[¶5015] USING THE PORTFOLIO INTEREST EXEMPTION

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U.S. issuers seeking access to the international capital markets should be aware of various exceptions and limitations applicable to the portfolio interest exemption. When the exemption does not apply, other statutory exemptions or tax treaty exemptions or rate reductions may enable foreign lenders to avoid or reduce the 30% withholding tax on interest.

Two parts. Part One of this analysis at ¶5014 examined the basic features of the portfolio interest exemption. This Part Two will examine the exceptions to the portfolio interest exemption (including the exclusion of contingent interest), discuss special rules in applying the exemption, and also provide planning tips when the conditions to the exemption cannot be readily met. To assist you, the analysis is divided into the following main topics:

1. Exceptions to the portfolio interest exemption ¶5015.1
2. Special rules ¶5015.2
3. Planning points ¶5015.3

[¶5015.1] EXCEPTIONS TO THE PORTFOLIO INTEREST EXEMPTION

The portfolio interest exemption is not available in a number of circumstances, apart from failure to comply with the detailed requirements previously discussed in ¶5014.

(1) Payments to 10-Percent Shareholder

In general. Portfolio interest does not include interest paid to a "10-percent shareholder" of the payor.[1] A 10-percent shareholder is defined, in the case of a corporate obligation, as a person who owns 10% or more of the total combined voting power of all classes of voting stock in the corporation. In the case of a partnership obligation, the term is defined as a person who owns 10% or more of the capital or profits of the partnership. Corporations and partnerships would include any entity characterized as such under the entity classification regulations, both in their current form and under the "check-the-box" proposal, finalized on December 17, 1996.[2]

Attribution rules. The Code provides attribution rules for determining ownership of corporate stock and gives the IRS regulatory authority to prescribe similar rules for attribution of ownership of a partnership interest. The corporate attribution rules are based on IRC §318(a), modified to remove the 50% limitations in IRC §318(a)(2)(C) and (a)(3)(C). Under these rules, attribution is required among members of the same family. For example, shares owned by an individual's parents, spouse, and children must be added to determine if he or she is a 10-percent

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[1]. IRC §871(h)(3)(A), §881(c)(3)(B).

[2]. Reg. §301.7701-1, -2, and -3, TD 8697, 61 Fed. Reg. 66584 (Dec. 18, 1996).

shareholder. However, attribution is not required between siblings, and double attribution among family members (attributing shares that an individual is treated as owning only by attribution) also is not required.[3]

Example. If F and his children S and D, and D's husband DH, own shares in a corporation, the following will result:

- F will be treated as owning all of the shares owned by S and D, but not those owned by DH.
- S will be treated as owning all of the shares owned by F, but not those owned by D or DH.
- D will be treated as owning all of the shares owned by F and DH, but not those owned by S.
- DH will be treated as owning all of the shares owned by D, but not those owned by S or F.

When a corporation owns stock in another corporation, that stock can be attributed proportionately to any of the first corporation's shareholders. Conversely, when a shareholder owns stock in two corporations, his or her stock in the first is attributed to the second. However, when stock is potentially attributable to a corporation through a minority shareholder, the corporation is treated as owning a proportion of that stock proportionately to the minority shareholder's interest in the corporation to whom attribution is to be made.

> **Example**. Alpha, a foreign corporation, owns 7% of the voting stock of Beta, a U.S. issuer, as well as an obligation issued by Beta that potentially yields portfolio interest. Charles, a foreign investor, owns 10% of the voting stock of Beta and also owns 45% in value of the stock of Alpha. Under IRC §871(h)(3)(C)(ii)(II), there is attributed to Alpha 4.5% (45% of Charles' 10%) of the voting stock of Beta. Therefore, Alpha owns a total of 11.5% of the Beta voting stock, 7% actually and 4.5% constructively. Alpha is a 10% shareholder of Beta.

A further modification to the attribution rules relating to options states that, when applying the rules for attributing stock from a corporation to its shareholder and vice versa, a corporation is not treated as actually owning stock attributed to it by holding an option over the shares.[4]

Options, warrants and conversion rights. Eurobonds commonly carry warrants or conversion rights. If these warrants or conversion rights are exercisable at the bondholder's option, they will cause the bondholder to be treated as owning the stock that can thereby be

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[3] FSA 1998-376 (released Aug. 10, 1992), where lender and borrower were corporations each controlled by a nonresident alien brother. The Service found the note to be in bearer form without complying with the foreign targeting requirements. The Service made nothing of the family relationship of the shareholders of lender and borrower.

[4]. IRC §871(h)(3)(C)(iii).

acquired for purposes of testing whether the bondholder is a 10-percent shareholder.[5] However, a right of first refusal does not constitute an option.[6]

The IRS considers that an option is deemed exercised by the holder immediately, even if it can only be exercised according to its terms after a lapse of time. A private letter ruling indicates that continued employment as a condition to its exercisability at some future time is not a contingency. On the other hand, the option is not deemed exercised if there are contingencies attached to the right to exercise the option beyond the control of the holder.[7] However, it is not clear how to deal with warrants or conversion rights, which the option holder clearly has the right to exercise at some future time but where the number or value of the shares is to be determined by future events, such as the market price of the stock or the profitability of the issuer. Neither the regulations under IRC §318(a)(4) nor the published rulings in this area offer guidance on this subject.

An unresolved area of controversy under IRC §318(a)(4) concerns whether all outstanding options must be deemed exercised or just those held by the taxpayer whose attribution percentage is being tested. The IRS position is that attribution must be tested shareholder by shareholder--that is, ignoring the options held by unrelated persons--but at least one appellate court disagrees.[8]

Neither Congress nor the IRS offer any relief to a centralized borrowing or treasury center subsidiary, a company used by a multinational group to centralize its borrowings and other treasury functions. In the case of a non-CFC foreign borrowing subsidiary, it seems that the proceeds of a loan from an unrelated foreign lender or group of lenders could not be lent to a U.S. member of the group without falling afoul of the 10-percent shareholder rule.

(2) Contingent Interest

So long as the underlying obligation is properly viewed as debt rather than equity, interest for U.S. income tax purposes can include compensation for the use of money, the amount or payment of which is contingent on some economic attribute of the borrower or a related party, such as profits, gross sales, or an increase in value of the borrower's property.[9] This proposition has been under assault. The failed debt:equity regulations of the early 1980s attempted to recharacterize hybrid instruments as stock. In 1989, Congress gave the Treasury authority,

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5. Rev. Ruls. 68-601, 1968-2 CB 124 and 89-64, 1989-1 CB 91; see also Ltr. Rul. 8936016 (June 8, 1989).

6. Ltr. Rul. 8106008 (Oct. 21, 1980).

7. See Reg. §1.318-3(c); Rev. Ruls. 68-601, *supra* note , and 89-64, *supra* note ; see also Ltr. Rul. 8936016 (June 8, 1989).

8. Sorem v. Commr. (10-CA, 1964), 334 F.2d 275 and Patterson Trust v. Commr. (6-CA, 1984), 729 F.2d 1089; but see Bloch v. Commr. (5-CA, 1967), 386 F.2d 839, and Morris, 70 T.C. 959 (1978).

9. See, for example, Rev. Rul. 83-52, 1983-1 C.B. 48 (contingent interest portion of shared appreciation mortgage treated as interest, although it equaled 40% of the appreciation of the property); Reg. §1.897-1(h) (payment of contingent interest treated as interest and not as amount realized on disposition of a U.S. real property interest. However, the obligation itself was a U.S. real property interest and its disposition could give rise to effectively connected gain or loss).

unexercised to date, to prescribe regulations bifurcating the treatment of obligations with hybrid characteristics.[10] After a false start in 1991, the IRS eventually issued regulations in 1996 requiring contingent interest on debt instruments issued for money or publicly traded property to be projected and taken into account as if it were actually payable, with appropriate adjustments based on actual experience.[11] The same regulations treat the contingent interest portion of a debt instrument not issued for money or publicly traded property as a separate instrument.[12] In neither case, however, would these rules change the underlying treatment of both instruments as debt.

Without changing the rule for general purposes and unwilling to wait for the IRS to issue regulations on bifurcated instruments, Congress in 1993 excluded various categories of contingent interest from the definition of portfolio interest, applicable to debt obligations issued after April 7, 1993 (other than those issued after that date pursuant to a written binding contract in effect before that date).[13] Portfolio interest does not include interest if the amount of the interest is determined by reference to receipts, sales or other cash flow, income or profits of the debtor or a related person, any change in value of the property of the debtor or a related person, or any dividends, partnership distributions, or similar payments made by the debtor or a related person.[14] The term "related person" is defined in IRC §267(b) and §707(b)(1) but also includes any person who is "a party to any arrangement undertaken for a purpose of avoiding the application" of the limitation.[15]

The Act makes several clarifying exceptions to the scope of the limitation.[16] The new limitation therefore does not apply in the following situations:

! Solely because timing (rather than amount) of a payment of interest or principal is subject to a contingency.

! Solely because the debt is without recourse or with limited recourse.

! If all or substantially all of the interest is determined by reference to (1) any other amount of interest not subject to the new limitation or (2) the principal amount on which that other interest is paid. This provision is designed for the benefit of REMICs and pass-through

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10. IRC §385, as amended by the Revenue Reconciliation Act of 1989, Pub. L. 101-239, Sec. 7208(a)(1). The regulations may not be retroactive to a date earlier than the date public guidance is issued by regulations, ruling, or otherwise. Pub. L. 101-239 §7208(a)(2). See also Farley Realty Corp. v. Commr. (CA-2, 1960), 279 F.2d 701.

11. Reg. §1.1275-4(b) (June 14, 1996).

12. Reg. §1.1275-4(c) (June 14, 1996).

13. IRC §871(h)(4) and §881(c)(4), enacted by the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, 107 Stat. 312 (hereinafter OBRA '93), Sec. 13237(a)(1). The effective date provision is in IRC §871(h)(4)(D).

14. IRC §871(h)(4)(A).

15. The legislative history does not explain what types of arrangements Congress had in mind.

16. IRC §871(h)(4).

trusts that pay interest based on collections of interest and principal from a pool of mortgage obligations.[17]

! Solely because the debtor or a related person enters into a hedging transaction to reduce the risk of interest rate or currency fluctuations.

! If interest is determined by reference to (I) changes in the value of actively traded property other than a U.S. real property interest;[18] (II) the yield on actively traded property (other than U.S. real property interests and contingent interest debt); or (III) changes in any index of the value of property described in (I) or the yield of property described in (II) (which, as the House report explains, would include beneficial interests in the debtor).

In addition, the legislative history adds some guidance. The House report states that interest is not contingent merely because its payment can be impaired by a default by the debtor. The Conference Committee makes clear that interest, which is otherwise contingent but subject to a minimum rate, is not subject to the limitation as to the minimum interest. The Committee gives as an example interest on a debt instrument which yields the greater of 6% of the principal amount or 10% of gross profits. Only the excess of the interest paid over the 6% amount would be treated as contingent.

The IRS is given authority to prescribe by regulations other types of contingent interest when denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of federal income tax.[19] The IRS may also by regulation identify other types of interest that are treated as not subject to a contingency.[20] The IRS might be expected to use this power to limit the use of debt with a high fixed rate of interest when the ability of the debtor to pay the full amount of the interest is illusory or excessively dependent on cash flow. The legislative history gives as an example a nonrecourse debt accruing interest at a rate significantly above the market rate, which permits the debtor to defer interest payments in the event of inadequate cash flow. If the creditor and debtor expected that deferral would occur and that ultimately a large part would

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[17]. The House Report states that, in determining whether an amount is payable by reference to another amount of interest not subject to the new limitation, there must not be taken into account other factors that affect the amount of the interest but that are not contingencies contemplated by the Act. As an example, the report gives a regular interest in a REMIC when the REMIC pays interest based on interest received from the REMIC pool to the extent of any excess over a LIBOR-based rate. As LIBOR rises, the amount of excess interest will fall, especially if the underlying mortgages are fixed rate or adjust more slowly than the LIBOR rate. Nevertheless, the interest paid by a REMIC in this situation is not disqualified from being portfolio interest.

[18]. The reference to actively traded stock described in IRC §897(c)(1) or (g) (that is, a U.S. real property interest or an interest in a partnership or trust that owns U.S. real property interests) is puzzling. Interests in a public traded corporation or partnership are treated as U.S. real property interests only for a taxpayer who holds 5% or more of the class of stock in question during a prescribed period. It is not clear who the taxpayer is for the purpose of applying the exemption from the contingent interest limitation.

[19]. IRC §871(h)(4)(A)(ii).

[20]. IRC §871(h)(4)(C)(vi).

never be paid, the exception for nonrecourse debt and for timing of payments might not be available.[21]

>>>>**OBSERVATION>>>**This example is not very helpful in the real world. Unrelated debtors and creditors rarely, if ever, enter into arrangements when there is an expectation, unspoken or otherwise, that interest provided for in a contract will not be paid. A more appropriate analysis of the problem of excessive fixed interest rates would be to recompute the issue price by adding back the present value of fixed interest payments above the market rate and checking what effect this would have on the debt to equity ratio of the debtor. This might reveal a thinly capitalized borrower.[22]

The legislation does not materially modify the rule on withholding tax on portfolio interest. The withholding agent is required to determine what is portfolio interest and what, because of the limitation on contingent interest or other exceptions, is not.

Since the portfolio interest exemption is a statutory exemption available to any foreign taxpayer, the United States can choose to limit its scope in any manner it chooses. The limitation on contingent interest does not purport to change the definition of interest for general income tax purposes or, more narrowly, for the purpose of the tax (and any associated withholding requirement) on FDAP income of foreign persons.[23] The legislative history makes clear that the denial of portfolio interest treatment does not override any treaty exemption.[24] Because interest for general purposes continues to include contingent interest that is not recharacterized under general debt:equity principles, a treaty exemption can still exempt contingent interest unless the treaty itself has some special provision. The United States has in fact begun to negotiate provisions under which contingent interest will be treated as if it were a dividend and routinely requires such a provision in all new treaties.[25] Treaty withholding rates on individuals are almost always higher or at least the same as rules on interest.

(3) Interest Received by a CFC from a Related Person

In general. Portfolio interest also does not include interest received by a controlled

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[21]. H.R. Rprt. 103-101, 103rd Cong. 1st Sess. (1993) at 954, 958.

[22]. The IRS also has the right to bifurcate debt into debt and equity portions under a never used grant of authority under IRC §385. Like many debt-equity problems, however, this one raises issues well beyond the narrow context of the portfolio interest exemption, and so progress on preparing regulations tends to be slowed by the need to obtain the concurrence (not to mention the attention) of numerous groups within the IRS National Office.

[23]. Normally, the definition of a term not defined by a treaty is the definition given that term by the country seeking to impose a tax, provided the definition is reasonable and not intended to defeat the reasonable expectations of the treaty partner when it signed the treaty.

[24]. H.R. Rprt. 103-111, 103 1st Sess. 958.

[25]. For example, U.S.-Netherlands income tax treaty of 1992 (entered into force January 1, 1994), art. 12.

foreign corporation (CFC) from a related person.[26] The rationale for this rule is not entirely clear. Originally it may have been included to prevent recharacterization of U.S.-source income as foreign-source and unwarranted deferral by CFCs having subpart F income lower than the 10% threshold (5% since the Tax Reform Act of 1986).[27] However, other provisions of IRC §881(c), described in greater detail below, counteract these and other avoidance techniques (see ¶5015.2(2) below).

Definition of related person. A "related person" is defined as any person who is a related person of the corporation under IRC §267(b) and any person who is either a "United States shareholder" (as defined in IRC §951(c)) of the CFC or related person of that shareholder (again using the IRC §267(b) rules).[28]

In the corporate area, IRC §267(b) essentially provides that a corporation is related to an individual if the individual actually or constructively owns more than 50% in value of the outstanding stock of the corporation. (For this purpose, IRC §267(c) provides constructive ownership rules differing from (and generally broader than) the rules of IRC §318(a).[29] IRC §267(b) further provides that a corporation is related to another corporation if both are members of the same controlled group, defined under a modified version of IRC §1563.[30]

(4) Establishing That a Bondholder Is Not a 10-Percent Shareholder or a Related Person of a CFC

The Treasury and the IRS have struggled with the question of how a withholding agent is

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[26]. IRC §881(c)(3)(C).

[27]. Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (1986), Sec. 1223(a). See Staff of the Joint Committee on Taxation, *Tax Treatment of Interest Paid to Foreign Investors* 15 (Comm. Print) JCS-23-84 (1984). The print describes the background to a number of proposals to repeal the withholding tax on interest.

[28]. IRC §864(d)(4).

[29]. For example, an individual is treated as constructively owning stock actually owned by his or her family, which unlike that for IRC §318(a) purposes, includes the individual's brothers and sisters (including half-brothers and sisters). IRC §267(c)(4). Again unlike IRC §318(a), the individual is also treated as constructively owning stock owned by his or her partners. IRC §267(c)(3). On the other hand, IRC §267(b) does not apply option rules comparable to those of IRC §318(a)(4).

[30]. The author invites readers to note that to reach the definition of a related person, we have traveled, by the magic of cross-references, from IRC §881(c)(3)(C) through IRC §864(d)(4) past IRC §267(b) on to IRC §267(c) arriving finally at a definition in IRC §1563(a), which itself is supplemented by a series of complex subsections of IRC §1563 as well as being significantly modified by IRC §267(c). Also, a reader trying to work out whether a person is a related person of a CFC will also have to determine whether that person is a related person of any "United States shareholder" of the CFC. For that purpose, he or she will have to travel to IRC §951(b) where he or she will be directed to the constructive ownership rules of IRC §958(b), which themselves apply an inscrutably modified version of IRC §318(a). The author suggests that the alternative of using of a smell test, although slightly less precise, in the end may prove less taxing.

to establish that a payee is not a 10-percent shareholder of the payor or a CFC of which the issuer is a related person. In December 1986, the IRS issued temporary regulations that dealt with four possible scenarios, three involving either a public issuer or payee and one a wholly private transaction.

These regulations instantly evoked an adverse response from the market, which caused the IRS on February 13, 1987, to suspend the operation of the temporary regulations retroactive to January 21, 1987, the original effective date.[31] On May 18, 1988, the IRS deleted these temporary regulations.[32] By deleting the temporary regulations, the IRS also withdrew the proposed regulations because these existed by cross-reference only.[33]

The IRS and the Treasury then opened a regulation project to respond to the market's concerns but it never received any priority and has been superseded by the new regulations under IRC §1441, discussed in Part I.[34] The new regulations do not include a separate certification requirement. Instead, the withholding agent would be entitled to accept a claim that interest qualifies for the exemption unless the withholding agent knows or has reason to know that the claim is incorrect. Such a claim implicitly would include a representation that the payee is neither a 10-percent shareholder nor a CFC of the payor.

(5) Interest Paid to Foreign Banks

Except for interest paid on an obligation of the United States, interest received by a bank on an extension of credit in the ordinary course of its trade or business is not portfolio interest.[35] This exclusion apparently was intended to discourage domestic loans by foreign branches of foreign banks not subject to U.S. banking regulations (for example, the Federal Reserve Board's reserve requirements).[36]

> **>>>>LIMITED TO CORPORATIONS>>>**This denial of the portfolio interest exemption applies only to banks that are corporations. A dwindling number of merchant banks are still operated as partnerships. Notwithstanding the rule that a *domestic* bank is always taxable as a corporation, it would appear that these foreign banks can make loans in the ordinary course of business and remain entitled to the exemption, provided the partnership is not treated as an association taxable as a corporation.[37]

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[31]. Temp. Reg. §35a.9999-5(f) (issued on Dec. 16, 1986, TD 8111, 1987-1 CB 69, and suspended retroactively to its effective date by Notice 87-24, 1987-1 CB 470, supplemented by Notice 87-67, 1987-2 CB 377).

[32]. TD 8202, par. 4 (May 18, 1988), 1988-1 CB 78.

[33]. This interpretation was informally confirmed to the author by Carl Cooper, the principal IRS draftsman of the portfolio interest regulations, in a telephone conversation on July 20, 1988.

[34]. See ¶5014.5.

[35]. IRC §881(c)(3)(A).

[36]. See Joint Committee Print, JCS-23-84.

[37]. The reason for this is that the definition of portfolio interest in IRC §871(h) (the exemption applicable to nonresident aliens) does not exclude interest on bank loans. If the bank

Neither the legislative history nor the regulations give guidance as to what is a bank or what is an extension of credit in the ordinary course of a trade or business. However, in a pair of private letter rulings in 1998, the Service has ruled that a "bank," for purposes of the portfolio interest exemption, is defined by reference to IRC §581, the only code section which actually defines the term "bank".[38] IRC §581 contains an operational test which requires that the taking of deposits and making of loans are a substantial part of the bank's business. In addition, the entity must be regulated, supervised, and examined as a bank.

So far as extensions of credit in the ordinary course of business are concerned, perhaps some guidance might be derived from the regulations defining an eligible loan for calculating bad debt reserves for banks as "a loan ... which is incurred in the course of the normal customer loan activities of a financial institution .... Nothing within the preceding sentence will be construed to exclude from the term `eligible loan' a bona fide loan in a new market or under a novel repayment arrangement if the likelihood of nonrepayment is at least as great as other customer loans of the financial institution."[39] However, even these regulations do not address the question of interest paid to banks on loans they did not originate.

At the invitation of the IRS and the Treasury, an *ad hoc* committee of the Tax Section of the New York State Bar Association submitted a report in 1992 on the foreign bank exemption.[40] The report recommended against extensive regulations but did make a number of recommendations on the definition of banks and bank loans. On the definition of bank loans, the report recommended safe harbor exceptions for debt obligations registered with the Securities Exchange Commission (SEC) or entitled to one of a number of exemptions from registration, such as Regulation S, commercial paper, Fannie Mae offerings, or obligations exempt from registration under SEC Rule 144A, or §3(a)(2) or §4(2) of the Securities Act of 1933. The report seeks to distinguish direct loans by banks from other loans based on the presence of direct negotiations between borrower and lender, as opposed to the purchase of an interest in a loan organized by a broker-dealer. Market practice suggests that publicly offered deals are not covered by the foreign bank exception, but practitioners should be much more wary in the case of privately syndicated loans.

An unresolved issue concerns the treatment of secondary market transactions. Does it make any difference if a bank originates a loan that it then sells or buys an interest in a loan it did not originate? The New York State Bar report suggests that in the former case, the bank loan exception should not apply to a participation held by a nonbank lender. In the latter case, the

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is a partnership, the entitlement to the exemption ultimately will depend on each partners' status, so that the share of a corporate partner in the bank will not be exempt but the share of an individual or trust will be. On treatment of domestic banks as corporations, see IRC §581; the rule is not affected by the recently issued check-the-box regulations. See Reg. §301.7701-2(b)(5) and (7) (1996).

[38]37. Ltr. Rul. 9822007 and 9822008 (both Feb. 10, 1998).

[39]. Reg. §1.585-2(e)(3).

[40]. New York State Bar Association, Tax Section, Report on the "Bank Loan" Exception to the "Portfolio" Interest Rules, summarized in 57 Tax Notes 123 (1992) and available electronically under document 92 TNT 189-37.

report suggests that the exception should apply (and the interest should not be portfolio interest). The report admits that treating the purchased interest as a loan covered by the bank loan exception may not fit squarely with the statutory language, which refers to a loan "entered into" in the ordinary course of business, but that such a rule is needed to prevent the frustration of the statute's purpose.

The IRS has informally stated in the past that it was working on a regulations project in this area[41] but there seems to be no particular sense of urgency.

(6) Use of Back-to-Back Loans by 10-Percent Shareholders and Foreign Banks

The legislative history of the portfolio interest exemption indicates Congressional concern that taxpayers will seek to use "back-to-back" loans (loans through an unrelated foreign party) to circumvent the restriction on loans by 10-percent shareholders and foreign banks. The Conference Report on the Tax Reform Act of 1984[42] directs the IRS, when appropriate, to use means at its disposal to determine whether back-to-back loans exist.[43]

These Congressional directives were concisely stated but their application to the myriad arrangements entered into by borrowers and lenders is not easily described. The IRS initially gave guidance regarding back-to-back loans (not directly in the context of the portfolio interest exemption) in a pair of published rulings in 1984 and a further ruling in 1987.[44] The 1984 rulings were attacks on the use of international finance subsidiaries by foreign and U.S. investors. The 1987 ruling attacked back-to-back loans through banks to avoid a direct loan by a CFC to its U.S. parent, when such a direct loan is an increase in earnings invested in U.S. property and, hence, treated as a dividend from the CFC to the parent.[45] The rulings are discussed in further detail below.

These rulings were controversial because they stated a broad concept of what constitutes a back-to-back loan. Rev. Rul. 87-89, in particular, propounded the concept that a back-to-back loan is present simply when the intermediate lender would not have made the loan without a deposit, even if the deposit is not security for the loan to the ultimate borrower. Taking this argument to its logical conclusion, a loan in a purely domestic context made by a bank to a subsidiary when the parent maintained a compensating balance would be treated as a loan to the parent rather than the subsidiary. Although the rulings could perhaps be regarded primarily as devices intended to hold taxpayers *in terrorem*, enactment of IRC §7701(l) gave legislative authority, which the IRS has now exercised, for recharacterization of a wide variety of multiple party financings.

>>>>**PROBLEM**>>>Even with guidance from the IRC §7701(l)

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41. Telephone conversation between the author and Carl Cooper, the principal IRS draftsman of the portfolio interest regulations, on Aug. 14, 1995.

42. Pub. L. 93-369, 98 Stat. 494, 648 (1984).

43. Conference Report on the 1984 Deficit Reduction Act, H.R. Rept. No. 861, 98th Cong. 2d Sess. 937-8 (1984).

44. Rev. Rul. 84-152, 1984-2 CB 381, and its companion, Rev. Rul. 84-153, 1984-2 CB 383, both modified by Rev. Rul. 85-163, 1985-2 CB 349, and 87-89, 1987-2 CB 195.

45. IRC §956.

regulations, it can be difficult or impossible to determine whether an extension of credit made by a foreign corporation that in turn is financed by a bank falls within the prohibition on back-to-back loans. For example, suppose a heavy equipment manufacturer extends a three-year credit to a U.S. customer and, instead of discounting the obligation to its bank, pledges the obligation to the bank as security for a loan. What difference would it make if the loan was or was not specifically associated with the equipment sale? This problem will be exacerbated by the fact that, in many foreign countries, banks are often major shareholders of industrial groups of companies.

The IRC §7701(l) regulations have effectively replaced the three revenue rulings for payments after September 10, 1995.[46] The regulations are described in greater detail below but, in summary, they provide a structured approach allowing the IRS to disregard the participation of one or more intermediate entities in a financing arrangement when the entities are acting as conduit entities.[47]

(7) Treasury Determination of Inadequate Information Exchange

Portfolio interest does not include interest paid to residents of a country if the Treasury has determined that the exchange of information with that country is inadequate to prevent tax evasion by U.S. persons, but only for obligations issued after the date the determination is published.[48] If applied literally, this provision is capable of seriously undermining the portfolio interest exemption, because there are numerous countries with which the United States has no arrangements at all to exchange tax information. However, no determination has been made to date, and it is not understood that any is contemplated.

[¶5015.2] SPECIAL RULES

(1) Pass-Through Certificates

A pass-through or participation certificate is, broadly, a certificate of the holder's right to participate in the interest and principal received regarding a pool of mortgages or other similar pooled fund. Generally, this arrangement is treated as a grantor trust under IRC §671-§678, each certificate holder being treated as the owner of a portion of the pool.

The primary requirements for a pool to be treated as a pass-through trust rather than an association taxable as a corporation are set out in what are commonly known as the Sears regulations.[49] The key requirements of the Sears regulations are that the trust not have multiple classes of interest (other than classes with identical rights when one class is subordinated to another) and the trustee may not have power to change the investment of the beneficiaries. The IRS has interpreted these requirements quite restrictively, and tax lawyers reviewing pass-through trusts tend to pore over them obsessively, hunting for the slightest hint that any person's entitlement to anything under the trust constitutes a second class of interest or that any power of the trustee to take any action at all--especially in relation to the acceptance of additional assets,

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46. See Rev. Rul. 95-56, 1995-2 CB 322.

47. Reg. §1.881-3(a)(1). See text accompanying note et seq.

48. IRC §871(h)(6).

49. Reg. §301.7701-4(c).

the temporary investment of surplus trust assets, or exercise of trust remedies in relation to its assets--could constitute a power to vary.

Originally, it was not clear whether interest on the certificates is tested under the portfolio interest rules, with or without regard to the status of interest on the underlying mortgage obligations. The August 22, 1984 temporary regulations did not answer this question. Thus, for the following reasons, it seemed uncertain whether interest paid for certificates could qualify for the portfolio interest exemption:

! If the status of the underlying obligations was relevant, the exemption would not have applied under the regulations then in effect because the underlying obligations were generally residential mortgages issued by natural persons. They were not, therefore, registration-required obligations and at the time could not qualify as portfolio interest.

! Even if the requirement that an obligation be registration-required had been lifted (as it eventually was), a typical home mortgage still is unlikely to meet the IRC §871(h)(2) requirement that it either be in registered form or meet the foreign-targeting requirements that would permit it to be in bearer form.

The IRS received a number of protests that its position was denying the U.S. housing industry a source of financing that Congress had intended to provide.[50] In fact, the Blue Book on the Tax Reform Act of 1984, released December 31, 1984, specifically stated that Congress intended that interest on mortgage pass-through certificates be eligible for the portfolio interest exemption.[51] On August 20, 1985, the IRS issued regulations that largely satisfied its critics' demands. The regulations provided that, effective for obligations issued after 1982, mortgage pass-through certificates were to be regarded as registration-required and that the underlying obligations were considered to be in registered-form.[52] The regulations further provided that, effective for obligations issued after July 18, 1984, interest on the certificates qualified as portfolio interest if three conditions were met. These conditions were slightly liberalized by the October 1997 finalized regulations, effective January 1, 2000.[53] The conditions are as follows:

! A pass-through certificate will be considered as issued after July 18, 1984, only if all the underlying obligations are issued after that date.[54] This rule has been slightly relaxed for certificates issued after 1986 when payment is guaranteed by an independent third party (that is,

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50. See, for example, letters from Reps. Gibbons and Conable to the Treasury, reported in 25 Tax Notes 406 (1984) and 25 Tax Notes 1065 (1984); letter from Lawrence D. Fink, of First Boston Corp., to the Treasury, reported in 25 Tax Notes 611 (1984).

51. Staff of the Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," 396 (Comm. Print 1984), JCS-41-84. Had the Treasury failed to reverse its position, an interesting question would have arisen on the status of Blue Books as authoritative legislative history.

52. Temp. Reg. §1.163-5T(d), TD 8046, 1985-2 CB 61. When the temporary regulations under Temp. Reg. §1.163-5T(c) were made final by TD 8110, 1987-1 CB 81, Temp. Reg. §1.163-5T(d) was inadvertently removed. It was republished by TD 8202, 1988-1 CB 78.

53. Reg. §1.871-14(d).

54. Reg. §1.871-14(d)(3).

in practice, an organization such as Fannie Mae, Freddie Mac, Ginny Mae, or the VHA) under a commitment issued not more than 14 months before the issuance of the certificate. However, the pool cannot contain obligations on which the first scheduled monthly payment of interest and principal was made more than 12 months before issuance of the commitment.[55]

! The interest is considered to be paid on the pass-through certificate and not the underlying obligations. Therefore, the pass-through certificate must satisfy the generally applicable conditions for obligations in bearer form or registered form. Whether the underlying obligation satisfies those conditions is irrelevant (except for the requirements concerning the date of issuance of the underlying obligations).[56]

! The trustee of the pass-through trust must be a U.S. person.[57]

The pass-through certificate rules have been used to package obligations which are not traditional mortgages secured by real property, such as auto and boat loan receivables and other forms of consumer receivables. This device has been used when the use of registered form for the underlying obligation would be impracticable, the requirement that consumers file Form 1042 is compliance-proof, and the foreign-targeting requirements could not even theoretically be complied with.

There had been an uncertainty about whether Reg. §1.163-5(d)(1) covers obligations not secured by mortgages of real property. In this connection, an interesting pair of private rulings in 1993 confirms that a pool of securitized loans, at least if they are self-amortizing, will qualify for treatment under the pass-through trust rules even if not secured by real estate.[58] The rulings concern a pool of notes or contracted indebtedness with respect to the purchase of time-share interests which were organized either as shares in a nonprofit corporation or as club memberships. In both cases, the timeshare interests pledged by the purchasers could not have been treated as real property because the purchaser/debtor acquired the right to stay at the resort only in a specified class of units, rather than a specifically identified unit, and only during a range of weeks in a particular season, rather than a particular week. The rulings could therefore be extended to other securitized loans, such as auto loans, recreational vehicle loans, and boat loans. The rulings may not be as directly helpful where the securitized loan is a pool of credit

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[55]. Reg. §1.871-14(d)(3)(i)-(iv). This does not represent much of a liberalization and, in fact, cannot apply to underlying obligations issued before Oct. 1, 1984, at the absolute earliest (27 months before Jan. 1, 1987) unless the first payment of interest and principal had been deferred beyond one month. The Treasury's decision not to extend the exemption to pools of mortgages composed of or including older mortgages was criticized because the legislative policy underlying the July 18, 1984, cut-off was to protect the Netherlands Antilles from the effects of the repeal of the tax it collected on the 1% spread earned by international finance subsidiaries. In all other respects, the legislative policy liberalized access to the Eurocurrency market. Because pass-through certificates were not placed on the Eurodollar market in any quantity before 1985, both legislative policies would have been served by a more liberal approach. The passage of the years is solving the problem in any event - the number of unrefinanced mortgages

[56]. Reg. §1.871-14(d).

[57]. Id.

[58]. Ltr. Rul. 9321008 (Feb. 12, 1993) and Ltr. Rul. 9321009 (Feb. 12, 71993).

card receivables, which are not self-amortizing (and, more importantly, the receivables are collateral for bank-issued debt rather than owned by the trust).

It is essential to avoid characterizing the trust as a business entity, which in turn, requires careful attention to the new "check-the-box" regulations and to a line of cases and rulings related to investment trusts.[59]

>>>>**WARNING**>>>The check-the-box regulations indicate that an investment trust that fails the requirements of a grantor trust will be treated as a "business entity." A domestic business entity will, in general, be treated by default as a partnership if it does not fall into one of eight specific categories, none of which are apt to describe a trust. The problem is that, although a partnership is a pass-through entity, there are no rules allowing interest received on obligations held by the partnership which do not meet either the registered or bearer form requirements to be treated as portfolio interest, even if the partnership interests are in registered form.[60]

>>>>**PLANNING POINT**>>>The pass-through trust may be a useful vehicle when it is desired to convert an instrument or group of instruments not in registered form into registered form instruments without the cooperation of the borrower. The private letter rulings referred to above make it clear that there can be a single holder of the trust instruments.

The IRS had not previously indicated its position on whether a "pool" could consist of a single obligation, but there was no policy reason why it should not. The point of the registered form rules is to ensure that a U.S. issuer knows (and can tell the IRS) who the holder is and either receives the certification of foreign status or notification of the holder's taxpayer identification number. A pass-through trust with a U.S. person as trustee achieves this irrespective of the number of certificate holders or the number of underlying obligations. In a private letter ruling in 1995, the IRS apparently agreed, holding that a single loan can be held by a pass-through trust.[61]

FASIT. Finally, the Small Business Job Protection Act of 1996 enacted IRC §§860H-L, effective September 1, 1997, to allow creation of a new type of entity called a FASIT (financial asset securitization investment trust).[62] The FASIT is defined as any entity electing FASIT treatment (1) in which all interests are "regular interests" or a single ownership interest to be held by a domestic corporation and (2) that, as of the close of the third month following the day of

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[59]. Reg. §301.7701-4(a) and (c); Commr. v. North American Bond Trust, 122 F.2d 545 (CA-2 1941); Commr. v. Chase National Bank, 122 F.2d 540 (CA-2 1941); Rev. Ruls. 70-545, 1970-2 CB 8; 71-399, 1971-2 CB 433; 75-192, 1975-2 CB 384; 77-349, 1977-2 CB 20; 78-149, 1978-1 CB 448; and 80-96, 1980-1 CB 317; Ltr. Ruls. 8512061 (Dec. 27, 1984) and 8803006 (Sept. 23, 1987).

[60]. See Reg. §301.7701-4(c) and §301.7701-3(b)(1) as amended by T.D. 8697 (1996).

[61]. Ltr. Rul. 9548018 (June 30, 1995)

[62]. Small Business Job Protection Act of 1996, Sec. 1621(a), enacted Aug. 20, 1996.

formation, holds only "permitted assets."[63]

"Regular interests" are defined as interests permitting the owner to receive a specified principal amount (or other similar amount) and interest at a fixed or variable rate. In addition, maturity must not exceed 30 years (including options to renew), and the issue price must not exceed 125% of the stated principal amount. The yield to maturity must not exceed the applicable high yield discount obligation trigger rate (applicable Federal rate plus 5%).[64] Certain high-yield interests are nevertheless permitted.[65]

"Permitted assets" include cash, cash equivalents, debt instruments, foreclosure property, various non-equity derivatives used as hedges, contract rights to acquire debt obligations or derivatives, regular interests in another FASIT, and regular interests in REMICs.[66]

The FASIT legislation never mentions the treatment of foreign holders. FASITs are not taxable, except for the usual 100% tax on prohibited transactions.[67] A regular interest in a FASIT is treated as a debt instrument and the applicable high-yield debt obligation rules do not apply to the interest. Holders are required to use the accrual method of accounting, although this appears to be irrelevant to foreign holders.[68]

Although it is too early to tell, the FASIT may turn out to be a useful vehicle which does not suffer some of the uncertainties caused by the restrictive rules defining a traditional pass-through trust. There appears to be no reason why the portfolio interest exception would not apply to the yield paid by a FASIT to its regular interest holders, although it would be helpful if the IRS used its grant of regulatory authority to state this explicitly.[69]

(2) Controlled Foreign Corporations

As noted earlier, portfolio interest does not include interest received by a CFC from a related person.[70] Also, IRC §881(c)(4) sets out a number of special rules for CFCs. These rules are designed to remove any advantages that might otherwise arise when CFCs lend money to unrelated U.S. persons (instead of distributing the income to the shareholders). Several of these rules are the subject of technical corrections found in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88) that were required by the extensive changes made to the CFC provisions by the Tax Reform Act of 1986:

! Interest is foreign base company income (and thus part of subpart F income) even if the CFC is otherwise subject to the de minimis exception applicable when the sum of foreign base company income and gross insurance income is less than 5% of gross income or $1 million,

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63. IRC §860L(a)(1).

64. IRC §860L(b)(1)(A).

65. IRC §860L(b)(1)(B).

66. IRC §860L(c).

67. IRC §860H(a) and §860L(e).

68. IRC §860H(c).

69. IRC §860L(h).

70. IRC §881(c)(3)(C). See ¶5015.1(3).

whichever is less.[71]

! Interest is foreign base company income notwithstanding the exception for high withholding tax interest.

! Interest is foreign personal holding company income (and therefore foreign base company income) even if it would otherwise not be under the special rule for income received from related persons.[72]

(3) International Finance Subsidiaries

Grandfathered international finance subsidiaries. In enacting the portfolio interest exemption, Congress intended to preserve the favorable treatment accorded to pre-July 19, 1984, loans through preexisting Netherlands Antilles finance subsidiaries and to encourage the use of direct borrowing by U.S. multinationals in the Eurodollar market.

As already noted, portfolio interest does not include interest on obligations issued before July 19, 1984.[73] The legislative history indicates that this prohibition cannot be circumvented by the device of having a U.S. parent company assume its finance subsidiary's obligations.[74] The IRS has issued at least one private ruling permitting the exemption to apply when a U.S. parent assumed its Netherlands Antilles finance subsidiary's obligation to issue notes after July 18, 1984, under warrants issued on or before that date.[75]

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71. IRC §881(c)(4)(A)(i) and §954(b)(3). IRC §954(b)(3) was amended by Tax Reform Act of 1986, Sec. 1223(a), for tax years beginning after 1986. Previously, the threshold applied if foreign base company income was less than 10% of gross income and there was no monetary cap. Unlike other cross-references to CFC provisions, an appropriate amendment tracking the change was made to IRC §881(c)(4)(A)(i) by Tax Reform Act of 1986, Sec. 1223(b)(2).

72. According to IRC §881(c)(5)(A)(iii) and (iv), portfolio interest is foreign personal holding company income notwithstanding the rule of IRC §954(c)(3)(B) and (C) excepting income received from unrelated persons by banks and finance companies in the conduct of its business or by insurance companies from investments of unearned premiums or reserves or one third of its earned premiums. IRC §954(c) was rewritten by Tax Reform Act of 1986, Sec. 1221(a)(1), so that all interest and interest equivalents (such as loan commitment fees) are now foreign personal holding company income except export financing interest. TAMRA '88 Sec. 112(i)(17) corrects the cross-reference in IRC §881(c)(5)(A)(iii) to refer to the exception in IRC §954(c)(3)(A)(i) for income received from related parties and to delete IRC §881(c)(5)(A)(iv). Under IRC §881(c)(5)(A)(v), such interest is also foreign personal holding company income notwithstanding the rule of former IRC §954(c)(4)(A) and (B) excepting interest received by a CFC from an unrelated payor if either the payor is created or organized and does a substantial part of its business in the CFC's country of incorporation or the CFC is a bank that does most of its business with unrelated persons. TAMRA '88 deletes the cross-reference because the exception has been repealed.

73. Tax Reform Act of 1984, Sec. 127(g)(1).

74. See Conference Report on the 1984 Deficit Reduction Act, H.R. Rept. No. 98-861, 98th Cong., 2d Sess., at 937. But compare statement of the Manager of the Conference on the Revenue Reconciliation Act of 1989 (H.R. 3299) (Nov. 21, 1989) at 66-7.

75. Ltr. Rul. 8546024, PH Private Letter Rulings ¶4074(85).

In setting the July 19, 1984, effective date, Congress decided to regularize the position of existing finance subsidiaries. These subsidiaries would have otherwise remained subject to IRS challenge. Thus, Sec. 127(g)(3) of the Tax Reform Act of 1984 provides an amnesty for "applicable CFCs" in existence on June 22, 1984. Under the amnesty, the IRS cannot impose a withholding tax on that interest based on treaty shopping arguments.

Specifically, interest paid on a "United States affiliate obligation" to an applicable CFC is treated as paid to a resident of the country where the applicable CFC is incorporated. This rule applies provided the CFC continues to meet the IRS requirements formerly imposed as a condition to the issuance of favorable rulings to finance subsidiaries in connection with the interest equalization tax.[76] Broadly, these rulings required maintenance of a 5 to 1 debt to equity ratio.[77] This ratio was increased by Sec. 6128 of TAMRA '88 to 25 to 1 for tax years after November 10, 1988.

The following definitions are applicable:

! "Applicable CFC" is defined as a CFC, the principal purpose of which on the date of the interest payment is the issuing of "CFC obligations" and the holding of short-term obligations and lending the proceeds of these obligations to affiliates.[78]

! "United States affiliate obligation" is defined as any obligation which is payable by a U.S. affiliate. Strictly speaking, therefore, an obligation need not meet any additional tests.

! "CFC obligation" is defined as an obligation that met the targeting condition when issued.[79] Also, to be a CFC obligation, an obligation issued after 1982 (the effective date of the TEFRA issuer sanctions for unregistered obligations that are registration-required) had to meet the interest payment condition and the legending condition.[80]

In brief, a typical international finance subsidiary entitled to the benefit of a treaty, almost invariably the treaty between the United States and the Netherlands or that treaty as extended to the Netherlands Antilles, in most but not all cases should continue to receive interest from its

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76. Tax Reform Act of 1984, Sec. 127(g)(3)(B).

77. The rulings in question are Rev. Ruls. 69-501, 1969-2 CB 233; 69-377, 1969-2 CB 231; 70-645, 1970-2 CB 273; and 73-110, 1973-1 CB 454. Sec. 6128 of TAMRA '88 increased the ratio to 25 to 1.

78. See Tax Reform Act of 1984, Sec.121(b)(2)(D), as modified for the purposes of the grandfathering rule by Sec. 127(g)(3)(C). The term "affiliate" is defined as a related person within the meaning of IRC §482. Experts in related party rules will appreciate the fact that, with all the related party rules to choose from, the drafters of the legislation chose to refer to a Code provision that in fact does not refer to related persons. (The implementing regulations under IRC §482 yield no further light.)

79. That is, the condition in IRC §163(f)(2)(B)(i) that an obligation be issued under arrangements reasonably designed to ensure that it would not be sold (or resold in connection with its original issuance) to U.S. persons. Tax Reform Act of 1984, Sec. 121(b)(2)(G)(i). This requirement is a little harsh in light of the fact that the foreign targeting requirements were only introduced in TEFRA.

80. TEFRA, Sec. 121(b)(2)(G)(ii). See ¶5014.4(2) for a description of these conditions.

U.S. parent on pre-July 19, 1984, loans free of withholding tax. Given the passage of time, the number of these loans has diminished.

Assaulting other finance subsidiaries. Soon after enactment of the portfolio interest exemption, the IRS issued Rev. Ruls. 84-152 and 84-153, which attacked finance subsidiaries not covered by the grandfathering provisions (such as foreign controlled finance subsidiaries). The IRS was criticized for not using its power under IRC §7805(b) to make the rulings prospective in effect and the capriciousness of applying the rules to the offerings of U.S.-owned finance subsidiaries in the window period between June 22 and July 18, 1984.[81] After issuance of the rulings, the IRS soon began issuing private letter rulings to the effect that Rev. Rul. 84-153 would not be applied retroactively.[82] Eventually, on October 15, 1985, the IRS issued Rev. Rul. 85-163, which stated that neither Rev. Rul. 84-152 nor Rev. Rul. 84-153 would be applied to obligations issued before October 15, 1984, or under a binding commitment issued before that date. This largely eliminated problems encountered by U.S. issuers in the Eurodollar market but it placed significant pressure on foreign-controlled international finance subsidiaries, as discussed in greater detail below in the discussion of back-to-back loans.[83]

The 1987 partial termination of the Netherlands Antilles treaty. On June 29, 1987, the IRS announced that it had notified the Netherlands Antilles and Aruba that it was terminating the extension of the 1948 U.S.-Netherlands income tax treaty to those countries.[84] The termination was to be effective as of January 1, 1988. Soon afterwards, the Treasury reversed course in response to protests from a substantial number of U.S. institutional holders and announced on July 10, 1987 a revision to the notice of termination. The revised notice terminated the entire Dutch treaty, as extended, except for Article VIII.[85]

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[81]. For a critique of the rulings and citations to a series of articles and letters criticizing the rulings, see 6 Northwestern Journal of Law and International Business, 963-966 (Northwestern Note).

[82]. The IRS has already indicated that relief under IRC §7805(b) from the effects of Rev. Rul. 84-153, *supra* note 43, might be available for obligations issued during the “window period” from June 22 through July 18, 1984. IR-84-110 (October 18, 1984). See discussion in Feingold and Fishman, “The DRA's elimination of the `withholding tax' on portfolio interest”, 62 J. Tax. 170, note 47 (1985); Northwestern Note at 966.

[83]. See text accompanying note et seq.

[84]. Technically, what was being terminated was the extension of the 1948 U.S.-Netherlands treaty as extended to the Netherlands Antilles in 1955 and as further extended to Aruba when it separated from the Antilles in 1986. The text applies equally to the Netherlands Antilles and Aruba.

[85]. There are doubts as to the validity of reinstating of Article VIII in this way. For example, because there was no apparent defect in the original notice terminating the Antilles treaty, the reinstatement of Article VIII arguably constituted a new treaty. Treaties generally can only be constitutionally entered into with the advice and consent of the U.S. Senate. In any event, the IRS has confirmed in Rev. Rul. 87-79, 1987-2 CB 334, that it will uphold the continued effectiveness of Article VIII unless and until a further notice of termination becomes effective. In 1996, the protocol to the Dutch treaty terminated Article VIII's application.

There had been some concern about how the Netherlands would react to the modification of the notices. However, the Treasury announced that, at a meeting in the Hague on September 4, 1987, with Dutch officials, a "common understanding" was reached that the entire treaty, except for Article VIII and its "ancillary provisions," would indeed terminate effective January 1, 1988.[86] The "common understanding" was never published in writing, despite uncertainties about the constitutionality of first terminating and then reversing its position and partially reinstating a treaty.

The full termination of the treaty in 1996. On October 12, 1995, the Treasury Department announced that it had reached agreement two days earlier with the Netherlands on the final termination of the extended Dutch treaty to the Netherlands Antilles and Aruba, effective on the later of June 30, 1996 or exchange of instruments of ratification. The arrangements to terminate the treaty include preservation of a zero rate of withholding on pre-October 15, 1984, Eurobonds issued by Netherlands Antilles corporations. No such rule is made for Aruba, as the Treasury announced that it was not aware of any such Eurobonds issued through Aruba.[87] Instruments of ratification were exchanged on December 30, 1996, regarding the Netherlands Antilles and on January 1, 1997, regarding Aruba.

(4) Estate Tax

If the interest on any part of an obligation would be portfolio interest if paid to the holder at his or her death, the obligation is exempt from the estate tax.[88] However, the IRS is given authority by OBRA '93 to issue regulations treating as U.S. situs property for estate tax purposes an appropriate portion of a debt obligation that carries contingent interest disqualified under OBRA '93 rules from portfolio interest treatment.[89] No regulations have been issued to date.

Gifts of these obligations by nonresident alien donors are not subject to gift tax under the

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[86]. See report in BNA's Daily Tax Reporter No. 178, G-2 (Sept. 16, 1987). Rev. Rul. 87-79, *supra* note , refers to the survival of "such other ancillary provisions ... as apply to effectuate, modify or limit the exemption from tax provided by Article VIII." This obviously includes Article I of the 1963 Protocol, which requires that the Netherlands Antilles corporation not avail itself of the special reduced rates of Articles 13, 14, and 14A of the Netherlands Antilles Profits Tax Ordinance of 1940. (Typical Netherlands Antilles finance companies do not rely on these reduced rates and, instead, have avoided Netherlands Antilles profits tax by deducting interest paid on shareholder and other loans. This in turn can lead to the conduit problems dealt with in Rev. Rul. 84-152, *supra* note ; 84-153 1984-2 CB 383; and 87-89, *supra* note).

[87]. Protocol dated October 10, 1994, between Netherlands and the United States (Netherlands Antilles); exchange of letters dated September 15, 1995, between Netherlands and United States (Aruba).

[88]. IRC §2105(b)(3) provides that, for a nonresident alien, an obligation will be deemed properly situated outside the United States (and hence not subject to the estate tax) if any interest thereon would be eligible for the portfolio interest exemption if that interest were received by him or her at the time of his or her death (but without regard to whether any required statement of beneficial ownership had been received). For estate tax purposes, a nonresident alien is defined in terms of his or her domicile. See Reg. §20.0-1(b)(2).

[89]. IRC §2105(b)(3) and flush language following.

general rule that the tax only applies to real property and tangible personal property.[90] OBRA '93's rule relating to treatment of contingent interest obligations for estate tax purposes does not affect this rule, because the situs of intangible property is irrelevant for gift tax purposes.

Finally, under regulations published at the end of 1995, direct skip transfers by nonresident aliens are subject to the tax on generation-skipping transfers only if the transfer is subject to gift tax or estate tax.[91] A taxable termination or distribution is similarly taxable under these rules only if the transfer of property into trust would have been subject to estate or gift tax.[92]

[¶5015.3] **PLANNING POINTS**

(1) Alternatives to the Portfolio Interest Exemption

Sometimes, the conditions for qualifying for the portfolio interest exemption cannot be readily met. The following describes some alternative techniques of general application.

RUFs, NIFs, and other revolving facilities. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar techniques evolved to take advantage of the exemption from withholding tax available for original issue discount (OID) on obligations having a maturity of 183 days or less.[93] Unlike portfolio interest obligations, these facilities create obligations that can be held by banks as principals.

Although RUFs and NIFs come in many forms and acronyms, the basic idea is that a bank or syndicate of banks undertake a multi-year commitment to purchase short-term obligations (notes or commercial paper) issued by the borrower. The notes are then sold to the market on a best-efforts basis, through a tender panel or on a fully underwritten basis.[94]

The IRS has challenged fully underwritten note issuances to the extent not resold in the public market. The IRS reasons that the true maturity of the notes in reality exceeds 183 days because the syndicate must buy and, if no purchaser is found, hold a replacement note at

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90. IRC §2501(a)(2). Note, however, that certain former U.S. citizens are subject to the tax on all U.S.-situs assets during the 10 years following loss of citizenship. IRC §2501(a)(3), §2511(a). For this purpose, a debt obligation issued by a U.S. person or by the United States, a state or local government, or the District of Columbia is deemed to be situated within the United States. IRC §2511(b).

91. See IRC §2612(c)(1). Reg. §26.2663-2(b)(1) (December 29, 1995; corrected June 12, 1996).

92. Reg. §26.2662-2(b)(2) (December 29, 1995; corrected June 12, 1996).

93 IRC §871(g), enacted by Tax Reform Act of 1984 Sec. 128(a), effective for payments on or after September 16, 1984, for obligations issued after March 31, 1972. The 1984 amendments continued approximately the same exemption under prior law. Under prior law, OID on instruments issued after March 31, 1972, was subject to withholding tax only under IRC §871(a)(1)(C), which by its own terms did not apply to obligations payable six months or less after the date of original issue.

94. See, generally, *Euronotes: RUFs, TRUFs, NIFs, SNIFs and BONUSES*, ed. Bankson and Lee (Euromoney Publications 1985) at 63; Dilworth and Harter, "U.S. tax considerations when issuing short-term Euronotes", 6 Int'l. Fin. Law Rev. 34 (1987)

maturity.[95] However, although lenders and borrowers under these arrangements need to tread warily, RUFs and NIFs remain a popular alternative to Eurobonds.

Treaty lenders. Another alternative is simply to take advantage of the exemptions and rate reductions provided in most U.S. income tax treaties. This alternative is generally appropriate when a lender entitled to treaty protection makes a loan for which it either does not require (or is not entitled to) the greater marketability afforded by a portfolio interest obligation, particularly one in bearer form.

For treaty-protected lenders related to the borrower, reliance on the treaty is the principal available option. However, it is generally a good idea to comply with the portfolio interest requirements to the extent possible, so as to make it possible for the obligation to be assigned to an unrelated person. Also, treaty lenders should be aware of the base erosion rule contained in several treaties, permitting the United States to deny interest deductions when the percentage of the borrower's taxable income sheltered by related party interest exceeds a specified percentage.[96]

Increasingly, lenders in treaty countries must also qualify under the limitation on benefits article invariably included in any treaty negotiated or renegotiated by the United States beginning in the mid-1980s.[97]

Treaties are also useful when the lender is a foreign bank that expects to retain the loan in its portfolio. An example would be a loan made by a treaty country bank to the U.S. subsidiary of a multinational based in the treaty country.

U.S. branch of foreign bank. When the lender is a foreign bank, the bank may be entitled to the benefit of a treaty (see above). However, if the treaty does not completely eliminate the tax, the tax may be greater than the bank's net profit. Banks may earn a gross profit margin (spread) of less than a single percentage point on a loan, so that a tax rate of 10% or even 5% on gross interest income could represent a tax rate on net income of many times more than 100%. One way to overcome this is for the foreign bank to make the loan through its U.S. branch, so that it will be taxable only on the net profit after deduction of cost of funds and other deductible expenses. The foreign bank must deliver to the U.S. borrower an IRS Form 4224 [Exemption From Withholding of Tax on Income Effectively Connected With the Conduct of a Trade or Business in the United States], stating that the interest is effectively connected with the conduct of a U.S. trade or business and is therefore not subject to withholding.[98] Form 4224 will be replaced by Form W-8A after 1999.[99] This approach may prove practical because, with the

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95. See GCM 39301 (May 25, 1983). The IRS will not now rule on whether a debt instrument is a short-term obligation if the instrument is issued to a CFC of the issuer. Rev.Proc 87-6, 1987-1 CB 541.

96. For example, 1975 U.S.-U.K. income tax treaty, Article 11(7) (signed December 31, 1975, entered into force April 25, 1980).

97. See, for example, 1984 U.S.-Netherlands income tax treaty, art. 26, probably the most complex and extensive example. Among our major treaty partners, the United Kingdom and Japan stand out as not having yet negotiated new treaties with a limitation-on-benefits provision.

98. Casa De La Jolla Park Inc., 94 TC 384 (1990).

99. Announcement 98-51, 1998-24 IRB1.

reduced U.S. tax rates of the Tax Reform Act of 1986, foreign banks may be more willing than in past years to book loans to a U.S. branch.

80:20 companies. An alternative technique when using the proceeds of the loan outside the United States is the 80:20 company. Before the Tax Reform Act of 1986 changes, the 80:20 company was any U.S. corporation if more than 80% of its gross income in a three-year test period preceding the tax year of payment derived from foreign sources.[100] All interest paid by the 80:20 company was treated as foreign-source.

The Tax Reform Act of 1986 changed the rules to require that, during this test period, the 80:20 corporation must derive at least 80% of its gross income from "active foreign business income," defined as foreign-source income derived from the active conduct of a trade or business by the corporation or a subsidiary or chain of subsidiaries.[101] Also, when the interest is received by a related person,[102] the Tax Reform Act of 1986 only treats as foreign-source a percentage of the interest corresponding to the percentage of the corporation's foreign-source gross income to gross income from all sources.[103]

There is no requirement that the proceeds of the loan actually be used outside the United States provided the 80:20 company can meet the 80% foreign business requirement. Obviously, however, an indirect consequence of using the proceeds in the United States is likely to be an increase in U.S.-source gross income, making the 80:20 requirement harder to meet.

(2) Back-To-Back Loans

The expression "back-to-back loan" covers a variety of devices. The basic idea behind all of them is the interposition of an intermediate lender between a lender and a borrower when a loan by the lender to the borrower would not qualify for any exemption or acceptable rate reduction. Unless the transactions are recharacterized, the intermediate lender will be entitled to an exemption or will be entitled to pay tax only on the spread between the rate charged to the borrower and the rate charged by the lender.

The obvious example is a loan made by a lender not resident in a treaty country, foreign or domestic, to a corporation organized in a treaty country that in turn lends the funds to the U.S. borrower. If the treaty country (for example, the Netherlands) imposes no withholding tax on the interest paid to the lender and taxes the intermediate lender only on the spread, the structure achieves its objective. A similar idea is the making of a bank deposit with a bank when the bank or a U.S. branch or subsidiary lends an equivalent amount to the U.S. borrower.

As noted earlier, this type of planning reached its height in the international finance subsidiary. It has been heavily disfavored by Congress[104] and the IRS. The IRS evidently took the transitional provisions of the Tax Reform Act of 1984 as a signal to mount an assault on finance subsidiaries not covered by the grandfathering provisions. The two obvious targets were

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100. IRC §861(a)(1)(B), before amendment by Tax Reform Act of 1986 Sec. 1214(a)(1).

101. IRC §861(c)(1)(B) and (C).

102. A "related person" is defined, this time, by reference to a modified set of rules under IRC §954(d)(3). IRC §861(c)(2)(B).

103. IRC §861(c)(2)(A).

104. See Conference Report on the 1984 Deficit Reduction Act, H.R., Rep. No. 861, 98th Cong. 2d Sess. 937-8 (1984); see also IRC §7701(l), enacted by OBRA '93, Sec. 13238.

U.S.-owned finance subsidiaries issuing obligations after June 22, 1984, and finance subsidiaries owned by foreigners and used to finance U.S. operations. Thus, on October 15, 1984, the IRS issued Rev. Rul. 84-152 and Rev. Rul. 84-153.[105] Although these rulings have now been declared obsolete by the IRS in connection with issuance of the anti-conduit regulations under IRC §7701(l), a description of them has been retained in this update because they remain applicable for interest paid prior to September 11, 1995.[106]

Rev. Rul. 84-152. The facts in these rulings are somewhat similar. In Rev. Rul. 84-152, P, a Swiss parent company, owned all of the stock of R, a U.S. corporation, and S, a Netherlands Antilles corporation. R required a significant increase in working capital and, on August 1, 1984,[107] P advanced funds (presumably in dollars) to S at a fixed rate of 10% per year. S in turn advanced them to R at a fixed rate of 11% per year. R timely paid interest to S, which in turn timely paid interest to P. S retained the spread less expenses. The ruling stated that neither R nor S was thinly capitalized and the transactions had "some business or economic purpose."

Relying principally on the *Aiken Industries* case,[108] the IRS ruled that S, while a valid Netherlands Antilles corporation, did not "derive" the interest from R as required by Article VIII of the Netherlands treaty. As interpreted by the ruling, this expression referred to obtaining dominion and control over the interest and not merely temporary physical possession. S was merely a conduit for the passage of interest payments from R to P. Therefore, the interest paid by R was treated as received by P and subject to withholding tax at the 5% rate available under the Swiss treaty. Presumably, if P was resident in a nontreaty partner state, the full 30% tax would have to be withheld.

Rev. Rul. 84-153. In Rev. Rul. 84-153, the IRS reached an identical result when P was a U.S. parent and S was a Netherlands Antilles finance subsidiary. The ruling involved two Eurobond offerings, one on July 1 and the other on September 1, 1984, each carrying a 10% coupon, with the proceeds being relent to R, a U.S. subsidiary of P, at 11%. Unlike in Rev. Rul. 84-152, the date of issuance of the obligation is significant. The obligations issued on July 1, 1984, fell in the window between the June 22, 1984, cut-off date for CFC obligation under the grandfathering rules for applicable CFCs and the July 19, 1984, effective date for the portfolio interest exemption.

Interest received by S on the obligation issued on September 1, 1984, was not directly entitled to the portfolio interest exemption because S is a CFC receiving interest from a related person. However, consistent with its position that a Netherlands Antilles finance subsidiary such as S is a mere conduit, the IRS has ruled privately on several occasions that interest paid through such a conduit is exempt if the conduit's obligations meet the portfolio exemption requirements.[109]

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105. See note .

106. See Rev. Rul. 95-56, *supra* note .

107. The date was not, in fact, material at the time the ruling was issued because there had been no change in the law and the ruling at the time was retroactive. The application of the ruling later was made prospective only by Rev. Rul. 85-163, *supra* note .

108. Aiken Industries, 56 TC 925.

109. For example, Ltr. Rul. 8728015, PH Private Letter Rulings ¶ 2296(87).

The IRS efforts to combat the use of conduits through rulings nevertheless encountered several problems. The 1984 rulings' reliance on *Aiken Industries* was suspect, since the case is distinguishable in critical respects.[110] The IRS made a further effort with Rev. Rul. 87-89[111] but this ruling never made much impact, perhaps because it was so overreaching that practitioners assumed it would be invalidated. Nonetheless, tax planners are aware that it is not a simple task to determine that a loan is a back-to-back loan, especially before the IRC §7701(l) regulations, and perhaps even now. It seems clear that a back-to-back loan would exist when (1) the deposit with the intermediate lender or other assets was pledged to secure the loan to the ultimate borrower, (2) the lender and ultimate borrower were related, (3) a minimal or inadequate spread was earned, (4) the intermediate lender would not have made the loan absent the deposit, (5) the ultimate borrower had little or no credit of its own, and (6) the intermediate lender had only transitory control of the interest before turning it over to the lender.

However, relatively few loans fall into the above description. Many of the facts may not be present or may be present in attenuated form. The difficulty lies in determining how attenuated the facts need be to negate the presence of a back-to-back loan arrangement. Until recently, this required a careful analysis of the *Aiken Industries* line of cases, Rev. Ruls. 84-152, 84-153, and 87-89 and recent legislative history.

Anti-conduit legislation and regulations. Congress intervened in 1993 by enacting IRC §7701(l), authorizing the IRS to issue regulations "characterizing any multiple-party financing transaction as a transaction directly among any 2 or more such parties" when needed to prevent tax avoidance.[112] On August 11, 1995, the IRS finalized the first set of anti-conduit regulations.[113]

The new regulations are intended to prevent the avoidance or reduction of U.S. withholding taxes by foreign investors through the use of intermediate "conduit" entities.[114] Under the regulations, IRS District Directors have the authority to recharacterize various "conduit" transactions and disregard the intermediate entities, if the effect would be to increase applicable U.S. withholding taxes. Because the regulations apply to any payment made after

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110. For example, in Aiken Industries, the conduit company did not earn a spread and the company was inserted into an existing lending arrangement. Further, the loan arrangements were found to have *no* business purpose at all. In the rulings, the IRS does not even mention, let alone analyze, these factual differences. Interestingly, on January 30, 1985, the IRS declassified GCM 37940, which analyzed a proposed but never issued ruling on facts very similar to those of Rev. Rul. 84-152, *supra* note , and that reached a similar result. However, the proposed ruling stated that, as a factual matter, routing the loan through S had no business purpose. In this respect, at least, GCM 37940's reliance on Aiken Industries is not misplaced.

111. See Rev. Rul. 87-89, 1987-2 CB 195.

112. OBRA '93, Sec. 13238.

113. TD 8611, 60 Fed. Reg. 40997. The regulations were issued in proposed form on October 14, 1994. See 59 Fed. Reg. 52110.

114. The heart of the regulations are set out in Reg. §1.881-3 (conduit financing agreements) and §1.881-4 (recordkeeping requirements). See also, Regs. §1.441-3(g) and §1.441-7(a) in relation to withholding obligations.

September 11, 1995, except for transactions grandfathered by the Tax Reform Act of 1984, Sec. 127(g)(4), taxpayers should review existing transactions that may be affected by the regulations. The regulations should supplant the published and private rulings issued by the IRS regarding conduit transactions, and transactions that were appropriate under prior IRS guidance may need to be reexamined under the regulations.

The regulations, which introduce a new vocabulary of terms not used elsewhere in the Code, apply to "financing arrangements" that involve "intermediate entities." In general terms, a "financing arrangement," for purposes of the regulations, includes any series of "financing transactions" by which one person (the "financing entity") advances money or other property, or grants rights to use property, and another person (the "financed entity") receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (the "intermediate entity") and there are financing transactions linking the financing entity, the intermediate entity, and the financed entity. "Financing transactions" are broadly defined. In addition to conventional loans, the definition includes leases, licenses and royalty arrangements. In addition, certain stock issuances (in which redemption by the issuer or repurchase by a party related to the issuer is required or more likely than not to occur) may be deemed financing transactions.

If there is a financing arrangement, an IRS District Director may disregard an intermediate entity if (1) the participation of the intermediate entity reduces U.S. withholding tax (for example, because of a reduced or eliminated withholding under an applicable tax treaty), (2) the participation of the intermediate entity, under all the facts and circumstances, is pursuant to a "tax avoidance plan," and (3) either (i) the intermediate entity is related to the financing or the financed entity or (ii) the intermediate entity is unrelated but would not have entered into the financing arrangement on substantially the same terms but for the fact that the financing entity is engaged in the financing transaction with the intermediate entity.

The participation of an intermediate entity that is related to either the financing or financed entity will be presumed not to be pursuant to a tax avoidance plan if the intermediate entity engaged in significant financing activities (the active conduct of a trade or business to earn rents or royalties, or active management of a business, including risk management) in connection with the financing arrangement. If there is a guarantee of the financed entity's liability to an unrelated intermediate entity, it will be presumed that the unrelated intermediate entity would not have entered into the financing transaction without the guarantee, unless there is clear and convincing evidence to the contrary.

The IRS has also indicated that it is concerned about other potentially abusive transactions involving conduits, is monitoring the situation, and may issue additional regulations or other guidance regarding conduit transactions.

Information gathering. The IRS task has been complicated by its difficulties in information gathering. To some extent, these were remedied by IRC §6038A, enacted by TEFRA, and expanded by the Revenue Reconciliation Act of 1989 and the Omnibus Budget Reconciliation Act of 1990, which requires annual reporting by foreign-controlled U.S. corporations of their transactions with related foreign persons. Beyond this, the IRS has information gathering authority under a variety of U.S. laws as well as certain rights to receive exchanges of information from treaty partners, including several agreements specifically devoted to exchange of information.[115] This remains, nonetheless, a difficult area for the IRS to police.

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[115]. Several such agreements have been entered into with countries which will be considered as part of the "North American area" under IRC §274(h)(6), enacted in 1983 as part of the

Guaranteed or Collateralized Loans. A loan by an unrelated person guaranteed by a parent or related party is not automatically disqualified from portfolio interest treatment under the 10-percent shareholder rule. A guarantee may be an indicator of a back-to-back loan if it is secured by a pledge of the guarantor's assets or the borrower is thinly capitalized. In more extreme cases, the IRS may assert that the transaction is a loan to the parent and a contribution of capital to the borrower. Recent developments suggest, however, that the IRS's principal weapon here will not be denial of interest exemption for the lender but denial of a deduction to the borrower. This will be the impact of the earnings skipping rules of IRC §163(j), as expanded by OBRA '93 to cover interest paid on a loan guaranteed by a related foreign person. “Guarantee” is defined to include “any arrangement under which a person (directly or indirectly through an entity or otherwise) assures [a loan] on a conditional or unconditional basis.”[116] The regulations under IRC §7701(l) provide that a guarantee in and of itself is not a financing transaction.[117] Note, however, that the posting of collateral consisting of a cash deposit or of property, which can be converted to cash before a default is treated as a financing transaction.[118] More problematic is the loan made by a domestic bank, secured by an agreement with its foreign affiliate, which in turn holds significant deposits from a foreign parent of the borrower. Such deposits may or may not be tied to repayment of the U.S. loan. . . .

> **>>>>PLANNING POINT>>>** Suppose a lender, instead of making a loan, gives a guarantee to a bank supported, directly or indirectly, by a pledge or deposit, and the bank makes the loan. Suppose that if the lender had made a direct loan to the borrower, interest could have qualified as portfolio interest, but only if the appropriate registered form provisions were included in the loan documentation and a Form W-8 was provided. Arguably, the transaction as structured does not cause a reduction in U.S. tax compared to what the parties could have done. What the transaction does is potentially avoid the need to comply with the registered form or bearer form requirements. This sort of structuring therefore has an undesirable element of uncertainty. It should be used only if there are substantial business reasons unrelated to avoidance of the formal requirements of the portfolio interest exemptions.

(3) Private Obligations

In planning for obligations that will be held by a single holder, or perhaps a small group of investors, it generally will be preferable to choose an interest in registered form. In a private

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Caribbean Basin Initiative: The countries currently covered are American Samoa, Barbados, Costa Rica, Dominica, Dominican Republic, Grenada, Guam, Honduras, Jamaica, Saint Lucia, Trinidad & Tobago and the U.S. Virgin Islands. Other agreements cover Aruba, Australia, the Bahamas, Bermuda, the Marshall Islands, Mexico and Peru. The United States has also ratified the information exchange provisions of the Convention on Mutual Assistance in Tax Matters promoted by the Council of Europe and the Organization for Economic Cooperation and Development.

[116]. IRC §163(j)(6)(B)(i) and (6)(D).

[117]. Reg. §1.881-3(e), Example 1.

[118]. Reg. §1.881-3(a)(2)(ii)(A)(4).

transaction, the requirements of the registered form obligation are, compared to the foreign-targeting requirements for bearer obligations, relatively straightforward.

The most important consideration is to ensure that the instrument is in registered form. This can be a little awkward, especially when the borrower is an individual, because most creditors would prefer not to allow their debtor to maintain a book entry system and even the requirement that the creditor has to surrender the note or other evidence of the obligation for reissuance is a little unappealing. Nevertheless, the inconvenience is probably justified by the tax savings.

In many cases involving private issuances of obligations, the obligation will be evidenced by a promissory note. For example, a foreign corporation might sell its U.S. or foreign subsidiary to a U.S. purchaser. A nonresident alien might sell a residence located in the United States or a foreign investor might lend money to a U.S. corporation. In these cases, the note must be drafted carefully if it is to meet the registered form requirement, as noted earlier (see ¶5014.3(2) above).

In private transactions, the related person restrictions are more likely to come into play. The lender must be made aware of the general rules concerning the definition of a related person, especially the attribution rules. Note, however, that there apparently is no restriction on applying the exemption in the case of loans by one individual to another. The restrictions apply only to loans by CFCs to a related party and to loans by 10-percent shareholders and partners. If the lender is a shareholder in the borrower (or vice-versa), the lender should particularly be made aware of how changes in capital structure can cause a shareholder to become a 10-percent shareholder.

(4) Converting Obligations to Registered Form

There are a number of situations when the holder of a note may want to take advantage of the portfolio interest exemption but cannot do so because the note does not meet the registered form requirements. There are two alternatives which may be considered here: amending the obligation and using a pass-through trust.

Amending the obligation. The parties to an obligation can agree to amend the note to put it in registered form. Although this would appear at first blush to be an innocuous step, some thought should be given to whether amendment would constitute a disposition of the note by the lender under the principles of *Cottage Savings v. Comm'r*[119] and recent regulations under IRC §1001.[120] Whether amendment constitutes a disposition may be of little significance in the case of an interest bearing note that is current because, if there are no other changes, the holder will recognize a gain of zero.[121] If the note carries significant original issue discount (OID), however, a deemed disposition of the note by a foreign person would result in accelerating the OID under applicable rules relating to OID in favor of foreign persons.[122]

Is conversion to registered form a disposition? The new regulations under IRC §1001 are

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119. 499 U.S. 544 (1991).

120. Reg. §1.1001-3.

121. Under Reg. §1.1273-2(d) the issue price of an instrument without OID is the stated redemption price at maturity, which is not changed when a debt instrument is converted to registered form.

122. IRC §871(a)(1)(c) and §881(a)(3).

silent, and the taxpayer would have to rely on a favorable application of the general principle of the regulations that a modification is only significant if, based on all the facts, the legal rights or obligation that are altered and the degree to which they are altered are economically significant. A private letter ruling issued prior to the finalization of the *Cottage Savings* regulations considered a situation under which the holder of a principal obligation and a stripped interest obligation could combine the two and receive the underlying bond in exchange.[123] It was proposed to amend the arrangement by providing that the principal obligation could also be combined with a stripped Treasury security providing for the same payment on the same date as the stripped interest obligation. The Service ruled that no IRC §1001 event occurred in the case of such a reconstitution transaction. The Service also noted, in passing, that because the interest certificates being replaced by the Treasury strips pre-dated July 19, 1984, the interest payments under the reconstituted obligations would not qualify for the portfolio interest exemption. Thus, the Service said, a reconstitution transaction "will not alter any of the economic or federal tax consequences" of the certificates. But, what if the transaction *had* changed the certificates so that the interest now qualified? In an informal conversation with the author, the principal drafter of the *Cottage Savings* regulations expressed his view that change from bearer to registered form was a modification but not a "significant modification" of the obligation.[124]

The author believes this view to be correct. Similarly, the general view of the tax bar in the somewhat analogous situation of the exchange of privately placed paper for SEC-registered paper is that exchange is not a realization. Many such transactions are structured with an initial issuance of privately placed instruments followed by an exchange offer in which the holders are offered SEC-registered paper. Tax discussions in offering circulars invariably state that these exchanges do not give rise to an exchange for tax purposes or other taxable event.[125]

Use of pass-through trust. In the same conversation, the author raised the possibility that the holder of an obligation wishes to convert the obligation into registered form with the involvement of the issuer. The nature of the obligation (for example, a credit card receivable) might not lend itself to the use of registered form or the issuer might be uncooperative or unwilling to take any withholding tax risk. The solution could be for the issuer to establish a pass-through trust with a U.S. trustee. There is no *Cottage Savings* issue--the obligation has not been modified and the transfer of an obligation to a grantor trust should not be a sale or exchange for tax purposes.

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[123]. Ltr. Rul. 9670006 (Feb. 1, 1996).

[124]. Telephone conversation with Tom Kelley, April 2, 1996.

[125]. Similarly, the general view of the tax bar in the somewhat analogous situation of an exchange of privately placed paper for SEC-registered paper is that the exchange is not a realization. Many such transactions are structured with an initial issuance of privately placed instruments followed by an exchange offer in which the holders are offered SEC-registered paper. Tax discussions in offering circulars invariably state that these exchanges do not give rise to an exchange for tax purposes or other taxable event. See, for example, Commodore Media, Inc. (13¼% Senior Subordinated Notes due 2003) (August 1995 - Pryor, Cashman, Sherman & Flynn); Protection One Alarm Monitoring, Inc. (13 5/8% Senior Subordinated Discount Notes due 2005) (October 1995 - Mitchell, Silberberg & Knupp); In-Flight Phone Corporation (14% Series A Senior Discount Notes due 2002) (December 1995 - Rogers & Wells).

The drafter of the *Cottage Savings* regulations also expressed the view that a transfer of notes (not in registered form) by a holder to a grantor trust when the participation interests are in registered form would not be treated as a disposition of the notes under the proposed regulations under IRC §1001, assuming that the holder was the sole grantor. The regulations do not address transactions among holders (that is, with no involvement on the part of the issuer), and given that under the grantor trust rules the holder would be treated as the owner of the very same notes, the holder could not be deemed to dispose of the notes to himself.

(5) Investment Funds

The banking and savings and loan industry experienced significant losses in the later 1980s and early 1990s, which led to a credit squeeze felt particularly acutely in the real estate industry. Developers in particular found conventional land acquisition funding and construction loans much more difficult to obtain. At the same time, interest rates shrank dramatically as countries struggled to stimulate economies severely affected by recession. This caused lower rates of return to be available to depositors in banks and money market funds.

This combination of illiquidity for real estate industry borrowers and lower interest rates payable to conventional depositors and bondholders resulted in several proposals for investment funds designed to provide high-yield loans to the real estate industry. Before OBRA '93, such loans might include a return combining a relatively low rate of interest (fixed or keyed to a variable rate such as LIBOR, Treasury bills, or prime) with an equity kicker. For non-U.S. investors not protected by treaty, the equity kicker loan is no longer viable because the portfolio interest exemption on contingent interest has been eliminated. However, a high-rate fixed-interest loan is still viable.

The making of a single loan to a single borrower involves few issues not already covered in this analysis. The lender must not be a bank making a loan in the ordinary course of business. What constitutes a bank is not entirely clear, although a typical fund probably is not a bank because it does not take deposits and make the loans in the conventional manner. There is always a question whether a loan at a sufficiently high rate may in practice involve an element of interest which is *de facto* contingent, whatever the documents may say. IRS suspicions on this account might be raised if a significant portion of the interest were deferred (except, perhaps, in the case of a relatively short-term loan of two or three years).

The making of a series of loans, however, whether to a single borrower or multiple borrowers, raises an additional question. The portfolio interest exemption is not an exemption from tax on ECI. Therefore, the applicability of the portfolio interest exemption is irrelevant if it is found that the lender, by virtue of the regularity and continuity of its business within the United States, is engaged in a U.S. trade or business with which the interest is effectively connected. On this basis, the lender would be subject to tax not under the flat-rate tax regime applicable to FDAP income to which the portfolio interest rules provide an exemption but under the net income regime applicable to ECI and (in the case of corporate lenders) to the taxes on branch level profits and interest.

The Code does not define engaging in a trade or business. IRC §864(b)(2) does explain when trading in securities or commodities constitutes a trade or business. However, it appears that an active business of financing should not be treated as trading in securities for purposes of IRC §864(b)(2).[126] On the other hand, a lender clearly can be treated as engaged in a U.S. trade

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[126]. See Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* ¶20.8 (Little Brown & Company 1996, looseleaf).

or business if it solicits loans within the United States and then actively manages the process within the United States of making and later administering the loans directly or through U.S. agents.[127] Judicial decisions indicate that the mere performance of clerical functions within the United States, even if quite extensive, is much less important than the exercise of discretion or business judgment regarding the activities under examination.[128]

We cannot here undertake a detailed analysis of the various factors to be considered in establishing a fund to make loans to U.S. borrowers that is designed to avoid engaging in a U.S. trade or business. By way of general guidelines, it seems safe to allow recordkeeping and collection functions to take place in the United States. By contrast, the lender should avoid, either directly or through agents, any loan origination activities in the United States as well as active involvement in supervising the borrower's activities, particularly if consents are required for various borrower actions based to any significant extent on the exercise of discretion or business judgment. The need for the lender to limit loan origination activities may compel the lender to limit its activities to approving on a take it or leave it basis a loan originated by a third party, perhaps based on standard pre-approved criteria. Left to judicial decision, the result will be driven by a weighing of all the facts and circumstances with little assurance to the parties in close cases.[129]

(6) Installment Sales

When a foreign person sells property, gain normally is taxable only if it is ECI or is deemed to be ECI under the Foreign Investment in Real Property Tax Act (enacted as IRC §897). However, if the foreign person sells property to a U.S. resident and in the process extends credit for part of the purchase price, U.S. tax considerations may come into play, whether or not the payments of principal are subject to U.S. taxing jurisdiction or are exempt. In particular, interest may actually be provided for by agreement or it may be imputed under IRC §1274 or the vestiges of IRC §483.

In any case, when interest on seller-provided credit would not be treated as ECI, the foreign seller should consider the availability of the portfolio interest exemption when the credit is capable of extending beyond an initial 183-day period (in that case, the interest will automatically be covered by the exemption for short-term OID). If the purchase money obligation is evidenced by a note or other instrument, it can be put in registered form and the seller can provide a Form W-8 to the buyer. In appropriate cases, when there are multiple U.S.

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[127]. See Inez de Amodio, 34 T.C. 894 (1960), on the attribution of an agent's activities to the taxpayer. Tax treaties usually recognize that an independent agent's activities should not be treated as a permanent establishment of the taxpayer and that even a dependent agent's activities will be not be so attributed unless the agent has (and habitually exercises) the power to enter into binding contracts on behalf of the taxpayer. For example, U.S. model income tax treaty of 1996, art. 5, para. 6.

[128]. Higgins, 312 U.S. 212 (1941); Spermacet Whaling & Shipping Co., S.A., 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (CA-6 1960); Scottish American Investment Co., Ltd., 12 T.C. 49 (1949).

[129]. The IRS agrees that this is a determination based on all the facts and circumstances, Rev. Rul. 88-3, 1988 C.B. 26, and will ordinarily not rule on whether the taxpayer is engaged in a U.S. trade or business, RevProc 94-7, 1994-1 C.B. 542, sec. 4.

buyers, especially consumers, a pass-through trust may be appropriate. When the interest might be ECI because of the nature of the activities which generated the debt, the seller might consider transferring the debt to another person who is not engaged in a U.S. trade or business and for whom the interest would not be ECI.[130]

One as yet uncertain area concerns the sale of a business by a foreign person in what is colloquially termed an "earn-out", meaning a transaction when the purchase price is contingent on some performance indicator regarding the business. In the most common variation, any portion of the price, contingent or otherwise, that is deferred more than one year will be subject to imputed interest under IRC §1274 or §483, except in the rare case when "open transaction" treatment is appropriate.[131] The question is whether the interest falls within IRC §871(h)(4), which as noted earlier, denies portfolio interest exemption treatment to interest contingent on performance indicators of the debtor or a related party of the debtor. In the typical earn-out, the interest rate is not contingent in the proscribed manner--being either fixed or variable using some conventional index such as prime, LIBOR, or even the applicable Federal rate--but the amount of the interest is affected by the amount of the principal obligation and the amount of that obligation *is* contingent. The exact phrase used by IRC §871(h)(4)(A)(i) is that "the amount of the interest is determined by reference to" the performance indicators. Indirectly, one might argue that it is, but it is equally and perhaps more forcefully arguable that the interest is calculated only when the amount of the contingent principal payment has been fixed. There are numerous variations to a transaction of this type.

> **Example.** How might one characterize interest payments on an escrowed fund which follow the seller's and buyer's respective entitlements to the fund's principal, when those entitlements might be contingent on the truthfulness of representations and warranties concerning past or future performance? The author can only draw attention to the issue without resolving it.

CONSULT TABLE UNDER THE TAB CARD "CROSS REFERENCE TABLE/INDEX" FOR OTHER ARTICLES AND NEW DEVELOPMENTS RELATED TO THIS SUBJECT

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130. See FSA 1998-232 (Released Mar. 12, 1992) (interest on FIRPTA installment receivable).

131. See Burnet v. Logan, 283 U.S. 404 (1931); Reg. §1.483-5 applies because the earn-out obligation is not a debt obligation within the meaning of IRC §1274.