FOREIGN PARTNERS DESERVE THEIR SHARE OF THE P.I.E.: THE PORTFOLIO INTEREST EXEMPTION AS APPLIED TO PARTNERSHIPS

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In this article, the author provides a brief overview of the 10 percent ownership limitation under the portfolio interest exemption and proposes that the limitation be applied at the partner level. The author believes that the limitation as applied at the partnership level creates unjust and unintended results, whereas, if applied at the partner level, the limitation would adequately prohibit the use of the portfolio interest exemption by persons owning 10 percent or more of the obligor, while allowing those who properly deserve to qualify under the portfolio interest exemption to benefit from the exemption.

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I. Introduction

In 1994 the IRS issued a field service advice indicating that it would take an aggregate approach in applying the 10 percent ownership limitation in section 871(h)(3)(A) with respect to the portfolio interest exemption. Thus, the determination of whether interest is received by a “10 percent shareholder” for purposes of disallowing the portfolio interest exemption would be made at the partner level as opposed to the partnership level. As is apparent from the legend on field service advice and private letter rulings, however, determinations made in that limited authority “may not be used or cited as precedent.”

Since then, the IRS has been silent on whether the 10 percent ownership limitation should be applied at the partnership or the partner level. This article provides a basic overview of the portfolio interest exemption and concludes that the 10 percent ownership limitation should be applied at the partner level. Partner-level application of the 10 percent ownership limitation would not only be in accord with the withholding rules regarding portfolio interest (which provide a look-through rule for determining whether withholding is required on portfolio interest) and the general purpose underlying the portfolio interest exemption, but would prevent penalizing taxpayers that choose to pool their resources and lend money through a partnership vehicle. Regardless of what position the IRS ultimately takes, the importance of certainty cannot be discounted. Without it, taxpayers and withholding agents are left to their own musings as to what the correct answer is or should be.

II. Overview of the Portfolio Interest Exemption

Nonresident aliens and foreign corporations that are not engaged in a U.S. trade or business and that receive U.S.-source interest are generally subject to tax under sections 871(a)(1) and 881(a)(1) (at a current rate of 30 percent), unless an applicable income tax treaty reduces or eliminates the tax or an exception under domestic law

Table 1

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<th>Section</th>
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<td>871(a)(1)</td>
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<td>881(a)(1)</td>
<td>U.S.-source interest tax for foreign corporations</td>
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3 Internal Revenue Code of 1986, as amended (the code). All section references herein are to the code unless otherwise indicated.
applies.\footnote{Interest is generally treated as “U.S. source” if it is paid or accrues on a debt obligation of a U.S. person. Section 861(a)(1).} One exception, commonly referred to as the “portfolio interest exemption,” can be found in sections 871(h) and 881(c). Under those provisions, U.S.-source interest received by nonresident individuals and foreign corporations that would otherwise be subject to U.S. tax under sections 871(a)(1) and 881(a)(1) will not be subject if the interest qualifies as “portfolio interest.”

A. Basic Portfolio Interest Exemption

The definition of portfolio interest is relatively broad, and generally includes interest (including original issue discount) on a debt obligation (A) in registered form, provided the relevant withholding agent receives proper certification that the beneficial owner of the obligation is not a U.S. person and (B) in unregistered form (that is, in obligations in bearer form), provided that the obligation is described in section 163(f)(2)(B). Section 163(f)(2)(B) requires that interest on an unregistered obligation be payable only outside the United States and its possessions, that a statement appear on the face of the obligation that any U.S. person holding the obligation will be subject to limitations under the income tax laws of the United States, and that arrangements are in place reasonably designed to make certain that the obligation will only be sold (or resold in connection with original issue) to a person other than a U.S. person.

The definition of portfolio interest, however, is subject to some exceptions. Portfolio interest does not include interest received by (a) a “10 percent shareholder” (the 10 percent ownership limitation),\footnote{Sections 871(h)(3)(B) and 881(c)(3)(B).} (b) a bank with respect to interest received by (a) a “10 percent shareholder” (the 10 percent ownership limitation),\footnote{Section 881(c)(3)(A).} (c) a bank with respect to interest received by (a) a “10 percent shareholder” (the 10 percent ownership limitation),\footnote{Section 881(c)(3)(C).} (d) a bank with respect to interest received by (a) a “10 percent shareholder” (the 10 percent ownership limitation),\footnote{Sections 871(h)(3)(C)(ii).} (e) a controlled foreign corporation in addition to its 8 percent direct ownership interest in corporation A, and has a 25 percent interest in the capital and profits of WXYZ partnership. WXYZ also owns directly 8 percent of corporation A stock. Under the attribution rules of section 318, each of W, X, Y, and Z is treated as owning 10 percent of corporation A stock. Because each of W, X, Y, and Z is treated as owning its proportionate share of the stock owned directly or indirectly by WXYZ partnership (that is, 2 percent of corporation A stock) in addition to his 8 percent direct stock interest in corporation A, WXYZ partnership, on the other hand, is treated as owning 40 percent of corporation A stock because under the attribution rules, WXYZ partnership is deemed to own all of the corporation A stock owned by each of W, X, Y, and Z (that is, 8 percent owned by each partner (or 32 percent of corporation A stock) in addition to its 8 percent direct ownership interest in corporation A stock.

The constructive ownership rules as applied to and from partnerships can be illustrated by the following example. Assume each of W, X, Y, and Z is a partner in WXYZ partnership, owns 8 percent of the stock of corporation A, and has a 25 percent interest in the capital and profits of WXYZ partnership. WXYZ also owns directly 8 percent of corporation A stock. Under the attribution rules of section 318, each of W, X, Y, and Z is treated as owning 10 percent of corporation A stock, because each of W, X, Y, and Z is treated as owning its proportionate share of the stock owned directly or indirectly by WXYZ partnership (that is, 2 percent of corporation A stock) in addition to his 8 percent direct stock interest in corporation A. WXYZ partnership, on the other hand, is treated as owning 40 percent of corporation A stock because under the attribution rules, WXYZ partnership is deemed to own all of the corporation A stock owned by each of W, X, Y, and Z (that is, 8 percent owned by each partner (or 32 percent of corporation A stock) in addition to its 8 percent direct ownership interest in corporation A stock.

B. IRS Field Advice

In 2003 the IRS made available a field service advice, issued in 1994, that applied the 10 percent ownership limitation at the partner level and concluded that section 871(h)(3)(C)(iii) prevented attribution of options owned by a partnership from the partnership to its partners.\footnote{Section 871(h)(3)(B)(ii).} In the field service advice, a foreign partnership made a loan to several domestic partnerships that was convertible into a 10 percent or more equity interest in each of the

\footnote{Section 871(h)(3)(C).}
partnerships. It appears that because the loan was convertible into a 10-percent-or-greater equity interest in each of the domestic borrowers, the borrowers took the position that the interest was not portfolio interest and so the portfolio interest exemption from withholding was unavailable to a foreign partner in the foreign partnership — even though the foreign partner did not directly own an equity interest in the domestic borrowers — because the foreign partnership itself should be deemed to own a 10-percent-or-greater equity interest in each of the borrowers under the constructive ownership rules. Thus, the borrowers took an entity approach regarding the 10 percent ownership limitation and withheld U.S. tax on the foreign partner’s allocable share of interest income paid under the loan. The foreign partner challenged the borrowers’ determination and claimed a refund of the tax withheld, asserting that the portfolio interest exemption applied.

The IRS agreed with the foreign partner, determining that the 10 percent ownership limitation should be applied at the partner level. The IRS reasoned that to apply the 10 percent ownership limitation at the partnership level would effectively attribute the entire partnership’s equity interest in the partnership to each individual partner. That result would be inconsistent with the application of section 318(a)(2), which limits attribution from partnerships to the partner’s proportionate interest in the partnership. Although the IRS admitted that the constructive ownership rules in section 318 literally apply an entity approach, the rationale behind the IRS’s determination was that a partner is generally the beneficial owner of income received by a partnership and, unlike a corporation, a partnership is not a taxpayer. The IRS stated that the application of the 10 percent ownership limitation at the partner level was “consistent with the overall policies embodied in the portfolio interest exception; to provide U.S. borrowers with access to foreign capital, but to distinguish foreign lenders from foreign persons making direct (10 percent) equity investments in U.S. operations.” The IRS also stated that venture capital firms generally lend money to domestic entities through partnership vehicles, which implies that the IRS believed that the application of the 10 percent ownership limitation at the partnership level could negatively affect foreign investment in domestic business.

III. Analysis Under Current Law

A. Ownership Limitation at the Partner Level

The determination and result of the field service advice should be applauded and followed. Under current law, however, it is unclear whether the 10 percent ownership limitation would be applied at the partnership level or the partner level. Indeed, under a literal reading of section 871(h)(3), a partnership could be a 10 percent shareholder such that payments made by a domestic obligor to a partnership would not constitute “portfolio interest.” As discussed above, a 10 percent shareholder is defined as “any person” owning 10 percent or more of some equity interests in a domestic obligor, and the term “person” is defined in the code to mean “an individual, a trust, estate, partnership, association, company or corporation.” Thus, it is possible that the IRS would take the position that the 10 percent ownership limitation should apply at the partnership level. That position could produce unjust and unintended results.

For instance, assume six foreign individuals — A, B, C, D, E, and F — form partnership Y, a foreign partnership, and contribute $100 to Y in exchange for a partnership interest. Each of A, B, C, D, E, and F agrees to share equally in the profits and losses of Y. Y then uses the $600 to acquire registered notes of corporation X, a publicly traded corporation that has only one class of stock — common voting stock — outstanding. Each of A, B, C, D, E, and F owns 2 percent of X common stock. If the 10 percent ownership limitation were applied to Y and X — but for the inbound partnership attribution rules — would have otherwise qualified for the portfolio interest exemption, the individual partners would be barred from claiming the portfolio interest exemption on interest payments made by X to Y, despite the fact that none of the individual partners owns more than 10 percent of X stock and that each of the individual partners of Y could have qualified for the portfolio interest exemption had she acquired the notes directly, because Y would be deemed to own 12 percent of X voting stock under the constructive attribution rules.

That is particularly troubling for foreign investment partnerships (especially publicly traded foreign partnerships) that invest in debt obligations of publicly traded corporations, when foreign partners could own in the aggregate 10 percent or more of the voting stock of a publicly traded corporate borrower but no individual partner owns more than a fraction of a percent of the stock of that borrower. Foreign partners exit and enter investment partnerships, sometimes on a daily basis, and the administrative burden of having to determine whether the 10 percent ownership limitation has been violated seems patently unfair. Partnerships would then have to determine the percentage of equity interests owned by its partners in any obligors of the partnership and require that the partners notify the partnership if any such equity interest is sold or acquired. It is doubtful that any investor would freely supply this information to a partnership rather than forgo investing in the partnership altogether. Even if an individual did want to supply the information, determining equity ownership could prove an impossible task given the broad sweep of the constructive ownership rules, particularly when the individual invests in a partnership through higher-tier partnerships or pass-through entities. Similarly, for the individual partner claiming the portfolio interest exemption, it is doubtful whether such a partner would have information readily available to ascertain the equity ownership interests of all other partners of the partnership. While the burden is less troublesome for small partnerships, to apply the 10 percent ownership limitation (assuming its partners could determine what stock they directly and constructively own) at the partnership level in today’s world of investment funds and large partnerships seems

15Section 7701(a)(1).
an unwieldy and overly burdensome task, especially when higher-tier partnerships are involved.

Moreover, to prevent foreign partners from benefiting from an exemption that was originally intended to promote foreign investment in the United States simply because the foreign partner decides to invest through a foreign partnership vehicle runs contrary to the very purpose behind the portfolio interest exemption. When, as here, there is no abuse, the application of the 10 percent ownership limitation to partnerships could preclude individual investors from investing through foreign partnerships. Arguably, a partner that is not a 10 percent shareholder of an obligor would choose to acquire debt obligations of the obligor directly rather than taking the risk of suffering a 30 percent tax cost (assuming no treaty or other exception applies) on interest payments made by the obligor to the partnership.

Given the proliferation of securities investments made by investment partnerships and the access that those investment partnerships have to investment opportunities, compared with the difficulty of (and often preclusion from) investing in those investments as an individual investor, it seems unfortunate that a foreign partner could be effectively precluded from making investments that are, in practice, only available to large investment partnerships and major financial institutions. The result seems unjustified and would favor some investors (that is, persons that do not make equity investments) over others. Even if an individual could gain access to equally attractive debt investments, information and transaction costs could preclude the foreign investor from investing in U.S. obligations and cause the investor to take her business elsewhere. Similarly, it seems unjustified that the equity ownership of a domestic partner in a foreign partnership could preclude foreign partners from claiming the portfolio interest exemption, particularly when none of the foreign partners own an equity interest in a domestic borrower.

It is interesting to note that if the 10 percent ownership limitation were to apply at the partner level, the partners could arguably form a domestic partnership and the portfolio interest exemption would be available to those same partners (assuming each partner did not directly, indirectly, or constructively own more than a 10 percent interest in the obligor). It seems an anomaly to burden foreign partners by preventing the application of the portfolio interest exemption merely because partners decide to invest in a foreign partnership rather than a domestic partnership.

B. Withholding on Portfolio Interest

The portfolio interest exemption, if applied at the partner level, would also conform to the current withholding rules regarding interest received by foreign persons.

I. Current withholding rules generally. Interest that qualifies as portfolio interest is generally exempt from withholding, subject to a specific knowledge exception. In particular, no tax must be deducted or withheld from interest that qualifies as portfolio interest unless the withholding agent knows, or has reason to know, that the interest is not portfolio interest because the interest is either contingent interest (within the meaning of sections 871(h)(4) and 881(c)(4)) or received by a disqualified recipient.16 If the 10 percent ownership limitation were determined at the partnership level so as to disallow the portfolio interest exemption, one would have to look to the general rules applicable to withholding on interest payments. To apply the 10 percent ownership limitation at the partnership level is countertuitive to the current framework of the withholding rules, which generally provide a look-through rule regarding withholding on interest payments made to foreign partnerships.

The code provides that a withholding tax (currently at a rate of 30 percent) applies to payments of interest that is not effectively connected income made to nonresident alien individuals and foreign partnerships and corporations, unless a treaty applies (to either reduce or eliminate the tax) and except as otherwise provided in the regulations. Whether withholding is required on payments of interest made to a partnership based on the aggregate or entity approach generally depends on the status of the partnership as either domestic or foreign, and if the partnership is foreign, whether the partnership is a “nonwithholding foreign partnership” or a “withholding foreign partnership.” The withholding rules regarding payments made to partnerships, however, generally favor a look-through approach. Domestic partnerships are generally treated as withholding agents with respect to interest that is not effectively connected income in the hands of its partners and must withhold tax on any interest paid to foreign partners to the extent the interest is includable in the gross income of the foreign partner and subject to withholding.17

Regarding foreign partnerships that are nonwithholding foreign partnerships, the withholding rules under the code provide that interest paid to a foreign partnership is generally treated as paid to its partners if “the withholding agent can reliably associate a partner’s distributive share of the [interest] with a valid Form W-8, or other appropriate documentation, certifying that the partner is a payee that is a foreign beneficial owner.”18

Interest payments made to a foreign partnership that is a “foreign withholding partnership” are not subject to withholding, although the withholding agent may treat the payments as made to the foreign partnership, so long as the withholding agent can reliably associate the interest payment with a withholding foreign partnership.
withholding certificate.\textsuperscript{19} Foreign withholding partnership status, however, can be obtained only if the foreign partnership enters into an agreement with the IRS (subject to the IRS’s discretion) regarding distributions and guaranteed payments that the partnership makes to its partners. Also, if a foreign partnership obtains status as a foreign withholding partnership, it becomes subject to a series of withholding and reporting provisions generally applicable to withholding agents, unless the agreement with the IRS provides otherwise.\textsuperscript{20}

In the absence of proper documentation regarding a foreign partnership’s status as either a nonwitholding foreign partnership or a foreign withholding partnership, some presumptive rules in Treas. reg. section 1.1441-1(b)(3)(ii) apply to the classification of the partnership.\textsuperscript{21} If, under those presumptive rules, the partnership is treated as a foreign partnership, the partnership is not treated as the recipient of the interest payments; rather, the beneficial owners of the interest (generally the partners, or if a particular partner is a look-through entity, the ultimate beneficial owners of the interest payments) are treated as the recipients of the interest.\textsuperscript{22} Thus, in the absence of those complex rules regarding withholding obligations for nonwithholding and withholding foreign partnerships, foreign partnerships that are treated as such under the presumptive rules would necessarily be treated as look-through entities for purposes of determining the amount of withholding required with respect to interest paid to the partnership.

2. Withholding rules as applied to the portfolio interest exemption, assuming the 10 percent ownership limitation applied at the partnership level. Assuming the 10 percent ownership limitation were applied at the partnership level, the determination of whether withholding is required under the current withholding rules would produce incongruous results. If the partnership were treated as a 10 percent shareholder, the partners would be precluded from claiming the portfolio interest exemption. The language of the withholding regulations, on the other hand, specifically requires that a withholding agent of a partnership (other than a withholding foreign partnership) treat the partners, and not the partnership, as the recipients of interest income. Thus, for purposes of determining whether withholding is required, the portfolio interest exemption would be applied at the partner level, and as a result, it is possible that no withholding would be required on interest that qualifies as portfolio interest at the partner level, even though the partners would ultimately be precluded from claiming the portfolio interest exemption if the partnership owned a 10-percent-or-greater equity interest in the U.S. borrower. As a result, partners would benefit from a timing difference because no withholding would be required, although ultimately the partners could be responsible for tax on the interest (assuming no treaty or other exception applied).

That peculiar result becomes further complicated depending on whether the partnership is foreign or domestic, and if foreign, is a withholding foreign partnership or a nonwithholding foreign partnership. If the beneficial owner of a domestic partnership is treated as the recipient of interest payments, then for purposes of determining the domestic partnership’s withholding obligations, the 10 percent ownership limitation would be applied only at the partner level and the domestic partnership would not be required to withhold tax on any interest income that qualifies as portfolio interest in the hands of the foreign partner, is received by the partnership from a domestic obligor, and is allocated by the partnership to the foreign partner.

If the partnership were a nonwithholding foreign partnership, the determination of whether the foreign partnership would be subject to withholding would also be determined based on each particular partner, because the partner is treated as the recipient of the payment under the withholding rules. Thus the 10 percent ownership limitation would apply only at the partner level, not the partnership level, and as described above, foreign partners would benefit from a timing difference because no withholding would be required — although ultimately, the partners would be liable for tax on the interest (assuming no treaty or other exception applied).

On the other hand, if the foreign partnership were a withholding foreign partnership, the withholding agent could choose to treat the interest payments as made to the foreign partnership or its partners. Assuming the withholding agent treated the payments as made to the foreign partnership and the 10 percent ownership limitation would be violated at the partnership level, a 30 percent withholding tax would apply to interest paid to the partnership (in the absence of a treaty or other exception). Alternatively, if the withholding agent treated the payments as made to the foreign partners, arguably no withholding by the withholding agent would be required because the interest would qualify as portfolio interest (assuming the other requirements under the portfolio interest exemption are satisfied) for purposes of determining the withholding agent’s withholding obligations. The foreign partnership would then be obligated to withhold and would also treat the interest payments as made to the partners, so that the 10 percent ownership limitation would apply at the partner level. Thus, the partners would not be subject to withholding, although the partners could ultimately be subject to tax because the partnership owned a 10-percent-or-greater equity interest in the U.S. obligor.

3. Withholding rules as applied to the portfolio interest exemption, assuming the 10 percent ownership limitation applied at the partner level. Now assume that the 10 percent ownership limitation were applied at the partner level. This application would be consistent with the framework of the current withholding rules. A domestic partnership that owned securities of a domestic corporate obligor would not be required to withhold on interest payments made to a foreign partner who did not directly or indirectly own a 10-percent-or-greater equity interest in the borrower. If the partnership owned 100 percent of the debtor corporation, and the foreign partner owned a 10 percent equity interest in the partnership, upstream

\textsuperscript{19} Treas. reg. section 1.1441-5(c)(1)(ii).
\textsuperscript{20} Treas. reg. section 1.1441-5(c)(2).
\textsuperscript{21} Treas. reg. section 1.1441-5(d).
\textsuperscript{22} Treas. reg. section 1.1441-1(b)(3)(ii).
attrition would preclude the partner from benefiting from the portfolio interest exemption and the partner would be subject to withholding tax at a 30 percent rate (assuming no treaty or other exception applied).

Similarly, if the partnership were a nonwithholding foreign partnership, the look-through approach would apply so that withholding obligations and the availability of the portfolio interest exemption would be determined at the individual partner level. Thus, if a particular partner qualified for the portfolio interest exemption, the partner would not be subject to tax on the portfolio interest and, in keeping with the principles underlying the withholding rules, no withholding would be required. If any particular partner did not qualify for the portfolio interest exemption, both withholding and the 30 percent tax on interest payments would apply.

The same result would occur if, with respect to a withholding foreign partnership, the withholding agent of the partnership chose not to withhold on payments made to the foreign partnership. The foreign withholding partnership would then have the obligation to withhold on payments of interest that qualified as portfolio interest, and depending on the availability of the portfolio interest exemption to each particular partner, the foreign partnership would be obligated to withhold only when the particular partner did not qualify for the portfolio interest exemption. If a partner were also a partnership, the look-through rules could arguably apply up the chain, assuming each of the partnerships is a withholding foreign partnership, so that the 10 percent ownership limitation would be applied only to the ultimate beneficiary owner.

If, on the other hand, the withholding agent of the withholding foreign partnership decided to treat the foreign partnership as the payee, the withholding agent could presumably withhold tax on interest paid to the partnership. The foreign partnership, as the withholding agent for its partners, would determine the ultimate tax liability of each partner. If some or all of the partners were entitled to the portfolio interest exemption, the partnership could itself claim a refund of amounts that were erroneously withheld by the withholding agent. While there may be a timing mismatch with respect to amounts overwithheld by the withholding agent, that result is not particular to the portfolio interest exemption, because the withholding agent is generally permitted under the regulations to treat the foreign partnership as the payee with respect to U.S.-source income paid to a foreign partnership.

In each instance, the withholding rules track the actual availability of the portfolio interest exemption, so that a foreign partner who is not subject to withholding would not later have an obligation to pay tax on the interest. Such a result is fair, reasonable, and in keeping with the principles underlying the 10 percent ownership limitation — to preclude some persons related to the domestic borrower from claiming an exemption intended to promote foreign investment. Such a system is also in keeping with the purpose behind the withholding rules, which effectively require foreign persons to pay tax on receipt of U.S.-source income rather than requiring the government to track down foreign persons in other jurisdictions and attempt to impose U.S. tax. Moreover, to impose inconsistent withholding rules and tax obligations by applying the 10 percent ownership limitation at the partner level seems inappropriate and unjustified, particularly given the proliferation of foreign partnerships since the dawn of the check-the-box era.

4. Possible concern with the application of the 10 percent ownership limitation at the partner level. One concern with applying the 10 percent ownership limitation to partners of a partnership may have been that abusive transactions could result if a partnership owning 100 percent of the equity interests of, or a controlling stake in, a domestic obligor could somehow adjust the partnership allocations so that interest payments were made to a foreign partner owning less than 10 percent in the partnership, whereas other income would be allocated to another partner. However, the current regulations dealing with shifting and transitory allocations should prevent that result. If the IRS were still concerned about potential abuse, one solution could be to limit the application of the portfolio interest exemption to partners who do not have effective control of the borrower based on the facts and circumstances surrounding the transaction, and with respect to a withholding obligation, the IRS could apply a "reason to know" rule similar to that under section 1441(c)(9). In any event, such a rule could be applied generally to the portfolio interest exemption and need not be dealt with solely with respect to partnerships.

C. Treaty Benefits

The application of the 10 percent ownership limitation at the partnership level also seems inconsistent with the application of income tax treaties. Like the portfolio interest exemption, treaty benefits provide an additional means by which foreign persons can receive an exception from, or a reduced rate of, tax on the receipt of interest payments from a domestic obligor.

Income tax treaties to which the United States is a party generally provide that partnerships and other passthrough entities are not entitled to claim treaty benefits. Rather, a look-through rule generally applies for purposes of determining who is an ultimate beneficial owner of the income received by a partnership or other passthrough entity. Thus, if a reduced rate of, or no, U.S. federal income tax is due on interest because treaty applies, the partner (or other ultimate beneficiary of such income) must claim the treaty benefit, rather than the partnership. That rule is generally intended to prevent forum shopping and to prevent persons from claiming benefits of a particular treaty with the United States by simply becoming a partner in a partnership located in a jurisdiction different from that of the particular partner.

Like the treaty exception to U.S. tax on interest payments, the 10 percent ownership limitation should be

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23There are, however, some exceptions. For instance, on August 26, 2005, the competent authorities of the United States and Mexico signed an agreement regarding when some passthrough entities (for example, partnerships and limited liability companies) would be entitled to treaty benefits. See Ann. 2005-72, 2005-41 IRB 692, Doc 2005-20508, 2005 TNT 195-15 (Oct. 7, 2005).
applied at the partner level. That approach would provide parity for foreign persons entitled to claim either treaty benefits or the portfolio interest exemption with respect to payments of interest by a domestic obligor.

IV. Conclusion

The portfolio interest exemption should be applied at the partner level so that individual partners are not penalized for choosing to invest in foreign partnerships that purchase debt obligations. While it is understandable that the 10 percent ownership limitation should be applied to a corporation, there is a distinct difference between partnerships and corporations. As stated in the 1994 field service advice, a corporation, unlike a partnership, is a taxpayer. Thus, to deny the portfolio interest exemption to a corporation that owns 10 percent or more of the equity interests in a domestic borrower would preclude the interest payments made to the corporate borrower from qualifying for the portfolio interest exemption. That outcome does not unjustifiably harm foreign shareholders, because corporations are separate taxpayers and payments made to those shareholders would generally be in the nature of dividends, not interest. The double taxation that results from that approach, and the preclusion from claiming the portfolio interest exemption, is within the purpose and structure of the portfolio interest exemption. Foreign partners, on the other hand, would suffer an unwarranted detriment, because the foreign partnership is not a taxpayer, and to deny the portfolio interest exemption to a foreign partnership effectively denies the portfolio interest exemption to the foreign partner.

There is no policy justification for that result, and the current rules effectively prohibit the unwarranted application of the portfolio interest exemption. Under the current rules, each particular partner ultimately will be subject to U.S. tax and withholding on nonportfolio interest. The only result obtained if the 10 percent ownership limitation were applied at the partnership level is that foreign partners who choose to invest in a foreign partnership, and would qualify for the portfolio interest exemption on an individual basis, would be penalized for their choice. To protect foreign partners who invest in domestic businesses, the portfolio interest exemption should be applied to promote foreign investment in U.S. business, and therefore the 10 percent ownership limitation should be applied only at the partner level, or the beneficial owner level.