PARTNERSHIP WITHHOLDING REGS.

At Long Last . . .Final Regulations on Foreign Partner Withholding

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"Tis the only comfort of the miserable to have partners in their woes." [1]

Better late than never, sort of. On May 13, 2005, the IRS issued over 200 pages of final, Temporary, and Proposed Regulations under Section 1446, [2] which was enacted in its current form in 1988. [3] This two-part article reviews the Regulations and offers some comments on the future of this tangled area of the law. Before we get into the gory details, however, some general observations are in order.

Section 1446 requires the withholding of tax by partnerships with foreign partners where the partnership has income that is effectively connected with a trade or business carried on by the partnership within the United States. However, Section 1446 is an incomplete, simplistic, and poorly realized piece of legislation. It belongs to an increasing line of laws and Regulations that were intended to target a relatively narrow class of noncompliance or avoidance and end up with overbroad solutions that casually and unfairly burden reasonable, non-evasive business activity. [4]

In this case, the problem related to foreign taxpayers that were investing in partnerships that technically generated effectively connected income (not subject to withholding prior to Section 1446) even though the investment was essentially passive and did not involve the partner in any direct presence in the United States. Section 1446 reaches these taxpayers, but it also reaches foreign taxpayers that have a substantial U.S. presence and business activities. The straightjacket designed to restrain the passive investors ends up nearly strangling the active ones as well as their U.S. partners.

Section 1446 reaches entire classes of taxpayers who should have been left in peace and unreasonably interferes in the relationship between U.S. business partnerships and their foreign partners. Following are some of the disconnects:

- A foreign corporation engaged in a trade or business within the United States is not subject to withholding of any sort on income effectively connected with that trade or business. A nonresident alien individual is likewise not subject to withholding on such income, except with respect to income from rendering services. A foreign partner in a partnership engaged in the exact same trade or business is subject to withholding that is essentially guaranteed to exceed the tax due, even if the foreign partner controls the partnership. The moral: foreign persons should carry on business directly and avoid entering into partnerships.

- A U.S. limited partnership with a 50% U.S. general partner and a 50% foreign partner loses $2 million in year 1 and earns $1 million in year 2. The partnership has to withhold $175,000 in year 2 that is paid to the government. Since the partnership in this situation may have no cash, the general partner may have to fund the withholding. Nevertheless, most of the tax will be returned many months later to the limited partner as a refund because the limited partner has loss carryovers from year 1. There is no statutory or regulatory mechanism to require the refund to be repaid to the partnership. In effect, Section 1446 operates in this case not only to provide a tax-free loan to the government but to compel a distribution by the partnership to the foreign partner that it would not otherwise make. The moral: U.S. persons should avoid having foreign partners.
- A partnership earns cancellation-of-indebtedness (COD) income. If it allocates any such income to a foreign partner, it will have to pay tax under Section 1446 on behalf of the foreign partner. If the foreign partner is likewise insolvent, the partner will exclude the COD income and receive a refund, which will be available to the foreign partner's creditors. The effect of Section 1446 is therefore to compel a distribution by a partnership that may itself be insolvent to a foreign partner for the benefit of the foreign partner's creditors. Treasury and the IRS have taken the position that this is compelled by statute and they do not have the authority to do anything about it. The moral: partnerships with foreign partners should not borrow money if there is any measurable risk that it will not be repaid.
- In 2004, under the American Jobs Creation Act of 2004 (P.L. 108-357, October 22, 2004), Congress enacted Section 199, intended to provide a reduced effective rate to all taxpayers for domestic production activities. [5] It chose the mechanism of a deduction rather than a rate cut and then required the deduction to be taken at the partner level. Result: a partnership must withhold tax on a foreign partner's share of income without regard to the Section 199 deduction, even though the deduction will inevitably reduce the foreign partner's tax. The moral: when it comes down to it, common sense ain't so common.

One has to consider whether a Congress fully appreciates how inconsistent these anomalies are with a policy of encouraging foreign investment in the United States. Section 1446 in its current form is not a sensible law for a country with annual trade and budget deficits each in the neighborhood of half a trillion dollars. [6] Legislation that produces such results would be a little more acceptable if Congress would either promptly correct these excesses or empower the Service to fix them by regulation. But our Congress is rarely capable of admitting that it has made a mistake. Not surprisingly, in the final Regulations under Section 1446, Treasury and the Service have proved unwilling or unable to replace the Congressional shotgun with a more narrowly targeted rifle. Instead, the Service has made a heroic effort to implement the law as written and provide some all too modest relief, but it will come as little surprise to learn that the result is a towering structure groaning under its own weight.

This article takes a detailed look at the final Regulations under Section 1446. After providing some background, it examines the documentation requirements of Reg. 1.1446-1; the rules under Reg. 1.1446-2 for determining a partnership's effectively connected taxable income allocable to foreign partners under Section 704; Reg. 1.1446-3, which sets out the time and manner of calculating, reporting, notifying, and paying Section 1446 tax, provides rules for treating tax withheld as a distribution to the foreign partner, explains when a partnership may consider the character of income allocated to a foreign partner and take account of special rates for individuals with respect to capital gains, depreciation recapture, and collectibles gain, and also deals with the interaction between Section 1446 andSection 1445 (FIRPTA withholding); the Reg. 1.1446-4 rules for publicly traded partnerships (PTPs); and the Reg. 1.1446-5 rules for tiered partnership structures.

A second article in a forthcoming issue of JOIT will examine the Temporary and Proposed Regulations, Reg. 1.1446-6, that provide a route for compliant foreign taxpayers, “good drivers” as they are referred to in the Preamble, to certify that past-year losses and deductions will be available to reduce their taxable income that would otherwise be subject to withholding. It will also comment on the steps that a partnership with foreign partners might take to deal with the problems created by overwithholding and other aspects of the Section 1446 regime.

Background

Discussed below are the rules on taxing and collecting tax from foreign persons and an overview of Section 1446, including its state prior to the final Regulations.

Taxing and collecting tax from foreign persons.

The United States imposes tax on foreign persons in one of two ways. First, tax is imposed on income (other than income effectively connected with a U.S. trade or business) that is fixed or determinable annual or periodical (FDAP) income derived from U.S. sources (Sections 871(a) and 881(a)). FDAP income includes dividends, interest, rents, royalties, and other types of passive income but not capital gains. It is taxed at a flat rate of 30% with no deductions allowed. The tax rate on some forms of FDAP is often reduced by treaty. Tax must be withheld at 30% or the applicable treaty rate if appropriate documentation is provided. Since the tax is imposed at a flat rate on the gross amount of the income, withholding is generally quite accurate and no returns are required by the taxpayer (Sections 1441(a) and 1442(a)). [7]

Second, if the foreign person is engaged in a trade or business within the United States, the foreign person is taxed at regular graduated rates on income effectively connected with the conduct of such trade or business (ECI) (Sections 871(b) and 882(a)). If the foreign person is resident in a country with which the United States has an income tax treaty and the foreign person is not disqualified by a limitation-on-benefits provision, the threshold for imposition of tax is raised by requiring that the foreign person have a permanent establishment in the United States and that the income be attributable to the permanent establishment. Although this article refers to ECI, it should also be taken to include income attributable to a permanent establishment of a foreign treaty resident.

Tax on ECI is collected primarily by requiring the foreign person to deposit quarterly estimated taxes in exactly the same manner as a U.S. person (Section 6655). There are, however, four situations where withholding is required on ECI: [8]

> (1) Section 1441 requires tax to be withheld on income (other than wages) from personal services rendered in the United States by nonresident alien individuals at a flat rate of 30%.
> (2) Wage withholding applies to wages of foreign individuals.
> (3) Section 1445 requires withholding of tax on dispositions of United States real property interests at 10% of the amount realized or, in some cases, at full individual or corporate rates applied to gain from the disposition.
> (4) Section 1446 applies when a foreign person is a partner in a partnership that is engaged in a trade or business within the United States. Section 1446 requires withholding by the partnership on the foreign persons allocable share of effectively connected taxable income (ECTI).

Overview of the statute.

Section 1446 was enacted as part of the Tax Reform Act of 1986. The original legislation, which required withholding on distributions to foreign partners, suffered from significant impracticalities. Congress sought to address these in the Technical and Miscellaneous Revenue Act of 1988 by requiring a partnership, foreign or domestic, that has ECI for any tax year, any portion of which is allocable under Section 704 to a foreign partner, to withhold tax at the time and manner prescribed by the IRS. [9] Since the beginning, the IRS has required quarterly withholding using the estimated tax procedures of Section 6655(e)(2). [10] The final Regulations refer to the tax to be withheld as “1446 tax” and that term is used in this article even though Section 1446 itself does not use it.

Section 1446(b) provides that the amount of 1446 tax is based on the highest rate of tax applicable to the foreign partner under Section 1 (for a noncorporate foreign partner) or 11 (for a foreign corporations) multiplied by the ECTI allocable to the partner under Section 704. ECTI is defined as the taxable income of the partnership that is or is treated as effectively connected with a U.S. trade or business, with certain key adjustments. [11] In particular, the statute provides that Section 703(a)(1) does not apply (meaning that items of income, gain, loss, and credit described in Section 702 are not separately stated).

A payment of tax with respect to a foreign partner is treated as a credit to the foreign partner under Section 33 and is allowed for the partner's tax year that ends in or with the partnership tax year for which the tax was withheld. The credit is in turn treated as a distribution to that partner on the earlier of the day that the tax was paid by the partnership or the last day of the partnership's tax year for which the tax was paid (Section 1446(d)). Distributions generally are not taxable to a partner except to the extent that the amount of the distribution exceeds the partner's basis in the partnership (Section 731(a)).

Excess distributions are unlikely to occur under normal conditions. However, Section 1446 is capable of creating artificial and involuntary distributions in excess of basis. One way that this can happen is that under Section 705 and Reg. 1.705-1, allocations of income (and therefore increases in the taxpayer's basis in the partnership interest) are ordinarily not made until the last day of the partnership's tax year, whereas Section 1446(d)(2) provides that the distribution on account of a payment of Section 1446 payment is treated as made on the earlier of the last day and the date that the payment was made. Another way that it can happen is where a payment of 1446 tax is made but the foreign partner's basis is zero and is not increased above zero by the allocation.

A Section 1446 distribution, like any other, will reduce the partner's basis and capital account. How a Section 1446 distribution should be treated as among the partners is a not entirely straightforward question.

The statute grants the IRS authority to prescribe “such Regulations as may be necessary to carry out the purposes of this Section” including (but presumably not limited to) Regulations to deal with PTPs and Regulations applying Section 6655 (estimated tax penalties) to a partnership required to pay 1446 tax as if the partnership were a corporation (Section 1446(e)).

Section 1446 before the final Regulations.

Before embarking on a review of the final Regulations, it may be helpful to set out a brief history of Section 1446 subsequent to 1988. (However, the history of the treatment of PTPs is set out in the discussion of the final Regulations.)

Rev. Proc. 89-31. Soon after enactment of TAMRA, the IRS issued Rev. Proc. 89-31, 1989-1 CB 895, which set out the basic approach that has been followed ever since. Rev. Proc. 89-31 implements the Code's directive to partnerships with ECI for any tax year, any portion of which is allocable under Section 704 to a foreign partner, to withhold tax “at the time and manner prescribed by the IRS.” It does so by requiring partnerships other than PTPs to withhold tax by making installment payments on the amounts of ECTI based on the principles of Section 6655(e)(2), with payments due on the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year. [12] Under these principles, as the Procedure notes, the partnership's ECI and deductions for each payment period are annualized, the foreign partner's allocable share of these amounts is determined, and the annualized Section 1446 withholding tax is computed by applying the Section 1446 applicable percentage to the partner's annualized ECTI. The installment to be paid on account of each foreign partner is the difference between the applicable percentage under Section 6655(e)(2)(B)(ii) (i.e., 25%, 50%, 75%, and 100%) of the annualized tax over the aggregate of 1446 tax payments previously made for the partnership's taxable year.

A safe harbor applied if the installments were each at least 25% of the tax that would be payable on ECTI allocable to foreign partners in the prior year, so long as the prior year consisted of 12 months, a Form 1065 (U.S. Return of Partnership Income) was filed for the prior year, and the ECTI for the prior year was not less than 50% of the ECTI shown on the annual return of 1446 tax for the current year.

The applicable tax rate was the highest rate specified in Sections 1 and 11, with no reduced rate for capital gains of individual foreign partners, and in 1988, although Congress had left the capital gains regime in place, the highest rate for both ordinary income and capital gains of individuals was 28%. Rev. Proc. 89-31 stated that net operating loss carryovers and charitable contributions may not be taken into account in computing ECTI.

In addition to laying out the basic withholding scheme, Rev. Proc. 89-31 provided procedures to allow partnerships to determine, based on certifications received from partners, whether the partner was foreign or domestic. A partnership that had obtained a certification of non-foreign status, similar to those provided for by the Section 1445 Regulations, was permitted to rely on the certification to determine that the partner was not subject to withholding, but only if the partnership did not have actual knowledge that the certification was false. A partnership that relied in good faith on a certification subsequently determined to be false was not subject to the liability for a failure to pay 1446 tax. [13]

Rev. Proc. 89-31 provided rules for coordinating Section 1446 withholding with other withholding regimes. The Procedure notes that there is no overlap with FDAP income subject to tax only under Section 871(a) or 881 because such income is not included in the partnership's ECTI. It did not address that certain types of ECTI are in fact subject to Section 1441 withholding. [14]

More controversial, however, was Rev. Proc. 89-31's handling of FIRPTA withholding. As might be expected, a foreign partnership subject to withholding under Section 1445(a) during a tax year was allowed to credit the amount withheld against its Section 1446 liability for that year. However, for a domestic partnership subject to Section 1446, the Procedure provides that the partnership is not also subject to the requirements of Section 1445(e)(1) with respect to income from the disposition of a U.S. real property interest. (Section 1445(e)(1), enacted just four years earlier in 1984, had required a partnership to withhold at the highest tax rate on a foreign partner's allocable share of gain from the partnership's disposition of a U.S. real property interest.) In effect, the Procedure made it impossible for a domestic partnership to use the FIRPTA withholding certificate procedures to reduce withholding, because those procedures apply only to Section 1445 and no comparable procedures were made available for purposes of Section 1446. The rule that Section 1446 trumps Section 1445 has been retained in the Proposed and final Regulations, as discussed below.

Rev. Proc. 89-31 explained that a partnership's payments of 1446 tax on ECTI allocable to a foreign partner relate to the partner's tax liability for the partner's tax year in which the partner is subject to U.S. tax on that income and are allowed to the partner as a credit under Section 33. It further provided that 1446 tax in excess of the foreign partner's tax liability could be credited by the partner against the partner's tax liability for other subsequent years. The partner could not claim an early refund of these amounts under the estimated tax rules. Amounts paid by a withholding agent under Section 1446 with respect to a partner are to be treated as distributions made to that partner on the last day of the partnership tax year for which the amount was paid, or if earlier, the last day on which the partner owned an interest in the partnership during that year. The Procedure confirmed that amounts paid are not refundable to the withholding agent.

Rev. Proc. 89-31 responded to the statutory invitation to provide rules for PTPs by requiring a PTP to pay 1446 tax by withholding from distributions to a foreign partner, unless it elects instead to withhold based on ECTI allocable to foreign partners. [15]

The legislative history expresses concern that overwithholding can result with regard to tiered partnership structures. [16] Rev. Proc. 89-31 therefore addressed tiered partnerships where a partnership has a foreign partnership as a partner. Under the entity approach adopted by the Procedure, the lower-tier partnership (LTP) was required to withhold at the highest rate in Section 1 on the an allocable share of ECTI of the foreign upper-tier partnership (UTP), irrespective of whether the UTP partners were corporate or noncorporate, domestic or foreign. A foreign partnership was not excused from reporting 1446 tax to the Service or to its partners because it had already incurred withholding—the UTP simply received a credit for the 1446 tax paid by the LTP and therefore was not required to withhold tax (except, presumably, if the Section 11 rate were higher than the Section 1 rate). [17] This could result in overwithholding if the UTP had U.S. partners, a situation that has been addressed in the Proposed and Final Regulations.

Rev. Proc. 92-66. Minor modifications were made to Rev. Proc. 89-31 by Rev. Proc. 92-66, 1992-2 CB 428, of which the most significant was permitting a partnership to obtain a refund where it had paid more 1446 tax during the year than it allocated to foreign partners. (This can happen if the partnership overestimates its income compared to the amount that it eventually earns or if a change in the partnership agreement results in reduced allocations to foreign partners; it is not clear what would happen if an individual foreign partner retroactively changes status during the year and becomes a U.S. person.)

2003 Proposed Regulations. The IRS issued Proposed Regulations under Section 1446 on September 2, 2003. [18] The Proposed Regulations are generally consistent with Rev. Proc. 89-31, although there were some significant departures.

In particular, the Proposed Regulations attempted, with less than complete success, to adapt the documentation requirements of the Section 1441 Regulations to Section 1446. The Proposed Regulations require partnerships to obtain a Form W-8BEN, W-8IMY, or W-9 [19]from every partner. If the partnership receives no form or it knows or has reason to know that the form that it did receive is unreliable, the Proposed Regulations contained a presumption that the partner is foreign. However, this presumption does not apply to the extent that the partnership relies on other means to ascertain the non-foreign status of a partner, and the partnership determination is in fact correct (Prop. Reg. 1.1446-1(c)).

The Proposed Regulations also require the partnership to presume that the partner attracts the highest tax rate in Section 1 or 11 if the partnership cannot determine whether the partner is corporate or noncorporate (Prop. Reg. 1.1446-1(c)(3)). (At the time, however, the highest rate was 35% for all partners, as the Proposed Regulations did not permit the use of preferential capital gains rates for individual foreign partners.)

The Proposed Regulations confirmed the government's position that the partnership cannot take into account losses or deductions from prior years, including partnership losses that had previously been allocated to a partner, or even suspended losses. [20] It did permit the partnership to offset capital losses incurred during the year against capital gains of the year, but not against ordinary income of individuals up to $3,000 under Section 1211(b). The Proposed Regulations made no special provision for what to do about COD income but the Preamble invited comments on this subject. As will be seen below, however, the final Regulations continue, controversially, to make no special provision on COD income or foreclosures, leaving partnerships and general partners hung out to dry in the common situation of a cash-less partnership that recognizes gain on a foreclosure or ordinary income when its creditors provide it with relief.

The Proposed Regulations modified the safe harbor in Rev. Proc. 89-31 so that a partnership does not need to have filed Form 1065 and the annual return of 1446 tax on Form 8804 (Annual Return for Partnership Withholding Tax) for the prior year at the time that it makes an installment payment. Instead, the Proposed Regulations allow the safe harbor to apply so long as the partnership eventually timely files these forms (Prop. Reg. 1.1446-3(b)(2)(v)(F)).

The Proposed Regulations provide anti-avoidance rules to counteract the use of domestic trusts by foreign partners to claim inappropriate refunds, to avoid reporting of ECTI, or to avoid Section 1446 entirely (Prop. Reg. 1.1446-3(d)(2)(iii)). The Proposed Regulations therefore provide that a foreign trust's or estate's allocable share of ECTI is deemed to have been paid by the taxpayer ultimately liable for tax on that income. In a foreign grantor trust, the taxpayer ultimately liable for the tax on that income is the grantor of such trust.

Further, the Proposed Regulations includes rules and examples dealing with tiered structures. The first rule applies where a foreign trust or estate is a partner in a partnership required to pay the 1446 tax and the beneficiary of the foreign trust or estate is either another foreign trust (with a foreign person as a beneficiary of such trust) or a foreign person. In that circumstance, the Proposed Regulations provide that the foreign trust or estate is entitled to claim only the portion of the Section 33 credit corresponding to the ECI on which it is taxable.

Another rule addresses the use of a domestic trust, where a partnership knows or has reason to know that a foreign person that is the ultimate beneficial owner of the ECI holds its interest in the partnership through a domestic trust or chain of domestic trusts, and the domestic trust was formed or availed of with a principal purpose of avoiding the 1446 tax. When applicable, this rule would allow the Service to impose the 1446 tax obligation on the partnership as if each domestic trust in the chain were a foreign trust.

The Proposed Regulations modified the rules in Rev. Proc. 89-31 with respect to tiered partnership structures (Prop. Reg. 1.1446-5). The basic approach was to permit a foreign UTP to submit a Form W-8IMY to the LTP, along with the Form W-8BEN, Form W-8IMY, or Form W-9 that it received for some or all of its partners, as well as information describing how effectively connected items are allocated among its partners. The LTP was required to look through the UTP to its partners based on the documentation, and allocation information. To the extent that the LTP received a valid Form W-8IMY from the UTP but could not reliably associate the UTP's allocable share of effectively connected partnership items with a withholding certificate for each of the UTPs partners, the LTP was required to withhold at the higher of the applicable percentages in Section 1446(b) (in 2003 and today, 35% for both corporate and noncorporate partners). The UTP with foreign partners remained obligated to file and report with respect to its 1446 tax obligation but presumably was able to file for a refund under the principles of Rev. Proc. 92-66, which were carried over into the Proposed Regulations. The Service was apparently uncertain about this approach and asked for comments, including on a domestic UTP with foreign partners.

The Proposed Regulations did not address the artificial recognition of gain under Section 731 caused by a Section 1446 “distribution.”

Finally, the Proposed Regulations essentially did nothing to address a series of comments received over the years requesting that the Service mitigate Section 1446's capacity to require overwithholding of tax. Some examples of overwithholding are given in the rant at the beginning of this article and will be addressed more systematically in the description of the final Regulations and analyzed in greater depth in the second part of this article. However, the basic overwithholding problem arises from the Code's requirement that the amount that is subject to the 1446 tax is the partnership's ECTI allocable to foreign partners, with no explicit language permitting the partnership to take into account partner-level tax attributes. For example, nothing explicitly permits net operating loss carryovers to be taken into account, even if the losses were originally allocated to the foreign partner by the partnership.

In the Preamble to the Proposed Regulations, the Service justified its negative approach as follows:

These Proposed Regulations do not contain other provisions[[21]] 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. In particular, comments are requested on whether the rules coordinating sections 1445 and 1446 should be modified to address these concerns.

Despite the Service's references to concerns about administrability, the greater concern may have been about the absence of statutory language that directly referred to overwithholding. In the comments made through the American Bar Association Section of Taxation, the authors and their colleagues argued that such authority could be found in the language of Section 1446(f) (“The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section”), and the legislative history. [22] Treasury and the Service responded by providing some but ultimately limited relief from overwithholding.

Final Regulations

As recently as September 2003, the IRS had shown itself reluctant to make much use of the relatively broad language of the grant of regulatory authority in Section 1446(f). At well over 200 pages, the final Regulations and accompanying Proposed and Temporary Regulations take seriously the statutory direction to issue Regulations to carry out the purposes of Section 1446 but it is questionable whether the Regulations, lengthy as they may be, make all the use that might have been made of this regulatory authority to cure the infirmities of the statute. Certainly we may say that the IRS has interpreted the phrase “to carry out the purposes of this section” very cautiously.

Reg. 1.1446-1: overview and determining whether a partnership has a foreign partner.

The final Regulations set out three steps that a partnership (domestic or foreign) must take to determine its 1446 tax:

(1) Determine whether it has a foreign partner.

(2) Determine whether it has ECTI allocable to a foreign partner under the normal partnership allocation rules (Section 704 and Reg. 1.704-1(b)).
(3) Compute and pay over the 1446 tax and report the amount to the IRS and the foreign partners.

Reg. 1.1446-1 is primarily concerned with the first step. Readers familiar with the Section 1441 Regulations will be relieved to learn that the approach under Section 1446 is quite closely coordinated. The Regulation requires all partnerships to determine their partners' status as domestic or foreign. “Foreign partner” generally means any partner of the partnership that is not a U.S. person within the meaning of Section 7701(a)(30) and includes persons treated as U.S. persons for only limited purposes (Reg. 1.1446-1(c)(1)). [23] The Regulation relies on the Section 1441 regulatory documentation requirements, i.e., Forms W-8BEN, W-8ECI, W-8EXP, and W-9 to determine foreign or domestic status as well as tax classification (e.g., corporate or noncorporate). [24] We will refer to these forms (as we wish the IRS had done) as “status forms” and this term includes acceptable substitute forms developed by the partnership (Reg. 1.1446-1(c)(5), cross-referencing Reg. 1.1441-1(e)(4)(vi)).

For U.S. persons, the only form to be used is Form W-9. Although by far the most common users of Form W-9 are noncorporate U.S. persons, Form W-9 is indeed used by corporations for purposes of the withholding rules of Chapter 3, including Section 1446, and the current version of the form contains a box for the U.S. person to check indicating status as an “individual/sole proprietor, corporation, partnership or other.”

Foreign persons can use any of the W-8 series forms that apply to their particular circumstances. Generally, if a foreign partner submits a form to the partnership for purposes of the Section 1441 Regulations, it does not need to submit a second form. [25] The general expectation is that the foreign person will use Form W-8BEN, but a foreign partnership may use Form W-8IMY if it wants the withholding partnership to make use of the look-through rules described below. The Regulations also make provision for disregarded entities and nominees (the owner, not the entity or nominee, must submit the form); grantor trusts (the trust generally has to provide status forms with respect to its grantor or other owner); and foreign governments and tax-exempt organizations (Reg. 1.1441-6(c)(2)(i)). [26] The status form for a foreign government will not exempt the government from withholding under Section 1446 but it may help foreign tax-exempt organizations that have gone to the trouble of securing U.S. tax exempt status, as explained below.

Reliance. Similar to the Section 1441 Regulations, the final Regulations allow the partnership to rely, within the applicable validity period, [27] on the forms received unless the partnership actually knows or has reason to know that the information is incorrect or unreliable and—this is important—the effect would be to require a greater amount of 1446 tax to become payable. This is most likely to arise where the absence of a (reliable) form would lead the partnership to treat the partner as foreign rather than domestic or to treat a partner as being subject to a higher 1446 tax rate by virtue of his or its status (Reg. 1.1441-6(c)(2)(iii)(A)). A partnership is in no event required to rely on anything except a status form to determine the non-foreign status of a partner and may demand that a partner furnish such a form (Reg. 1.1446-1(c)(3)).

Where the partnership is permitted to rely on a status form, it is not subject to penalties for failure to pay or report 1446 tax. What the Regulations do not make explicitly clear is whether the partnership also does not have to pay arrears of unpaid tax when it is later determined that the form was incorrect or unreliable (Reg. 1.1446-1(c)(2)(iii)(C)).

Presumptions where partner fails to provide status form. A partnership that has not received a status form from a partner must presume that the partner is a foreign person, unless the partnership relies on other means to determine the non-foreign status of the partner and it turns out that the partner is indeed a U.S. person (Reg. 1.1446-1(c)(3)). Since most partnerships and their advisors are unaware of Section 1446, we have to hope that for those partnerships the phrase “relies on other means” includes making no determination at all and still getting it right.

So far as tax classification is concerned, the Regulations provide that if the partnership knows that the partner is an individual, the partnership must treat a partner known to be an individual as a nonresident alien, an entity known to be a per se corporation as a corporation, and everyone else as corporate or noncorporate, whichever produces the higher 1446 tax. However, even if the partnership knows that a partner is an individual, it may not apply preferential rates, such as the 15% rate on net long-term capital gain, unless the partner has provided a status form (Reg. 1.1446-3(a)(2)).

Additional documentation considerations. Under the final Regulations, a partner must notify the partnership of an election that it has made (or will make) under Section 871(d) or Section 882(d). If an election has already been made, the partner is required to provide the partnership a copy of such election. However, unlike the Proposed Regulations, the final Regulations do not require a partner to notify the partnership that it is a dealer. Also, there is no affirmative duty on the partnership to inquire as to a partner's status as a dealer or whether an election under Section 871(d) or Section 882(d) has been made.

Except with respect to certain tax-exempt organizations described in Section 501(c), the submission of a Form W-8EXP has no effect on whether there is a 1446 tax due with respect to a partner's allocable share of partnership ECTI. For example, a partnership still must pay 1446 tax with respect to a foreign government partner's allocable share of ECTI because the partner is treated as a foreign corporation under Section 892(a)(3). However, a partnership need only pay 1446 tax with respect to UBTI of a foreign entity that is tax exempt under Section 501(c). To get to this result, procedures under the Section 1441 Regulations for claiming an exemption from FDAP withholding will apply for claiming an exemption from withholding under Section 1446. Under those procedures, the organization may specify the portion of its allocable share of partnership income that will not be includable in the organization's computation of its UBTI. Should the partnership later determine that a partner's representation as to amounts not includable in the organization's UBTI is unreliable or lacking, it must then presume that the partnership item will be includable in computing the partner's UBTI (Reg. 1.1446-2(c)(3) and see Reg. 1.1441-9). [28]

Reg. 1.1446-2: determining a partnership's ECTI allocable to foreign partners.

The Regulations require the partnership to compute its ECTI and then pay tax based on the ECTI allocated to each foreign partner. A foreign partner's allocable share of partnership ECTI for the partnership's tax year is equal to (1) that foreign partner's distributive share of partnership gross income and gain for the partnership's tax year that is effectively connected under the principles of Section 864 and properly allocable to the partner, reduced by (2) the foreign partner's distributive share of partnership deductions for the partnership tax year connected with such income under Section 873(a) or 882(c) and properly allocable to the partner. Allocations of income and deductions must be made in accordance with Section 704 and the Regulations thereunder. By definition, only items allocable to a foreign partner enter into the computation.

Three basic principles therefore underpin the computation of ECTI and the foreign partner's share of it:

- Only income that is ECI in the hands of the partnership is considered, taking into account any status forms submitted by the foreign partner. We refer to this as the "income principle."
- Partner-level deductions and exclusions are not taken into account ("deduction principle").
- Partner-level credits are not taken into account ("credit principle").

Effect of the income principle. A foreign partner's allocable share of partnership ECTI does not include income or gain exempt from U.S. tax. With regard to income excluded by reason of an income tax treaty or shipping or aircraft agreement, the income must be derived by a resident of a treaty country, the resident must be the beneficial owner, and all other requirements for benefits under the treaty must have been satisfied. Not surprisingly, the partnership must have received from the partner a valid withholding certificate (Form W-8BEN) that specifies the treaty and article under which exemption is claimed. Often this will be the exemption for business profits where neither the partnership nor the partner has a permanent establishment within the United States. The partnership may rely on the Form W-8BEN in the usual way with respect to the question of whether the partner has a permanent establishment to which partnership income might be attributable but presumably it must make its own determination as to whether the partnership has a permanent establishment that would be attributed to the treaty resident partner. [29]

Effect of the deduction principle. The deduction principle is implemented by a series of specific rules. These rules, and other unspecified effects of the deduction principle, are the cause of the many ways in which Section 1446 can result in more tax having to be withheld than will ultimately be found due. The Service plainly rejected more favorable treatment for a foreign partner's deductions and losses of the partnership and other losses and deductions available to the foreign partner, even though the partnership presumably would always be more confident in its knowledge of the first type of item. Overwithholding can be mitigated only if the partner is a "good driver" and the partnership and the partner are willing to navigate the bumps and chicanes of the Temporary Regulations that will be covered in detail in the second part of this article. And whatever the good-driver rules accomplish, they do not permit current-year deductions to be taken into account. Hence:

- The deduction for depletion with respect to oil and gas wells is allowed, but the amount of the deduction is to be determined without regard to Sections 613 (percentage depletion) and 613A (limitations on percentage depletion for oil and gas wells).
- Charitable contributions, whether made by the partnership or the partner, may not be deducted. No deduction is allowed for personal exemptions or the additional itemized deductions for individual.
- Partnership capital losses and capital gains allocable to a partner may be offset but losses are otherwise not allowable. No account is taken of net operating loss deductions of any foreign partner, or any suspended losses or capital loss carrybacks or carryovers available to a foreign partner.
- For purposes of determining interest expense that is allocable to ECI in calculating a noncorporate foreign partner's allocable share of partnership ECTI, the interest allocation rules of Temp. Reg. 1.861-9T(e)(7) apply. For a corporate foreign partner, the rules ofReg. 1.882-5 are applied by treating the partnership as a foreign corporation and using the partner's pro rata share of the partnership's assets and liabilities for these purposes; elections under Reg. 1.882-5(a)(7) are made at the partnership level.

As noted above, new Section 199 provides for a deduction for qualified production activities of 9% (3% for tax years beginning in 2005 and 2006; 6% in 2007, 2008, and 2009). Section 199 is applied at the partner level (Section 199(d)(1)(A)). Although issued nearly seven months after enactment of the 2004 Act, the Section 1446 final Regulations were essentially finished by that date. The Regulations, therefore, do not deal explicitly with the interaction of Sections 1446 and 199. Applying the deduction principle, however, it would seem that a Section 199 deduction would be treated under the Regulations just like all other current-year deductions required to be computed at the partner level.

Perhaps the most egregious effect of the deduction principle is that the exclusion for COD income, which is computed at the partner level, may not be taken into account. The Regulations themselves say nothing about COD income or its cousin, gain realized on a sale by foreclosure or deed in lieu of foreclosure of assets secured by debt in excess of basis. However, the Preamble to the Regulations essentially confirms that the deduction principle applies in all its glory to COD income. Thus sayeth the Preamble:

Treasury and the IRS believe that section 1446 requires a partnership to pay 1446 tax on COD income and gain recognized by reason of a foreclosure or deed in lieu of foreclosure on property when such income or gain is allocated to foreign partners. The purpose of the statute is to collect taxes that foreign persons may not otherwise pay, regardless of the liquidity or financial situation of the withholding agent. Further, unlike section 1441, section 1446 does not require that a partnership have control, receipt, custody, disposal, or payment over the income that is subject to withholding. As a result, no exception is mandated. In addition, Treasury and the IRS do not believe that a deemed distribution under section 1446(d) would violate any provisions of the Bankruptcy Code.

Gritting our teeth, we will have more to say about this in Part 2 of this article.

Effect of the credit principle. The 1446 tax is computed without regard to a partner's distributive share of the partnership's tax credits. This seems unnecessarily harsh. While tax credits can sometimes be limited by reference to a foreign partner's specific circumstances, the risk to the government appears moderate and the Regulation's approach does not seem compelled by the language of Section 1446 .

Reg. 1.1446-3: calculating, paying over, and reporting the 1446 tax.

Reg. 1.1446-3 sets out a series of rules concerning the payment and reporting of 1446 tax. These include:

- Rules for determining the applicable rate.
- Rules for payment of the tax by installments, using the principles of corporate estimated taxes derived from Section 6655.
- Rules for reporting the tax to the IRS and to foreign partners.
- Coordination of the tax with other withholding taxes.

In addition, the Regulation explains the effect of withholding on the foreign partner and, indirectly, on the partnership, basically by treating the 1446 tax withheld as a distribution to the foreign partner.

Rate. A partnership is generally required to use the highest tax rate in Section 1 (noncorporate taxpayers) or Section 11 (corporate taxpayers) applicable to a partner. At present, this is 35% for both.

However, in a significant departure from the Proposed Regulations, the final Regulations permit the partnership to consider the type of income or gain allocable to a foreign partner during the tax year when computing its 1446 tax obligation, so long as the foreign partner has provided a valid status form that confirms that the partner is not a corporation. As a result, in an allocation to a noncorporate partner, a partnership generally can pay 1446 tax using the highest capital gains rate (currently 15%), the highest tax rate for collectibles gain (currently 28%), and the maximum tax rate for unrecaptured Section 1250 gain (currently 25%) (Section 1(h)(1)-(6)). The partnership must use the highest preferential rate for a particular type of income or gain. For example, in some cases capital gain may be taxed at only 5% or even 0% (the 0% rate is provided after 2007; see Section 1(h)((1)(B)) but the rate of 1446 tax is still 15%.

The right of partnerships to use preferential gains rates will be a considerable benefit to real estate partnerships with individual investors, especially in view of the IRS's insistence that Section 1446 trumps Section 1445 (FIRPTA withholding) but without any provision for applying for a withholding certificate as permitted by the latter section.

Installment payments. Section 1446 imposes a withholding regime that applies, with modifications, the principles of Section 6655, the provision that sets out the estimated tax requirements applicable to corporations (Reg. 1.1446-3(b)). The basic approach of Section 6655 as applied by the Section 1446 Regulations is to require a partnership to pay four installments of tax during the year, with a truing up after the end of the year. The installments are due on the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year (April 15, June 15, September 15, and December 15 for a calendar-year partnership). The final payment is due at the same time as the partnership's annual information return (Form 1065, whether the partnership is foreign or domestic).

The partnership may not reduce installments based on a foreign partner's estimated tax payments. A foreign taxpayer faced with overwithholding might consider reducing its estimated tax payments with respect to its non-partnership ECI to take into account any overwithholding by the partnership (Reg. 1.1446-3(b)(iii)). A variety of rules cover the situation of a partner whose interest terminates during the partnership tax year and various technical exceptions to the rules of Section 6655 and necessary adaptations (see Regs. 1.1446-3(b)(iv) and (v)).

Under the principles of Section 6655, installments are the aggregate of each foreign partner's annualized share of ECTI multiplied by the applicable percentage based on the classification of the partner and the type of income. As a practical matter, the applicable percentage will usually be 35% except where preferential rate gain of some sort is allocable to a noncorporate partner. As will be explained in Part 2 of this article, the partnership may also take into account the deductions and credits certified to the partnership by a foreign partner that has satisfied the good-driver requirements of Temp. Reg. 1.1446-6T.

The standard Section 6655(e)(2) annualization method requires the taxpayer to estimate the tax that would be due for the whole year by annualizing the taxable income at various intervals. For the first and second installments, the taxpayer takes the taxable income for the first three months. For the third and fourth installments, the taxpayer takes the taxable income for the first six and nine months, respectively. The taxpayer then applies the appropriate tax rates to the annualized income and multiplies it by 25%, 50%, 75%, and 100% for the first, second, third, and fourth installments. The first installment is the amount so calculated; the second, third, and fourth installments are the amounts so calculated less all previous installments.

Section 6655 provides two safe harbors, under which a corporation is not liable for an underpayment addition to the tax if the corporation pays 25% of either the preceding or current year's tax liability in each quarterly installment. These safe harbors are often referred to as the “prior-year safe harbor” and “current-year safe harbor” (Section 6655(d)(1)(B)).

The final Regulations provide that the Section 6655 current-year safe harbor can apply to a partnership subject to Section 1446, but the prior-year safe harbor does not. Instead, the Regulation provides a modified version of the prior-year safe harbor that eliminates penalties for underpayment of withholding tax if (1) each installment is 25% of the withholding tax that would be payable on the amount of ECTI allocable to the foreign partners for the prior year; (2) the prior tax year consisted of 12 months; (3) the partnership had filed its partnership return for the prior tax year; and (4) the amount of ECTI for the prior year is not less than 50% of the ECTI for the current year. This last requirement involves a certain level of prognostication for partnerships whose profitability increases rapidly from one year to another (Reg. 1.1446-3(b)(3)).

Once the partnership has decided, in its first installment, to use a safe harbor, it must stick to it unless it later determines that it is going to fail the 50%-of-ECTI test. If so, it can change back to the standard annualization method but must disclose this on its annual return of 1446 tax.

Section 6655(f) provides that a corporation is not required to pay estimated tax when the tax is less than $500. The final Regulations apply the principles of the Section 6655(f) rule by requiring a partnership to take into account the liability of all foreign partners. That is, the partnership must compare its total 1446 tax liability for all foreign partners to the $500 threshold in Section 6655(f). This rather dilutes the value of the de minimis rule.

See Exhibit 1 for an illustration of withholding under Section 1446.

Payment of tax. In general, a partnership must pay to the IRS a portion of its estimated “annual Section 1446 payment” for each foreign partner on or before the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year for U.S. income tax purposes. As noted below, a final payment is made with the annual return of 1446 tax.

Reporting and notification to partners of installment payments. The final Regulations require a partnership that pays 1446 tax on behalf of a foreign partner to notify the partner when a payment of tax has been made. The payment is made using a voucher prescribed as Form 8813. [30]

Because the 1446 tax installment due dates are the 15th day of the fourth, sixth, ninth, and 12th months of the partnership's tax year, a partnership generally must notify a foreign partner four times during the tax year of the 1446 tax paid on the partner's behalf. The notice is not required to be in any particular form but must contain, among other items, information sufficient to identify the partnership, the partner, the annualized amount of ECTI estimated to be allocated to the partner, and the amount of 1446 tax paid to the IRS on behalf of the foreign partner. The notification must be given within ten days of the installment due date or, if paid later, the date of payment (Reg. 1.1446-3(d)(1)). [31]

Annual return and notification to partners. After the close of the partnership tax year, the partnership is required to file Forms 8804 and 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax) with the IRS and to provide a Form 8805 to each foreign partner (Reg. 1.1446-3(d)(1)(iii)). When completing its Form 8804 (as well as all Forms 8805), the partnership will use the actual results of its operations for the previous year. If the partnership determines that its 1446 tax is greater than previously estimated, it is required to pay any shortfall when filing the form.

Form 8805 sets out the 1446 tax paid on the foreign partner's behalf for the entire tax year. Each foreign partner receiving a Form 8805 is generally permitted to claim a tax credit under Section 33 on its U.S. federal income tax return in the amount shown on the form as paid on the partner's behalf. Rather annoyingly for foreign partners, the form does not record the installments previously notified to the partner but simply the grand total for the year.

A partnership that considers a foreign partner's certificate under Temp. Reg. 1.1446-6T (relating to exemption from withholding if certain certification requirements are met) when computing its 1446 tax is required to furnish a Form 8805 to the partner and the IRS, even if the form submitted to the partner shows no payment of 1446 tax on behalf of the partner.

Forms 8804 and 8805 are separate from Form 1065 and are not to be filed together. In fact, irrespective of where the partnership files its information return, Forms 8804 and 8805 are filed with the Philadelphia Service Center. A partnership generally must file Forms 8804 and 8805 on or before the due date for filing the partnership's Form 1065 (see Reg. 1.6031(a)-1(c)). However, with respect to partnerships that keep their records and books of account outside the United States and Puerto Rico, Forms 8804 and 8805 are not due until the 15th day of the sixth month following the close of the partnership's tax year (see Reg. 1.6081-5(a)(1)).

Application of Section 6655(i) to partnership tax year of less than 12 months. The final Regulations provide that even if a partnership has a tax year of less than 12 months, it is required to pay 1446 tax (including installments of the tax) if the partnership has ECTI allocable to foreign partners. The partnership must adjust its installment payments of 1446 tax in a reasonable manner (e.g., the annualized amounts of ECTI estimated to be allocable to a foreign partner, and the percentage of tax to be paid with each installment) to account for the short tax year. However, if the partnership's tax year is less than four months, it is only required to file Form 8804 in accordance with the Regulations and report and pay the appropriate 1446 tax for the short tax year.

Coordination with other withholding rules. The final Regulations provide that when Section 1445 (FIRPTA withholding) and Section 1446 both technically apply, a partnership is required to pay withholding tax on behalf of its foreign partners in accordance withSection 1446. [32] This rule, referred to as the “trumping rule,” relates primarily to a domestic partnership's disposition of a U.S. real property interest, which is subject to withholding under Section 1445(e)(1). Even where Section 1445 would grant an exclusion from withholding tax, presumably for the good reason that no tax will be due (Reg. 1.1445-2(d)(3)(B)(ii)), Section 1446 withholding still applies. This is unfortunate because the Section 1445 withholding certificate procedure involves a Service determination of whether the seller of a U.S. real property interest has made a reasonable case for reducing the tax to be withheld, in accordance with procedures that, in the authors' experience, work pretty well.

The Preamble explains the position taken in the Regulations as follows: “Treasury and the IRS do not believe Congress intended for Section 1445 to apply to the exclusion of Section 1446 where the Sections overlap.” No support is given for this statement, perhaps for the good reason that Congress has never in fact expressed itself on the point. Section 1446 (not to mention Section 1445) is silent; the legislative history is silent; even the Joint Committee on Taxation Blue Book is silent. Saying it don't make it so.

About the only argument based on statutory interpretation that might be made here is that Section 1446 was enacted four years after Section 1445. But why would that argument prevail against an alternative interpretation, namely that there is a specific provision,Section 1445(e)(1), dealing with dispositions by partnerships, which Congress did not repeal when it enacted Section 1446? If the Preamble were correct, Section 1445(e)(1) would have no residual effect at all and it is hard to believe that Congress intended to repeal a provision that is directly on point without actually saying so. Congressional silence about Section 1445(e)(1) when it enacted Section 1446 would suggest that, contrary to the Preamble's belief, Congress did not intend for Section 1446 to disturb the existing regime for partnership dispositions of real property interests.

Reg. 1.1446-3: deemed distribution from payment of 1446 tax.

Section 1446(d) requires a foreign partner's share of any withholding tax paid by the partnership to be treated as a tax credit that is distributed to the partner on the earlier of the day that the tax was paid by the partnership, or the last day of the partnership's tax year for which the tax was paid. The Section permits the Regulations to prescribe a different treatment.

The Code section suffers from two infirmities, only one of which is treated by the final Regulations (Reg. 1.1446-3(d)(2)(v)). Both relate to Section 731, which provides that a distribution of money in excess of the partner's basis is gain required to be recognized by the partner. Leaving aside the question of whether such gain is actually taxable to a foreign partner in a case not involving real estate—the Service says that it is taxable[33] but this is a view of dubious credentials—a deemed distribution under Section 1446(d) will give rise to gain if it exceeds the foreign partner's basis in the partnership interest.

Such an excess can arise simply because the distribution is deemed to occur when the tax is paid whereas the income to which the distribution relates does not get allocated until the last day of the partnership year. To cure this, the final Regulations generally provide that a deemed distribution under Section 1446(d) is treated as an advance or drawing against the partner's distributive share of income from the partnership. As a result, the tax ramifications of a partnership's payment of 1446 tax on a foreign partner's allocable share of ECTI will be considered by the partner at the end of the partnership's tax year, or the last day of the partnership's tax year during which that person was a partner in the partnership. The advance or drawing treatment applies only to installment payments of 1446 tax made during the partnership's tax year with respect to ECTI earned in the same tax year.

Any 1446 tax payments after the close of the partnership's tax year, including amounts paid with the filing of Form 8804, that are on account of partnership ECTI allocated to partners for the prior tax year are treated under Section 1446(d) and the Regulations as a distribution from the partnership on the earlier of (1) the last day of the partnership's prior tax year for which the tax is paid, and (2) the last day in the prior tax year on which the foreign partner held an interest in the partnership. These rules apply only to determine the tax ramifications of the deemed distribution to a foreign partner under Sections 705 (determination of basis of partner's interest), 731 (extent of recognition of gain or loss on distribution), and 733 (basis of distributee partner's interest).

What the Regulation does not cure is what happens if the tax withheld is in fact greater than the taxpayer's basis even after applying the rule that defers the distribution until the last possible moment. This is illustrated in the sidebar “Section 1446(d) at Work.” One suggestion made to the IRS was that gain recognition should occur only to the extent that the partnership agreement permits a distribution to the foreign partner and does not require the foreign partner to recontribute any amount to the partnership on account of excessive Section 1446 withholding.

The IRS declined to adopt this or any of the suggestions made by various commenters. In doing so, the drafters of the Preamble included a justification that would come as a complete surprise to anyone who has ever had the validity of a Section 704(b) allocation tested in an audit: “Such an approach would not be administrable because it would require the IRS to review each partnership agreement and interpret the provisions of the agreement for purposes of section 1446.” Imagine that: the IRS would be unable to review the effect of a partnership agreement and therefore cannot allow its provisions to be taken into account in determining the effect of a partnership distribution. The Preamble also frets that the suggested approach would “inappropriately” result in different treatment for similarly situated partners but does not explain why.

Without regulatory help, can the partnership avoid the phantom gain problem through self-help? For example, what would happen if the partnership agreement provided that any distribution resulting from a payment of 1446 tax on the partner's behalf would automatically create an obligation on the partner to contribute an equal amount to the partnership? Would it make any difference if the obligation were backed or secured by the taxpayer's note? The note of a related party? A note payable by the partner to a general partner rather than to the partnership?

Precedent in this area is thin but generally holds that a contribution of a partner's written obligation to the partnership, except where the obligation is readily tradable, does not increase the basis of the partner's interest because the partner has a zero basis in the written obligation. Payments on the written obligation are added to the partner's basis in the partnership only when the payments are actually made. [34] The Service's position appears to be that the zero basis rule applies even if the obligation to make the future contribution is secured. Therefore, to avoid application of Section 731, not only should the partnership agreement provide for the foreign partner to make a contribution that will prevent its basis from becoming negative, but the contribution must actually be made no later than the last day of the partnership's tax year.

Another possibility would be for the partnership to establish a line of credit, not unlike a refund anticipation loan, that would be drawn against to fund all 1446 tax payments, with the obligation being allocated to the foreign partners. Drawing down on the line would result in an increase in the foreign partners' basis under Section 752(a), assuming that the requirements of the Section 752 Regulations were met in relation to the allocation of the liabilities.

The ability of foreign partners to escape the phantom gain consequences of Section 1446(d) by such maneuvers means that the Service's refusal to provide explicit relief makes losers of the ill-informed while overriding or ignoring the effect of a partnership agreement that prohibits distributions in excess of a partner's basis.

Special rules for trusts and estates.

The final Regulations contain several rules applicable to domestic and foreign trusts and estates.

First, the final Regulations require that a domestic grantor trust provide a statement to the partnership that it is a grantor trust and also provide a status form of the grantor or other owner of the trust. A foreign grantor trust must provide Form W-8IMY to the partnership along with documentation of the grantor or other owner of the trust. In both of these situations, the partnership computes its 1446 tax based on the status of the grantor or other owner, rather than the trust, to the extent of such grantor's or other owner's interest. All other trusts are required to provide Form W-8BEN or Form W-9, as appropriate, to the partnership on their own behalf (Reg. 1.1446-1(c)(2)(ii)(E)).

Foreign grantor trusts are a rarer beast than in olden days. The Small Business Job Protection Act of 1996 enacted Section 672(f)(1), pursuant to which the grantor trust rules generally apply only to the extent that the result is for amounts being currently taken into account, directly or through one or more entities, in computing the income of a U.S. person. Generally speaking, the grantor trust rules continue to apply if the trust is revocable by the grantor, or the grantor or the grantor's spouse are the only lifetime beneficiaries of income and capital (plus certain grandfathered trusts in existence on September 19, 1995). [35]

Second, the final Regulations require a foreign non-grantor trust (including an estate) to allocate any 1446 tax between the trust or estate and its beneficiaries. This allocation is based on the taxpayer (trust/estate or beneficiary) that will ultimately report and pay tax on the ECTI allocable from the partnership. The rule is designed to match the tax credit under Section 33 for the 1446 tax to the taxpayers who will ultimately be responsible for the income tax liability on the net income allocated from the partnership (Reg. 1.1446-3(d)(2)(iii)(A)).

This rule even applies in a simple trust, which is one where the trustee is obligated to distribute all of its income currently and the trustee is therefore entitled to a deduction for any amount that it must distribute (Sections 651 and 652; Reg. 1.651(a)-1)). One might therefore have expected that all the Section 33 credit would go to the beneficiaries. Not so. Section 1446 reaches “income” (ECTI) that may not be “income” for purposes of the governing trust instrument and local trust law. [36] Where the income in question is an allocation of ECTI that is subject to 1446 tax, it may not be required to be distributed to the beneficiaries. As a result, partnership income that is allocable to a foreign simple trust may not enter into a simple trust's computation of income that it is required to distribute. The final Regulations provide an example of this circumstance where a foreign simple trust does not act as a mere conduit between the partnership and the beneficiary with respect to the trust's allocable share of partnership ECTI. Other examples illustrate what happens if the simple trust makes a partial distribution or if a complex trust distributes all of its ECTI (Reg. 1.1446-3(d)(2)(vi)).

Third, the final Regulations contain a “domestic trust rule” to prevent avoidance of Section 1446 withholding by the interposition of a domestic trust. The Regulation provides 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 non-grantor trust, or possibly other entities, and the trust was formed or availed of with a principal purpose of avoiding the 1446 tax, the domestic trust will be treated as a foreign trust. As a result, 1446 tax will be due with respect to the domestic trust's share of ECTI and the rule described in the previous paragraph will require the allocation of the credit for 1446 tax. When applicable, this rule permits the IRS to impose the 1446 tax obligation on a partnership as if each domestic trust in a chain is a foreign trust.

The final Regulations do not limit the “reason to know” standard to situations where a minimum threshold of ownership can be shown. However, they do provide that a PTP (or a nominee required to pay 1446 tax under Reg. 1.1446-4) will not be considered to know or have reason to know that a domestic trust is formed or availed of to avoid the 1446 tax, provided that the interest in the PTP is publicly traded.

Reg. 1.1446-4: publicly traded partnerships.

Under Rev. Proc. 89-31, a PTP was defined as a regularly traded partnership within the meaning of the Regulations under Section 1445(e)(1), but not a PTP treated as a corporation under Section 7704(a). Generally, PTPs with ECI were required to withhold based on distributions to foreign partners. Rev. Proc. 92-66 modified the applicable percentage for withholding on distributions to the highest tax rate imposed under Section 1, and applied that same percentage to both corporate and noncorporate partners. The rules also permitted the withholding obligation to be assumed by a domestic nominee holding an interest in the partnership on behalf of one or more foreign partners.

Rev. Proc. 89-31 permitted PTPs to elect to apply the general rules that determine the 1446 tax based on a foreign partners' allocable shares of partnership ECTI rather than on distributions. The election was made by complying with the payment and reporting requirements and attaching a statement to Form 8804 indicating that the election was being made.

The Proposed Regulations made minor changes to these rules. First, PTPs were defined solely by reference to the definition in Section 7704. Second, the documentation requirements were conformed to the requirements for all partnerships with foreign partners. Third, the applicable percentage became the rate applicable under Section 1446(b), i.e., the highest rate for partners depending on their classification as corporate or noncorporate.

The final Regulations continue the approach of requiring a PTP to pay 1446 tax on distributions of ECI to its foreign partners, rather than based on a foreign partner's allocable share of partnership ECTI, but eliminated the approach of permitting an election to apply the general rules of withholding with respect to ECTI. In the Proposed Regulations, the IRS had asked for comments on whether the PTP rules should be extended to large partnerships, but it received no such comments and so made no further change to the scope of the PTP rules. As a result, the scope of the rules is somewhat limited since a PTP will be a corporation under Section 7704 unless at least 90% of its gross income is "qualifying income." Many (but not all) categories of qualifying income are likely to be FDAP income rather than ECI. [37]

Withholding continues to be required at the Section 1446(b) rate; preferential rates permitted for partnerships with respect to, for example, long-term capital gains of individuals, may not be used by PTPs.

Because of the prevalence of the use of street names and other nominee relationships in the public traded securities arena, the Proposed Regulations provided rules for shifting liability for withholding to nominees, and the final Regulations refine these rules to conform with market practice. Under the final Regulations, where a nominee is designated as a withholding agent with respect to a foreign partner of the PTP, the obligation to withhold on distributions is imposed solely on the nominee. The nominee rules apply only where the nominee is a "domestic person," which presumably means a U.S. person.

All of the usual rules apply for a PTP to determine the status of its partners. A nominee who has established its status to the partnership, presumably using Form W-9, thereby becomes the withholding agent for purposes of Section 1446 and subject to liability underSections 1461 and 6655, as well as all applicable penalties and interest (Reg. 1.1446-4(d)). The nominee's withholding obligation arises with respect to a distribution attributable to ECI of the PTP provided in accordance with the usual requirements for notification to the National Association of Securities Dealers (NASD) or the relevant exchange of payment of dividends. [38] The Regulations clarify that the notice does not have to be delivered to the nominee; the nominee is deemed to receive notice when it is published by delivery to the NASD or the exchange. A nominee will be treated as a withholding agent only to the extent of the amount specified in the qualified notice.

The final Regulations eliminate any separate requirement for nominees to provide a Form W-9 to PTPs. The Service noted that this goal is already accomplished by other means.

Reg. 1.1446-5: tiered partnership structures.

The final Regulations contain a set of rules where a partnership (LTP) has a partner that is itself a partnership (UTP).

LTP permitted to elect look-through of foreign UTP. Under the final Regulations, an LTP that has received documentation and information from a partner that is a foreign UTP may look through the UTP to the partners of the UTP when computing its 1446 tax obligation. The touchstone of Prop. Reg. 1.1446-5 had been that the LTP must be able to "reliably associate" (see Reg. 1.1441-1(b)(2)(vii)) the UTP's allocable share of ECTI from the LTP with the partners of the UTP. The final Regulations clarify that the look-through regime is not an all-or-nothing proposition, as under the Proposed Regulations. Rather, to the extent that an LTP can reliably associate a portion of a UTP's allocable share of ECTI with a partner of the UTP, the LTP will look through when computing its 1446 tax or any installment. This result is consistent with the regime under Section 1441 (see Reg. 1.1441-1(b)(2)(vii)(B)(2), Examples 3 and 4).

Domestic UTP permitted to elect look-through by LTP. A domestic UTP may elect to have look-through rules apply. Under these rules, the LTP becomes responsible for paying 1446 tax with respect to the domestic LTP's foreign partners. In response to comments pointing out that the LTP might not want to have Section 1446 obligations involuntarily transferred to it, the final Regulations require that the LTP consent in writing to the election. The domestic UTP must provide a Form W-9 to the LTP and attach to the Form W-9 its election to have the look-through provisions apply. The UTP's election must be in writing to the LTP and be received by the LTP at least 15 days prior to any installment due date or Form 8804 filing due date for which it will be considered.

To make an election to which the LTP can consent, the domestic UTP must provide information to the LTP to enable the LTP to reliably associate at least a portion of the UTP's allocable share with a foreign partner of the UTP. If the LTP does not consent to the election, the LTP treats the domestic UTP as a U.S. person for purposes of Section 1446. Whether the UTP is a domestic or foreign partnership, and regardless of whether the LTP looks through the UTP in computing its withholding tax, the UTP remains obligated to report and pay tax under Section 1446.

Similarly, under Reg. 1.1446-5, a partnership may not be able to reliably associate 100% of a UTP's allocable share of ECTI with the partners of the UTP. In such circumstances, Reg. 1.1446-5(c)(2) requires the LTP to pay 1446 tax on the portion that it cannot reliably associate with partners of the UTP at the higher of the rates in Section 1446(b). Even though the UTP has provided documentation on its own behalf (e.g., Form W-8IMY), and the LTP therefore knows that the UTP is a noncorporate entity, the LTP may not consider any preferential rate when computing its 1446 tax due on the portion of the ECTI that the LTP cannot reliably associate with partners of the UTP.

Application of the look-through rules to PTPs in tiered structures. The look-through rules apply to a lower-tier PTP (or its nominees required to pay 1446 tax) if all of the requirements of Reg. 1.1446-5 are met. In other words, if a lower-tier PTP has a foreign UTP, it may look through the foreign UTP and if it has a partner that is a domestic UTP, the look-through election may be made with the lower-tier PTP's consent. On the other hand, look-through rules cannot apply whenever the UTP is publicly traded.

Additions to tax, interest, and penalties for noncompliance with Section 1446.

The final Regulations do not cover all of the potential penalties that may apply to a partnership required to pay 1446 tax, but do explain and illustrate the application of Sections 6655 (addition to tax for underpayment of an installment of 1446 tax), 6601 (interest on underpayments of tax), and 6651 (failure to file and failure to pay penalties).

Deemed payment rule. The final Regulations include a rule (“deemed payment rule”) that is used to cut off the liability of a partnership to interest and penalties (but not the tax itself, if the foreign partner does not pay it). Under this rule, a partnership that fails to pay 1446 tax will be deemed to have paid the 1446 tax associated with the ECTI allocable to a foreign partner on the later of the date that the partner is considered to have paid its U.S. income tax under Section 6513(a) and (b)(2), or the last date for payment of the 1446 tax without extensions. Section 6651(b)(1) reduces the base on which the Section 6651(a)(1) penalty is computed (the amount required to be shown as tax on the return) by the partnership's actual and deemed payment of tax, provided that the actual or deemed payment occurs on or before the date prescribed for payment of the tax.

To the extent that the partnership has not paid (or been deemed to have paid) all 1446 tax due with respect to a partner as of the date prescribed for payment of the tax, the failure-to-file penalty under Section 6651(a)(1) will begin to accrue on the Form 8804 filing due date and continue to accrue until the earlier of the date that Form 8804 is actually filed, or the date that the maximum monthly accrual has occurred under the section, i.e., five months. Stated differently, if a partnership fails to file Form 8804 and the 1446 tax has not been paid or deemed paid by the date prescribed for payment of the tax, the failure-to-file penalty will begin to accrue and may be stopped only by the partnership filing such form or the statutory limit of the penalty being reached; payment of the 1446 tax (actual or deemed) after the date prescribed for payment of the tax, without actually filing Form 8804, will not stop accrual of the penalty.

A similar analysis applies to the accrual of the failure-to-pay penalty under Section 6651(a)(2). However, the failure-to-pay penalty cannot be imposed unless Form 8804 is filed and the accrual of the penalty can be stopped by paying the 1446 tax. Once Form 8804 is filed, the penalty accrues at 0.5% of the amount of the unpaid 1446 tax beginning on the due date for payment of the tax (with regard to extensions), regardless of when the form was filed, and continues to accrue each month on the unpaid 1446 tax until the earlier of the date that the 1446 tax is completely paid or deemed paid, or the maximum monthly accrual of 25% in the aggregate is reached. The time at which a partnership is deemed to have paid 1446 tax for purposes of Sections 1446, 1461, 1463, 6601, 6651, and 6655 is discussed above.

Addition to tax under Section 6655. The final Regulations provide that the addition to the tax begins to accrue on the date that the partnership underpays an installment and stops on the earlier of the date that all of the 1446 tax is satisfied, or the 15th day of the fourth month following the close of the partnership's tax year (15th day of the sixth month for a partnership keeping its books and records outside the United States and Puerto Rico).

A partner's payment of tax that deems a partnership to have paid 1446 tax will not be credited to the partnership's account until the later of the date that the tax is considered to have been paid by the partner under Section 6513(a) and (b)(2) (prescribing the date that tax is considered paid for purposes of Sections 6511(b)(2) (limit on amount of credit or refund), 6511(c) (special rules applicable to extension of time by agreement), and 6512 (limitations in case of petition to Tax Court)), or the last date for paying 1446 tax without extensions (i.e., the unextended due date for Form 8804). Under this “later of” rule, the earliest that a partner's payments can be credited to the partnership is the last date for paying the 1446 tax without extensions (the unextended due date for Form 8804), the date that the accrual of the Section 6655 addition to the tax would stop in any event. As a result, a partner's payments of estimated tax will not provide a partnership with any benefit with respect to the partnership's computation of the underpayment addition to the tax under Section 6655, as applied in the Regulations.

Interest under Section 6601. Interest begins to accrue when a partnership's 1446 tax liability has not been satisfied, or deemed satisfied, by the last date prescribed for payment without extensions, and stops accruing on the date and to the extent that the partnership actually pays the 1446 tax or is deemed to have paid the 1446 tax under the deemed-payment rule.

Failure to file and failure to pay. Section 6651(a)(1), which generally applies to failure to file any tax return by the due date (including extensions), applies to failure to file Form 8804. The penalty accrues at 5% of the tax required to be shown on the return for each month or fraction of a month during which the required return is not filed, but not exceeding, in the aggregate, 25% of that amount. Similarly, under Section 6651(a)(2), an addition to tax of 0.5% is made for each month after the date prescribed for payment that a taxpayer fails to pay an amount shown as tax on any return, not to exceed 25% in the aggregate. While Section 6651(a)(1) applies on a failure to file a return, and Section 6651(a)(2) applies only if a return has been filed, there are de minimis circumstances where both penalties can apply (see Section 6651(c)). Both penalties provide an exception if it is shown that the failure is due to reasonable cause and not willful neglect.

In addition to the above penalties, if the general partner of the partnership or the manager of the limited liability company does not make the required filings or remit the withholding taxes, the general partner may be subject to civil and, in rare cases, criminal penalties for failure to file and to pay tax under Section 7203 and the trust fund recovery penalty under Section 6672. Moreover, officers or other responsible persons of a corporation that is either a general partner or manager of a limited liability company may be subject to a civil penalty under Section 6672 equal to the amount that should have been withheld, if they acted willfully.

Effective Date

The final and Temporary Regulations were effective May 18, 2005. A partnership is permitted to apply the final Regulations for partnership tax years beginning after December 31, 2004. A partnership that makes this election may also elect to apply the Temporary Regulations for partnership tax years beginning after December 31, 2004.

Conclusion

Part 2 of this article will explore the wonderful world of overwithholding, the response of Treasury and the IRS manifested by the Temporary and Proposed Regulations, and the need for more change in this area if partnerships are to be a viable form of business entity for foreign investment in the United States.

Exhibit 1.Section 1446 Withholding

A partnership has income of $20,000 during the first three months of the tax year, $80,000 in the first six months, and $108,000 in the first nine months. The foreign partner's share of the income will be exactly 50%, irrespective of how much income the partnership makes. Actual income for the year is $140,000.

Quarter	Foreign partner's share of annualized income	Estimated tax	Explanation
1	$40,000	$3,500	25% x 35% x 40,000
2	$40,000	$3,500	(50% x 35% x $40,000) - $3,500
3	$80,000	$14,000	(75% x 35% x $80,000) - ($3,500 + $3,500)
4	$72,000	$4,200	(100% x 35% x $72,000) - ($3,500 + $3,500 + $14,000)

At the end of the year, the foreign partner's share is $70,000, with tax payable of $24,500. Since the partner has already incurred withholding of $25,200, it will receive a refund of $700. The corporate foreign partner will file its return on March 15 and the refund typically will be processed quite quickly because any refund that takes longer than about six weeks is interest bearing.

Section 1446(d) at Work

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, even though P has no cash with which to make the payment.

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 of 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 that it does not have and a collateral effect is to create a phantom gain. The gain may be taxable under Sections 731(a) and 897(g) or under Rev. Rul. 91-32, 1991-1 CB 107.*

* This example was presented to the IRS in the ABA Tax Section comments noted in fn. 22 in the text.

[1] Cervantes, *Don Quixote*, Part I, Book III, Chapter 10 (1605).

[2] TD 9200, REG-108524-00.

[3] P.L. 100-647, 102 Stat. 3342, 3526, 1012(s) ("1988 Act"). Rev. Proc. 88-21, 1988-1 CB 777, which provided guidance prior to the 1988 Act, was thereby rendered obsolete. Minor technical amendments to Section 1446 were made by Section 7811(i)(6) of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239, 103 Stat. 2106, 2410). These changes were retroactive to the effective date of the 1988 Act and are not discussed separately in this article.

[4] Perhaps the authors' sensitivities on this subject have been heightened by the recent promulgation of revised Treasury Circular 230, 31 CFR Part 10, the language of which is so overbroad that it has led otherwise sensible tax practitioners to pile multi-line disclaimers onto trivial e-mails and to question whether an article such as this one should be legended to make sure that no taxpayers believe that they can rely on it to avoid penalties. See Cotorceanu, Michaels, Morse, O'Donnell, and Marcovici, "The Changing Role of the International Tax and Estate Planning Practitioner: *Pasquantino*, Circular 230—What's Next?," 16 JOIT 46 (October 2005).

[5] See Cummings and Hanson, "American Jobs Creation Act: New Section 199 Domestic Production Deduction," 16 JOIT 14 (April 2005).

[6] To quote bounty hunter Jack Walsh, played by Robert de Niro in the film *Midnight Run* (1988), this qualifies as “a very respectable neighborhood.” See http://www.imdb.com/title/tt0095631/quotes.

[7] Section 871 applies to the taxation of nonresident alien individuals and Section 881 to foreign corporations. Section 1441 requires withholding of tax on payments to nonresident alien individuals. Section 1442 is its corporate counterpart. Section 881 and especiallySection 1442 and the Regulations thereunder cross-refer frequently to the law and Regulations applicable to nonresident alien individuals. Accordingly, if a citation in this article is made only to Section 871 or 1441, or the Regulations thereunder, it means either that the law is substantially identical for foreign corporations or is in fact subject to a direct cross-reference to the provisions relating to individuals. Unless otherwise stated, all references to sections are to the Internal Revenue Code of 1986, as amended.

[8] In addition, tax on wages that are ECI is collected by normal procedures for employer withholding, and tax on independent personal services income that is ECI is collected by requiring withholding at a flat rate of 30%. Temp. Reg. 1.1441-4T. This latter type of withholding may also lead to overwithholding but Reg. 1.1441-4(b)(3) provides a procedure for a withholding agreement. Taxpayers affected by the 30% withholding include touring performing artists; the IRS regularly negotiates central withholding agreements with the tour promoter. See Rev. Proc. 89-47, 1989-2 CB 598.

[9] See note 3, *supra*.

[10] Rev. Proc. 89-31, 1989-1 CB 895, 898-9.

[11] Section 1446(c). The words “treated as” presumably are intended to pick up gain that is treated as effectively connected income under Section 897 (FIRPTA) as well as real estate income that is treated as effectively connected by virtue of an election under Section 871(d) or 882. This was confirmed by the Service in Rev. Proc. 89-31, *id*.

[12] Rev. Proc. 89-31, *supra* note 10, section 7.

[13] *Id*. section 5.

[14] *Id*. section 7.02.

[15] *Id*. section 10.

[16]

See H. Rep't No. 100-795, 100th Cong., 2d Sess. 291 (1988); S. Rep't No. 100- 445, 100th Cong., 2d Sess. 305 (1988).

[17] Rev. Proc. 89-31, *supra* note 10, sections 7.01 (3) and 11. Rev. Proc. 89-31 uses the terms “tiered partnership” and “subsidiary partnership” but this article uses the acronyms corresponding to the terminology in the final Regulations.

[18] REG-108524-00; 2003-42 IRB 869; 68 Fed. Reg. 52465 *et seq.*, corrected at 68 Fed. Reg. 62553 (November 5, 2003).

[19] Form W-8BEN, “Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding” (December 2000); Form W-8IMY, “Certificate of Foreign Intermediary, Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding” (December 2003); Form W-9, "Request for Taxpayer Identification Number and Certification” (January 2005), as applicable, or an acceptable substitute form permitted.

[20] Prop. Reg. 1.1446-2(a), mercilessly driven home by Prop. Reg. 1.1446-2(b)(3) and especially paragraph (b)(3)(vii) (“[with no meaningful exceptions], any limitations on losses or deductions that apply at the partner level when determining ECTI allocable to a foreign partner shall not be taken into account”).

[21] The Service cited Prop. Reg. 1.1446-5 as an example (actually the only example) where it had sought to mitigate overwithholding. This is the provision that allowed a foreign UTP to provide information to an LTP to cause the LTP to withhold based on the situation of the foreign UTP's partners, so as to avoid overwithholding where the UTP had U.S. partners.

[22] Members of the Committee on U.S. Activities of Foreigners and Tax Treaties, Section of Taxation, American Bar Association (Appel and Karlin, eds.), “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” (January 27, 2004), page 8, available at http://www.abanet.org/tax/pubpolicy/2004/0401ftt.pdf and Tax Notes Today, 2004 TNT 33-16 (February 19, 2004).

[23] The Regulations give one example of a corporation making a nondiscrimination election under Section 897(i) to be treated as domestic for purposes of FIRPTA. Others might include a stapled entity under Section 269B or an individual who makes an election underSection 6013(g) (Election to treat nonresident alien individual as resident of the United States) or (h) (Joint return, etc., for year in which nonresident alien becomes resident of United States). Examples of foreign corporations treated as domestic for all income tax purposes include insurance companies electing under Section 953(d) or contiguous country corporations electing under Section 1504(d).

[24] Form W-8ECI, “Certificate of Foreign Persons Claim for Exemption from Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States” (December

2000); Form W-8EXP, “Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding” (December 2000), as applicable, or an acceptable substitute form permitted. Query whether a domestic corporate partner must also provide a Form W-9, since corporations do not normally provide such forms.

[25] For example, submission of a Form W-8ECI by a foreign partner seeking to avoid Section 1441 withholding will act as a certification for purposes of Section 1446, the effect being essentially to trade the frying pan for the fire.

[26] For example, a partnership still must pay 1446 tax with respect to a foreign government partner's allocable share of ECTI because the partner is treated as a foreign corporation under Section 892(a)(3).

[27] See Reg. 1.1441-6(c)(2)(iv) on validity requirements; Section 3406 and Reg. 31.3406(h)-3(e) (Form W-9); Reg. 1.1441-1(e) (Form W-8 series) for rules on period of validity of the forms.

[28] These procedures apply only if the foreign tax-exempt entity has secured an exemption under Section 501(c). It is not sufficient for the entity to be exempt under a treaty provision, such as the 1992 U.S.-Netherlands income tax treaty (Article 36). In such a case, Form W-8BEN would be used.

[29] See Section 875; *Donroy*, 9 AFTR 2d 1129, 301 F2d 200, 62-1 USTC ¶9373 *,* ; *Unger*, TC Memo 1990-15, PH TCM ¶90015, 58 CCH TCM 1157 , .

[30] Form 8813, “Partnership Withholding Tax Payment Voucher (Section 1446)” (February 2001).

[31] However, a withholding agent is not required to notify a partner of an installment of 1446 tax paid on the partner's behalf, unless requested by the partner, if (1) the partnership's agent responsible for providing notice also acts as an agent of the foreign partner in filing the partner's U.S. federal income tax return for the partner's tax year that includes the installment payment date; or (2) the partnership has at least 500 foreign partners and the total 1446 tax that the partnership determines will be required to be paid for the partnership tax year on behalf of the partner with respect to the partner's allocable share of ECTI is less than $1,000.

[32] The final Regulations also permit a foreign partnership to credit the amount withheld by a transferee under Section 1445(a) when computing its 1446 tax obligation.

[33] Rev. Rul. 91-32, 1991-1 CB 107.

[34] Reg. 1.704-1(b)(2)(iv)*(d)(2)*; Rev. Rul. 80-235, 1980-2 CB 229; *Oden*, TC Memo 1981-184, PH TCM ¶81184, 41 CCH TCM 1285 , *aff'd without pub. opinion* 679 F.2d 885 (CA-4, 1982).

[35] Section 672(f); Small Business Job Protection Act of 1996, P.L. 104-188, section 1904(d), 110 Stat. 1910.

[36] No special rule has been required in the case of FDAP income taxable under Section 1441 because the withholding tax arises by reason of a payment of income that (if the trust is indeed a simple trust) the trust is usually obligated to distribute.

[37] With some exceptions, “qualifying income” means interest, dividends, real property rents, gain from the sale or other disposition of real property, income and gains relating to any mineral or natural resource, any gain from a capital or Section 1231 asset held for the production of such income, and certain income and gains from commodities and commodities-based derivatives. Other requirements under Section 7704 must be met for a PTP to avoid classification as a corporation.

[38] These are described in 17 C.F.R. section 240.10b-17(b)(1) or (3) issued pursuant to the Securities Exchange Act of 1934 (.

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