

Chapman Client Alert

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Current Issues Relevant to Our Clients

Proposed Registered Form Regulations Change Scope and Clarify Requirements

In mid-September, 2017, the IRS released proposed regulations that would not only change (both expand and contract) the types of instruments that are registration-required obligations, but also clarify when a registration-required obligation meets the requirements to be treated as issued in registered form.

Failure of a registration-required obligation to meet the requirements to be treated in registered form would potentially cause certain issuer and holder sanctions to apply. For the issuer, these sanctions are (i) a loss of interest deductions and (ii) an excise tax. For the holder, these sanctions are (i) a withholding tax on interest, (ii) the treatment of gains as ordinary income and a denial of loss deductions on the disposition of the instrument, and (iii) in the case of municipal bonds, the loss of tax exemption on interest.

Certain portions of the proposed regulations will be effective when published as final; other portions will be effective retroactively to debt instruments issued after March 18, 2012.

Registration-Required Obligations

Registration-required obligations include any obligation, including a pass-through certificate, participation interest, and a regular interest in a real estate mortgage investment conduit (“REMIC”), other than (i) obligations issued by a natural person, (ii) obligations not of a type offered to the public, and (iii) obligations with a maturity of not more than one year. Thus, the registration requirements currently do not apply directly to home mortgages and other consumer receivables that are obligations of individuals. In addition, conventional commercial and multi-family mortgages have generally not been of a type offered to the public and traditionally have been issued in bearer form. Although commercial loans are not of a type offered to the public, they are often issued in registered form so that interest on them can be payable free of U.S. withholding tax under the portfolio interest exemption.

Obligations of a Type Offered to the Public

In determining whether an obligation is of a type offered to the public, current regulations look to whether similar obligations are in fact offered or traded. This means that an obligation could be treated as of a type offered to the public even if the particular obligation being considered is not, in fact, offered to the public.

Under the proposed regulations, an obligation is not of a type offered to the public unless the obligation itself is traded on an

established securities market—however, for this purpose, the proposed regulations would now refer specifically to the broad “publicly traded” OID regulations issued in 2012. Under those regulations, an obligation is traded on an established securities market if, at any time during the 31-day period ending 15 days after the issue date—

- There is a reasonably available sales price for the obligation;
- There are one or more firm quotes for the obligation; or
- There are one or more indicative quotes for the obligation.

The change in definition of “not of a type offered to the public” has at least one curious effect. Under the definition in the proposed regulations, it may be possible to issue bearer securities that are readily tradable, but are not registration-required because they are not traded on an established securities market. This may occur if the initial holder acquires the entire issue in a private placement and retains them for a period of time. Because of the potential for abuse, it is likely that this result was unintended. Separately, it may be that—in light of the breadth of the “publicly trading” OID regulations referenced by the proposed regulations as the relevant trading benchmark—syndicated loans not previously commonly regarded as registration-required may be more definitively covered.

Pass-Through Certificates

A pass-through certificate is a certificate that evidences an ownership interest in a grantor trust or similar fund that holds a pool of underlying loans. A pass-through certificate may itself be a registration-required obligation, even if none of the obligations held by the pass-through entity are registration-required obligations.

Under current regulations it has been unclear whether a pass-through certificate includes interests in a partnership or a disregarded entity. Further, although the IRS has issued several private letter rulings concluding that interests in such entities would be treated as pass-through certificates, many sponsors and their tax advisors have been reluctant to rely upon these rulings. (Pass-through certificate treatment has been sought principally to allow interest on underlying debt instruments that are not in registered form to qualify for the portfolio interest exception from withholding.) However, under the proposed regulations, a similar fund would explicitly include a disregarded entity or a partnership.

The proposed regulations also would eliminate a requirement that the fund hold a “pool” of loans for pass-through certificate treatment to be available, extending that treatment to funds holding but a single loan. Also, under the proposed regulations, a registration-required obligation can include participations, which encompass interests in an instrument that evidences a conveyance of a specified portion of one or more obligations (and not an ownership interest in an entity). Thus, the grantor of a participation interest will now clearly be required to maintain a “participant register” to ensure that its participation is not subject to the excise tax or other adverse consequences imposed on registration-required obligations not issued in registered form. This already may be a requirement under current Treasury regulations and many loan agreements currently provide for such registration.

Registered Form Qualification

In general, under the proposed regulations, an obligation will be in registered form if a transfer of the right to receive both principal and any stated interest on the obligation may be effected only:

- By the surrender of the old obligation;
- Through a book entry system; or
- Through a combination of the above two methods.

An obligation (including a dematerialized obligation) will be considered transferable through a book entry system if

ownership of the obligation or an interest in the obligation is required to be recorded in an electronic or physical register maintained by the issuer, the issuer’s agent, or by a clearing organization.

An obligation that is not in registered form is considered to be in bearer form. However, an obligation represented by one or more physical certificates in bearer form will be considered to be in registered form if the physical certificate is effectively immobilized by a clearing organization and the clearing organization maintains a book-entry system for transfers of interests in the obligation.

In general, an obligation is not considered to be in registered form if at some point in the future the obligation may be in bearer form. However, neither a dematerialized nor an immobilized obligation is treated as being in bearer form merely because an obligation held by a clearing organization may be converted to bearer form if (i) the clearing organization ceases to do business without a successor or (ii) the issuer may convert the obligation to bearer form upon a change in tax law that would be adverse to the issuer but for a conversion to bearer form. Prior IRS guidance also permitted the issuance of physical bearer securities in the case of an issuer default of a registration-required obligation (the “default exception”), but the proposed regulations do not provide for such a rule. Foreign issuers routinely permit such right in order to facilitate a holder’s ability to make a claim against the issuer. If physical bearer securities are actually issued in respect of registered securities as contemplated by this exception, the securities will be treated as bearer securities as of the time they are issued and the various holder sanctions would presumably apply. Issuer sanctions likely would not apply because unless the securities are treated as reissued for tax purposes, they would not have been *issued* in bearer form.

Consequences of Failing to be in Registered Form

The requirements related to registration-required obligations appear in a variety of places in the Code. The issuer of a registration-required obligation will be denied a deduction for the interest expense if the obligation is not in registered form and will also be subject to an excise tax equal to 1% of the face amount of the obligation multiplied by the number of years of the obligation’s term. Further, interest on a municipal bond that is in bearer form will be includable in a holder’s gross income.

To the extent that the relevant issuer is not subject to the above excise tax, the holder of a registration-required obligation that is not in registered form is not eligible for capital gains treatment on any gain, or a deduction for any loss, on the sale of the obligation.

Non-U.S. holders often rely upon the portfolio interest exception to escape U.S. withholding tax on payments of interest. The portfolio interest exception only applies to instruments in registered form—whether or not the instruments are registration-required obligations.

Who Will Be Affected by the Proposed Regulations

The proposed regulations will directly affect issuers and holders of registration-required obligations. In general, “issuer” refers to the person who will be entitled to deduct the interest on the obligation. For purposes of the excise tax (discussed above), “issuer” refers to the recipient of the proceeds of a pass-through certificate, participation interest, or a regular interest in a REMIC, rather than the issuing entity.

Effective Dates

The rules described above to determine whether an obligation is of a type offered to the public and the application of the rules to pass-through certificates, participation interests and regular interests in REMICs will be effective after those rules are published in final form. The rules defining the sponsor of pass-through certificates, participation interests, or a regular interest in a REMIC as the issuer of the interests for the purposes of the excise tax will apply to issuances after March 18, 2012. In general, the definition of registered form applies to debt instruments issued after March 18, 2012, but taxpayers may rely on the prior “default exception” for obligations issued

before the regulations are finalized. The existing tax-exempt obligation regulations—requiring such obligations to be in registered form (as defined therein) in order for the interest to be tax-exempt—will continue to apply to tax-exempt bonds issued prior to the date 90 days after the final regulations are published.

For More Information

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