

COMMENTS REGARDING NEED FOR GUIDANCE ON PORTFOLIO INTEREST RULES UNDER SECTIONS 871(h) AND 881(c) OF THE INTERNAL REVENUE CODE

The following comments represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on U.S. Activities of Foreigners & Tax Treaties of the Section of Taxation. Principal overall responsibility for the comments was exercised by Tim Devetski and Bill Ewing. The following individuals exercised principal responsibility for the noted subsection of the comments: Registered Form Requirement (Matthew S. Blum), Contingent Interest Exception (Joseph Mandarino), Bank Loan Exception (Richard Andersen) and Ten Percent Ownership Exception (Daniel Kheel). Substantive contributions to the report were made by all of the foregoing, as well as Alan Appel, Todd Beutler, Peter Genz, David Goldman, John Harrell, Michael Karlin, Christopher Kippes, Michael Lloyd, Mitch Moetell, Wayne Pressgrove and Roger Wise. Special thanks to Prof. Linda J. Rusch who provided guidance regarding certain aspects of the Uniform Commercial Code for purposes of an earlier draft.

The comments were reviewed by Jason Bazar and Edward Tanenbaum, Chairs of the Portfolio Withholding Issues & Investments Subcommittee, Joan C. Arnold, Chair of the Committee. Elinore J. Richardson, Council Director for the Committee on U.S. Activities of Foreigners & Tax Treaties and Thomas Crichton, IV of the Tax Section's Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Contact Persons:

Tim Devetski
(713) 758-2975
tdevetski@velaw.com

Bill Ewing
(404) 815-6139
wewing@kilpatrickstockton.com

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I. Introduction

These comments recommend that the Internal Revenue Service (the “Service”) provide guidance addressing several issues involving the application of the “portfolio interest” exemption under sections 871(h) and 881(c) of the Internal Revenue Code of 1986, as amended (the “Code”).¹ Sections 871(h) and 881(c) generally provide that a non-U.S. person is exempt from the 30 percent tax generally imposed on the receipt of U.S. source interest where such interest falls within a defined class of “portfolio interest” (the “portfolio interest exemption”).

“Portfolio interest” is defined as interest on any obligation that is either in registered form, provided the withholding agent receives an appropriate statement that the beneficial owner of the obligation is not a U.S. person (the “registration requirement”), or not in registered form, provided the obligation meets certain foreign-targeting requirements. The portfolio interest exemption does not apply in situations involving: (i) interest that is contingent in certain designated ways (the “contingent interest exception”), (ii) interest received by a bank on an extension of credit under a loan agreement entered into in the ordinary course of its trade or business (the “bank loan exception”), and (iii) interest received by a “10-percent shareholder” (the “10-percent ownership exception”).

The comments are divided into four parts discussing issues arising under: (i) the registration requirement (Section III), (ii) the contingent interest exception (Section IV), (iii) the bank loan exception (Section V), and (iv) the 10-percent ownership exception (Section VI). Section II summarizes our requests for additional guidance in these four areas. For your convenience, we have also attached examples of possible rulings and notices in an Appendix. We believe that the requested guidance would be beneficial both to taxpayers and the Service and would further the legislative objectives of the portfolio interest exemption.

II. Executive Summary of Requests for Guidance

A. Registration Requirement

As set forth above, in order for interest on a debt obligation to qualify for the portfolio interest exemption, the debt obligation must either be “in registered form” (and the holder must satisfy certain documentation requirements) or it must meet certain foreign targeting requirements for bearer debt obligations. For purposes of the portfolio interest exemption, “in registered form” has the same meaning as under the registration requirement enacted by TEFRA.² As described in Section III below, the portfolio interest rules’ incorporation of the TEFRA registration requirement leads to uncertainty in situations not otherwise governed by TEFRA. Guidance is requested to clarify the application of the TEFRA registration requirement in such situations, especially in situations that arise frequently in practice (such as promissory notes, with respect to which there may be additional uncertainty in light of the approach adopted in a 1992 Field Service Advice). Guidance also is requested regarding satisfaction of the

¹ Unless otherwise indicated, please assume that all references to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

² “TEFRA” refers to the Tax Equity and Fiscal Responsibility Act of 1982. The registration requirement enacted by TEFRA is described in detail below.

registration requirement where the terms of a debt obligation itself would not satisfy the registration requirement but arrangements are made (extraneous to the debt obligation) to ensure satisfaction of such requirement. While existing regulations indicate that such arrangements may satisfy the registration requirement where the arrangements qualify as trusts for federal tax purposes, we do not believe that an arrangement qualifying as a trust is necessary and request that the Service publish guidance confirming this conclusion.

B. Contingent Interest Exception

The contingent interest exception precludes interest determined by reference to, among other things, the value of property owned by the debtor from qualifying for the portfolio interest exemption. In this manner, the contingent interest exception may be viewed as a backstop to the withholding tax on dividends and certain other FDAP income paid by a U.S. debtor. It is noted that, by contrast to the treatment of such income, gains on the sale of stock (other than stock of a U.S. real property holding corporation) generally are not subject to withholding tax. Thus, guidance is requested regarding whether interest determined by reference to the value of the debtor's own stock may qualify for the portfolio interest exemption or whether it falls within the contingent interest exception. Guidance also is requested confirming that penalty interest triggered by a change in value of the debtor's assets (or certain other events), but determined by reference to the principal amount of indebtedness, qualifies for the portfolio interest exemption.

C. Bank Loan Exception

Portfolio interest does not include any interest that is received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. There are no Treasury Regulations, cases or published guidance interpreting this bank loan exception, and we urge the Service and Treasury to issue guidance in the following areas:

- The term "bank" should be defined, and we suggest that it would be reasonable and administrable to define it by reference to the "active bank" definition set forth in Proposed Regulation § 1.1296-4(b).
- We suggest that a non-bank foreign lender should not be tainted by its affiliation with a foreign bank where the loan is made by the lending affiliate in the ordinary course of its business and the structure for holding the loan in question is not motivated by a principal purpose to avoid the bank loan exception.
- We suggest that the term "loan agreement" should encompass only negotiated bank loans and should not include publicly traded debt instruments or debt instruments issued to the public in compliance with securities registration requirements or an exemption therefrom.
- We suggest that a foreign bank that participates in a loan syndication and enters into direct contractual privity with the borrower at the time the loan is made should be viewed as having made "an extension of credit pursuant to a loan agreement." In contrast, if a foreign bank purchases all or a portion of a lender's interest in an existing loan in the secondary market or takes a partial or complete assignment of the

originating lender's rights without acquiring contractual privity with the borrower, such foreign bank should not be viewed as making "an extension of credit pursuant to a loan agreement."

D. 10-Percent Ownership Exception

Interest received from a corporation by a "10-percent shareholder" thereof is excepted from the definition of portfolio interest. In cases where the lender is treated as a partnership for federal tax purposes, we recommend that guidance be issued concluding that the 10-percent shareholder exception for the portfolio interest exemption should be applied at the partner level, rather than the partnership level. We also request guidance regarding the time for determining the requisite ownership. Finally, in the context of applying the 10-percent shareholder exception with respect to the borrowings of partnerships, guidance is requested regarding the manner for determining a partner's percentage interest in a partnership where such partner has a fixed or varying profits interest in the partnership.

III. Registration Requirement

In order to qualify for the portfolio interest exemption, as set forth above, an obligation must be issued "in registered form" or meet certain highly complex requirements for foreign-targeted bearer debt obligations.³ This Section III discusses the meaning of the term "in registered form" for purposes of the portfolio interest exemption, beginning with the historical context in which the term has been used in the federal tax law. This section then outlines the need for guidance in practical situations faced by taxpayers for which the standard meaning of the term has no applicability or existing guidance is otherwise uncertain of application. Finally, this section concludes with a discussion of the application of the "in registered form" requirement to pass-through certificates and partnership interests.

A. Background and Historical Context

1. "In Registered Form"

Federal tax law has distinguished between obligations "in registered form" and obligations not in such form for close to a century. Early statutes imposed documentary stamp taxes on the issuance of corporate bonds or debt securities, which the Treasury Department interpreted generally to include obligations issued by a corporation "in registered form" or "with coupons attached."⁴ Subsequent statutory enactments followed the Treasury's approach, applying stamp tax at one rate to obligations "with interest coupons or in registered form" and at

³ I.R.C. § 871(h)(2)(B).

⁴ Documentary stamp taxes were imposed beginning in 1898 and applied at different rates to "bonds" and "debentures" than to "promissory notes". The earliest statutes did not define these terms, but the Treasury Department distinguished between these categories of instruments by focusing on whether the instruments were either *in registered form* or *with coupons attached*, and whether the instruments contained other provisions deemed typical of corporate bonds or debentures. See T.D. 2713, 20 Treas. Dec. Int. Rev. 358 (1918).

another rate to ordinary promissory notes.⁵ Since these early statutes, the quoted phrase “with interest coupons or in registered form” has been used throughout the Internal Revenue Code, generally as a means of distinguishing marketable corporate securities from other debt obligations,⁶ and courts and the Service generally have interpreted these Code provisions *in pari materia* with respect to the meaning of the phrase “in registered form.”

In *Miller v. Commissioner*, 32 T.C. 954, 965-66 (1959), *acq.*, 1959-2 C.B. 6, *rev'd. on other issues*, 285 F.2d 843 (10th Cir. 1960), the Tax Court interpreted “in registered form” for purposes of a predecessor to section 1271 (which applied sale or exchange treatment to retirement of certain evidences of indebtedness “with interest coupons or in registered form”) as follows:

Registration, for practical purposes, means that the obligation runs only to the registered owner. The primary purpose [outside of any function registration may serve in the tax statute] is to safeguard the investor or holder by making unregistered transfers ineffective. To accomplish this, the note or other evidence of indebtedness must show on its face that it is registered. *Gerard v. Helvering*, 120 F.2d 235 (C.A. 2, 1941), *affirming* 40 B.T.A. 64 (1939). Likewise, the phrase “in registered form” [when used in the tax statute] implies, at least, that the ownership of the instrument is listed in an appropriate record or register maintained for that purpose by the issuing corporation.⁷

In another case, *Martin v. Commissioner*, 7 T.C. 1081 (1946), the Tax Court relied on case law interpreting the previously mentioned statute (i.e., the predecessor to section 1271) in order to determine the meaning of the phrase “in registered form” for purposes of the predecessor to current section 165(g) (which allows a deduction for certain worthless “securities,” defined to include corporate evidences of indebtedness “with interest coupons or in registered form”). The Tax Court concluded that the instrument at issue in *Martin* was “in registered form,” since it was evidenced by a numbered certificate of indebtedness issued in the name of the creditor which provided that it was “non-negotiable, transferable only on the books of the association [that issued the certificate], and no payment [may] be received or withdrawal paid, without the presentation of [the] certificate.” *Id.* at 1087.

⁵ See Revenue Act of 1918, § 1100 Schedule A, Pub. L. No. 65-254, 40 Stat. 1057, 1135 (1919); *see also* Treas. Reg. § 55 (1919) (defining a promissory note as “an unconditional promise in writing made by one person to another signed by the maker engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to such other person or to order or to bearer, free from restrictions as to registration or transfer and usually without coupons.”). The stamp tax applicable to ordinary promissory notes was repealed in 1924, thus giving rise to the dispute in *United States v. Leslie Salt Co.*, 350 U.S. 383 (1956), regarding the applicability of the stamp tax to corporate obligations having certain features of corporate debentures, but which among other things were not in registered form (although they were convertible into registered form obligations).

⁶ See, e.g., I.R.C. §§ 23(k)(3), 117(f), 125(b), 165(b), 481(a)(3), 1801 (1953); I.R.C. §§ 165(g)(2)(C), 402(a)(3), 1232(a)(1), 1402(a), 4381(a) (1954); 1954 Code § 6049(b)(1)(A) (1963); I.R.C. §§ 165(g)(2)(C), 402(a)(3), 1402(a).

⁷ The statute at issue in *Miller*, the predecessor to current section 1271, was enacted to change the result of case law that had concluded that a loss on retirement of marketable corporate securities was eligible for treatment as an ordinary loss, despite the clear character of the assets at issue as capital, due to the absence of a “sale or exchange” of the assets at issue.

Finally, although not ruling specifically on this point, in Rev. Rul. 54-66, 1954-1 C.B. 128, the Service indicated that the phrase “in registered form” as used in the predecessor to section 171 (which permits amortization of premium paid for taxable bonds) would be interpreted consistently with the interpretation given such phrase in the predecessor to section 1271 (described above). As a result of the foregoing, it is clear that as early as the 1950s, the phrase “in registered form” had developed an accepted meaning when used in federal tax statutes and generally referred to *marketable corporate securities* whose ownership was reflected in a record maintained by the issuer.

2. Information Reporting Applicable to Obligations “In Registered Form”

In 1962, Congress considered various proposals to improve tax compliance by recipients of investment income, including interest, and ultimately enacted certain information reporting requirements. With respect to payments of interest, the information reporting requirements generally were limited to deposit interest and “interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation *in registered form*.”⁸ Although not completely clear, the limitation of information reporting requirements to corporate evidences of indebtedness “in registered form” may have been due in part to concerns about the administrability of such requirements with respect to payments of interest on unregistered or bearer obligations.⁹

The Technical Explanation to the House Ways & Means Committee’s Report to the Revenue Act of 1962 provided the following with respect to the meaning of “in registered form:”

[A]n instrument is in registered form if its transfer must be effected by the surrender of the old instrument and either the reissuance of the old instrument by the corporation to the new holder or the issuance by the corporation of a new instrument to the new holder. If an instrument can be transferred by endorsement it is not in registered form even though a list is maintained by the corporation of such instruments issued by it. Therefore, an evidence of indebtedness issued by a corporation falls [within this category] if it . . . is nonnegotiable¹⁰

⁸ I.R.C. § 6049(b)(1)(A), *as enacted by* the Revenue Act of 1962, P.L. 87-834, §19(c) (emphasis added). The statute also imposed information reporting in certain other limited contexts, including interest received by nominees, and authorized the Treasury Department to promulgate regulations imposing information reporting on corporations making payments of interest in other contexts.

⁹ See Hearings Before the Committee on Finance, 87th Cong. 4144-47 ex. 1 (1962) (statement of Sen. Paul H. Douglas) (Answer to Question 4, questioning the feasibility of an information reporting system with respect to bearer instruments). It is noted, however, that the Treasury Department was granted authority to impose information reporting requirements on all corporate evidences of indebtedness that were “of a type offered by corporations to the public,” and thus the primary focus of the legislation may have been simply investment securities considered likely to be owned by individuals. See I.R.C. § 6049(b)(1)(A) (1962).

¹⁰ Technical Explanation of the Revenue Bill of 1962, *reprinted in* 1962-3 C.B. 501, 638-39. With respect to the second sentence of the quotation in the text, compare *Gerard v. Helvering*, 120 F.2d 235 (2d Cir. 1941) (per curiam), in which the Second Circuit concluded that a bond and mortgage were not “in registered form” where no provision had been made for registering a transfer in the corporate obligor’s books and the bond did not contain any
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The Treasury Department subsequently promulgated regulations that provided a similar definition.¹¹

Congress again addressed concerns about compliance by recipients of investment income in TEFRA.¹² Congress recognized the failings of the then existing system of information reporting, especially with respect to unregistered, marketable corporate debt securities, which noncompliant persons may have been using to earn interest income without being subject to information reporting.¹³ The Senate Finance Committee simply concluded that “fair and efficient information reporting cannot be achieved with respect to interest-bearing obligations as long as a significant volume of long-term bearer debt securities [exists].”¹⁴ Thus, Congress placed significant restrictions on the issuance by corporate debtors of bearer debt obligations, including denying deductibility of interest payments on unregistered obligations that it had defined as “registration required.”¹⁵

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stipulation that it could be transferred only by registry or other entry upon the books of the obligor; the court stated, consistent with the Ways and Means Committee report cited in the text, “The mere fact that the debtor keeps books of account upon which the debt appears is altogether immaterial.”

¹¹ See Treas. Reg. § 1.6049-2(a)(1), as promulgated by T.D. 6628, 1963-1 C.B. 272 (“An evidence of indebtedness is in registered form if it is registered as to both principal and interest and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.”). The regulatory requirement that the evidence of indebtedness be registered “as to both principal and interest” arguably relates to the possibility that an evidence of indebtedness may be registered as to principal payments but may also be issued with detachable interest coupons that, when detached, effectively represent bearer obligations.

¹² See, *supra*, Note 2.. Various statutory provisions enacted between 1962 and 1982 further enhanced the information reporting requirements enacted in 1962. TEFRA, however, represented a wholesale revision of such requirements.

¹³ A strategy sometimes referred to as “coupon washing” or “bond washing” involves the purchase of a marketable corporate debt security by a noncompliant person immediately after an interest payment date (or involves simply the purchase by such a person of a zero coupon debt security). The noncompliant person holds the security until just before the next interest payment date, at which time it sells it to a third party who may not be aware of the noncompliant taxpayer’s strategy. Cf. Treas. Reg. § 1.1441-2(b)(3)(ii) (requiring withholding by purchaser on accrued original issue discount, under current law, to the extent the purchaser has actual knowledge or reason to know that the sale or exchange is part of a plan the principal purpose of which is to avoid tax), Treas. Reg. § 1.1441-3(b)(2) (same with respect to accrued interest). Absent the involvement of a “broker” making a direct payment of the proceeds to the noncompliant person, the noncompliant person may be entitled to receive the proceeds of the sale (and thus obtain the benefit of the accrued interest or original issue discount) while avoiding information reporting. See Treas. Reg. 1.6045-1(g)(4) (Example 9).

¹⁴ S. Rep. No. 97-494, at 242 (1982).

¹⁵ See *id.*; see also I.R.C. § 163(f). TEFRA also imposed an excise tax on debtors issuing certain unregistered, “registration required obligations.” See I.R.C. § 4701. TEFRA precluded holders of other such unregistered, registration required obligations from treating gain on the obligations as capital gain, see I.R.C. § 1287, or deducting losses on such obligations. See I.R.C. § 165(j). Further, TEFRA required all tax-exempt obligations to be in registered form, failing which the interest received on such obligations would be taxable. See I.R.C. § 103(j) (1954) (as amended by TEFRA); see I.R.C. § 149(a). Certain state and local obligations relating to housing and energy programs had previously been required to be issued in registered form in order for interest on the obligations to be exempt from federal income tax. See Crude Oil Windfall Profit Tax Act §§ 241(b)(4), 243(a)(1)(E), 244(a) (1980);

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In response to concerns that the imposition of a registration requirement might affect the liquidity of financial markets, the Senate Finance Committee's report to TEFRA stated: "The committee . . . recognizes the importance of preserving liquidity in the financial markets. Thus, a flexible book-entry system of registration is permitted and exceptions from the registration requirements are provided for [obligations of natural persons], for short-term obligations, for obligations of a type not offered to the public and for certain obligations issued abroad."¹⁶ The Secretary of the Treasury was given authority to require registration of specific types of obligations falling within any of the excepted categories, however, upon a finding that such obligations were used frequently to avoid federal taxes.

With respect to the "flexible book-entry system" that would satisfy the registration requirement, the Senate Finance Committee's report stated:

an obligation [may satisfy the registration requirement either by complying with a more traditional definition of "in registered form"¹⁷ or] if the right to principal and interest is transferable only through a book entry consistent with regulations issued by the [Treasury] Secretary. This book entry requirement will be satisfied by entries, consistent with regulations issued by the Secretary on the books of any person holding an obligation in street name or safekeeping an obligation for another, only if the ultimate beneficial owner of the obligation and its interest is determinable by way of the system.¹⁸

Soon after the enactment of TEFRA, the Treasury Department promulgated temporary regulations elaborating on the meaning of the registration requirement for purposes of the TEFRA registration requirement.¹⁹

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see also Treas. Reg. §§ 5f.103-1(g), 6a.103A-1(a)(5). TEFRA's information reporting requirements originally were an adjunct to a withholding tax applicable to certain types of investment income; this withholding tax was repealed retroactively (as if never enacted) in 1983 and was replaced by the "backup withholding" rules of I.R.C. §3406.

¹⁶ S. Rep. No. 97-494, at 242-43 (1982).

¹⁷ The Senate report included a definition of "obligations in registered form" that tracked the existing regulatory definition under section 6049 set forth above at note 10.

¹⁸ *Id.* at 244; *see also* Staff of the Joint Comm. on Tax'n, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 185-89 (Joint. Comm. Print 1982).

¹⁹ In *South Carolina v. Baker*, 485 U.S. 505 (1988), the Supreme Court concluded that the application of the registration requirement to State and local obligations was constitutionally permissible. The Court described the difference between registered and bearer bonds as follows:

Historically, bonds have been issued as either registered bonds or bearer bonds. These two types of bonds differ in the mechanisms used for transferring ownership and making payments. Ownership of a registered bond is recorded on a central list, and a transfer of record ownership requires entering the change on that list. The record owner automatically receives interest payments by check or electronic transfer of funds from the issuer's paying agent. Ownership of a bearer bond, in contrast, is presumed from possession and is transferred by physically handing

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Temp. Treas. Reg. § 5f.103-1 provides that an obligation is in registered form if:

- (i) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;²⁰
- (ii) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) [i.e., if the ownership of an interest in the obligation is required to be reflected in a book entry, whether or not physical securities are issued, and for this purpose, a book entry is a record of ownership that identifies the owner of an interest in the obligation];²¹ or
- (iii) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred through both of the methods described in subdivisions (i) and (ii) [above].²²

Amendments to these regulations promulgated in 1986 clarify that any obligation that is transferable by any other means is not considered to be “in registered form.”²³ Thus, an

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over the bond. The bond owner obtains interest payments by presenting bond coupons to a bank that in turn presents the coupons to the issuer's paying agent.

Id. at 508.

²⁰ The regulatory language quoted in this paragraph tracks the definition contained in the Senate report and is substantially identical to the definition of “in registered form” contained in Treas. Reg. § 1.6049-2(a)(1) published in T.D. 6628, 1963-1 C.B. 272, and set forth in note 10, *supra*. It is noted that Treas. Reg. § 1.6049-2(a)(1) was promulgated pursuant to Congress’ 1962 effort to improve compliance in reporting investment income, which served as a platform for the reforms enacted in TEFRA.

²¹ The regulatory language quoted in this paragraph appears to follow the language of the Senate report quoted in the text above.

²² Temp. Treas. Reg. § 5f.103-1 was promulgated, in part, under the grant of authority provided in section 103(j) of the Code, which was enacted as part of TEFRA and required all tax-exempt obligations to be issued “in registered form.” *See* T.D. 7852, 1982-2 C.B. 47. Temp. Treas. Reg. § 5f.163-1(a), which defined “in registered form” for purposes of section 163 (and thus for purposes of the other Code provisions enacted in TEFRA that cross-referenced the section 163 definition of “in registered form”), simply incorporated by reference the definition of “in registered form” in Temp. Treas. Reg. § 5f.103-1. *See* I.R.C. §§ 163(f), 165(j) (referring to the definition of “in registered form” under sections 163(f), 165(g)(2)(C), 1287, 4701, 6049; *see also* Treas. Reg. § 1.6049-1 (incorporating the definition of “in registered form” provided in Temp. Treas. Reg. § 5f.103-1 for purposes of determining the types of corporate evidences of indebtedness, payments of interest on which were subject to information reporting under the TEFRA revisions to the information reporting requirements enacted in 1962 and described previously).

²³ Temp. Treas. Reg. § 5f.103-1(e)(2). It is noted that the temporary regulations set forth in the text, which contain the definition of “in registered form” for purposes of the TEFRA reforms (and, as set forth below, the portfolio interest exemption) have been in temporary form for more than twenty years. *Cf.* I.R.C. § 7805(e)(2) (temporary regulations enacted after November 20, 1988 must expire within 3 years after the date of issuance).

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obligation that is initially transferable only by one of the foregoing means but may be converted into “a form in which the right to the principal of, or stated interest on, the obligation may be effected by physical transfer of the obligation” is not in registered form.²⁴

As set forth above, the TEFRA requirements, like the earlier information reporting requirements, applied only to corporate debt obligations. Further, the TEFRA requirements applied only to obligations of a type ordinarily offered to the public. Thus, in defining the key phrase, “in registered form,” the temporary regulations clearly approached this task from the perspective of a corporate issuer of marketable debt securities. It is noted that all of the historical uses of the phrase “in registered form,” described previously, also appear to emanate from an attempt to distinguish marketable corporate debt securities (which were typically issued “with interest coupons or in registered form”) from other debt obligations.

3. The Portfolio Interest Exemption for Obligations “In Registered Form”

Congress enacted the portfolio interest exemption two years after TEFRA. In debating the enactment of the portfolio interest exemption, Congress expressed concern that noncompliant U.S. persons may attempt to use the combined effect of (i) the exception to the TEFRA reporting requirements for foreign targeted obligations and (ii) the portfolio interest exemption from withholding tax for payments to non-U.S. persons, to avoid tax. Thus, Congress expanded the Treasury Department’s authority to require registration of foreign targeted obligations to eliminate the need for a finding of “frequent tax avoidance usage” that had been required under TEFRA.²⁵ Congress also required that in order for interest on an obligation to qualify for the portfolio interest exemption, the obligation must be in registered form or qualify for an exemption from registration under the newly expanded definition of “registration required” obligations under TEFRA (i.e., as expanded to permit the Treasury to require certain foreign targeted, marketable corporate debt securities to be registered).

Although the statutory exemption for portfolio interest was not limited to interest paid on marketable corporate debt securities, soon after enactment the Treasury Department promulgated regulations that indicated that the portfolio interest exemption would apply only to those types of obligations that were “registration required” under TEFRA (or would be registration required but for the exception for obligations that met certain foreign targeting criteria),²⁶ thus effectively restricting the portfolio interest exemption to corporate obligations of a type issued to the public. Apparently recognizing that its restrictive view of the portfolio interest exemption may not have

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Further, although the temporary regulations are referenced under section 103, the registration requirement that was contained in section 103 at the time the temporary regulations were issued has been moved to section 149. Thus, continuing to index these regulations under section 103 has led to some confusion even among practitioners familiar with their requirements.

²⁴ See Temp. Treas. Reg. § 5f.103-1(f) (Example 4).

²⁵ Staff of the Joint Comm. on Tax’n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 393 (Joint Comm. Print 1984) (“1984 Blue Book”).

²⁶ See Temp. Treas. Reg. §35a.9999-5, Q&A 1, Q&A 8 (1984).

been supported by the language of the statute, the Treasury Department sought a clarifying amendment to the statute in connection with congressional debate of the Technical Corrections Act of 1985. It is fair to say that Congress rejected the proposal as contrary to its intent in enacting the portfolio interest exemption.²⁷ As a result, the Treasury Department amended its regulations to make clear that interest on an obligation “in registered form” may qualify for the portfolio interest exemption, even if the obligation itself would not be required to be registered under TEFRA (e.g., because the obligation was issued by a natural person or was not of a type offered to the public).²⁸

The portfolio interest regulations were recently re-written in connection with a broader project to update and modernize the Treasury Regulations relating to withholding taxes and information reporting. The new regulations, while clearly indicating that the portfolio interest exemption applies to more than just corporate obligations of a type offered to the public, simply incorporate the definition of “in registered form” from the TEFRA regulations.²⁹ Thus, to this date there remains no formal guidance applying the registration requirement for the portfolio interest exemption to obligations excepted from TEFRA.³⁰ Further, the historic context in which the phrase “in registered form” developed, and existing case law interpreting such phrase, may add little to the analysis. The result is a lack of clarity in many standard situations that clearly fall within the intended scope of the portfolio interest exemption.

B. Guidance Concerning “Registered Form” With Respect to Obligations Not Covered by TEFRA

As set forth above, the phrase “in registered form” may have a generally accepted meaning when applied to marketable corporate debt securities. For example, obligations held through the standard central securities depositories, such as the Depository Trust Company, Clearstream (formerly CEDEL), Euroclear and Fedwire, and transferable only by book entry through such systems are clearly in registered form.³¹ Further, it is clear that a corporate debt

²⁷ See H.R. Rep. No. 99-29, at 257 (1985).

Mr. Gibbons [interrupting]. What you are doing is asking us to come back under the guise of technical corrections and make the law.

Mr. Mentz. I started off by saying that I think a taxpayer can fairly construe the law as written to say that it applies to all interest. I am raising the point—

Mr. Gibbons [interrupting]. That was my intent, and I am the author of the bill.

²⁸ Temp. Treas. Reg. §35a.9999-5, Q&A 8.

²⁹ See Treas. Reg. § 1.871-14(c)(1)(i).

³⁰ Treas. Reg. § 1.871-14 clearly applies to obligations excepted from TEFRA. Nonetheless, it simply incorporates the TEFRA definition of “in registered form.” See Treas. Reg. § 1.871-14(c)(1)(i).

³¹ See Priv. Ltr. Rul. 88-42-051 (Jan. 27, 1988) (apparently issued to the Depository Trust Company, to judge by the stated facts). It is noted that under certain circumstances, issuers may treat interests in debt obligations maintained through these clearing systems as bearer obligations provided the holders are permitted to require the exchange of their interests in such obligations for definitive bearer bonds upon notice. The analysis generally is that because such debt obligations may be converted into obligations that are not in registered form, they are treated as bearer obligations under Treas. Reg. § 1.871-14(c)(1)(i) (third sentence). See Michael L. Schler, *Issuing Bonds to* (continued...)

security that is privately placed may be treated as being in registered form, even though it is not held through a central securities depository, provided the issuer (or its agent) operates its own private book entry system that properly reflects ownership of such securities.³²

But there are many situations apart from those described above that create debt relationships for tax purposes, and frequently these debt relationships are not evidenced by formal debt instruments capable of registration in a manner similar to marketable corporate debt securities. Furthermore, in many such situations, the very determination of the “owner” of the debt obligation at issue may be complicated by the general assignability of contractual payment rights and local law restrictions on the effectiveness of anti-assignment clauses in agreements governing such rights.³³ Nonetheless, as set forth above, it is clear that the portfolio interest exemption was intended to apply to more than just marketable corporate debt securities and thus may apply in such other situations.

The Service has recognized, on an ad hoc private ruling basis, that certain debt relationships brought before it constitute obligations “in registered form,” even though such obligations were not capable of registration in the same manner as marketable corporate debt securities. For example, the Service has ruled that interest paid with respect to a judgment rendered by a court, interest paid with respect to an award by an arbitration tribunal, and interest paid on a proof of claim in a bankruptcy proceeding, were paid with respect to obligations in registered form.³⁴ In each case, the Service stated that the registration requirement was satisfied

(continued...)

Non-U.S. Investors: Finding a Path Through the Tax Maze, 15 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 975, 1000 n. 10 (PLI 2003); *Michael J.A. Karlin, A Guide to the Portfolio Interest Exemption*, J. of Tax'n of Investments 312, 331 (Summer 1999).

³² See Treas. Reg. § 1.871-14(c)(1)(i)(B) (Obligation is registered in the event “the right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained *by the issuer . . .*” (emphasis added)). It is noted that corporate debt securities generally are governed by the relevant state’s enactment of Article 8 of the Uniform Commercial Code, which permits an issuer to treat the person registered on its books (or the books of an agent) as the person exclusively entitled to exercise all the rights and powers of an owner. U.C.C. § 8-207(a) (2002).

³³ See Restatement (Second) of Contracts § 322 (1981). The TEFRA regulations’ reference to “ownership” of a debt obligation should be distinguished from the concept of “beneficial ownership” used in the Chapter 3 (i.e., sections 1441-42) withholding regulations. Thus, for example, a debt obligation should not fail to be treated as “registered” for present purposes because interests in such debt obligation are owned by disregarded entities or foreign partnerships and the issuer’s books and records do not identify the owners of such disregarded entities or foreign partnerships (who may be treated as the beneficial owners of any interest paid on such debt obligations). Compare Temp. Treas. Reg. § 5f.103-1(c)(2) (describing a book entry system maintained by an issuer as satisfying the registration requirement and referring to a record of ownership that “identifies the owner of an interest in [an] obligation”) with Treas. Reg. §§ 1.1441-1(c)(6) (defining “beneficial owner”) and 1.871-14(c)(2) (describing the statement required to have been received from a beneficial owner of portfolio interest).

³⁴ Priv. Ltr. Rul. 96-26-056 (April 11, 1996); Priv. Ltr. Rul. 96-23-045 (March 11, 1996). Similarly, the Service has accepted representations that payments with respect to certain annuity contracts were paid with respect to obligations in registered form. Priv. Ltr. Rul. 87-05-058 (Nov. 4, 1986); Priv. Ltr. Rul. 88-19-027 (Feb. 10, 1988). These rulings were subsequently revoked on the grounds that certain issues analyzed therein were under study by the Service. Priv. Ltr. Rul. 90-28-094 (April 18, 1990). The Service currently indicates that it is not ordinarily willing to rule on this issue. Rev. Proc. 2004-7, 2004-1 I.R.B. 237, 238.

because the relationship giving rise to the debt claim at issue (i.e., the judgment, award or proof of claim) provided “a record of the owner of an interest in the principal in, and stated interest on, the [obligation]” consistent with the flexible book-entry system of registration described above.

In reaching its conclusions in these private rulings, the Service implicitly ignored the fact that contractual payment rights and money judgments generally are assignable without notice.³⁵ While such obligations generally are assignable, however, except in the case of an obligation required to be presented for payment (e.g., a negotiable instrument), an obligor without notice of an assignment generally is permitted to make payment to the named payee/assignor in full satisfaction of the obligation, and the rights of an assignee thus may be limited to seeking redress from its assignor.³⁶ As a result of the limited rights obtained by an assignee without notice, we recommend that so long as the obligation at issue (by its terms or otherwise) ensures that, at all times, the records of the obligor or its agent will properly reflect the identity of *a person* to whom the obligor may make payment in full satisfaction of the obligation (whether or not there may be, from time to time, another person or persons, i.e., certain assignees without notice, who may be able to maintain an action for payment against the obligor), the obligation be treated as satisfying the registration requirement.

As set forth above, the Tax Court has stated, “Registration, for practical purposes, means that the obligation runs only to the registered owner.”³⁷ Similarly, we recommend that an obligation that may be satisfied by payment to the person identified to the obligor as the proper payee, without regard to who else may be entitled to make a claim for payment, be treated as running only to the person identified to the obligor and therefore be treated as satisfying the registration requirement. An obligation that may be satisfied in such manner is unlikely to be used for tax avoidance, as the assignee is subject to losing its rights against the obligor unless it has notified the obligor of its status.³⁸ Furthermore, it may be argued that the documentation requirements for the portfolio interest exemption, as implemented by the updated and modernized withholding regulations referred to above, and significant advances in computerized tracking of financial payments since the enactment of the portfolio interest exemption, have relieved some of the pressure on the registration requirement as a means of ensuring compliance.

In keeping with the approach to the registration requirement described above, the possibility of assignment of an obligation by operation of law (e.g., to a personal representative

³⁵ See Restatement (Second) of Contracts § 322; see also, e.g., *Boarman v. Boarman*, 556 S.E.2d 800 (W. Va. 2001) (“It is a well established principle that judgments are akin to property, and as such, may be assigned to another party: ‘An assignment may be made of a judgment, even if the claim which is later reduced to a money judgment was unassignable, because a court judgment is considered property which may be transferred, like other property, even prior to payment of the judgment.’” (citation omitted)). In order to enforce a judgment, however, the assignment may be required to be registered with a court. Cf. Fed. Rule Bankr. P. 3001(e) (requiring notice of transfer of a proof of claim in bankruptcy).

³⁶ See Restatement (Second) of Contracts § 338.

³⁷ *Miller v. Commissioner*, 32 T.C. at 965.

³⁸ See Restatement (Second) of Contracts § 338(1) (“Except as stated in this Section, notwithstanding an assignment, the assignor retains his power to discharge or modify the duty of the obligor to the extent that the obligor performs or otherwise gives value until but not after the obligor receives notification that the right has been assigned and that performance is to be rendered to the assignee.”)

of a decedent payee,³⁹ a surviving corporation, limited liability company or partnership in a merger,⁴⁰ or a bankruptcy estate⁴¹) or through foreclosure of a security interest is ignored, since an obligor without actual or constructive notice of such assignment may make payment to the payee reflected in its records in full satisfaction of the obligation.⁴² An obligation that may be transferred by delivery (i.e., a bearer obligation) or endorsement (e.g., a negotiable instrument) does not satisfy this formulation of the registration requirement, however, since the obligor may not make payment to a person reflected in its records as the payee in full satisfaction of its payment obligations; instead, the obligor may satisfy its obligations only by making payment to the person presenting the obligation for payment.

We believe the approach to the registration requirement described above reflects a proper application of the TEFRA regulations to situations not contemplated by TEFRA. Nonetheless, we believe there is a great deal of uncertainty surrounding the application of the registration requirement and guidance is needed to determine its appropriate application to various situations arising in common practice that involve payments of interest to non-U.S. persons. Some of these situations involve rights to payment that simply are specifically rendered nontransferable by statute or regulation—e.g. interest on tax refunds—but which may remain transferable by operation of law.⁴³ Other situations involve rights to payment that are nontransferable by contract—e.g., interest paid by brokers on cash balances in brokerage accounts and embedded interest on a swap (or interest paid on cash posted as collateral for transactions) documented on the standard Master Agreements published by the International Swaps and Derivatives Association (“ISDA”)—but which may remain subject to a determination of whether an anti-assignment clause should be respected in a given case.⁴⁴

Please see the Appendix, at A-1, for an example of a possible revenue ruling describing certain of these situations that we believe merit immediate attention.

³⁹ Uniform Probate Code § 3-711 (2003).

⁴⁰ E.g., Del. Code tit. 8, § 259 (2003).

⁴¹ 11 U.S.C. §541 (2003).

⁴² At least one commentator has come to the same conclusion. David C. Garlock et. al., *Federal Income Taxation of Debt Instruments* § 17.04[C][1][a][i], at n.169 (4th ed. 2000 & Supp. 2004) (“Garlock”).

⁴³ A claim for a tax refund against the federal government cannot be assigned vis-à-vis the government. Assignment of Claims Act, 31 U.S.C. § 3727; Rev. Rul. 86-55, 1986-1 C.B. 373. Regarding the status of interest paid on a tax refund as income effectively connected with the conduct of a trade or business within the United States, we note that the Service has ruled that interest paid with respect to a refund of taxes imposed on income that is effectively connected with a U.S. trade or business is itself effectively connected income. Rev. Rul. 72-280, 1972-1 C.B. 275. But it is easy to imagine circumstances where a refund of taxes might be paid with respect to taxes imposed on income that is not effectively connected with a U.S. trade or business. We recommend that interest paid with respect to such a refund not be viewed as effectively connected income either.

⁴⁴ Compare *Singer Asset Finance Co. v. CGU Life Ins. Co.*, 275 Ga. 328 (2002) (respecting an anti-assignment clause in a structured settlement agreement, because the court concluded that the obligor had bargained for it), with *Wonsey v. Life Ins. Co.*, 32 F. Supp. 2d 939 (E.D. Mich. 1998), (upholding the assignment of structured settlement payments in violation of an anti-assignment clause, finding a “modern trend” of upholding assignments in the face of contractual anti-assignment clauses and concluding that the clause had been included for the benefit of the assignor and thus waived).

C. Ambiguously Registered Obligations

As set forth above, the regulations governing the meaning of “in registered form” for purposes of the portfolio interest exemption take the position that an obligation that may be transferred other than in one of the three ways specifically described (i.e., surrender and reissuance, book-entry or a combination thereof) is a bearer obligation.⁴⁵ Thus, an obligation that would be in registered form “except for the fact that it can be converted at [some] time in the future into an obligation that is not in registered form,” is treated *ab initio* as an obligation that is not in registered form.⁴⁶ In a Field Service Advice, the Service’s Office of Chief Counsel has indicated that ambiguity in the provisions of a debt instrument regarding the manner in which the instrument may be transferred will be resolved in favor of treating the instrument as a bearer obligation (i.e., as failing to satisfy the registration requirement).⁴⁷

As a result of the foregoing, the Service concluded in the Field Service Advice just referenced that a debt instrument that contained certain “magic” words of a negotiable instrument (i.e., “pay to the order of” the payee) would not satisfy the registration requirement notwithstanding the fact that the instrument at issue also contained the following paragraph:

This instrument is registered as to both principal and interest with the [issuer] and transfer of this obligation may be effected only by surrender of this instrument and either (a) the reissuance by the [issuer] of this instrument to the new holder or (b) the issuance by the [issuer] of a new instrument to the new holder. Transfer of this instrument at any time by any means other than the method described in this paragraph shall be deemed void and ineffectual.⁴⁸

The Service correctly noted that the use of the words “pay to the order of,” without an expression of a contrary intention, generally would permit the named payee to transfer the instrument to another payee, or even to cause the instrument to be payable to “bearer,” and the issuer would be obligated to make a payment to whomever presented the instrument for payment.⁴⁹ The Service concluded that in light of the inclusion in the instrument of both (i) the quoted words of negotiability and (ii) the paragraph set forth above purporting to restrict transfers, the parties’ intentions were ambiguous with respect to the manner in which the instrument may be transferred. The Service construed this ambiguity against treating the instrument in question as satisfying the registration requirement, effectively disregarding the

⁴⁵ Treas. Reg. 1.871-14(c)(1)(i); Temp. Treas. Reg. § 5f.103-1(e).

⁴⁶ Treas. Reg. § 1.871-14(c)(1)(i).

⁴⁷ 1992 FSA LEXIS 159 (Aug. 10, 1992) (“The regulations specifically define registered form obligations by spelling out exactly how an instrument can be transferred. All other obligations are classified as bearer form. These rules embody policies intended to augment the accuracy of the information reporting system and to diminish the exploitation of the system by tax evaders in order to conceal income. Accordingly, these rules cannot be interpreted to accommodate the degree of conflict and ambiguity apparent in a document.”).

⁴⁸ The Service noted that the original paragraph substituted the word “payee” for the word “issuer” inserted in the text. In light of the context, the Service assumed that the parties meant “issuer” where they had indicated “payee.” We agree that this assumption was appropriate on the facts presented.

⁴⁹ See Uniform Comm. Code § 3-305.

paragraph set forth above.⁵⁰ Consequently, interest paid on the debt instrument was determined not to qualify for the portfolio interest exemption.⁵¹

In reaching its conclusion in the Field Service Advice, the Service indicated that it relied on the provisions of the relevant state's enactment of the Uniform Commercial Code ("UCC"). The Service stated that the relevant state law generally resolved conflicts such as those appearing on the face of the instrument in question "in favor of negotiability." Although it is unclear which state's formulation of the UCC the Service reviewed, we note that the resolution of conflicts in favor of negotiability is certainly not the rule in all states.⁵² Regardless of this issue, however, we question whether in light of (i) the detail of the transfer restriction contained in the instrument at issue (which generally parroted the TEFRA regulations), (ii) the likelihood under the facts presented that the parties would have acted in accordance with the restriction (and did not understand the import of the use of the words "pay to the order of") and (iii) the unlikelihood that such an "ambiguously registered" obligation would be used for tax avoidance,⁵³ it was appropriate to conclude that the instrument at issue failed to satisfy the registration requirement.

Based upon the Service's conclusion in the Field Service Advice, it will be critical for taxpayers attempting to qualify for the portfolio interest exemption to include a transfer restriction in the terms of their promissory notes that is effective to cause such notes not to be negotiable instruments.⁵⁴ Because the finer points of the law of negotiable instruments are

⁵⁰ *But cf. Miller v. Commissioner*, 32 T.C. 954, 965 (1959) (predating the Uniform Commercial Code) (concluding that an instrument that provided, "pay to the order of REGISTERED bearer," was "in registered form" for purposes of a predecessor to section 1271, which provided sale or exchange treatment to certain corporate obligations "with interest coupons or in registered form").

⁵¹ Concluding that an obligation is not in registered form generally is the same thing as concluding that the interest paid on the obligation does not qualify for the portfolio interest exemption, as the requirements for the portfolio interest exemption applicable to bearer obligations are so administratively burdensome that no taxpayer would ever satisfy them by accident.

⁵² *See Ingram v. Earthman*, 993 S.W.2d 611 (Tenn. Ct. App. 1998) ("When in doubt, there is a presumption that an instrument is not negotiable."); *see also Republican Valley Bank v. Security State Bank*, 426 N.W.2d 529 (Neb. 1988) (certificate of deposit not negotiable where it states "not transferable except on bank's books"); *Franke v. Third Nat'l Bank & Trust Co.*, 509 N.E.2d 955 (Ohio App. 1986) (certificate of deposit not negotiable where it states "transferable only by assignment on the books of the bank"); *cf. UCC § 3-104(d)* ("A promise or order other than a check is not [a negotiable] instrument if, at the time it is issued or first comes into possession of a holder, it contains a conspicuous statement, however expressed, to the effect that the promise or order is not negotiable or is not an instrument governed by [art. 3].").

⁵³ Query whether a person considering the purchase of an instrument would be willing to rely, for its enforceability without notice to the issuer, on the inclusion in the instrument of the words "pay to order"—in the face of a clear statement contained therein that assignments without notice are void and ineffectual.

⁵⁴ We note that further inquiry may be required in those very limited cases in which an obligation not qualifying as a "negotiable instrument" may be transferable by delivery, even notwithstanding terms to the contrary contained in documents evidencing the obligation. *See, e.g., Republican Valley Bank v. Security State Bank*, 426 N.W.2d 529 (Neb. 1988) (unregistered assignee successfully maintained an action for payment on a nonnegotiable certificate of deposit, which indicated that it was "not transferable except on bank's books", because the court concluded that certificates of deposit are transferable by delivery in the ordinary course of business and thus constitute "instruments" in which a security interest may be perfected by delivery under UCC Article 9); *see also Ex Parte The Kelly Group*, 159 B.R. 472 (Bankr. W.D. Va. 1993) (reaching the same conclusion with respect to a nonnegotiable promissory note that was not assignable pursuant to its terms).

generally beyond the expertise of most tax practitioners (and many generalist lawyers), we believe that the absence of guidance regarding the application of the registration requirement to private, negotiated transactions will likely lead to further disputes between the Service and taxpayers, similar to the dispute described in the Field Service Advice. We therefore recommend that the Service consider the publication of a ruling with respect to a model promissory note that includes the requisite restrictions on transfer. Please see the Appendix, at A-4, for an example of the type of revenue ruling suggested.

D. Registered Interests in Obligations

At the time of enactment of the portfolio interest exemption, significant amounts of debt obligations (especially residential mortgages) had been securitized and sold to the public. The Service had issued several revenue rulings concluding that certain securitization arrangements (whether or not adopting the form of a trust under state law) would be treated as grantor trusts for federal tax purposes, thereby permitting the owners of interests in such arrangements to be treated as owners of the underlying debt obligations for nearly all federal income tax purposes.⁵⁵ In enacting the portfolio interest exemption, Congress acknowledged the structure of these and similar securitization arrangements and expressed its intent that such arrangements not be permitted to be used as a means to avoid the strictures imposed by TEFRA:

For most Code purposes, income received from an entity taxable as a trust (such as a mortgage pass-through trust) is characterized by reference to the underlying obligation held by the entity, on which the income was originally earned, rather than by reference to the interest in the investing entity held by the investor. However, in determining whether an interest in certain intermediate investing entities, such as mortgage pass-through trusts, is registration-required under TEFRA, it is the nature of the interest itself that is relevant; if the interest is liquid and actively traded, it would pose compliance problems were it not registration-required. Mortgage pass-through securities are liquid and actively traded. As they are readily negotiable substitutes for cash, Congress considers them to be subject to the TEFRA registration requirements.⁵⁶

The Treasury Department subsequently promulgated temporary regulations carrying out this congressional intent. The regulations provided that a “pass-through” or “participation” certificate evidencing an interest in “a pool of mortgage loans,” which is treated as a grantor trust

⁵⁵ See, e.g., Rev. Rul. 70-544, 1970-2 C.B. 6 and Rev. Rul. 70-545, 1970-2 C.B. 7 (pool of mortgage loans transferred to a custodian treated as a grantor trust), as modified by Rev. Rul. 74-169, 1974-1 C.B. 147.

⁵⁶ See 1984 Blue Book, at 396 & n.19. The 1984 Blue Book continued, however, that “the determination of the applicability of the registration requirements with reference to [the pass-through] securities rather than with reference to the underlying mortgages does not imply, for example, that interest income passed through an intermediate mortgage-investing entity to holders of such securities will be eligible for the exemption from the 30-percent tax where the interest income derives from underlying mortgages originated before the date of enactment.” *Id.* at n.19. Thus, determinations unrelated to the registration requirement (and reporting, more generally) may be required to be made as if the owner of the pass-through certificates actually owned its share of the underlying obligations. Cf. Treas. Reg. § 1.6049-5(a)(6) (“For purposes of section 6049, interest paid on amounts invested in pooled funds or trusts, such as mortgage pass-through certificates, shall be considered to be the interest paid as stated on the certificate, and shall not be the interest on any notes or obligations underlying such certificates.”).

under Subchapter J of the Code, or “a similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust,” is considered to be a “registration-required obligation” under TEFRA if the evidence of such interest is described in section 163(f)(2)(A) (defining “registration-required obligations”) without regard to whether any obligation held by the “fund” or “trust” to which the evidence of interest relates is described in section 163(f)(2)(A).⁵⁷ Temporary regulations promulgated at the same time under the portfolio interest exemption further provided that amounts paid on such a “pass-through certificate” will be considered separately from amounts paid on the underlying debt obligations, and thus “interest paid to the holder of a pass-through certificate is portfolio interest if the pass-through certificate [satisfies the registration requirement], without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates [satisfies such requirement].”⁵⁸

The regulations left a number of unanswered questions. First, it was unclear what types of evidences of an interest in a fund or trust would be treated as “similar” to the pass-through or participation certificates described in the regulations.⁵⁹ Second, it was unclear what types of arrangements would qualify as “similar pooled fund[s] or pooled trust[s]” under the regulations. While the regulations seemed to make clear that a state law trust was not required (referring to a “fund” or “trust”), it was unclear whether a securitization arrangement that did not rise to the level of a trust for federal tax purposes would qualify as a “similar pooled fund or pooled trust” under the regulations.⁶⁰ Assuming a tax-law trust were not required, it also was unclear whether a securitization arrangement treated as a partnership for federal tax purposes (whether or not formed as a state law partnership) would qualify as a “similar pooled fund” under the regulations.⁶¹ The preamble to the regulations simply indicated, “the Service is especially

⁵⁷ Temp. Treas. Reg. § 1.163-5T(d).

⁵⁸ Temp. Treas. Reg. § 35a.9999-5 (Q&A 20) (1984).

⁵⁹ As a preliminary matter, it may have been open to argument whether Congress intended the present rules to extend only to “liquid and actively traded” evidences of interest in such pools or funds. In light of the portfolio interest exemption’s reference to the TEFRA registration requirement, and the application of such exemption to non-publicly traded debt instruments, however, it seems relatively clear that the present rules should apply to more than just “liquid and actively traded” evidences of indebtedness (or interests therein).

⁶⁰ As set forth above, the regulations specifically referred only to a pool or fund that was treated as a grantor trust for federal income tax purposes. See James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions* 167 n.53 (2001) (“A grantor trust holding a pool of [debt obligations not in registered form] and issuing pass-through certificates in registered form can be used to convert the obligations into registered form, whereas technically the same is not true for a co-ownership arrangement.”) (“Peaslee & Nirenberg”). But cf. New York State Bar Ass’n, Tax Section, *Report on Securitization Reform Measures*, Rep. No. 1024, at 41 n.52 (2002) (The reference to “similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust” is ambiguous in that it is not clear if “treated as a grantor trust” modifies “pooled fund” as well as “pooled trust.”) (“NYSBA Report on Securitization Measures”); cf. also Priv. Ltr. Rul. 95-48-018 (June 30, 1995) (discussed in the text below) (“The regulations do not specify what types of arrangements may qualify as similar pooled funds other than pooled trusts . . .”).

⁶¹ See Peaslee & Nirenberg, at 739 n.20 (“The reference in two places [of the regulations] to grantor trusts prevents (perhaps unintentionally) a pass-through certificate from qualifying as such for tax purposes if, because of either a minor impermissible power to vary [investments], it is characterized as a partnership for tax purposes.”); see also NYSBA Report on Securitization Measures, at 41 (“[U]nder a literal reading of the [regulatory] definition, if a certificate issuer were classified as a partnership rather than a grantor trust, interest payments on consumer obligations passed through to its partners may not qualify as portfolio interest.”).

interested in receiving comments as to . . . what should qualify as a similar pooled fund or pooled trust treated as a grantor trust for purposes of section 163(f)(2)(A) and (B).⁶²

Following the promulgation of the temporary regulations, the Service issued several private letter rulings applying the principles set forth in the regulations (and the legislative history described above).⁶³ In one such ruling, Priv. Ltr. Rul. 95-48-018, the Service concluded that certain securitization arrangements that involved the issuance of participation interests in a single loan identified on the books of the issuer (and that, although not completely clear, may not have risen to the level of a trust for federal tax purposes)⁶⁴ would be treated as a “similar pooled fund” for purposes of the portfolio interest regulations.⁶⁵ As a result, provided the participation interests at issue met the other requirements for qualification as “registered,” the Service concluded that the “interest” payments on such participation interests would be considered paid on a registered obligation for purposes of the portfolio interest exemption, notwithstanding the fact that the underlying loan did not itself meet the registration requirement.⁶⁶ In 1997, the Service promulgated final regulations under the portfolio interest exemption. While the final regulations contained certain minor language changes from the temporary regulations, the preamble stated that “the final regulations incorporate without substantive changes the relevant provisions from the existing temporary regulations implementing the repeal of the 30-percent tax on portfolio interest.”⁶⁷ Consequently, the final regulations shed no light on the present issues.

⁶² T.D. 8046, 1985-2 C.B. 61, 62.

⁶³ See, e.g., Priv. Ltr. Rul. 96-23-045 (discussed above); Priv. Ltr. Rul. 95-48-018 (discussed in the text below); Priv. Ltr. Rul. 93-21-009 (Feb. 12, 1993) (participation interests in loans associated with time share arrangement).

⁶⁴ In the ruling, the Service described several possible types of participation interests, including participation interests in a single loan, that (i) paid interest equal to a percentage of the interest received on the underlying loan (which percentage was equal to the “participation percentage” and thus, presumably, the participant’s share of the underlying principal) and (ii) had a term equal to the term of the loan subject to the participation. Under these circumstances, although not completely clear due to the issuer’s retention of certain discretionary powers, it may be argued that the securitization arrangement qualifies simply as a co-ownership of property and not as a trust for federal tax purposes. See Rev. Rul. 81-251, 1981-2 C.B. 156 (treating an owner of a participation interest as “in substance” the owner of the underlying note).

⁶⁵ See Priv. Ltr. Rul. 95-48-018 (reserving on the application of the portfolio interest exemption in any given case but reaching the conclusion that the participation interests at issue “will not fail [to qualify as passthrough certificates described in Temp. Treas. Reg. § 1.163-5T(d)] merely by virtue of lacking a trust structure or being limited to a single loan”).

⁶⁶ Some commentators have cautioned taxpayers against relying on the Service’s conclusion in this private letter ruling. See Peaslee & Nirenberg, at 740 n.24 (“In P.L.R. 9548018 . . . the Service ruled that a single commercial loan could be a pool for purposes of the pass-through certificate regulations. The conclusion is surprising, and it would be risky to rely solely on that ruling in determining how many loans are required to form a pool.”).

⁶⁷ T.D. 8734, 1997-2 C.B. 109, 111 (1997). Temp. Treas. Reg. § 35a.9999-5(e) Q&A-21, the predecessor to the current regulations on pass-through certificates, referred to pass-through certificates “as described in Reg. § 1.163-5T(d)(1).” That regulation in turn refers to “a pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust).” The final portfolio interest regulations refer to a pass-through certificate but without the qualifier “as described in § 1.163-5T(d)(1).” The final regulations therefore no longer refer directly to a “similar evidence of interest.” The final regulations, also unlike the temporary regulations, do not focus on securitizations of mortgage loans. The significance of these changes is not clear and is not explained or even specifically mentioned in the preamble to the final regulations.

In keeping with Priv. Ltr. Rul. 95-48-018, we believe that a broad view of the principles reflected in the legislative history set forth above is warranted. Thus, we recommend that the application of these principles to a given securitization arrangement should not turn on the status of the arrangement, for federal tax purposes, as (i) a mere co-ownership of property, (ii) a grantor trust or (iii) a partnership.⁶⁸ It is clearly conceivable that interests in any or all of such securitization arrangements may be evidenced by readily transferable certificates or evidences of interest. In each case, therefore, it would seem that Congress's concerns about compliance by holders of such interests would be best served by treating interests in any such securitization arrangement, regardless of its federal tax characterization, as registration required (provided such interests are not otherwise excepted from TEFRA). Similarly, it would seem that interests in each of these types of securitization arrangements should potentially qualify as "registered" for purposes of the portfolio interest exemption, without regard to the treatment of the underlying debt obligations as so registered. We believe that the characteristics that distinguish each type of arrangement for federal tax purposes do not justify different treatment for purposes of the registration requirement.⁶⁹ Moreover, the distinction currently being drawn (at least by various commentators) between arrangements that qualify as trusts for federal tax purposes, and those that do not so qualify, presents a real trap for the unwary, as it may be argued (for example) that providing even a de minimis power to vary the underlying investments of a securitization arrangement may cause the arrangement to fail to qualify as a trust and thus cause interests therein to fail to qualify as registered for purposes of the portfolio interest exemption.

Notwithstanding the foregoing, we note that in many situations a well-advised taxpayer may form a passive, fixed investment trust to hold debt obligations and issue pass-through certificates that evidence interests therein in a manner that substantially complies with the literal terms of the regulations. We believe that requiring taxpayers to form and maintain a trust simply to fit within the terms of the regulations yields nothing more than needless expense and burden, however. Please see the Appendix, at A-6, for an example of a possible revenue ruling that

⁶⁸ Under the applicable regulations, a securitization or participation arrangement that vests certain decisionmaking responsibilities in the owners of interests in an underlying loan or loans does not constitute a trust for federal tax purposes. Treas. Reg. § 301.7701-4(a) ("Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries *who cannot share in the discharge of this responsibility* and, therefore, are not associates in a joint enterprise for the conduct of business for profit." (emphasis added)). By contrast, a securitization arrangement that vests such decisionmaking authority in a third party "trustee," who has duties to the beneficial owners that exceed those of an agent, may be treated as a trust for federal tax purposes. *See, e.g.,* Rev. Rul. 84-10, 1984-1 C.B. 155. In the event such third party is entitled to vary the underlying investments, or there are multiple classes of interests in the arrangement, such arrangement may be disqualified as a trust and instead treated as an eligible entity (and thus, generally, a partnership) for federal tax purposes. *See* Treas. Reg. § 301.7701-2.

⁶⁹ As noted by other commentators, "Indeed, partnership interests are subject to more extensive reporting than debt obligations, including a requirement under temporary Treasury regulation section 1.6031(c)-1T that nominees holding partnership interests on behalf of a beneficial owner identify the owner to the partnership." *See* NYSBA Securitization Report, at 42. Further, with respect to any distinction to be drawn for purposes of the registration requirement between arrangements qualifying as trusts and those that are treated as mere property co-ownerships, it is noted that under a proposed regulation, no distinction would be drawn between the ownership of an interest in a grantor trust and the ownership of the underlying assets of the grantor trust for all federal income tax purposes. *See* Prop. Treas. Reg. § 1.671-2(f).

analyzes the satisfaction of the registration requirement in the context of interests in a securitization arrangement treated as a partnership for federal tax purposes.

IV. Contingent Interest Exception

A. Background

1. General Definition of Contingent Interest

In the Omnibus Budget Reconciliation Act of 1993, Congress amended the definition of portfolio interest to exclude certain “contingent interest.”⁷⁰ In general, contingent interest for this purpose is defined as interest the amount of which is determined by reference to:

- any receipts, sales or other cash flow of the debtor or a related person,⁷¹
- any income or profits of the debtor or a related person,
- any change in value of any property of the debtor or a related person, or
- any dividend, partnership distribution, or similar payment made by the debtor or a related person.⁷²

In enacting this contingent interest exception, Congress acknowledged that the portfolio interest exemption had provided non-U.S. persons with an opportunity to participate in the earnings of U.S. obligors (including earnings based upon the value of U.S. real property interests) free from federal income tax, by investing in debt that paid interest contingent on such earnings. The 1993 amendment was intended to eliminate this opportunity.⁷³

⁷⁰ Pub. L. 103-66, 107 Stat. 312.

⁷¹ As used in the foregoing, the term “related person” means “any person who is related to the debtor within the meaning of section 267(b) or 707(b)(1), or who is a party to any arrangement undertaken for a purpose of avoiding” the contingent interest exception.

⁷² I.R.C. § 871(h)(4)(A)(i)(I), (II), (III), (IV). Section 871(h)(4)(A)(ii) also excludes from the definition of portfolio interest “any other type of contingent interest that is identified by the Secretary by regulation, where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax.” I.R.C. § 871(h)(4)(A)(ii). No regulations have been issued under this authority.

⁷³ As described in more detail later in the comments, only the contingent part of interest payable on debt that pays both contingent and non-contingent interest is subject to the contingent interest exception (i.e., may not qualify as portfolio interest). Similarly, only a proportionate part of debt that pays both contingent interest and non-contingent interest qualifying for the portfolio interest exemption will qualify for the corresponding estate tax exemption. I.R.C. § 2105(b). There is no authority that indicates the manner of computing the proportion of such debt that qualifies for the estate tax exemption, and thus guidance would be welcome on this issue as well on the issues described in the text, below.

2. Exceptions for Timing Contingencies, Nonrecourse Debt and Hedged Debt

Notwithstanding the general definition of “contingent interest,” as set forth above, the statute provides that the following types of interest are not treated as contingent interest and thus may qualify as portfolio interest:

- interest that comes within the general definition of contingent interest solely by reason of the fact that the *timing* of any interest or principal payment is subject to a contingency (e.g., where the debtor makes principal payments based upon its available cash),⁷⁴
- interest that comes within the general definition of contingent interest solely by reason of the fact that the interest is paid with respect to *nonrecourse or limited recourse indebtedness* (e.g., fixed interest payable in all events but upon failure to pay the lender may recover only against a specified, pledged asset of the debtor), and
- interest that comes within the general definition of contingent interest solely by reason of the fact that the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to such interest, and thus the interest due is effectively determined by reference to the debtor’s receipts on such hedging transaction (e.g., floating rate interest that the debtor has hedged by entering into a fixed-for-floating interest rate swap).⁷⁵

3. “Actively Traded” Exceptions

The statute provides further exceptions to the general definition of “contingent interest” for interest determined by reference to any of the following:

- changes in the value of property (including stock) that is actively traded (within the meaning of section 1092(d)) other than certain U.S. real property interests described in section 897(c)(1) or (g),
- the yield on property described in the immediately preceding bullet point, other than a debt instrument that pays interest described in the general definition of contingent interest, or stock or other property that represents a beneficial interest in the debtor or a related person, or

⁷⁴ It is noted that when a debtor is required to make principal payments based upon its available cash, the greater the debtor’s cash flow, the sooner the debtor will retire the debt. The result will be that, unless an early retirement penalty (treated as additional interest) is payable, the amount of any interest payable on the debt will decline as the debtor’s cash flow increases. While the amount of such interest may be, in some sense, “determined by reference to the debtor’s cash flow,” we suggest that interest that varies inversely with the debtor’s cash flow in this manner should not fall within the general definition of contingent interest, since it does not represent a surrogate for the distribution of the debtor’s earnings.

⁷⁵ See I.R.C. § 871(h)(4)(C)(i), (ii), (iv).

- changes in any index of the value of property described in the first bullet point above or of the yield on property described in the second bullet point above.⁷⁶

It is noteworthy that the second bulleted item immediately above, but not the first, excepts from its reach actively traded stock of the debtor or a related person. Thus, by virtue of this “exception to the exception” to the definition of contingent interest, it is clear that interest determined by reference to the “yield” on the debtor’s own stock—regardless of whether such stock is actively traded—constitutes contingent interest and thus may not qualify for the portfolio interest exemption.⁷⁷ It is equally clear that interest determined by reference to the value of the debtor’s stock—provided such stock is actively traded—does not constitute contingent interest and thus may qualify for the portfolio interest exemption.⁷⁸ It is not entirely clear, however, whether interest determined by reference to the value of the debtor’s stock may qualify as portfolio interest when such stock is not actively traded. We recommend that the Service should clarify that it does so qualify.

In enacting the contingent interest exception, Congress clearly intended to address arrangements that would utilize the portfolio interest exemption to permit a non-U.S. person to participate in the earnings of a U.S. obligor (or the value of a U.S. real property interest) without incurring withholding tax on dividends and certain other types of contingent payments under Chapter 3 of the Code. By contrast, it is noted that non-U.S. persons who are not engaged in trade or business in the United States generally may sell stock of U.S. corporations without incurring withholding tax and without regard to the portfolio interest exemption. As a result, we believe that interest determined by reference to the value of a debtor’s stock (so long as such stock does not represent a U.S. real property interest) was not intended to be treated as contingent interest disqualified from the portfolio interest exemption, regardless of whether the debtor’s stock is actively traded.

In reaching this conclusion, we note the specific references to the dividends or yield on stock paid by the debtor in both the general definition and the actively traded exception to the definition of contingent interest, and the absence of any statutory reference to the debtor’s stock when describing the types of property that may not be referenced in computing interest qualifying for the portfolio interest exemption. Further, while it may be argued that the value of all of the debtor’s properties is reflected in the value of the debtor’s stock,⁷⁹ we note that the debtor’s stock literally is not property “of the debtor.” In addition, while there may be more reliable evidence of value of actively traded stock than non-actively traded stock, we do not

⁷⁶ *Id.* § 871(h)(4)(C)(v)(I), (II), (III).

⁷⁷ In the case of stock, “yield” is commonly defined as the percentage rate of return paid in the form of dividends. See N.Y. Times on the Web, *Glossary of Financial and Business Terms* (Campbell R. Harvey ed.), <http://www.nytimes.com/library/financial/glossary/bfglosy.htm> (last visited Feb. 3, 2004). Some would argue that the yield of a stock also should reflect capital appreciation, and therefore should include some measure of the change in its value. Regardless of the general merits of this approach, we assume that this is not the meaning intended in section 871 or else Congress would not have used the phrase “changes in the value of property” in counterpoint to the phrase “the yield on property.”

⁷⁸ See I.R.C. § 871(h)(4)(C)(v)(I) (first bulleted item in the text).

⁷⁹ See I.R.C. § 871(h)(4)(A)(i)(III) (contingent interest includes interest determined by reference to any “change in value of any property of the debtor or a related person”).

believe that this distinction provides adequate support from a policy perspective (and no support appears in the legislative history) for differentiating between actively traded stock of the debtor and stock of the debtor that is not so traded for purposes of the portfolio interest exemption. As a result, we believe that, in light of the congressional intent as outlined above, the general definition of contingent interest should not be interpreted to reach interest determined by reference to the value of the debtor's stock (and there is thus no need for such stock to be actively traded in order for such interest to qualify for the portfolio interest exemption).

In light of the uncertainty regarding the withholding tax treatment of interest determined by reference to the value of the debtor's own stock, we recommend that the Service should clarify its position in this regard.⁸⁰

4. Exception for Interest Determined by Reference to Principal/Non-Contingent Interest

In addition to the foregoing specific exceptions, a catch-all exception to the definition of contingent interest also appears in the statute. Pursuant to this exception, contingent interest does not include interest all or substantially all of which is determined by reference to any type of interest not described in the general definition (set forth in 1, above) or by reference to the principal amount of indebtedness on which such interest is paid.⁸¹ Further, the Conference Report makes clear that only the amount of interest paid on an obligation in excess of non-contingent interest fails to qualify for the portfolio interest exemption. Thus, for example, with respect to a debt instrument that pays an amount of interest each year that is equal to the greater of (i) a fixed percentage of the outstanding principal amount or (ii) some percentage of the debtor's gross receipts for such year, only interest actually paid in excess of the fixed percentage of the principal amount may fall within the contingent interest exception to the portfolio interest exemption.⁸²

⁸⁰ The Treasury Department has the authority to identify interest that should not be treated as "contingent interest." I.R.C. § 871(h)(4)(C)(vi).

⁸¹ The statute provides no guidance regarding the meaning of the term "substantially all" in this context. Thus, it is unclear whether or when interest on a debt obligation, substantially all of which is determined on a fixed basis but a small part of which is ultimately determined on a contingent basis by reference to one of the proscribed factors (e.g., the debtor's earnings), will qualify in its entirety for the portfolio interest exemption. We believe the Service should consider publishing a revenue ruling outlining circumstances in which the Service will consider contingent interest paid on a debt obligation to qualify as portfolio interest despite being determined by reference to one of the proscribed factors set forth above, because substantially all of the remaining interest paid on the debt obligation is noncontingent (based upon other factors).

⁸² H.R. Rep. 103-213, at 653-54 (1993). It is noted that withholding tax generally is imposed only upon an actual payment, as opposed to accrual of a liability for payment, of amounts subject to withholding. I.R.C. §§ 871(a)(1)(C)(3) and 881(a)(3); Treas. Reg. § 1.1441-2(b)(3). Thus, although in certain situations the rules for accruing interest on contingent debt may require the debtor and creditor on such debt to accrue interest based upon a fixed payment schedule (i.e., under the "noncontingent bond method") and then "true up" these accruals for the actual amount of the contingent payments made, it is clear that no withholding should be required until actual payment of the contingent amounts (regardless of whether the amounts ultimately paid are less than, equal to or greater than the amount of the fixed accruals). See Treas. Reg. § 1.1274-5(b) (noncontingent bond method); see also *id.* § 1.1441-2(b)(3) (requiring withholding on actual payments of original issue discount). Because of the complexity of the rules applicable to contingent payment debt, some of us would encourage the Service to publish
(continued...)

Although the exception to the definition of contingent interest for interest determined by reference to the principal amount of indebtedness appears to provide a very useful and bright-line rule, some practitioners have expressed uncertainty regarding whether a strictly literal reading of such exception was intended. Thus, for example, some practitioners have expressed concern regarding whether this exception applies to penalty interest, computed by reference to the principal amount of indebtedness but payable upon a decline in value of the debtor's assets below a certain amount, because the amount of interest payable is affected by the value of the debtor's assets. These practitioners note that, in certain situations, it may be a simple matter to use interest determined based upon the principal amount of indebtedness, the payment of which is triggered upon the debtor's assets attaining a certain value, as a surrogate for interest based upon such value.

Example. US Co. issues a debt instrument for US\$1 million that provides for payment of five percent interest per annum, plus an amount of additional interest each year equal to one percent of the outstanding principal amount for each US\$100,000 by which a certain US Co. asset has increased in value. The debt instrument provides for a bullet repayment of the US\$1 million principal amount in ten years.

In this example, US Co. is effectively obligated to pay 10 percent of the increase in value of the referenced asset (one percent of the principal amount equals US\$10,000; 10 percent of US\$100,000 also equals US\$10,000) as additional interest on the debt instrument. Nonetheless, an argument may be made that such additional interest is determined by reference to the principal amount of the indebtedness. We believe such an argument would be inappropriate under these circumstances. Due to the potential uncertainty, however, we encourage the Service to publish guidance addressing clearly situations in which interest payable upon the occurrence of events relating to the value of a debtor's assets would qualify as portfolio interest. These would include, for example, penalty interest due based upon a decline in value of the debtor's assets and determined based upon the principal amount of indebtedness outstanding clearly should qualify as portfolio interest, as the interest payable does not represent a surrogate for distribution of the debtor's revenues, earnings or value of assets.⁸³ An example of a possible revenue ruling addressing this point is included in the Appendix, at A-9, for reference.

V. Bank Loan Exception

A. Overview

Section 881(c)(3)(A) provides that the term "portfolio interest" does not include any interest that is "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business," unless the interest is paid on an

(continued...)

guidance that demonstrates the operation and interaction of the noncontingent bond method and the portfolio interest rules.

⁸³ In fact, the amount of interest payable increases as the debtor's assets decline in value. *See supra* note 74.

obligation of the United States. This is referred to herein as the “bank loan exception.”⁸⁴ The scope of this exception is, of course, limited to loans made by foreign banks the interest on which is not effectively connected with a U.S. trade or business (*e.g.*, loans not made through the U.S. branch office of a foreign bank).⁸⁵ This Section V focuses on three main issues relating to the bank loan exception, as follows: (i) the definition of “bank,” (ii) the definition of “loan agreement,” and (iii) how the bank loan exception should be applied to loan syndications and participations.

There are no Treasury regulations, cases or published Service guidance interpreting the bank loan exception. While the legislative history of the provision is generally unrevealing,⁸⁶ the Joint Committee explanation states that:

[F]oreign banks are generally not eligible for the [portfolio interest] exemption with respect to interest they receive on debt on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. Whether a foreign bank will be considered to have extended credit pursuant to a loan agreement entered into in the ordinary course of its banking business will be determined, with respect to a particular obligation, under regulations prescribed by the Secretary. Interest on any obligation that performs the function of a loan entered into in the ordinary course of a banking business will be ineligible for the exemption. Interest on an obligation that does not perform that function -- for example, a Eurobond held by a foreign bank as an investment asset -- may be eligible for the exemption. Foreign banks also may obtain the exemption with respect to otherwise eligible interest paid on obligations of the United States. *In addition to addressing a Federal Reserve concern regarding reserve*

⁸⁴ It should also be noted that the bank loan exception applies only to corporations and would not apply to deny portfolio interest treatment to interest paid by an individual to a bank.

⁸⁵ Under section 864(c)(2), interest and other portfolio-type income is treated as effectively connected income (“ECI”) if the income is derived from assets used in or held for use in a trade or business (the “asset use test”), or the activities of the trade or business were a material factor in the realization of the income (the “business activities test”). Special rules apply for determining when a foreign corporation is treated as engaged in the active conduct of a “banking, financing or similar business” in the United States and when portfolio-type income will be treated as effectively connected with such trade or business. Treas. Reg. § 1.864-4(c)(5). A non-U.S. person is considered to be engaged in a banking, financing or similar business if at some time during the year the taxpayer is engaged in business in the United States and the activities of the business consist of any one or more of the following activities carried on in the United States involving the public: (i) receiving deposits of funds from the public, (ii) making loans to the public, (iii) purchasing, selling or negotiating for the public on a regular basis notes or other evidences of indebtedness, (iv) issuing letters of credit to the public and negotiating drafts drawn thereunder, (v) providing trust services to the public, or (vi) financing foreign exchange transactions for the public. Treas. Reg. § 1.864-4(c)(5)(i). The regulations also provide that the fact that the taxpayer is subject to the banking and credit laws of the United States is taken into account in determining whether the taxpayer is engaged in a banking, financing or similar business, but the character of the business actually carried on in the United States is determinative. Thus, a U.S. branch of a foreign bank that is subject to U.S. regulation, accepts deposits and has the authority to approve loans is engaged in a U.S. trade or business, while foreign banks that maintain only a “representative office”—*i.e.*, one that communicates with U.S. borrowers but lacks the authority to commit the entity to lend funds, with all transactions approved by the head office outside of the United States—may not be engaged in a U.S. trade or business.

⁸⁶ See H.R. Rep. (Conf.) No. 98-861, 936, at 938-38 (1984); S. Rep. No. 98-169, at 423 (1984).

*requirements, the foreign bank exception was intended to prevent U.S. banks, which are subject to U.S. tax on interest income, from suffering a competitive disadvantage vis a vis foreign banks that make loans to U.S. persons.*⁸⁷

(Emphasis added.)

As the 1984 Blue Book thus indicates, the purpose of the bank loan exception was twofold. The first objective was to eliminate a perceived competitive advantage for foreign banks: If foreign banks could make loans to U.S. borrowers (other than through a U.S. branch) and avoid the 30 percent withholding tax via the portfolio interest exemption, then such foreign banks could, in theory, underprice U.S. banks, which would be fully subject to U.S. income tax on their U.S. lending activities. The second objective was to eliminate an incentive for foreign banks to channel U.S. lending activities away from their U.S. branches, which are subject to reserve maintenance requirements imposed by the Federal Reserve Board.

In 1992, the Tax Section of the New York State Bar Association submitted to the Treasury and Service a comprehensive report on the bank loan exception discussing the tax law and non-tax law definitions of the term “bank” (referred to herein as the “NYSBA Report on the Bank Loan Exception”).⁸⁸ We agree with much of the substance of the NYSBA Report on the Bank Loan Exception and the basic thrust of the recommendations set forth therein, and therefore our analysis is confined to certain essential points.⁸⁹

⁸⁷ 1984 Blue Book, at 395.

⁸⁸ See New York State Bar Ass’n, Tax Section, *Report on the “Bank Loan” Exception to the “Portfolio” Interest Rules* (Aug. 28, 1992). Richard Andersen, one of the authors of this section of the report, also contributed to the NYSBA Report on the Bank Loan Exception.

⁸⁹ The NYSBA Report on the Bank Loan Exception further recommended that a foreign corporation with U.S. activities should be considered to be a “bank” if it maintains in the United States a Federal branch, Federal agency, State branch or State agency (as those terms are defined in section 1(b) of the International Banking Act of 1978) that is subject to regulation by the Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, or equivalent bank regulatory authority of a State or the District of Columbia. The NYSBA Report on the Bank Loan Exception recommended that a foreign bank that does not have a U.S. branch subject to banking regulation should be classified as a bank if it (i) regularly accepts deposits from, and makes or participates in loans to, persons unrelated to the foreign corporation in the course of a trade or business, and (ii) conducts the banking activities in an Organisation for Economic Co-operation and Development (“OECD”) country and is subject to regulation as a bank by the banking authorities in such country or is licensed or authorized to conduct such banking activities or, if the foreign corporation does not conduct banking activities in a country belonging to the OECD, would be subject to regulation as a bank by Federal or State banking authorities if it conducted banking activities through a U.S. branch or agency. This approach is based on the notion that countries belonging to the OECD have regulated banking systems that are functionally similar to that of the United States and therefore would provide reasonable assurance of avoiding major qualitative gaps in the regulatory environment between the United States and the foreign country in question. If the foreign corporation conducts banking activities in a non-OECD country, the NYSBA Report on the Bank Loan Exception’s recommendation would be to apply the regulatory test by focusing on whether such non-U.S. activities would be subject to regulation by Federal or State banking authorities if they were carried on in the United States.

B. Definition of “Bank”

1. Definitions of “Bank” Found in the Code and Regulations

By using the term “bank,” Congress clearly did not intend to encompass broadly all business entities that engage in lending activities. An approach that applies the bank loan exception to any foreign corporation that extends credit in the ordinary course of its trade or business would ignore the statute’s use of the word “bank.” The Code contains numerous instances where Congress has included the term “bank” as a subset of financial services businesses.⁹⁰ In drafting the portfolio interest exemption, Congress could have used the more expansive term “banking, financing, or similar business” had it wished to sweep in all entities engaged in lending and financing activities, but instead chose the more targeted word “bank.”

a. Code Section 581/585 Definition of “Bank”

The first points of reference in defining “bank” for purposes of the portfolio interest exemption logically are those places in the Code and Treasury Regulations that specifically define “bank” for other purposes. Section 581 defines “bank,” for purposes of sections 582 and 584 (which provide certain special federal income tax rules applicable to banks, e.g., relating to bad debts), as (i) a domestic bank or trust company, (ii) a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers, and (iii) “which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions,” and specifically includes a domestic building and loan association.⁹¹

Section 585(a)(2)(B) also defines the term “bank,” for purposes of determining the deduction for loan loss reserves allowed to banks, to mean not only “banks” as defined in

⁹⁰ See, e.g., I.R.C. § 871(h)(5)(B) (providing that the statement of beneficial ownership required to substantiate the portfolio interest exemption may be provided by a “securities clearing organization, a bank, or other financial institution that holds customer securities in the ordinary course of its trade or business”); *id.* § 864(c)(4)(B)(ii) (referring to dividends or interest derived in the “active conduct of a “banking, financing or similar business”); *Id.* § 954(h)(3)(A)(i) (defining “qualified banking or financing income” as income of an eligible controlled foreign corporation derived in the “active conduct of a banking, financing or similar business”); *id.* § 904(d)(2)(C)(i) (defining the term “financial services income” as any income received or accrued by any person predominantly engaged in the “active conduct of a banking, insurance, financing, or similar business”).

⁹¹ While there are a number of Code provisions that define “bank” in other contexts by cross referencing the section 581 definition, Congress failed to include such a cross reference in the bank loan exception under Code section 881(c)(3)(A). It should be noted that in *The Limited, Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002), the Sixth Circuit Court of Appeals observed that the section 581 definition of “bank” applies for purposes of section 582 and 584 and that it was not intended to serve as a general definition of “bank” for purposes of Code provisions not expressly cross referencing section 581. Thus, it rejected the application of the section 581 definition to section 956 in interpreting the phrase “carrying on the banking business” in section 956(b)(2)(A). Proposed legislation would alter the result under *The Limited*. See American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 3027 (2003) (exception from the definition of U.S. property under section 956 for deposits with persons carrying on the banking business is limited to deposits with corporations with respect to which a bank holding company (as defined in section 2(a) of the Bank Holding Company Act of 1956) or a financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 451 (2003) (similar, although not identical, provision).

section 581, but also U.S. branches of foreign banks—specifically, “any corporation [to which section 581 would apply] except for the fact that it is a foreign corporation,” but only with respect to loans giving rise to interest that constitutes ECI. The section 585(a)(2)(B) bank definition is adopted by regulations issued under a number of different Code provisions involving the taxation of foreign banks that are engaged in a banking business in the United States. For example, the Treasury Regulations under section 882, which determine a foreign corporation’s effectively connected interest deduction, provide that a foreign corporation that is a “bank” within the meaning of section 585(a)(2)(B)—i.e., an entity that would qualify as a bank under section 581 if it were domestic—is permitted to use an elective fixed ratio for purposes of determining its U.S.-connected liabilities.⁹²

The Service, in interpreting the section 585(a)(2)(B)/581 definition of bank, has emphasized the taking of deposits from the public as the key indicator of bank status. This is illustrated in Priv. Ltr. Rul. 2000-27-021 (April 6, 2000), which involved a foreign bank’s use of the fixed ratio method under Treas. Reg. § 1.882-5(c)(4). The taxpayer was an international banking institution (“Bank”) organized under the laws of Country A that maintained a branch in the United States under a state banking license through which it actively conducted a banking, financing or similar business within the meaning of Treas. Reg. § 1.864-4(c)(5)(iii). In the taxable year at issue, Bank was required by Federal banking regulators to relinquish its banking license. It continued many of its banking activities in the United States by transferring its U.S. assets to a wholly owned U.S. based limited liability company (“LLC”). The employees and income-producing activities of Bank’s banking business were operated through LLC, but LLC did not have a banking license and was not eligible to receive deposits. Bank had elected the 93 percent fixed ratio method of determining its U.S. connected liabilities under Treas. Reg. § 1.882-5(c)(4). Bank sought a ruling that, beginning with its tax year in which it relinquished its banking license, it could continue to be treated as a bank and use the fixed 93 percent ratio method of determining its U.S. connected liabilities.

As noted above, Treas. Reg. § 1.882-5(c)(4) defines a “bank” by cross referencing section 585(a)(2)(B), which provides that a foreign bank is a “bank” only if it would qualify under section 581 if it were a domestic corporation. Thus, the National Office ruled that, because Bank was not a trust company and a substantial part of its business did not consist of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, Bank could qualify as a “bank” for purposes of Treas. Reg. § 1.882-5(c)(4) only if it conducted the other activities prescribed by section 581. Namely, Bank could qualify as a bank under section 585(a)(2)(B) only if (i) a substantial part of Bank’s business in the United States consisted of accepting deposits and making loans and discounts, and (ii) Bank was subject to regulatory supervision and examination by a State or Federal

⁹² The version of the section 882 regulations proposed in 1992 provided that the 93% fixed ratio could be elected by a taxpayer “that is a U.S. banking, finance or similar business (as defined in section 1.864-4(c)(5)(i)).” Prop. Treas. Reg. § 1.882-5(c)(3), 57 Fed. Reg. 28470 (1992). The final regulations issued in 1996 limited the 93% election to taxpayers that are banks as defined in section 585(a)(2)(B), without regard to the second sentence thereof (which limits its application to loans giving rise to interest that constitutes ECI). The preamble to the 1996 regulations states only that this change was made “to clarify the previous definition” and to limit the 93% fixed ratio to “the intended class of businesses.” Preamble to T.D. 8658, 1996-1 C.B. 161, 163.

regulatory agency. Because Bank relinquished its banking license and ceased taking deposits, Bank could not qualify as a bank under sections 581 and 585(a)(2)(B).⁹³

The “branch interest tax” regulations governing the determination and taxation of “excess interest” also employ section 585(a)(2)(B) to define foreign banks.⁹⁴ Those regulations provide a special rule under which a qualifying foreign corporation may treat a minimum of 85 percent of its excess interest as bank deposit interest (thereby exempting such interest from withholding tax under section 871(i)(3)).⁹⁵ In order to qualify under this rule, (i) the foreign corporation must qualify as a bank under section 585(a)(2)(B), and (ii) “a substantial part of its business in the United States, as well as all other countries in which it operates,” must consist of “receiving deposits and making loans and discounts.”⁹⁶

b. Definition of “Bank” under PFIC Rules

The term “banking business” is used in the passive foreign investment company (“PFIC”) rules, and we believe guidance issued under that provision also is relevant to the present inquiry. Section 1297(b)(2)(A) provides that the term “passive income” for purposes of the PFIC rules does not include any income “derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation).” In Notice 89-81,⁹⁷ the Service provided interim guidance on this statutory rule pending the issuance of regulations. In general, the Notice provides that neither (i) income that is effectively connected with the active conduct of a U.S. trade or business by a foreign corporation licensed to do business as a bank in the United States (a “U.S. licensed bank”), nor (ii) income from bona fide banking activities derived by such U.S. licensed bank outside the United States, is passive income.⁹⁸ A foreign corporation that is not a U.S. licensed

⁹³ See also Priv. Ltr. Rul. 2002-32-025 (May 7, 2002) (although foreign bank continued to possess a banking license in the U.S., it ceased taking deposits and thus failed to continue to meet the definition of a bank under sections 581 and 585(a)(2)(B)); Priv. Ltr. Rul. 2000-18-027 (Feb. 1, 2000) (foreign bank ceased to take deposits and make loans in the U.S. and thus ceased to be a bank under section 585(a)(2)(B) (despite the fact that it continued to accept deposits and make loans outside the U.S.), but was permitted to continue to treat a portion of its excess interest as deposit interest and to use the 93 percent fixed ratio because it continued to receive income from customer loans, securities, and investments belonging to the former U.S. branch that was treated as ECI under sections 864(c)(6) and (c)(7)); Priv. Ltr. Rul. 2001-25-088 (March 28, 2001); Priv. Ltr. Rul. 2001-25-030 (March 19, 2001); Priv. Ltr. Rul. 2000-27-021 (April 6, 2000); Priv. Ltr. Rul. 98-20-005 (Jan. 30, 1998).

⁹⁴ See Treas. Reg. § 1.884-4.

⁹⁵ *Id.* § 1.884-4(a)(2)(iii).

⁹⁶ *Id.* The branch tax regulations that define when a foreign corporation will be considered a “qualified resident” of a treaty country and thus eligible to claim treaty benefits with respect to the branch taxes imposed by section 884 provide that a foreign corporation is a qualified resident if it is engaged in the active conduct of trade or business in its home country, and the U.S. trade or business is an integral part of that business. Treas. Reg. § 1.884-5(e). A U.S. trade or business of a foreign corporation qualifying as a bank within the meaning of Treas. Reg. § 1.884-4(a)(2)(iii) is presumed to be an integral part of an active banking business conducted by the foreign corporation in its home country if a substantial part of the business of the foreign corporation in both its country of residence and the United States consists of receiving deposits and making loans and discounts. Treas. Reg. § 1.884-5(e)(4)(ii).

⁹⁷ 1989-2 C.B. 399.

⁹⁸ The Conference Report accompanying the Tax Reform Act of 1986, which adopted the PFIC provisions, states that the banking exception was intended to apply to bona fide banks, and that any foreign corporation licensed to do
(continued...)

bank will qualify for the passive income exception if it is an “active foreign bank,” as defined in paragraph (A) of the Notice and the income in question is earned in the performance of bona fide banking activities under paragraph (B)(1) of the Notice.

In 1995, the Service issued proposed regulations under section 1296 (now renumbered as section 1297), which are still in proposed form.⁹⁹ The proposed regulations provide that “banking income”¹⁰⁰ earned by an “active bank” (or a “qualified bank affiliate”) is nonpassive income. A foreign bank can qualify as an active bank by being a “U.S. licensed bank” or, if not licensed in the United States, by meeting three tests: (i) a home country licensing test, (ii) a deposit-taking test and (iii) a lending activities test.¹⁰¹ These rules, described in detail below, are generally similar to those described in the Notice.

Licensing Test. A foreign corporation is a U.S. licensed bank if it is licensed by Federal or State bank regulatory authorities to do business as a bank in the United States.¹⁰² This requirement is not satisfied if the foreign corporation’s U.S. license(s) merely permit it to maintain a representative office that is prohibited by Federal or State law from taking deposits or making loans.¹⁰³ The preamble to the proposed regulations states that being licensed by a bank regulatory authority provides “strong evidence that a corporation is a bank and serves to distinguish banks from investment funds.”¹⁰⁴ In the case of a foreign corporation not licensed in the United States, active bank status first requires that the corporation be licensed or authorized to accept deposits from residents of the country in which it is organized and to conduct the banking activities specified by the proposed regulations.¹⁰⁵

Deposit Taking Test. To satisfy this test, the foreign corporation must regularly accept deposits in the ordinary course of its trade or business from customers who are residents of the country in which it is licensed or authorized.¹⁰⁶ In addition, the deposits shown on its balance sheet must be “substantial,” taking into account whether the corporation’s capital structure and funding are similar to comparable banking institutions engaged in the same activities and subject to the same regulatory environment.¹⁰⁷ The preamble to the proposed regulations states that the

(continued...)

business under Federal or State law should generally be presumed to be a bona fide bank for this purpose. H.R. Rep. (Conf.) No. 99-841, at 644 (1986).

⁹⁹ 60 Fed. Reg. 20922 (1995). The proposed regulations are proposed to be effective for taxable years beginning after December 31, 1994.

¹⁰⁰ “Banking income” is defined as gross income from the active conduct of any banking activity described in Prop. Treas. Reg. § 1.1296-4(f)(2). That paragraph identifies 14 different banking activities, such as lending, issuing letters of credit, performing trust services, etc.

¹⁰¹ Prop. Treas. Reg. § 1.1296-4(a), 60 Fed. Reg. 20922 (1995).

¹⁰² *Id.* § 1.1296-4(b)(1).

¹⁰³ *Id.*

¹⁰⁴ 60 Fed. Reg. 20922.

¹⁰⁵ Prop. Treas. Reg. § 1.1296-4(c).

¹⁰⁶ *Id.* § 1.1296-4(d)(1)(i).

¹⁰⁷ *Id.* § 1.1296-4(d)(1)(ii), (d)(3).

deposit taking test is intended, in part, to distinguish banks from finance companies, which do not take deposits.¹⁰⁸ The proposed regulations eliminate the Notice’s numerical requirement that at least 50 percent of the total liabilities of the corporation constitute deposit liabilities. The proposed regulations also eliminate the bright line rule set forth in the Notice that the corporation hold deposits from at least 1,000 persons who are bona fide residents of the home country; instead, the proposed regulations simply require that the corporation regularly accept deposits from residents of the country in which it is licensed. According to the preamble, this requirement is aimed at corporations that are licensed by the banking authorities in their home country but are prohibited from accepting deposits from residents and thus do not have full-fledged bank status.¹⁰⁹

Lending Activities Test. In order to satisfy this test, the corporation must regularly make loans to customers in the ordinary course of its trade or business.¹¹⁰ The proposed regulations define a “loan” using language identical to that which appears in the bank loan exception; namely, the loan must be received by the corporation on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its banking business.¹¹¹ They also state that the debt instruments generally will not be considered “loans” if they are not classified as loans on the corporation’s financial statements, e.g., they are shown as securities or other investment assets.¹¹²

2. Technical Advice Memoranda Interpreting “Bank” Under Bank Loan Exception

In two technical advice memoranda issued by the National Office of the Service in 1998, the Service adopted the section 581 definition of “bank” for purposes of applying the bank loan exception.¹¹³ The taxpayer in Technical Advice Memorandum 98-22-007 was a leasing company and a resident of country X (“Taxpayer X”), which engaged in “a variety of financial activities, including making commercial loans, equipment and real property leasing, installment financing, and other forms of financing and credit support, trading activities, and financial services.” This technical advice memorandum further states that “commercial loans and installment obligations” constituted a significant part of the assets of Taxpayer X. Because Country X law prohibited leasing companies like Taxpayer X from making loans to foreigners, Taxpayer X engaged in a “square trip financing” transaction with a wholly owned subsidiary (“Sub Y”) that was organized under the laws of Country Y. Sub Y then loaned the funds to an unrelated U.S. borrower (“U.S. Borrower”) in a conventional loan, the terms of which matched the financing transaction between Taxpayer X and Sub Y. This technique allowed Taxpayer X to provide funds to nonresidents of country X in the form of an installment sale contract.

¹⁰⁸ 60 Fed. Reg. 20922 (1995).

¹⁰⁹ *Id.*

¹¹⁰ Prop. Treas. Reg. § 1.1296-4(e).

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ Tech. Adv. Mem. 98-22-007 (Feb. 10, 1998); Tech. Adv. Mem. 98-22-008 (Feb. 10, 1998).

The District Director contended that (i) Sub Y should be disregarded as a conduit and that the interest paid by U.S. Borrower should be deemed paid directly to Taxpayer X, and (ii) Taxpayer X was a “bank” to which the bank loan exception applied, thereby preventing the interest from qualifying for the portfolio interest exemption. The District Director took the position that the bank loan exception should apply if the loan resembled loans made by commercial banks under the “family resemblance” test adopted by the courts in the securities law area. For purposes of the technical advice request, Taxpayer X did not contest the conduit characterization, but asserted that it was not a bank because it did not receive deposits, was not subject to regulation in Country X as a bank, and would not be subject to regulation by the Federal Reserve Board or the Comptroller of the Currency if it were present in the United States.

The National Office stated that, in the absence of regulations adopting an expansive definition of the term “bank,” the term “must be construed narrowly and must be given a meaning that distinguishes it from all other entities that make commercial loans.” It concluded that “bank” should be defined by reference to section 581, which it viewed as incorporating an operational test, requiring that the entity both accept deposits and make loans, and a regulatory test, requiring that the entity be regulated, supervised and examined as a bank. Since the National Office viewed the taking of deposits as an essential characteristic of a section 581 bank, and Taxpayer X did not take deposits, the National Office concluded that the bank loan exception did not apply and thus the interest paid by U.S. Borrower qualified for the portfolio interest exemption.¹¹⁴

Because Taxpayer X did not accept deposits and therefore did not meet the operational test of section 581, the National Office did not address the question of how it would have analyzed the regulatory test of section 581 in the context of a foreign bank not engaged in a banking business in the United States. Possible approaches would be to determine whether Taxpayer X was subject to regulation as a bank in its home country (or some other jurisdiction) or whether Taxpayer X would have been subject to regulation as a bank in the United States if it conducted the relevant operational activities in the United States. We note that Taxpayer X argued that it was not subject to banking regulation in its home country and that it would not be subject to banking regulation in the United States; however, the National Office did not indicate which of these arguments would have been relevant had it reached the regulatory test.

3. Conclusion as to Definition of “Bank”

The definition of a bank in section 581, even as modified by section 585(a)(2)(B), requires the subject organization or entity to be licensed as a bank in the United States and engaged in a banking business in the United States. Therefore, if the section 581 standard were adopted for section 881(c) purposes, it would need to be modified to apply to foreign banks not engaged in a banking business in the United States.¹¹⁵ The proposed PFIC definition of “active bank” already provides detailed rules for determining whether a foreign bank not engaged in a

¹¹⁴ The facts and holding of Tech. Adv. Mem. 98-22-008 are similar, except that the relevant taxpayer was the U.S. borrower who had the withholding responsibility on interest paid in respect of loans made to it by Country Y subsidiaries of Country X leasing companies.

¹¹⁵ See *supra* note 85.

U.S. banking business will qualify as a bank based on its activities in its home country and whether it is subject to regulation there. We do not believe there would be material differences between the PFIC definition and the section 581 definition if it were modified to apply to foreign banks without U.S. banking activities.

Accordingly, we believe that the Service and Treasury should define “bank” by importing into the bank loan exception the definition of an “active bank” in Proposed Regulation § 1.1296-4(b). Under this approach, a foreign lender would be classified as a bank if it were licensed by Federal or State bank regulatory authorities to do business as a bank in the United States and the license permits the corporation to take deposits and make loans. In the case of a foreign lender that does not have such a license, it would be classified as a bank if it met the foreign licensing test of Prop. Treas. Reg. § 1.1296-4(b),¹¹⁶ the deposit-taking test of Prop. Treas. Reg. § 1.1296-4(d), and the lending activities test of Prop. Treas. Reg. § 1.1296-4(e). While the purposes of the bank loan exception and the active bank definition in the PFIC proposed regulations are obviously different, we think the standards of the proposed regulations are reasonable, workable and administrable in the context of the bank loan exception. Please see the Appendix, at A-11, for an example of a possible notice that defines “bank” for purposes of the portfolio interest exemption in the manner recommended.

4. Other Issues Related to Definition of Bank

a. Non-Bank Affiliates of Foreign Banks

A foreign corporation that qualifies as a bank may have one or more wholly or partly owned affiliated entities that do not independently qualify as banks under the suggested test described above. This raises the issue of whether and under what circumstances the “bank” status of a foreign bank should be imputed to an affiliated lender and the portfolio interest exemption denied to the latter.

A variety of fact patterns can be readily imagined. At one end of the spectrum is a wholly-owned subsidiary of a parent bank that conducts a bona fide non-banking business with its own officers and employees, such as an investment banking business, and that makes loans in the ordinary course of that business, but which does not accept deposits from the public. We believe that the bank loan exception should not apply to a loan by such a non-bank affiliate. At the other end of the spectrum is a single purpose subsidiary formed by a parent bank for the sole purpose of holding a single loan whose terms were negotiated by employees of the parent bank (in their capacities as such) but which was closed in the subsidiary in an attempt to place the loan beyond the reach of the bank loan exception.¹¹⁷ A loan by such an entity should be within the bank loan exception. Evaluating other points on the spectrum may prove more difficult.

Provided some business purpose exists for the formation of the non-bank affiliate, or it carries on some business following its formation and all corporate formalities are observed, we

¹¹⁶ The licensing test would be applied without regard to the anti-abuse rule contained in the second sentence of Proposed Regulation § 1.1296-4(c), which has relevance only in the pro-taxpayer context of the active banking exception to the PFIC rules.

¹¹⁷ *Cf.* Garlock § 17.04[C], at 17-48 (Example 17-12).

believe that the separate existence of the affiliate generally should be respected for federal tax purposes under the doctrine of *Moline Properties*.¹¹⁸ Nonetheless, there remain various legal doctrines the Service may assert to impose withholding tax on interest paid on a loan made by a non-bank affiliate, including (i) agency, (ii) back to back loan/conduit treatment,¹¹⁹ (iii) sham, substance over form and step transaction doctrines,¹²⁰ and (iv) in some cases, section 269, which permits the Service to disallow a tax allowance, benefit or exclusion if the principal purpose for the parent's acquisition of control of the subsidiary was to avoid tax.

The Conference Report accompanying the Tax Reform Act of 1984 states as follows with respect to possible taxpayer use of back to back loans to avoid the bank loan and 10-percent ownership exceptions:

The conferees understand that taxpayers may attempt to circumvent the foreign [10-percent] shareholder/bank rule of the agreement by entering into "back to back" loans, wherein a foreign affiliate of a U.S. taxpayer (or a bank) lends money to an unrelated foreign party that relends that money at discount to the U.S. taxpayer. The conferees intend that the Internal Revenue Service, when appropriate, use means at its disposal to determine whether back to back loans exist.

H.R. Rep. (Conf.) No. 98-861, at 937-38 (1984).¹²¹

Clearly, the bank loan exception does not apply to all foreign lenders who happen to be affiliated with a foreign bank. The statutory language is narrowly limited to a "bank." Congress did not incorporate any related party or constructive ownership rules in the bank loan exception that would cause a loan made by a non-bank affiliate to be treated as made by an affiliated bank, although such rules generally pervade provisions of the Code with respect to which Congress perceives an opportunity for abuse. Moreover, we do not believe an approach to the bank loan exception that would "taint" all affiliates of a bank would have been appropriate, since it would effectively ignore the separate existence of such non-bank affiliates.¹²² Thus, the legislative history of the portfolio interest provisions quoted above focuses on the existing back to back

¹¹⁸ *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

¹¹⁹ See, e.g., Treas. Reg. § 1.881-3; see also *Del Commercial Properties, Inc. v. Commissioner*, 251 F.3d 210 (D.C. Cir. 2001); *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971).

¹²⁰ Cf. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

¹²¹ The District Director's Office asserted such a conduit argument in Tech. Adv. Mem. 98-22-007 and 98-22-008, where a parent leasing company, prohibited by its home country's law from making loans to nonresidents of such country, engaged in a financing transaction with a wholly owned subsidiary organized in a different country, with the subsidiary on-lending the proceeds to the U.S. borrower. The District Director asserted the wholly-owned subsidiary was a conduit and treated the loan to the U.S. borrower as if it had been made by the parent leasing company, and then analyzed whether that leasing company was a "bank" for purposes of the portfolio interest exemption. The National Office did not rule on the conduit issue because the taxpayer conceded it for purposes of technical advice.

¹²² Cf. *Moline Properties*, 319 U.S. 436. It is noted that dealer status is determined on a "taxpayer" by "taxpayer" basis. See *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984) (partnership's status as a dealer did not cause the partner to be treated as a dealer); *Pacific Securities v. Commissioner*, 63 T.C.M. (CCH) 2060 (1992) (partner's status as a dealer did not cause the partnership to become a dealer).

loan/conduit authorities to police abuses but does not provide any delegation of authority to Treasury to expand the scope of the statute by imputing a foreign corporation's "bank" status to its affiliated entities.¹²³

We note that the proposed PFIC regulations provide special rules under which banking income derived by an affiliate of an active bank, where the affiliate does not qualify as an active bank on a stand alone basis, will nevertheless be treated as nonpassive income for purposes of applying the PFIC rules to its parent bank (or to entities that are part of a "related group" of the affiliate).¹²⁴ Moreover, in determining the PFIC status of a corporation, a special "look-through" rule applies to permit an upper-tier corporation to take into account the assets and income of lower-tier corporations.¹²⁵ The intent of the rule in the proposed regulations was to allow banking income of a non-bank affiliate to be treated as nonpassive income for the limited purpose of testing whether the parent is a PFIC, even though the affiliate is not itself a bank, so long as the related group, as a whole, carries on an active banking business.¹²⁶ We do not believe it would be appropriate to apply a similar rule in the context of the bank loan exception given the absence of a look-through rule in that exception.

In light of the limited authority interpreting the bank loan exception, we believe that taxpayers and the Service would benefit from published guidance describing the Service's approach to the bank loan exception in the context of loans made by non-bank affiliates of banks. We believe that guidance that focuses on the application of the existing judicial doctrines to commonly encountered situations would be invaluable to those frequently faced with these situations, but could be crafted so as not to limit the Service's ability to challenge cases of abuse. As an example, such guidance might take the form of a revenue ruling analyzing a loan made by a non-bank affiliate of a foreign bank where (1) the non-bank affiliate was formed for valid business purposes and has been in existence and conducting trade or business or investment activities prior to making the present loan, (2) the loan is made by the non-bank affiliate in the

¹²³ We note, in this regard, that in Tech. Adv. Mem. 98-22-008, a foreign leasing company that was ruled to be a "non-bank" was in fact owned 70% by a "long-term credit bank" organized in the same country as the leasing company subsidiary. The Service appropriately did not adopt a bright line test that presumptively attributed to the leasing company subsidiary the bank status of its majority parent, but instead analyzed the leasing company's bank status on a stand-alone basis.

¹²⁴ To be a qualified bank affiliate, (i) at least 60% of the affiliate's total gross income for a taxable year must consist of banking income, "securities income" (defined as gross income from certain defined types of securities activities such as purchasing or selling stock, debt securities, etc., effecting transactions in securities as a broker, arranging futures, forwards, options or notional principal contracts with customers, etc.) and gross income from insurance activities; (ii) at least 30% of the related group's aggregate financial services income must consist of banking income earned by active banks who are members of the related group during the taxable year; and (iii) at least 70% of the aggregate financial services income earned during the taxable year by the related group must consist of banking income, securities income and gross income from insurance activities. Prop. Reg. § 1.1296-4(i). "Related group" for these purposes includes the affiliate in question, all persons that control or are controlled by such affiliate, and all persons that are controlled by the same person that controls such affiliate. "Control" for these purposes means the ownership of more than 50% of the vote or value of a corporate entity's stock or more than 50% of the value of the beneficial interests in a partnership, trust or estate.

¹²⁵ See I.R.C. § 1297(c).

¹²⁶ Prop. Treas. Reg. § 1.1296-4(i)(1). The income of the qualified bank affiliate will continue to be passive with respect to its shareholders that are not members of the related group.

ordinary course of its bona fide non-banking trade or business or is consistent with its investment activities and (3) the loan is not part of a conduit financing arrangement pursuant to which the non-bank affiliate's role may be disregarded under Treas. Reg. § 1.881-3.¹²⁷ Please see the Appendix, at A-13, for an example of a possible revenue ruling addressing this matter.

b. Banking Entities Treated as Partnerships

We believe the Service and Treasury should also make clear, with respect to foreign corporations that are members of lending entities treated as partnerships for federal income tax purposes, that the bank loan exception is applied by taking into account only the activities of the partnership. We believe this position is generally consistent with Code § 702(b) as well as applicable case law regarding the determination of dealer income earned through a partnership.¹²⁸ Furthermore, this approach is consistent with the approach adopted by the Service and the Treasury Department in the recently promulgated “Brown Group” regulations, in which subpart F provisions applicable to the activities of a controlled foreign corporation that is a partner in a partnership generally are applied “at the level of the entity that actually earns the income (i.e., the partnership).”¹²⁹

Accordingly, if the partnership lender itself does not qualify as a bank and makes loans to U.S. borrowers in the ordinary course of bona fide business or investment activities, a corporate partner's distributive share of interest income should qualify for the portfolio interest exemption even if that partner would itself qualify as a bank under the test set forth above. By contrast, if a foreign corporation is not a bank, but is a member of a banking partnership that receives interest income on an extension of credit made pursuant to a loan agreement in the ordinary course of the partnership's banking business, the bank loan exception would apply to the foreign corporation's distributive share thereof.

¹²⁷ Treas. Reg. § 1.881-3 provides a District Director with the authority to disregard the role of a “conduit entity” in a “conduit financing arrangement” generally comprised of two “financing transactions,” one of which is between the “financing entity” and the conduit entity, and the other of which is between the “financed entity” and the conduit entity. The effect of disregarding the conduit entity's role generally is the imposition of withholding tax, as if payments by the financed entity to the conduit entity were instead paid by the financed entity to the financing entity. For purposes of this recharacterization, the conduit entity is generally treated as an agent of the financing entity. *See* Treas. Reg. § 1.881-3(a)(3)(ii).

¹²⁸ *See* I.R.C. § 702(b) (providing that character of any income included in a partner's distributive share shall be determined as if “incurred in the same manner as incurred by the partnership”); *see also* *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984) (partnership's status as a dealer did not cause the partner to be treated as a dealer); *Pacific Securities v. Commissioner*, 63 T.C.M. (CCH) 2060 (1992) (partner's status as a dealer did not cause the partnership to become a dealer).

¹²⁹ Preamble to T.D. 9008, 2002-2 C.B. 335, 337. We note that the “Brown Group” regulations further take the approach that, for purposes of those subpart F provisions that consider the relationship between the parties to a transaction, the relevant relationship generally is determined at the CFC partner level. *See id.* at 336. Consistent with this approach, as set forth in Section VI below, we believe the 10-percent ownership exception should be applied at the partner level.

C. Definition of Loan Agreement

1. Legislative Background

The bank loan exception prevents interest from qualifying as portfolio interest only if it is received by a bank “on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.” As a result, whether interest will qualify as portfolio interest depends on the types of debt instruments held by a bank that may be considered a “loan agreement” for such purpose. Not all debt instruments acquired and held by a bank should fall within the definition of “loan agreement.” As discussed above, the bank loan exception was enacted, in part, to address congressional concerns regarding the competitiveness of U.S. banks with foreign banks that make loans to U.S. persons. The objective of Congress was to eliminate such business competition with respect to bank loans, not with respect to bank investments.

Section 881(c)(3)(A) provides in part that interest paid on an obligation of the United States is not subject to the bank loan exception. The existence of this so-called “U.S. obligation carve-out” suggests that Congress believed it was possible for a foreign bank to extend credit to the U.S. government pursuant to a loan agreement. Given that the U.S. government regularly borrows money by means of issuing bonds in the market rather than by means of traditional bank loans, it could be argued that the U.S. obligation carve-out is support for the conclusion that the term “loan agreement” must encompass a broad class of debt instruments, including publicly-traded bonds, rather than being limited to traditional bank loans.

We do not believe that such an argument has merit. It seems clear that the U.S. obligation carve-out was intended simply to provide that foreign banks may receive interest income from U.S. obligations without being subject to the bank loan exception. In the statute, the carve-out is separate from the loan agreement language; in fact, it is an exception to the bank loan exception. Further, the 1984 Blue Book states that:

Interest on any obligation that performs the function of a loan entered into in the ordinary course of a banking business will be ineligible for the exemption. Interest on an obligation that does not perform that function—for example, a Eurobond held by a foreign bank as an investment asset—may be eligible for the exemption. Foreign banks also may obtain the exemption with respect to otherwise eligible interest paid on obligations of the United States.¹³⁰

There is no indication in the statute or the legislative history that the U.S. obligation carve-out somehow defines the term “loan agreement.” Given that Congress understood how underwriters and financial institutions marketed Eurobonds to banks and other investors and that there was an established secondary market for such bonds, it seems clear that, with respect to the bank loan exception, Congress purposefully distinguished between a traditional bank loan and a debt instrument acquired in the secondary market by a bank for investment purposes.

¹³⁰ 1984 Blue Book, at 395.

2. Distinguishing Characteristic for Bank Loans: Negotiations

A common characteristic of a bank loan that distinguishes it from a debt instrument acquired in the secondary market, such as a Eurobond or other investment security, is that a bank loan is typically made on terms that the bank has negotiated with the borrower. In contrast, the terms of investment securities are typically established by the issuer together with its underwriter. Once those terms are established, all investors in the securities purchase them on the same terms. We believe the key factor distinguishing a bank “loan agreement” from other debt instruments acquired by a bank for investment purposes is that a bank directly negotiates the terms of a loan agreement with the borrower. We believe that it is consistent with Congress' intent in adopting the bank loan exception to define the term “loan agreement” by a negotiated instrument standard, because it is with respect to negotiated loan transactions that foreign and domestic banks most directly compete. While domestic and foreign banks both purchase securities for investment, so do many other market participants. The portfolio interest exemption was enacted in an attempt to expand the market for such securities.

Other provisions of the Code and regulations similarly differentiate between bank loans and other debt instruments acquired by a bank. For purposes of the PFIC regime's characterization of certain banking income of foreign banks as passive, the Service provided interim guidance in Notice 89-81¹³¹ distinguishing a bank loan, defined as a debt instrument received on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of a banking business, from other debt instruments acquired by a bank. The Service thus used language identical to that of the bank loan exception to make such a distinction. The proposed PFIC regulations described above provide a similar rule but also describe such bank loans as loans to customers. The regulations further state that debt instruments generally will not be considered bank loans if they are not treated as loans on the corporation's financial statements but are classified as “securities or other investment assets.” In effect, the proposed PFIC regulations distinguish a debt instrument that a bank negotiates with its customer from a debt instrument that the bank purchases for investment.

Furthermore, in Rev. Rul. 86-154¹³², the Service ruled that interest income from a security held by the U.S. branch of a foreign bank is considered effectively connected with the active conduct of a U.S. banking business pursuant to section 1.864-4(c)(5) of the regulations. The Service found that the U.S. branch made a loan to a customer, in part, because the U.S. branch proposed and negotiated the terms of the loan with the customer.

3. Summary

We believe the Service should provide regulatory or other administrative guidance that defines “loan agreement” as encompassing only negotiated bank loans. We recommend that the guidance provide that the following debt instruments are not considered loan agreements subject to the bank loan exception: (i) debt instruments that are regularly traded on an established securities exchange or other secondary market and (ii) debt instruments that are issued to the

¹³¹ See, *supra*, Note 97.,

¹³² 1986-2 C.B. 103

public in transactions subject to the registration requirements of the federal securities laws (or an exemption therefrom). We believe that such debt instruments should be entitled to “safe harbor” treatment as they are not the product of negotiations between a bank and a borrower.

We recommend that regulations or other guidance adopt a factor-based analysis focused on the extent of negotiations between the bank and the borrower with respect to the terms of the debt instrument to determine whether other debt instruments acquired by a bank should be considered loan agreements for purposes of the bank loan exception. Treating a negotiated instrument as a loan agreement will result in certain debt instruments not labeled as or otherwise resembling traditional bank loans for religious or other purposes,¹³³ the terms of which are negotiated between foreign banks and U.S. persons, being subject to the bank loan exception. The following examples address common situations would could serve as the basis for useful guidance as to the type of negotiated debt instruments that constitute “loan agreements”:

1. Foreign corporation X, which is a bank, and domestic corporation A, execute an agreement pursuant to which X lends \$100 million to A. Prior to executing the agreement, X and A directly negotiate various terms, including rights upon default and financial covenants. The agreement between X and A is a “loan agreement”.

2. Foreign corporation X, which is a bank, purchases a medium term note issued by domestic corporation A, through Dealer C, a foreign underwriter. The covenants and representations of the borrower are fixed in a fiscal agency agreement that was negotiated between A and Dealer C. However, the term, currency of issue and interest rate on the medium term note satisfy the specifications of X. The medium term note is freely transferable. The medium term note is not issued pursuant to a “loan agreement”.

3. Foreign corporation X, which is a bank, is the lead underwriter of a bond offering for domestic corporation A. X directly participates in negotiations with A that result in a dealer agreement. The notes issued in the bond offering are freely transferable. Foreign corporation Y, which is a bank, acquires some of the notes. The notes are not issued pursuant to a loan agreement.

Please see the Appendix, at A-17, for an example of a possible revenue ruling that analyzes these examples.¹³⁴

D. Application of Bank Loan Exception to Loan Syndications/Loan Participations

In the syndicated lending market, multiple lenders typically participate in the funding of a loan to a borrower in order to spread the credit risk on substantial loans among a pool of lenders. The borrower generally selects one lead bank (commonly known as the agent or administrative agent) that serves the primary role in negotiating the terms of the loan with the borrower and

¹³³ See generally Joel S. Newman, *Islamic & Jewish Perspectives on Interest*, 89 Tax Notes 1311 (Dec. 4, 2000).

¹³⁴ These examples are described at Situations 1-3 of the sample revenue ruling.

preparing the loan documents. The agent or one of its affiliates also prepares a term sheet for the transaction and the “bank book” (essentially a private placement memorandum describing the borrower and its business, as well as the terms of the loan, for the benefit of those banks that may wish to participate).

The participating banks review the term sheet and bank book and perform their own credit analyses. The banks that commit to participate in the loan generally have the right to comment on the loan documents prior to closing and typically (but not always) channel their comments through the lead bank. The document evidencing the loan is executed by all of the banks in the syndicate, placing them in direct contractual privity with the borrower. After the closing, banks may transfer their interests in the loan to other lenders, and generally do so by assigning all or a portion of their rights to the loan to another lender in a manner that creates direct contractual privity between the new lender and the borrower.

The lead bank administers the funding of the loan and the collection of payments on the loan with the borrower. All lenders fund their pro rata shares of borrowing requests to the agent, who makes funds available to the borrower. The borrower pays principal, interest and fees to the agent, who allocates the payments pro rata among the lenders. Amendments, waivers and the exercise of remedies are decisions made by all or a significant portion of the bank group. Most consents require a majority or supermajority vote of the lenders and some require unanimous consent. The borrower generally does not object to being in contractual privity with multiple participating lenders, and indeed may prefer it because many borrowers like to know who their lenders are.

Another way for banks to spread risk on substantial loans among multiple lenders is what is often referred to as a “loan participation,” where the lead bank initially takes the entire loan position and remains the only party in direct contractual privity with the borrower throughout the loan term. The lead bank may contemplate “laying off” a portion of its position to third parties at the time it negotiates the loan, or it may determine to do so after the loan is funded. In either case, the participants merely purchase a pro rata portion of the risk in the lead bank’s rights in the loan and often have no right to comment on the loan documents or to influence the terms of the loan, and have limited or no voting rights. Borrowers may be unaware that the lead bank has sold a risk participation in the loan to a third party and may continue to deal entirely with the lead bank.

As mentioned above, at times a lead bank will negotiate a loan with the full intention of participating it to a group of identified lenders immediately upon closing. Under some of these arrangements, the lead bank will permit the potential participants to review drafts of the loan documents as they are being produced, and the potential participants will indicate to the lead bank the terms they will and will not accept. Even under these circumstances, however, the lead bank is the only party that has direct contractual privity with the borrower.

We believe that foreign banks that join in a syndication and enter into direct contractual privity with the borrower at the time a loan is made should be viewed as having made an “extension of credit pursuant to a loan agreement,” since they typically are accorded an opportunity to join in loan negotiations, to provide input on the loan documents, and can fairly be said to have extended their credit in a loan agreement that they joined in negotiating. It is

difficult to characterize such activity as being outside the ordinary course of the bank's lending business or bearing a more significant resemblance to a security investment.¹³⁵

A lender's purchase of a participation in a loan that it did not join in negotiating may present a more difficult case, as in some circumstances such a participation may constitute nothing more than a loan to another bank, which may have been entered into in the ordinary course of the purchaser's lending business.¹³⁶ Where a foreign bank purchases all or a portion of a lender's interest in an existing loan in a secondary market transaction, without having participated in negotiations and without acquiring privity with the borrower, we believe that the bank loan exception should not apply because the foreign bank is effectively purchasing an investment security and has no input in negotiating the terms or the documents. We do not believe that such secondary market purchases by foreign banks present the same anti-competitiveness concern that prompted Congress to enact the bank loan exception because the foreign bank purchaser had no hand in the pricing or structuring of the loan. However, in those circumstances in which potential participants play an active, although behind-the-scenes role in negotiating the terms of the loan agreement, we believe that such participants should be viewed as having made an extension of credit pursuant to a "loan agreement" because of their ability to influence the pricing and structure of the loan.

Please see the Appendix, at A-17, for an example of a possible revenue ruling that analyzes the treatment of certain syndications or participations under the bank loan exception.¹³⁷

VI. Ten Percent Ownership Exception

As described above, an exception to the definition of portfolio interest applies for interest received by a "10-percent shareholder." This Section VI addresses the following issues associated with this 10-percent ownership exception: (i) whether, for interest paid to a lending partnership, the interest should be treated as "received" by the partnership or by the partner, and thus whether the requisite ownership should be determined at the partnership or partner level; (ii)

¹³⁵ This is consistent with the approach taken by the Service in Rev. Rul. 86-154, 1986-2 C.B. 103. In that ruling, the Service ruled on three different facts patterns presenting the issue of whether loans made by a foreign corporation ("FC") that conducted a banking business in the United States through two branches (A and B) gave rise to ECI. One of the factual situations addressed a situation analogous to a loan syndication. FC's head office solicited and negotiated directly with a multinational borrower for a loan facility to meet the multinational's global funding needs. It was contemplated that the multinational's U.S. subsidiary would have the right to draw down funds under the credit facility. FC's head office approved the terms of the facility with the intention that FC's various worldwide branches, including Branch A and Branch B, would participate in the funding of the facility. FC forwarded the loan documentation to Branch A, which then applied its normal credit review to the facility. Branch A then directed Branch B to do the credit review, following which Branch A's account officer negotiated directly with the U.S. subsidiary regarding the loan collateral. The Service ruled that Branch A and Branch B had actively and materially participated in the loan acquisition and that their share of the facility gave rise to ECI, notwithstanding that the head office was likewise an active and material participant. While the analogy is not perfect, Branch A and Branch B can be viewed as occupying roles similar to that of participating banks while FC's head office can be viewed as playing the role of lead bank.

¹³⁶ Compare Rev. Rul. 78-118, 1978-1 C.B. 219 (agreement characterized by the parties as a loan participation treated as a separate loan), with Rev. Rul. 81-251, 1981-2 C.B. 156 (loan participation treated as assignment of interest in underlying loan).

¹³⁷ Situations 4-6 of the sample revenue ruling examine syndication or participation arrangements.

the manner in which a partner's ownership interest in a borrowing partnership should be determined; and (iii) the time when a lender's ownership in a borrower should be tested for purposes of the 10-percent ownership exception.

A. Legislative Background and History

Section 871(h) defines "10-percent shareholder" to mean:

- (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or
- (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.¹³⁸

For purposes of determining ownership of stock in this context, section 871(h)(3) provides that the constructive ownership rules under section 318 apply with certain modifications. These modifications are:

- (i) section 318(a)(2)(C) [attribution from corporations] shall be applied without regard to the 50-percent limitation therein,¹³⁹
- (ii) section 318(a)(3)(C) [attribution to corporations] shall be applied without regard to the 50-percent limitation therein; however, in any case where a shareholder owns less than 50 percent of the stock in a corporation, this attribution rule will be applied to treat the corporation as owning any stock of such shareholder in the same proportion as such shareholder's ownership interest in the corporation,¹⁴⁰ and
- (iii) any stock which a person is treated as owning after the application of section 318(a)(4) [attribution with respect to options] shall not, for purposes of applying paragraph (2) [attribution from entities] and paragraph (3) [attribution to entities] of section 318(a), be treated as actually owned by such person.¹⁴¹

¹³⁸ I.R.C. § 871(h)(3)(B).

¹³⁹ Section 318(a)(2)(C) provides that a 50-percent or greater shareholder of a corporation will be treated as the constructive owner of its proportionate share of stock owned by the corporation for purposes of the provisions of the Code that invoke section 318.

¹⁴⁰ Section 318(a)(3)(C) provides that stock owned by a 50-percent or greater shareholder of a corporation will be treated as constructively owned by the corporation for purposes of the provisions of the Code that invoke section 318.

¹⁴¹ I.R.C. § 871(h)(3)(C). Section 318(a)(4) provides that stock options will be treated as exercised for purposes of the provisions of the Code that invoke section 318. It is noted that section 871(h)(3) also provides that "under regulations prescribed by the Secretary," rules similar to the constructive ownership rules described in the text above "shall be applied in determining the ownership of the capital or profits interest in a partnership" that is an obligor making interest payments potentially eligible for the portfolio interest exemption. Thus, the Code expressly mandates regulations interpreting the application of the contributive ownership rules in the case of a "10-percent
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The legislative history of the portfolio interest exemption contains only limited reference to the 10-percent ownership exception.¹⁴² In the 1984 Blue Book, however, the Joint Committee on Taxation explained the basis for the exception, indicating—

Congress did not believe it appropriate to repeal the 30-percent tax for interest paid to related foreign parties, because the combination of U.S. deduction and non-inclusion would create an incentive for interest payments that Congress did not intend.¹⁴³

and—

Interest is also not eligible for the [portfolio interest] exemption if it is paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the capital or profits interest in the partnership.¹⁴⁴

B. Application of the 10-Percent Ownership Exception at the Partner Level

There has been a significant amount of debate regarding the application of the 10-percent ownership exception to debt held by a lending partnership.¹⁴⁵ Despite the volume of commentary on the subject and specific requests for guidance indicating the importance of this issue to taxpayers,¹⁴⁶ however, the Service has not issued any published guidance on the subject.¹⁴⁷ For

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shareholder” of a partnership obligor under section 871(h)(3)(B)(ii). To date, the Treasury Department has not promulgated any regulations under section 871(h)(3).

¹⁴² S. Rep. No. 98-169, at 422-23.

¹⁴³ 1984 Blue Book, at 393-94.

¹⁴⁴ *Id.* at 395.

¹⁴⁵ See, e.g., Garlock § 17.04[C] (“there are worthy arguments for concluding ... that the test should be applied at the partner level”); William H. Newton, III, *International Income Tax & Estate Planning* § 409 n.133 (2001) (concluding that the 10-percent ownership exception should be applied at the partner level); Seth Entin, *The Treatment of Partnerships under the U.S. Portfolio Interest Exemption: Inconsistencies and Opportunities*, 31 Tax Notes Int’l 267 (July 21, 2003) (concluding that 10 percent ownership exception should be applied at the partnership level); Andrew Needham, *Special Problems with Debt Financing by Private Equity Funds*, 97 Tax Notes 1457 (Dec. 16, 2002) (“Whether the ownership test in fact applies at the fund level is not entirely clear.”); Robert J. Staffaroni, *Partnerships: Aggregate v. Entity and U.S. International Taxation*, 49 Tax Law. 55, 122-23 (1995) (application of the 10-percent ownership exception “should” be determined at the partner level).

¹⁴⁶ The ABA has asked for guidance on this exact issue before. See Letter to Jonathan Talisman from Pamela Olson, “Recommendations for the 2001 Treasury-IRS Guidance Priority List” dated January 18, 2001. The NYSBA also has asked for guidance on this issue. See NYSBA Report on Securitization Measures, at n. 60.

the reasons discussed below, we believe that the Service should publish a revenue ruling clarifying that the 10-percent ownership exception should be applied at the partner level. Thus, for interest paid to a partnership, the 10-percent ownership exception should be applied separately for each partner, based upon such partner's actual and constructive ownership of the debtor.

1. Statutory Framework

We believe the statutory framework of the portfolio interest exemption supports the application of the 10-percent ownership exception at the partner level. Sections 871(a) and 881(a), respectively, impose tax on certain U.S. source interest "received" by nonresident aliens and foreign corporations. Under sections 871(h) and 881(c), portfolio interest "received" by a nonresident alien or a foreign corporation is exempt from such tax. Sections 871(h)(3) and 881(c)(3) provide an exception to this portfolio interest exemption for interest "received" by a "10-percent shareholder."

The parallel nature of the language of sections 871(a), 871(h), and 871(h)(3), and 881(a), 881(c) and 881(c)(3) is apparent. The referenced provisions of section 871 focus on interest received by a nonresident alien, and the referenced provisions of section 881 focus on interest received by a foreign corporation. It would be inconsistent for the 10-percent ownership exception to exclude certain types of interest received by a lending partnership from the definition of portfolio interest, when only interest received by a nonresident alien or foreign corporation could fall within the general definition of portfolio interest (or, more generally, be subject to tax under section 871(a) or 881(a)).¹⁴⁸ We believe these provisions should be interpreted consistently, by treating interest paid to a lending partnership as received by the partners (i.e., nonresident individuals and foreign corporations) for purposes of the 10-percent ownership exception.¹⁴⁹

Some commentators have pointed out that the portfolio interest statute defines a 10-percent shareholder in terms of any "person" who owns the requisite interest in the debtor, and section 7701(a)(1) generally defines "person" for purposes of the Code to include a partnership.¹⁵⁰ This definition of "person," however, is explicitly inapplicable where it would be "manifestly incompatible with the intent [of the provision of the Code that contains the word "person"]."¹⁵¹ We believe the context in which the word "person" appears in the definition of 10-percent shareholder would make use of this general definition manifestly incompatible with the

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¹⁴⁷ The regulations promulgated under the portfolio interest exemption deal primarily with the registration requirement under Section 871(h)(5). *See, e.g.*, Treas. Reg. § 1.871-14.

¹⁴⁸ *See* Peaslee & Nirenberg, at 750, n. 51 (stating that the "portfolio interest exception is coterminous with the [withholding] tax" and so that interest should be "received" by a foreign investor when held through a partnership).

¹⁴⁹ *Cf.* 1994 FSA LEXIS 430; 1994 WESTLAW 1866354 (Feb. 2, 1994) ("it seems clear that the partners are the beneficial owners of the interest income" who are then subject to both the portfolio interest exemption and the 10-percent ownership exception).

¹⁵⁰ Entin, *supra* note 145, at 272-73; Needham, *supra* note 145, at 1457.

¹⁵¹ I.R.C. § 7701(a).

remainder of the statutory portfolio interest exemption, as described above. Thus, we believe the reference to “person” in the definition of a 10-percent shareholder should be interpreted to refer to the persons that are the subject of the relevant statute—a nonresident alien in the case of section 871 and a foreign corporation in the case of section 881.

Moreover, we do not believe the interpretation of the portfolio interest statute described immediately above is inconsistent with the recommended application of the bank loan exception described in Section V above.¹⁵² We believe that the partners of a lending partnership should be viewed as having “received” their shares of interest paid to a partnership for purposes of sections 871(h) and 881(c). The relevant relationship, for purposes of the 10-percent ownership exception, in the case of a partnership, is the relationship between any the recipient (the partner) and the debtor. Nonetheless, in determining whether a partner’s activities merit excepting its share of such interest from the portfolio interest exemption, we believe the activities of the entity that actually earns the income (i.e., the partnership) are the most relevant. Thus, it was recommended that the bank loan exception be applied to the partners of a partnership based solely on the activities of the partnership.¹⁵³

2. Field Service Advice

In the lone pronouncement by the Service on the present subject, the Service’s Office of Chief Counsel concluded in a Field Service Advice (the “FSA”) that the 10-percent ownership exception should be applied at the partner level.¹⁵⁴ The FSA involved a foreign corporation that was a partner of a foreign partnership, which in turn was a partner of a domestic partnership. The domestic partnership made convertible loans to various domestic limited partnerships.¹⁵⁵ The question posed was whether the foreign corporation’s allocable share of interest received on such convertible loans qualified for the portfolio interest exemption.

Although it acknowledged that section 318 effectively treats partnerships as entities by providing rules for the constructive ownership of stock owned by partnerships or their partners, the FSA noted that a “partnership is not a taxpayer[; instead] the partners are” and that “it seems clear that the partners are the beneficial owners of the interest income [at issue].”¹⁵⁶ As a result, the FSA concluded that the 10-percent ownership exception should be applied at the partner level.¹⁵⁷ Moreover, because options held by a partnership (in the form of convertible loans) are not attributed to a partner under the constructive ownership rules in section 871,¹⁵⁸ the FSA

¹⁵² In Section V, we concluded that the bank loan exception should be applied, for amounts paid to a partnership, by taking into account only the activities of the partnership.

¹⁵³ See *supra* note 129.

¹⁵⁴ 1994 FSA LEXIS 430.

¹⁵⁵ Although the FSA is heavily redacted, it is clear from the discussion that the loan was convertible into an equity interest of 10 percent or more of the debtor.

¹⁵⁶ 1994 FSA LEXIS 430.

¹⁵⁷ *Id.*

¹⁵⁸ I.R.C. § 871(h)(3)(C)(iii).

concluded that the foreign corporation in question was not a 10-percent shareholder, and its allocable share of interest paid by the debtor qualified for the portfolio interest exemption.¹⁵⁹

Some commentators have argued that the portfolio interest statute's limitation on the re-attribution of stock constructively owned pursuant to the option rule described immediately above indicates that the 10-percent ownership exception must be applied at the partnership level.¹⁶⁰ These commentators effectively conclude that failure to apply the exception at the partnership level would render the option attribution rule surplusage for options owned by a partnership, since stock ownership by the partnership would be irrelevant under a partner level determination and stock treated as owned by the partnership pursuant to the option rule would be disregarded in calculating ownership by the partners.¹⁶¹

Contrary to the commentators' view that the option rule may be salvaged by a partnership level application of the 10-percent ownership exception, however, we believe that the option rule's flaws run deeper. As others have recognized, application of the option rule to corporate and trust owners of options permits ownership arrangements that would seem to be targeted by the 10-percent ownership exception to avoid its sweep.¹⁶² Thus, a case can be made that statutory change may be necessary to address these concerns.¹⁶³ We do not believe, however, that these flaws should stand in the way of guidance generally applying the 10-percent ownership

¹⁵⁹ Although the issue involved the ownership of partnership capital or profits, the FSA stated, "Congress intended the rules for attribution of ownership in partnership debtors to parallel the rules for attribution of ownership in corporate debtors" and thus applied the principles of section 318, as modified by section 871(h)(3), to determine the ownership of the relevant partnerships. 1994 FSA LEXIS 430.

¹⁶⁰ Entin, *supra* note 145, at 277; *cf.* Needham, *supra* note 145, at 1459.

¹⁶¹ See Entin, *supra* note 145, at 277; *cf.* Needham, *supra* note 145, at 1459 ("At a more practical level, a literal reading of the FSA implies that a foreign owner of convertible debt representing more than 10 percent of the underlying voting stock may avoid the portfolio interest limitations by transferring a convertible debt claim to a partnership, including one in which it holds substantially all of the partnership interests. It is difficult to conceive that Congress could have intended this result." (footnote omitted)).

¹⁶² See, e.g., Sarah G. Austrian & Willys H. Schneider, *Tax Aspects of Foreign Investment in U.S. Real Estate*, 45 Tax Law. 385, 393 (1992) ("[A] planning opportunity involves issuance to an affiliate of the foreign-lending shareholder of an option to acquire stock of the borrower in excess of the 10% threshold. Although the issuance of such an option to a holder of portfolio debt would violate the 10% stock ownership rule, the issuance of such an option to an affiliate of the holder appears to be permissible." (footnote omitted)). Further, the option rule may result in excessive constructive ownership. According to the Service, constructive ownership is calculated by measuring only the stock actually outstanding and the particular option holder's optioned shares. Rev. Rul. 68-601, 1968-2 C.B. 124. *But cf.* Karen B. Brown, Portfolio 554-3rd T.M., *The Attribution Rules*, at A-16 n.107 (Tax Mgmt. 2003) (surveying cases adopting differing approaches). Adopting the Service's approach, options held by others are not counted in determining constructive ownership of a lender. Thus, where a significant amount of options are granted (typical in start-up and mezzanine financing), it is possible that foreign lenders constructively own 10-percent or more of the voting stock of the issuer even though such lenders are unlikely to ever actually own 10-percent or more of the voting stock of the issuer.

¹⁶³ *Cf.* Entin, *supra* note 145, at 277-78 (concluding that the Service may be able to treat the partners of a partnership that owns options as the owner of such options under an application of the abuse of entity rule under Treas. Reg. § 1.701-2(e)(2)). Please note that these comments are limited to providing analysis with respect to potential administrative guidance that may be issued by the Service and thus should not be read as advocating an amendment to the statute.

exception in a partnership context, and on this ground, we would follow the approach of the FSA.

3. Partnership-Level Characterization of Income Under Subchapter K

In drafting Subchapter K of the Code, Congress developed a comprehensive scheme for the taxation of partners that called on both the aggregate and the entity conceptions of a partnership.¹⁶⁴ Under a pure aggregate approach, each partner would be treated as the owner of an undivided interest in partnership assets and operations. Under a pure entity approach, the partnership would be treated as a separate entity, and the partners would have no direct interest in the partnership's assets and operations. Congress did not specifically address the treatment of a partnership as an aggregate or an entity (or some combination thereof) outside of Subchapter K, and thus one or the other (or some combination) approach may govern a given situation.¹⁶⁵

Under Subchapter K, the character of an item of partnership income or expense generally is “determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.”¹⁶⁶ Although it is not completely clear whether, in a given case, the specific characteristics of the partners should be taken into account in making such determination, in their treatise on partnership taxation, McKee, Nelson and Whitmire indicate, “those cases that have directly considered whether partnership items should be characterized at the partner or partnership level have generally concluded that the characterization question should be resolved at the partnership level.”¹⁶⁷ They further conclude, however, that “the partnership-level determination of ‘character’ is properly limited to the classification of individual partnership items” and thus does not involve a conclusion as to whether a particular item is taxable or not to a given partner; such determinations must be made at the partner level.¹⁶⁸

As set forth above, the determination of whether interest income generally is exempt from tax under section 871(h) or 881(c) is clearly determined at the partner level. Sections

¹⁶⁴ See, generally, McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 1.02[3] (“McKee Nelson”).

¹⁶⁵ Compare H.R. Conf. Rep. No. 83-2543, at 59 (1954) (“No inference is intended, however, that a partnership is to be considered as a separate entity for purposes of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.”); and Field Serv. Adv. 2000-26-009 (Mar. 23, 2000) (examining the purpose of a statute in determining whether an aggregate or entity approach should be applied), with *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11th Cir. 2002) (court concluded that outside of Subchapter K, the entity approach may be controlling absent specific statutory directive).

¹⁶⁶ See I.R.C. § 702(b) (“The character of any item of income, gain, loss, deduction, or credit included in a partner’s distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.”).

¹⁶⁷ McKee Nelson ¶ 9.01[4][a], at n.60. But see Rev. Rul. 89-72, 1989-1 C.B. 258 (applying section 702(b) to determine the character of partnership items, as if realized directly by the partners); see also McKee Nelson ¶ 9.01[4][c] (discussing Rev. Rul. 89-72).

¹⁶⁸ See McKee Nelson ¶ 9.01[4][b].

871(h) and 881(c) define portfolio interest in terms of interest received by a nonresident alien or foreign corporation, respectively, that would be subject to tax under section 871(a) or 881(c). The question may remain, however, whether interest must be properly “characterized” as portfolio interest *vel non* at the partnership level, without regard to the status or other characteristics of the partners, and then passed through in this form to the partners. We believe that the determination of whether interest qualifies as portfolio interest as a result of the 10-percent ownership exception should be determined by taking into account the relationship between the taxpayer at issue (i.e., the nonresident alien or foreign corporation) and the debtor.

Under sections 1441 and 1442, the type of income received is generally determined at the partnership level; nonetheless, withholding tax on income paid to the partnership generally is determined based upon the specific tax status of the partners. Thus, “as a general rule, a payment to a foreign partnership is treated as a payment directly to the partners.”¹⁶⁹ Meanwhile, in the case of a payment to a domestic partnership, or a withholding foreign partnership, the obligation to withhold is passed on to the partnership, which determines the applicable withholding tax based upon the specific characteristics of the partner (as if this person “received” its share of items paid to the partnership).¹⁷⁰ If a pure entity approach were adopted, then neither a payment to a domestic partnership nor a payment by such an entity would be subject to tax under section 1441 or 1442, since a payment to such an entity would not constitute a payment subject to withholding tax under section 1441 or 1442,¹⁷¹ and a distribution by a partnership is generally non-taxable under section 731.

Further, we note that the recent “Brown Group” regulations adopt an approach similar to that adopted here for purposes of applying subpart F to a controlled foreign corporation that is a partner in a partnership. Under those regulations, for transactions between such a partnership and a third party, “if a provision of subpart F requires a determination of whether an entity is a related person . . . this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership.”¹⁷² The preamble to this regulation indicates, “For purposes of applying the policies of subpart F, which focus in part on whether income is being shifted between a CFC and a related entity . . . the IRS and Treasury believe it is appropriate to make the determination of whether an entity is a related person with respect to the CFC . . . at the CFC partner level.”¹⁷³ We believe a similar policy motivated the 10-percent ownership exception and this same approach should be adopted with respect to such exception,

¹⁶⁹ T.D. 8734, 1997-2 C.B. 109. *See also* 1994 FSA LEXIS 430 (focusing on the partners of a lending partnership as the beneficial owners of interest paid to the partnership).

¹⁷⁰ Interest received by a domestic partnership is not subject to withholding when received by a domestic partnership. Treas. Reg. § 1.1441-5(b)(1). Instead, the domestic partnership must pay withholding tax at the earlier of (i) any actual distribution of such interest income, (ii) the date the statement required under section 6031(b) is mailed or otherwise provided to the partner or (iii) the due date for furnishing the statement. Treas. Reg. § 1.1441-5(b)(2)(i)(A).

¹⁷¹ Section 1441 imposes withholding tax on certain payments to nonresident aliens and, except as provided in regulations, foreign partnerships. Regulations under section 1441 generally look through foreign partnerships to their partners for purposes of the section 1441 withholding tax. *See* Treas. Reg. § 1.1441-5. Section 1442 imposes withholding tax on certain payments to foreign corporations.

¹⁷² Treas. Reg. § 1.954-1(g)(1).

¹⁷³ Preamble to T.D. 9008, 2002-2 C.B. 335, 336.

i.e., the 10-percent ownership exception should be applied at the partner level by taking into account the partner's actual and constructive ownership interest in the debtor.

4. Policy Reasons to Apply the 10-Percent Ownership Exception at the Partner Level

Congress' main focus in enacting the portfolio interest exemption was to reduce U.S. taxpayers' costs of borrowing funds from nonresident aliens and foreign corporations. According to the 1984 Blue Book, however, in enacting the portfolio interest exemption, Congress felt that it would be inappropriate to repeal the U.S. withholding tax on interest paid to "related foreign parties" based on a view that the combination of a deduction for interest and an exemption from withholding tax "would create an incentive for interest payments that Congress did not intend."¹⁷⁴ The 10-percent ownership exception thus may be viewed as a first statutory attempt to prevent earnings-stripping.¹⁷⁵

Currently, a significant amount of investment (both equity and debt) in the United States is made through large investment funds¹⁷⁶ organized as partnerships and so treated for U.S. federal tax purposes. We believe that interpreting the 10-percent ownership exception to require a partnership level determination of ownership would significantly disadvantage these types of investors and could lead to application of withholding tax in many situations in which neither the partnership nor the affected partners has any voting or other interest in the debtor—plainly in conflict with the policy underlying the portfolio interest exemption.

As set forth above, under section 871(h)(3), a 10-percent shareholder is defined as any person who owns 10 percent or more of the total combined voting power of all classes of voting

¹⁷⁴ 1984 Blue Book, at 393-94.

¹⁷⁵ The earnings-stripping rules under section 163(j), originally enacted five years after the portfolio interest exemption, bear a somewhat complementary relationship to the 10-percent ownership exception. Section 163(j) denies a tax deduction for interest paid by a U.S. borrower, while the 10-percent ownership exception may result in withholding tax being imposed on such payment. To the extent interest is subject to withholding tax as a result of the application of the 10-percent ownership exception, however, it generally is not also subject to disallowance as a tax deduction under section 163(j). Unlike the 10-percent ownership exception, the threshold relationship between debtor and creditor under section 163(j) focuses on overlapping economic interests and is significantly higher (50%) than that required under section 871(h)(3). In determining whether the required relationship is satisfied in the case of a partnership creditor, the statute provides a modified look-through rule depending upon the tax status of the partners. *See* I.R.C. § 163(j)(4)(B)(i) ("Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer."). There is no coordination between sections 163(j) and 871(h)(3), however, on this point. Further, it is noted that under proposed legislation the provisions of section 163(j) would apply to partnership debtors. *See* Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 462 (2003). Under this approach, interest paid or accrued by a partnership to a person related to the partnership may be nondeductible as to all partners; thus all partners would bear the burden of the application of the earnings stripping rules under this proposed legislation, whereas under section 871(h)(3) only the related partner bears such burden (in the form of withholding tax on interest it, or a related person, receives).

¹⁷⁶ *See, e.g.*, Recent Developments in Hedge Funds, 108th Cong., 1st Sess. (Comm. Print 2003) (statement of Sen. Jon S. Corzine (D-NJ)) ("Hedge funds represent a \$600 billion industry.").

stock of a corporation entitled to vote. Stock ownership for purposes of this definition includes constructive ownership under, *inter alia*, section 318(a)(2)(A) (attribution from partnership) and 318(a)(3)(A) (attribution to partnership). Under the former constructive ownership rule, stock owned by a partnership is treated as constructively owned by its partners, in proportion to their ownership interests in the partnership. Under the latter constructive ownership rule, stock owned by a partner is treated as constructively owned by a partnership (i.e., attribution is total, not partial, and does not depend upon the size of the partner's interest in the partnership).

Example 1: Each of ten, unrelated U.S. citizens (together, the "U.S. citizens") owns 1 percent of the stock of a publicly-traded domestic corporate issuer of debt ("Issuer"). Each of the U.S. citizens also owns a 0.1% limited partner interest in a large hedge fund organized as a foreign partnership ("PS") whose general and limited partners, other than the U.S. citizens, are nonresident aliens and foreign corporations unrelated to the U.S. citizens. PS invests certain of its funds in medium term bonds selected by its managers, including a debt obligation issued by Issuer. Neither PS nor any of its partners, other than the U.S. citizens, owns any stock of Issuer.

Notwithstanding the fact that none of the U.S. citizens in Example 1 has a significant interest in either Issuer or PS, and notwithstanding the fact that none of the foreign investors in PS has any voting or other interest in Issuer, if the 10-percent ownership exception were applied at the partnership level, PS would be treated as a 10-percent shareholder of Issuer, and the foreign partners' shares of interest paid by Issuer would not qualify for the portfolio interest exemption. In effect, the participation of the U.S. citizens in PS has tainted their foreign partners (who are effectively attributed their partners' ownership in Issuer),¹⁷⁷ and the minimal, relatively investment of the U.S. citizens in each of PS and Issuer may cause PS to decline to purchase debt obligations of Issuer. By contrast, under a partner level determination, none of the foreign partners in PS would be treated as the constructive owner of any stock of Issuer, and each would be entitled to receive its share of the interest paid by Issuer free from withholding tax. We believe the partner level approach appropriately focuses on the actual or constructive ownership of the affected taxpayers.¹⁷⁸

We note that policy reasons also have been cited in favor of a partnership level application of the 10-percent ownership exception. At least one commentator has concluded that a partner level determination would permit nonresident aliens or foreign corporations, acting

¹⁷⁷ This effect is sometimes referred to as "sidewise" attribution. We note that section 318(a)(5)(A) was enacted in 1964 to prevent, among other things, stock attributed to a partnership from one partner, under section 318(a)(3)(A), from being re-attributed to another partner, under section 318(a)(2)(A). *See* I.R.C. § 318(a)(5)(A); *see also* S. Rep. 88-1175, at 7 (1964) ("Your committee concluded, since there is no basis either in family relationship or in common economic interest for the application of these two attribution rules at the same time, that sidewise attribution should be eliminated from the constructive ownership rules of present law.").

¹⁷⁸ *See also* the examples set forth in Garlock at § 17.04[C], and the NYSBA Report on Securitization Measures, at 48; *cf.* NYSBA Report on Securitization Measures, at 47-49 (asking the Service to publish guidance indicating that even if the 10-percent ownership exception is applied at the partnership level, a partnership's constructive ownership of stock owned by a given partner will not be taken into account in determining whether the partnership is a 10-percent shareholder for purposes of determining another partner's share of interest earned by the partnership).

together, to loan funds to a borrower they control in conflict with the 10-percent ownership exception.¹⁷⁹ The example cited is a partnership of eleven unrelated foreign persons who form an equal partnership that both (i) owns all of the stock of a U.S. corporation and (ii) loans funds to such corporation. Under the example, a partner level application of the 10-percent ownership exception may permit the investors to receive interest from the U.S. corporation that is exempt from tax.¹⁸⁰

We do not believe that the example cited necessarily presents a case of abuse. The statute expressly permits a lender that owns less than 10 percent of the equity of a U.S. borrower to receive interest free of tax under the portfolio interest exemption.¹⁸¹ Thus, if eleven unrelated foreign persons own equal shares of the outstanding stock of a U.S. corporation and make loans to such corporation, they would be permitted to receive interest on such loans without imposition of tax. We question why it necessarily would be abusive for these eleven persons, for example, to form a partnership to hold their debt and equity investments in the corporation—provided each partner had rights with respect to the partnership that were closely analogous to its former, direct rights in the stock of the corporation.¹⁸² If their rights with respect to the partnership were not so closely analogous, the partners who had a greater share in the partnership may be subject to tax on their shares of any interest paid by the corporation.¹⁸³ We believe that this is an appropriate result and one that comports with the language and intent of the portfolio interest exemption.

¹⁷⁹ Entin, *supra* note 145, at 277.

¹⁸⁰ *Id.*

¹⁸¹ I.R.C. §§ 871(h)(3)(A), 881(c)(3)(B).

¹⁸² We note that a different result would obtain if the partners caused the partnership to be treated as a corporation under the entity classification (“check-the-box”) regulations, since the 10-percent ownership exception would then be applied at the corporate level. We believe this different result is justified and required under the statute, which imposes tax directly on organizations or entities treated as corporations (but not on organizations or entities treated as partnerships) for U.S. federal tax purposes.

¹⁸³ As indicated above, the focus of the 10-percent ownership exception in the context of a corporate borrower is on ownership of voting power of the borrower’s voting stock. Under section 871(h)(3) and 318(a)(2)(A), stock owned by a partnership is considered as owned “proportionately” by its partners. Thus, in determining the partners’ “proportionate” ownership of the voting power of voting stock owned by the partnership in this context, the question arises whether the voting power of the partners in the partnership is relevant. We believe that partners’ proportionate ownership generally should be determined based upon the greater of their proportionate ownership of partnership capital or profits. See Advisory Committee on Subchapter C of the Internal Revenue Code of 1954, 85th Cong., Revised Report on Corporate Distributions and Adjustments, at 26 (Ways & Means Comm. Print 1959) (recommending that section 318(a)(2)(A) be amended to reflect this method of computing proportionate ownership). We note that other commentators have expressed other views, however. See Entin, *supra* note 145, at 277; cf. Garlock § 17.04[C] (“[H]ow would one apply the ‘voting’ portion of the test at the partner level? If the partnership is a limited partnership, and the partner is a limited partner, so that the partner has no voice in how the partnership exercises its voting rights, does this mean that the partner does not own any voting rights?”). We also note that, in other contexts, commentators also have recommended other approaches. Compare Dirk J.J. Suringa, Portfolio T.M. 922-2nd, *Foreign Personal Holding Companies*, at A-7 to A-8 (Tax Mgmt. 2001) (describing a proposed approach to determination of a partner’s proportionate ownership of voting power of voting stock owned by a partnership under the foreign personal holding company rules), with Brown, *supra* note 162, at A-40 (considering the same issue but indicating, “Lack of guidance in this area leaves it uncertain whether proportionality would be based upon pure voting rights or upon a facts and circumstances test which would examine a number of factors, including special allocation of profit and loss.”).

Moreover, we do not believe a partnership level application of the 10-percent ownership exception would be necessary or sufficient to address the concerns expressed by the commentator. Consider, as alternative examples, (i) as set forth above, eleven unrelated foreign persons directly (or through a grantor trust) own equal shares of the debt and equity of a U.S. borrower, (ii) a partnership formed by such persons owns the equity of the U.S. borrower, but the partners (and not the partnership) directly own the debt of the borrower,¹⁸⁴ or (iii) a partnership formed by such persons owns both the debt and the equity of the U.S. borrower, but the partnership distributes the debt to the partners before any interest is received.¹⁸⁵ In each case, the commentator's concerns appear to be implicated, yet application of the 10-percent ownership exception at the partnership level would not alter the result. We believe that any concern regarding foreign taxpayers acting together through a partnership to make loans to a controlled entity are more properly addressed through interpretation of generally applicable anti-abuse rules and the general earnings stripping rules.

5. Summary

We recommend that the 10-percent ownership exception for the portfolio interest exemption be applied at the partner, not the partnership, level. Please see the Appendix, at A-20, for an example of a possible revenue ruling consistent with this recommendation.

C. General Guidance Regarding Time for Testing 10-Percent Ownership

As described above, sections 871(h)(3) and 881(c)(3) exclude interest "received" by a 10-percent shareholder from the definition of portfolio interest. Because interest may accrue over time, and because some have argued that the 10-percent ownership exception is focused on a lender's ability to control the borrower (which may be particularly relevant at the time a loan is made), there may be some uncertainty regarding the time for determining whether a particular recipient of interest satisfies the 10-percent shareholder definition. Nonetheless, we believe that the statute requires that the relevant ownership interest be measured at the time of actual receipt of interest potentially qualifying for the portfolio interest exemption.¹⁸⁶ For this purpose, we believe "receipt" should be interpreted to include the receipt of proceeds from the disposition of a debt obligation, to the extent such proceeds are properly treated as satisfying accrued interest under existing authorities.¹⁸⁷ Although withholding generally is not required by a purchaser of a debt obligation between interest payment dates, the withholding tax regulations recognize that the seller of a debt obligation may have substantive tax liability under section 871 or 881 with respect to the amount of any sales proceeds treated as interest.¹⁸⁸ We believe this conclusion is

¹⁸⁴ If the partners were the actual lenders, they would each constructively own less than 10 percent of the voting stock of the borrower and the 10-percent ownership exception would be inapplicable. *See* I.R.C. § 318(a)(2)(A).

¹⁸⁵ *See* I.R.C. § 871(h)(3)(A); *see also* Needham, *supra* note 145, at 1459 (providing a similar example).

¹⁸⁶ This report does not address issues relating to constructive receipt or other situations where interest is deemed paid, such as a result of a section 482 adjustment. *See, e.g., Central de Gas de Chihuahua, S.A. v. Commissioner*, 102 T.C. 515 (1994); *see also* Treas. Regs. §1.1441-2(e)(2).

¹⁸⁷ *See* Treas. Reg. § 1.61-7(c), (d) ("When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income.").

¹⁸⁸ *See* Treas. Reg. § 1.1441-3(b)(2) ("A withholding agent is not required to withhold under section 1.1441-1 upon interest accrued on the date of a sale or exchange of a debt obligation when that sale occurs between two
(continued...)")

appropriate and that the seller's status as a 10-percent shareholder should be determined at the time of such "receipt."

D. Guidance Regarding Manner of Testing Partnership Ownership

As set forth above, in the case of an obligation issued *by* a partnership, a 10-percent shareholder is defined as any person who owns 10 percent or more of the capital or profits interests in the partnership.¹⁸⁹ Neither the Code nor the regulations provides any guidance on how to determine a partner's capital or profits interest in a partnership for this purpose.¹⁹⁰ We believe that there are two main areas of uncertainty with respect to this aspect of the definition of a 10-percent shareholder: (i) when to determine a partner's capital or profits interest when such interest changes during the year due to contributions, distributions or sales, and (ii) how to determine a partner's profits interest when such interest changes during the year pursuant to its terms.¹⁹¹ The discussion below focuses on the case of a partnership borrower and assumes that the relevant loan by a partner to the partnership is respected as debt for federal income tax purposes and that interest payments are treated as interest on the debt, and not as guaranteed payments for contributed capital.¹⁹²

(continued...)

interest payment dates (even though the amount is treated as interest under section 1.61-7(c) or (d) and *is subject to tax under section 871 or 881*)." (emphasis supplied).

¹⁸⁹ I.R.C. §§ 871(h)(3)(B)(ii) and 881(c)(3)(B). It is again noted that the 30-percent tax imposed by sections 871 and 881 generally applies to "U.S. source" fixed or determinable annual or periodical income. Unlike the determination of whether interest paid by a corporation arises from a source within the United States, which is generally (with a few exceptions) based upon the place of incorporation or organization of the corporation, the determination of whether interest paid by a partnership arises from a source within the United States is determined under current law based upon whether the partnership is engaged in trade or business in the United States at any time during the year of payment (without regard to the place of organization of the partnership). *See* §§ 861(a)(1), 862(a)(1); Treas. Reg. § 1.861-2(a)(2). *But cf.* American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 1090 (2003) (proposing to conform the source rule for payments of interest by foreign partnerships to the source rule for payments of interest by foreign corporations); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 228 (2003) (same). Because this partnership source rule is not always immediately apparent, we have described it here for reference and in order to frame the analysis that follows.

¹⁹⁰ Capital interests are generally defined through a deemed liquidation analysis. *See* Rev. Proc. 93-27, 1993-2 CB 343 (defining a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership," and a profits interest as "a partnership interest other than a capital interest"); *see also* Treas. Reg. § 1.704-1(e)(1)(v) (defining capital interest in a partnership for purposes of section 704(e) consistent with the foregoing definition).

¹⁹¹ We believe the principles discussed in the text also are relevant in determining a partner's proportionate ownership of the voting power of voting stock owned by a partnership under sections 871(h)(3) and 318(a)(2)(A). *See supra* note 183.

¹⁹² *See* Treas. Reg. § 1.707-1(a) ("A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership [and] the sale of property by the partner to the partnership"); *see also* McKee Nelson, ¶ 13.02[1] ("There is a potential overlap between the Regulations under section 707(a), indicating that a loan by a partner (not acting in his capacity as a partner) to a partnership is a section 707(a) transaction, and section 707(c),
(continued...)

1. Fixed Capital or Profits Interests

Where a partnership interest represents a fixed, unvarying interest in partnership capital or profits, but that interest changes as the result of an event, the main question relates to the time at which a partner's capital or profits interest should be determined. As indicated above, we believe that the Service should issue guidance that clarifies that a partner's capital or profits interest is tested at the time of the partner's actual receipt of the interest potentially qualifying for the portfolio interest exemption. In this manner, if a partner's capital or profits interest changes during the year because of the sale of part of the partner's interest, the purchase of an additional interest, or the admission or withdrawal of another partner, the partner's capital or profits interest should be re-tested at each such time and the resulting interest should be applicable for purposes of applying the portfolio interest exemption to any interest received after the change. The partner's share of any interest deduction, which may depend upon proper application of section 706(d), would be ignored. This approach may be illustrated by the following examples.

Example 2: At the beginning of year 1, Partner A, a nonresident alien individual, makes a loan to ABC partnership, with interest paid semi-annually on March 1 and September 1. When the loan is made, Partner A holds a 15-percent interest in partnership capital and profits. On June 1 of year 1, Partner A sells a portion of his partnership interest, representing 8 percent of partnership capital and profits, to an unrelated individual.

Partner A would be a 10-percent shareholder with respect to the interest payment on March 1 of year 1. Partner A would not be a 10-percent shareholder with respect to the interest payment on September 1 of year 1, even though (i) a portion of that payment accrued before Partner A sold part of his interest (i.e., while Partner A still held a greater than 10 percent interest), and (ii) under section 706(d), Partner A would be entitled to (A) 15 percent of the interest deduction with respect to the period ending on June 1 and (B) 7 percent of the interest deduction with respect to the period beginning thereafter. Therefore, the March 1 interest payment would not be treated as portfolio interest, but the September 1 interest payment may be.

Example 3: The facts are the same as Example 2, except that Partner A does not sell part of his interest on June 1. Instead, a new partner contributes funds to the partnership on June 1 of year 1 in exchange for a 50-percent interest in partnership capital and profits. Following the admission of the new partner, Partner A would have only a 7.5 percent interest in partnership capital and profits.

As with Example 1, Partner A would be a 10-percent shareholder with respect to the interest payment on March 1 of year 1, but not with respect to the interest payment on September 1 of year 1. Please see the Appendix, at A-22, for an example of a possible revenue ruling consistent with the foregoing.

(continued...)

which applies to payments for the 'use of capital.' This conflict should be resolved by treating interest on *loaned* capital under section 707(a), and treating payments (computed like interest) on *contributed* capital under section 707(c).").

2. Varying Profits Interests

The determination of a partner's profits interest becomes more difficult where a partnership interest does not represent a fixed, unvarying interest in partnership profits. For example, partners in a service partnership often determine their profit allocations after the end of the year, in reliance on section 761(c).¹⁹³ A partnership agreement also may provide for a sharing of different types of income in different percentages, such as where a partner is entitled to 5 percent of management fees and 10 percent of performance fees earned by an investment advisory partnership. A partnership agreement also may build in different profit percentages during different time periods. For example, many investment fund agreements provide for a sharing of profits in accordance with capital contributions (often made 99 percent by the limited partners and 1 percent by the general partner) until the limited partners have received a return of their capital contributions, and thereafter 80 percent to the limited partners and 20 percent to the general partner. The determination of a partner's profits interest in any of the above situations would be further complicated by the sale of a portion of the partner's interest or the admission or withdrawal of another partner during the year.

These are relatively common issues under Code provisions that refer to a partner's interest in partnership profits;¹⁹⁴ nonetheless, they generally remain unresolved. There are several possible approaches. First, a partner's profits interest may be determined based on a reasonable estimate of all future profit allocations. For example, under the 1960 entity classification ("Kintner") regulations,¹⁹⁵ continuity of life did not exist if the death, retirement or other withdrawal of a general partner of a limited partnership caused the dissolution of the partnership, notwithstanding the fact that dissolution could be avoided by a vote of at least a "majority in interest" of the remaining partners. For this purpose, a majority in interest meant the holders of a majority of capital and profits, and "profits are determined and allocated based on any reasonable estimate of profits from the date of the dissolution event to the projected termination of the partnership, taking into account present and future allocations of profits under the partnership agreement that is in effect as of the date of the dissolution event."¹⁹⁶

A more administrable alternative for resolution of the present issue may be to determine a partner's profits interest based on the partner's share of items of partnership income and gain,

¹⁹³ I.R.C. § 761(c) provides that a partnership agreement may be amended at any time until the filing of the partnership tax return (determined without extensions). *See also* Treas. Reg. § 1.761-1(c) ("A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return.").

¹⁹⁴ *See, e.g.*, I.R.C. § 708(b)(1)(B) (termination of partnership if, within 12-month period, there is a sale or exchange of 50 percent or more of total interest in partnership capital and profits); I.R.C. § 707(b)(1) (denying losses on sales or exchanges of property between a partnership and a person owning more than 50 percent of the capital or profits interest in the partnership, or between two partnerships in which the same persons own more than 50 percent of the capital or profits interests); I.R.C. § 706(b) (partnership taxable year is the taxable year of one or more partners holding an aggregate interest in partnership profits and capital of more than 50 percent, or taxable year of all partners having an interest of 5 percent or more in partnership profits or capital).

¹⁹⁵ T.D. 6503, 1960-2 C.B. 409.

¹⁹⁶ Rev. Proc. 94-46, 1994-2 C.B. 688. *See* McKee Nelson ¶ 12.03[2][b], at 12-14 n.57 (considering this a "reasonable approach" to follow in the context of partnership terminations under section 708(b)(1)(B)).

reduced by its share of items of partnership deduction and loss, for the year in which the interest payment is received. A third alternative would temper this rule by determining what the relevant partner's share would have been disregarding any changes occurring as a result of admissions, withdrawals or dispositions of partnership interests occurring after the actual receipt of the interest at issue. Under current law, it is not clear whether one of the foregoing (or another) approach should apply for purposes of determining a 10-percent shareholder of a partnership obligor under sections 871(h)(3) and 881(c)(3)(B). Although we believe this question may not be susceptible of final resolution in the present context, we believe the Service should consider creating a safe harbor for the determination of a partner's profits interest.

Assuming no admissions, withdrawals or dispositions of partnership interest during a year, such a safe harbor could reasonably be based upon *actual* allocations of partnership income and loss for the entire year. For example, under such circumstances, so long as a given partner with a stated interest of less than 10 percent in the capital of a partnership received an allocation of less than 10 percent of the net amount of the partnership's items of income and gain, reduced by items of loss and deduction, for the year (and such allocations had substantial economic effect), the partner would not be considered a 10-percent shareholder of the partnership for that year. Of course, such a safe harbor may require hindsight to apply, which may not be available at the time the withholding agent makes the payment potentially subject to withholding tax. Nonetheless, we believe that taxpayers would benefit from such a rule, since it may be possible to determine with some certainty at the time of payment that the payee will satisfy such test.¹⁹⁷ Moreover, such a safe harbor would provide certainty on the question of substantive taxation and would enable a foreign partner subjected to withholding to obtain a refund if the partner's profits interest was ultimately determined to have been below 10 percent at the time of actual receipt.¹⁹⁸

¹⁹⁷ We believe the Service also should consider adopting an approach to withholding in connection with this safe harbor similar to the approach taken in the withholding regulations in connection with dividend payments. With respect to dividend withholding, a distributing corporation or intermediary may elect not to withhold on a distribution if, based on a "reasonable estimate," the distributing corporation or intermediary determines that the distribution is not paid out of current or accumulated earnings and profits. See Treas. Reg. § 1.1441-3(c)(2)(i)(C). Similarly, in connection with the proposed safe harbor, a domestic partnership could elect not to withhold on a payment of interest to a foreign partner if, based on a "reasonable estimate," the foreign partner's interest in the partnership would entitle the partner to less than 10 percent of partnership profits for that year.

¹⁹⁸ See Treas. Reg. § 1.1441-1(b)(8).

Appendix

**Example of Possible Revenue Ruling on Definition of Registered Form
With Respect to Obligations Not Formally Evidenced/Documented**

Rev. Rul. 2004-XX

ISSUE

Is interest in the following situations paid with respect to obligations in “registered form” for purposes of Section 871(h)(2)(i) of the Internal Revenue Code?

FACTS

Situation 1: X is a U.S. broker/dealer regulated by the Securities and Exchange Commission, a U.S. futures commission merchant regulated by the Commodities Futures Trading Commission, or both. Y is a customer of X and is a nonresident alien or foreign corporation that is not engaged in a trade or business in the United States.

Y conducts trading activities on margin. Under the rules of the relevant securities and/or commodities market, as well as X’s own house rules, Y is required to keep funds on deposit with X in order to meet margin calls. X and Y have agreed that X will pay Y interest on Y’s funds on deposit with X, at a rate determined with reference to current money market conditions. The brokerage agreement between X and Y identifies Y by name, and provides that X shall not be obligated to recognize any person other than Y as having an interest in Y’s account unless Y notifies X, in the manner set forth in the brokerage agreement, that Y has transferred the account.

Situation 2: A is a nonresident alien or foreign corporation that is not engaged in a trade or business in the United States. A invests in the U.S. securities markets through B, a U.S. broker, and derives interest, dividend and capital gain income with respect to A’s investments. In Year 1, A files suit in a United States court, or initiates arbitration proceedings, against B, claiming that B has violated U.S. securities laws, applicable state laws or both. In Year 2, either the court renders judgment in favor of A, the arbitration tribunal grants an award in favor of A, or A and B reach a settlement of A’s claims. In all cases, the judgment, award or settlement provides that A is to receive both pre-judgment and post-judgment interest with respect to A’s claims.

Situation 3: C is a nonresident alien or foreign corporation that is not engaged in a U.S. trade or business. C owns stocks and bonds that generate U.S.-source dividends and interest. Under a double taxation treaty between C’s country of residence and the United States, dividends received by C with respect to C’s stock investments generally are subject to 15% withholding tax. All of C’s bond investments generate interest income generally qualifying for exemption from U.S. tax under the portfolio interest exemption of section 871(h). C did not duly certify his foreign status and right to treaty benefits, and so the withholding agent withheld tax at the 30% rate. C filed a claim for refund of the excess tax withheld. C’s claim was allowed and overpayment interest paid to the extent provided in section 6611.

LAW AND ANALYSIS

Sections 871(a)(1) and 881(a)(1) generally provide that nonresident aliens and foreign corporations are subject to tax at a 30% rate on interest received from sources in the United States, unless an income tax treaty or exception under domestic law is available. Sections 1441(a) and 1442(a) provide that persons having control, receipt, custody, disposal or payment of such interest must deduct and withhold such tax at the source.

Sections 871(h) and 881(c) provide an exemption from tax, and sections 1441(c)(9) and 1442(a) provide an exemption from withholding, for “portfolio interest.” One of the requirements for interest to qualify as portfolio interest is that either the obligation must be in bearer form, and issued under certain conditions reasonably designed to ensure that it will not be sold to U.S. persons, or the obligation is issued in “registered form” and a prescribed statement is obtained that the beneficial owner is not a United States person.

Section 1.871-14(c)(1)(i) provides that an obligation is treated as an obligation in registered form if –

(A) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;

(B) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) described in this paragraph (c)(1)(i)(B). An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation, is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation; or

(C) It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in paragraph (c)(1)(i)(A) or (B) of this section.

The legislative history of the portfolio interest rules indicates that Congress was particularly concerned about the proliferation of long-term bearer debt obligations that could be used to facilitate tax avoidance. The expressed purpose behind the registration requirement was to ensure that U.S. persons could not use the portfolio interest rules to avoid U.S. tax by acquiring interests in obligations that could not be readily traced, e.g., through 1099 reporting, and thus avoid backup withholding tax.

Nonetheless, under generally applicable contract law, the holder of rights under a contract generally may validly assign its rights to a third party. See Restatement (Second) of Contracts, §322. Since it often is not possible for an obligor to prevent an obligee from so assigning its rights, no obligations could be in registered form if the possibility of a private assignment were considered an impediment to treatment of the obligation as in registered form. This result could

not have been intended by Congress. For the same reasons, transfers by operation of law, such as in connection with a merger, a bankruptcy, or the administration of a decedent's estate must be disregarded in determining whether an obligation is in registered form. See, e.g., Uniform Probate Code §3-711, 8 Del. C. §259, 11 U.S.C. §541.

In light of the practical limitations of restrictions on assignments of debt obligations, satisfaction of the legislative goal behind the registration requirement requires that it must be possible to determine, from the records of the issuer or its agent, the identity of *the person* to whom the issuer may make payment in full satisfaction of its payment obligations. If the issuer may make payment to that person in full satisfaction of its obligations, and a transferee of that person who has not been identified to the issuer may not later make a successful claim against the issuer for payment, the issuer and its transferee have a strong incentive to follow the restrictions on transfer set forth in terms of the obligation. In such a case, the registration requirement generally is satisfied.

By contrast, a negotiable instrument or other instrument payable to bearer is not in registered form, since the issuer's knowledge of the identity of its holder at any given time is largely irrelevant—the issuer may make payment in satisfaction of the obligation only to a person properly presenting the instrument for payment. Thus, a transferee or assignee of such an instrument may obtain full benefits of ownership without notice to the issuer; can enforce the obligation directly against the issuer without the participation of any named owner; and thus may fail to identify itself to the issuer without any concern that such failure may diminish its right to payment. This is precisely the situation Congress intended to address when it enacted the registration requirement.

In each of the three situations set forth above, the identity of a person to whom the issuer may make payment in full satisfaction of its obligation may be determined from the records of the issuer or his agent at all times. In Situation 1, by the terms of the brokerage agreement, X is obligated to pay Y, and only Y, unless X receives notice from Y in the manner set forth in the agreement. A payment to Y would relieve X of any further payment obligations. In Situation 2, A, as the plaintiff of record, is the only person entitled to present its claim against B. In Situation 3, C, and only C, is entitled to receive the tax refund, including any interest thereon. See Assignment of Claims Act.

HOLDINGS

In each of Situation 1, Situation 2, and Situation 3, the interest is paid with respect to an obligation in “registered form” for purposes of section 871(h)(2)(i) of the Internal Revenue Code. No inference is intended as to whether these obligations are “registration-required obligations” within the meaning of sections 149(a)(2), 163(f), 165(j)(2), 312(m), 1287, or 4701.

Example of Possible Revenue Ruling on Application of Registered Form Requirement to Promissory Notes

Rev. Rul. 2004-XX

ISSUE

Whether the promissory note described below constitutes an obligation “in registered form” within the meaning of section 881(c)(2)(B) of the Internal Revenue Code.

FACTS

X is a domestic corporation. X purchases personal property from foreign corporation Y, which is not engaged in trade or business in the United States. X pays an amount to Y in cash and delivers its promissory note (the “Note”) for the balance of the agreed purchase price at closing. The Note provides standard commercial terms, including quarterly interest payments at a fixed rate and provides a fixed maturity date for repayment of the principal amount. The Note bears a notation that it is not negotiable and contains the following statement:

This instrument is registered as both principal and interest with the issuer and any transfer of the instrument may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder. Transfer of the instrument at any time by any means other than the method described in the paragraph shall be deemed null and void.

LAW AND ANALYSIS

Section 881(a)(1) and (3) imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest or original issue discount.

Section 881(c) provides that no tax shall be imposed under paragraph (a)(1) or (3) in the case of any portfolio interest received by a foreign corporation from sources within the United States.

Section 881(c)(2) defines the term “portfolio interest” to mean any interest (including original issue discount) that would be subject to tax under section 881(a), which is paid on an obligation in bearer form and is described in section 871(h)(2)(A), or is paid on an obligation in registered form and the person who would otherwise be required to deduct and withhold tax under section 1442(a) receives a statement that the beneficial owner of the obligation is not a United States person.

Section 881(c)(7) provides that the term “registered form” shall have the same meaning given to that term by section 163(f).

Treasury Regulation section 1.871-14(c)(1)(i) defines the term “registered form” by reference to Treasury Regulation section 5f.103-1, which provides, *inter alia*, that an obligation is in registered form if it is registered as to both principal and interest with the issuer (or its

agent) and transfer of the obligation may be effected only by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder.

Because the transfer restriction that appears on the face of the note complies with the requirements of Treasury Regulation section 5f.103-1(c)(1)(i) and because the note bears a notation that it is “not negotiable,” the form of the instrument indicates that it is in all substantial respects an obligation in registered form within the meaning of section 881(c)(2)(B).

HOLDING

The Note described above constitutes an obligation in registered form within the meaning of section 881(c)(2)(B).

Example of Possible Revenue Ruling on Registered Interests in Unregistered Obligations

Rev. Rul. 2004-XX

ISSUE

Whether interest paid to a nonresident alien or foreign corporation that is the beneficial owner of the “pass-through certificates” described below qualifies as portfolio interest.

FACTS

Situation 1: T is a trust organized under the laws of one of the United States.

T has entered into a management agreement with a portfolio manager (the “Manager”). Pursuant to the terms of this management agreement, as permitted by T’s organizational documents, Manager will designate an initial portfolio of consumer loans and receivables to be purchased by T that meet certain defined investment criteria. T was formed, and all debt obligations owned by T were been issued, after July 18, 1984.

Under the management agreement, and as permitted by T’s organizational documents, Manager will have the power to sell assets of T that no longer meet the defined investment criteria and re-invest the proceeds in other debt obligations that meet such criteria, with the goal of maximizing T’s investment return over a specified term. In general, neither the debt obligations comprising T’s initial portfolio, nor any after-acquired debt obligations, will be in “registered form” within the meaning of Treasury Regulation section 1.871-14(c), and such debt obligations will not meet the rules concerning debt obligations in bearer form under Treasury Regulation section 1.871-14(b).

T has outstanding a single class of ownership interests, referred to as “pass through certificates,” each of which entitles its owner to a pro rata share of all principal and interest received on debt obligations owned by T (and the proceeds of sale or other disposition of such debt obligations), subject to a pro rata share of the expenses of T. The pass-through certificates issued by T, if considered as “obligations” of T on which T makes (pass-through) payments of principal and interest for purposes of Treasury Regulation section 1.871-14(c), would be treated as “obligations in registered form” under such regulation section. The pass through certificates will not be traded on an established securities market and will not be readily tradable on a secondary market or the substantial equivalent thereof under section 7704(b). At least one of these pass through certificates is owned by a nonresident alien or foreign corporation.

T has not filed an entity classification election under Treasury Regulation section 301.7701-3(c).

Situation 2: Same as Situation 1, except T is organized as a limited liability company under the laws of one of the United States.

LAW AND ANALYSIS

Sections 871(a)(1) and 881(a)(1) generally provide that nonresident aliens and foreign corporations are subject to tax at a 30 percent rate on interest received from sources in the United States, unless an income tax treaty or exception under domestic law is available. Sections 1441(a) and 1442(a) provide that persons having control, receipt, custody, disposal or payment of such interest must deduct and withhold such tax at the source.

Sections 871(h) and 881(c) provide an exemption from tax, and sections 1441(c)(9) and 1442(a) provide an exemption from withholding, for “portfolio interest.” Under sections 871(h)(2) and 881(c)(2), interest may qualify as portfolio interest under sections 871(h) and 881(c) provided the obligation is issued in “registered form” and a prescribed statement is obtained certifying that the beneficial owner is not a United States person.

Treasury Regulation section 1.871-14(c)(1)(i) provides that an obligation is treated as an obligation in registered form if –

(A) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;

(B) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) described in this paragraph (c)(1)(i)(B). An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation, is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an interest in the obligation; or

(C) It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in paragraph (c)(1)(i)(A) or (B) of this section.

Treasury Regulation section 1.871-14(d)(1) provides that interest received on a pass-through certificate may qualify as portfolio interest under sections 871(h)(2) and 881(c)(2) if the interest satisfies the registration requirements under Treasury Regulation section 1.871-14(c)(1) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates satisfies the rules concerning registered debt obligations under Treasury Regulation section 1.871-14(c) or (e) or debt obligations in bearer form under Treasury Regulation section 1.871-14(b).

Treasury Regulation section 1.163-5T(d) defines a pass-through certificate as a “pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under Subpart E of Subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust.”

Treasury Regulation section 301.7701-4(c)(1) provides that an investment trust will not be classified as a trust for federal tax purposes if there is a power under the trust agreement to vary the investment of the certificate holders. Revenue Ruling 78-149, 1978-1 C.B. 448, states, “A power to vary the investment of the certificate holders [of a trust] exists where there is managerial power, under the trust instrument, that enables a trust to take advantage of variations in the market to improve the investment of the investors.” Thus, Revenue Ruling 78-149 concluded that an investment trust would not be treated as a trust for federal tax purposes where the trust agreement permitted the trustee to reinvest the proceeds of certain prepayments of debt obligations owned by the trust in new debt obligations under specified conditions.

Treasury Regulation section 301.7701-2(a) provides that a business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. For this purpose, a business entity is defined as any entity recognized for federal tax purposes that is not properly classified as a trust under Treasury Regulation section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. Treasury Regulation section 301.7701-3(b) provides that a business entity with more than one member that is not defined as a corporation under Treasury Regulation section 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) will be treated as a partnership unless it elects otherwise.

Treasury Regulation section 1.1441-5(b)(2) requires a U.S. partnership to withhold under Treasury Regulation section 1.1441-1 as a withholding agent on an amount subject to withholding (as defined in Treasury Regulation section 1.1441-2(a)) that is includible in the gross income of a partner that is a foreign person. Such withholding generally is required upon the earliest of a distribution to such foreign person that includes amounts subject to withholding, the date that the statement required under section 6031(b) is mailed or otherwise provided to the partner, or the due date for furnishing such statement.

HOLDINGS

Provided that the pass-through certificates in Situations 1 and 2, as described above, satisfy the registration requirement under Treasury Regulation section 1.871-14(c), distributions on such pass-through certificates to a beneficial owner or member that is a nonresident alien or foreign corporation may qualify for the portfolio interest exemption under sections 871(h) and 881(c) to the extent such distributions include amounts that satisfy the other requirements for the portfolio interest exemption (i.e., the requirements other than the requirement under section 871(h)(2)(A) or (B) or 881(c)(2)(A) or (B)).

Example of Possible Revenue Ruling on Interest Based Upon Decline in Value of Issuer's Property

Rev. Rul. 2004-XX

ISSUE

Whether the portfolio interest exemption of section 881(c) of the Internal Revenue Code will apply to a penalty determined by reference to the principal amount of indebtedness outstanding.

FACTS

X is a domestic corporation that issues a debt instrument to Y, a foreign corporation that (i) is not a bank within the meaning of section 881(c) of the Internal Revenue Code, (ii) owns no stock of X and (iii) is not engaged in trade or business in the United States. The debt instrument provides for interest payable on a quarterly basis at a specified fixed rate. In addition, the debt instrument provides for the payment of a penalty, equal to 3% of the then outstanding principal amount, in the event that X's debt is downgraded below a specified credit rating.

LAW AND ANALYSIS

Section 881(a)(1) and (3) imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest or original issue discount.

Section 881(c) provides that no tax shall be imposed under paragraph (a)(1) or (3) in the case of portfolio interest received by a foreign corporation from sources within the United States.

Section 881(c)(4) provides that portfolio interest does not include any interest which is treated as not being portfolio interest under the rules of section 871(h)(4).

Section 871(h)(4)(A)(i) provides that "portfolio interest" shall not include any interest if the amount of such interest is determined by reference to (i) any receipts, sales or other cash flow of the debtor or a related person, (ii) any income or profits of the debtor or a related person, (iii) any change in value of any property of the debtor or a related person, or (iv) any dividend, partnership distributions, or similar payments made by the debtor or a related person. Pursuant to section 871(h)(4)(A)(ii), the Service may identify any other contingent interest where a denial of the portfolio interest exemption is necessary or appropriate to prevent the avoidance of Federal income tax.

Section 871(h)(4)(C) generally sets forth exceptions to the definition of contingent interest. Section 871(h)(4)(C)(iii) excludes from the definition of contingent interest "any amount of interest all or substantially all of which is determined by reference to any other amount of interest not described in subparagraph (A) (or by reference to the principal amount of indebtedness on which such other interest is paid)."

Based on facts set forth above, the entire amount of the penalty due is determined by reference to the principal amount of indebtedness on which non-contingent interest is paid,

notwithstanding the fact that the payment of the penalty interest is triggered only upon a credit downgrade of X's debt.

The contingent interest exception was enacted because of a concern by Congress with certain arrangements that otherwise could utilize the portfolio interest exemption to permit a non-U.S. person to participate in the earnings of a U.S. obligor (or the value of a U.S. real property interest) without incurring the tax on dividends and certain other types of fixed or determinable annual or periodical gains, profits, and income under sections 871 and 881. The penalty interest at issue does not represent a substitute for the distribution of X's revenues, earnings or value of assets.

HOLDING

The penalty interest received by Y is not excluded from the definition of portfolio interest under section 881(c)(4) and thus qualifies as portfolio interest under section 881(c) of the Internal Revenue Code.

Example of Possible Notice on the Meaning of the Term “Bank” for Purposes of the Bank Loan Exception to the Portfolio Interest Exemption

Notice 2004-XX

I. *PURPOSE*

This notice provides guidance relating to the meaning of the term “bank” for purposes of the bank loan exception to the portfolio interest exemption in section 881(c) of the Internal Revenue Code of 1986, as amended (the “Code”). The Treasury Department and the Internal Revenue Service intend to issue regulations concerning the definition of the term “bank” for purposes of the bank loan exception that incorporates the guidance set forth in this notice.

II. *BACKGROUND*

Sections 881(a)(1) and (a)(3) of the Code provide that a foreign corporation is subject to a 30% tax on amounts of interest income and original issue discount received from U.S. sources, provided the interest is not effectively connected with a U.S. trade or business (in which event it is subject to net basis taxation). Section 881(c) provides, however, that the 30% tax imposed under sections 881(a)(1) and (a)(3) of the Code does not apply to “portfolio interest.”

Section 881(c)(3)(A) provides that the term “portfolio interest” does not include any portfolio interest that is “received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business,” unless the interest is paid on an obligation of the United States.

III. *DEFINITION OF “BANK” FOR PURPOSES OF THE BANK LOAN EXCEPTION*

A. *In General*

On April 28, 1995, the Service and Treasury issued proposed regulations under section 1296 of the Code (now renumbered as section 1297) providing guidance on the definition of “active bank” for purposes of the rule under section 1297(b)(2)(A) that banking income derived by an active bank will not be treated as passive income for purposes of determining whether an entity is a passive foreign investment company. The Treasury and the Service believe it is appropriate to use the definition of “active bank” in the proposed section 1297 regulations to define “bank” for purposes of section 881(c)(3)(A) of the Code. Therefore, the Treasury and Service will issue regulations under section 881(c)(3)(A) that defines the term “bank” by reference to a test substantially identical to the test for active bank status set forth in Proposed Regulation Section 1.1296-4(b).

B. *U.S. licensed banks*

The regulations will treat a foreign corporation as a bank if it is licensed by federal or state bank regulatory authorities to do business as a bank in the United States. A foreign

corporation will not meet this test if, under its federal or state license or licenses, it is permitted to maintain only an office, such as a representative office, that is prohibited by federal or state law from taking deposits or making loans.

C. *Other foreign banks*

A foreign corporation that is not a U.S. licensed bank within the meaning of Proposed Regulation Section 1.1296-4(b)(1) will be treated as a bank for purposes of the bank loan exception of section 881(c)(3)(A) only if it meets the licensing requirement set forth in Proposed Regulation Section 1.1296-4(c), the deposit-taking requirements of Proposed Regulation Section 1.1296-4(d), and the lending activities test of Proposed Regulation Section 1.1296-4(e).

To meet the licensing requirement in Proposed Regulation Section 1.1296-4(c), the entity must be licensed or authorized to accept deposits from residents of the country in which it is chartered or incorporated and to conduct in that country one or more identified banking activities. To meet the deposit-taking requirements of Proposed Regulation Section 1.1296-4(d), the entity must regularly accept deposits in the ordinary course of its trade or business from customers who are residents of the country in which it is licensed or authorized, and the amount of deposits shown on its balance sheet must be substantial. Finally, to meet the lending activities test of Proposed Regulation Section 1.1296-4(e), the entity must regularly make loans to customers in the ordinary course of its trade or business.

The Service and the Treasury do not intend to incorporate the “qualified bank affiliate” rules of Proposed Regulation Section 1.1296-4(i) into the definition of a bank for purposes of section 881(c)(3)(A). The Service and the Treasury will issue separate guidance regarding the treatment of interest received by an affiliate of a bank for purposes of the portfolio interest exemption.

IV. *EFFECTIVE DATE*

Regulations to be issued relating to the guidance set forth in this notice will be effective for taxable years beginning after December 31, 2004. Until such regulations are issued, taxpayers may rely on this notice.

Example of Possible Revenue Ruling on Application of Bank Exception to Loans Made by Bank Affiliate

Rev. Rul. 2004-XX

ISSUE

Whether in the situation described below, interest is received by a bank within the meaning of section 881(c)(3)(A) of the Internal Revenue Code.

FACTS

Sub, a foreign corporation, is wholly owned by Parent Bank. Parent Bank is an entity that is properly treated as a bank within the meaning of Section 881(c)(3)(A). Without regard to its ownership by Parent Bank, Sub would not be treated as a bank for purposes of section 881(c)(3)(A).

Sub generally engages in investment activities outside the United States and is not engaged in trade or business in the United States. Sub has not been formed solely to make the Loan or to make loans to U.S. borrowers.

Sub makes a loan (the "Loan") to a U.S. domestic corporation for purposes of investment. Sub negotiates the terms of the Loan through its own employees or agents, some of whom may also be employees of Parent Bank.

Parent Bank originally capitalized Sub and has periodically provided additional funds to Sub as Sub has justified to support its investment activities. Parent Bank will not directly or indirectly provide the funds necessary to fund the Loan, however. Sub will fund the Loan with the proceeds of sale of certain of its existing investment assets or through borrowing from a third party.

LAW AND ANALYSIS

Sections 881(a)(1) and (a)(3) provide that a foreign corporation is subject to a 30% tax on amounts of interest income and original issue discount received from U.S. sources, provided the interest is not effectively connected with a U.S. trade or business (in which event it would be subject to net basis taxation).

Section 881(c) provides that the 30% tax imposed under sections 881(a)(1) and (a)(3) does not apply to "portfolio interest." Section 881(c)(3)(A) provides that the term "portfolio interest" does not include any portfolio interest that is "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business," unless the interest is paid on an obligation of the United States.

In Notice 2004-XX, the Service and the Treasury provided guidance on the meaning of the term "bank" for purposes of the bank loan exception. The Service and Treasury adopted a definition substantially identical to the definition of "active bank" provided in Proposed Regulations Section 1.1296-4(b). Under that definition, a foreign corporation will be treated as a

bank if it either is licensed by federal or state bank regulatory authorities to do business as a bank in the United States or, if it is not so licensed, meets a three-part test. To satisfy this test, the entity must be licensed or authorized to accept deposits from residents of the country in which it is chartered or incorporated and to conduct in that country one or more identified banking activities. It must also regularly accept deposits in the ordinary course of its trade or business from customers who are residents of the country in which it is licensed or authorized, and the amount of deposits shown on its balance sheet must be substantial. Finally, the foreign corporation must regularly make loans to customers in the ordinary course of its trade or business.

The bank loan exception was enacted in part because of a concern by Congress that foreign banks could gain a competitive advantage over U.S. domestic banks if they could make loans to U.S. borrowers without incurring U.S. tax. By not incurring U.S. tax, foreign banks could loan money to U.S. borrowers at rates with which taxable domestic banks could not compete. Congress was also concerned that, if foreign banks could qualify for the portfolio interest exemption, they would channel their U.S. lending activities away from their U.S. branches, which are subject to reserve maintenance requirements imposed by the Federal Reserve Board.

The Service recognizes that there are many foreign non-bank entities that make loans to U.S. borrowers either as investments or pursuant to a bona fide non-banking trade or business such as an investment banking or similar financial business. Many of these entities do not meet the definition of a bank described above, primarily because they are not regulated as banks and do not accept deposits from customers. Loans by such entities do not implicate the policy concerns behind the bank loan exception, because the lender does not regularly compete with U.S. banks and would not be subject to the reserve requirements of the Federal Reserve Board if it operated a U.S. branch through which it conducted its non-banking business. The fact that such an entity is related to a foreign bank does not change the analysis, provided the loan is not made by the non-bank related entity with a principal purpose of avoiding the bank loan exception. Accordingly, interest received by a foreign non-bank entity on a loan made to a U.S. borrower will not be subject to the bank loan exception despite the non-bank entity's affiliation with a foreign bank.

HOLDING

Interest received by Sub on the Loan will not be treated as interest received by a bank within the meaning of section 881(c)(3)(A).

Example of Possible Revenue Ruling on Application of Bank Exception to Loans Made by a Partnership

Rev. Rul. 2004-XX

ISSUE

Whether in the situations described below, interest is received by a bank within the meaning of section 881(c)(3)(A) of the Internal Revenue Code.

FACTS

Situation 1: X is a foreign entity that is treated as a partnership for U.S. federal income tax purposes but is not a bank within the meaning of section 881(c)(3)(A). Y, a partner of X, is a foreign entity that is treated as a corporation for U.S. federal income tax purposes and is properly treated as a bank within the meaning of Section 881(c)(3)(A). X makes a loan to a U.S. borrower in the ordinary course of its non-banking trade or business. The making of the loan by X does not have as a principal purpose the avoidance by Y of the bank loan exception to the portfolio interest exemption under section 881(c)(3)(A).

Situation 2: The facts are the same as in Situation 1, except that X is properly treated as a bank for purposes of section 881(c)(3)(A) and makes the loan pursuant to a loan agreement entered into in the ordinary course of its trade or business, and Y is not a bank within the meaning of section 881(c)(3)(A).

LAW AND ANALYSIS

Sections 881(a)(1) and (a)(3) provide that a foreign corporation is subject to a 30% U.S. tax on amounts of interest income and original issue discount received from U.S. sources, provided the interest is not effectively connected with a U.S. trade or business (in which event it would be subject to net basis taxation).

Section 881(c) provides that the 30% tax imposed under section 881(a)(1) and (a)(3) does not apply to “portfolio interest.” Section 881(c)(3)(A) provides that the term “portfolio interest” does not include any portfolio interest that is “received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business,” unless the interest is paid on an obligation of the United States.

In Notice 2004-XX, the Service and the Treasury provided guidance on the meaning of the term “bank” for purposes of the bank loan exception. The Service and Treasury adopted a definition substantially identical to the definition of “active bank” provided in Proposed Regulations Section 1.1296-4(b). Under that definition, a foreign corporation will be treated as a bank if it either is licensed by federal or state bank regulatory authorities to do business as a bank in the United States or, if it is not so licensed, meets a three-part test. To satisfy this test, the entity must be licensed or authorized to accept deposits from residents of the country in which it is chartered or incorporated and to conduct in that country one or more identified banking activities. It must also regularly accept deposits in the ordinary course of its trade or business from customers who are residents of the country in which it is licensed or authorized, and the

amount of deposits shown on its balance sheet must be substantial. Finally, the foreign corporation must regularly make loans to customers in the ordinary course of its trade or business.

The bank loan exception was enacted in part because of a concern by Congress that foreign banks could gain a competitive advantage over U.S. domestic banks if they could make loans to U.S. borrowers without incurring U.S. tax. By not incurring U.S. tax, foreign banks arguably could loan money to U.S. borrowers at rates with which taxable domestic banks could not compete. Congress was also concerned that, if foreign banks could qualify for the portfolio interest exemption, they would channel their U.S. lending activities away from their U.S. branches, which are subject to reserve maintenance requirements imposed by the Federal Reserve Board.

Given the policy concerns underlying the bank loan exception, the determination of whether interest received by a partnership is subject to the bank loan exception should be made at the partnership level rather than the individual partner level. If a partnership that is not itself properly treated as a bank makes a loan to a U.S. borrower, that loan would not implicate the policy concerns behind the bank loan exception, because the partnership itself does not compete with U.S. banks and would not be subject to the reserve requirements of the Federal Reserve Board if it operated a U.S. branch through which it conducted its non-banking business. The fact that the partnership has a partner that is treated as a bank should not change the outcome, provided the loan is not made by the partnership with a principal purpose of avoiding the bank loan exception. Conversely, if a partnership is properly treated as a bank, any loans made by it to a U.S. borrower would potentially implicate the policy concerns underlying the bank loan exception. Therefore, a foreign corporate partner should not be able to exclude as portfolio interest its distributive share of interest received by a partnership that is a bank. Accordingly, whether or not interest received by a foreign partnership should be treated as interest received by a bank will be determined by testing whether the partnership itself is a bank within the meaning of section 881(c)(3)(A).

HOLDING

Situation 1: Interest received by X will not be treated as interest received by a bank within the meaning of section 881(c)(3)(A). Therefore, Y's distributive share of the interest income with respect to the loan will be eligible for the portfolio interest exemption if the other requirements set forth in section 881(c) are met.

Situation 2: Interest received by X will be treated as interest received by a bank within the meaning of section 881(c)(3)(A). Therefore, Y's distributive share of the interest income with respect to the loan will not be eligible for the portfolio interest exemption despite Y's non-bank status.

Example of Possible Revenue Ruling on Definition of Loan Agreement

Rev. Rul. 2004-XX

ISSUE

Whether, in the situations described below, interest is received by a bank on “an extension of credit made pursuant to a loan agreement entered into the ordinary course of its trade or business” within the meaning of Section 881(c)(3)(A) of the Internal Revenue Code.

FACTS

Situation 1: X, a foreign bank, and A, a U.S. corporation, execute an agreement pursuant to which X will lend \$100 million to A. Prior to executing the agreement, X and A directly negotiate various terms, including rights upon default and financial covenants.

Situation 2: X, a foreign bank, purchases a medium term note issued by A, a U.S. corporation, through C, a foreign underwriter. The covenants and representations of the borrower are fixed in a fiscal agency agreement that was negotiated between A and C. The medium term note is freely transferable.

Situation 3: X, a foreign bank, is the lead underwriter of a bond offering for A, a U.S. corporation, which offering complies with an applicable exemption from the U.S. securities registration requirements. X directly participates in negotiations with A that result in a dealer agreement. The notes issued in the bond offering are freely transferable. Y, another foreign bank, acquires some of the notes in the secondary market.

Situation 4: X, a foreign bank, participates in a loan syndication involving a loan to A, a domestic corporation. In connection with the syndication, X has an opportunity to participate in the loan negotiations and to provide input on the terms of the loan. X enters into direct contractual privity with A, via a Loan Agreement, at the time the loan is made.

Situation 5: X, a foreign bank, purchases all or a portion of an originating lender’s interest in an existing loan in the secondary market or takes a partial or complete assignment of the originating lender’s rights without participating in the negotiation of the terms of the loan and without acquiring contractual privity with a U.S. corporate borrower.

Situation 6: X, a foreign bank, takes a partial or complete assignment of the originating lender’s rights in a loan to a U.S. corporate borrower through a participation in which X was part of a group of potential participants throughout the process of the negotiation of the loan. X did not negotiate directly with the borrower, but it was permitted to review drafts of the loan documents as they were being produced and to inform the lead bank in the participation as to whether it would be willing to accept the terms of the loan as they were being negotiated. X participated in the loan without acquiring contractual privity with the borrower.

LAW AND ANALYSIS

Section 881(c) generally provides that the 30% withholding tax under section 881(a)(1) shall not be imposed in the case of portfolio interest received by a foreign corporation from sources within the United States. Section 881(c)(3)(A) provides that the term “portfolio interest” does not include any portfolio interest received by a bank “on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its business.”

Based on this statutory language, any interest received by a bank on any obligation that performs the function of a loan entered into in the ordinary course of a banking business will not be eligible for the portfolio interest exemption. However, the legislative history of the portfolio interest rules indicates that Congress believed that a debt instrument which does not perform the function of a loan entered into in the ordinary course of a bank’s business, such as a Eurobond acquired for investment purposes, should not be treated as a loan agreement for purposes of the bank loan exception.

A common characteristic of a bank loan that distinguishes it from a debt instrument acquired in the secondary market, such as a Eurobond or other investment security, is that a bank loan is typically made on terms that the bank has negotiated individually with the borrower. In contrast, the terms of investment securities are typically established by the issuer together with its underwriter. After those terms are established, all investors in the securities purchase them on the same terms. Thus, the key factor for distinguishing a bank “loan agreement” from other debt instruments acquired by a bank for investment purposes is that a bank directly negotiates the terms of a loan agreement with the borrower.

Foreign banks that participate in a loan syndication and enter into direct contractual privity with the borrower when the loan is made should be viewed as having made an extension of credit pursuant to a loan agreement. In a loan syndication, each syndicate member generally has an opportunity to participate in the loan negotiations and to provide input as to the terms of the loan and underlying documentation. In contrast, where a foreign bank acquires a “loan participation” interest or pro rata portion of a lead bank’s rights in the loan, such foreign bank often has no rights to comment on the loan documents or to influence the terms of the loan and has limited or no voting rights. In this situation, the bank loan exception should not apply because the foreign bank is purchasing an existing security and has no input in negotiating the loan terms. However, in those circumstances in which a potential participant has the right to comment on loan documents and indirectly to negotiate the terms of the loan by informing the lead bank whether it will or will not accept various terms of the loan, the bank loan exception should apply because the foreign bank will have influence over the terms of the loan.

The following debt instruments will not be considered loan agreements subject to the bank loan exception: (i) debt instruments which are regularly traded on an established securities exchange or other secondary market; and (ii) debt instruments which are issued to the public in transactions subject to registration requirements of the federal securities laws or an exemption therefrom. These debt instruments will not be treated as loan agreements because they do not result from the negotiations between a bank and a borrower.

With respect to whether other debt instruments acquired by a bank will be considered a loan agreement for purposes of the bank loan exception, a factor-based analysis will be applied focusing on the extent of negotiations between the bank and the borrower with respect to the terms of the debt instrument.

HOLDINGS

Situation 1: Since X, a foreign bank, negotiated directly with A as to the terms of agreement providing for the \$100 million loan, X will be viewed as having extended credit pursuant to a “loan agreement” in the ordinary course of its business within the meaning of Code § 881(c)(3)(A).

Situation 2: In this transaction, the terms of the term note were fixed by A and its underwriter, C, with no input or negotiations from X. Accordingly, the medium term note was not issued pursuant to a “loan agreement” for purposes of Code § 881(c)(3)(A).

Situation 3: In this transaction, the notes were issued in a bond offering subject to an applicable exemption from the registration requirements of the federal securities laws. Accordingly, the notes were not issued pursuant to a “loan agreement” for purposes of Code § 881(c)(3)(A).

Situation 4: In this loan syndication transaction, X had the opportunity to participate in the loan negotiations and provide input as to the terms of loan and the underlying documentation. Moreover, X entered into direct contractual privity with A at the time the loan was made. Accordingly, X will be viewed as having extended credit pursuant to a “loan agreement” in the ordinary course of its business for purposes of Code § 881(c)(3)(A).

Situation 5: In this loan participation transaction, X will not be viewed as having extended its credit pursuant to a “loan agreement” in the ordinary course of its business within the meaning of Code § 881(c)(3)(A) since X (i) purchased an existing security in the secondary market and had no input in negotiating the terms and conditions of the loan or the underlying documents and (ii) does not have direct contractual privity with the U.S. corporate borrower.

Situation 6: In this loan participation transaction, X indirectly participated in the negotiation of the terms of the loan. Therefore X will be viewed as having extended credit pursuant to a loan agreement in the ordinary course of its business despite not having direct contractual privity with the borrower.

Example, Possible Revenue Ruling Applying the 10-Percent Ownership Exception to Partnership Lenders

Rev. Rul. 2004-XX

ISSUE

Whether, in the situations described below, interest is received by a “10-percent shareholder” within the meaning of section 871(h)(3) of the Internal Revenue Code.

FACTS

Situation 1: A non-withholding foreign partnership, FP, has four unrelated foreign individual partners, A, B, C and D. Each owns 25 percent of the capital and profits interests in FP. FP owns 20 percent of the only class of stock outstanding of a domestic corporation, DC. Other than by virtue of its partnership interest in FP, none of A, B, C or D owns any of the stock of DC for purposes of section 871(h)(3). FP makes a loan to DC.

Situation 2: Same as Situation 1, except that individual A owns 15 percent of the stock of DC.

LAW AND ANALYSIS

Section 871(a)(1)(A) and (C) imposes a tax of 30 percent of the amount received from sources within the United States by a foreign individual as interest or original issue discount.

Section 871(h)(1) provides that, in the case of any portfolio interest received by a nonresident individual from sources within the United States, no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

Section 871(h)(3) provides that portfolio interest shall not include any interest described in subparagraph (A) or (B) of paragraph (2) which is received by a 10-percent shareholder.

Section 871(h)(3)(B) provides that a 10-percent shareholder means (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

Section 871(h)(3)(C) provides that, for purposes of determining ownership of stock under subparagraph (B)(i), the rules of Section 318(a) shall apply.

Section 318(a)(2)(A) provides that stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

HOLDINGS

For purposes of determining whether a lender is a 10-percent shareholder for purposes of section 871(h)(3), interest is treated as being received by a partnership's partners and not by the partnership itself.

Situation 1: Interest paid by DC to FP is not received by a 10-percent shareholder under section 871(h)(3), since none of the partners of FP owns, directly or by application of the attribution rules of section 871(h)(3)(C), 10 percent or more of the total combined voting power of DC.

Situation 2: Partner A's share of interest paid by DC to FP is interest received by a 10-percent shareholder under section 871(h)(3) and, thus, is not eligible for the portfolio interest exemption. Interest paid by DC to FP that is properly allocable to partners B, C and D is not received by a 10-percent shareholder.

Example of Possible Revenue Ruling Applying 10-Percent Ownership Exception to Partnership Borrowers

Rev. Rul. 2004-XX

ISSUE

Whether, in the situations described below, interest is received by a “10-percent shareholder” within the meaning of Section 871(h)(3) of the Internal Revenue Code.

FACTS

Situation 1: A non-resident alien individual, A, is a partner in a domestic partnership, DP. A makes a loan to DP with market rate interest paid semi-annually on March 1 and September 1. When the loan is made, A owns a 15-percent interest in DP’s capital and profits. On June 1 of year 1, A sells an 8-percent interest in DP’s capital and profits to an unrelated individual.

Situation 2: The facts are the same as Situation 1, except that A does not sell his interest on June 1. Instead, a new, unrelated person contributes funds to DP on June 1 of year 1 in exchange for a 50-percent interest in the capital and profits of DP. Following such contribution, A maintains a 7.5-percent interest in the capital and profits of DP.

LAW AND ANALYSIS

Section 871(a)(1)(A) and (C) imposes a tax of 30 percent of the amount received from sources within the United States by a foreign individual as interest or original issue discount.

Section 871(h)(1) provides that, in the case of any portfolio interest received by a nonresident individual from sources within the United States, no tax shall be imposed under paragraph (1)(A) or (1)(C) of subsection (a).

Section 871(h)(3) provides that portfolio interest shall not include any interest described in subparagraph (A) or (B) of paragraph (2) which is received by a 10-percent shareholder.

Section 871(h)(3)(B) provides that a 10-percent shareholder means (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

Section 871(h)(3)(C) provides that, for purposes of determining ownership of stock under subparagraph (B)(i), the rules of Section 318(a) shall apply.

Section 318(a)(2)(A) provides that stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

HOLDINGS

Situation 1: A is a 10-percent shareholder under section 871(h)(3) with respect to the interest payment received from DP on March 1, and thus such interest would not qualify for the portfolio interest exemption. A is not a 10-percent shareholder with respect to the interest payment received on September 1.

Situation 2: Same as Situation 1.