[4830-01-p] Published June 13, 2006

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-118775-06

RIN 1545-BF64

Revisions to Regulations Relating to Repeal of Tax on Interest of Nonresident Alien Individuals and Foreign Corporations Received from Certain Portfolio Debt Investments.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under sections 871 and 881 of the Internal Revenue Code (Code) relating to the exclusion from gross income of portfolio interest paid to a nonresident alien individual or foreign corporation. These regulations clarify how the portfolio interest rules apply with respect to interest paid to a partnership (or simple or grantor trust) that has foreign partners (or beneficiaries or owners). This document also provides notice of a public hearing.

DATES: Written or electronic comments must be received by August 13, 2006. Outlines of topics to be discussed at the public hearing scheduled for Thursday, September 7, 2006, at 10 a.m., must be received by August 24, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-118775-06), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions also may be hand-delivered Monday through Friday

between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-118775-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-118775-06). The public hearing will be held in IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jason Kleinman, (202) 622-3840; concerning the submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 871(a) of the Code imposes a tax of 30 percent on United States (U.S.) source fixed or determinable annual or periodic (FDAP) income received by a nonresident alien individual to the extent the amount so received is not effectively connected with the conduct of a trade or business within the U.S. Section 881(a) imposes a similar tax with respect to FDAP income received by a foreign corporation. Pursuant to these sections, U.S. source interest generally is considered FDAP income and is subject to tax. See sections 871(a)(1)(A) and 881(a)(1)(A). This tax generally is collected by means of withholding under sections 1441 and 1442, which require a payor of FDAP income to withhold 30 percent of the gross amount of such payment, unless the beneficial owner claims a reduced rate of tax on such interest under an applicable Code or treaty

provision. See §§1.1441-1(b)(4) and 1.1441-6.

Notwithstanding the general imposition of tax on U.S. source interest under sections 871(a) and 881(a), sections 871(h) and 881(c), respectively, provide that no tax is imposed in the case of portfolio interest received by a nonresident individual or foreign corporation. Under section 871(h)(2) and section 881(c)(2), respectively, portfolio interest includes any interest (including original issue discount) that would be subject to tax under section 871(a) or section 881(a) but for section 871(h) or section 881(c).

However, both sections 871(h)(3)(A) and 881(c)(3)(B) provide, among other limitations, that portfolio interest does not include interest received by a 10-percent shareholder, as defined in section 871(h)(3)(B). Section 871(h)(3)(B) provides that the term 10-percent shareholder means, in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or, in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.

Section 871(h)(3)(C) provides that the attribution rules of section 318 apply, with three modifications, for purposes of determining whether a person is a 10-percent shareholder (the 10-percent shareholder test) of the obligor. The first modification provides that the attribution of stock from a corporation is made without regard to the 50 percent threshold set forth in section 318(a)(2)(C). The second modification provides that the attribution of stock to a corporation is made

without regard to the 50 percent threshold set forth in section 318(a)(3)(C), but if a corporation would not be attributed a shareholder's stock in another corporation but for the removal of the 50 percent threshold, then the corporation is only attributed that portion of the shareholder's stock in such other corporation as the value of the shareholder's stock in the corporation bears to the value of all stock in the corporation. The third modification provides that if a person is treated as owning stock after the application of section 318(a)(4) (relating to options to acquire stock being treated as stock actually owned), then such stock shall not be treated as actually owned by such person for purposes of attributing ownership to other persons under section 318(a)(2) or (3). The flush language of section 871(h)(3) also provides that, under regulations, rules similar to the rules described above shall apply when determining the ownership of the capital or profits interest in a partnership obligor for purposes of applying the 10-percent shareholder test.

Notwithstanding the general definition of a 10-percent shareholder and the application of section 318 described in section 871(h)(3), neither the Code nor the legislative history applicable to section 871(h)(3) specifically addresses how the 10-percent shareholder test is to apply when interest is paid to a partnership that has foreign partners. That is, neither the Code nor the legislative history explicitly provides whether the 10-percent shareholder test should be applied at the foreign partner level, the partnership level, or both levels.

Explanation of Provisions

1. In General.

These proposed regulations address the application of the 10-percent shareholder test in section 871(h)(3) when a nonresident alien individual or foreign corporation is a partner in a partnership that is paid interest. In doing so, the proposed regulations address the two key points needed to apply the test. First, the regulations address the issue of which person "receives" interest for purposes of the 10-percent shareholder test. Second, the proposed regulations address the time at which a withholding agent must determine if the person who receives the interest is a 10-percent shareholder. Because similar issues arise with respect to interest paid to a simple trust or grantor trust, the proposed regulations also provide rules for that context.

2. Person Who "Receives" Interest for Purposes of the 10-percent Shareholder Test.

Section 871(h)(3) generally provides that interest received by a 10-percent shareholder is not considered portfolio interest exempt from taxation. When a partnership with foreign partners holds a debt instrument, the issue arises as to whether the withholding agent should apply the 10-percent shareholder test at the partner level (because such partner is the beneficial owner of the interest within the meaning of §1.1441-1(c)(6)), at the partnership level (because the partnership holds the debt instrument), or at both levels. The conclusion as to the level or levels at which the 10-percent shareholder test is applied is necessarily a conclusion as to the person or persons considered to "receive" the interest for purposes of the test. As mentioned, neither section 871(h) nor the legislative history explicitly addresses this issue. However, the IRS and the

Treasury Department have previously stated that, based upon the authority of subchapter K and the policies underlying a particular provision of the Code, a partnership may be treated as an aggregate of its partners or as an entity separate from its partners, depending on which characterization is more appropriate to carry out the purpose of the Code or regulatory provision. See TD 9008, 2002-2 CB 335 [67 FR 48020]; Rev. Rul. 89-85, 1989-2 CB 218; H.R. Conf. Rep. No. 2543, 83rd Cong., 2d Sess. 59 (1954); See also TD 9240, 2006-7 IRB 454 [71 FR 2462].

After considering the alternatives, the IRS and the Treasury Department conclude that the 10-percent shareholder test should apply at the foreign partner level to the nonresident alien individual or foreign corporation that is the beneficial owner of the income. Accordingly, the proposed regulations provide that when interest is paid to a partnership, the persons who receive the interest for purposes of applying the 10-percent shareholder test are the nonresident alien individual partners and the foreign corporations that are partners in the partnership. The 10-percent shareholder test is then applied by determining each such person's ownership interest in the obligor. No inference is intended as to whether other limitations set forth in the definition of portfolio interest should be considered at the partner level, partnership level, or at both levels (section 881(c)(3)(A)).

The approach taken in the proposed regulation is supported by the statute and legislative history which convey Congress' desire to facilitate the efficient and effective flow of foreign capital to U.S. borrowers while distinguishing true

portfolio investors in the obligor from foreign persons making direct (ten percent) equity investments in U.S. operations. See S. Rep. No. 98-169, 98 Cong., 2d Sess. 416 (1984); H.R. Rep. No. 98-861, 98 Cong., 2d Sess. 936 (1984); See also, Staff of the Joint Comm. on Tax'n, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 391-394. With regard to the statute, it is clear from subchapter K, section 871, and section 881 that, in the absence of the portfolio interest exception, the tax on interest paid to a partnership is substantively imposed on the nonresident alien individual or foreign corporation that is a partner in the partnership. That is, the beneficial owner with respect to interest paid to a partnership is the foreign partner (other than a partner that is itself a passthrough entity) and not the partnership. Based upon this fact, the IRS and the Treasury Department believe that applying the 10-percent shareholder test in section 871(h)(3) at the partner level is consistent with the statutory framework of sections 871(h)(1) and 881(c)(1) which provide that portfolio interest "received by a nonresident individual" or "received by a foreign corporation", respectively, from sources within the U.S. is exempt from taxation under sections 871(a) and 881(a).

Further, notwithstanding the general regime for imposing tax under sections 871 and 881, the IRS and the Treasury Department do not believe that in enacting the 10-percent shareholder test, Congress intended for the test to be applied at the partnership level. Such an interpretation would condition a foreign beneficial owner's entitlement to the portfolio interest exception on the ownership in the obligor held by either a person that is not a taxpayer (the partnership) or a

person who is wholly unrelated to the beneficial owner (another partner in the partnership). The practical effect of this interpretation would be to characterize interest payments made to a partnership as being received by a 10-percent shareholder in many cases where there is no apparent abuse, thereby disallowing a tax benefit to foreign persons, and impairing the free-flow of foreign capital to U.S. business, solely because a foreign person acted indirectly rather than directly with its U.S. borrower. For example, if 100 unrelated nonresident alien individuals and foreign corporations invest in a partnership that holds 10 percent of a domestic corporation, and such domestic corporation pays U.S. source interest to the partnership, each of the foreign partners in the partnership would be denied the benefit of the portfolio interest exception if the 10-percent shareholder test is applied at the partnership level. The same result occurs if unrelated U.S. persons that are partners in the partnership hold, in combination with the partnership, 10-percent of the domestic corporate obligor. The IRS and the Treasury Department believe that such a result is inapposite to the statutory framework and underlying purpose of the statute, especially considering that section 871(h) invokes the attribution rules of section 318 for the purpose of policing the 10-percent shareholder prohibition, and generally liberalizes the application of such rules to reach more subtle ownership arrangements.

3. Time When 10-percent Shareholder Test is Applied.

Section 871(h)(3) does not explicitly provide the time at which the 10-percent shareholder test is applied. Thus, an issue arises as to whether the test is applied at the beginning of the year, on each interest payment date, at the end

of the year, at all times during the year, or at some other time. Consistent with the withholding regime under sections 1441 and 1442, the proposed regulations provide that the 10-percent shareholder test is applied with respect to a nonresident alien individual or foreign corporation that is a partner in the partnership at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest. See §1.1441-3(b). For example, in the case of U.S. source interest paid by a domestic corporation to a domestic partnership or withholding foreign partnership (as defined in §1.1441-5(c)(2)), the 10-percent shareholder test is applied on the earliest of when the interest is distributed by the partnership to the foreign partner, the date that the statement under section 6031(c) is mailed or otherwise provided to such partner, or the due date for furnishing such statement. See §§ 1.1441-5(b)(2) and 1.1441-5(c)(2)(iii).

4. Application of the 10-percent Shareholder Test to Interest Paid to a Simple or Grantor Trust.

Under subchapter J of the Code, a trust generally computes it taxable income in the same manner as an individual. See section 641(b). However, subchapter J contains rules that generally permit a trust required to distribute all of its income currently (simple trust) a deduction for the amounts it is required to distribute. See section 651. To the extent a simple trust claims a deduction for amounts it is required to distribute to its beneficiaries, the trust acts as a passthrough entity because such amounts are generally subject to taxation in the hands of the beneficiaries of the trust under section 652.

Further, subchapter J contains so called grantor trust rules pertaining to trust arrangements where a grantor or other person has retained rights or powers with respect to trust property or trust income. See sections 671-679. Pursuant to the grantor trust rules, the grantor or other person may be considered the owner of all or a portion of the trust. To the extent that the grantor or other person is considered the owner of any portion of a trust, the grantor or other person (and not the trust) is required to take into account those items of income, deduction, and credit attributable to the portion owned when computing the grantor or other owner's taxable income. See section 671.

When interest is paid to a simple trust or a grantor trust, an issue arises as to whether the 10-percent shareholder test should be applied at the trust or beneficiary or owner level. Accordingly, the proposed regulations provide rules for that context. Under the proposed regulations, when interest is paid to a simple trust or grantor trust and such interest is distributed to or included in the gross income of a nonresident alien individual or foreign corporation that is a beneficiary or owner of such trust, as the case may be, the withholding agent is to apply the rules of the proposed regulations with respect to determining whether a 10-percent shareholder has received interest, at the beneficiary or owner level. Further, the 10-percent shareholder test is applied with respect to a nonresident alien individual or foreign corporation that is a beneficiary of a simple trust or an owner of a grantor trust at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest.

Effective Date

These proposed regulations apply to interest paid on obligations issued on or after the date that the regulations are issued as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a new collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 7, 2006, beginning at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors

must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by July 13, 2006**.** A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of the proposed regulations is Jason Kleinman, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.871-14 is amended as follows:

1. Paragraphs (g) and (h) are redesignated as paragraphs (h) and (i), respectively.

2. New paragraph (g) is added.

The addition reads as follows:

§1.871-14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

* * * * *

(g) Portfolio interest not to include interest received by 10-percent shareholders--(1) In general. For purposes of section 871(h), the term portfolio interest shall not include any interest received by a 10-percent shareholder.

(2) Ten-percent shareholder--(i) In general. The term 10-percent shareholder means--

(A) In the case of an obligation issued by a corporation, any person who owns 10-percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote; or

(B) In the case of an obligation issued by a partnership, any person who owns 10-percent or more of the capital or profits interest in such partnership.

(ii) Ownership--(A) Stock ownership. For purposes of paragraph

(g)(2)(i)(A) of this section, stock owned means stock directly or indirectly owned and stock owned by reason of the attribution rules of section 318(a), as modified by section 871(h)(3)(C).

(B) Ownership of partnership interest—(1) For purposes of paragraph (g)(2)(i)(B) of this section, rules similar to the rules in paragraph (g)(2)(ii)(A) of this section shall be applied in determining the ownership of a capital or profits interest in a partnership.

(2) Special rules. [Reserved].

(3) Application of 10-percent shareholder test to partners receiving interest through a partnership--(i) Partner level test. Whether interest paid to a partnership and included in the distributive share of a partner that is a nonresident alien individual or foreign corporation, is received by a 10-percent shareholder, shall be determined by applying the rules of this paragraph (g) only at the partner level.

(ii) Time at which 10-percent shareholder test is applied. The determination of whether a nonresident alien individual or foreign corporation that is a partner in a partnership is a 10-percent shareholder under the rules of section 871(h)(3), section 881(c)(3), and this paragraph (g) with respect to interest paid to such partnership shall be made at the time that the withholding agent, absent the provisions of section 871(h), 881(c) and the rules of this paragraph, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest. For example, in the case of U.S. source interest paid by a domestic corporation to a domestic partnership or withholding

foreign partnership (as defined in §1.1441-5(c)(2)), the 10-percent shareholder test is applied on the earliest of when the interest is distributed by the partnership to the foreign partner, the date that the statement under section 6031(c) is mailed or otherwise provided to such partner, or the due date for furnishing such statement. See §1.1441-5(b)(2) and (c)(2)(iii).

(4) Application of 10-percent shareholder test to interest paid to a simple trust or grantor trust. Whether interest paid to a simple trust or grantor trust and distributed to or included in the gross income of a nonresident alien individual or foreign corporation that is a beneficiary or owner of such trust, as the case may be, is received by a 10-percent shareholder, shall be determined by applying the rules of this paragraph (g) only at the beneficiary or owner level. The 10-percent shareholder test is applied with respect to a nonresident alien individual or foreign corporation that is a beneficiary of a simple trust or an owner of a grantor trust at the time that a withholding agent, absent any exceptions, would otherwise be required to withhold under sections 1441 and 1442 with respect to such interest.

(5) Effective date. The rules of this paragraph (g) apply to interest paid on obligations issued on or after the date these regulations are issued as final regulations.

Par. 3. Section 1.881-2 (a)(6) is added to read as follows:

§1.881-2 Taxation of foreign corporations not engaged in U.S. business.

(a) * * *

(6) Interest received by a foreign corporations pursuant to certain portfolio

debt instruments is not subject to the flat tax of 30 percent described in paragraph (a)(1) of this section. For rules applicable to a foreign corporation's receipt of interest on certain portfolio debt instruments, see sections 871(h), 881(c), and §1.871-14.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.