Done in Washington, DC, this 16th day of December 1986.

J.K. Atwell

Deputy Administrator, Veterinary Services, Animal and Plant Health Inspection Service.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8110] IL-50-86

Income Taxes; Sanctions on Issuers and Holders of Registration-Required Obligations Not in Registered Form

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of the term "registration-required obligation" with respect to obligations issued to certain foreign persons. This document also contains final regulations on the imposition of sanctions on issuers issuing registration-required obligations in bearer form and on persons holding registration-required obligations in bearer form. This document provides final regulations with respect to the proposed regulations published in the Federal Register at 49 FR 33276 (Aug. 22, 1984) and 50 FR 33552 (Aug. 20, 1985).

EFFECTIVE DATE: The regulations apply generally to obligations issued after January 20, 1987.

FOR FURTHER INFORMATION CONTACT: Carl Cooper of the Office of the Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T) (202-566-3388).

SUPPLEMENTARY INFORMATION:

Background

On August 22, 1984, the Federal Register published temporary regulations under T.D. 7965 (49 FR 33228) and proposed amendments (49 FR 33276) to the Income Tax Regulations (26 CFR Part 1) under sections 163, 165, and 1287 of the Internal Revenue Code of 1954. A number of written comments responding to the notice were received. A public hearing was held on January 28, 1985. On August 20, 1985, the Federal Register published T.D. 8046 (50 FR 33522), an amendment of the temporary regulations under T.D. 7965, and an amendment of the notice of proposed rulemaking (50 FR 33552). After consideration of all comments regarding the proposed regulations, these final regulations published in this document are adopted.

Section 310 of TEFRA added new sections 163(f), 165(j), and 1232(c) to the Code. The Tax Reform Act of 1984 (Pub. L. 98-369; 98 Stat. 562) redesignated section 1232(c) as section 1287. Section 163(f) disallows an interest deduction otherwise allowable under section 163(a), or any other provision of the Code, if the interest is attributable to a registration-required obligation that is held in bearer form. Section 165(j) disallows a deduction for any loss sustained on a registration-required obligation that is held in bearer form. Section 1287(a) provides that, if a registration-required obligation is held in bearer form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income.

Explanation of Provisions

The final regulations contained in this document provide rules for determining whether an issuer may claim an interest deduction for interest paid on an obligation in bearer form, which is otherwise a registration-required obligation, because the issuer satisfies the conditions set forth in section 163(f)(2)(B). Under section 163(f)(2)(B), an obligation is not a registration-required obligation if it meets the following conditions: interest on the obligation is payable only outside the United States and its possessions; on the face of the obligation there is a statement that any person who holds the obligation will be subject to limitations under United States income tax laws; and there are arrangements reasonably designed to ensure its sale (or resale in connection with the original issue) only to a person who is not a United States person.

Section 1.163-5T(c)(1) of the former temporary regulations provides that an obligation cannot be considered to be issued pursuant to arrangements reasonably designed to ensure sale to non-United States persons if, once the obligation has been made payable to a named payee, the obligation may be made payable to bearer. A number of commenters raised questions concerning the scope of this rule (the conversion rule), such as its application to the voluntary recording of obligations under the laws of certain foreign countries. Other commenters questioned whether this rule is necessary to ensure tax compliance by United States taxpayers. In the final regulations, the conversion rule is deleted. Under section 103(j) and the regulations thereunder, an obligation that is otherwise considered to be in registered form is not considered to be in registered form as of a particular time if, at that time or at any time until its maturity, it can be transferred by a means other than the reissuance of the obligation, issuance of a new obligation, or a book-entry notation by the issuer (or its agent). Such an obligation (a convertible obligation) is therefore considered to be in bearer form. As a result of the deletion of the conversion rule, a convertible obligation can be foreign-targeted in the same manner as any other bearer obligation.

Section 1.163-5T(c)(1)(ii)(B) requires a legend on the face of any bearer obligation or on any detachable interest coupon for the purpose of notifying purchasers of the penalties imposed under the United States income tax laws on a United States person who purchases it. The final regulations clarify that the legend requirement applies to a bearer obligation evidenced by a book entry. With respect to such an obligation, the legend must appear in the book or record in which the book entry is made.

Section 1.163-5T(c)(1)(i) requires that there be arrangements reasonably designed to ensure that an obligation will be sold (or resold in connection with its original issuance) only to a person who is not a United States person or a United States person that is a financial institution that agrees to comply with certain requirements contained in section 165(j) and the regulations thereunder. Paragraph (c)(2)(i) of the regulations provides three alternative ways to satisfy this requirement. These methods, which are described in subdivisions (A), (B), and (C) of paragraph (c)(2)(i), impose certain requirements in connection with the original issuance of an obligation. The third method under subdivision (C) applies to an obligation that is issued outside the United States and its possessions by an issuer that does not significantly engage in interstate commerce with respect to the issuance of the obligation.

In applying the test of arrangements reasonably designed to ensure sale to non-United States persons, commenters asked for clarification of the meaning and duration of an "original issuance" or of an "issuance" for purposes of the issuer sanctions. Commenters have raised the question of whether an assumption or an assignment of an obligation is an event that requires the new obligor to comply with one of these alternative arrangements reasonably designed to ensure sale to non-United States persons or to certain United States persons. Commenters have also

asked whether a material change in an obligation's terms, which results in the recognition of gain or loss under section 1001, is an event that requires an obligor to comply with one of these alternative arrangements. Commenters have asked that the final regulations be clarified to state that the substitution of an obligation, even an obligation with materially different terms, does not impose a requirement to comply with one of these alternative arrangements as long as the obligation surrendered was issued under one of these alternative arrangements.

The final regulations do not define an original issuance in terms of a time period because the activities that constitute an original issuance are completed within different time frames depending on the circumstances of the transaction. However, the final regulations clarify that an exchange of one obligation for another is an original issuance only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. Thus, in connection with an exchange that does not constitute the disposition of an obligation under section 1001, an obligor does not have to comply with one of the alternative arrangements. In connection with an exchange of obligations that is defined as a disposition for purposes of section 1001, the final regulations do require an obligor to comply with one of the alternative arrangements. This requirement is imposed in order to provide more assurance that bearer obligations will not become readily available to United States persons.

In applying the test of arrangements reasonably designed to ensure sale to non-United States persons, commenters also asked whether this requirement applies to the issuance of a temporary global security. The final regulations contain a statement that a temporary global security need not satisfy the conditions of § 1.163-5(c)(2)(i).

Section 1.163-5(c)(2)(i)(A) provides that the test of arrangements reasonably designed to ensure sale to non-United States persons is met if the obligation is offered for sale and delivered only outside the United States and its possessions and need not be registered under the Securities Act of 1933 because it is intended for distribution to persons who are not United States persons. Commenters asked that this method of satisfying the test of arrangements reasonably designed be available to an issuer of an obligation that is registered under the Securities Act of 1933 or exempt from registration under section three or four of the Act or because the obligation does not qualify as a security. This change was not made in the final regulations because the evidence that this test has been satisfied is a written opinion of Counsel that the security need not be registered under the Securities Act of 1933 for the reason that it is intended for distribution to persons who are not United States persons. Although a commenter requested that the requirement of a written opinion of counsel be deleted on the basis of cost, the requirement was retained. Its purpose is to document the specific steps to be taken to place an obligation in the hands of non-United States persons, and such an analysis would be required in any event to ensure that an issuer would not violate the Securities Act of 1933.

Section 1.163-5(c)(2)(i)(B) provides that the test of arrangements reasonably designed to ensure sale to non-United States persons is met if the obligation is registered under the Securities Act of 1933, if it is exempt from registration under section 3 or 4 of the Act, or if the obligations does not qualify as a security and if five conditions are met, including the place of offer, sale, and delivery, the execution of a covenant by the issuer, each underwriter, and each member of the selling group, the delivery of a confirmation, the receipt of a certificate, and the requirement of no actual knowledge that the certificate is false. Several commenters noted that the certificate requirement contemplates purchase of a bearer obligation by a United States person acquiring through a financial institution but that the rest of the conditions of the test under paragraph (c)(2)(i)(B) do not specifically provide for the purchase by a United States person acquiring through a financial institution. These commenters also objected to the requirement of offer, sale, and delivery only outside the United States given that the purchase by United States persons through financial institutions is contemplated under this test.

Because of the statutory requirement of arrangements reasonably designed to ensure sale (or resale in connection with original issuance) only to non-United States persons, the Treasury Department does not have the authority to permit the offer, sale, or delivery of bearer obligations inside the United States in connection with their original issuance. Therefore, the regulation was not changed in this respect. However, the final regulations have been clarified to the effect that a bearer obligation may be offered and sold outside the United States to a financial institution purchasing for the account of a customer that is a United States person if the financial institution agrees as a condition of the purchase to provide on delivery a statement under penalties of perjury that it is a financial institution, that it will comply with the requirements in section 165(j)(3)(A), (B), or (C) and the regulations thereunder and that it is not purchasing for offer to resell or for resale inside the United States. The other conditions of this test have been revised to be consistent with this change.

In addition, the statement to be provided by any person under this test has been changed by the addition of the statement that the obligation is not being acquired for offer to resell or for resale to any person inside the United States.

In connection with the third test of compliance with arrangements reasonably designed to ensure sale to non-United States persons, the test applicable to issuers who are not significantly involved in interstate commerce with respect to the issuance of an obligation, commenters objected that the threshold of "significant" involvement in interstate commerce under the temporary regulations is too strict. Generally these commenters were concerned because failure to meet the interstate commerce test would subject an issuance of a certificate of deposit by a foreign branch of the United States bank or by a controlled foreign corporation engaged in the banking business to requirements stricter than the maintenance of documentary evidence of non-United States beneficial ownership. The interstate commerce test, as published in the former temporary regulations, has been retained.

As suggested by a commenter, documentary evidence has been defined using one reference point. The reference point selected is the definition under subdivision (iii) of A-5 of § 35a.9999-4T for consistency with the information reporting and backup withholding rules. Under the (C) alternative, a purchaser of an individual certificate of deposit whose status as a foreign person is not established by documentary evidence must provide a signed statement that the obligation is not being acquired by or on behalf of a United States person or that, if a beneficial interest in the obligation is being acquired by a United States person, such person is a financial institution or is acquiring through a financial institution and the obligation is held by a financial institution that has agreed to comply with section 165(j)(3) and the regulations thereunder.

The interstate commerce test has been retained. As in the temporary regulations published on August 22, 1984, foreign branches of United States banks and controlled foreign corporations engaged in the active conduct of the banking business outside the United States can satisfy this alternative only under the conditions described in § 1.163–5(c)(2)(i)(C) (2), (3), and (4).

In connection with the interstate commerce test, some commenters objected to the rule that substantially identical loans disqualify an obligation from the interstate commerce test and other commenters suggested that the rule be applied only where the obligations are identical. The regulations have not been changed because the existence of a substantially identical obligation of a United States shareholder may indicate the involvement of the shareholder in the issuance, and the interstate commerce test should be available only if the facts clearly indicate that the transaction takes place only outside the United States and between foreign persons.

Section 1.163–5(c)(2)(v) requires that interest, including original issue discount, be payable only outside the United States and its possessions. A commenter suggested that this requirement be considered satisfied even if a person presents an original issue discount obligation inside the United States provided an amount equal to the original issue discount is payable only outside the United States and its possessions. This suggestion was not adopted because the requirement that an obligation be presented outside the United States tends to reduce the convenience of disposing of bearer obligations by United States persons. At the request of a commenter, the place of payment rule was changed by the addition of language to the effect that the amount of interest to be considered payable only outside the United States and its possessions is not affected by the amount of market discount determined under section 1278(a).

A commenter suggested that the requirement that interest on a bearer obligation be payable only outside the United States be changed to a requirement that the issuer, underwriter, and members of the selling group must agree at the time of original issuance to pay interest only outside the United States. This suggestion was not adopted because the requirement to pay interest only outside the United States, like the requirement of a legend, applies throughout the term of the obligation.

The effective date provision of the issuer sanctions has been clarified by stating that the former temporary regulations under § 5f.163–1(c) and the former proposed regulations under § 1.163–5(c) published in September, 1983, only apply to an obligation issued after December 31, 1982 and on or before September 21, 1984. This change makes it clear that the Service will not apply the former temporary or proposed regulations to the determination of whether an obligation issued on or before December 31, 1982 satisfied section 163(f)(2)(B)(i) for the purpose of satisfying section 127(g)(3) of the Tax Reform Act of 1984. Consistent with the effective date change to the foreign-targeting regulations, the effective date provisions of the holder sanctions under § 1.165–12 and § 1.128–1 with respect to the definition of registered form have been changed to apply the definition to obligations issued after December 31, 1982.

The effective date of the definition of registered form was also changed to provide that the former temporary regulations under 5f.163–1 or the former proposed regulations published on September 2, 1983 apply to the definition of registered form with respect to obligations issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or convertible obligation (including conversion privilege) was issued on or before September 21, 1984.

The holder sanctions under § 1.165–12 and § 1.1287–1 have been revised in a number of ways in response to suggestions by various commenters. First, a person holding a bearer obligation under § 1.165–12(c) (1) and qualifying as a registered broker-dealer (or a person exempt from such registration because it is a bank) is not required to hold the obligation outside the United States in connection with a trade or business conducted outside the United States, and a financial institution is not required to hold a bearer obligation outside the United States. A registered broker-dealer (or a person exempt from such registration because it is a bank) is allowed to hold a bearer obligation inside the United States for sale to customers in the ordinary course of its trade or business conducted inside or outside the United States. A financial institution is allowed to hold a bearer obligation inside the United States for sale to customers in the ordinary course of its trade or business conducted outside the United States only if the financial institution offers to sell, sells, and delivers the obligation outside the United States. Second, a broker-dealer holding an obligation under § 1.165–12(c)(1) is allowed to offer to sell and sell inside the United States in a transaction consisting of the purchase of a block of obligations with a total denomination of at least $1,000,000 to a financial institution that provides a statement under penalties of perjury that it is a financial institution purchasing for its own account or for the account of another financial institution or exempt organization as defined in section 501(c)(3) and that it will comply with section 165(j)(3) (A), (B), or (C) and the regulations thereunder. Similary, the final regulations provide that a financial institution holding for its own account under § 1.165–12(c)(2) or a person holding a bearer obligation through a financial institution under § 1.165–12(c)(3) is permitted to offer and resell the obligation inside the United States only to a financial institution for its own account or for the account of an exempt organization. Further, the requirement to report payments of interest and gross proceeds with respect to bearer bonds held through financial institutions has been expanded by requiring such reporting in the case of payments to exempt recipients under § 1.6049–4(c)(1)(ii).

Although some commenters asked for a change in the confirmation and documentary evidence requirements applicable to deliveries outside the U.S., the final regulations were not changed to eliminate the requirement of a confirmation on delivery to a financial institution and of documentary evidence on delivery to a person who is not a financial institution. These requirements were included in the former temporary regulations in lieu of the more stringent certificate requirement in the former proposed regulations issued in September of 1983. At the time the certificate requirement was deleted, the confirmation and documentary evidence requirements were viewed as workable and as minimizing the administrative burden while providing a degree of assurance that bearer obligations would not be readily available to United States persons; there is no reason to further relax these rules.

Non-Applicability of Executive Order 12291

The Commissioner of Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Regulatory Flexibility Act

Although a notice of proposed rulemaking that solicited public comment was issued, the Internal

Revenue Service concluded when the notice was issued that the regulations are interpretative and that the notice and public procedure requirements of 5 U.S.C. did not apply. Accordingly, the final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6).

Paperwork Reduction Act

The collection of information requirements contained in this regulation have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB under Control No. 1545-0795.

Drafting Information

The principal author of this regulation is P. A. Fisher of the Office of the Associate Chief Counsel (International) within the Office of Chief Counsel, Internal Revenue Service. Personnel from other offices of the Internal Revenue Service and Treasury Department, however, participated in developing the regulations, on matters of both substance and style.

List of Subjects

26 CFR 1.61-1 through 1.281-4

Income taxes, Taxable income, Deductions, Exemptions, Industrial development bonds, Registration requirements.

26 CFR 1.1201 through 1.1297-1T

Income taxes, Capital gains and losses, Recapture.

26 CFR Part 602

OMB control numbers, Paperwork Reduction Act.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Sections 1.165-12 and 1.1287-1 also issued under 26 U.S.C. 165(j) (3).

§ 1.163-5T [Removed]

Par. 2. Section 1.163-5T is removed. New § 1.163-5 is inserted in its place, to read as follows:

§ 1.163-5 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a) [Reserved]

(b) [Reserved]

(c) *Obligations issued to foreign persons after September 27, 1984—(1) In general.* A determination of whether an obligation satisfies each of the requirements of this paragraph shall be made on an obligation-by-obligation basis. An obligation issued directly (or through affiliated entities) in bearer form by, or guaranteed by, a United States Government-owned agency or a United States Government-sponsored enterprise, such as the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Loan Mortgage Corporation, the Farm Credit Administration, and the Student Loan Marketing Association, may not satisfy this paragraph (c). An obligation issued after September 27, 1984 is described in this paragraph if—

(i) There are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with its original issuance) only to a person who is not a United States person or who is a United States person that is a financial institution (as defined in § 1.165-12(c)(1)(v)) purchasing for its own account or for the account of a customer and that agrees to comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder, and

(ii) In the case of an obligation which is not in registered form—

(A) Interest on such obligation is payable only outside the United States and its possessions, and

(B) Unless the obligation is described in subparagraph (2)(i)(C) of this paragraph or is a temporary global security, the following statement in English either appears on the face of the obligation and on any interest coupons which may be detached therefrom or, if the obligation is evidenced by a book entry, appears in the book or record in which the book entry is made: "Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1287(a) of the Internal Revenue Code." For purposes of this paragraph, the term "temporary global security" means a security which is held for the benefit of the purchasers of the obligations of the issuer and interests in which are exchangeable for securities in definitive registered or bearer form prior to its stated maturity.

(2) *Rules for the application of this paragraph—(i) Arrangements reasonably designed to ensure sale to non-United States persons.* An obligation will be considered to satisfy paragraph (c)(1)(i) of this section if the conditions of subdivision (A), (B), or (C) of this subdivision (i) are met in connection with the original issuance of the obligation. An exchange of one obligation for another is considered an original issuance if and only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. Obligations that meet the conditions of subdivisions (A), (B) and (C) (other than certificates of deposit issued under the conditions of subdivision (C)) by a United States person or by a controlled foreign corporation within the meaning of section 957(a) that is engaged in the active conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect prior to the Tax Reform Act of 1986, and the regulations thereunder) may be issued in a single public offering. A temporary global security is not required to satisfy the conditions of this subdivision (i).

(A) In connection with the original issuance of an obligation, the obligation is offered for sale or resale only outside of the United States and its possessions, is delivered only outside the United States and its possessions and is not registered under the Securities Act of 1933 because it is intended for distribution to persons who are not United States persons. An obligation will not be considered to be required to be registered under the Securities Act of 1933 if the issuer, in reliance on the written opinion of counsel received prior to the issuance thereof, determines in good faith that the obligation need not be registered under the Securities Act of 1933 for the reason that it is intended for distribution to persons who are not United States persons. Solely for purposes of this subdivision (i)(A), the term "United States person" has the same meaning as it has for purposes of determining whether an obligation is intended for distribution to persons under the Securities Act of 1933.

(B) The obligation is registered under the Securities Act of 1933, the obligation is exempt from registration by reason of section 3 or section 4 of such Act, or the obligation does not qualify as a security under the Securities Act of 1933, and all the conditions set forth in paragraphs (c)(2)(i)(B)(*1*), (*2*), (*3*), (*4*) and (*5*) are met with respect to such obligation.

(*1*) In connection with the original issuance of an obligation in bearer form, the obligation is offered for sale or resale only outside the United States and its possessions.

(*2*) The issuer does not, and each underwriter and each member of the selling group, if any, covenants that it will not, in connection with the original issuance of the obligation, offer to sell or

resell the obligation in bearer form to any person inside the United States or to a United States person unless such United States person is a financial institution as defined in § 1.165–12(c)(v) purchasing for its own account or for the account of a customer, which financial institution, as a condition of the purchase, agrees to provide on delivery of the obligation (or on issuance, if the obligation is not in definitive form) the certificate required under paragraph (c)(2)(i)(B)(4).

(3) In connection with its sale or resale during the original issuance of the obligation in bearer form, each underwriter and each member of the selling group, if any, or the issuer, if there is no underwriter or selling group, sends a confirmation to the purchaser of the bearer obligation stating that the purchaser represents that it is not a United States person or, if it is a United States person, it is a financial institution as defined in § 1.165–12(c)(v) purchasing for its own account or for the account of a customer and that the financial institution will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder. The confirmation must also state that, if the purchaser is a dealer, it will send similar confirmations to whomever purchases from it.

(4) In connection with the original issuance of the obligation in bearer form, it is delivered in definitive form (or issued, if the obligation is not in definitive form) to the person entitled to physical delivery thereof only upon presentation of a certificate signed by such person to the issuer, underwriter, or member of the selling group, which certificate states that the obligation is not being acquired by or on behalf of a United States person, or for offer to resell or for resale to a United States person or any person inside the United States, or, if a beneficial interest in the obligation is being acquired by a United States person, that such person is a financial institution as defined in § 1.165–12(c)(v) or is acquiring through a financial institution and that the obligation is held by a financial institution that has agreed to comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder and that is not purchasing for offer to resell or for resale inside the United States. When a certificate is provided by a clearing organization, it must be based on statements provided to it by its member organizations. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity or physical delivery of the obligation. For purposes of paragraph (c)(2)(i)(B), the term "delivery" does not include the delivery of an obligation to an underwriter or member of the selling group, if any.

(5) The issuer, underwriter, or member of the selling group does not have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(4) of this section is false. The issuer, underwriter, or member of the selling group shall be deemed to have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(4) of this section is false if the issuer, underwriter, or member of the selling group has a United States address for the beneficial owner (other than a financial institution as defined in § 1.165–12(c)(v) that represents that it will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder) and does not have documentary evidence as described in subdivision (iii) of A–6 of § 35a.9999–4T that the beneficial owner is not a United States person.

(C) The obligation is 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. In the case of an issuer that is a United States person, such issuer may only satisfy the test set forth in this paragraph (c)(2)(i)(C) if—

(1) It is engaged through a branch in the active conduct of a banking business, within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, outside the United States;

(2) The obligation is issued outside of the United States by the branch in connection with that trade or business;

(3) The obligation that is so issued is sold directly to the public and is not issued as a part of a larger issuance made by means of a public offering; and

(4) The issuer either maintains documentary evidence as described in subdivision (iii) of A–6 of § 35a.9999–4T that the purchaser is not a United States person (provided that the issuer has no actual knowledge that the documentary evidence is false) or on delivery of the obligation the issuer receives a statement signed by the person entitled to physical delivery thereof and stating either that the obligation is not being acquired by or on behalf of a United States person or that, if a beneficial interest in the obligation is being acquired by a United States person, such person is a financial institution as defined in § 1.165–12(c)(v) or is acquiring through a financial institution and the obligation is held by a financial institution that has agreed to comply with the requirements of 165(j)(3) (A), (B) or (C) and the regulations thereunder and that it is not purchasing for offer to resell or for resale inside the United States (provided that the issuer has no actual knowledge that the statement is false).

In addition, an issuer that is a controlled foreign corporation within the meaning of section 957 (a) that is engaged in the active conduct of a banking business outside the United States within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, can only satisfy the provisions of this paragraph (c)(2)(i)(C), if it meets the requirements of this paragraph (c)(2)(i)(C)(2), (3) and (4).

(ii) *Special rules.* An obligation shall not be considered to be described in paragraph (c)(2)(i)(C) of this section if it is—

(A) Guaranteed by a United States shareholder of the issuer;

(B) Convertible into a debt or equity interest in a United States shareholder of the issuer; or

(C) Substantially identical to an obligation issued by a United States shareholder of the issuer.

For purposes of this paragraph (c)(2)(ii), the term "United States shareholder" is defined as it is defined in section 951 (b) and the regulations thereunder. For purposes of this paragraph (c)(2)(ii)(C), obligations are substantially identical if the face amount, interest rate, term of the issue, due dates for payments, and maturity date of each is substantially identical to the other.

(iii) *Interstate commerce.* For purposes of this paragraph, the term "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.

(A) An issuer will not be considered to engage significantly in interstate commerce with respect to the issuance of an obligation if the only activities with respect to which the issuer uses the means or instrumentalities of interstate commerce are activities of a preparatory or auxiliary character that do not involve communication between a prospective purchaser and an issuer, its agent, an underwriter, or member of the

selling group if either is inside the United States or its possessions. Activities of a preparatory or auxiliary character include, but are not limited to, the following activities:

(1) Establishment or participation in establishment of policies concerning the issuance of obligations and the allocation of funding by a United States shareholder with respect to obligations issued by a foreign corporation or by a United States office with respect to obligations issued by a foreign branch;

(2) Negotiation between the issuer and underwriters as to the terms and pricing of an issue;

(3) Transfer of funds to an office of an issuer in the United States or its possessions by a foreign branch or to a United States shareholder by a foreign corporation;

(4) Consultation by an issuer with accountants and lawyers or other financial advisors in the United States or its possessions regarding the issuance of an obligation;

(5) Document drafting and printing; and

(6) Provision of payment or delivery instructions to members of the selling group by an issuer's office or agent that is located in the United States or its possessions.

(B) Activities that will not be considered to be of a preparatory or auxiliary character include, but are not limited to, any of the following activities:

(1) Negotiation or communication between a prospective purchaser and an issuer, its agent, an underwriter, or a member of the selling group concerning the sale of an obligation if either is inside the United States or its possessions;

(2) Involvement of an issuer's office, its agent, an underwriter, or a member of the selling group in the United States or its possessions in the offer or sale of a particular obligation, either directly with the prospective purchaser, or through the issuer in a foreign country;

(3) Delivery of an obligation in the United States or its possessions; or

(4) Advertising or otherwise promoting an obligation in the United States or its possessions.

(C) The following examples illustrate the application of this subdivision (iii) of § 1.163–5(c)(2).

Example (1). Foreign corporation A, a corporation organized in and doing business in foreign country Z, and not a controlled foreign corporation within the meaning of section 957(a) that is engaged in the conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, issues its debentures outside the United States. The debentures are not guaranteed by a United States shareholder of A, nor are they convertible into a debt or equity interest of a United States shareholder of A, nor are they substantially identical to an obligation issued by a United States shareholder of A. A consults its accountants and lawyers in the United States for certain securities and tax advice regarding the debt offering. The underwriting and selling group in respect to A's offering is composed entirely of foreign securities firms, some of which are foreign subsidiaries of United States securities firms. A U.S. affiliate of the foreign underwriter communicates payment and delivery instructions to the selling group. All offering circulars for the offering are mailed and delivered outside the United States and its possessions. All debentures are delivered and paid for outside the United States and its possessions. No office located in the United States or in a United States possession is involved in the sale of debentures. Interest on the debentures is payable only outside the United States and its possessions. A is not significantly engaged in interstate commerce with respect to the offering.

Example (2). B, a United States bank, does business in foreign country X through a branch located in X. The branch is a staffed and operating unit engaged in the active conduct of a banking business consisting of one or more of the activities set forth in § 1.954–2(d)(2)(ii). As part of its ongoing business, the branch in X issues negotiable certificates of deposit with a maturity in excess of one year to customers upon request. The certificates of deposit are not guaranteed by a United States shareholder of B, nor are they convertible into a debt or equity interest of a United States shareholder of B, nor are they substantially identical to an obligation issued by a United States shareholder of B. Policies regarding the issuance of negotiable certificates of deposit and funding allocations for foreign branches are set in the United States at B's main office. Branch personnel decide whether to issue a negotiable certificate of deposit based on the guidelines established by the United States officers of B, but without communicating with the United States offices of B with respect to the issuance of a particular obligation. Negotiable certificates of deposits are delivered and paid for outside the United States and its possessions. Interest on the negotiable certificates of deposit is payable only outside the United States and its possessions. B maintains documentary evidence described in § 1.163–5(c)(2)(i)(C)(4). After the issuance of negotiable certificates of deposit by the foreign branch of B, the foreign branch sends the funds to a United States branch of B for use in domestic operations. B is not significantly engaged in interstate commerce with respect to the issuance of such obligation.

Example (3). The facts in Example (2) apply except that the foreign branch of B consulted, by telephone, the main office in the United States to request approval of the issuance of the certificate of deposit at a particular rate of interest. The main office granted permission to issue the negotiable certificate of deposit to the customer by a telex sent from the main office of B to the branch in X. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of involvement of B's United States office in the issuance of the obligation.

Example (4). The facts in Example (2) apply with the additional fact that a customer contacted the foreign branch of B through a telex originating in the United States or its possessions. Subsequent to the telex, the foreign branch issued the negotiable certificate of deposit and recorded it on the books. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of its communication by telex with a customer in the United States.

(iv) *Possessions.* For purposes of this section, the term "possessions" includes Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Wake Island, and Northern Mariana Islands.

(v) *Interest payable outside of the United States.* Interest will be considered payable only outside the United States and its possessions if payment of such interest can be made only upon presentation of a coupon, or upon making of any other demand for payment, outside of the United States and its possessions to the issuer or a paying agent. The fact that payment is made by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account does not affect this result. Interest payments will be considered to be made within the United States if the payments are made by a transfer of funds into an account maintained by the payee in the United States or mailed to an address in the United States, if—

(A) The interest is paid on an obligation issued by either a United States person, a controlled foreign corporation as defined in section 957 (a), or a foreign corporation if 50 percent or more of the gross income of the foreign corporation from all sources of the 3-year period ending with the close of its taxable year preceding the original issuance of the obligation (or for such part of the period that the foreign corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; and

(B) The interest is paid to a person other than—

(1) A person who may satisfy the requirements of section 165 (j)(3) (A), (B), or (C) and the regulations thereunder; and

(2) A financial institution as a step in the clearance of funds and such interest is promptly credited to an account maintained outside the United States for such financial institution or for persons

for which the financial institution has collected such interest.

Interest is considered to be paid within the United States and its possessions if a coupon is presented, or a demand for payment is otherwise made, to the issuer or a paying agent (whether a United States or foreign person) in the United States and its possessions even if the funds paid are credited to an account maintained by the payee outside the United States and its possessions. Interest will be considered payable only outside the United States and its possessions notwithstanding that such interest may become payable at the office of the issuer or its United States paying agent under the following conditions: the issuer has appointed paying agents located outside the United States and its possessions with the reasonable expectation that such paying agents will be able to pay the interest in United States dollars, and the full amount of such payment at the offices of all such paying agents is illegal or effectively precluded because of the imposition of exchange controls or other similar restrictions on the full payment or receipt of interest in United States dollars. A lawsuit brought in the United States or its possessions for payment of the obligation or interest thereon as a result of a default shall not be considered to be a demand for payment. For purposes of this subdivision (v), interest includes original issue discount as defined in section 1273(a). Therefore, an amount equal to the original issue discount as defined in section 1273(a) is payable only outside the United States and its possessions. The amount of market discount as defined in section 1278(a) does not affect the amount of interest to be considered payable only outside the United States and its possessions.

(vi) *Rules relating to obligations issued after December 31, 1982 and on or before September 21, 1984.* Whether an obligation originally issued after December 31, 1982 and on or before September 21, 1984, or an obligation originally issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, is described in section 163(f)(2)(B) shall be determined under the rules provided in § 5f.163–1(c) as in effect prior to its removal. Notwithstanding the preceding sentence, an issuer will be considered to satisfy the requirements of section 163(f)(2)(B) with respect to an obligation issued after December 31, 1982 and on or before September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, if the issuer substantially complied with the proposed regulations provided in § 1.163–5(c), which were published in the Federal Register on September 2, 1983 (48 FR 39853) and superseded by temporary regulations published in the Federal Register on August 22, 1984 (49 FR 33228).

(3) *Effective Date.* These regulations apply generally to obligations issued after January 20, 1987. A taxpayer may choose to apply the rules of § 1.163–5(c) with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987.

If this choice is made, the rules of § 1.163–5(c) will apply in lieu of § 1.163–5T(c) except that the legend requirement under § 1.163–5(c)(1)(ii)(B) does not apply with respect to a bearer obligation evidenced exclusively by a book entry and that the certification requirement under § 5f.163–1(c)(2)(i)(B)(4) applies in lieu of the certification under § 1.163–5(c)(2)(i)(B)(4).

Par. 3. Section 1.165–12T is removed. New § 1.165–12 is inserted in its place, to read as follows:

§ 1.165–12 Denial of deduction for losses on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, nothing in section 165(a) and the regulations thereunder, or in any other provision of law, shall be construed to provide a deduction for any loss sustained on any registration-required obligation held after December 31, 1982, unless the obligation is in registered form or the issuance of the obligation was subject to tax under section 4701. The term "registration-required obligation" has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall not be allowed a deduction for any loss sustained on such obligation unless paragraph (c) of this section applies. The term "holder" means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984.* With respect to any obligation originally issued after September 21, 1984, the term "registered form" has the meaning given that term in section 163(f)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to be in registered form if it can be transferred at that time or at any time until its maturity by any means not described in § 5f.103–1(c). An obligation that, as of a particular time, is not considered to be in registered form because it can be transferred by any means not described in § 5f.103–1(c) is considered to be in registered form at all times during the period beginning with a later time and ending with the maturity of the obligation in which the obligation can be transferred only by a means described in § 5f.103–1(c).

(2) *Obligations issued after December 31, 1982 and on or before September 21, 1984.* With respect to any obligation originally issued after December 31, 1982 and on or before September 21, 1984 or an obligation originally issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984, that obligation will be considered in registered form if it satisfied § 5f.163–1 or the proposed regulations provided in § 1.163–5(c) and published in the Federal Register on September 2, 1983 (48 FR 39853).

(c) *Registration-required obligations not in registered form which are not subject to section 165(j)(1).* Notwithstanding the fact that an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 165(j)(1) if the holder meets the conditions of any one of the following subparagraphs (1), (2), (3), or (4) of this paragraph (c).

(1) *Persons permitted to hold in connection with the conduct of a trade or business.* (i) The holder is an underwriter, broker, dealer, bank, or other financial institution (defined in paragraph (c)(1)(v)) that holds such obligation in connection with its trade or business conducted outside the United States; or the holder is a broker-dealer (registered under Federal or State law or exempted from registration by the provisions of such law because it is a bank) that holds such obligation for sale to customers in the ordinary course of its trade or business.

(ii) The holder must offer to sell, sell and deliver the obligation in bearer form only outside of the United States except that a holder that is a registered broker-dealer as described in paragraph (c)(1)(i) may offer to sell and sell the obligation in bearer form inside the United States to a financial institution as defined in paragraph (c)(1)(v) for its own account or for the account of another financial institution or exempt organization as defined in section 501(c)(3) if the transaction consists of the purchases of a block of obligations the total denominations of which are at least $1,000,000.

(iii) If a financial institution purchases an obligation in bearer form that is offered or sold inside the United States, it must agree as a condition of the purchase to provide on delivery the statement described in paragraph (c)(1)(iv).

(iv) The holder may deliver an obligation in bearer form that is offered or sold inside the United States only if the holder delivers it to a financial institution that states that it is a financial institution as defined in § 1.165-12(c)(1)(v) that is purchasing for its own account or for the account of another financial institution or exempt organization, that will comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder and the holder has no actual knowledge that the statement is false. The statement must contain the name and address of the person entitled to delivery and must be signed by such person under penalties of perjury. The holder may deliver an obligation in bearer form that is offered and sold outside the United States to a financial institution if it delivers to such person a confirmation stating that any United States taxpayer who holds this obligation in bearer form and who is not exempt under section 165(j)(3) (A), (B), or (C) and the regulations thereunder will, for purposes of the United States income tax, be denied a deduction for any loss incurred with respect to the obligation and will be denied capital gain treatment with respect to the obligation. The holder may deliver a registration-required obligation in bearer form that is offered and sold outside the United States to a person other than a financial institution only if the holder has documentary evidence as described in subdivision (iii) of A-5 of § 35a.9999-4T that the person is not a United States person. For purposes of this paragraph (c), the word "deliver" includes the transfer of an obligation evidenced by a book entry including a book entry notation by a clearing organization evidencing transfer of the obligation from one member of the organization to another member. For purposes of this paragraph (c), the word "deliver" does not include a transfer of an obligation to the issuer or its agent for cancellation or extinguishment. If a holder that is a member of a clearing organization (defined in § 1.163-5(c)(2)(i)(B)(4)) delivers an obligation to another member of the same or another clearing organization by transfer of the obligation between the clearing organization accounts of such members, the selling member shall receive the statement from the purchasing member (in the case of obligations offered or sold inside the United States) or send the confirmation to the purchasing member (in the case of obligations offered and sold outside the United States).

(v) For purposes of paragraph (c) of this section, the term "financial institution" means a person which itself is, or more than 50 percent of the total combined voting power of all classes of whose stock entitled to vote is owned by a person which is—

(A) Engaged in the conduct of a banking, financing, or similar business within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder;

(B) Engaged in business as a broker or dealer in securities;

(C) An insurance company;

(D) A person that provides pensions or other similar benefits to retired employees;

(E) Primarily engaged in the business of rendering investment advice;

(F) A regulated investment company or other mutual fund; or

(G) A fiannce corporation a substantial part of the business of which consists of making loans (including the acquisition of obligations under a lease which is entered into primarily as a financing transaction), acquiring accounts receivable, notes or installment obligations arising out of the sale of tangible personal property or the performing of services, or servicing debt obligations.

(2) *Persons permitted to hold obligations for their own investment account.* The holder is a financial institution holding the obligation for its own investment account that satisfies the conditions set forth in subdivisions (i), (ii), (iii), and (iv) of his paragraph (c)(2).

(i) The holder reports on its Federal income tax return for the taxable year any interest payments received (including original issue discount includable in gross income for such taxable year) with respect to such obligation and gain or loss on the sale or other disposition of such obligation;

(ii) The holder indicates on its Federal income tax return that income, gain or loss described in paragraph (c)(2)(i) is attributable to registration-required obligations held in bearer form for its own account;

(iii) The holder of a bearer obligation that resells the obligation inside the United States resells the obligation only to another financial institution for its own account or for the account of another financial institution or exempt organization; and

(iv) The holder delivers such obligation in bearer form to any other person in accordance with paragraph (c)(1) (ii) and (iv) of this section.

(3) *Persons permitted to hold through financial institutions.* The holder is any person that purchases and holds a registration-required obligation in bearer form through a financial institution with which the holder maintains a customer, custodial or nominee relationship and such institution agrees to satisfy, and does in fact satisfy, the conditions set forth in subdivisions (i), (ii), (iii), (iv) and (v) of this paragraph (c)(3).

(i) The financial institution makes a return of information to the Internal Revenue Service with respect to any interest payments received. The financial institution must report original issue discount includable in the holder's gross income for the taxable year on any obligation so held, but only if the obligation appears in an Internal Revenue Service publication of obligations issued at an original issue discount and only in an amount determined in accordance with information contained in that publication. An information return for any interest payment shall be made on a Form 1099 for the calendar year. It shall indicate the aggregate amount of the payment received, the name, address and taxpayer identification number of the holder, and such other information as is required by the form. No return of information is required under this subdivision if the financial institution reports payments under section 6041 or 6049.

(ii) The financial institution makes a return of information on Form 1099B with respect to any disposition by the holder of such obligation. The return shall show the name, address, and taxpayer identification number of the holder of the obligation, Committee on Uniform Security Information Procedures (CUSIP), gross proceeds,

sale date, and such other information as may be required by the form. No return of information is required under this subdivision if such financial institution reports with respect to the disposition under section 6045.

(iii) In the case of a bearer obligation offered for resale or resold in the United States, the financial institution may resell the obligation only to another financial institution for its own account or for the account of an exempt organization.

(iv) The financial institution covenants with the holder that the financial institution will deliver the obligation in bearer form in accordance with the requirements set forth in paragraph (c)(1) (ii) and (iv).

(v) The financial institution delivers the obligation in bearer form in accordance with paragraph (c)(1) (ii) and (iv) as if the financial institution delivering the obligation were the holder referred to in such paragraph.

(4) *Conversion of obligations into registered form.* The holder is not a person described in paragraph (c) (1), (2), or (3) of this section, and within thirty days of the date when the seller or other transferor is reasonably able to make the bearer obligation available to the holder, the holder surrenders the obligation to a transfer agent or the issuer for conversion of the obligation into registered form. If such obligation is not registered within such 30 day period, the holder shall be subject to sections 165(j) and 1287(a).

(d) *Effective Date.* These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of § 1.165–12 with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987, which obligation is held after January 20, 1987.

Par. 4. Section 1.1287–1T is removed. New § 1.1287–1 is inserted in its place, to read as follows:

§ 1.1287–1 Denial of capital gains treatment for gains on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, any gain on the sale or other disposition of a registration-required obligation held after December 31, 1982, that is not in registered form shall be treated as ordinary income unless the issuance of the obligation was subject to tax under section 4701. The term "registration-required obligation" has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall be required to treat the gain on the sale or other disposition of such obligation as ordinary income. The term "holder" means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984.* With respect to any obligation originally issued after September 21, 1984, the term "registered form" has the meaning given that term in section 103(j)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to be in registered form if it can be transferred at that time or at any time until its maturity by any means not described in § 5f.103–1(c). An obligation that, as of a particular time, is not considered to be in registered form because it can be transferred by any means not described in § 5f.103–1(c) is considered to be in registered form at all times during the period beginning with a later time and ending with the maturity of the obligation in which the obligation can be transferred only by a means described in § 5f.103–1(c).

(2) *Obligations–issued after December 31, 1982 and on or before September 21, 1984.* With respect to any obligation originally issued after December 31, 1982 and on or before September 21, 1984 or an obligation originally issued after September 21, 1984 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued after December 31, 1982 and on or before September 21, 1984 that obligation will be considered to be in registered form if it satisfied § 5f.163–1 or the proposed regulations provided in § 1.163–5(c) and published in the Federal Register on September 2, 1983 (48 FR 39953).

(c) *Registration-required obligations not in registered form which are not subject to section 1287(c).* Notwithstanding the fact that an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 1287(a) if the holder meets the conditions of § 1.165–12(c).

(d) *Effective Date.* These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of § 1.1287–1 with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987, which obligation is held after January 20, 1987.

PART 602—[AMENDED]

Par. 5. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.10 [Amended]

Par. 6. Section 602.101(c) is amended by inserting in the appropriate places in the table "§ 1.165–12 . . . 1545–0786" and "§ 1.1287–1 . . . 1545–0786."

Approved:

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

October 28, 1986.

J. Roger Mentz,

Assistant Secretary of the Treasury.

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