

IRS issues private letter ruling on portfolio interest exception

In a recent private letter ruling ([PLR201504004](#)), the Internal Revenue Service ["IRS"] issued guidance on how nonregistered securities held within a partnership may nonetheless not be subject to US withholding tax if the partnership interests themselves meet the requirements to be considered in registered form.

The Taxpayer in the ruling was organized in a typical master-feeder structure. The offshore master fund (the "Master Fund") was treated as a partnership for US federal income tax purposes. The Taxpayer was in the business of buying and selling so-called "scratch and dent" commercial mortgages. These are mortgage loans with incurable defects which often require modifications in order for the loans to continue payments or become re-performing loansⁱ. Once the portfolio of mortgages was purchased, Taxpayer contributed the mortgages to a trust (the "Trust") which was wholly owned by the Master fund, and treated as a disregarded entity for US federal income tax purposes.

Taxpayer represented that the mortgages themselves were not in registered form and therefore the interest on such mortgages would not qualify for the portfolio interest exception, and such interest would therefore be subject to withholding to the extent interest was beneficially owned by non-US holders.

Under the general rule for obligations to be considered in registered form, and thus not subject to withholding under the portfolio interest exception, one of three requirements must be met:

1. The obligation is in registered form both as to principal and any stated interest with the issuer or its agent, and transfer of the obligation may only be affected by surrender of the old instrument and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument the new holder, or
2. The right to the principal of, and the stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer or its agent, or
3. The obligation is registered as to both principal and any stated interest with the issuer or its agent and may be transferred through both of the methods described above.^{ii iii}

Further, Regulations issued by Treasury provide that an interest (a "pass-through certificate") in a trust that is treated as a grantor trust is considered to be an obligation in registered form if the pass-through certificate is in registered form "without regard to whether any obligation held by the fund or trust to which the pass-through certificate" relates is in registered form.^{iv} These Regulations give Treasury the ability to expand these rules to arrangements that may achieve the same effect and thus be treated as similarly pooled funds.

Neither the Master Fund nor the Trust was treated as a grantor trust under Treas. Reg. 301.7701-4(c)(1), and therefore these entities do not fall squarely within the pass-through certificate rules described above. Nonetheless, the Taxpayer in the ruling represented the interests in the Master Fund, and therefore the interests in the Trust as a disregarded entity of the Master Fund will only be transferable pursuant to the registration and transfer rules described above, and therefore would be considered to be in registered form within the meaning of these rules. The IRS agreed and concluded that the interests in the Master Fund and the Trust are evidences of interests in a similarly pooled fund, and therefore if the registration requirements are met, interests in the Master Fund and the Trust will be considered obligations in registered form.^v The implication of this conclusion is that interest on the mortgages held by the Master Fund and the Trust may qualify for the portfolio interest exception to withholding, assuming other requirements to meet the exception are met.

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Contacts

If you have any questions or would like to discuss potential implications, please contact us.

Paul Epstein
Director
Deloitte Tax LLP
+1 202 758 1390
pepstein@deloitte.com

David Benz
Principal
Deloitte Tax LLP
+1 213 996 4986
dbenz@deloitte.com

Edward H. Dougherty
National Managing Partner –
Investment Management Tax
Deloitte Tax LLP
edwdougherty@deloitte.com

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ⁱ The modification of the underlying loans itself could have tax implications for a taxpayer under Code Sec. 1001, although this issue was not the subject of the ruling.

ⁱⁱ Reg. Sec. 1.871-14(c)(1). The registration rules for portfolio interest purposes are the same as for tax-exempt treatment under Reg. Sec. 5f.103-1(c).

ⁱⁱⁱ There are other requirements to qualify for the portfolio interest exception, but these were not in issue or factual concern for purposes of the ruling

^{iv} Reg. Section 1.871-14(d) also provides parallel rules for portfolio interest treatment that the IRS adopted for purposes of satisfying registration required obligation treatment in Reg. Sec. 1.165-5T(d)(1). Section 1.871-14(d)(1) provides:

Interest received on a pass-through certificate qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1), or (e) of this section without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. This paragraph (d)(1) applies only to payments made to the holder of the pass-through certificate from the trustee of the pass-through trust and does not apply to payments made to the trustee of the pass-through trust. For example, a mortgage pass-through certificate in bearer form must meet the requirements set forth in paragraph (b)(1) of this section, but the obligations held by the fund or trust to which the mortgage pass-through certificate relates need not meet the requirements set forth in paragraph (b)(1), (c)(1)(ii), or (e) of this section. However, for purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a pass-through certificate will be considered as issued after July 18, 1984, only to the extent that the obligations held by the fund or trust to which the pass-through certificate relates are issued after July 18, 1984.

However, we note that foreign-targeted obligations referenced in Reg. section 1.871-14(e) have been statutorily repealed except with respect to obligations issued before January 1, 2014. Notice 2012-20, 2012-13 I.R.B. 574, Section 4.

^v In recent years, the organizational documents of newer funds contain transferability provisions that are not entirely dissimilar from those procedures described in Regs. Section 1.871-14(c)(1) and Temp. Reg. Sec. 5f.103-1(c). Nonetheless, the taxpayer at issue in the ruling took care to note that in addition to the surrender/reissuance procedure on the transfer of interests, the right to receive distributions of principal and interest on the assets held by the partnership would be transferable only through a book entry system described in Temp. Reg. Sec. 5f.103-1(c).

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