Use of Derivatives in Inbound Tax Planning
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Agenda

- I. Planning with Portfolio Interest
  - Option attribution exception through partnership
  - Contingent interest
- II. Swaps and FIRPTA

Planning with Portfolio Interest Exception

Planning with Portfolio Interest Exception

- Foreign persons generally are subject to U.S. taxation on two categories of income:
  - (1) Certain passive types of U.S. source income, e.g., interest, dividends, rents, annuities, and other types of "fixed or determinable annual or periodical income" (FDAP).
  - (2) Income that is effectively connected to a U.S. trade or business (ECI).
- FDAP income is subject to a 30% withholding tax that is imposed on a foreign person's gross income (subject to reduction or elimination by an applicable income tax treaty).
- ECI is subject to tax on a net basis at the graduated tax rates generally applicable to U.S. persons.

Planning with Portfolio Interest Exception

- Subject to certain exceptions, U.S. source interest paid to a foreign person that is not ECI is subject to 30 percent withholding tax.
- However, Sections 871(h) and 881(c) provide that interest that qualifies as "portfolio interest" is exempt from U.S. taxation.

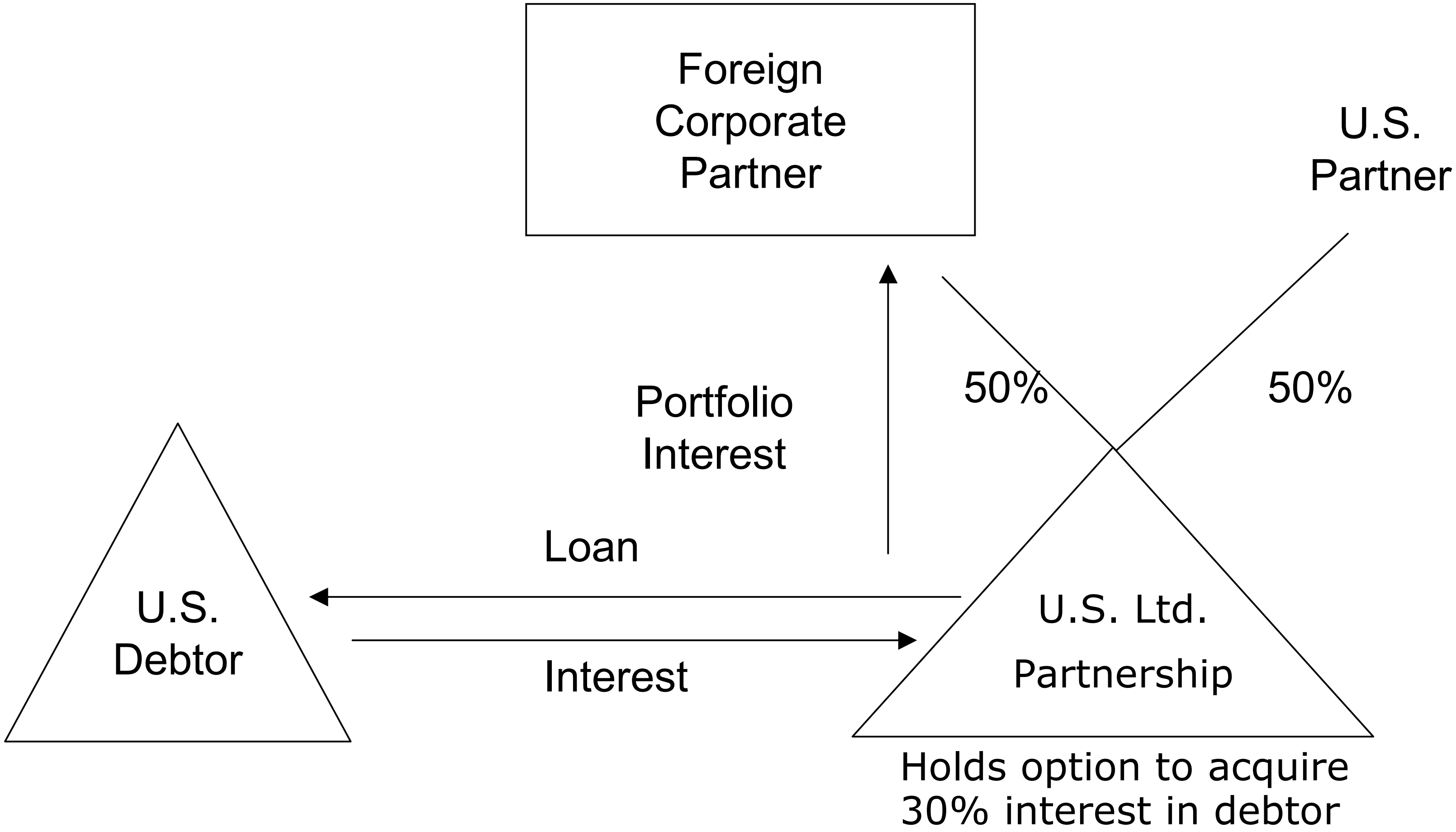
Planning with Portfolio Interest Exception (cont.)

- Exception to portfolio interest: Does not apply if lender is 10-percent voting shareholder of issuing corporation or 10-percent owner of capital or profits interest in issuing partnership.
- For this purpose, Section 318 attribution rules apply to determine ownership, including Section 318(a)(4) option attribution rule.

Planning with Portfolio Interest Exception

- However, Section 318(a)(4) option attribution rule is limited by Section 871(h)(3)(C)(iii), so that the ownership of stock represented by option is attributed only to partnership that holds the option, not the partners.
- Therefore, it may be possible for non-U.S. investor to indirectly own more than 10-percent of debtor and still obtain portfolio interest treatment if invest through a partnership that holds an option to acquire more than 10-percent of stock of debtor.

Planning with Portfolio Interest Exception



Planning with Portfolio Interest Exception

- In example, even though Section 318(a)(4) treats U.S. limited partnership as owning 30-percent of debtor, Section 871(h)(3)(C)(iii) prevents the equity interest from being attributed to the foreign corporate partner.
- Therefore, no U.S. withholding tax on distributive share of interest payments even though, economically, foreign corporate partner owns more than 10 percent of debtor through option.
- Result confirmed in 1994 FSA LEXIS 430 (Feb. 2, 1994).

Planning with Portfolio Interest Exception

- In general, portfolio interest also does <u>not</u> include certain contingent interest. Sections 871(h)(4) and 881(c)(4).
- For this purpose, contingent interest is defined as
- (i) any interest if the amount of such interest is determined by reference to
  - (I) any receipts, sales or other cash flow of the debtor or a related person,
  - (II) any income or profits of the debtor or a related person,
  - (III) any change in value of any property of the debtor or a related person, or
  - (IV) any dividend, partnership distributions, or similar payments made by the debtor or a related person, or
- (ii) any other type of contingent interest that is identified by the Secretary by regulation, where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of Federal income tax.

Planning with Portfolio Interest Exception

- However, there is an exception to the contingent interest rule for:
  - Any amount of interest determined by reference to
    - (I) changes in the value of property (including stock) that is "actively traded" (within the meaning of section 1092(d)) other than property described in section 897(c)(1) or (g)) (*i.e.*, USRPIs and interests in partnerships, trusts, or estates that are considered USRPIs),
    - (II) the yield on property described in subclause (I), or
    - (III) changes in any index of the value of property described in subclause (I) or of the yield on property described in subclause (II).
  - Therefore, interest paid to a foreign person that is contingent on one of the above factors will be exempt from the 30 percent U.S. withholding tax (regardless of the existence of a treaty).

Planning with Portfolio Interest Exception

- PLR 200933002:
  - A U.S. corporation issues equity-linked and credit-linked notes to foreign persons.
  - The notes paid contingent interest, which was based on the performance of an unrelated investment fund during the term of the note.
  - Corporation hedged its exposure to the contingent interest payment by holding shares of the fund while the notes were outstanding.
  - The fund was registered in the E.U. under a regime comparable to registration in the U.S. under the Investment Company Act of 1940.
  - The fund’s daily net asset value was available on a quotation system.
  - The IRS ruled that the contingent interest payments were exempt from U.S. withholding tax under the portfolio interest exception holding that interests in the fund were traded in an “interdealer market” where information on the fund's daily net asset value was available to subscribers to a quotation system.

Planning with Portfolio Interest Exception

- What is considered “actively traded” property (within the meaning of Section 1092(d)) for purposes of this rule?
- The legislative history to Section 1092 merely provides that “[i]n order to be treated as actively traded, property need not be traded on an exchange or in a recognized market.”
- In the preamble to the Regulations under Section 1.446-3 (dealing with notional principal contracts), the IRS stated that it “believes that the term 'actively traded' under Section 1092 was intended to cover financial instruments that are liquid or easily offset, even when those instruments are not traded in an exchange or in a recognized secondary market.”

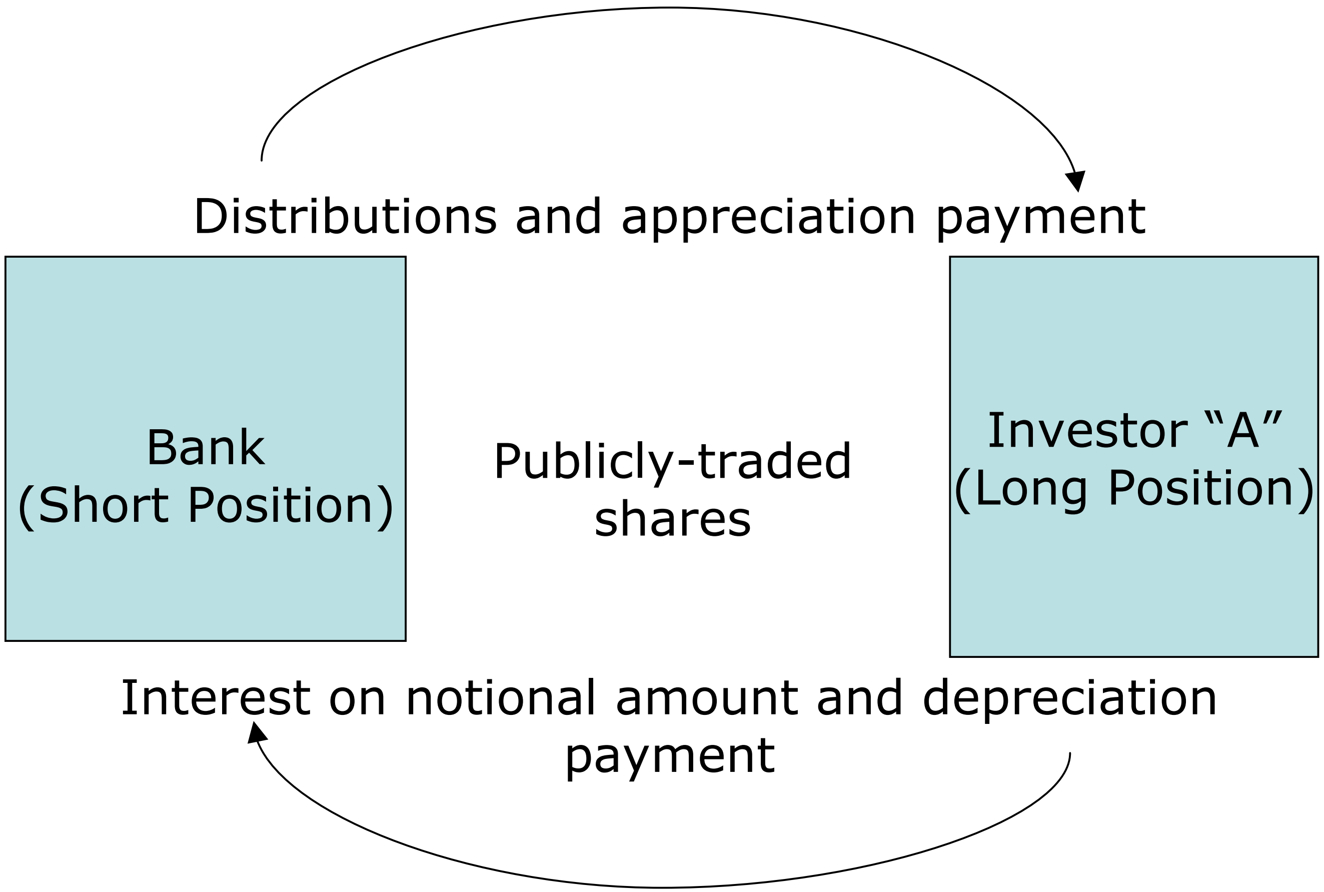
Swaps and FIRPTA

- Swaps and FIRPTA
- Section 861(a)(5) treats FIRPTA gain as U.S.-source income.
- Regulation Section 1.863-7(b) sources income from swap payments based on resident of recipient.
- Query whether long party to a swap, the payments of which are tied to U.S. real property will be subject to Section 897?

FIRPTA Planning

- What is an equity swap?
  - Cash-settled bilateral contract, in which each party agrees to make certain payments to the other depending on the price and dividend performance of the underlying equity.
  - Used to either (i) simulate an investment in an underlying equity interest without making an actual investment or (ii) to divest oneself of economic exposure with respect to the underlying equity.
  - Payments are based on notional amount, which may be number of shares or value of certain number of shares.

FIRPTA Planning



Swaps in General

- U.S. withholding tax consequences of equity swaps
  - Foreign investors generally subject to 30% withholding tax on U.S.-source dividends.
  - Income from equity swaps (i.e., NPCs) sourced according to residence of recipient. 1.863-7(b).
  - Thus, payments received by a foreign investor under an equity swap will be foreign-source income and not subject to withholding tax. Reg. Section 1.1441-4(a)(3)(i).
  - Consider using swaps (as opposed to direct investment) to avoid withholding tax on U.S.-source dividends, including ordinary REIT dividends.
    - Proposed regulations under Section 871(m) provides certain exceptions from favorable withholding exemption for specified notional principal contracts.
    - Specified NPC includes (i) crossing in or out of swap; (ii) swaps where shares are not publicly traded; (iii) swaps with terms less than 90 days; (iv) long party controls short party's hedge; (v) swap represents significant percentage of trading volume (i.e., 5 percent of total public float or 20 percent of the average 30-day trading volume).
    - In general, synthetic equity swap should still work to avoid U.S. withholding tax on dividends in many cases.

Swaps and FIRPTA

- Swaps and FIRPTA
  - Preamble to NPC regulations issued in 1993 indicates that “[T]he IRS is considering whether notional principal contracts involving…[certain] specified indices (e.g., United States real property) are subject to Section 897.”
    - No guidance had been issued for 15 years.
  - Treas. Reg. Section 1.897-1(d)(3)(i)(D) (FIRPTA interest includes direct or indirect to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property.)

FIRPTA Planning

- Swaps and FIRPTA
  - Rev Rul. 2008-31 (released June 12, 2008)
    - Issue was whether an interest in an NPC, the return on which is calculated by reference to an index referencing data from a geographically and numerically broad range of United States real estate, is a USRPI under section 897(c)(1) of the Code?

FIRPTA Planning

- Swaps and FIRPTA – Facts of Rev. Rel. 2008-31
  - X maintains and widely publishes an index (the "Index") that seeks to measure the appreciation and depreciation of residential or commercial real estate values within a metropolitan statistical area ("MSA"), a combined statistical area ("CSA") (both as defined by the United States Office of Management and Budget), or a similarly large geographic area within the United States.
  - The MSA, CSA or similarly large geographic area has a population exceeding one million people. The Index is calculated by reference to (1) sales prices (obtained from various public records), (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period. Using proprietary methods, this information is weighted, aggregated, and mathematically translated into the Index.
  - Because of the broad-based nature of the Index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by the Index.

FIRPTA Planning

- Swaps and FIRPTA – Facts of Rev. Rul. 2008-31 (cont.)
  - On January 1, Year 1, FC, a foreign corporation, enters into a NPC, with unrelated counterparty DC, a domestic corporation. Neither FC nor DC is related to X.
  - Pursuant to the NPC, FC profits if the Index appreciates (that is, to the extent the underlying United States real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the Index depreciates (or fails to appreciate more than at a specified rate).
  - During the term of the NPC, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the Index.

FIRPTA Planning

- Swaps and FIRPTA – Holding of Rev. Rul. 2008-31
  - Because of the broad-based nature of the Index, the NPC does not represent a "direct or indirect right to share in the appreciation in the value . . . [of] the real property" within the meaning of Treas. Reg. Section 1.897-1(d)(2).
  - Accordingly, FC's interest in the NPC calculated by reference to the Index is <u>not</u> a USRPI under section 897(c)(1).

FIRPTA Planning

- Swaps and FIRPTA (cont.)
  - Questions not answered by ruling:
    - How broadly based does the index need to be?
    - Is the maturity of a swap a "disposition" for purposes of Section 897(a)?
      - TAM 9730007 and PLR 9824026 would seem to indicate not.
  - See also Treas. Reg. Section 1.897-1(h), example 2 (shared appreciation mortgage is USRPI but final payments (*i.e.*, maturity of contract) is not a "disposition" for purposes of Section 897(a)).
    - Rationale of example is that final loan payments do not constitute "gain" for tax purposes.
  - Query whether same rationale should apply to final payments received pursuant to swap.

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