

Client Alert

A report
for clients
and friends
of the Firm April 2007

Final Regulations Issued On Portfolio Interest Paid to Partnerships

On April 12, 2007, the U.S. Department of the Treasury issued final regulations under Sections 871 and 881 of the Internal Revenue Code of 1986, as amended, clarifying the application of the “portfolio interest exemption” to interest income earned by partnerships. The final regulations clarify that the “10-percent shareholder” test is applied at the partner level, not the partnership level. This is a favorable result for investment partnerships that make debt and equity investments in portfolio companies. The final regulations are in substantially the same form as the proposed regulations that were issued on June 13, 2006.

Background

Non-U.S. persons generally are subject to a 30% withholding tax on U.S.-source interest that is not effectively connected to the conduct of a U.S. trade or business. Interest received by non-U.S. individuals or corporations that qualifies as “portfolio interest,” however, is exempt from U.S. federal income tax withholding. This exemption does not depend on the availability of an income tax treaty.

Portfolio interest generally includes interest paid on certain debt obligations of U.S. issuers that meet specified requirements. The portfolio interest exemption, however, does not apply if the non-U.S. recipient owns 10% or more of the total combined voting power of all classes of voting stock of the issuer (or, if the issuer is a partnership, 10% or more of the capital or profits interest in the issuer)—a so-called “10-percent shareholder.”

Portfolio Interest Paid to Partnerships

Prior to the issuance of the proposed regulations, it was not clear if a non-U.S. person would qualify for the exemption with respect to a debt obligation held through a partnership if the partnership was a 10-percent shareholder, even if the non-U.S. person’s indirect interest did not reach the 10% threshold. The final regulations adopt the approach of the proposed regulations, clarifying that the 10-percent shareholder test is determined at the partner level, rather than at the partnership level. Accordingly, if a partnership receives portfolio interest, the 10-percent shareholder test is applied to each of the partnership’s non-U.S. partners, based upon such partner’s indirect interest in the debt issuer on a “look-through” basis. The final regulations apply similar “look-through” rules to the beneficiaries or owners of simple trusts and grantor trusts in determining 10-percent shareholder status.

The final regulations also clarify that the 10-percent shareholder test is applied when the withholding agent otherwise would be required to withhold with respect to the interest income. This may require the test to be applied multiple times with respect to a single interest payment, depending on the timing of distributions and allocations of such interest payment.

Effective Dates

The final regulations apply to portfolio interest paid after April 12, 2007. Taxpayers may also apply the final regulations to portfolio interest paid in any other taxable year if (1) the year is not closed by the statute of limitations as of April 12, 2007 and (2) the “look-through” approach is consistently applied by the taxpayer to all relevant partnerships during such period.

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