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IRS Proposes Rules for Portfolio Interest Paid to Partnerships

Prop. Reg. Sec. 1.871-14(g) (June 13, 2006)

Overview

Treasury and IRS have issued proposed regulations under code section 871(h) that apply an aggregate concept to determine whether portfolio interest received by a partnership is eligible for the exemption from withholding tax for portfolio interest.

Background

Under code sections 871 and 881, nonresident alien individuals and foreign corporations are subject to 30 percent withholding tax on certain fixed and determinable annual or periodical income (FDAP) from U.S. sources, unless an income tax treaty reduces or eliminates the withholding tax. Under code section 1441, this tax is collected or withheld from payments of FDAP by the withholding agent (defined as a person subject to U.S. income tax jurisdiction that has control over an item of FDAP payable to a foreign person). Generally, interest paid by a U.S. borrower to a foreign lender is U.S. source FDAP and subject to withholding tax.

Under a statutory exception, the 30 percent withholding tax does not apply to "portfolio interest." Portfolio interest (including original issue discount) is interest that would otherwise be subject to 30 percent withholding tax but meets one of the following tests. First, interest paid on an obligation that is in registered form is portfolio interest if the beneficial owner of the interest provides documentation to the withholding agent showing that it is not a U.S. person. Second, interest paid on an obligation that is not in registered form (a bearer obligation) is portfolio interest if there are arrangements reasonably designed to ensure that U.S. persons will not acquire the obligation, interest on the obligation is payable only outside the U.S., and the obligation has a statement on its face that any U.S. person who holds the obligation will be subject to limitations under U.S. income tax law.

Exception for Interest Paid to a 10 Percent Shareholder

Portfolio interest does not include contingent interest and interest received by a bank on a loan or extension of credit entered in the ordinary course of business or interest received by a 10 percent shareholder or a 10 percent partner of the borrower (we refer to such persons herein as the "10 percent shareholder"). Where the borrower is a corporation, a 10 percent shareholder is a person who owns at least 10 percent of the voting power of all classes of stock of the borrower. Where the borrower is a partnership, a 10 percent shareholder is a person who owns at least 10 percent of the capital or profits interest in the borrower. The code section 318 ownership attribution rules (with some modifications) apply in measuring ownership levels under this rule. Although the code section 318 rules apply only in determining ownership of a corporation, code section 871(h) specifies that the rules are to apply in determining ownership of a partnership under regulations to be prescribed. The regulations have not yet been issued.

Neither the code nor the legislative history specifically addresses whether the 10 percent shareholder test is applied to a partnership lender at the entity or the partner level. For example, if a foreign partnership with five equal unrelated partners owns 49 percent of the voting stock of a U.S. corporation, interest paid by the corporation to the partnership will be subject to 30 percent withholding tax (assuming no applicable income tax treaty or other withholding tax exemption) if the 10 percent test is applied at the partnership level, but not if the test applies at the partner level (assuming the partners have no direct ownership in the borrower). The only authority on how to apply the 10 percent shareholder test to portfolio interest received by a partnership is a 1994 IRS Field Service Advice (FSA) that was published in 2003. In this document, the IRS applied the 10 percent test at the partner level and concluded that the interest payments at issue were exempt from withholding tax as portfolio interest. However, unlike a revenue ruling, an FSA is not binding on the IRS in future matters.

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The Proposed Regulations

The proposed regulations provide that when interest is paid to a partnership, the partners are considered to receive the interest for purposes of applying the 10 percent shareholder test and the test is then applied by determining each partner's ownership interest in the borrower. IRS and Treasury reasoned that the test should apply at the partner rather than the partnership level because partners, and not the partnership, ultimately bear the cost of any U.S. income tax imposed on interest received by a partnership. Partner level application of the 10 percent shareholder test is consistent with the treatment of FDAP received by a partnership under the code section 1441 withholding rules, which generally treat the partner as the beneficial owner of FDAP received by the partnership. Moreover, application of the 10 percent shareholder test at the partner level is consistent with the broad policy of the withholding tax exemption for portfolio interest – to encourage the flow of foreign capital to the United States.

The proposed regulations provide that the 10 percent shareholder test is applied with respect to a foreign partner in a partnership at the time a withholding agent would, absent any exemptions, be required to withhold tax with respect to the interest payment under the code section 1441 withholding regime. This means that the 10 percent shareholder test must be applied on the earliest of (i) the day the partnership distributes the interest to the foreign partner, or (ii) the day the partnership sends the foreign partner the Form K-1 pertaining to the taxable year in which the interest was received (or, if earlier, the due date for sending such Form K-1).

Application of Test to Interest Paid to a Simple or Grantor Trust

The proposed regulations also apply the 10 percent shareholder test at the beneficiary level with respect to interest received by a grantor trust or a simple trust (in a grantor trust the beneficiary is treated as the owner of all trust assets and income, and a simple trust is one that by its terms is required to distribute all of its income annually to its beneficiaries). The 10 percent shareholder test must be applied at the time the withholding agent would be required to withhold tax with respect to the interest payment, which is the date the interest is paid.

Effective Date

The proposed regulations are effective for interest paid on obligations issued after the regulations are issued in final.

Planning Considerations

While the application of the 10 percent shareholder test at the partner (or beneficiary) level is a very positive development, the proposed regulations appear to leave some significant loose ends. First, the proposed regulations do not address portfolio interest paid to a partnership under current law. Since few withholding agents are willing to refrain from withholding on the basis of the 1994 FSA, which applied the 10 percent shareholder test at the partner level, many commentators have suggested that the IRS clarify the state of current law by issuing a published ruling. Second, the proposed regulations only tell the withholding agent when it must apply the 10 percent shareholder test, not how it must apply the test. While other provisions in the code attribute tax items to or from a partnership based on a partner's capital and profits interest in the partnership, the measurement of such interests in complex partnerships may be very difficult for withholding agents. Ultimately withholding agents may need further guidance (perhaps in the form of presumptions) to establish workable tests for measuring a partner's interest in the capital and profits of a partnership.

For further information contact Kevin Rowe (212-210-9505) or Edward Tanenbaum (212-210-9425).

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