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## Final Portfolio Interest Regulations Pertaining to Partnerships

*Treas. Reg. § 1.871-14(g) (April 12, 2007)*

### Overview

Treasury and the IRS have finalized regulations under section 871(h) that apply an aggregate concept to determine whether U.S. source interest received by a partnership is "portfolio interest" exempt from withholding tax. The final regulations adopt the aggregate approach and may apply retroactively to interest paid in prior years.

### Background

Under 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 including interest paid by a U.S. borrower. The tax is collected or withheld by the withholding agent. Under a statutory exception, the 30 percent withholding tax does not apply to "portfolio interest," defined as interest otherwise subject to 30 percent withholding tax that is paid on a registered obligation provided the beneficial owner of the interest provides documentation showing that it is not a U.S. person. Interest paid on a bearer obligation may also qualify as portfolio interest provided there are arrangements reasonably designed to ensure that U.S. persons will not acquire the obligation, interest is payable only outside the United States 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.

Among other things, portfolio interest does not include interest received by a 10-percent shareholder or a 10-percent partner of the borrower ("related person interest"). The section 318 ownership attribution rules (with some modifications) apply in measuring ownership under this rule. Prior to the issuance of regulations, it was not clear how the related person interest test was to be applied with respect to interest received by a partnership.

### The Final Regulations

The final regulations generally follow the proposed regulations. The regulations determine whether interest received by a partnership is related person interest under the aggregate theory of partnership taxation. Thus, the related party interest test applies at the partner level and each partner is considered to own a pro rata share of what the partnership owns. The final regulations clarify when the test is applied: when any distributions that include interest are made or, to the extent a foreign partner's distributive share of interest has not been distributed, on the due date for filing the Form K-1 for the year in which the partnership recognized the interest income (or the date such form is actually mailed, if earlier). This timing rule is consistent with general provisions in the section 1441 regulations.

The final regulations are effective for interest paid after April 12, 2007. Taxpayers may also apply the regulations to interest paid in any open year provided they do so consistently for all relevant partnerships during such years. This effective date represents a significant taxpayer victory over the proposed regulations' prospective effective date (applying only to interest on obligations issued after finalization of the regulations).

### Planning Considerations

The most significant provision in the final regulations is the retroactive effective date allowing taxpayers to apply the aggregate approach to interest paid on all outstanding obligations. Treasury and the IRS should be commended for responding to taxpayer critiques of the proposed regulations' prospective effective date. Still to come perhaps is guidance on application of the 10-percent shareholder test where a partner's interest in the partnership varies during the year or where the partners have different shares of different classes of income.

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# Net Consideration Method Adopted for Qualified Patent Cross Licensing Arrangements

Rev. Proc. 2007-23, 2007-10 I.R.B. 1 (February 14, 2007)

## Overview

Revenue Procedure 2007-23 permits taxpayers to use the net consideration method to determine income and expense from a qualified patent cross licensing agreement ("QPCLA").

## Background

The typical cross licensing agreement ("CLA") is an agreement in which owners of intellectual property license each other under their respective intellectual property rights to eliminate the risk of infringing on the intellectual property rights held by the other parties to the agreement. CLAs are very important when a company is expanding a particular area of technology (sometimes called taking technology to the "next level") because they provide protection from litigation over competing claims. The CLA may require cash payments from one party to the other to equalize values of the intellectual property covered by the CLA. Taxpayers have taken the position that non-cash consideration under a CLA generates neither income nor deductions to its participants, although there is no single theory advanced in support of this position. Notice 2006-34 outlined the uncertainty over the income tax treatment of CLAs describing three competing models for CLAs – reciprocal licenses, reciprocal agreements to refrain from suing for infringement and an exchange of property. Under the reciprocal license model, there is a risk in a cross-border CLA that a U.S. person could be subject to withholding tax on the gross value of the foreign party's intellectual property used in the United States pursuant to the CLA (i.e., the license granted by the U.S. person to the foreign party is an in-kind U.S. source royalty).

## Revenue Procedure 2007-23

In response to comments received on Notice 2006-34, the IRS issued Revenue Procedure 2007-23. It provides that taxpayers may elect to measure consideration paid or received under a QPCLA using the net consideration method. A QPCLA is a nonexclusive and nontransferable patent cross licensing agreement between uncontrolled parties. The QPCLA must be limited to the present or future patent rights of the parties. If the arrangement also addresses other types of intellectual property, it will not qualify as a QPCLA. Net consideration is defined as the amount of consideration (other than license rights) received by a party under the QPCLA reduced by the amount of consideration paid by a party under the QPCLA (other than license rights). The net consideration method applies to determine amounts that are subject to withholding as well as to measure costs associated with the QPCLA. The taxpayer must elect to use the net consideration method. An election changing the reporting of a QPCLA to the net consideration method is a change in accounting method requiring IRS consent under section 446(e).

The QPCLA rules generally apply to arrangements entered on or after February 14, 2007. The IRS will not pursue taxpayers that use the net consideration method for QPCLAs entered before February 14, 2007.

## Planning Considerations

Revenue Procedure 2007-23 in effect adopts the reciprocal license model for CLAs. While the net consideration method eliminates the risk of withholding tax on cross-border QPCLAs by ignoring the value of licensing rights, the narrowness of the definition of the QPCLA raises concerns. A QPCLA does not include a CLA involving non-patent intellectual property and one that is part of an arrangement for the joint development of intellectual property. Even for CLAs only involving patents, the limitation of QPCLAs to parties with essentially no other dealings with each other may severely limit the utility of the provision. Moreover, absent the net consideration method, the reciprocal license model creates significant risk of withholding tax on the gross value of licensing rights granted by a U.S. party to a foreign party to a cross-border CLA. Thus, parties involved in or contemplating a CLA including one involving patents should exercise caution. On a positive note, Treasury and the IRS request comments regarding the definition of the QPCLA and whether the net consideration method should be extended to other types of CLAs, suggesting that the application of the method could be expanded.

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