer bonds, where the bonds are held through a financial institution that agrees to report the holder’s income to the IRS, although the uncertainties regarding the current prohibition on “offers” to these U.S. holders will need to be addressed. In this way, the TEFRA rules would evolve from a focus on whether the bonds are registered or bearer to a focus on whether ownership of the bonds can be fully traced to the beneficial owner.

4. The terms of the portfolio interest exemption should not continue to favor bearer bonds by easing documentation requirements for foreign-targeted bonds only when they are issued in bearer form. The current rules on foreign targeted registered bonds in some cases waive the requirement of a Form W-8, but they impose other documentation requirements that are not required of bearer bonds. If a U.S. issuer is prepared to target a registered issue to foreign markets, it should enjoy rules at least as favorable as those applicable to bearer bonds. Otherwise, the U.S. tax law is promoting the issuance of bearer bonds, hardly a sensible policy. This proposal may be more palatable

273 See supra notes 167-169 and accompanying text.
274 See supra note 55 and accompanying text.
275 See Treas. Reg. § 1.871-14(e)(3).
to the government if the holder sanctions are strengthened as suggested above.

The United States has leveraged its prominence in the capital markets to require non-U.S. participants to heed U.S. laws to a far greater extent than U.S. market participants are required to heed foreign laws. One can imagine the reaction in the United States if, say, France attempted to impose documentation requirements on domestic U.S. issues. At a time when U.S. unilateralism is straining relationships with allies, it is worth maintaining an attitude of restraint in imposing U.S. obligations on foreigners. The suggestions outlined above would make life easier for issuers, but harder for U.S. holders that seek to avoid transparency in their holdings. This is as it should be, if the objective of these rules is improved U.S. tax compliance by holders.
APPENDIX I

FORM OF SELLING RESTRICTIONS

(1) Except to the extent permitted under U.S. Treas. Reg. § 1.163-5(c)(2)(i)(D) (the “D Rules”), (a) each Manager represents that it has not offered or sold, and agrees that during the restricted period it will not offer or sell, the Bonds to a person who is within the United States or its possessions or to a United States person, and (b) represents that it has not delivered and agrees that it will not deliver within the United States or its possessions definitive Bonds that are sold during the restricted period;

(2) each Manager represents that it has and agrees that throughout the restricted period it will have in effect procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the Bonds are aware that the Bonds may not be offered or sold during the restricted period to a person who is within the United States or its possessions or to a United States person, except as permitted by the D Rules;

(3) if it is a United States person, each Manager represents that it is acquiring the Bonds for purposes of resale in connection with their original issue and if it retains Bonds for its own account, it will only do so in accordance with the requirements of U.S. Treas. Reg. § 1.163-5(c)(2)(i)(D)(6);

(4) with respect to each affiliate that acquires Bonds from it for the purpose of offering or selling the Bonds during the restricted period, each Manager either (a) repeats and confirms the representations and agreements contained in clauses (1), (2) and (3) on its behalf or (b) agrees that it will obtain from such affiliate for the benefit of the Issuer the representations and agreements contained in clauses (1), (2) and (3); and
(5) each Manager represents that it has not and agrees that it will not enter into any written contract (other than a confirmation or other notice of the transaction) pursuant to which any other party to the contract (other than one of its affiliates or another Manager) has offered or sold, or during the restricted period will offer or sell, any Bonds, except where pursuant to the contract the Manager has obtained or will obtain from that party, for the benefit of the Issuer and the several Managers, the representations contained in, and that party’s agreement to comply with, the provisions of clauses (1), (2), (3) and (4).  

Terms used in clauses (1), (2), (3), (4) and (5) have the meaning given to them by the U.S. Internal Revenue Code of 1986 and regulations thereunder, including the D Rules.

276 Paragraph (5) may be omitted in offerings that do not have any such chains of distributors.
APPENDIX II

FORM OF CLEARING SYSTEM CERTIFICATION

This is to certify that, based solely on certificates we have received in writing, by tested telex or by electronic transmission from member organizations appearing in our records as persons being entitled to a portion of the principal amount set forth below (our “Member Organizations”) substantially to the effect set forth in the Fiscal Agency or other Agreement,* as of the date hereof, [] principal amount of the above-captioned Securities:

(i) is owned by persons that are not citizens or residents of the United States, domestic partnerships, domestic corporations or any estate or trust the income of which is subject to United States Federal income taxation regardless of its source (“United States persons”), (ii) is owned by United States persons that (a) are foreign branches of United States financial institutions (as defined in U.S. Treasury Regulations Section 1.165-12(c)(1)(iv) (“financial institutions”)) purchasing for their own account or for resale, or (b) acquired the Securities through foreign branches of United States financial institutions and who hold the Securities through such United States financial institutions on the date hereof (and in either case (a) or (b), each such United States financial institution has agreed, on its own behalf or through its agent, that we may advise the Issuer or the Issuer’s agent that it will comply with the requirements of Section 165(j)(3)(A), (B) or (C) of the Internal Revenue

Code of 1986, as amended, and the regulations thereunder), or (iii) is owned by United States or foreign financial institutions for purposes of resale during the restricted period (as defined in U.S. Treasury Regulations Section 1.163-5(c)(2)(i)(D)(7)), and to the further effect that United States or foreign financial institutions described in clause (iii) above (whether or not also described in clause (i) or (ii)) have certified that they have not acquired the Securities for purposes of resale directly or indirectly to a United States person or to a person within the United States or its possessions.

* Unless Euroclear Bank is otherwise informed by the lead manager or Issuing Agent, the Standard Long-Form Certification set out in these Operating Procedures will be deemed to meet the requirements of this sentence.