The Portfolio Interest Exemption: A Pretty Good Thing

12/4/2013 by William Kastin, Mark Ziemba | Snell & Wilmer

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You know what's better than earning *portfolio interest*? Nothing. OK, that may be an overstatement. But for non-U.S. lenders looking to earn a return on their U.S.-based investments, with respect to paying U.S. taxes, that's not much of an overstatement.

I. Investing in U.S. Real Property

Oftentimes, non-U.S. investors look to benefit from the historical strength and stability of the U.S. economy. And, in light of the recent decline in the U.S. real estate industry, many non-U.S. investors are looking to take advantage of property values which may still be at historic lows. However, some of these investors are hesitant to acquire a U.S. real property interest for a couple of reasons.

First, some of these non-U.S. investors simply do not want to pay U.S. taxes on their U.S.-source income, whether such income arises from the rental or disposition of a U.S. real property interest. For example, if the non-U.S. investor's rental activities rise to the level of being engaged in the conduct of a U.S. trade or business, by election or otherwise, then the *net* rental income received would be subject to U.S. tax the same as if the non-U.S. investor were a U.S. taxpayer. Alternatively, if the non-U.S. investor's activities do not rise to the level of being engaged in the conduct of a U.S. trade or business, then the *gross* rental income received would be subject to a 30% tax. And, to ensure the U.S. tax is collected, the tenant is required to withhold such tax from each rental payment. Regardless of whether the property is ever rented, gain from its sale would be subject to U.S. tax. And, to ensure the U.S. tax is collected, the buyer is required to withhold 10% of the gross amount realized from the sale.

Another reason why some non-U.S. investors may be hesitant to acquire a U.S. real property interest is because they simply do not want to file anything with the IRS. Even with the benefit of foreign tax credits and reduced tax rates available pursuant to an applicable income tax treaty, some non-U.S. investors nevertheless find it undesirable to apply for a U.S. tax identification number and/or file a non-resident income tax return or information return.

For those non-U.S. investors looking to participate in the U.S. economy, but who find the applicable tax rules associated with acquiring a U.S. real property interest to be burdensome, lending to a U.S. borrower may be a viable alternative.

II. Lending to a U.S. Borrower

Under the right circumstances lending to a U.S. borrower may address almost all of the non-U.S. investor's concerns mentioned above. The general rule is that, like rental income discussed above, U.S.-sourced interest income received by a non-U.S. lender is subject to a 30% tax. However, an exception to this general rule provides that U.S.-sourced interest income which qualifies under the *portfolio interest exemption* is not subject to this tax. Additionally, the non-U.S. lender does not have to file U.S. tax returns respecting such income. And these "benefits" arise without regard to any U.S. income tax treaty. Furthermore, the loan may be secured by a U.S. real property interest, allowing

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the non-U.S. lender to at least indirectly participate in the U.S. real estate market (e.g., if the non-U.S. person believes that the real estate value will appreciate over time, then any such appreciation will add to the security of the loan).

As you could imagine, the portfolio interest exemption is not available to every non-U.S. lender. And potential lenders would be wise to carefully follow the applicable rules, as failure to do so could have significant adverse tax implications for everyone involved. The following are a handful of rules which, if applicable, would result in the portfolio interest exemption being *un*available.

- **Rules Relating to the Transfer of the Loan; Registered Obligations Only**. The debt instrument must be in registered form. In general, this means that the debt may only be transferred either (i) by the non-U.S. lender surrendering the debt instrument to the U.S. borrower, and having the borrower issue the surrendered debt instrument (or a new one) to the transferee, or (ii) through a book-entry system maintained by the borrower. If the loan is transferable in any other way (e.g., directly from one non-U.S. lender to another), then the interest payable pursuant to the loan will not qualify as portfolio interest and, in such a case, U.S. tax would apply.
- **Rules Relating to the Interest Payable; No Contingent Interest**. If the loan provides that any interest payable to the non-U.S. lender is determined by reference to, for example, cash flow, income, fluctuations in property value, or anything similar, then any such interest payable pursuant to the loan will not qualify as portfolio interest and, in such a case, U.S. tax would apply to such interest.
- **Rules Relating to the Non-U.S. Lender**. There are several rules applicable to the non-U.S. lender.
    - First, non-U.S. lenders who are related to the U.S. borrower cannot benefit from the portfolio interest exemption. In general, interest payments made to a non-U.S. lender who owns, directly or indirectly, 10% or more of the borrower do not qualify as portfolio interest. The 10% ownership test varies depending on whether the lender is a partnership, in which case the test is applied at the partner, as opposed to the partnership, level. Additionally, there are complex attribution rules to determine a non-U.S. lender's relationship with the U.S. borrower.
    - Second, the non-U.S. lender cannot be a bank.
    - Third, the non-U.S. lender cannot be a controlled foreign corporation ("CFC"). A CFC is generally defined as any foreign corporation in which U.S. shareholders (each of whom owns 10% or more of the foreign corporation) own more than 50%.
    - Fourth, the non-U.S. lender cannot be engaged in the conduct of a U.S. trade or business relating to the loan.
    - And finally, the non-U.S. lender must provide the U.S. borrower (as opposed to file with the IRS) an applicable IRS Form W-8 certifying, under penalty of perjury, that among others the non-U.S. lender is not a U.S. person.

In summary, as a general matter, if (i) a non-U.S. lender (which is unrelated to the U.S. borrower, is not a bank, is not a CFC, and is not engaged in the conduct of a U.S. trade or business), (ii) lends money to a U.S. borrower pursuant to (iii) a registered debt instrument, (iv) which pays a fixed rate of interest, and (v) the non-U.S. lender provides adequate documentation as to its non-U.S. status, then the interest payable pursuant to the loan should qualify for the portfolio interest exemption and, in such a case, no U.S. tax would arise with respect to such interest. Assuming the arrangement otherwise makes good financial sense, non-U.S. persons looking to participate, in one form or another, in the U.S. economy should consider lending as an alternative to acquiring a U.S. real estate interest.

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As with much of international tax planning, the complexities relating to portfolio interest provide planning opportunities for well advised investors. With careful planning and structuring, non-U.S. investors looking to develop a long-term portfolio of U.S. real estate-related investments can use the portfolio interest exemption to increase their overall after U.S.-tax rate of return. And, in certain carefully structured transactions, the non-U.S. lender may also have the opportunity to participate in the equity appreciation of the underlying real estate.

This article is intended to introduce you to the portfolio interest exemption rules and is not a substitute for careful tax planning. Before seeking to benefit from the portfolio interest exemption, non-U.S. lenders should consult with your own tax advisor. Also, please be advised that any tax advice included in this article, is not intended, and cannot be used, for the purpose of (i) avoiding any federal tax penalty or (ii) promoting, marketing, or recommending any transaction or matter to another person.

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