COMMENTS CONCERNING PROPOSED REGULATIONS RELATING TO THE OBLIGATION OF A PARTNERSHIP TO WITHHOLD TAX UNDER SECTION 1446 ON EFFECTIVELY CONNECTED TAXABLE INCOME ALLOCABLE TO FOREIGN PARTNERS

The following comments (the "Comments") constitute the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on U.S. Activities of Foreigners and Tax Treaties (the "Committee"). Principal responsibility was exercised by Alan I. Appel and Michael J. Karlin. Substantive contributions were made by Matthew Blum, Doris S. Hsu, Michael J. Miller, Russell J. Pinilis and Stanley C. Ruchelman. The Comments were reviewed by Joan C. Arnold, Chair of the Committee, Nicholas S. Freud of the Section's Committee on Government Submissions and Elinore J. Richardson, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, except as noted below, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 26, 2004

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These Comments respond to the request for comments regarding the regulations proposed n the Federal Register on September 3, 2003 with respect to Section 1446 (the "Proposed Regulations").[1] The Proposed Regulations provide rules for the implementation of Section 1446's requirement that a partnership pay to the Internal Revenue Service (the "Service") taxes on behalf of a foreign partner with respect to the foreign partner's applicable percentage of the partnership's effectively connected taxable income ("ECTI").

[1] Fed. Reg. Vol. 68, No. 17, P. 52465. Unless otherwise noted, all Section references are to the Internal Revenue Code of 1986, as amended and regulations promulgated thereunder.

I. EXECUTIVE SUMMARY

The recommendations in these Comments include the following:

A. Identification of Appropriate Tax Rate

The preamble to the Proposed Regulation repeats Section 1446(b)(2) and provides that the rate for the payment of the 1446 tax[2] for foreign corporate partners is the highest rate of tax specified in Section 11(b) and for foreign non-corporate partners it is the highest rate of tax specified in Section 1.

We suggest that the final regulations contain a clarification that the 'highest rate of tax' refers to the highest rate of tax on ordinary income, where what is being allocated to the foreign partner is ordinary income or short-term capital gain, and as referring to the applicable maximum rate of tax on long-term capital gains, where what is being allocated to the foreign partner is long-term capital gain that is part of ECTI (i.e., for individuals, under current law, 15% on gains and certain dividends or 25% for Section 1250 gain and 28% for gains from collectibles).

B. Sections 1445 and 1446 Overlap

Proposed Regulation Section 1.1446-3(c)(2) addresses the overlap of the 1446 tax and the withholding obligations imposed under Section 1445 (sales of U.S. real property interests).

We recommend that the well developed rules for the collection of tax on the disposition of U.S. real property interests apply in lieu of Section 1446, and that such income be excluded from ECTI.

C. Mitigating Overwithholding – Calculating ECTI.

Overwithholding under Section 1446 largely results from the disallowance of partner-level deductions in computing the amount of ECTI subject to withholding. The deductions may be divided into two categories: Partner level deductions attributable to partnership items ("Attributable Deductions") and partner level deductions that derive from partner activities that are not related to the partnership ("Unrelated Deductions").

- With respect to Attributable Deductions, we propose that a partnership be permitted to reduce ECTI by the foreign partner's allocable share of current year items of the partnership, such as partnership's charitable contributions, certain state and foreign taxes on income, as well as loss carryovers computed at the partnership level as if the partnership were a corporation (that were previously allocated to the foreign partner on a Form K-1). We suggest various safeguards

[2] We applaud the efforts in the Proposed Regulations to use the term "1446 tax" instead of "withholding tax." While the latter term is used in the statute, it causes confusion for business people. They have an intuitive sense of a withholding tax, and the 1446 tax does not comport with that sense. We will, throughout this material, continue the usage of the term "1446 tax".

based on certifications by the foreign partner as to the availability of these deductions and a safe harbor based on certifications by tax professionals.

- With respect to Unrelated Deductions, we recommend that procedures be put in place to permit foreign partners to obtain a withholding certificate modeled on the procedures under Section 1445.

D. Treatment of Compliant Foreign Partners

We recommend that the final regulations allow a foreign partner to qualify as a "compliant foreign partner" by satisfying certain criteria to be determined, and that the partnership would be entitled to rely on the compliant partner's certificate as to the tax liability of the partner.

E. COD Income/Foreclosure Income

We recommend that the final regulations provide that so long as the partnership receives no cash or other property as part of the cancellation of a debt or the foreclosure on property, income attributable to such amounts should be excluded from ECTI. We refer to Treas. Reg. Sec. 1.1445-2 for previous applications of the principle. To the extent the partnership makes a distribution in the year of the realization of the income, the amount of the cancellation of indebtedness ("COD") or foreclosure income would be included in ECTI.

F. Clarify Treatment of Partnership Agreement Requiring Return of Overwithheld Tax

We recommend that to the extent the partnership agreement provides for treatment of the payment of the 1446 tax as other than a distribution, or requires the reimbursement to the partnership of the payment of the 1446 tax, the payment should not be treated as a distribution for purposes of Section 731.

G. Modify Proposed Regulations Regarding Trusts and Tiered Partnerships

With respect to the provisions relating to trusts and tiered partnerships, we recommend that:

- The look through requirement for domestic grantor trusts should be modified to comport with the standards of "know or should have known" applicable to the Section 1441 regulations.

- The anti-abuse rule that requires domestic trusts, and possibly other entities, to be treated as foreign in certain situations should be restricted to related-party situations (or other situations where the Service had specifically advised the general partner that the rule must be applied), absent actual knowledge, and should not apply to unrelated financial institutions, again in the absence of actual knowledge.

- The look through treatment of domestic tiered partnerships for withholding purposes should only be available if the lower-tier partnership specifically manifests its consent, in a manner to be set forth in the final regulations.

- The look through rules for foreign upper-tier partnerships should conform to the withholding foreign partnership rules of Treas. Reg. Sec. 1.1441-5.

II. BACKGROUND

Section 1446(a) provides that if a partnership has effectively connected taxable income for any taxable year, and any portion of such income is allocable under Section 704 to a foreign partner, the partnership "shall pay a withholding tax under this Section at such time and in such manner as the Secretary shall by regulations prescribe." For this purpose, Section 1446(c) defines ECTI as the taxable income of the partnership that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, subject to certain adjustments The withholding tax imposed on partnerships pursuant to Section 1446 is based upon ECTI, and therefore is imposed regardless of when or whether the partnership makes distributions to its foreign partners.

A. Prior Guidance

Prior to the Proposed Regulations, the Service issued Rev. Proc. 89-31,[3] to provide guidance under Section 1446, as amended by the Technical and Miscellaneous Revenue Act of 1988.[4] Rev. Proc. 89-31 generally follows the regime set forth in Section 6655 for estimated tax payments by corporations and requires a partnership to annualize its ECTI and pay over the withholding tax to the Service in quarterly installments with a final payment with the annual tax return. Rev. Proc. 89-31 also provides special rules for publicly traded partnerships and tiered partnerships.

The Proposed Regulations are generally consistent with Rev. Proc. 89-31, although there are significant departures.

B. Calculation of ECTI

The principal issues in applying Section 1446 arise in the calculation of ECTI. As provided in Section 1446(c), ECTI is calculated by determining the income that is effectively connected pursuant to Section 864 and allocating the appropriate deductions. Generally, in determining the taxable income of a partnership, certain items listed in Section 702(a) are excluded because they are separately stated.[5] In calculating ECTI, however, those amounts are included because Section 1446(c) provides that Section 703(a)(1) does not apply.

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[3] 1989-1 C.B. 895.

[4] P.L. 100-647, 102 Stat. 3342, 3526 ("TAMRA"). Rev. Proc. 88-21, 1988-1 C.B. 777, which provided guidance prior to the 1988 Act, was thereby rendered obsolete.

[5] Section 703(a)(1). Most notably this section requires that current losses on the sale of Section 1231 property not be included in calculating taxable income of the partnership.

The Proposed Regulations do not, however, allow for taking into account certain items that may cause there to be significant over-payment of the final tax liability of a foreign partner. Those items include:

1. Net operating losses and capital losses of the partnership that would reduce the tax liability of the partners
2. State and local taxes paid by the partnership
3. Charitable contributions paid by the partnership
4. Foreign taxes that are paid by the partnership
5. Gains on the sale of U.S. real property interests, the taxation of which is governed specifically by Section 1445

The Proposed Regulations also do not alter the rules that are generally applicable to COD income although the Preamble to the Proposed Regulations (the "Preamble") requests comments on the appropriate treatment of COD income under Section 1446.[6]

The Preamble also requests general comments on the calculation of ECTI, specifically

> with respect to approaches that would permit an adjustment to the amount of 1446 tax obligation that are consistent with the statute and legislative history and administrable by partnerships, partners and the Service. In particular, comments are requested on whether the rules coordinating Sections 1445 and 1446 should be modified to address these concerns.[7]

C. Publicly Traded Partnerships

Section 1446(f)(1) provides the authority to prescribe regulations specifically addressing the application of Section 1446 to publicly traded partnerships. The Proposed Regulations modify some of the rules provided in Rev. Proc. 89-31. The Preamble asks for comments as to whether the special rules applicable to publicly traded partnerships should be extended to other partnerships. Specifically, the Preamble indicates that consideration was being given to whether these special rules should apply to partnerships that make an election under Section 775 of the Code (electing large partnerships) or partnerships with a specified minimum number of partners.[8]

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[6] Fed. Reg. Vol. 68, No. 170, P. 52465.

[7] Fed. Reg. Vol. 68, No. 170, P. 52471

[8] Fed. Reg. Vol. 68, No. 170, P. 52470

D. Trusts as Partners

The Proposed Regulations apply to "foreign partners," defined as partners that are not "U.S. persons" within the meaning of Section 7701(a)(30). Thus, ordinarily, if a partner were a U.S. simple or complex trust (there is a special rule for U.S. grantor trusts, discussed below), the 1446 tax would not apply to that partner's distributive share. However, the Proposed Regulations provide that if a partnership "knows or has reason to know that a foreign person that is the ultimate beneficial owner of the ECTI holds its interest in the partnership through a domestic trust (and possibly other entities), and such domestic trust was formed or availed of with a principal purpose of avoiding the 1446 tax," the partnership must comply with the Section 1446 rules.

In general, both domestic and foreign grantor trusts are looked through for Section 1446 purposes. A grantor trust (or the portion of a trust treated as a grantor trust) cannot provide withholding documentation in its own right for purposes of Section 1446. A foreign grantor trust would provide Form W-8IMY, together with documentation (Form W-9, Form W-8BEN, etc) from its owners, and allocation information. The partnership would act as if the grantors were direct partners. This is consistent with the general rules for foreign grantor trusts under Section 1441. A domestic grantor trust would do the same (although the "cover" form would not be Form W-8IMY, but a statement in the form prescribed in the proposed regulations). This is not consistent with the general rules for domestic grantor trusts under Section 1441.

E. Tiered Partnerships

The Proposed Regulations address situations in which one partnership (the "upper-tier partnership") is a partner in another partnership that generates ECTI (the "lower-tier partnership"). Under the Proposed Regulations, if the upper-tier partnership is foreign, the upper-tier partnership must pass along documentation regarding its partners, and allocation information, to the lower-tier partnership. The lower-tier partnership would perform withholding as if the partners of the upper-tier partnership were direct partners of the lower-tier partnership. The Preamble asks for comments on whether a similar approach would be desirable, and workable, in situations where upper-tier partnership is domestic.

The Comments set forth below provide suggestions as to how final regulations under Section 1446 might address these issues.

III. COMMENTS

A. General Comments

Before providing specific suggestions, we note and respond below to the following statement in the Preamble in connection with prior public comments about the accuracy of withholding under Section 1446 and, in particular, the potential of the Proposed Regulations to require too much tax to be paid, which we will refer to in shorthand as "overwithholding":

> These proposed regulations do not contain other provisions that have been suggested because, among other reasons, of concerns regarding the administrability of such approaches. Comments are requested with respect to approaches that would permit an

adjustment to the amount of 1446 tax obligation that are consistent with the statute and legislative history and administrable by partnerships, partners and the IRS.

We believe that solutions to overwithholding and some of the other difficulties that result from the application of Section 1446 are both within the Secretary's authority and administrable.

1. Authority

We understand that Treasury and the Service may be concerned about the authority to provide relief from overwithholding under Section 1446. Informal conversations indicate that the concern may focus on the history of Section 1446. The initial enactment of Section 1446 in 1986 required withholding on distributions. The Section was subject to considerable criticism because the payment of the tax was not based on income, and could have resulted in significant overpayment of tax. The 1988 amendments de-linked the 1446 tax from distributions and focused on ECTI. There may be some concern, therefore, that Congress provided for relief in the legislative change and did not intend administrative actions to provide further relief.

We believe that if this is indeed the nature of the concern, it is not consistent with Congressional intent.

Section 1446 contains a specific grant of authority to the Secretary to make "such regulations as may be necessary to carry out the purposes" of the Section, <u>including</u> regulations applying to publicly traded partnerships and regulations providing for the coordination of Sections 1446 and 6655 in the case of foreign corporate partners. It is clear that the specifically enumerated grants of authority are illustrative only. The House Ways and Means Committee report on TAMRA stated that:

> Further, the bill provides the Secretary the authority to prescribe regulations necessary to carry out the purposes of the provision. *<u>For example</u>*, special rules may be necessary in identifying a publicly traded partnership's partners as U.S. or foreign. In addition, rules may be necessary in the case of tiered partnerships to prevent the imposition of more tax than will be properly due (for example, rules to prevent the tax from being imposed on more than one partnership and rules to determine the applicable percentages). [Emphasis added][9]

It seems clear, therefore, that Section 1446(f) is a broad grant of authority to carry out the purposes of the Section. The plain reading of Section 1446(f) indicates that the reference to publicly traded partnership and the interaction of Section 1446 and Section 6655 is meant to be illustrative, not restrictive.

The principal purpose of Section 1446 is to facilitate the collection of the foreign partners' U.S. taxes attributable to the U.S. business of the partnership. The Joint Committee Report in 1986 supports the conclusion that Congress was concerned primarily with passive foreign investors and not those who have a continuing presence in the United States. The reason Congress enacted

[9] H. Rpt. 100-795, 100th Cong. 2d. Sess. 291 (July 26, 1988).

Section 1446 was that “Congress was concerned that the prior structure of withholding rules to foreign persons who invested in the United States through partnerships may have permitted passive investors to escape U.S. taxation.”[10] (emphasis added). In fact, Congress appeared to be primarily concerned with foreign investors in publicly traded partnerships since “these types of partnership investments ordinarily do not represent the type of substantial and continuing U.S. presence that justifies the absence of a withholding requirement.”[11]

The concern about collecting too much tax was apparent in the modifications made to the section in TAMRA. The Ways and Means Committee Report, noted that the revised Section 1446 is “a provision that accomplishes the objectives of [Section 1446 as enacted in 1986] more accurately and that results in less overwithholding~~.~~”.[12]

We believe that Treasury and the Service should not be reluctant to use the Section 1446(f) grant in furtherance of accurate tax payments. In a directly related area in Chapter 3 of the Code, we note that although there are scattered grants of specific authority to issue regulations in Sections 1441 and 1442, there is no general grant of authority. Nevertheless, the Secretary has felt comfortable in issuing significant regulations which include important relief from overwithholding as well as numerous detailed and specific requirements for taxpayers and withholding agents.

We accept that there are certain aspects of overwithholding that require Congressional action but we believe that all of the suggestions we have made in these Comments are within the scope of authority granted in Section 1446(f).

2. Administrability

The Service has not explained in detail the administrability concerns referred to in the above-cited passage from the Preamble. Based on informal contacts with the Service, it seems that there are concerns that a withholding certificate procedure comparable to the one operated under Section 1445 would be much more complicated in the case of partnership withholding than in the case of withholding on a single real estate transaction.[13] There may also be concerns as to how the Service or withholding agents would be able to verify representations made by or on behalf

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[10] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, Public Law 97-248, 99th Congress, H.R. 3838, JCS-10-87, p. 1055.

[11] Id.

[12] H. Rpt. 100-795, 100th Cong. 2d. Sess. 290 (July 26, 1988).

[13] This is consistent with a statement attributed to Steve Lainoff, then IRS Associate Chief Counsel (International), 1990: “Regarding the overwithholding of a foreign partner's tax liability that currently results in some circumstances under Section 1446, Lainoff said that a certification process similar to the FIRPTA certification is not feasible. The Service does not have the resources to negotiate with each partnership, he explained. Even if the partnership agrees to be liable for any taxes not paid by the foreign partners, an investigation would still be needed to determine if the fair market value of the partnership's assets provided sufficient security for the partnership's promise.” See 90 TNT 27-5 (Feb. 2, 1990)

of foreign partners as to factual matters (such as relevant tax attributes and the availability of tax losses).

We believe that more specific information about administrability issues is needed. We have tried, in formulating substantive proposals on solutions to overwithholding, to take general account of the administrative burdens that our solutions might cause for the Service and for partnerships. However, we have not discarded otherwise promising ideas based solely on concerns of administrability. If the Service has concerns about the administrability of any proposed solution, we strongly urge that, through a process of dialogue with the tax profession, those concerns be aired and addressed. We acknowledge that in some cases, it may in fact be the case that a solution, however desirable, simply cannot be administered by the Service within the currently available resources but believe the potential benefits support the consideration of our suggestions.

3. Balancing the Interests of the Parties

Closely related to issues of authority and administrability, are concerns as to the appropriate policy approach for the government to take in balancing the interests of the government, the taxpayer and withholding agents. Ultimately, we suggest that the regulations reflect a judgment as to how much risk the Service is allowed to take within the bounds of the statute and such guidance as is afforded by legislative history (authority), how any risks the Service does take are to be managed (administrability) and what risks are appropriate and reasonable (balancing the interests).

Plainly, the government could take the most protective possible approach, the one that collects the most tax up front and places the greatest burden on foreign partners to get the money back (and on partnerships). But we believe this is not the preferred option for the following reasons:

a. Section 1446 withholding has the peculiar effect of compelling distributions by a partnership to its foreign partners, distributions that the partnership might not otherwise make or even be able to make. Section 1446 therefore interferes with the relationship between a partnership and its partners. Other withholding provisions involving partnerships do this as well, but none with the high probability of excessive withholding. Section 1441, for example, requires a partnership to withhold the 30% tax with respect to a foreign partner's share of fixed or determinable annual or periodical income, but generally speaking, such income is associated with a high degree of liquidity, and the amount required to be withheld is accurate because the income usually does not have other expenses associated with it. The payment of the 1446 tax goes beyond simply imposing a collection burden on a withholding agent, and we believe the final regulations should minimize the impositions on the partnership.

b. Withholding regimes are an alternative to requiring advance payment of taxes with refunds in cases of overwithholding. When a withholding system is heavily weighted in favor of overwithholding, it essentially becomes a refund system. The United States has looked at alternatives to withholding in the past and, in the end, has generally concluded that an accurate withholding system, with strengthened certification procedures, is fairer to taxpayers and withholding agents and more administrable. For example, in 1982 in response to concerns about treaty shopping and inappropriate use of tax treaties to obtain reduced rates of withholding, Congress enacted Section 342 of the Tax Equity and Fiscal Responsibility Act, which instructed

the Treasury to "prescribe regulations establishing certification procedures, refund procedures, or other procedures which ensure that any benefit of any treaty relating to withholding of tax under Sections 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefit." Explaining this provision, the Joint Committee on Taxation described the policies to be considered in this area:

> The Act requires the Secretary to consider the refund system and the certification system as methods of limiting treaty benefits to those persons entitled to them. The Secretary is not limited to consideration of these methods; he is to consider other methods as well. In developing procedures to prevent abuse the Secretary is to consider the extent to which any procedures would prevent abuse, the administrability of such procedures (including the ability of U.S. treaty partners to provide cooperation), any negative effect on investment in the United States by foreign persons which could be caused by increased costs of complying with the procedures, and the effect on U.S. investment abroad should U.S. treaty partners apply a similar method to that utilized by the United States. The Secretary may thus apply different procedures for different treaties, for different kinds of income, and so forth.[14]

Reporting on progress in 1987, Deputy Secretary O. Donaldson Chapoton, then Acting Assistant Treasury Secretary for Tax Policy, noted a variety of disadvantages to regular and "quickie" refund systems, such as the negative effect on foreign investment in the United States and the administrative burdens on the Service.[15]

In the end, the Section 1441 regulations struck the balance in the case of portfolio income (the very kind of income that seemed most to concern Congress when it enacted Section 1446) by strengthening the certification system by tightening documentation and information collection requirements and placing a greater administrative burden on intermediaries in this regard.

If the system continues to be heavily weighted to overwithholding, the 1446 tax will effectively be a refund system, which is not consistent with U.S. tax policy. As in the Section 1441 area, reliance on up front certification would be a better solution and more consistent with overall U.S. policy on withholding.

c. Finally, overwithholding is not a problem that arises in isolated instances of insolvent partnerships. It is a true impediment to the choice of the partnership form by foreign investors and as such a barrier to foreign investment in the United States. Given that our articulated tax policy is to encourage such investment by foreign persons who pay their fair share of tax, the bias of the final regulations should strive to be accurate rather than biased towards excessive withholding.

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[14]Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity And Fiscal Responsibility Act Of 1982, Public Law 97-248, 97th Cong., H.R. 4961, JCS-38-82 page 249 (Committee Print).

[15] Statement of O. Donaldson Chapoton, Acting Asst. Treasury Secretary For Tax Policy, before the Subcommittee On Commerce, Consumer, And Monetary Affairs of the House Committee on Government Operations. (September 16, 1987) reprinted at 87 TNT 180-3.

Any system of withholding designed to collect tax that is measured by reference to net income will almost never be completely accurate. It is natural, in such circumstances, that the government should prefer that too much rather than too little be withheld. We do not suggest that the final regulations under Section 1446 should ignore the features of the legislation that tend to result in overwithholding. But from a policy perspective and for the sake of consistency with the approach taken in the Section 1441 regulations, we urge that the balance be struck wherever possible so as to avoid excessive withholding.

B. Overwithholding

We believe that the following are viable approaches to dealing with overwithholding.

1. The Nature of the Problem

Section 1446 almost invariably will mandate overwithholding except if the foreign partner is tax-exempt or the partnership's ECTI is rising quite quickly (but not doubling) from year to year. There are a number of reasons. To illustrate, Section 1446 requires the use of the highest rate of tax applicable to the class of taxpayer into which a partner falls. Thus, under current law individual and corporate partners will be subject to withholding at 35%. No account is taken of lower rates even though, in the case of a corporation, the 35% rate will not apply unless the corporation has taxable income in excess of $10 million, an amount well above the level of income of many foreign corporations who are partners in U.S. partnerships. The 35% rate is also excessive for nonresident alien individuals since that rate does not apply until taxable income reaches $311,950 (single individuals) or $155,975 (married individuals filing separately).[16]

In addition, no account is taken of the maximum rate of tax on long-term capital gains of individuals provided for under Section 1(h). There is no direct evidence as to what Congress meant by the expression “highest rate of tax specified in Section 1” when it enacted Section 1446(b)(2)(A), especially since at the time the rate was the same for both ordinary income and long-term capital gains.

Moreover, no account is taken of deductions to which a partner may be entitled at the partner level. Under partnership tax accounting rules, certain deductions of the partnership, including capital and Section 1231 losses, deductions for foreign taxes and a variety of items specified by regulation, which are required to be taken into account at the partner level, are nevertheless allowable for purposes of Section 1446. However, under the Proposed Regulations, other deductions of the foreign partner that may have been derived from the partnership that are allowed at the partner level rather than the partnership level cannot be taken into account. Such deductions include charitable deductions, net operating loss and capital loss carryovers and carrybacks from other years and previously suspended losses. In addition, no account is taken of state taxes which may be imposed on the foreign partner's share of partnership income. A foreign partner may also have unrelated deductions generated by other U.S. activities.

[16] It is noted that a foreign person who files a joint return as a U.S. resident under Section 6013(g) or (h) is still a nonresident for purposes of Section 1446. Sections 6013(g) and (h) apply for the purposes of Chapter 1, not Chapter 3, of the Code.

Finally, one of the most troubling aspects of Section 1446 is its silence on the question of what to do about cancellation of indebtedness income and gains arising in cashless foreclosures.

2. Relief Based on Statutory Construction

Define the "Highest Rate of Tax"

We recommend that the Service treat the expression "highest rate of tax" in Section 1446 as referring to the highest rate of tax on ordinary income, where what is being allocated to the foreign partner is ordinary income or short-term capital gain, and as referring to the applicable maximum rate of tax on long-term capital gains, where what is being allocated to the foreign individual partner is long-term capital gain (i.e., under current law 15% on gains and certain dividends, 25% for Section 1250 gain, and 28% for gains from collectibles).

The current uncertainty as to the meaning of "highest rate of tax" essentially means that when a U.S. partnership realizes gain on the sale of a U.S. real property interest, it will withhold at 35% even when long-term capital gains treatment is absolutely certain based on information available to the partnership. Clarification that the highest rate refers to the maximum rate on long-term capital gains would not create any administrative burdens.

There does not seem to be any doubt as to the Service's authority to construe the expression "highest rate of tax". It is, however, worth examining what that expression should mean in the light of legislative history. The expression or something similar appears in only a handful of places in the Code and these offer no guidance as to what is intended by the phrase in general or in Section 1446. Only once, in an obscure provision relating to merchant marine capital construction funds, is the differential treatment of capital gains taken into account.[17]

The legislative history of Section 1446 is also silent. We have been unable to locate any direct evidence that Congress thought about what it meant by the expression "highest rate of tax specified in Section 1" when it enacted Section 1446(b)(2)(A). However, it is worth recalling that in 1986 and 1988, the highest rates of tax on ordinary income and long-term capital gains were identical, at 28%; in 1991, the highest rate of tax on ordinary income rose to 31%[18] and in 1993 to 39.6%, while the maximum rate of tax on long-term capital gains remained at 28%; the gap widened further beginning in 1998 with the reduction in the top rate of tax on long-term

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[17] See Sections 460(b)(4)(B) (certain rules relating to completed contract method); 904(d) (definition of high-taxed foreign income for purposes of foreign tax credit limitation); 6867(b) (jeopardy assessment of large amounts of cash); 7516(g)(6)(A) (tax incentives relating to merchant marine capital construction funds). Only in the last of these is specific statutory provision made for treatment of reduced rates of tax on long-term capital gains; the others are silent – in the case of Sections 460 and 6867, understandably so since the former deals with items of income that can only be ordinary income and the latter deals with the taxation of the possessor of large amounts of cash where the possessor neither claims to be the owner nor identifies someone else as the owner whom the Service can identify and who acknowledges ownership.

[18] The last meaningful change to Section 1446 was made in 1989, when the rate differential was still zero. See Omnibus Budget Reconciliation Act of 1989, P.L. 101-239 Section 7811(i)(6)(C), which made a technical correction to Section 1446(f) by specifying that the regulatory authority of the Service extends to certain aspects of Section 6655 (estimated tax of corporations).

capital gains to 20% and now, in 2003, 15% - even with the reduction in the maximum ordinary income tax rate to 35%, the gap at 20% is the widest it has been since 1986. It seems doubtful that Congress could have fully contemplated this scenario when it enacted Section 1446 in 1986 and modified it in 1988, or last amended the statute in 1992.

We think it would be reasonable construction for the Service to take the view that highest rate means the maximum rate applicable to a particular category of capital gain. Virtually all of the information needed to determine whether partnership income is capital gain or ordinary income and whether gain is long-term or short-term is available to the partnership. This is also true of whether the gain relates to collectibles or Section 1250 property and to what extent.

Sections 1445 and 1446 Overlap.

Where a partnership has gain that would be subject to Section 1445 and 1446, we recommend that only Section 1445 should apply and that the gain on the disposition of a U.S. real property interest should be excluded from ECTI.

(i) U.S. Partnerships

A U.S. partnership that realizes gain on the disposition of a U.S. real property interest is generally required to withhold tax on a foreign partner's allocable share of the gain under Section 1445(e)(1).

Given that such income would also constitute ECTI, the partnership would also have an obligation to pay the 1446 tax. The Proposed Regulations provide that the partnership would not be subject to the obligations under Section 1445(e) in that case.

We believe that to the extent the gain is subject to withholding under Section 1445, or would be subject to such withholding but for an exemption, Section 1445 should control and the gain should be excluded from ECTI for purposes of Section 1446.

Section 1445 has a well developed mechanism for avoiding overwithholding. By giving Section 1446 primacy, the benefits of Section 1445 are negated. For example, withholding under Section 1445 would not apply if the partnership obtained a withholding certificate.[19] By removing the application of Section 1445 in the overlap with Section 1446, the ability to preclude withholding in that circumstance would be lost.

We recommend that if this suggestion is accepted the parameters for obtaining the Section 1445 withholding certificate be modified to take into account anticipated current year effectively connected losses of the partnership. This would be consistent with the estimated tax calculations that are part of the Proposed Regulations and would mitigate overwithholding.

[19] See Treas. Reg. Sec. 1.1445-5(c)(2)(iv).

(ii) <u>Foreign Partnerships</u>

The Proposed Regulations allow for a credit against the 1446 tax for any taxes withheld pursuant to Section 1445(a). As in the case of a U.S. partnership, we recommend that the well developed rules of Section 1445(a) be accorded primacy, and that gain on the sale of a U.S. real property interest be excluded from ECTI for purposes of Section 1446.

If the Section 1445 tax is a credit, any exemptions from the Section 1445 withholding tax are effectively lost. In addition to the loss of the ability to utilize the withholding certificate exemptions, the credit system would, as currently set up, require a payment of a 1446 tax on foreclosure amounts. Under Treas. Reg. Section 1.1445-2, if the foreign person does not realize any benefit other than the cancellation of a debt on a foreclosure event, with proper notification, the transferee is not obligated to withhold tax on the amount realized.

Under the Proposed Regulations, this important exemption would be lost because the Section 1446 tax would be imposed.

As in the case of U.S. partnerships, we recommend that the parameters for obtaining a withholding certificate be modified to allow for consideration of current year effectively connected losses of the partnership.

3. Partner-Level Deductions

A significant reason for the disparity between the 1446 tax and the amount of the tax a foreign partner may ultimately have to pay is that partners have deductions at the partner level that are not taken into account by the partnership in computing the effectively connected taxable income.

These deductions may be divided into two broad categories: Partner level deductions attributable to partnership items and partner level deductions that derive from partner activities that are not related to the partnership. Any meaningful regulatory solutions to overwithholding must address items in each of these categories. We have limited the application of partner level deductions to the areas that are within the knowledge base of the partnership, or for which the partner is able to produce an IRS certification similar to a Section 1445 certification. Our proposed solutions are organized accordingly:

Attributable Deductions

We propose that the Service permit a foreign partner to certify an amount of deductions that are available to offset partnership income if the deductions derive from current or prior year activities of the partnership and are consistent with the partnership's allocation of deductions to the partner.

In addition to the proposal that would eliminate gain on the sale of U.S. real property interest from ECTI, we propose that the final regulations permit a partnership to reduce ECTI by the foreign partner's allocable share of the following items attributable to the partnership:

- Net operating loss carryovers and capital loss carryovers previously allocated to the foreign partner;

- Charitable contributions, up to specified percentages of ECTI.
- State and local taxes paid by the partnership on behalf of the partner.
- The partner's allocable percentage of foreign taxes paid by the partnership.

(1) NOLs/Capital Loss Carryovers

In all cases, the partner would have to certify either that it had not used any of the NOL or capital loss carryovers against any other income or it could certify that it had used or expected to use the losses and deductions to any specified extent, in which case the partnership could not take the losses and deductions into account to such specified extent.

The Service could permit a partnership to rely on such a certification provided it did not know and had no reason to know that the certification was false and reliance was otherwise reasonable. By way of safe harbor, reliance would be presumed to be reasonable if the foreign partner's certification was accompanied by a certification from an attorney, a certified public accountant or an enrolled agent ("tax professional") that he or she had reviewed the prior year returns of the partner and determined that the foreign partner had not absorbed any part of the loss carryovers except to the extent specified in the certification.

We recognize that a foreign partner might not file a return for the preceding year until after the first day of the year on which withholding was required and that such partner could therefore be unable to provide a certification until such return had been filed. We would recommend that in such case, the foreign partner could provide a certification that such return when filed will not show the use of the losses and deductions beyond the specified extent and that, until the tax professional had provided his or her certificate, the partnership might be required to withhold but not remit the withheld amount to the Service.

We also realize that a tax professional certification would not cover situations where a foreign partner had, unbeknownst to the tax professional, filed an amended tax return in which some of the losses were used beyond what was contained in the original return. The solution to this problem would be for the Service to provide a procedure for an authorized tax professional to determine whether or not, according to the foreign partner's transcript, an amended return had been filed.

A procedure would be developed by which the Service could issue a notice similar to a back-up withholding notice under Treas. Reg. Sec. 31.3406(c)-1 in the event a foreign partner gave an improper certification and underwithholding resulted and which the foreign taxpayer did not correct on his annual return..

Although we do not believe that foreign and domestic partnerships should be treated differently for purposes of Section 1446, the Service could require that the tax matters partner or at least one

responsible person for a partnership be a U.S. person as a condition for allowing the partnership to take into account partner level items. There is ample precedent for this approach.[20]

(2) Taxes

The majority of state and local income taxes paid by a foreign partner will be those that are paid by the partnership with respect to non-resident partners. As such, the partnership has the information needed to more accurately calculate the reduction to ECTI. Similarly, if the partnership has paid foreign taxes, the amount attributable to the foreign partners is known and may be used to more accurately reflect ECTI.

If a partner is able to and does choose to claim a credit for the foreign taxes, that can be adjusted on the partner's U.S. tax return. Given the limitation on the ability of a foreign person to claim a foreign tax credit, we except it would be a limited number who would be involved in the credit election.

(3) Charitable Contributions.

The partnership will know the type of partner (individual or corporation) and type of charitable contribution. The applicable percentages are available to the partnership. As such, the partnership should allow the reduction in ECTI for the applicable percentage of the charitable contribution.

We recognize that there may be other partner level deductions and exemptions that may properly be included in these procedures but we believe the enumerated items represent the lion's share of the items where relief is needed and should be given.

Unrelated Deductions - Withholding Certificate Procedures

In any case where the procedures above still result in significant overwithholding, we recommend that the final regulations provide a withholding certificate procedure modeled on the procedures under Section 1445. To limit the number of cases in which the Service would be asked to implement such a procedure, the foreign partner might have to establish that the procedures for Attributable Deductions would be inadequate. For example, a foreign partner might be eligible to apply for such a certificate only if the Section 1445 withholding tax otherwise required to be withheld would exceed its US income tax liability by more than a specified percentage.

The Section 1445 regulations contain an elaborate set of alternative methods of avoiding excessive withholding. We believe that, with some adjustments, one or more of the procedures set forth in these regulations could be adapted to deal with excessive withholding under Section 1446.

[20] See the provisions of the Section 1441 regulations dealing with qualified intermediaries and withholding foreign partnerships or the provisions of Section 2056A relating to qualified domestic trusts, including, in particular, Section 2056A(a)(1). See, also, Treas. Reg. Sec. 1.871-14 effectively requiring a pass-through trust to be a domestic trust in order for the portfolio interest exemption to apply.

Section 1445(c) provides relief in two parts:

- Section 1445(c)(1) provides that the amount required to be withheld shall not exceed the transferor's "maximum tax liability", to be determined by the Service on application by either the transferor or the transferee.

- Section 1445(c)(2) authorizes the Service, at the request of the transferor or the transferee, to prescribe a reduced amount to be withheld if the Service determines that to substitute such reduced amount will not jeopardize the collection of tax.[21]

We believe that the grant of authority pursuant to Section 1446(f) to institute the purposes of Section 1446 would similarly allow for the consideration of such amounts.

Rev. Proc. 2000-35[22] sets out the procedures under which the amount of withholding can be reduced or eliminated pursuant to a withholding certificate issued by the Service. The Section 1445 withholding certificate is available in one of four circumstances:

- A determination by the Service that the amount otherwise required to be withheld would exceed the taxpayer's maximum tax liability.

- A determination by the Service that withholding of a reduced amount would not jeopardize collection of tax.

- The taxpayer is exempt from tax on all of the gain.

- An agreement between the Service and either the transferor or transferee provides security for the tax liability.

These circumstances could be adapted for use in a Section 1446 withholding certificate procedure, as described further below (although no additional provision needs to be made for tax-exempt foreign partners). As in the case of withholding under Section 1445, any withholding certificate procedure under Section 1446 should not involve any ruling on substantive tax questions, such as whether there is a permanent establishment and a review of information provided by the taxpayer should not be treated as an examination.

Our experience of the workings of the Section 1445 withholding procedures over the years has generally been favorable. The Service personnel who have implemented the procedures have been helpful and responsive. The requirements to obtain certification appear to us to balance approximately the interests of the government, taxpayers and withholding agents.

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[21] Subsection (c)(1) is, but subsection (c)(2) is not, self-executing in that the Service is required to determine the maximum tax liability but is authorized but not required to prescribe a reduced amount of tax if collection is not jeopardized. However, the Service has in any event adopted regulations and a comprehensive Revenue Procedure addressing the making of the determination.

[22] 2000-2 C.B. 211, superseding Rev. Proc. 88-23, 1988-1 C.B. 787.

(4) <u>Certificate Where Withholding Would Exceed Maximum Tax Liability or Foreign Partner Is Exempt.</u>

Rev. Proc. 2000-35 allows a taxpayer to establish its maximum tax liability on a gain from disposition of a U.S. real property interest. Gain is calculated in the conventional manner (amount realized less adjusted basis). However, the taxpayer may also take a deduction of net operating loss carryovers (but not operating losses anticipated for the current year). Rev. Proc. 2000-35, ¶ 4.06(2).

We have suggested above that a partnership should be allowed to offset any ECTI by an amount of the NOLS of the partnership that have not previously been used to offset other income. In the event that the partner is unable to produce the tax professional's certificate required under out suggested rules, a partnership withholding procedure could allow the taxpayer to establish any partner level deductions available as a result of carryovers of net operating losses, capital losses and suspended passive activity losses. To make the certification process administrable, we propose that the certification should be an annual certification.

More importantly, this would allow the partnership to take into account any suspended deductions that were classified as "passive". The procedure should also allow partners to take into account anticipated partnership-related deductions for the year, not currently allowable, in particular net operating loss carryovers and projected state taxes on income, but not net operating losses or other deductions projected for the year in which withholding is required unrelated to the partnership in question.

We recognize that, mechanically, a withholding certificate procedure for estimated net income from a year of business operations will not be fully comparable to a procedure for a withholding certificate in relation to a single disposition of a U.S. real property interest. Nevertheless, we are confident that a procedure can be developed which, without excessive complexity, will relieve partnerships and their foreign partners from a significant portion of overwithholding. We note that, in particular, we are not arguing that a withholding certificate procedure should try to project the anticipated effective tax rate to which a foreign partner will be subject (as opposed to requiring application of the highest rate). We are proposing that the Service issue a certificate specifying what loss carryovers and other deductions may be taken against the income that would otherwise be subject to tax.

A certification procedure could also cover the relatively less common situation where the foreign partner is tax exempt.

(5) <u>Certificate Based on Determination That Collection of Tax Not Jeopardized; Agreement to Secure Tax.</u>

Rev. Proc. 2000-35, ¶¶ 5 and 6, provide methods by which a transferor or transferee enters into an agreement for payment of the tax and provides security. Security may consist of a letter of credit, a pledge of collateral or a guarantee. The procedure includes model forms.

These methods are readily adaptable to partnership withholding. The principal difference is the need to determine what amount is required to secure the Service's position, a matter which is reasonably easy to compute in the case of sale of a U.S. real property interest. Nevertheless, we

believe that a reasonable formula could be worked out. For example, the amount could be related to the foreign partner's share of the preceding year's partnership ECTI multiplied by the highest rate applicable to such partner, similarly to the safe harbor in Proposed Regulation Section 1.1446-3(b)(3). Because this amount would change annually, the agreement would have to be reviewed annually. Alternatively, the Service could accept a larger amount of security in exchange for a longer term agreement.

4. Preferential Treatment of Compliant Foreign Partner – "Good Driver Preference"

The legislative history of Section 1446 clearly indicates Congressional concern about tax compliance by foreign partners in partnerships engaged in business in the United States, particularly where the foreign partner's role was essentially passive even though the partnership was engaged in a U.S. trade or business.[23] If that is the concern, a foreign partner should be treated more favorably if the partner has previously established a record of compliance. Such a foreign partner would in effect have earned a good driver preference. The preference would not give rise to an exemption from Section 1446 – this might require Congressional action, although there is some suggestion in the Senate report cited in an earlier footnote that the Service could do this.

We suggest that the Service develop criteria by which a foreign partner could apply for a certificate of good driver status and that such a partner would then be allowed to certify to a partnership the availability of losses and deductions, including losses and deductions that are not related to the partnership, such as losses and deductions from other partnerships or from activities directly carried on by the foreign partner in the United States. For example, the partner might previously have filed timely income tax returns for the three years preceding the year in which full withholding would otherwise be required.[24] A partnership could rely on the certificate by the Service as to compliant partner status and on any certificate by the foreign partner as to the existence of losses and deductions, including losses and deductions not related to the partnership.

We can envision a variety of details to be worked out in order for this treatment to be available and administrable. For example, we suggest that the Service's certificate would remain valid until revoked or suspended, rather than having to be renewed every year. The foreign partner would have to give every partnership in which it was a partner and which had ECTI an annual certificate that it continued to be in compliance with the Service's certificate. A foreign partner that chose to report its income inconsistently with the way it was reported on his Form°K-1

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[23] "The committee does not believe that a partnership's conduct of a U.S. trade or business provides any assurance that its foreign partners will comply with U.S. tax laws. In these cases, the investors are required to file U.S. tax returns and pay U.S. tax, but if they fail to do so the Service is likely to find it nearly impossible to locate them and collect the tax. . . . The Secretary may by regulations provide for exceptions to this withholding requirement in cases where withholding is not necessary to ensure compliance with U.S. tax laws." S. Rept. 313; 99th Cong. 2d Sess. 414

[24] For foreign partners who were not obligated to file a return every year, provision could be made for a foreign partner to be eligible for compliant foreign partner status if it had Federal income tax returns in at least six years in a 10-year period and that all such returns as were required were filed timely.

would have to copy its Form 8082 to the Service group that issued the certificate and such inconsistency could be grounds for revocation of the certificate.[25] As discussed above in the proposal to allow a partnership to take into account partner level deductions derived from the partnership, the Service could require that the tax matters partner or at least one responsible person for a partnership to be a U.S. person as a condition for allowing the partnership to take into account items certified to by a partner.

5. Cashless Income

One of the most vexing issues is that of cancellation of debt or the foreclosure on property when no cash or other property is received by the partnership. Frequently, that occurs when the partnership is in financial difficulty, and the obligation to prepay a foreign partner's potential tax obligation would be unduly burdensome.

In a similar circumstance, Treas. Reg. Sec. 1.1445-2 permits no withholding on income realized in the foreclosure of a U.S. real property interest if no benefit other than the debt relief inures to the holder, and certain reporting occurs. We believe the same rule should apply to the 1446 tax.

We recognize that the partnership may have other operations that will nonetheless produce cash that would allow for the payment of a distribution. We propose that to the extent the partnership makes a distribution within the same tax year that the COD or foreclosure income is realized, the ECTI of the year of realization would include the COD or foreclosure income up to the amount of the distribution.

6. Treatment of Payment of 1446 Tax

We urge the Service to allow the partnership and its partners to treat an obligation by the foreign partner to return any overwithheld tax as reducing the amount of any distribution to the foreign partner. Such a method would help limit the effect of Section 1446 in creating artificial gains to foreign partners because withheld amounts are treated as distributions. To illustrate:

> Assume P, a partnership composed of N, a nonresident alien, and C, a U.S. citizen, is engaged in a U.S. trade or business. C is the general partner; N may be a general partner or limited partner. N and C contribute nothing to the partnership capital, but borrow $1,000 from a bank. In year 1, the entire $1,000 is expended on deductible items and losses of $500 are allocated to N and C. No withholding is required under Section 1446, since there is no income.
>
> In year 2, P earns $1,000 from the conduct of its trade or business. All $1,000 is paid to the bank, perhaps under the terms of a security agreement. P is required to deduct and withhold 35% of $500, or $175, under Section 1446, despite the fact that P has no cash with which to make the payment.

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[25] See Treas. Reg. Sec. 301.6222(b) (notification to the Service when partnership items are treated inconsistently) and Service Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)) rev. Jan. 2002.

> N's basis is zero to begin with; the effect of the borrowing and the loss in year 1 is that it remains at zero and the profit and repayment of the loan in year 2 is that it remains at zero. But N has also received a deemed distribution of $175 as a result of withholding under Section 1446. Therefore, N will have a gain under Section 731 because Section 1446 forces the partnership to make a distribution with money it doesn't have and a collateral effect is to create a phantom gain. The gain may be taxable under IRC Sections 731(a) and 897(g) or under Rev. Rul. 91-32 (assuming the ruling is valid, a subject that is beyond the scope of this paper). If the gain is taxable, presumably the Service can just reduce N's refund.

We recommend that the final regulations take into account both explicit partnership agreement provisions requiring a foreign partner to contribute an amount withheld with respect to that partner and also partnership agreement provisions that have this effect even though they do not explicitly refer to Section 1446. For example, the final regulations should cover the situation where a partnership agreement may provide that a partner is not entitled to any distribution in excess of its capital account – a provision that Section 1446 may effectively override. If the effect of Section 1446 is to mandate a distribution in excess of the capital account in contravention of the partnership agreement, a presumption in the final regulations that the foreign partner is required to recontribute the amount of the excess distribution would be appropriate.

C. Tiered Trusts and Partnerships

1. Use of Domestic Trusts

The Preamble states that "Treasury and the Service are concerned about the potential abuse of tiered trust structures to claim inappropriate refunds of the 1446 tax, to avoid reporting by a beneficiary of ECTI earned by a partnership, or to avoid Section 1446 entirely," It is not entirely clear what kind of situation the Service has in mind. It would seem that any attempt to use a domestic trust to avoid Section 1446 would require the assistance of the trustee. Since, with certain limited grandfathering exceptions, a trust cannot be a U.S. trust unless, *inter alia*, "one or more United States persons have the authority to control all substantial decisions of the trust,"[26] in most cases the responsible party would be within U.S. jurisdiction. Given the connection between the trustee and the US tax system, we are unclear on the potential abuses. We would be more than willing to discuss the concerns to see if we can identify solutions.

In the situation in which the partnership interest is held by a domestic trust, Proposed Regulation Section 1.1446-3(d)(2)(iii)(B) requires that the 1446 tax be paid as if the trust were a foreign trust if the partnership "knows or has reason to know" that an interest is held "through a domestic trust (and possibly other entities)" "with a principal purpose of avoiding the 1446 tax." In a widely-held partnership – not just a publicly-traded partnership, but also, say, a hedge fund with a large number of unrelated partners, each with small interests – it is not clear what type of information is supposed to put a general partner or paying agent on notice that such a state of affairs may exist. Furthermore, the anti-abuse rule can apply not only to domestic trusts, but also

[26] Sec. 7701(a)(30)(E)(ii); Treas. Reg. §301.7701-6.

"possibly other entities." Examples would be very helpful of the type of other entities that may be problematic.. More generally, it is hard to know when a general partner or paying agent would have "reason to know" that, in the case of an unrelated partner that does not have a major stake in the partnership, (a) there *was* a foreign beneficiary behind a domestic trust (or "other entity") or (b) that a principal purpose of the interposition of a trust or ("other entity") was to avoid Section 1446 withholding.

In particular, consider partnership units that are held in custody at a financial institution for the account of a beneficial owner. This is certainly common for units of such publicly-traded partnerships that still exist,[27] and can also happen for private investment partnerships. Securities custody is a high-volume, low-margin business, and the business model does not support either extensive background checks, or assumption of this particular vague and ill-defined risk. The Service recognized this in the Section 1441 withholding rules, when it provided that a withholding agent that is a financial institution only has "reason to know" that investor certifications as to status are, or may be, false in certain narrowly-defined situations.[28]

If the Service deems it necessary to have such an anti-abuse rule, we respectfully submit the following four suggestions.

- First, a publicly-traded partnership that withholds on distributions, under the rules of Proposed Regulation Section 1.1446-4, should not be subject to this anti-abuse rule. This seems apparent from the structure of the regulations, since Proposed Regulation Section 1.1446-4(a) provides that publicly-traded partnerships that withhold on distributions do not withhold under the rules of Proposed Regulation Section 1.1446-3 (which is where this anti-abuse rule is located), but the point should be made explicit.

- Second, the final regulations should provide that if a publicly-traded partnership elects under Proposed Regulation Section 1.1446-4(g) to withhold on effectively connected income under the rules of Proposed Regulation Section 1.1446-3, this anti-abuse rule should not apply.

- Third, the final regulations should provide that the anti-abuse rule does not apply to nominees or paying agents that are financial institutions that are otherwise unrelated to the partnership.

- Fourth, the final regulations should provide that the portion of the anti-abuse rule dealing with "reason to know," as opposed to actual knowledge, does not apply to a partnership unless either (a) the partnership and the partner are sufficiently related under an objective standard – we would suggest the Section 707(b)

[27] The only list of publicly-traded partnerships that we are aware of can be found on the internet at www.ptpcoalition.org/ptplist. It is not possible to tell from this list how many of such partnerships might be engaged in a U.S. trade or business.

[28] Treas. Reg. Sec. 1.1441-7(b)(3).

standard of ownership of more than 50% of capital or profits – or (b) the partnership has been formally notified by the Service in writing that the claim of a named partner to be a domestic person exempt from 1446 withholding is unreliable and must be disregarded.

2. Grantor Trusts

The special rule for domestic grantor trusts found in Proposed Regulation Section 1.1446-3(d)(2)(iii)(B) (d)(2)(iii)(B) is inconsistent with the Section 1441 rules. Under the Proposed Regulations the domestic grantor trust is treated on a look through basis, and must provide the documentation with respect to its beneficiaries. We recommend that the final regulations be made consistent with the Section 1441 regulations to assist in the administrability of the rules.

For Section 1441 purposes, a domestic grantor trust can provide a Form W-9 in its own right. We recommend that the final regulations under Section 1446 adopt the same rule. If domestic grantor trusts are to be looked through for Section 1446 purposes, this will require partnerships, custodians, etc. to develop new procedures. Since a partnership might generate both ECTI and other income, a domestic grantor trust would have to be double documented: it would have to provide look through documentation for its ECTI and a W-9 for other income. This will be burdensome and confusing.

This rule seems to be based – like the anti-abuse rule noted above – on an apparent concern that any attempt by trustees of domestic trusts to assist their beneficiaries in avoiding U.S. tax might be beyond the control of the Service, even though, in fact, such trustees are most likely U.S. persons, as noted above. W strongly urge the Service to conform the documentation of domestic grantor trusts under Section 1446 with that provided under Section 1441.[29]

3. Tiered Partnerships

The Preamble describes the following modification to the tiered partnership rules of Rev. Proc. 89-31:

> If a partner in [an upper-tier] partnership that is required to pay the 1446 tax is a foreign partnership, it may submit a completed Form W-8IMY to the lower-tier partnership. If the upper-tier foreign partnership completes and submits Form W-8IMY to the lower-tier partnership, and passes along the Form W-8BEN, Form W-8IMY, or Form W-9 it received for some or all of its partners, as well as information describing how effectively connected items are allocated among its partners, the lower-tier partnership shall look through the upper-tier partnership to the partners of the upper-tier partnership (to the extent that it has received the appropriate documentation and allocation information and can reliably associate the allocation of its effectively connected items to the partners of the upper-tier partnership) to determine its 1446 tax obligation.

[29] The treatment of grantor trusts proposed rule may be contrasted with the treatment of pooled income trusts under Treas. Reg. Sec. 1.871-14(c), where the Service granted the portfolio interest exemption in circumstances where it accepted that compliance with the qualification for the exemption can rest with the domestic trustee. The Service (rightly) did not see any need to include an anti-avoidance provision in these regulations.

The Preamble then inquires whether such an approach would be desirable, and workable, in cases where the upper-tier partnership is domestic.

If this approach were extended to upper-tier domestic partnerships, the additional flexibility might be attractive to some such domestic upper-tier partnerships and will enable them to transfer the withholding responsibilities to a lower-tier partnership.

We would, however, make one substantive comment. We believe that in this situation look-through treatment for a situation where the upper-tier partnership is domestic should be optional, requiring the consent of both partnerships. Applying look-through treatment might be a major burden on the lower-tier partnership, and create systems problems. Disinclination to cooperate might have an effect on the ability of the sponsors of the lower-tier partnership to raise capital for the next partnership they may sponsor, but that is a business decision that the lower-tier partnership is best able to make.

Accordingly, we recommend that look-through treatment under rules similar to Proposed Regulation Section 1.1446-5(c) apply to a domestic upper-tier partnership only if both (a) the upper-tier partnership requests such treatment, and (b) the lower-tier partnership agrees to it. There would need to be a mechanism for the lower-tier partnership to formally notify the upper-tier partnership, in a way that the upper-tier partnership can rely on, as to whether the lower-tier partnership will agree to look-through treatment, so that the upper-tier partnership can know whether it has been relieved of its responsibilities or not.

If the upper-tier partnership is concerned about this point, it might insist, as a condition to agreeing to subscribe to the lower-tier partnership, that the lower-tier partnership must agree to look-through treatment. There should be no policy objection to such an agreement, or to a Court granting specific performance commanding the lower-tier partnership, in the event of default, to give its consent. Admittedly, until the lower-tier partnership has in fact given its consent in a manner specified under the final regulations (albeit possibly under judicial duress), the private agreement of the parties should not operate to shift the responsibility from the upper-tier partnership to the lower-tier partnership, so that the Service does not get caught in a whipsaw in which each partnership contends that withholding was the responsibility of the other partnership.

The proposed rule for foreign upper-tier partnerships provides that a domestic lower-tier partnership may look through the foreign upper-tier partnership. Thus, a domestic partnership may allocate its ECTI to partners of the upper-tier partnership and withhold accordingly, provided it is furnished with a valid Form W-8IMY, and the lower-tier partnership can reliably associate the ECTI allocable to the upper-tier partnership with a Form W-8BEN, Form W-8IMY or Form W-9 for each of the upper-tier partnership's partners.

We suggest that this rule be amended to provide for a withholding foreign partner rule similar to that provided for in Treas. Reg. Sec. 1.1441-5(c). Under that rule, if a foreign partnership qualifies as a withholding agent, a domestic partnership is not required to withhold on income of the foreign partnership, but rather the foreign partnership is responsible for U.S. withholding obligations. This rule is sensible because it relieves the burden of tax compliance on the domestic partnership provided the foreign partnership ensures compliance. However, not including a similar rule in the final Section 1446 regulations will severally limit the utility of

such rule in the Section 1441 regulations. Many domestic partnerships that have a significant portion of their income from dividends and interest have a small amount of ECTI. The Section 1441 regulations make it possible to avoid burdensome compliance obligations for compliant foreign upper-tier foreign partnerships that serve as an investment vehicle for foreign investors into domestic partnerships. However, the Proposed Regulations eviscerate that protection by requiring the domestic partnership to obtain U.S. tax forms for the foreign upper-tier partnership's partners solely for Section 1446 withholding purposes, even where the foreign upper-tier partnership has satisfied requirements to be a withholding foreign partnership. This seems unnecessary, as the Treasury is adequately protected against avoidance by the Section 1441 rules.

Including a withholding foreign partner rule in the proposed regulations that is similar to that in the Section 1441 rules will, however, further reduce the compliance burden on domestic partnerships, as intended by the Section 1441 rules.