

## Memorandum

### Re: Portfolio Interest and Portfolio Debt and its Income and Estate Tax Consequences

In today's global society, there is a mobility of labor and capital. With this mobility there has been an increase in the complexity of lending transactions, as cross border lending has become increasingly more common. This can create compliance issues. Additionally, if these lending transactions are not completed before a lender's time of death, this can result in additional complexities with regard to the estate tax consequences of this type of transaction.

***Example:***

A foreign national ("FN") makes a loan to a U.S. corporation. In creating this loan, FN transfers the funds to the U.S. corporation in exchange for a promissory note. The terms of the loan imposes a reasonable interest rate at or above the applicable federal rate of interest. FN does not own any shares in the corporation, either through direct or indirect ownership. FN dies. FN leaves his estate to John Sample, a U.S. citizen.

The primary issues here are (1) What are the income taxes to FN while he is alive as a result of the loan? and (2) What are the federal estate tax consequences at the time of his death?

If interest was paid from the U.S. corporation to FN while he was alive he would have had annual taxable income in an amount equal to the amount of interest received from U.S corporation. This interest would be considered fixed, determinable, annual, or periodical income and would result in the imposition of 30% withholding on the interest income. However, the 30% withholding amount would be removed if the interest income was considered to be portfolio interest income.<sup>1</sup>

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<sup>1</sup> IRS Pub. 519 defines portfolio interest as follows:

Portfolio interest. U.S. source interest income that is not connected with a U.S. trade or business and that is portfolio interest on obligations issued after July 18, 1984, is excluded from income.

Portfolio interest is interest (including original issue discount) that is paid on obligations:

Not in registered form (bearer obligations) that are sold only to foreign investors, and the interest on which is payable only outside the United States and its possessions, and that has on its face a statement that any U.S. person holding the obligation will be subject to limitations under the U.S. income tax laws,

In registered form that are targeted to foreign markets and the interest on which is paid through financial institutions outside the United States, or

In registered form that are not targeted to foreign markets, if you furnished the payer of the interest (or the withholding agent) a statement that you are not a U.S. person. You should have made this statement on a Form W-8BEN or on a substitute form similar to Form W-8BEN. In either case, the statement should have been signed under penalties of perjury, should have certified that you are not a U.S. citizen or resident, and should have included your name and address.

**IRS CIRCULAR 230 DISCLOSURE:**

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Portfolio interest is income from U.S. owners except for interest on unregistered obligation and obligations held by 10% or greater owners of the debtor. In general, portfolio interest is interest on a debt obligation, in registered form held by a foreign person that does not arise from the lender's active business activities. I.R.C. § 881(c). FN, the lender, was not in the active business of this corporation, the lendee. If this debt obligation was in registered form then the requirements of I.R.C. § 881(c) would have been satisfied and the interest on this debt obligation would be considered portfolio interest.

Interest on certain obligations not in registered form will also qualify as portfolio interest. Generally, such obligations must be reasonably designed to ensure that they are sold to non-U.S. persons and that interest is payable outside the United States and its possessions. See I.R.C. §§ 881(c)(2)(A), 163(f)(2)(B) (2006). If FN's interest was payable outside of the United States and its possessions it would be considered to be portfolio interest. If this was the case then there would have been no income tax consequences to FN while he was alive as a result of the loan as it would have been exempt from the 30% withholding tax.

At death, debt is generally a U.S. situs asset unless there is the portfolio debt exemption estate tax provision to I.R.C. § 871. Under I.R.C. § 871(h)(1) if any interest on a portfolio debt obligation is exempt from the 30% withholding tax under this provision of the code, then the obligation is treated as having a foreign situs for estate tax purposes. If the interest has satisfied and this debt obligation would be considered to be portfolio debt obligation, then it would be considered a foreign situs asset for estate tax purposes. The estate tax consequences at death would then be determined based on the domicile of the FN. If the FN was a U.S. domiciliary at the time of his death, then the estate will be taxed on the value of their worldwide assets owned at death in the same manner as U.S. citizens.

Non-U.S. domiciliaries are taxed only on the value of their U.S. "situs" assets. Assuming that this is in fact portfolio debt exempt interest, and therefore a foreign situs asset, there would be no U.S. estate tax consequences incurred as a result of the FN's ownership of the loan interest at death.

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