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WITHHOLDING NET WILL NOW CATCH MORE DEBT ARRANGEMENTS

When the U.S. terminated its income tax treaty with the Netherlands Antilles in 1984, there was criticism from U.S. corporations that they were being unfairly kept out of the competitive Eurobond financing market. In order to provide access to the Eurobond market, Congress enacted Section 871(h) to provide an exemption (the "portfolio interest exemption") from the 30% withholding tax on U.S.-source income earned by a nonresident alien individual or foreign corporation that is not effectively connected with the conduct of a U.S. trade or business. Portfolio interest, under Sections 871(h) and 163(f), is any U.S.-source interest (including original issue discount) that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions contained in Section 163(f), or for which the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) obtains a statement that the beneficial owner is not a U.S. person, and (2) which is not received by a 10% owner or issuer of the obligation taking into account shares owned by attribution.

Section 897 (FIRPTA) taxes the gain that a foreign person realizes on the sale of a U.S. real property interest (USRPI). Section 897(c)(1)(A)(ii) defines "United States real property interest" as any interest (other than an interest solely as a creditor) in any domestic corporation which is a U.S. real property holding corporation (USRPHC). A USRPHC is any corporation whose fair market value of USRPIs equals or exceeds 50% of the sum of (1) the fair market value of its USRPIs, (2) its interest in real property located outside of the U.S., and (3) any of its other assets that are used or are held for use in a trade or business.

Reg. 1.897-1(d)(1) provides that an interest solely as a creditor either in real property or in a domestic corporation does not constitute a USRPI. Whether an interest is debt under other Code provisions does not determine whether it constitutes an interest solely as a creditor under Sections 897, 1445, and 6039(C), or their Regulations. Reg. 1.897-1(d)(2) treats as interest other than solely as a creditor a loan to an individual or entity under which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of a debtor or a related person. Thus, such an interest may be a USRPI.

Because the FIRPTA rules do not tax an interest held solely as a creditor, Congress was concerned that it might be possible for foreign investors to structure U.S. investments by providing for equity participation rights so that their investment returns would be characterized as interest income and not other forms of income. Thus, for example, foreign persons wanting to acquire a package of real estate and mortgage indebtedness from the Resolution Trust Company (RTC) could form a U.S. partnership and two ***465** unrelated foreign investment vehicles in treaty countries. One vehicle merely held real estate, operating it either for profit or holding it for investment for gain on sale (assuming the real estate could be purchased at a favorable price from the RTC). The other entity acquired mortgage positions from the RTC by forming a U.S. entity to acquire the debt and then making a loan to the U.S. entity to provide the funds to acquire the debt, with the interest rate having both a fixed portion and a contingent portion. The contingent portion--the "equity kicker"--was measured by a percentage calculated from appreciation of the property the mortgage secures. Because the foreign entity was simply making loans, notwithstanding the equity kicker, the loans were still made solely as a creditor, were both exempt from FIRPTA, and qualified for the portfolio interest exemption.

Congress believed such structures eroded the U.S. tax base and determined that the exemption should not apply where a debt instrument held by a foreign investor is contingent on profits from the disposition of U.S. real property held by the borrower.

CONTINGENT INTERESTS NOW EXCLUDED

New Section 871(h)(4) now makes the portfolio interest exemption inapplicable to certain contingent interest income received by foreign persons. With an instrument where a foreign holder earns both contingent and non-contingent interest, denial of the portfolio exemption applies only to the portion of the interest that is contingent.

Under Section 871(h)(4), contingent interest includes interest determined by any of the following attributes of the debtor or any related person (as defined in Section 267(b) or 707(b)(1)), which include receipts, sales, cash flow, income, profits, and changes in the value of property. For example, the receipt by a foreign person of interest computed as a percentage of the borrower's profits would not be entitled to the exemption for portfolio interest. In addition, contingent interest includes interest determined by reference to any dividend, partnership, distribution, or similar payment made by the debtor or a related person. Thus, interest is contingent under this provision where its receipt by the foreign investor depends on payment of a dividend to the shareholders of the corporate borrower.

EXCEPTIONS.

New Section 871(h)(4)(c) provides exceptions to the general definition of contingent interest. Under one exception, interest is not contingent solely because the timing of the interest for any related principal payment is subject to a contingency. For example, a debt obligation accrues fixed interest at a competitive market rate. Prior to the instrument's maturity date, the debtor does not have enough cash to make an interest payment. The debt agreement allows the borrower to defer the payment but does not eliminate the borrower's liability for the deferred amount (or for interest that accrues on that amount). The interest is not contingent under Section 871(h)(4)(C)(i).

The Committee Reports also provide an example of a real estate mortgage investment conduit that pays fixed interest at a competitive market rate. The period in which the debt is to remain outstanding, however, depends on the extent to which qualified mortgages held by the REMIC are prepaid (or other contingencies related to the income earned or the expenses incurred by the REMIC). The interest received from the REMIC would not, merely because of this structure, be contingent interest.

Moreover, Section 874(h)(4)(c)(ii) provides that portfolio interest treatment is not denied solely because the interest is paid on recourse, limited recourse, or nonrecourse indebtedness. This exception would apply where a corporation issues a limited recourse debt instrument that pays fixed interest at a competitive market rate and is secured by trade receivables of the corporation.

Section 871(h)(4)(C)(iii) provides further that interest is not denied portfolio treatment if all or substantially all of it is determined by certain other interest that is not described as contingent (or by the principal amount indebtedness on which such other interest is paid). This would include a regular interest in a REMIC that pays annual amounts of interest equal to a percentage of the interest earned by the REMIC on qualified mortgages, where the interest earned by the REMIC is not contingent under this provision.

Also, where the debtor or a related person enters into a hedging transaction to reduce the risk of interest rate or currency fluctuation on interest payments, the hedge does not produce contingent interest under Section 871(h)(4)(C)(iv).

***466** The Committee Reports indicate that the exemptions contained in Section 871(h)(4)(C) are not to be used by taxpayers to avoid paying the withholding tax. If the parties enter into a transaction where the interest on the debt obligation is accrued at a rate much higher than market rate, but not paid, and if the parties know at the inception of the loan that the interest will not be paid, then the exceptions to the application of the provisions for nonrecourse indebtedness and for the timing of principal or interest payments contained in Sections 874(h)(4)(C)(i) and (ii) should not apply. Thus, the interest on the obligation would not get the benefits of portfolio treatment.

Treasury is granted authority to supplement the statutory description of a contingent interest to address cases where denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of U.S. income tax.

ESTATE TAX.

Prior to the Act, obligations considered to be portfolio interest obligations were exempt from the U.S. estate tax. Under the new provision, the Conference Committee Report clarifies that where a debt instrument has a minimum non-contingent interest rate, only the excess of the contingent amount, if any, over the minimum fixed interest amount is disqualified from portfolio treatment.

In determining the gross estate of a nonresident noncitizen decedent subject to the estate tax, the Conference Committee Report says that a special rule should apply to debt instruments with both contingent and non-contingent interest. Under Section 2105(b), if any portion of the interest on a debt obligation would be considered to be property without the U.S. and thus not subject to U.S. estate tax, the "appropriate" portion of the value of such an instrument, as determined by Treasury, should be treated as property within the U.S. and, thus, included in decedent's gross estate. Any reasonable method should, at least for the moment, be permitted in making this determination.

EFFECTIVE DATE.

The portfolio interest amendments apply to interest received after 1993. They do not apply to any interest paid or accrued on any indebtedness with a fixed term that was issued by 4/7/93, or issued afterwards under a binding contract in effect on such date and at all times thereafter before the debt was issued.

Planning

Based on the change in the portfolio interest rules, it is now inadvisable to structure a transaction with contingent debt and expect to escape income tax withholding on the interest unless the interest is paid to a person in a treaty jurisdiction. It may still be possible, in limited circumstances, to use Article 8 of the U.S.-Netherlands Antilles Income Tax Treaty, which is still effective despite revocation of the rest of the treaty. Use of Article 8, however, would require the use of a "Dutch sandwich" in order for it to be effective. A Dutch sandwich involves a Netherlands Antilles corporation owned by a Dutch corporation which is owned by another Netherlands Antilles corporation. This arrangement may be expensive to set up and maintain. Also, internal laws currently being proposed in the Netherlands may limit the utility of this approach.[1]

These amendments were enacted to prevent the receipt of U.S.-source interest by a foreign person without a withholding tax being imposed, when, in effect, the foreign person is attempting to avoid both the withholding tax and the FIRPTA Tax on the gain on the sale of real estate. The bifurcation of a real estate interest into a mortgage interest and a real property interest is still possible, however. The transaction can be structured to provide the foreign person with a purported debt interest that, in effect, changes an interest rate by taking into account appreciation on the real estate without actually subjecting the debt interest to the FIRPTA provisions. For example, by use of a real estate appraisal, a projection can be made as to what the expected appreciation of the property might be over the term of the loan. Then, a fixed non-contingent interest rate might be set on the debt instrument to match the expected appreciation. As long as the value of the real estate can be realistically equal to or greater than the amount of the debt, so that it would be reasonably certain that the interest would be paid, the transaction should fall within the exception of Section 871(h)(4)(C)(ii). This technique may, however, be precluded by the Regulations.

MULTIPARTY FINANCING

New Section 7701(l) authorizes Regulations to recharacterize any multiple-party financing transaction as a transaction directly among any two or more parties ***467** where recharacterization can prevent U.S. tax avoidance. Previously, the tax treatment of multiple-party transactions depended on the identity of the parties. Payments of interest by U.S. persons to related foreign persons may be subject to a 30% gross-basis withholding tax. The withholding tax, however, does not apply to payments by U.S. persons to unrelated foreign persons of portfolio interest. Under treaties, payment of interest by U.S. persons to related foreign persons who are qualified residents in a treaty country may be subject to little or no U.S. gross-basis tax. By contrast, if the related recipient of interest is resident in a country with which the U.S. has no income tax treaty in force, the 30% gross-basis withholding tax would be imposed.

In this area, the substance of a transaction may require recharacterization of its form. In *Aiken Industries, Inc.*, 56 TC 925

(1971), *acq. on another issue*, 1972-2 CB 1, for instance, the Tax Court recharacterized an interest by a U.S. person on its note held by a related treaty country resident, which in turn had a precisely matching obligation to a related non-treaty country resident, as a payment directly by the U.S. person to the non-treaty country resident. The transaction as recharacterized resulted in a loss of the treaty protection that would otherwise have applied in the payment of interest by the U.S. person to the treaty country resident. Thus, the interest payment was subject to the 30% withholding tax.

The Service expects a similar result even where back-to-back related party debt obligations are less closely matched than those in *Aiken Industries*, so long as the intermediate entity does not obtain complete dominion and control over the interest payments.[2] The Service has taken an analogous position where an unrelated financial intermediary is interposed between the two related parties as lender to one and borrower from the other, as long as the intermediary would not have made or maintained the loan on the same terms without the corresponding borrowing.[3]

In TAM 9133004, the IRS held that interest payments by a U.S. company to a related treaty-protected intermediary were to be treated as payments by the U.S. company directly the foreign parent of the financial intermediary even though the matching payments from the intermediary to the parent were not interest but dividend payments.

This technical advice came under heavy criticism by the private bar. Nevertheless, Congress was concerned that the taxpayers might be inappropriately avoiding income tax by structuring intricate financial transactions with multiple-party entities where one or more of those entities is a conduit. Congress felt that the IRS had the correct interpretation of what the law should be and was properly recharacterizing the transactions on which it ruled.

REGULATORY AUTHORITY GRANTED.

Thus, Treasury is now authorized to issue Regulations to prevent unwarranted avoidance of tax through multiple-party financial engineering and to provide guidance to taxpayers entering into financial transactions. New Section 7701(l) authorizes Regulations under which multiple-party financing transactions may be characterized as being directly among two or more such parties where such recharacterization will prevent U.S. tax avoidance. The Committee Report says that the Regulations should not apply only to back-to-back loans, but also to other financing transactions. Thus, Regulations may deal with multiple-party transactions involving debt guarantees or equity investments.

Taxpayers should consider, in devising loan arrangements and royalty arrangements, that the breadth of the Regulations Treasury will issue cannot yet be determined. Thus, loan transactions in the interim should avoid use of unnecessary conduits.

Footnotes

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[1] See van Weeghel, "Netherlands Draft Bill Attempts Crackdown on Tax Haven Transactions," 4 JOIT 422 (September 1993).

[2] Rev. Rul. 84-152, 1984-2 CB 381; Rev. Rul. 84-153, 1984-2 CB 383.

[3] See also Rev. Rul. 87-89, 1987-2 CB 195.

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