Part III – Administrative, Procedural and Miscellaneous

Guidance Regarding the Repeal of Section 163(f)(2)(B)

Notice 2012-20

PURPOSE

This notice provides guidance related to the repeal of section 163(f)(2)(B) of the Internal Revenue Code (Code) and related provisions enacted by section 502 of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111-147 (the HIRE Act). The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) intend to issue regulations implementing the guidance provided in this notice.

SECTION 1. BACKGROUND

Issuers of debt obligations that are required to be in registered form but are not issued in registered form are subject to the disallowance of interest deductions under section 163(f) and the imposition of an excise tax under section 4701. Any gain on the sale or other disposition of such an obligation is generally treated under section 1287 as ordinary income rather than capital gain, and, under section 165(j), no deduction is permitted for any loss sustained. In addition, the exception from tax for U.S. source

portfolio interest received by a nonresident alien or foreign corporation under section 871(h) and section 881(c) (portfolio interest exception) is generally not available with respect to interest paid on debt that is not issued in registered form (bearer debt).

The foregoing rules generally do not apply with respect to bearer debt that complies with the foreign-targeting rules of section 163(f)(2)(B) and the regulations thereunder. However, section 502 of the HIRE Act generally eliminated the various exceptions for foreign-targeted bearer debt, effective for obligations issued after March 18, 2012. As a result of this change in law, with respect to obligations issued after March 18, 2012, the portfolio interest exception will be available only for obligations issued in registered form.

In the case of debt obligations in registered form, the portfolio interest exception is generally available only if the United States person (U.S. person) who would otherwise be required to deduct and withhold tax from the interest under section 1441(a) (U.S. withholding agent) receives a statement (usually on Form W-8) indicating that the beneficial owner of the obligation is not a U.S. person. Under section 871(h)(5), this statement generally may be made by either the beneficial owner of the obligation or by a securities clearing organization, bank, or other financial institution that holds customers' securities in the ordinary course of its trade or business. With respect to obligations issued after March 18, 2012, section 871(h)(2)(B)(ii)(II) provides that the portfolio interest exception is available in the absence of such a statement if the Secretary has determined that such a statement is not required in order to carry out the purposes of the portfolio interest exception.

Section 1.871-14(e) provides that the portfolio interest exception is available for debt obligations in registered form that comply with certain foreign-targeting requirements if (1) the registered owner is a financial institution that holds customers' securities in the ordinary course of its trade or business; and (2) the U.S. withholding agent complies with certain simplified procedures to obtain, either from the financial institution or from a beneficial owner that is a member of a clearing organization, a certification that the beneficial owner is not a U.S. person. Notice 2006-99 announced, however, that Treasury and the IRS intended to amend §1.871-14(e) to eliminate this exception for foreign-targeted registered obligations (FTROs), retroactive to the date of the notice. Notice 2006-99, 2006-2 C.B. 907. Regulations implementing the guidance provided in Notice 2006-99 have not been issued.

SECTION 2. IN GENERAL

Treasury and the IRS have received comments regarding issues arising from the repeal of section 163(f)(2)(B), including comments requesting guidance regarding when obligations will be considered to be in registered form and requesting clarification with respect to certain collateral consequences of the repeal of section 163(f)(2)(B). In addition, Treasury and the IRS are aware that the implementation of section 501 of the HIRE Act, which added new sections 1471 to 1474 (commonly known as FATCA) to the Code, may require changes to the documentation collected by foreign financial institutions (including qualified intermediaries) and withholding agents with respect to payees and account holders.

Section 3 of this notice provides guidance addressing when obligations will be considered to be in registered form. Section 4 of this notice provides interim guidance with respect to the application of the portfolio interest exception to certain obligations in registered form issued after March 18, 2012, and before January 1, 2014. Section 5 of this notice addresses the continued availability of the existing exception from reporting of interest or original issue discount under section 6049 for certain foreign-targeted short-term obligations. Finally, section 6 of this notice provides guidance with respect to procedures required to comply with the foreign-targeting rules of section 4701(b) as amended by section 502 of the HIRE Act.

SECTION 3. DEFINITION OF A REGISTRATION SYSTEM

For purposes of determining whether a bond is in registered form under section 163(f) and the portfolio interest exception, the principles of section 149(a)(3) apply. Section 163(f)(3). Section 149(a)(3) provides that a book entry bond is treated as in registered form if the right to the principal of, and stated interest on, the bond may be transferred only through a book entry consistent with regulations prescribed by the Secretary. In addition, §1.871-14(c) provides that for purposes of the portfolio interest exception, the conditions for an obligation to be considered in registered form are identical to the conditions described in §5f.103-1.

Generally under §5f.103-1, an obligation is in registered form if: (i) the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and any transfer of the obligation may be effected only by surrender of the old obligation and reissuance to the new holder; (ii) the right to principal and stated interest with

respect to the obligation may be transferred only through a book entry system maintained by the issuer or its agent; or (iii) the obligation is registered as to both principal and stated interest with the issuer or its agent and can be transferred both by surrender and reissuance and through a book entry system. An obligation is considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued. A "book entry" is a record of ownership that identifies the owner of an interest in the obligation. An obligation that would otherwise be considered to be in registered form is not considered to be in registered form as of a particular time if it can be converted at any time in the future into an obligation that is not in registered form.

Notice 2006-99 addressed an arrangement in which no physical certificates are issued and under which ownership interests in bonds are required to be represented only by book entries in a dematerialized book entry system maintained by a clearing organization. Notice 2006-99 provided that an obligation issued under such an arrangement would be treated as in registered form notwithstanding the ability of holders to obtain physical certificates in nonregistered form upon the termination of the business of the clearing organization without a successor.

For obligations issued after March 18, 2012, section 163(f)(3) provides that for purposes of section 163(f), a dematerialized book entry system or other book entry system specified by the Secretary will be treated as a book entry system described in section 149(a)(3). Comments have expressed concern that the explicit reference in new section 163(f)(3) to a "dematerialized book entry system" may create uncertainty

with respect to obligations issued in a manner not specifically described in Notice 2006-99. In particular, comments requested guidance with respect to the treatment of obligations represented by a physical global security that is nominally in bearer form, but that is "immobilized" in a clearing system. In addition, comments have requested guidance regarding whether an obligation will be considered to be in registered form if holders may obtain physical certificates in nonregistered form in certain limited circumstances not described in Notice 2006-99.

Treasury and the IRS intend to issue regulations providing that an obligation will be considered to be in registered form if it is issued through: (i) a dematerialized book entry system in which beneficial interests are transferable only through a book entry system (as defined in §5f.103-1(c)) maintained by a clearing organization as defined in §1.163-5(c)(2)(i)(B)(4) (or by an agent of the clearing organization); or (ii) a clearing system in which the obligation is effectively immobilized. An obligation will be considered to be effectively immobilized if: (1) the obligation is represented by one or more global securities in physical form that are issued to and held by a clearing organization as defined in §1.163-5(c)(2)(i)(B)(4) (or by a custodian or depository acting as an agent of the clearing organization) for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms; and (2) beneficial interests in the underlying obligation are transferable only through a book entry system maintained by the clearing organization (or an agent of the clearing organization).

An interest in an obligation will be considered to be transferable only through a book entry system if the interest would be considered transferable through a book entry system under §5f.103-1(c)(2), except that holders may obtain physical certificates in bearer form in the following circumstances: (1) termination of the clearing organization's business without a successor; (2) default by the issuer; or (3) issuance of definitive securities at the issuer's request upon a change in tax law that would be adverse to the issuer but for the issuance of physical securities in bearer form. After the occurrence of one of the above circumstances, any obligation with respect to which a holder, or a group of holders acting collectively, has a right to obtain a physical certificate in bearer form will no longer be in registered form, regardless of whether any option to obtain a physical certificate in bearer form has actually been exercised. Treasury and the IRS request comments regarding whether any exceptions should be provided to this general rule.

SECTION 4. TEMPORARY EXTENSION OF PORTFOLIO INTEREST EXCEPTION TO FOREIGN-TARGETED REGISTERED OBLIGATIONS

As noted above, section 871(h)(2)(B) provides that the portfolio interest exception is generally available for holders of obligations in registered form only if a U.S. withholding agent receives a statement that the beneficial owner of the obligation is not a U.S. person. Under §1.871-14(c)(2), a U.S. withholding agent generally is considered to have received a statement that satisfies this requirement if it receives a statement from the foreign beneficial owner, or it receives a statement from a withholding foreign partnership, a qualified intermediary, or a U.S. branch of a foreign bank or foreign insurance company indicating that the payment will be made to a foreign

beneficial owner. A U.S. withholding agent may also rely upon a statement from a financial institution that holds customers' securities in the ordinary course of its trade or business when the financial institution provides a statement that it has received a withholding certificate on Form W-8 (or an acceptable substitute form) from each beneficial owner and attaches each form to its statement (including certificates from beneficial owners holding through other financial institutions acting as intermediaries with respect to the obligation). In each such case, the U.S. withholding agent must also satisfy the information reporting requirements of §1.1461-1(c)(2) with respect to interest paid on the obligation. See §§1.1461-1(c)(2)(i) and 1.1441-2(a).

Comments have noted that presently there may be difficulties obtaining statements satisfying the requirements of §1.871-14(c)(2) in certain foreign markets in which issuers and intermediaries have relied on the foreign-targeting rules of §1.163-5(c)(2)(i)(D) for issuances of debt. In response to these comments, this notice provides as a limited transition rule that, notwithstanding Notice 2006-99, a withholding agent (as defined in §1.1441-7(a)) paying interest on an obligation issued in registered form after March 18, 2012, and before January 1, 2014, may apply the foreign-targeted registered obligation rules of §1.871-14(e) if the obligation satisfies the requirements of those rules. For this purpose, a financial institution may certify that the beneficial owner of a payment of interest has not been a U.S. person (as described in §1.871-14(e)(3)(i)(A)(1)(i)) if the financial institution has determined the non-U.S. status of the beneficial owner of interest on the obligation(s) covered by the certificate by obtaining either (1) a Form W-8 (or substitute form) satisfying the requirements of §1.1441-

1(e)(4), or (2) documentary evidence satisfying the requirements of §1.6049-5(c). A withholding agent receiving such a certificate after the time described in §1.871-14(e)(4)(ii)(A) may rely on the certificate to the extent permitted under §1.1441-1(b)(7). As provided in §1.871-14(e)(4)(i)(G), a withholding agent who receives a valid certificate described in §1.871-14(e)(3)(i) that applies to a payment of portfolio interest on a foreign-targeted registered obligation is not required to report the interest payment on Form 1042-S.

SECTION 5. SHORT-TERM DEBT OBLIGATIONS

Section 6049 provides an exception from information reporting of interest or original issue discount with respect to debt obligations that have an original term of 183 days or less and that satisfy a number of other requirements intended to ensure that the debt is not held by U.S. non-exempt persons. Those requirements are provided in §1.6049-5(b)(10) and include the following: (1) payments on the instrument must be made outside the United States by other than a U.S. middleman; (2) the instrument must have a principal amount of at least $500,000; (3) the instrument must satisfy the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder; (4) the instrument must bear a specified legend stating that the holder represents that it is not, and does not hold on behalf of, a U.S. person that is a non-exempt recipient; and (5) if the instrument is in registered form, it must be registered in the name of an exempt recipient.

Comments have requested clarification on whether the short-term debt exception provided by §1.6049-5(b)(10) will continue to be available after March 18, 2012, the

effective date of the repeal of section 163(f)(2)(B) under section 502 of the HIRE Act. Treasury and the IRS intend to clarify that this short-term debt exception remains available by issuing regulations incorporating the foreign-targeting rules of §1.163-5(c)(2)(i) into the regulations under section 6049 in place of the existing reference to section 163(f)(2)(B).

SECTION 6. CLARIFICATION OF EXCISE TAX EXCEPTION UNDER SECTION 4701(B)

Section 4701 imposes an excise tax on a "registration-required obligation" that is not in registered form. The amount of the excise tax is equal to one percent of the principal amount multiplied by the number of calendar years until the obligation reaches maturity. Prior to the enactment of the HIRE Act, section 4701(b) provided that the term "registration-required obligation" generally had the same meaning as when used in section 163(f), which set forth the terms under which an issuer would be entitled to claim a deduction for interest paid on a registration-required obligation.

In connection with repealing section 163(f)(2)(B), section 502 of the HIRE Act amended section 4701(b) to provide that registration would not be required for obligations issued after March 18, 2012, that meet criteria similar to the foreign targeting rules under existing section 163(f)(2)(B). Comments requested clarification regarding how closely the procedures required under the new exception under section 4701(b) will mirror the procedures required under section 163(f)(2)(B). Treasury and the IRS intend to provide in regulations that rules identical to the rules that currently apply under section 163(f)(2)(B) and the regulations thereunder will apply for purposes of section 4701(b) to obligations issued after March 18, 2012.

EFFECT ON OTHER DOCUMENTS

Section 4 of Notice 2006-99, 2006-2 C.B. 907, is superseded.

EFFECTIVE DATE

The regulations incorporating the guidance described in this notice will be effective for obligations issued after March 18, 2012.

DRAFTING INFORMATION

The principal author of this notice is Susan E. Massey of the Office of Associate Chief Counsel (International). For further information regarding this notice contact John Sweeney at (202) 622-3840 (not a toll-free call).