

## Legal Updates & News

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#### **Foreign Account Tax Compliance Act of 2009: Proposed Repeal Of U.S. Bearer Bond Exception**

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On October 27, 2009, Senator Max Baucus (D-Montana) and Representative Charles Rangel (D-New York), chairmen of the Congressional tax writing committees, unveiled the Foreign Account Tax Compliance Act of 2009 (the "Bill"). If enacted in its current form, the Bill would, among other things, effectively end the practice whereby U.S. issuers sell bearer bonds to foreign investors. Both President Barack Obama and Treasury Secretary Timothy Geithner issued statements giving their unqualified support for the Bill.

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#### **Background**

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

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

Many U.S. issuers have European medium-term note or other foreign-targeted programs under which they issue bearer notes to non-U.S. investors. These issuances comply with TEFRA regulations and, as such, the instruments are not subject to the sanctions described above or to U.S. withholding tax. In

addition, many non-U.S. issuers include TEFRA restrictions in their debt offerings outside the U.S. to ensure that they are not subject to the TEFRA excise tax.

Some foreign jurisdictions, e.g. Switzerland do not permit their residents to certify as to their identity. Accordingly, there are special rules in the TEFRA regulations that permit offerings to be sold into those jurisdictions in bearer form if certain additional requirements are met.

### **The Bill – Sanctions on Issuances of Bearer Bonds**

The Bill would end the practice of selling bearer bonds to foreign investors under TEFRA C and TEFRA D. Thus, with respect to issuers of foreign targeted bearer bonds, the Bill would repeal the exception to (i) a denial of interest deduction for interest on bearer bonds and (ii) the 1% excise tax on the principal amount of the bonds.<sup>[1]</sup> In addition, interest paid on such bonds would no longer qualify for treatment as portfolio interest, thereby subjecting such interest to a 30% withholding tax, and any gain realized by a holder of such bonds would be treated as ordinary income.

This provision would apply to debt obligations issued after the date which is 180 days after the date of enactment of the Bill.

If enacted, the collateral damage from the Bill in the capital markets could be substantial. In the first instance, U.S. issuers would have to revise their existing programs to prohibit bearer debt. More importantly, they would have a harder time raising capital in foreign jurisdictions to the extent investors in those jurisdictions are unwilling to provide the non-U.S. person certification required for registered debt (*i.e.*, IRS Form W-8). Also, U.S. issuers could not raise debt capital from jurisdictions (e.g., Switzerland) where investors are legally barred from certifying as to residency. Finally, foreign issuers would no longer have the protection against the excise tax of TEFRA C or TEFRA D compliance and would instead run whatever risk exists that the U.S. would attempt to impose an excise tax on a purely “foreign-to-foreign” debt offering.

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### **Footnotes**

<sup>[1]</sup> Unless such bonds are (i) issued by a natural person, (ii) mature in one year or less, or (iii) not of a type offered to the public.