

TTN Conference Miami 2016

Portfolio Interest Planning

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General Disclaimer: This discussion is not all encompassing as to the various U.S. tax issues associated with the U.S. income taxation of non-U.S. persons (e.g., foreign corporations and U.S. income tax nonresident alien individuals). The intention of this discussion is to provide a basic and general discussion as to specific common issues associated with the portfolio interest exemption found in Internal Revenue Code §§ 871(h) and 881(c). You should not, and cannot, rely upon this discussion as U.S. tax advice. If there are any U.S. tax concerns in relation to a specific inquiry relating to the U.S. tax treatment of portfolio interest or the planning relating thereto, please contact or engage appropriate U.S. tax counsel to advise accordingly.

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General Taxation of Non-U.S. Persons

Non-U.S. Persons (e.g., U.S. income tax nonresident aliens and foreign corporations) are generally subject to U.S. income tax on:

- U.S. source fixed or determinable, annual, or periodical income and gains (“FDAPI”), which are generally passive sources of income such as certain types of interest, dividends, royalties, etc.; and
- Income that is effectively connected with the conduct of a U.S. trade or business (a “USTB”).

General Taxation of Non-U.S. Persons

-FDAPI is generally subject to a flat 30% U.S. withholding tax, subject to exemptions for certain types of income [for example, bank-deposit interest and **portfolio interest** meeting the requirements of §§ 871(h) and 881(c)] and reduced rates (as low as zero) granted under a U.S. income tax treaty (when applicable).

-Properly reported USTB income is reportable on a net basis (after appropriate deductions) at graduated rates, with a maximum rate of 39.6%.

U.S. Income Tax Free Portfolio Interest?!?

-Although the U.S. income tax law imposes a 30% withholding tax on U.S. source interest paid to a non-U.S. person (as noted in the prior slides), it may be possible for interest to be paid free of the 30% withholding tax pursuant to the portfolio interest exemption (“PIE”).

Portfolio Interest General Requirements

Portfolio interest is interest that meets certain requirements, most notably:

-The debt obligation is to be in “registered” form. This means, essentially, that there must be certain restrictions on the transferability of the debt obligation by the lender. This can be achieved, for example, by having restrictions in the loan document prohibiting the transfer by the lender without an entry on a ledger maintained by the borrower, or without the lender surrendering the promissory note to the borrower and the borrower issuing a new promissory note.

-Generally, interest on an obligation in “registered” form constitutes portfolio interest only if the “withholding agent” (generally, the one paying the interest) receives an IRS Form W-8BEN or W-8BEN-E certifying that the beneficial owner of the obligation is not a U.S. person.

Limitations on Portfolio Interest

PIE is not available in certain situations, for example, PIE does not apply to:

- Interest received by a non-U.S. lender that is a “10% shareholder” of the borrower.
- Certain forms of indebtedness where the interest to be paid is “contingent” on the borrower's activity (known as “contingent interest”).

The “10% Shareholder” Rules...

PIE is not available on interest received by a non-U.S. lender that is a “10% shareholder” of the borrower.

In the case of a corporate borrower, a 10% shareholder is a person that owns (directly, indirectly, or constructively) 10% or more of the voting power of the borrower. In the case of a partnership borrower, a 10% shareholder is a person that owns (directly, indirectly, or constructively) 10% or more of the capital or profits interests in the borrower.

The “10% Shareholder” Rules...

The 10% shareholder limitation also applies to indirect shareholders using certain broad rules of attribution to determine such relationships, and, for the purposes of determining ownership of stock, certain rules apply.

Constructive Ownership of Stock

-Generally, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse and his children, grandchildren, and parents.

-Stock owned, directly or indirectly, by or for a partnership shall be considered as owned proportionately by its partners. Stock owned directly or indirectly by a corporation will be considered as owned by the shareholders in that proportion which the value of the stock which such person so owns bears to the value of all stock in the corporation.

-Stock owned by or for a non-grantor trust is considered as owned proportionately by its beneficiaries. Stock owned by or for a grantor trust shall be considered as owned by the grantor.

-Stock owned, directly or indirectly, by or for a partner shall be considered as owned by the partnership. Stock owned, directly or indirectly, by or for a beneficiary of a non-grantor trust shall generally be considered as owned by the trust. Stock owned by a grantor of a grantor trust shall be considered as owned by the grantor trust. Stock owned, directly or indirectly, by a shareholder of a corporation shall be considered as owned by the corporation.

Constructive Ownership of Stock

-Nonetheless, stock constructively owned by an individual shall not be considered as owned by such individual in order to make another individual the constructive owner of such stock. Stock constructively owned by a partnership, trust or corporation is not considered as owned by such partnership, trust or corporation in order to make a partner, beneficiary or shareholder the constructive owner of such stock.

Contingent Interest Rules

Portfolio interest does not include certain forms of “contingent interest” paid on a debt, such as:

-Any interest if the amount of such interest is determined by reference to: (a) any receipts, sales or other cash flow of the borrower or a related person; (b) any income or profits of the borrower or a related person; (c) any change in the value of any property of the borrower or a related person; or (d) any dividend, partnership distributions or similar payments made by the borrower or a related person;

-Any other type of contingent interest which the Internal Revenue Service (“Service”) may identify in Regulations.

There are various exceptions to the contingent interest rules, including the allowance for the timing of any interest or principal payments to be subject to contingencies.

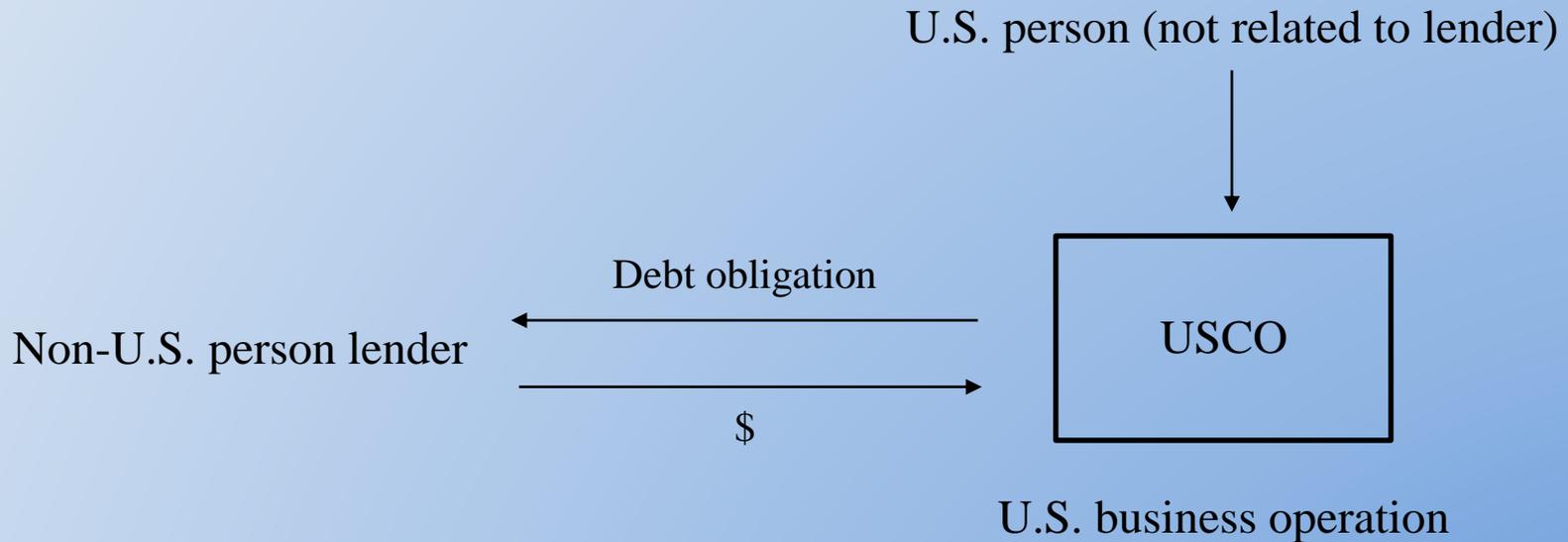
Other Limitations on Portfolio Interest

Additionally, PIE does not apply to:

- Interest received by a non-U.S. lender that is “effectively connected” with a trade or business of the non-U.S. lender in the United States.
- Interest received by a non-U.S. bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.

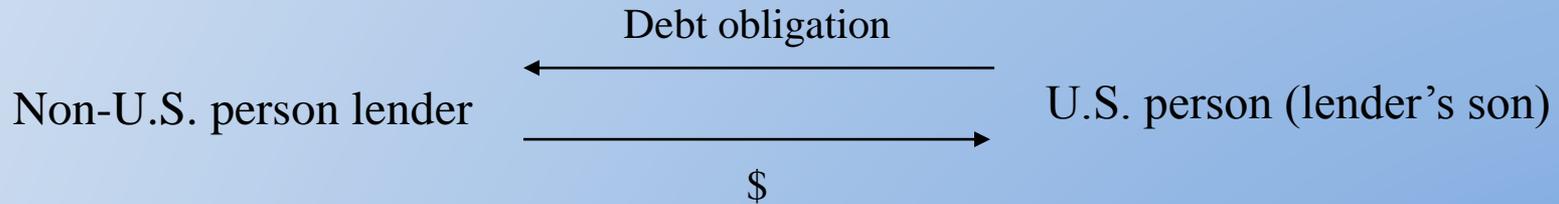
The U.S. federal income tax law has a strict set of “anti-conduit” Regulations. Essentially, if a lender would not qualify for PIE with respect to a direct loan to the U.S. borrower (e.g., if the non-U.S. lender is a 10% shareholder or a bank), the tax law provides a set of rules preventing the lender from circumventing these rules through “back-to-back” loans.

Case Study 1:
Loan to Unrelated Party



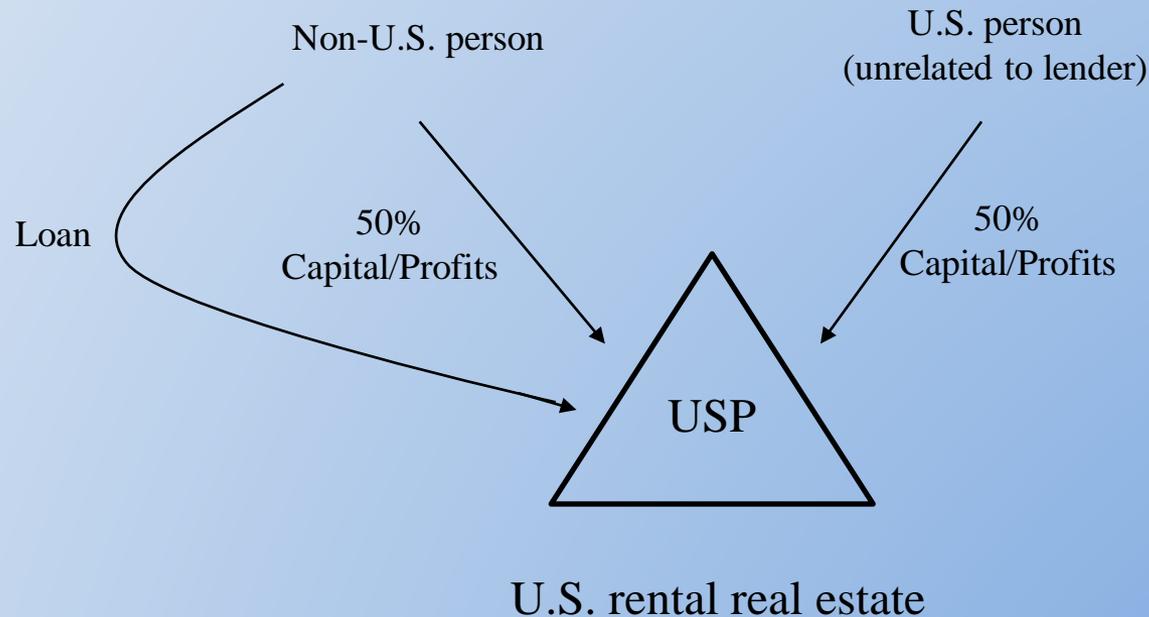
Assuming the debt obligation is in registered form and the borrower obtains a Form W-8BEN or W-8BEN-E from the lender, payments of interest on the debt obligation should qualify for PIE.

Case Study 2: Loan to Family Member



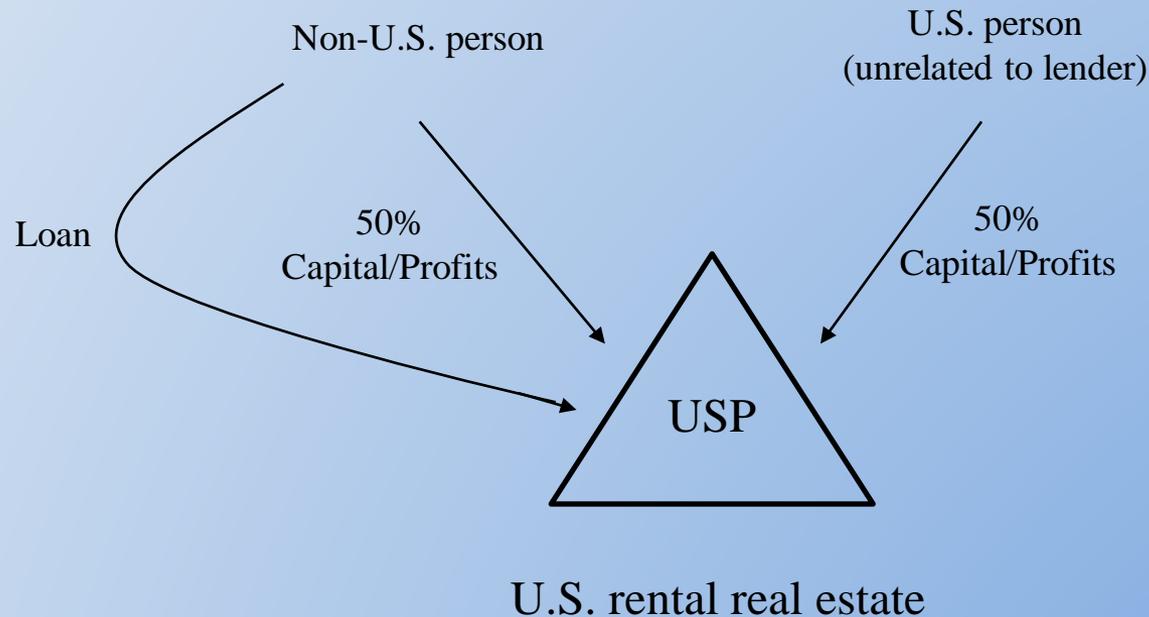
The debt obligation should qualify for PIE as it does not violate any of the technical restrictions regardless of the fact that the loan is to family. This is a great way to help U.S. family finance real estate acquisitions.

Case Study 3: 10% Shareholder Rule



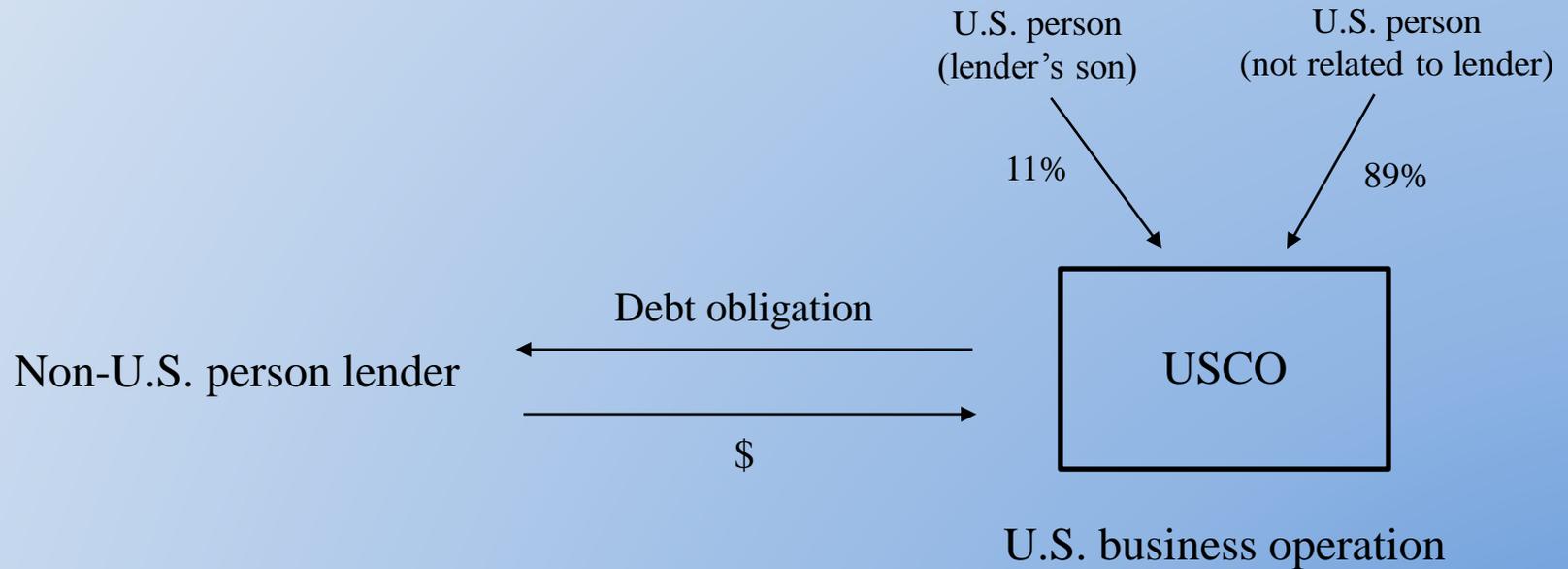
-Why structure this way? The goal is to offset USP's otherwise taxable rental income with an interest expense due on the debt obligation, which interest when earned by the non-U.S. person lender as PIE, would be free from U.S. income taxation. In this particular structure, PIE is not available....

Case Study 3: 10% Shareholder Rule



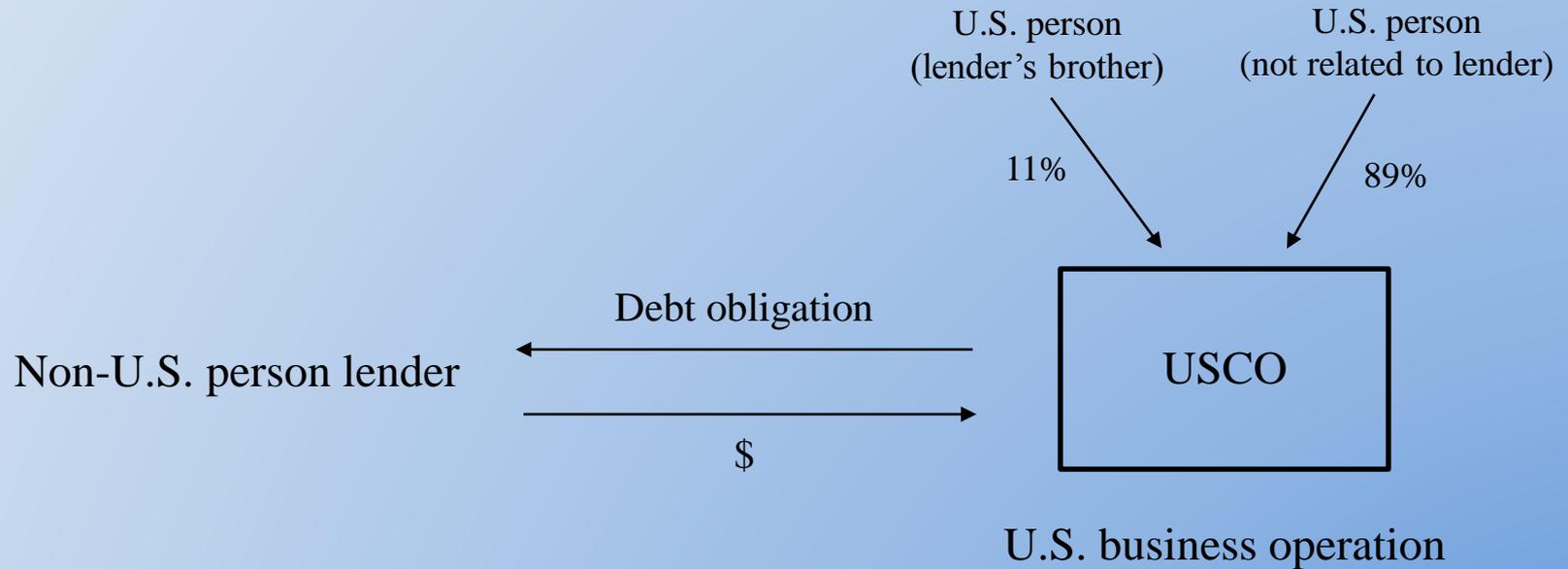
-PIE is not available on interest received by a non-U.S. lender that is a “10% shareholder” of the borrower. In the case of a partnership borrower, a 10% shareholder is a person that owns (directly, indirectly, or constructively) 10% or more of the capital or profits interests in the borrower. In this case, the lender has a 50% capital or profits interest in the borrower.

Case Study 4: Individual-to-Individual Attribution



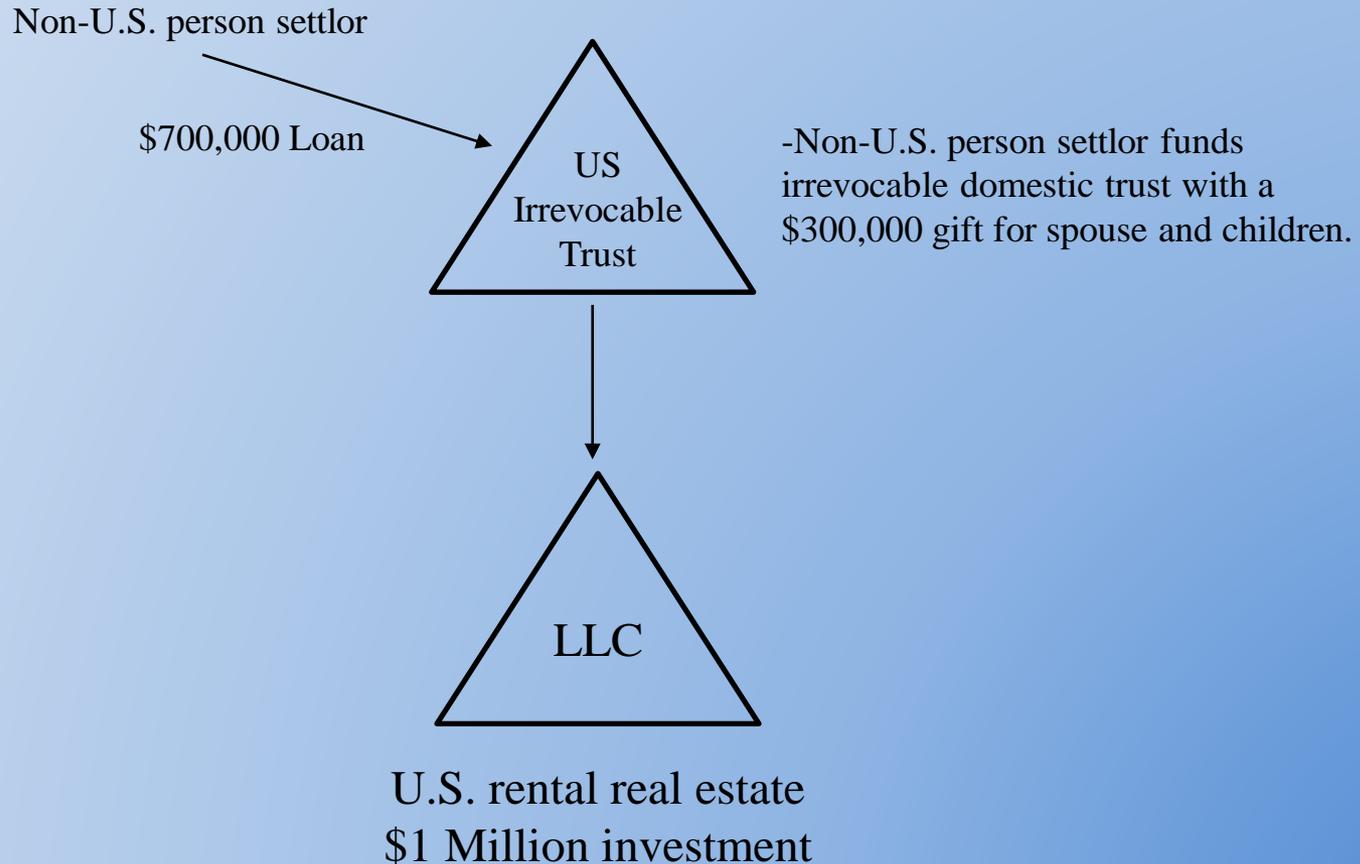
-Generally, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse and his **children**, grandchildren, and parents. Payments of interest will not qualify for PIE as the lender is treated as a 10% shareholder of USCO due to the individual-to-individual ownership attribution rules (i.e., father is seen as owning the stock of son).

Case Study 5:
No Individual-to-Individual Attribution

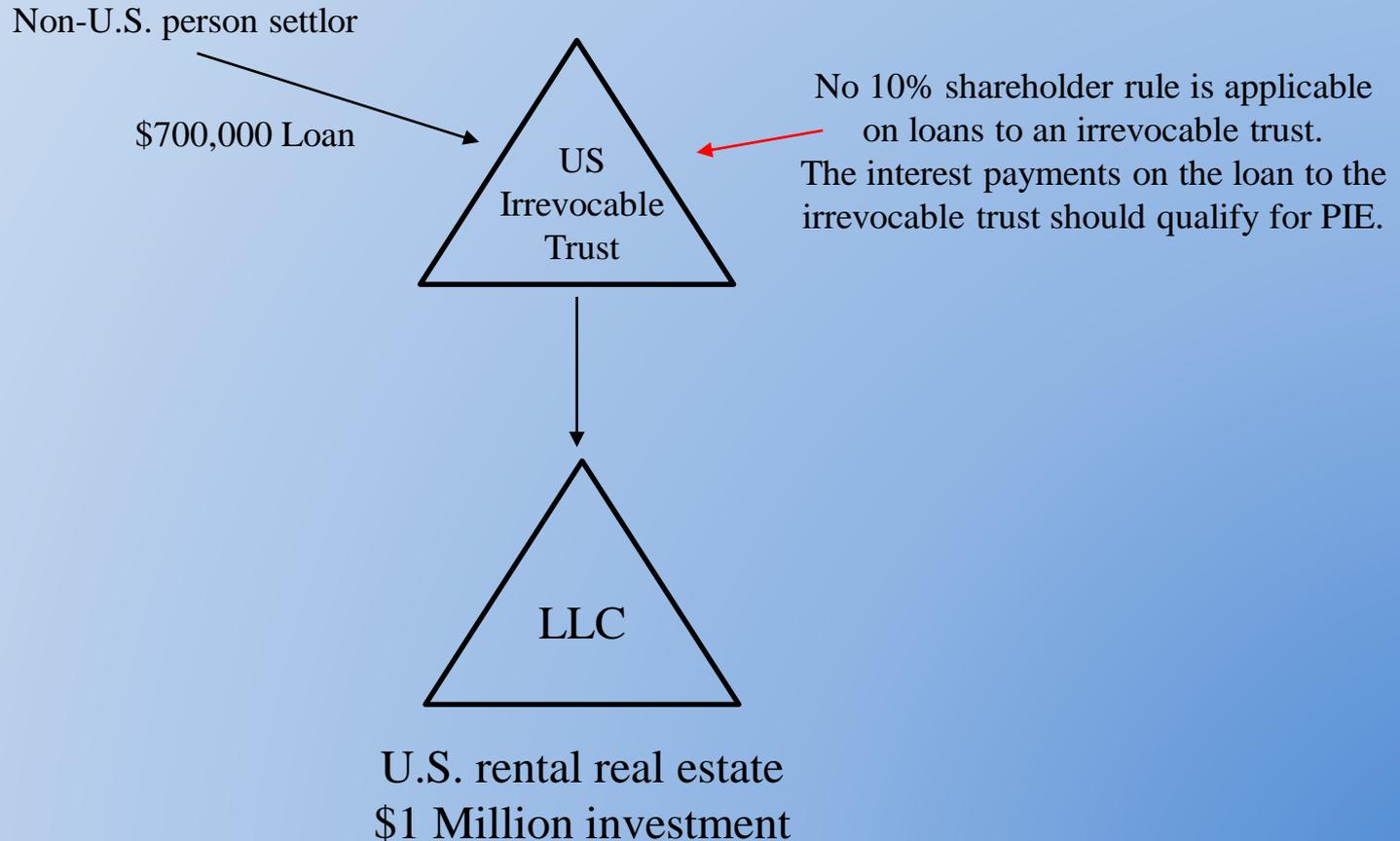


-Generally, an individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse and his children, grandchildren, and parents. The payments of interest will qualify for PIE as the lender is not treated as a 10% shareholder of USCO as there is no attribution between siblings.

Case Study 6: Use of an Irrevocable Trust



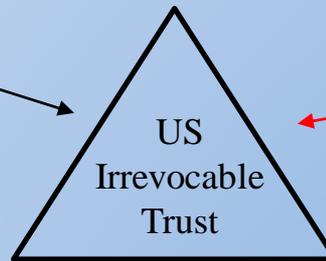
Case Study 6: Use of an Irrevocable Trust



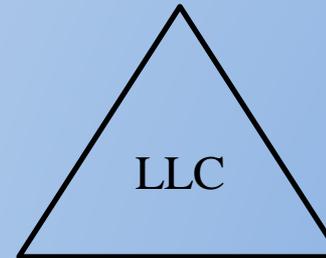
Case Study 6: Use of an Irrevocable Trust

Non-U.S. person settlor

\$700,000 Loan

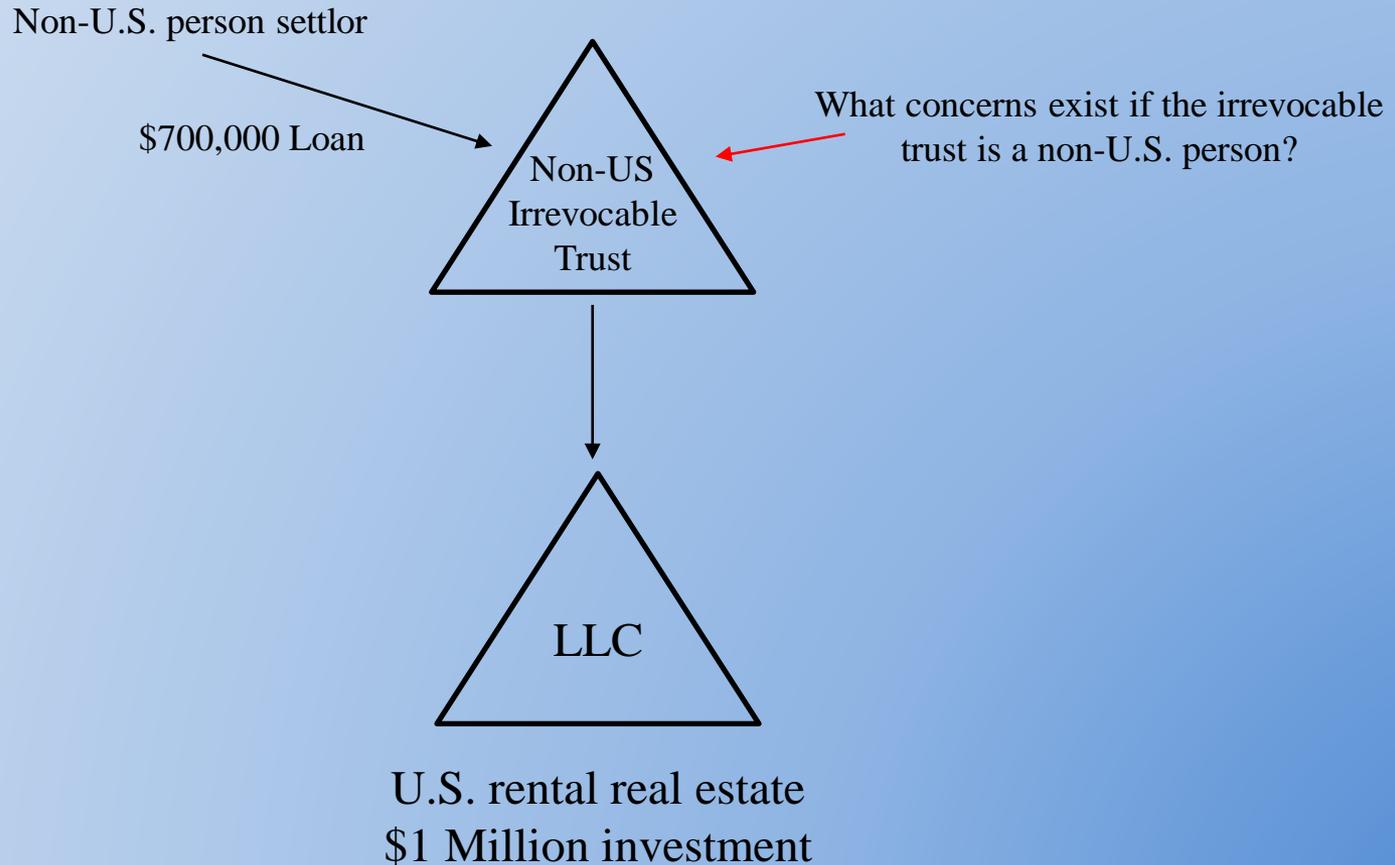


The irrevocable trust should now be able to offset its otherwise taxable rental income with an interest expense due on the debt obligation. The interest income in the hands of the non-U.S. person lender should qualify for PIE.

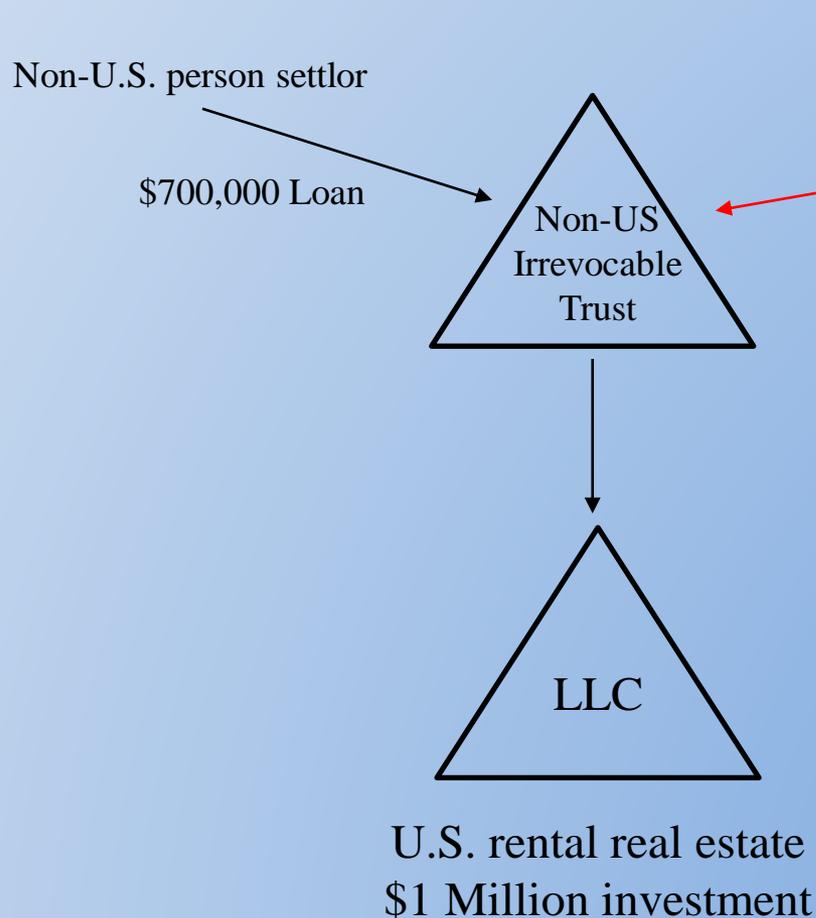


U.S. rental real estate
\$1 Million investment

Case Study 6: Use of an Irrevocable Trust

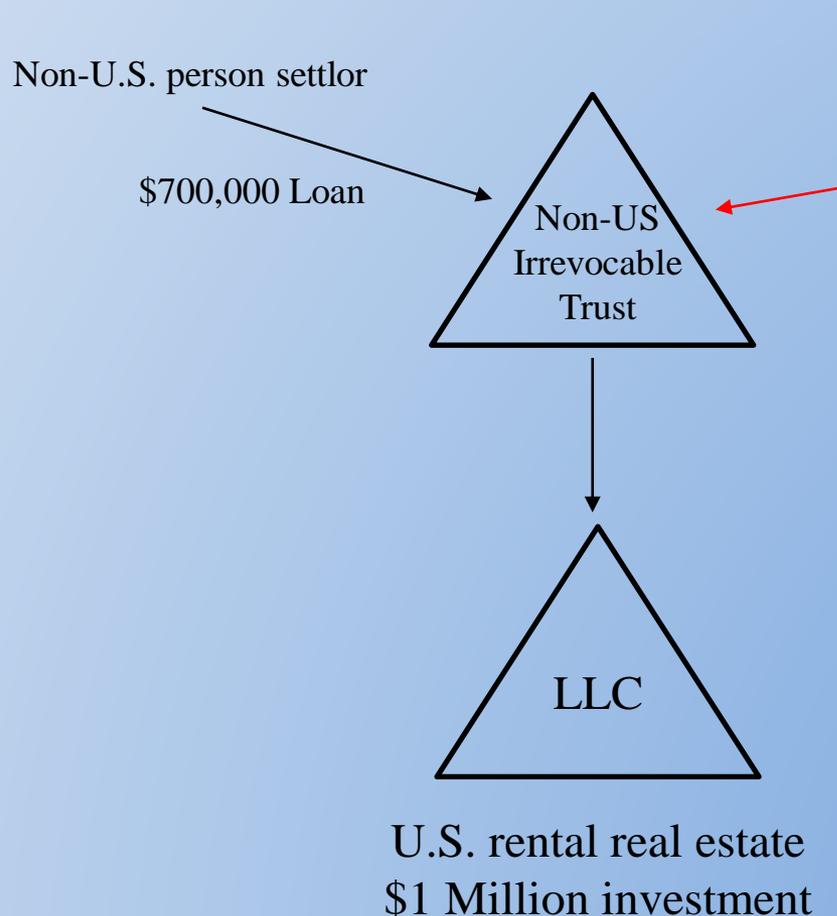


Case Study 6: Use of an Irrevocable Trust



An interest expense incurred by a nonresident alien shall be considered to be connected with income effectively connected with a USTB only to the extent that the interest expense is incurred with respect to liabilities that: (i) are entered on the books and records of the USTB when incurred; or (ii) are secured by assets that generate such effectively connected income.

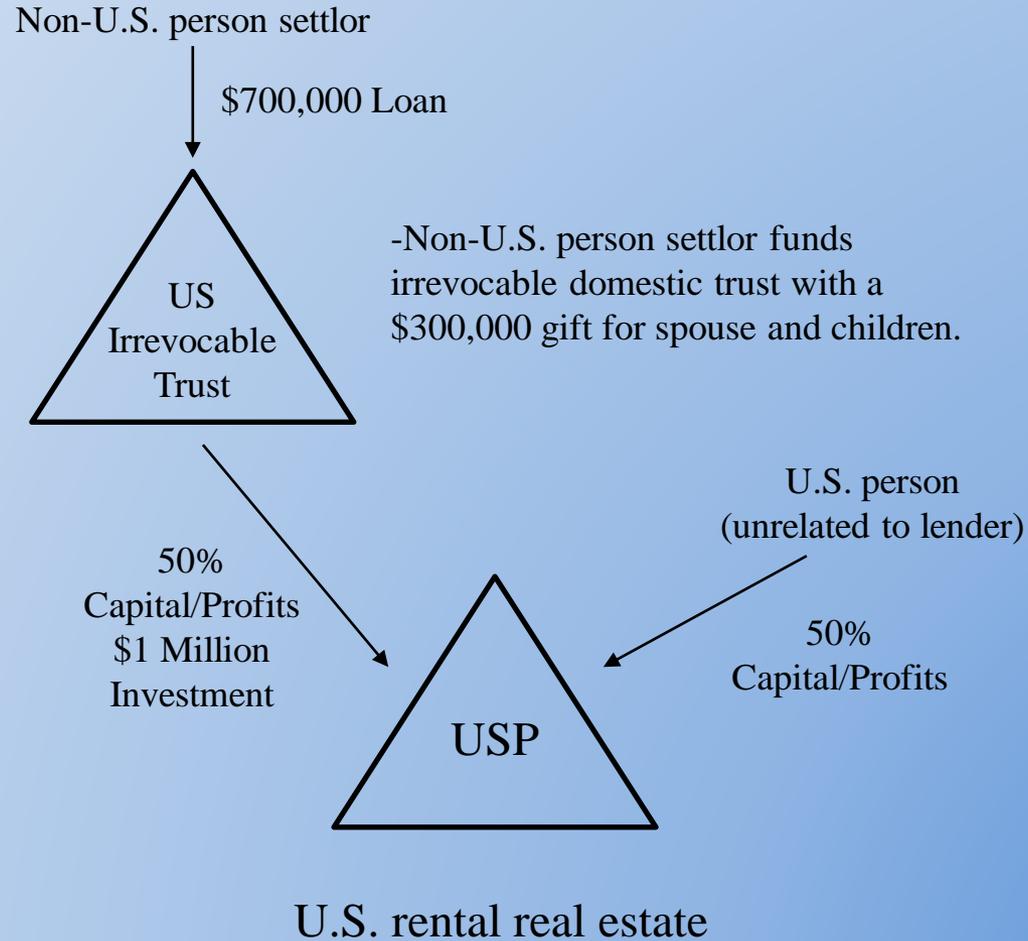
Case Study 6: Use of an Irrevocable Trust



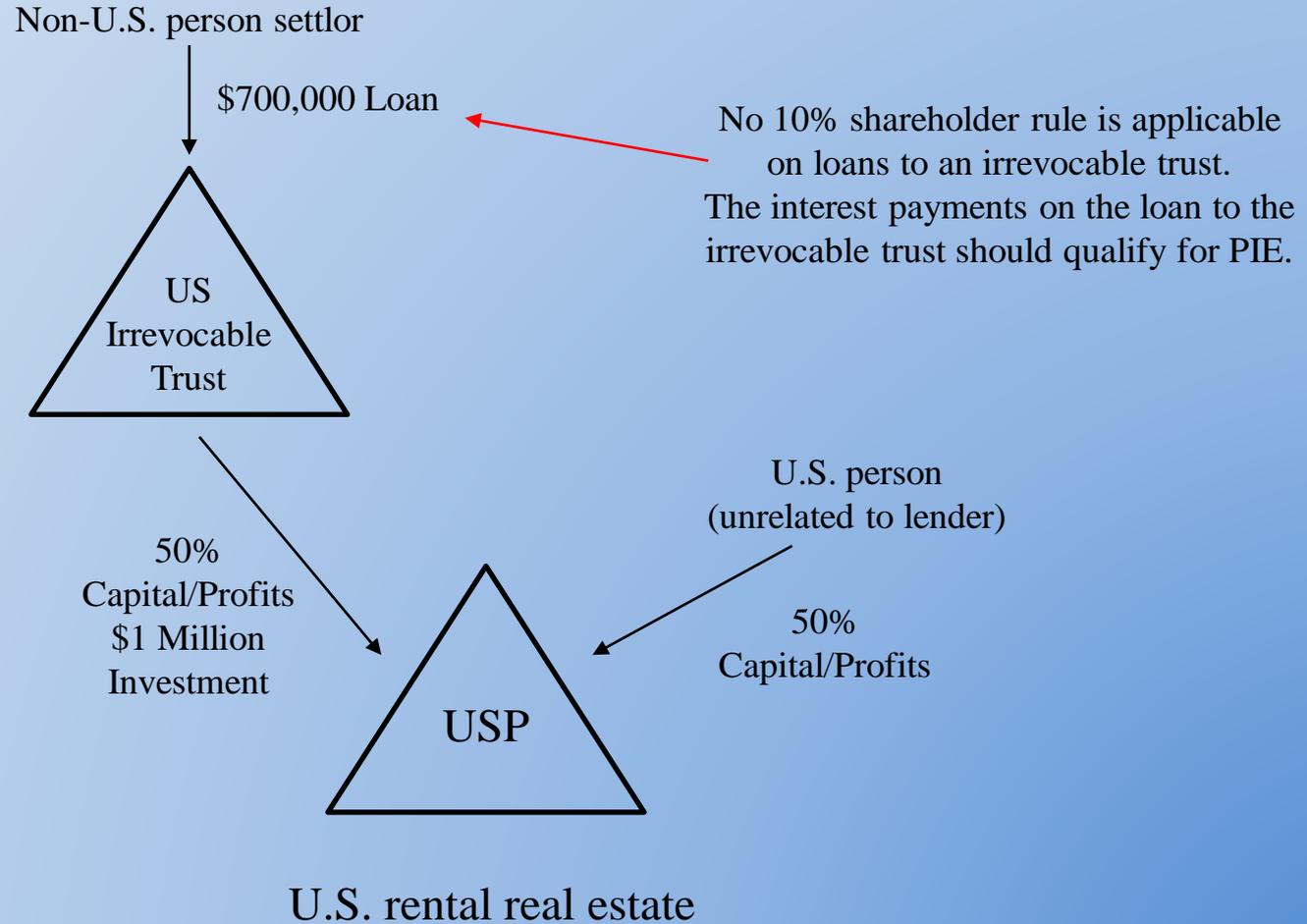
An interest expense incurred by a nonresident alien is not considered to be connected with effectively connected income to the extent that it is incurred with respect to liabilities that exceed 80% of the gross assets of the USTB.

The above should not be an issue in this case study as equity is \$300,000 (30%) and debt is \$700,000 (70%).

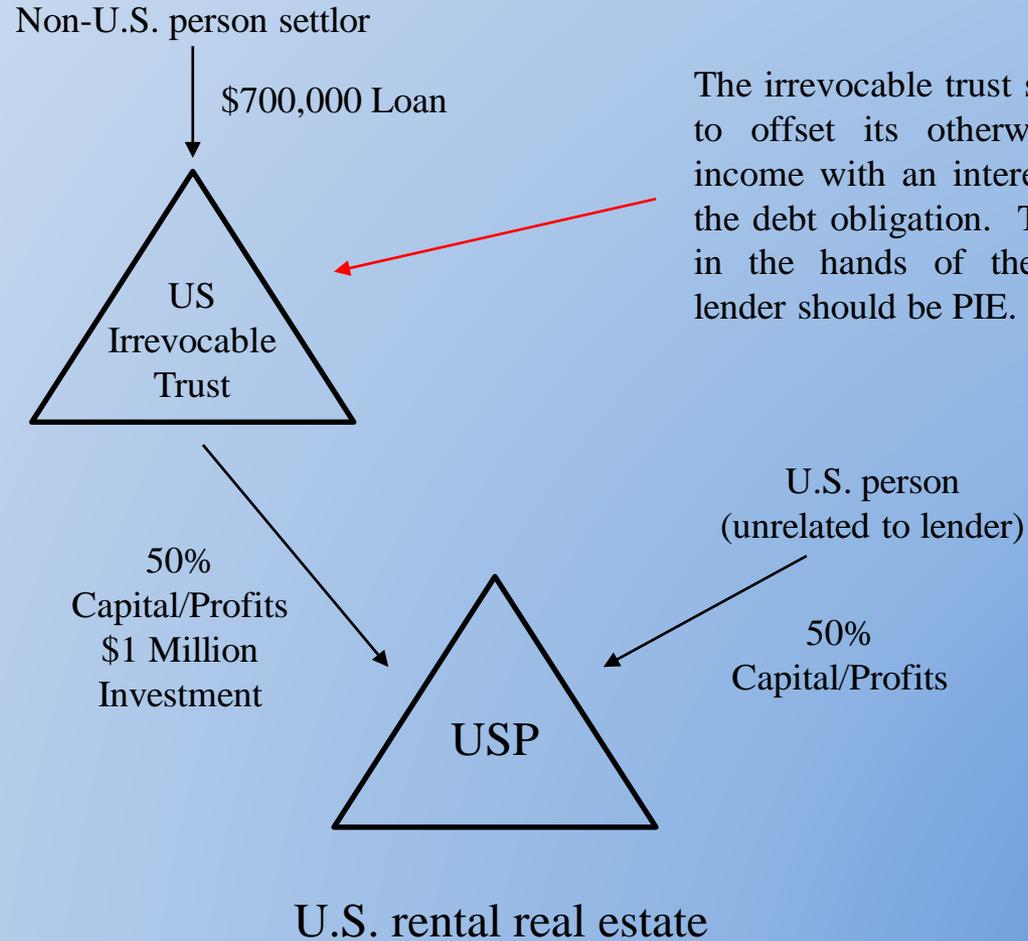
Case Study 7: Use of an Irrevocable Trust Partner



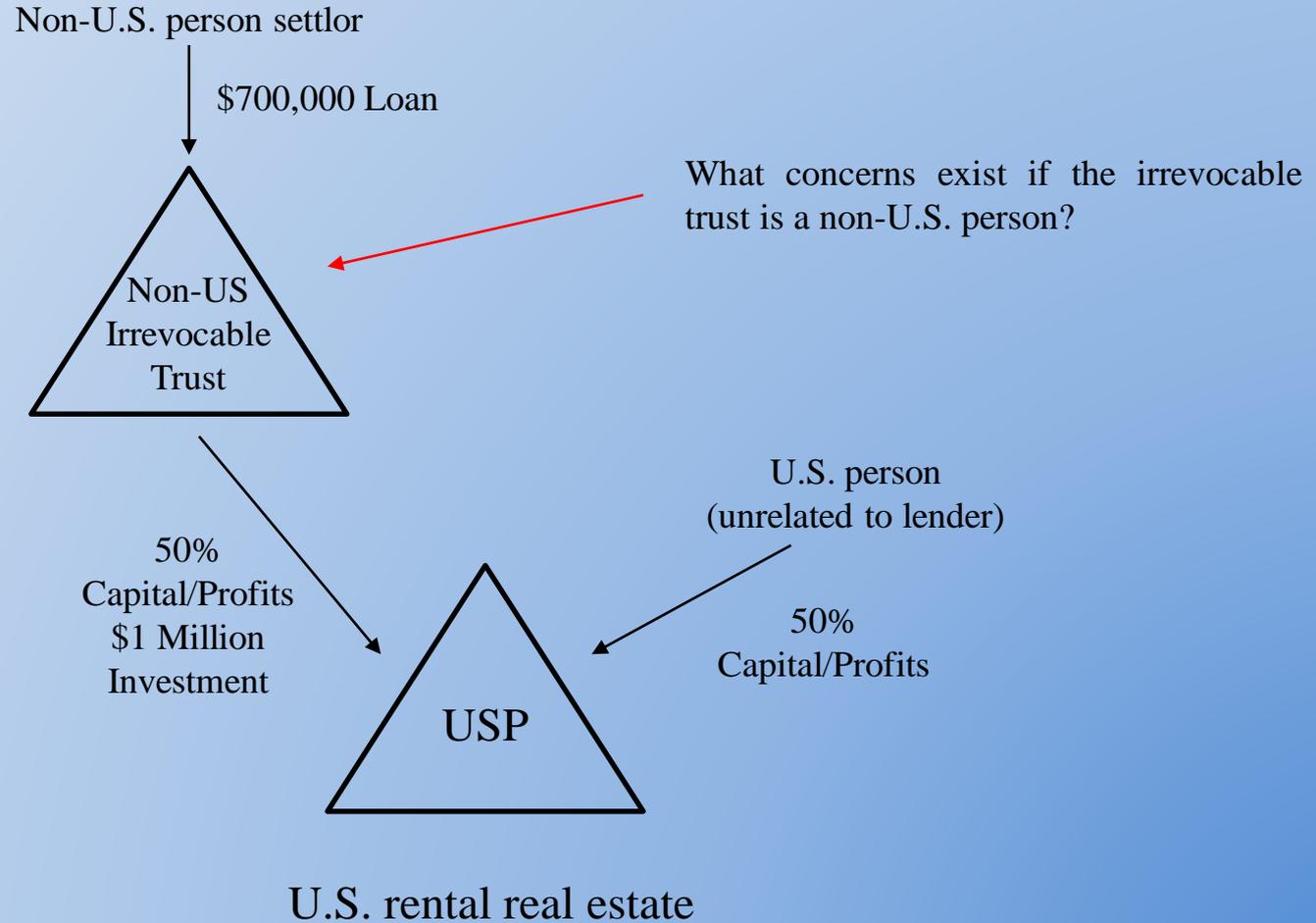
Case Study 6: Use of an Irrevocable Trust Partner



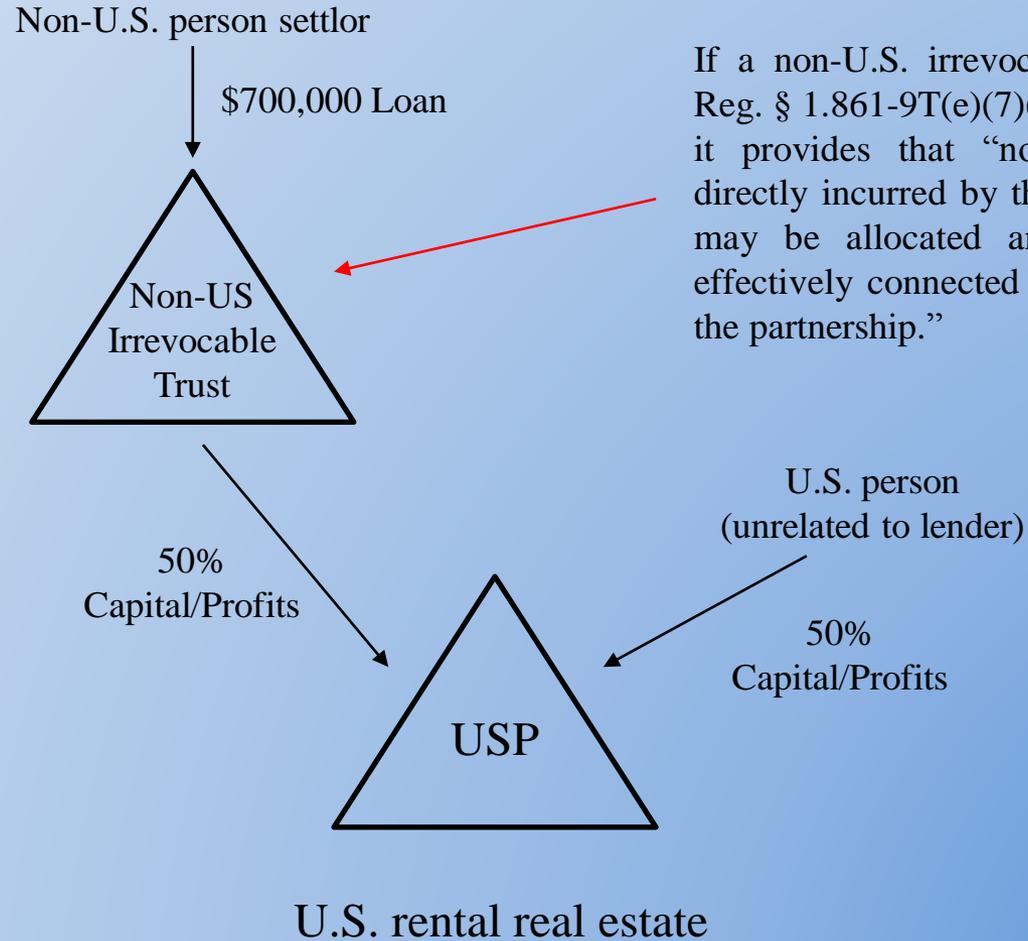
Case Study 6: Use of an Irrevocable Trust Partner



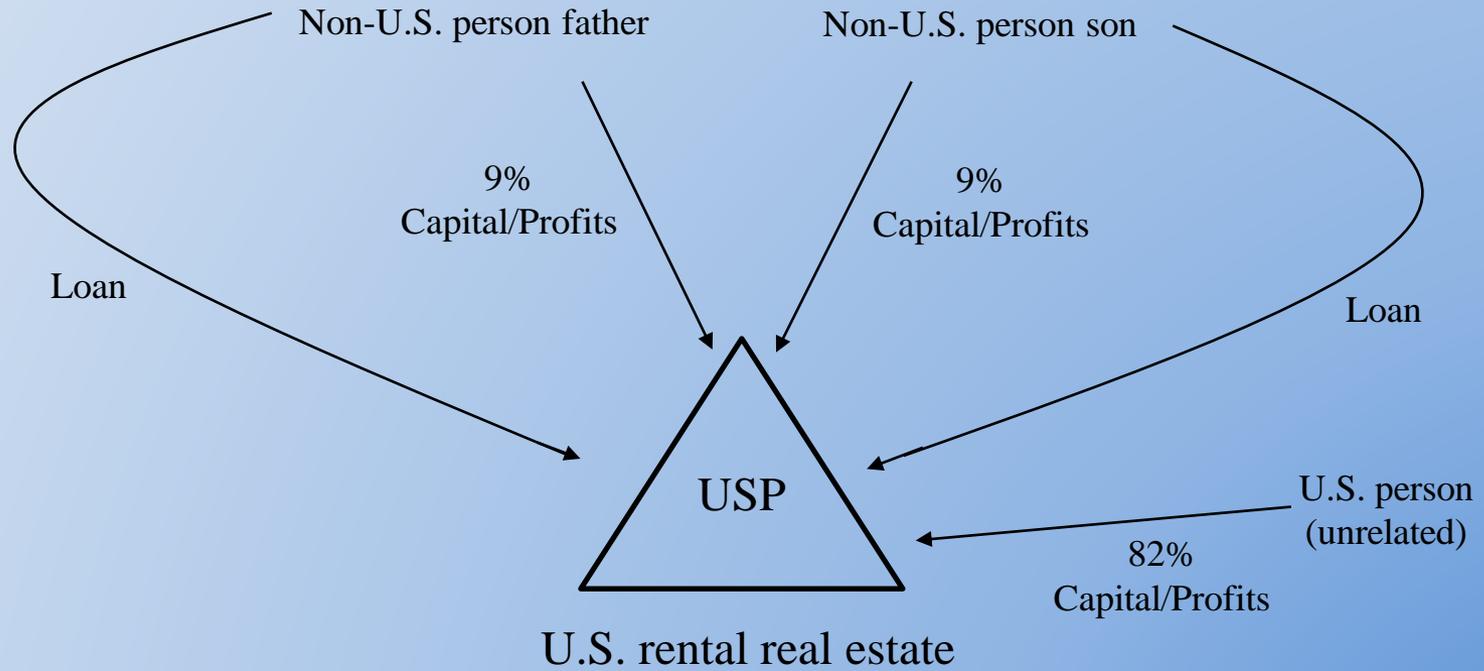
Case Study 6: Case Study 3 with an Irrevocable Trust Partner



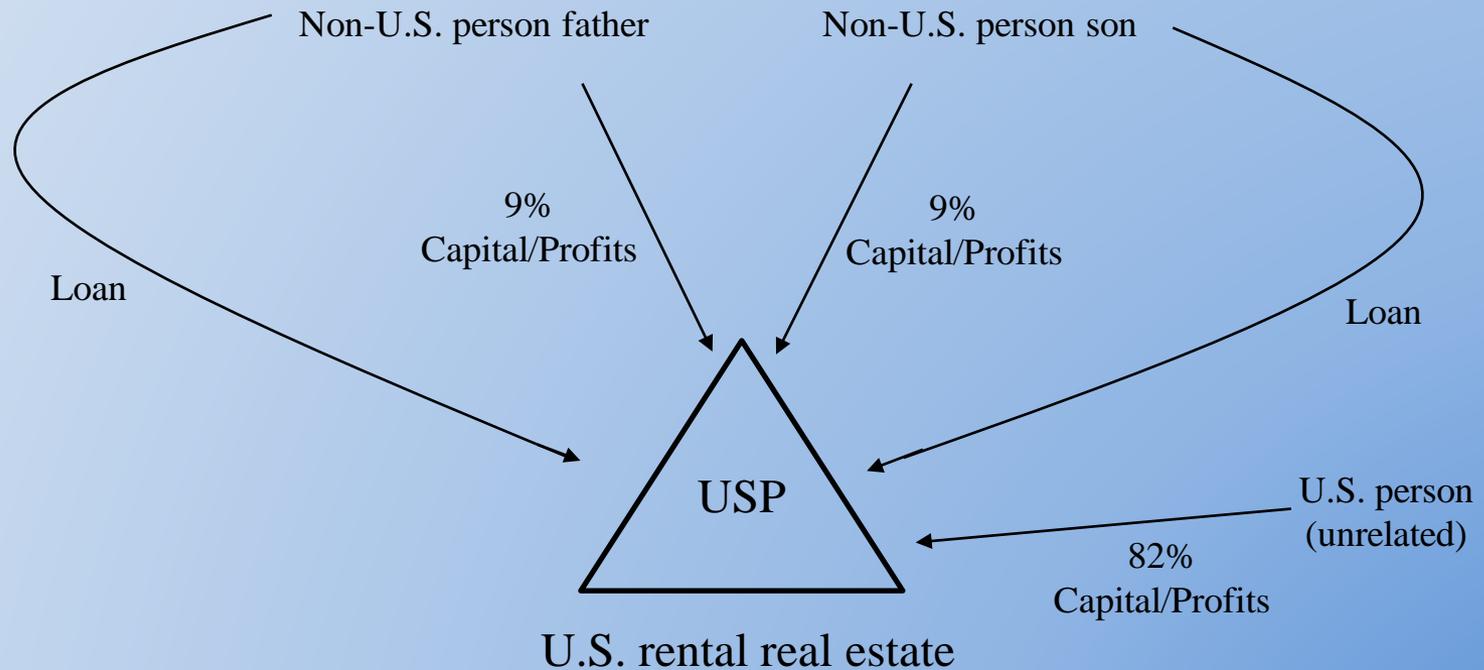
Case Study 6: Case Study 3 with an Irrevocable Trust Partner



Case Study 7: Voting and Non-Voting Shares

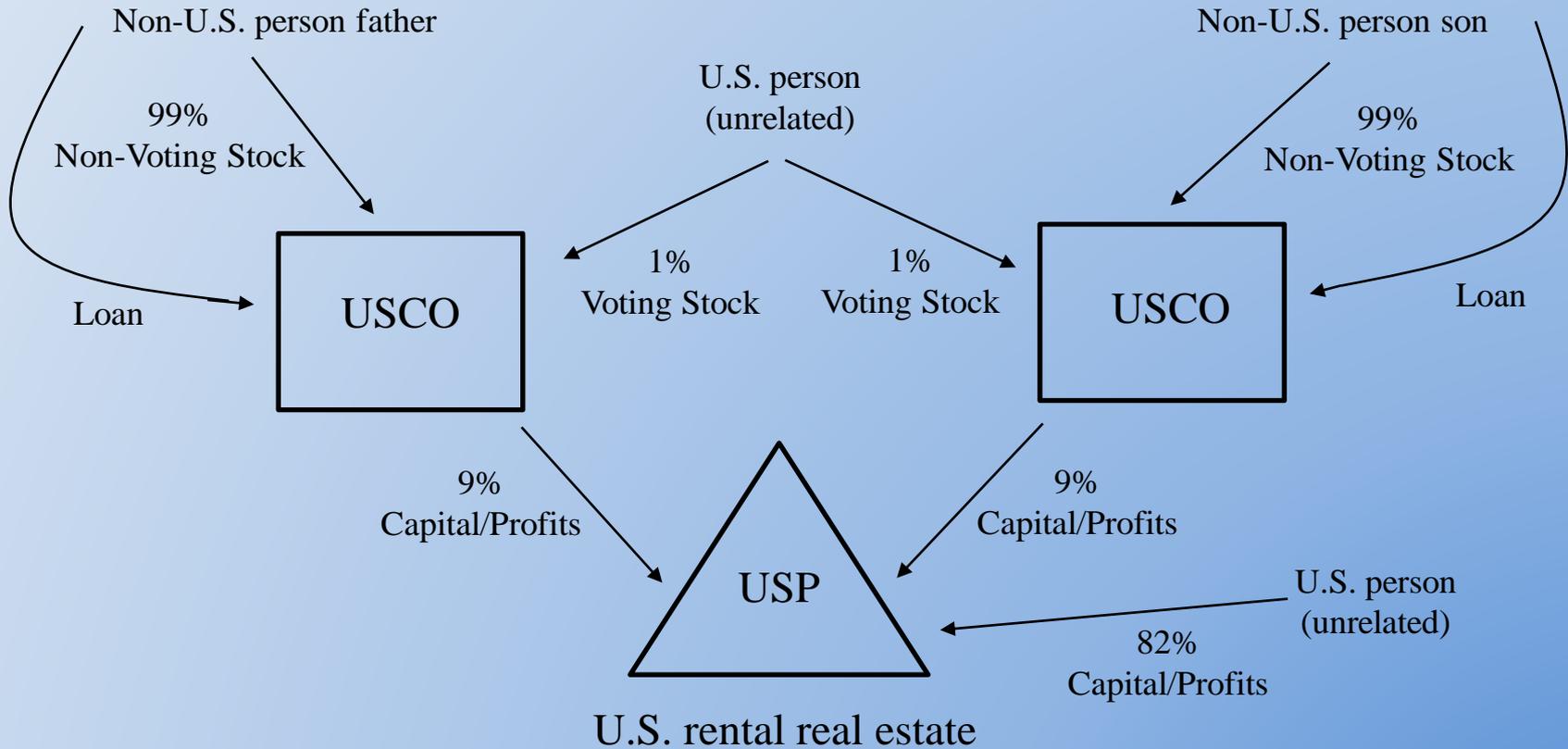


Case Study 7: Voting and Non-Voting Shares

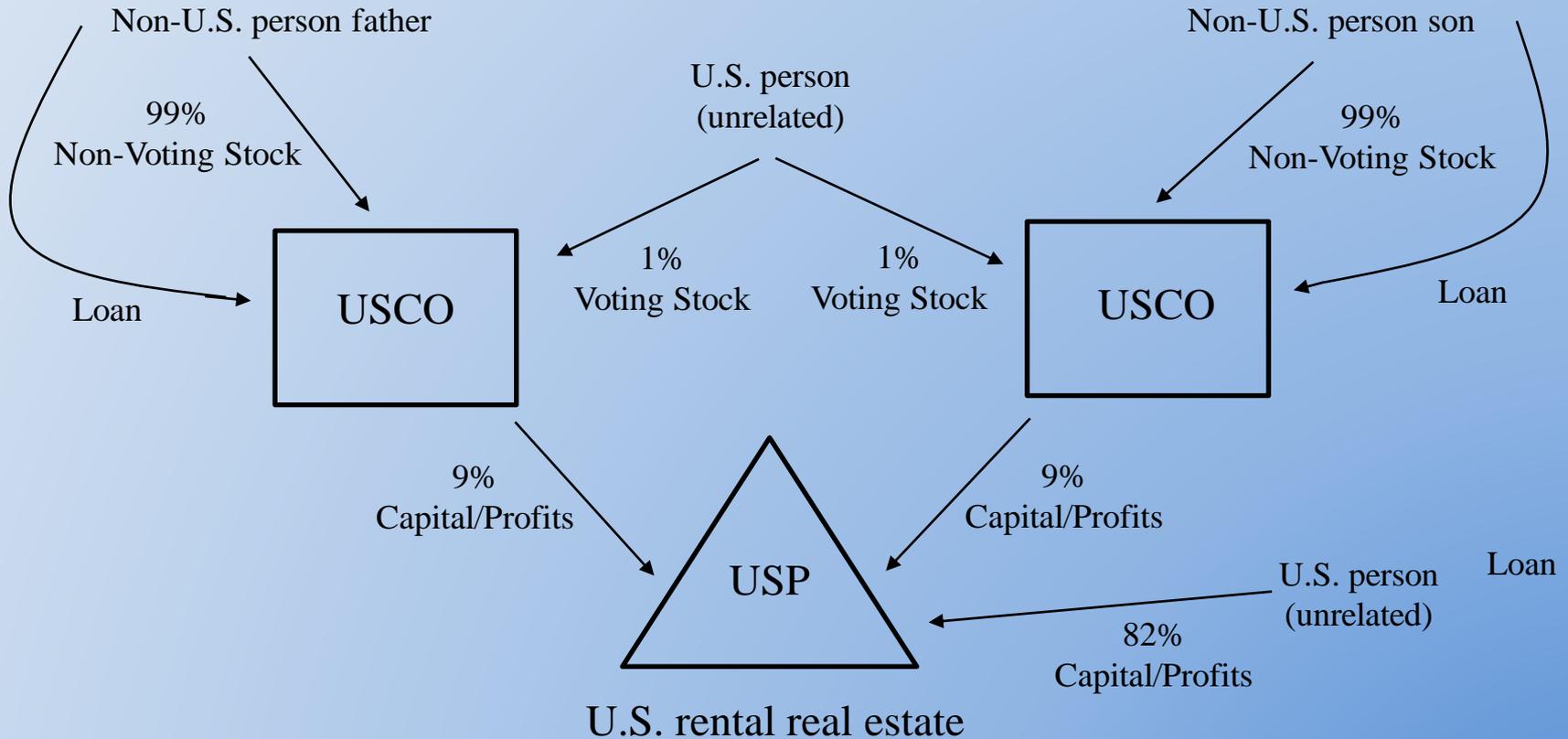


-The payments of interest will not qualify for PIE as both lenders are treated as a 10% shareholder of USP due to the individual-to-individual ownership attribution rules.

Case Study 7: Voting and Non-Voting Shares

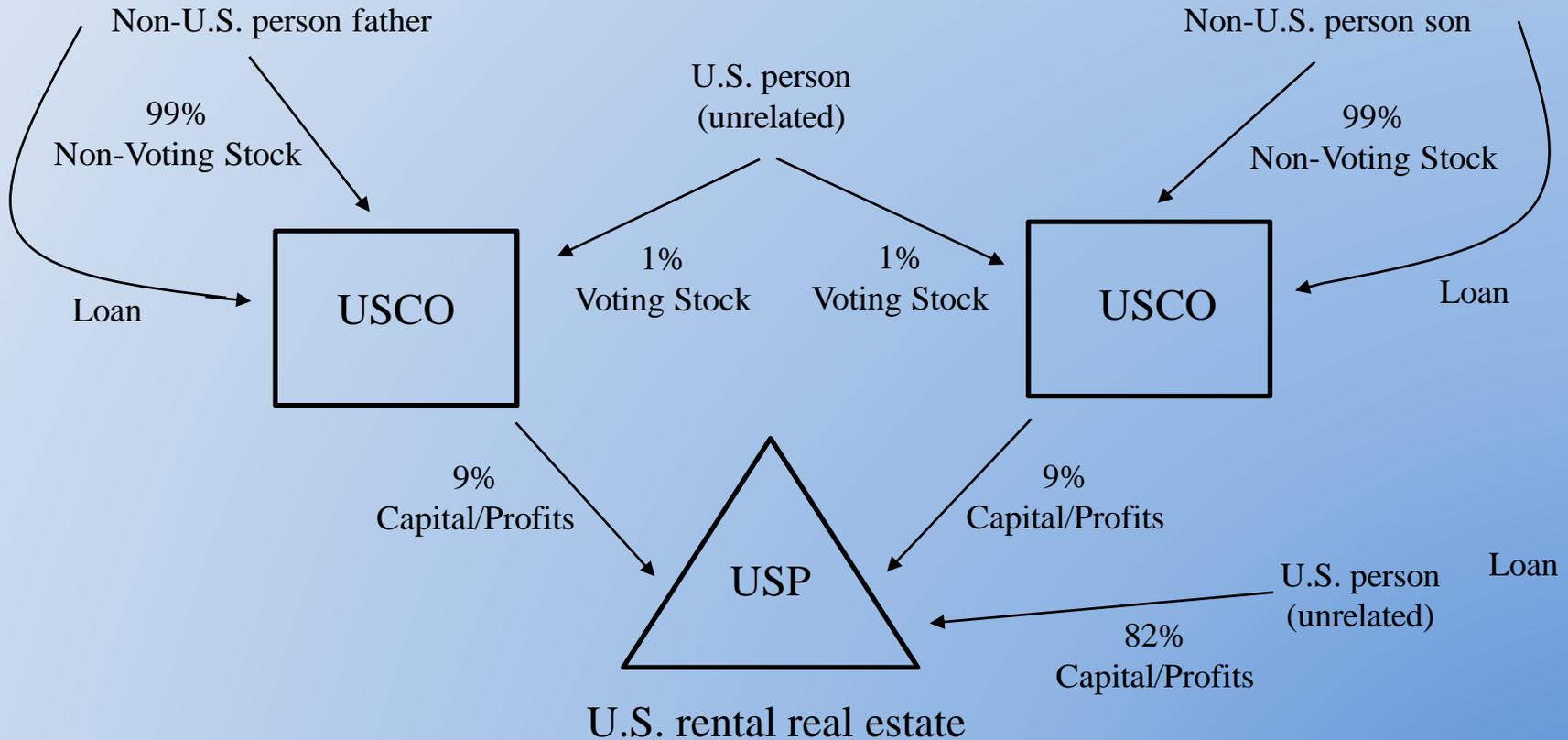


Case Study 7: Voting and Non-Voting Shares



-In the case of a corporate borrower, a 10% shareholder is a person that owns (directly, indirectly, or constructively) 10% or more of the **voting** power of the borrower.

Case Study 7: Voting and Non-Voting Shares



-Loans are being made to corporate borrowers in which the non-U.S. person lenders have 99% in the form of non-voting shares, and, thus, not 10% or more of the voting power. Absent a substance over form attack from the Service, interest on the debt obligations would technically qualify for PIE.

U.S. Gift Tax

in the Context of PIE Debt Obligations

-A PIE debt obligation should be considered an intangible asset, and, thus, not a taxable transfer for purposes of the U.S. gift tax system when transferred by a nonresident alien transferor.

U.S. Estate Tax in the Context of PIE Debt Obligations

- The U.S. imposes a tax on the transfer at death of the “taxable estate” of any nonresident alien decedent (“NRAD”).
- The term “taxable estate” is defined to include the NRAD’s “gross estate” for U.S. estate tax purposes, less certain allowable deductions.
- The term “gross estate” is defined to include any property owned by the NRAD at the time of his death which is situated in the United States.

U.S. Estate Tax in the Context of PIE Debt Obligations

The following is not considered property within the United States:

-A debt obligation, if, without regard to whether a Form W-8BEN has been received, any interest thereon would be eligible for PIE if such interest were received by the decedent at the time of his death.

In this regard, a PIE debt obligation held by a NRAD should not be subject to the U.S. estate tax. What if the NRAD was an U.S. income tax resident alien? PIE would arguably not be applicable, and, thus, caution as there may be inclusion in the U.S. gross estate of an NRAD who was an U.S. income tax resident alien at the time of death.

