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WITHHOLDING TAX AND PORTFOLIO DEBT ISSUES FOR US-SOURCE INTEREST INCOME

The US tax system essentially subsidizes business debt by making interest payments tax deductible, whereas equity financing isn't. It shouldn't be surprising then that most profitable US enterprises are funded with a significant amount of debt. This state of affairs benefits debt issuers by providing a relatively cheap and tax-deductible form of funding. Debt holders also benefit because they hold a more secure claim to the issuer's assets than its equity holders.

In recent years, the trend has been for private equity and other collective investment funds to include a large but theoretically manageable debt component in the funding of an investment. Because many collective investment funds today are agnostic regarding both their geographic sources of capital and the geographic location of their investments, debt is commonly owed across international borders.

For their investments in the United States, foreign investors can earn interest income free of US income and withholding tax if the debt instrument qualifies for the portfolio interest exception. As a result, tax-free portfolio interest is commonly deducted in the United States and paid to a tax haven.

While this happy state of affairs is encouraged by the US tax system, it has come under increased scrutiny. Anti-tax evasion measures, namely the Foreign Account Tax Compliance Act (FATCA) have been promulgated in response to evidence of massive offshore US tax evasion schemes. FATCA's intent is to ensure that taxpayers don't inappropriately evade US taxes through the use of foreign tax havens. Although FATCA became law back in 2010, it has only recently become operative.

In this new regulatory environment, borrowers shouldn't simply assume that presumed portfolio debt is free of US tax consequences. We'll discuss the tightening documentation requirements you'll need to meet in order for US-source interest income to potentially qualify for an exception to the statutory 30 percent withholding tax that would otherwise apply to such payments.

Withholding on US-Source Interest Income

Interest payments made by one US person to another are easily tracked and documented, making tax evasion in these circumstances fairly difficult. The payer of the interest is annually required to provide a Form 1099-INT, which documents the payments, to both the recipient of the interest and the IRS. These requirements narrow the chances for tax evasion, because few payers of interest would wish to forgo the tax deduction—or assume the risk of criminal prosecution—by *not* reporting the transaction.

Such payments are more difficult for the US government to track when the recipient is neither a US person nor engaged in a US trade or business. For US-source, cross-border interest payments, there's an elaborate regulatory mechanism to ensure that payments are properly reported and recipients identified.

To begin with, the Internal Revenue Code (IRC) imposes a 30 percent gross basis tax on cross-border, US-source "fixed, determinable, annual, or periodic" (FDAP) payments. These payments include interest, dividends, and royalties.¹ Because the recipient of such a payment may be beyond the reach of the US tax authorities, the FDAP tax law imposes the withholding tax obligation (and liability for nonpayment of the tax) on the payer rather than the recipient. The payer, as a withholding agent, is required to deduct and pay any required withholding tax and report the payments and withholding to both the recipient and the IRS on Forms 1042 and 1042-S.

A 30 percent withholding is the default for US-source, cross-border interest payments unless an exception applies. Bank account interest is generally excepted from the withholding tax,² but for nonbank payers, there are two primary situations in which the 30 percent withholding tax on US-source interest may be reduced or eliminated. The first is the application of a US income tax treaty, and the second is the portfolio interest exception. We'll look at each of these in the following sections.

Treaty Exceptions

If the recipient of an interest payment is a qualified resident of a country that has a bilateral income tax treaty with the United States, US-source withholding may be reduced or, under some treaties, eliminated.

To document its ability to benefit from a treaty, the interest payment recipient must provide a properly executed identification form to the payer—Form W-8BEN for individuals, Form W-8BEN-E for entities, and W-8IMY for intermediaries.³ The withholding agent must annually prepare and provide to the recipient and to the IRS Forms 1042 or 1042-S documenting the payments and the applicability of the appropriate treaty withholding rate or exemption. However, payers of interest must first confirm that the recipient of the interest is a qualified resident of the country in question. Nearly all US income tax treaties have extensive limitation-on-benefits provisions, which generally eliminate treaty benefits if the person in question is engaging in so-called treaty shopping.⁴ A withholding agent that relies unreasonably on a claim of treaty relief may be held liable for the unpaid withholding tax.

¹ IRC Section 871(a); IRC Section 881.

² See IRC Section 871(i)(2) as an example. Banks are nevertheless still subject to the FATCA Chapter 4 withholding and know-your-customer requirements.

³ The recipient will generally need to obtain and provide a US taxpayer identification number (TIN).

⁴ A full discussion of the application of bilateral US income tax treaties is beyond the scope of this paper. However, US income tax treaties—which are each to some degree unique—generally require that a prospective treaty beneficiary be a qualifying person under the limitation-on-benefits article of the treaty. Generally, a qualified person is an individual who qualifies as a resident of the treaty country in question, an organization that is owned by such residents (and only to the extent of such ownership), or a corporation or entity that is either publicly traded on a stock exchange in the treaty country or one that has a significant active trade or business in the country.

Portfolio Debt Exception

The FDAP tax law provides a broad exception to the general withholding rule (the 30 percent tax on US-source interest payments) for payments that qualify as portfolio debt interest.⁵ Unlike the treaty exception above, this exception doesn't require that the recipient of the interest be a resident of a treaty country.

What, then, is portfolio debt? It might be easier to define *portfolio debt* in reference to what it isn't. Portfolio debt interest is interest paid on an obligation that is none of the following:

- A bank loan⁶
- Debt held by a direct or indirect 10 percent owner of the payer⁷
- Owed to a controlled foreign corporation from a related person⁸
- A contingent interest obligation⁹
- Owed to a country that the IRS has determined inadequately exchanges information for purposes of tax evasion¹⁰
- Held by an unregistered owner¹¹

Because of this definition by negatives, it's sometimes assumed that any debt instrument held by an unrelated, nonbank, foreign (non-US resident) owner is likely to be portfolio debt. However, there are numerous traps for the unwary in the definition and documentation of *portfolio interest*. Issuers are well advised to carefully document such debt, because proper documentation will help avoid the risk of losing portfolio debt status upon audit—and consequently being retroactively liable for the unpaid withholding tax.

Avoiding Traps for the Unwary: Documenting Portfolio Debt

Documentation of Registered Form

According to the Code of Federal Regulations, a debt instrument is considered to be in registered form if:

- The obligation is registered as to both principal and stated interest in such a manner that any transfer may be accomplished only by the surrender of the old instrument and its reissuance (or the issuance of a new obligation) by the issuer to the new holder.
- The right to the obligation's principal and stated interest is transferrable only through a book-entry system that is maintained by the issuer and identifies the owner.¹²

⁵ IRC Section 881(c)(1).

⁶ IRC Section 881(c)(3)(A).

⁷ IRC Section 881(c)(3)(B).

⁸ IRC Section 881(c)(3)(C).

⁹ IRC Section 881(c)(4).

¹⁰ IRC Section 881(c)(6).

¹¹ IRC Section 881(c)(2)(B)(ii) (requiring portfolio interest to be held in registered form); IRC Section 871(h)(5).

¹² Treas. Reg. Section 1.871-14(c)(1)(i).

What this wordy definition means, essentially, is that the identity of the owner of the instrument must be documented in some presumably safe place and maintained by someone with the authority to direct the payments to the proper owners. Practically speaking, the payer—or any other person serving as a potential withholding agent—must know who the recipient of the interest is, the location of the debt holders’ ledger, and who maintains it.

After meeting the registered-form requirement, the portfolio interest exception will apply only if the US payer (and potential withholding agent) receives a statement indicating that the beneficial owner of the obligation isn’t a US person.¹³ Such statement must be made by either the beneficial owner of the obligation or “a securities clearing organization, a bank, or other financial institution that holds customers’ securities in the ordinary course of its trade or business.”¹⁴

Note that the IRS has an overriding right to determine that the statements provided don’t meet these requirements.¹⁵ In practice, withholding agents typically request one of the several IRS Forms W-8 or substitute forms prepared by the withholding agent to meet the relevant statement and documentation requirements.

Collecting a Form W-8 or substitute may seem obvious, but in the pre-FATCA world, the most common documentation payers collected was a bare Form W-8 listing a tax-exempt recipient and providing no indication of who the indirect owners were. It’s likely that some payers of portfolio interest are still relying on out-of-date information, because the Form W-8 series has been updated and payers don’t always require recipients to provide newer versions of the forms to replace the expired versions they have on file. Accordingly, payers holding a bare Form W-8 as evidence of the status of a tax haven company aren’t maintaining sufficient FATCA, FDAP, or portfolio debt documentation.

Form W-8BEN-E: FDAP and FATCA Requirements

Generally, US persons making FDAP payments to foreign persons are required to obtain one of the Form W-8 series documenting the beneficial owners. Prior to the implementation of FATCA, payers were required to obtain FDAP documentation only. As noted above, this wasn’t particularly burdensome. The recently developed Form W-8BEN-E provides the additional documentation required for corporate beneficial owners under the FATCA rules. Accordingly, a properly completed Form W-8BEN-E should fulfill both the FDAP withholding and FATCA documentation requirements regarding the payee’s status as a foreign beneficial owner.¹⁶

For purposes of Form W-8BEN-E, *beneficial owner* is defined as the person required, under US tax principles, to include the interest payment in his or her gross income. Foreign partnerships, foreign simple trusts, and foreign grantor trusts aren’t treated as the beneficial owners of income paid to a partnership or trust; the rules generally look

¹³ Treas. Reg. Section 1.871-14(c)(1)(ii)(C).

¹⁴ IRC Section 871(h)(5).

¹⁵ IRC Section 871(h)(5).

¹⁶ Individuals—who are by definition not subject to the Chapter 4 rules—if properly identified may still provide the simpler Form W-8BEN.

through these entities to determine the ultimate beneficial owner.¹⁷ However, unlike other trusts, a foreign complex trust is itself treated as the beneficial owner.¹⁸

For FATCA purposes, a US withholding agent is required to withhold 30 percent on “withholdable payments,” including US-source interest and regardless of treaty benefits or the portfolio-interest exemption. This is the case unless the foreign entity provides documentation that satisfies FATCA documentation requirements. The effect is that any such beneficial owner or payee is required to prepare Form W-8BEN-E and provide it to the payer—or suffer a 30 percent haircut on the payment.

Part I of the form requires that the foreign beneficial owner provide each of the following:

- The entity name and country of incorporation or organization
- The beneficial owner’s FDAP (Chapter 3) and FATCA (Chapter 4) status¹⁹
- A permanent address for the entity and its mailing address, if different from the permanent address
- The beneficial owner’s US tax identification number (TIN), global intermediary identification number, foreign tax identification number, or self-assigned reference number for US subsidiaries

The beneficial owner then completes the applicable section in Parts IV through XXVIII, based on the Chapter 4 status indicated in Part I. Finally, the beneficial owner is required to certify the form under penalties of perjury in Part XXIX.

It’s important for the withholding agent or payer to retain the completed Form W-8BEN-E until requested by the IRS to support a withholding or reporting decision. Failure to do so may result in the withholding tax and penalties being attributed to the agent for failure to withhold.²⁰ Naturally, many foreign debt holders are baffled by US tax forms—particularly Form W-8BEN-E, and especially the requirement to document the recipient’s FATCA status. It’s therefore in the payer’s best interest to carefully review the documentation received from the portfolio interest recipient. If the form is completed incorrectly, it’s very possible that the payer will be deemed negligent and potentially made subject to liability for failure to withhold.

Documenting a Lack of 10 Percent Ownership by Debt Holders

One of the principal restrictions to the portfolio debt withholding exception is the requirement that the recipient of the interest is *not* a 10 percent or more direct or indirect owner of the payer. This requirement, which is effectively an interest-stripping

¹⁷ Depending on the type of entity involved, the US withholding agent may either be required to ignore the intermediary entity (as in the case of most simple trusts) and obtain the requisite Form W-8BEN or W-8BEN-E or obtain the required withholding form for an intermediary (for example, Form W-8IMY for a nonqualified intermediary) along with the required beneficial owner’s Form W-8BEN or W-8BEN-E.

¹⁸ Determining whether a foreign trust is a grantor or complex trust is a challenging issue that is beyond the scope of this article.

¹⁹ Note the Chapter 4 (FATCA) status of a foreign entity isn’t necessarily obvious or easy to determine.

²⁰ Treas. Reg. Section 1.1441-1(b)(7)(D)(iii); Treas. Reg. Section 1.1471-3(e)(1).

limitation, significantly limits investment funds' ability to obtain portfolio debt treatment for the debt funding of equity investments.²¹

At the same time, the complex nature of many fund structures makes it imperative that the payer understand the ownership structure of the investment and the investors. Without doing so, it's nearly impossible for the payer to determine whether one or more 10 percent owners exist. Anecdotally, because many withholding agents lack detailed information about the identities of portfolio debt holders, this issue may be one of the most significant exposure areas for payers of portfolio interest.

A 10 percent owner is defined as any person who owns 10 percent or more of the total combined voting power in a corporation or 10 percent or more of the capital or profit interest in a partnership.²² Determinations of shareholder percentages held by partnerships, corporations, and individuals are subject to complex attribution rules.²³ For purposes of a partnership, ownership is determined at the partner level. Corporations are subject to slightly more complex rules:

- A **shareholder** of a corporation is considered to hold, proportionally, any stock held by that corporation. It may be held directly or indirectly.
- A **creditor corporation** is considered to own, proportionately, its shareholder's stock in a debtor corporation. However, if the shareholder owns more than 50 percent of the creditor corporation, then the creditor corporation is treated as owning *all* of the shareholder's stock in the debtor corporation.
- Any **person holding options** to purchase stock is treated as owning that stock.²⁴

In addition, estates, trusts, and family members may also find that shares that aren't held directly or indirectly will be attributed to them due to the related party attribution rules. These complicated attribution rules may negate the portfolio interest exception. Thus, it's important that US portfolio debt issuers maintain detailed ownership records and diligently identify all 10 percent shareholders.

Summary of Required Documentation

Portfolio debt, because of its ubiquity and apparent simplicity, nevertheless holds significant traps for the unwary. It isn't enough that an instrument qualifies to be treated as portfolio debt; it must be sufficiently documented if portfolio debt treatment is to be supported. If documentation is insufficient, foreign creditors may forgo the benefits of portfolio interest characterization, and the payer may be subject to secondary liability for unwithheld tax. Therefore, portfolio debt issuers should review the documentation they maintain for such instruments, taking into account both the updated FDAP and new FATCA documentation requirements.

²¹ See IRC Section 163(j) for examples. Broadly, because interest payments are tax deductible and dividend payments aren't, the IRC limits the amount of debt funding allowed in certain situations where a taxpayer might arguably be funded by either debt or equity.

²² IRC Section 871(h)(3)(B).

²³ IRC Section 871(h)(3)(C); IRC Section 318(a).

²⁴ IRC Section 871(h)(3)(C); IRC Section 318(a).

To harvest the benefits of portfolio debt treatment and avoid some of these potential pitfalls, debt issuers should—at minimum—follow these three important steps:

1. Maintain an updated copy of the debt instrument for purposes of documenting the registered form requirement.
2. Request a completed Form W-8BEN, Form W-8BEN-E, or Form W-8IMY documenting the beneficial ownership for purposes of FDAP and FATCA withholding. This form should be reviewed by a tax professional with experience in this area to demonstrate that the issuer followed proper due diligence.
3. Obtain and maintain an annually updated organizational and ownership chart to document that no portfolio interest recipient is a disqualified 10 percent owner.

To learn more about FATCA and FDAP withholding requirements or for insight on the documentation requirements and process, contact:

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Special thanks to Justin Jacobs, a staff member with our International Tax Services team, who helped to author this piece.