

# MEMORANDUM

## Kissing the Blarney Stone — A Practical Guide to Structuring Partnership Agreements and Limited Liability Company Operating Agreements in Light of the §1446 Regulations

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### Major References:

I.R.C. §1446; T.D. 9200, 70 Fed. Reg. 28702 (5/18/05).

### INTRODUCTION

Until the advent of §1446,<sup>2</sup> 1446's main claim to fame may have been that it was the year that Blarney Castle in its current incarnation was built in Cork, Ireland. There seems to be a mystical connection here. Certainly, the interminable §1446 regulations, and especially the ponderous temporary regulations in Regs. §1.1446-6T, lead one to believe that the drafters had visited the castle, more than once, where the Blarney Stone is said to confer the gift of the gab on those who kiss it (while hanging backward off a parapet).

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<sup>2</sup> Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

The authors previously have written and spoken, admittedly at competitive length, on §1446, and have submitted several sets of comments to a mostly, though not completely, unresponsive government over the past 10 years on the chronic problems the section, and now the implementing regulations, create for foreign partners but also and especially for U.S. business partnerships and their partners. This memorandum generally is not intended as a vehicle for repeating the authors' complaints and concerns about the regulations.<sup>3</sup> Instead, after describing the current state of the law rather more concisely than in prior publications, this memorandum focuses on some ways to mitigate the harshness of §1446 through drafting of the partnership agreement.

### SECTION 1446 BASICS

Enacted in its current form by the Technical and Miscellaneous Revenue Act of 1988,<sup>4</sup> §1446(a) provides that, if a partnership has effectively connected taxable income (ECTI) for any taxable year, and any portion of such income is allocable under §704 to a foreign partner, the partnership "shall pay a withhold-

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<sup>3</sup> Appel & Karlin, "At Long Last . . . Final Regulations on Foreign Partner Withholding," *J. of Int'l Tax'n* (Oct. 2005), and Appel & Karlin, "Uncle Sam Meets Uncle Scrooge—The Temporary Regulations on Foreign Partner Withholding," *J. of Int'l Tax'n* (Dec. 2005); 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" (Jan. 27, 2004), reproduced at <http://www.abanet.org/tax/pubpolicy/2004/0401ft.pdf>, 2004 *Tax Notes Today* 33-16 (2/19/04), and "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," Nov. 4, 2005, reproduced at <http://www.abanet.org/tax/pubpolicy/2005/051104sec1446.pdf>, 2005 *Tax Notes Today* 215-11 (11/8/05). Among various comments we have seen on the final and temporary regulations, the New York State Bar Association Tax Section "Report on the Final and Temporary Regulations under Section 1446," submitted Feb. 2, 2006 and primarily written by Andrew Walker, stands out for its quality and thoughtfulness, although the numerous differences of opinion between majority and minority views of the Tax Section's Executive Committee are refreshing in some places and disconcerting in others. The NYSBA report is available at [http://www.nysba.org/Content/ContentGroups/Section\\_Information1/Tax\\_Section\\_Reports/1103rpt.pdf](http://www.nysba.org/Content/ContentGroups/Section_Information1/Tax_Section_Reports/1103rpt.pdf).

<sup>4</sup> P.L. 100-647, §1012(s)(1)(A), further amended by P.L. 101-239, §7811(i)(6). Section 1446 originally was enacted by the Tax Reform Act of 1986, P.L. 99-514, §1246(a). The 1986 version was structured as a tax on distributions, which could produce startling instances of overwithholding — a foreign partner could contribute \$1,000 on day one and suffer withholding of \$350 tax when the same \$1,000 was returned the next day — and retroactively was replaced by §1446 in its current form.

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ing tax under this section at such time and in such manner as the Secretary shall by regulations prescribe." Section 1446(c) defines ECTI as the taxable income of the partnership that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, subject to certain adjustments

Withholding tax imposed on partnerships pursuant to §1446 is based upon allocations of ECTI. It therefore is imposed regardless of when or whether the partnership makes distributions to partners. Section 1446(f) authorizes issuance of "such regulations as may be necessary to carry out the purposes of this section." Nearly seventeen years following enactment, the IRS, on May 18, 2005, promulgated final regulations under §1446.<sup>5</sup>

Section 1446 operates by requiring the partnership to pay a withholding tax on a foreign partner's share of ECTI at the highest rate of tax specified" in §1 (noncorporate partner) or §11 (corporate), currently 35% in both cases. In computing ECTI §703(a)(1) does not apply; depletion deductions are allowed but not percentage depletion under §613; there is no reduction for special allocations of income or other items allocable to US partners; and finally there is no reduction for partner level items, e.g., losses, state taxes, charitable contributions.

Section 1446 requires the withholding of tax by partnerships with foreign partners where the partnership has income or gain that is effectively connected with a trade or business carried on by the partnership within the United States (ECI). The final regulations interpret the Code to require that in computing the ECTI on which tax is to be withheld, the deductions that a partner may be entitled to at the partner level are to be ignored. As a result, the "1446 tax," as it is referred to in the regulations, almost always will be greater than the foreign partner's actual tax. In some cases the partnership may owe a substantial 1446 tax when the foreign partner will owe no tax at all.

In this respect, §1446 may be unique. We could not think of a single significant withholding provision, in

the international or domestic area, where a recipient of income cannot escape significantly excessive withholding through some form of statutory or regulatory relief. In every other case, at least in the international area, the foreign taxpayer can get the tax to be withheld more reasonably approximated to the actual liability by providing documentation in a form prescribed by the IRS, by obtaining a ruling or determination or by entering into an agreement with the IRS.

Section 1446 creates a requirement to withhold tax on income rather than on cash or property that represents income. In this respect it is quite different from other forms of Chapter 3 withholding and, indeed, most forms of withholding required by the Code.<sup>6</sup>

This legislative structure creates four broad categories of potential overwithholding.

First, the use of maximum rates ensures that too much tax will be collected. In the final regulations, the IRS did allow the use of the maximum rates of tax applicable to individuals on long-term capital gains, §1250 recapture of real estate depreciation, and collectibles. Beyond that, the IRS understandably felt unable to reduce 1446 tax that is excessive because of the use of maximum rates. Any further relief would need to be obtained from Congress, for example with respect to the 35% corporate rate that very few foreign corporations have to pay.

Second, there is an overlap between §§1445 (FIRPTA withholding) and 1446 in the case of sales of U.S. real property interests by domestic partnerships. Section 1445(e)(1) and the regulations thereunder provide that tax is to be withheld by the partnership at the highest rate (ordinary income or preferential rates for long-term capital gains and depreciation recapture); §1446 does the same. But by giving priority to §1446, the so-called "trumping rule," the IRS prevents the partnership from reducing the amount withheld through the use of the FIRPTA withholding certificate procedure, for which there is no equivalent under §1446.<sup>7</sup>

The third broad category concerns partner-level deductions, including:

- Loss carryovers (net operating loss carryovers or capital loss carryovers), even where the losses were derived by the partnership;
- Suspended losses, even where it is the partnership's own losses that have been released from suspension;

<sup>6</sup> One of the authors previously has considered what might be called virtual withholding issues arising under §1441, but in most if not quite all of these cases, money had changed hands. See Karlin & Malocha, "Virtual Withholding: Expanding the Observable Universe," *J. of Int'l Tax'n* (Nov. 1999).

<sup>7</sup> Regs. §1 1446-3(c)(2)(i).

<sup>5</sup> See T.D. 9200, 70 Fed. Reg. 28702 (5/18/05). Not long after enactment, the IRS issued Rev. Proc. 89-31, 1989-1 C.B. 895, to provide guidance under §1446. Rev. Proc. 89-31 generally followed the regime set forth in §6655 for estimated tax payments by corporations and required a partnership to annualize its ECTI and pay over the withholding tax to the IRS in quarterly installments and make a final payment with the annual tax return. Rev. Proc. 89-31 also provided special rules for publicly-traded partnerships and tiered partnerships. On Sept. 3, 2003, the IRS issued proposed regulations that were generally consistent with Rev. Proc. 89-31. On May 18, 2005, the IRS issued the final regulations (Regs. §§1.1446-1 through 5) and the temporary regulations (Regs. §1.1446-6T), the latter also being issued as proposed regulations.

- Charitable contribution deductions, even when the contribution was made by the partnership;
- State income taxes, even where these are paid on the partner's behalf by the partnership and whether or not state law mandated withholding by the partnership;
- Section 199 deductions, even though these deductions are readily calculated by the partnership if they relate to income allocated by the partnership;
- The exclusion of income from cancellation of debt, even partnership debt, even when the partnership and its foreign partners are insolvent and/or in bankruptcy; and
- The partnership cannot take into account tax credits allocated to its foreign partners.

The final regulations categorically reject any relief for these sorts of deductions if incurred in the current year and even if the deductions result from the activities of the partnership. The regulations provide relief only to good drivers and only with respect to deductions available from prior years, which excludes relief for almost all of the items in the list except for loss carryovers.

The final category, related to the second and third, concerns "phantom income" and cashless withholding problems. Variations can be seen in several different situations, reproduced from our prior article:

**Foreclosure and Tufts Gain.** B is the general partner of a U.S. limited partnership (ABC) which owns real estate in the United States that it purchased for \$11 million, financed by \$1 million in cash contributions from the partners and \$10 million in nonrecourse debt secured by a mortgage held by the Z bank. ABC has foreign limited partners entitled to an allocation of 50% of the income, gain, loss, deduction, and credits of the partnership. Over a period of time, rental income on the property is offset by interest expense, property taxes and other property-related expenses. During this period, the basis in the property declines to \$9 million by reason of depreciation deductions. Z bank forecloses on its mortgage. ABC has realized and recognized gain of \$2 million as a result of the foreclosure by Z bank. One million of the gain will be allocated to the foreign partners of ABC and the general partners will be responsible for 1446 tax on that amount except to the extent the foreign partners are able to provide good driver certificates.

**Cancellation of Indebtedness (COD).** B is the general partner of a U.S. limited partnership (ABC) which owns real estate subject to a \$10 million nonrecourse debt secured by a mortgage held by the Z bank. ABC has foreign limited partners entitled to an allocation of 50% of the income, gain, loss, deduction, and credits of the partnership. The real property declines in value to \$9 million. In a workout, bank forgives \$1 million of the mortgage indebtedness. The result is ordinary income of \$500,000 for the foreign partners and \$1446 withholding of \$175,000. ABC has no cash to pay the withholding tax. If they are good drivers, the foreign partners can certify past year losses and deductions to ABC but they cannot anticipate that they will be entitled to exclude the cancellation of indebtedness income under §108. Note that there is no obligation on the foreign partner to make a good driver certification, unless the partnership agreement explicitly so provides.<sup>8</sup>

**Non-Existent Profits.** ABC has two partners, B, a general partner, and C, a nonresident alien. ABC borrows \$1 million secured by ABC's receivables, and spends this amount on deductible expenditures. The net loss of \$1 million is allocated to B and C. The following year, ABC turns the corner and earns a profit of \$500,000. ABC must withhold \$87,500 on C's \$250,000 allocable share of profit, notwithstanding the fact that ABC may have no funds and that all or most of the 1446 tax withheld with respect to C will be refundable to C (not to ABC) when C files a return and applies the NOL from year 1.

**Restricted Access to Cash.** ABC partnership has pledged all of its assets, including all cash rental income received, to Z bank to secure Z bank's loan. ABC has allocations of effectively connected taxable income to the foreign partners but is restricted from making any cash distributions to these partners because of ABC's security arrangement with Z bank.

<sup>8</sup> The NYSBA report cited in footnote 3, *supra*, helpfully distinguishes between COD income that arises in cases of insolvency and circumstances other than insolvency, such as in the case of certain significant modifications of a debt instrument under Regs. §1.1001-3, where the borrower (and the borrower's partners) may not in fact be insolvent.

Numerous comments had recommended varying forms of relief under §1446 in the case of foreclosure gain and COD gain where there was no cash. The need for relief where COD income will be excluded at the partner level is particularly acute because the good driver certificate currently does not permit a current year deduction to be included in the certificate. The government rejected relief in these situations, except to the limited extent available under a "good driver" certificate. It is continuing to consider comments submitted by the ABA Section of Taxation and others but it is not really possible to predict whether we can expect any additional relief beyond the "good driver" certification procedures, to which we now turn.

### **"GOOD DRIVER" CERTIFICATION**

In the final regulations, the IRS declined to consider any form of withholding certificate procedure. What the IRS has done is to provide a procedure in temporary and proposed regulations for certain foreign partners to certify certain losses and deductions to the partnership. The procedure is set out in Regs. §1.1446-6T. Regs. §1.1446-6T permits a foreign partner who has timely filed or will timely file a federal income tax return in each of the partner's preceding four taxable years (as well as the partner's taxable year or years during which the certificate is to be considered), and has timely paid (or will timely pay) all tax shown on the returns to certify annually to a partnership (other than a publicly traded partnership) the deductions and losses connected with or properly allocated and apportioned to gross income that is effectively connected with the partner's U.S. trade or business and that the foreign partner reasonably expects to be available to reduce the partner's U.S. income tax liability on the partner's allocable share of ECI from the partnership. This foreign partner is considered to be a "good driver." The partnership can, upon receipt of a good driver certificate, take into account the potential deductions and reduce the amount of ECTI with respect to the good driver partner to reduce the 1446 tax for such partner.

So far as the partnership is concerned, the preamble and the regulations make clear that this procedure is voluntary. In other words, the fact that the foreign partner has provided a "good driver" certificate does not mean the partnership has to consider it. Due to a partnership's continuing exposure to payment of 1446 tax as well as interest, additions to tax and penalties, not to mention the certificate actually being incorrect, the partnership might simply ignore such a certificate.

### **THE IMPACT OF OVERWITHHOLDING ON PARTNERSHIPS AND GENERAL PARTNERS**

In consistently requiring overwithholding of tax, §1446, as implemented by the regulations, creates a

burden that goes well beyond creating a cash flow problem for the foreign partner and potentially long-term interest-free deposits of tax with the U.S. Treasury. It places the burden of funding the overwithholding on the partnership and, if the partnership's cash flow is inadequate or the foreign partner's capital account is exhausted, the burden may fall directly on general partners, managers, and other responsible persons to fund what are, in substance, compelled distributions to the foreign partners. Moreover, this burden arises on the basis that 1446 tax is a withholding tax, even though in substance it is a form of estimated tax. Withholding taxes give rise to some of the toughest penalties in the Code and, because of §1446's unique structure, these can fall on persons who have not in fact failed to "withhold" anything since there may have been no money or property in their possession or control.

Under §1461, as a withholding agent, the general partner or the manager of the limited liability company is responsible for making the required partnership filings and for remitting the quarterly withholding payments to the IRS. If the partnership does not make the required filings or remit the withholding taxes, the general partner, the manager, and the officers of a corporate general partner or manager may be subject to civil and, in a rare case, criminal penalties for failure to file and to pay tax (including the trust fund recovery penalty under §6672) as well as interest for failure to pay estimated taxes and to remit tax when due. Thus the financial consequences of not complying with §1446 withholding can be very significant. The numerous penalties and interest payments combined with the actual withholding tax liability itself can become a large financial burden to the withholding agent. Even though the actual income tax liability rests with the individual partners, if the withholding agent has failed to withhold or has withheld incorrectly, the withholding agent remains liable for the partners' payment of those taxes.

Section 1446 interferes in the relationship between the partnership, its general partners or managers and other responsible parties, on the one hand, and the foreign partners on the other. Specifically, §1446 acts to compel distributions to partners that might not otherwise be made under the terms of the partnership's governing documents. The §1441 regulations do this too, but only in situations where partnerships actually have cash or property that gave rise to the withholding obligation and where the tax usually is pretty accurate. The exaction of withholding taxes from a partnership has the same effect as if the government had transferred partnership property to the foreign partners and forced the general partners or managers to fund the transfer in any case where cash is unavailable.

Nor can one realistically imagine some mechanism, statutory or regulatory, by which the partnership or the general partner could retrieve the tax once the determination of overwithholding had been made.

## DRAFTING A PARTNERSHIP AGREEMENT FOR A PARTNERSHIP WITH FOREIGN PARTNERS

We have demonstrated that in practice §1446 can impose significant excessive taxation. If the burden fell only on foreign partners, U.S. business partnerships might complain that the law is a barrier to foreign investment but could leave the costs (other than the compliance burden) entirely on the foreign partners.

Section 1446 commands a U.S. business partnership to pay tax on behalf of a foreign partner. Section 1446(d) correctly characterizes this payment as a distribution, because the payment will result in a credit to the partner's account with the IRS that will either discharge the partner's liability or will, eventually, be refunded to the partner. One way or the other, the foreign partner will get the benefit of the payment — the partnership will not see the payment again.

Perhaps this would not be a problem if the amount required to be withheld bore some reasonable relationship with the tax due by the foreign partner. Many partnerships include provisions requiring minimum distributions to partners sufficient to enable the partners to pay the tax due on their allocable shares of partnership income. But these provisions can and usually are structured to operate much more flexibly than §1446. For example, the rate usually will be a blended rate that takes into account state income taxes and the income to which the rate applies will take account of all of the partner level deductions that §1446 does not allow. There also will be some provision allowing the partnership not to make a distribution if the partnership does not have sufficient available cash flow or a distribution would breach loan covenants.

Drafters of partnership agreements need to be aware of this. Indeed this need applies even in the case of purely domestic partnerships with domestic partners, because partnership interests can end up in the hands of foreign partners.

## ALLOCATION PROVISIONS

What can the drafter do? One obvious approach to limiting the impact of §1446 would be to see if there is a way to limit allocations to foreign partners of ECTI. Fairly obviously, this will change the economics of the transaction or else invite a challenge by the IRS on whether the allocation has substantial economic effect under §704(b). Nevertheless, §1446 may

otherwise have such a severe impact on partnership economics that some change in the economics will make sense.

There are two general ways in which allocations might be changed. The first would be where the partnership has both ECTI and other forms of income. The non-ECTI might be foreign source income or FDAP income or other income not subject to tax, such as non-real estate capital gains. In such a situation, the allocation provision might provide for disproportionate allocations of ECTI to domestic partners and non-ECTI to the foreign partners.

Perhaps the most likely situation in which this approach might work would be a service partnership where the foreign partner was not performing services within the United States. Readers are referred to the thoughtful and detailed look at multinational partnerships by Kimberly Blanchard in an excellent article in the *Tax Lawyer* in 2003 and a similarly excellent article by Gregory May in *Tax Notes* in 2004.<sup>9</sup>

A second way would be to seek ways to minimize allocations of ECTI to the foreign partners during the early years of the partnership and then have the foreign partner catch up in later years. For example, a real estate partnership might allocate operating income to the domestic partners for four years with a catch-up provision coming into effect in the fifth year or on sale of the partnership's property. One reason for choosing four years is that it would give the foreign partner the four years needed to establish "good driver" status so that when ECTI allocations began, the partnership and the foreign partner could take advantage of certification of prior year losses.

If either or both of these approaches are adopted, the allocation provisions will have to satisfy the requirements of the §704(b) regulations. Allocations of income that are transitory as to class or timing tend to be viewed with suspicion<sup>10</sup> but so long as the parties are not guaranteed or afforded a high level of certainty that the results will be identical to proportionate allocations, the allocations should be upheld.

A third approach might be to estimate the amount of profits to which the foreign partner would be entitled and, instead of making an allocation of profits to such a partner, provide for the foreign partner to receive a guaranteed payment under §707(c). A §707(c) payment is not part of ECTI and therefore not subject to §1446. Moreover the partnership gets a deduction

<sup>9</sup> See Rev. Rul. 2004-3, 2004-7 I.R.B. 486. For a review of this issue, see May, "Wrongs And Remedies: The U.S. Tax Treatment of Multinational Partnerships of Individuals," 103 *Tax Notes* 1509 (2004) (considering the ruling in depth); Blanchard, "The Unresolved Tax Status of Multinational Service Partnerships and Their Partners," 56 *Tax Law.* 779 (2003) (pre-dating the ruling).

<sup>10</sup> See Regs. §1.704-1(b)(2)(iii)(c)

for guaranteed payments so that in the end no US partner will be taxed on amounts paid as a guaranteed payment. This approach lacks mathematical precision since a guaranteed payment is not dependent upon the income of the partnership. Rather, it is an estimate of what profits a partnership will have.<sup>11</sup>

## DISTRIBUTION PROVISIONS

In many cases, mitigation of §1446 cannot be adequately effected through the allocation provision. The partnership may only generate ECTI and the partners may be unwilling to accept the risks of disproportionate allocations.

The drafter of the partnership agreement will turn next to the distribution provision. The first step is to coordinate the distribution provisions of the agreement with the requirements of §1446. We have provided in the appendix a sample (not model!) distribution clause that includes provision for a minimum distribution to enable partners to pay their tax. This clause will illustrate points to be taken into consideration in drafting distribution provisions.

Subsection 1 calls, as do most partnership agreements, for the distribution to the partners of net cash available for distribution. Depending on the circumstances, the partnership agreement will give the general partner or the manager more or less discretion in determining what is available and of course the partnership may be constrained by loan covenants or other creditor rights.

Subsection 2 then provides that a minimum distribution of net cash will be distributed to the partners equal to each partner's assumed tax obligations resulting from allocations of profits for the fiscal year. Subsection 2 tracks §6655(d) to some extent, requiring an effective tax rate to be applied to 25% of the lesser of prior year profits and projected current year profits.

Subsection 2 includes alternative ways of determining the effective tax rate. The simple version is a fixed percentage. The more complex version is useful only if the partnership's tax affairs are complicated and there is a need for varying percentages based on activities in multiple jurisdictions or it is expected that long-term capital gain will be taxed at preferential rates. It should be noted that if a partnership has both corporate and individual partners, it may be necessary to ignore preferential rates in order to accomplish the twin aims of making the distributions proportionate and making distributions sufficient to enable the higher-rate paying partner to pay its tax.

Subsection 3 then provides, consistently with §1446(d), that any tax (federal, state, local, or foreign)

withheld by the partnership on account of any allocation or distribution to a partner is to be treated as a distribution to that partner. Subsection 3(e) provides that the tax is to be on account of the priority tax distribution under subsection 2.

Thus far, we have accomplished no more than to coordinate the partnership distribution provision, including the priority tax distribution, with the requirements of §1446 (and, indeed, any other withholding tax). Subsection 4, however, is the vehicle for protecting the partnership where the withholding tax exceeds the priority tax distribution. The partner in receipt of an excess distribution is required to make a capital contribution equal to the excess unless the general partner elects to equalize the treatment of the partners who do not receive excess distributions.

An alternative approach would be to require the foreign partner to fund any 1446 tax ahead of when it was due. This approach would be particularly appropriate in a case where the partnership does not wish to make any distributions at all. Subsection 4 provides for this possibility.

## PROVISIONS RELATING TO GOOD DRIVER CERTIFICATIONS

The partnership agreement should provide for the treatment of good driver certifications under Regs. §1.1446-6T. The regulations in fact do not require the partnership to accept a certificate, even one that on its face is valid and appears to meet all the requirements. However, the sample provision (subsection 3(c)) states that the partnership is required to accept and act on a valid and updated certificate but does not compel the foreign partner to submit one.

Whether or not the partnership agreement requires the partnership to accept a good driver certificate, the foreign partner still needs to decide whether to go through the burdensome certification process. The agreement could also be drafted to require that any eligible foreign partner must provide a certificate. But such a requirement presents its own difficulties. It is hard to envision a remedy for failure by a foreign partner to comply and failure to comply would most likely occur in circumstances where the difficulties of enforcement would be at their greatest, such as when the partnership or the foreign partner or both were financially distressed. A corporate foreign partner might have undergone a change of executive personnel leaving no one willing to make the declarations under penalty of perjury required to support a certification.

Good driver certifications are, in any case, of little practical use. They are not available until the foreign partner has timely filed four consecutive years of tax returns. They only allow claims to be made for prior year items. They require the provision of a great deal

<sup>11</sup> For further discussion of guaranteed payments, see May, at footnote 9, *supra*



of information and even the slightest modification requires the foreign partner to resubmit the entire certification to the government and the partnership. The partnership may not be entitled to rely on a certification deemed by the IRS to be defective and it actually is not clear if this is true for future withholding or whether reliance is retroactively invalidated. Finally, and most importantly, they provide little or no protection to the partnership — little more than relief from estimated tax penalties but not from payment of the tax, interest or other penalties. One list of these penalties appears in comments on §1446 submitted by the New York State Bar Association.<sup>12</sup>

- Section 6651, which imposes an addition to tax for failure to file a return, failure to pay tax shown, or failure to pay any tax that was required to be shown on the return after notice thereof, unless reasonable cause is demonstrated.
- Section 6672, which imposes liability for tax on any person (i.e., responsible persons other than the partnership itself) required to collect, truthfully account for and pay over the tax or that willfully attempts to evade or defeat the tax.
- Section 7202, which imposes criminal liability of a fine or up to five years imprisonment on any person required to collect, truthfully account for and pay over the tax who willfully fails to do so.
- Section 6662, which imposes accuracy-related penalties for substantial understatements of tax.
- Section 6663, which imposes penalties for understatements due to fraud.
- Section 6721, which imposes a penalty for each failure to file correct information returns.
- Section 6722, which imposes a penalty for each failure to file correct payee statements.
- Section 6723, which imposes a penalty for each failure to comply with information reporting requirements.
- Section 6724, which provides exceptions for liability under §§6721 through 6723 if reasonable cause is demonstrated.
- Section 7201, which imposes felony liability for willful attempts to defeat or evade tax.
- Section 7203, which imposes misdemeanor liability for willful failure to make returns or pay estimated tax.

Given the hoops that foreign partners must jump through to provide good driver certifications and the modest protection they afford to partnership and responsible persons, there may be few situations where a partnership should consider it worth the trouble or the risks involved to ask for or accept the certifications.

## RESTRICTIONS ON TRANSFER

As noted above, partnership interests can end up in the hands of foreign partners because of voluntary or involuntary transfers or because of a change of status. Voluntary transfers may include sales or exchanges, gifts as well as distributions of a partnership interest by partners that are corporations or partnerships; involuntary transfers could include transfers upon the death or bankruptcy of a partner or a foreclosure or the exercise of a power of sale in a security agreement. U.S. citizens may become foreign by expatriating or aliens simply cease to be resident; a domestic trust can become a foreign trust simply by failing the court test or the control test; domestic corporations and other entities can reorganize into foreign corporations or entities.

It follows that partnerships that may have considered themselves to be entirely domestic with no foreign partners can find that they have foreign partners as a result of events occurring after the partnership agreement was drafted.

Most partnership agreements contain provisions relating to the transfer of partnership interests. Given the burdensome nature of §1446 withholding, both in terms of the compelled distributions to foreign partners and the compliance requirements, drafters of partnership agreements should consider restricting or forbidding transfers of interests to foreign persons. In a case where a partnership interest comes into the hands of foreign partners through an involuntary transfer, the partnership interest should provide for prompt divestiture to a U.S. person, unless the partnership is willing to endure the consequences of having a foreign partner.

## LIMITATIONS TO APPROACHES BASED ON PARTNERSHIP AGREEMENT DRAFTING

Even the most artfully drafted partnership agreement, under which foreign partners are required to fund the 1446 tax in advance or refund it to the partnership in arrears, or at least the overwithheld portion of the 1446 tax, will not help in some circumstances. Such circumstances include the insolvency of the foreign partner or the existence of a dispute between the foreign partner and the partnership.

<sup>12</sup> NYSBA report, at footnote 3, *supra*

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In the COD example above, withholding may be required in a situation where the general partner may have no cash. Withholding may well result in U.S. general partners paying tax that gets refunded to an insolvent foreign partner and ends up being paid to the insolvent foreign partner's creditors. In this situation, there is no way for the U.S. partners to recoup the overwithholding.

In a less extreme situation, suppose that the partnership's financial misfortunes caused the foreign partners to become dissatisfied with the conduct of the business of the partnership. We can well imagine a foreign partner that was eligible to file a good driver certificate actually refusing to do so. We also can imagine that a corporate foreign partner that had undergone a change of management might be unwilling to give good driver certifications simply because the new managers were unwilling to make declarations under penalty of perjury concerning facts they might be unable to verify.

### ALTERNATIVES TO STRUCTURES WITH FOREIGN PARTNERS

U.S. businesses considering infusions of equity capital from foreign businesses need to consider if there are alternatives to structuring their investments without using a partnership vehicle. Leaving aside the possibility of using a domestic corporation instead, a choice that in many cases will be unacceptable to the U.S. owners, there seem to be three principal alternatives that might be used in appropriate circumstances.

The first, most suitable for holding real estate rental assets, would be co-tenancy. Any such structure would have to be carefully designed not to create a *de facto* partnership. Management of the property could be contracted out to a third party, perhaps one related to the U.S. promoter of the investment that would be entitled to receive commissions and fees that would serve as a proxy for the income allocations that would have gone to the promoter.

The second would be a partnership where the foreign partner was required to invest through a U.S. corporation. Such a corporation could be wholly-owned by one or more foreign investors and would not be subject to withholding under §1446. The additional cost of such an investment structure for all foreign investors would be potential double taxation of corporate earnings. The double taxation largely would be mitigated or even eliminated for foreign investors that are corporations based in treaty countries; it also would be somewhat mitigated if the partnership were engaged in a start-up business that was in any event expected to be incorporated and sold in a private sale or an IPO. In those circumstances, §1446 might not be such a burden because of the likely pattern of early

year losses but it would become a huge burden if the losses turn around and the good driver certification is not available, something that is all too likely if the foreign partners are late filing tax returns for loss years when no tax is due.<sup>13</sup>

A third alternative would be to require the foreign partnership to form its own domestic partnership to invest in a U.S. business partnership. This would not eliminate the application of §1446 but it would eliminate the exposure of the lower tier partnership and transfer responsibility for withholding to the upper tier partnership.<sup>14</sup> There appears to be no rule applicable to domestic partnerships comparable to the rule relating to the use of a domestic trust where a partnership knows or has reason to know that a foreign person holds its interest in the partnership through a domestic trust, and such domestic trust was formed or availed of with a principal purpose of avoiding the 1446 tax.<sup>15</sup>

### OTHER ISSUES: DISPOSITION OF PARTNERSHIP INTERESTS AND ESTATE PLANNING

Dispositions of partnership interests by foreign persons are not subject to §1446, or indeed any other form of withholding unless real estate assets are involved.<sup>16</sup> However, in structuring an investment, the drafter of the partnership agreement should be cognizant of the tax consequences of a potential exit strategy that may include such a sale. The IRS has ruled that where a foreign partner disposed of its interest in a partnership engaged in a trade or business through a fixed place of business in the United States, gain or loss would be U.S. source ECI (or loss that is allocable to ECI, as the case may be).<sup>17</sup> However, this was limited to the extent that the partner's distributive share of unrealized gain or loss would be attributable to property the sale of which would give rise to ECI or loss allocable to ECI.<sup>18</sup> This ruling is controversial, since the IRS offered no reasoned analysis or authority for its position and it is plainly arguable that the

<sup>13</sup> Perhaps the likelihood of late filing will be increased in light of the Tax Court's judgment in *Swallows Holding, Ltd. v. Comr.*, 126 T.C. No. 6 (2006) invalidating the 18-month rule in Regs. §1.882-4(a)(2) and (3)(i).

<sup>14</sup> See Regs. §§1.1446-1(c)(2)(ii)(A), 1.1446-5(a) and (e).

<sup>15</sup> Regs. §1.1446-3(d)(2)(iii)(B) (requiring, in such case, the partnership to pay §1446 tax as if the domestic trust was a foreign trust for purposes of §1446 and the regulations thereunder).

<sup>16</sup> §1445(g).

<sup>17</sup> Rev. Rul. 91-32, 1991-1 C.B. 107.

<sup>18</sup> Rev. Rul. 91-32, 1991-1 C.B. 107. See also Smiley, "Disposition of U.S. Partnership Interests by Nonresident Aliens," 8 *J. of Partnership Tax'n* 133, 139-140 (1991 — this article predated Rev. Rul. 91-32, discussed below).



sale of a partnership interest should be treated as a capital gain that is not effectively connected with a U.S. trade or business in the absence of a specific provision such as §897(g). The IRS also ruled that any gain would be attributable to a permanent establishment if the partnership had an office or fixed place of business and would not therefore be exempt under the capital gains provision of a treaty.

It is equally beyond the scope of this memorandum to consider the estate tax consequences of investing through partnerships and corporations. However, readers will no doubt be thinking of these when the foreign investors are individuals. A look at the tangled world of estate taxation of partnership interests can be

gleaned from the articles cited in the footnote.<sup>19</sup>

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<sup>19</sup> See Cassell, Karlin, McCaffrey, & Streng, "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," 99 *Tax Notes* 1683 (2003); State Bar of California, Taxation Section, International Committee, "Why Section 2104 Must Address when Partnership Interests Owned by Foreign Investors are (and are not) subject to United States Estate Tax" (2003) (the principal author of the paper was Patrick W. Martin); Hudson, "Tax Effects of Choice of Entities for Foreign Investment in US Real Estate and US Businesses," 4 *BET* 4 (Mar 2002); Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues," 51 *Tax Law* 110 (1997). Additional resources in this area can be found at <http://law.karlinks.com/ABA>.

## MEMORANDUM

### APPENDIX — Sample Partnership Distribution Provision

#### Section \_\_. DISTRIBUTIONS

##### \_\_1 Distribution of Net Cash

Subject to the following provisions of this Section, Net Cash available for distribution, if any, shall be distributed to the Partners in proportion to their Percentage Interests.

##### \_\_2 Minimum Distribution

(a) On [not later than \_\_ {number no greater than 15} day of April, June, September and December in each year, the Partnership shall distribute Net Cash in an amount equal to each Partner's assumed tax obligations for the fiscal quarter. In the event that all of the Partners and, in the case of any Partner that is itself a pass-through entity required to allocate its income to its owners, all of the owners of such Partner ("Owners") are individuals or pass-through entities, the word "January" shall be substituted for the word "December" in the preceding sentence.

(b) The assumed tax obligation of a Partner in each quarter shall be computed by applying the Effective Rate, as defined below, to the taxable amount for the quarter:

(1) For the each quarter, the taxable amount shall be the Partner's allocable share of 25% of the lesser of (A) the Profits for the fiscal year as projected by the Partnership and (B) the Profits of the preceding fiscal year. The allocable share of the Partner shall be determined consistently with section \_\_ of this Agreement (Allocations)

(2) The Partnership shall reduce the amount of Profits by the amount of any Losses charged to the Partner in any prior fiscal year net of any Profits allocated to such Partner in any prior fiscal year.

(c) The expression "Effective Rate" means an effective tax rate of \_\_\_\_\_percent (\_\_\_%).

*[The following is a sample of an effort to make the Effective Rate as accurate as possible. It takes into account multistate income but not the effects of where Partners are resident or commercially domiciled or the AMT. The assumption is that the rate will be the highest applicable to any (significant) Partner, realizing that such Partner might differ from one state to another. It's questionable whether all this complexity is worthwhile unless the amounts are large.]*

[(c) For purposes of this Section \_\_2, the expression "Effective Rate" shall be computed by first deriving a percentage applying the following formula

$$S - F \times (100 - S)$$

in the case all Partners owning at least a 10% interest in the Partnership and if there is none, then applying it to the Partners resident in the states where S is the highest. In the formula, S is the highest rate of tax applicable to any Partner or Owner under the laws of a state from which the Partnership has derived income subject to tax by that state and F is the highest rate to which §1 or §11 of the Internal Revenue Code. For the avoidance of doubt, no account shall be taken of the alternative minimum tax. The Partnership shall then treat as the Effective Rate for income from any state the highest percentage obtained by applying the formula.

**[Illustration:** The Partnership derives \$100 of long-term capital gain and \$100 of ordinary income in California and \$100 of income in Florida. The 10% Partners are all individuals resident, or corporations with a commercial domicile, in California. In California, S is 10.3% for individuals and 8.84% for corporations and in Florida S is 0% for individuals and 5.5% for corporations. Assume the Federal rate of tax on ordinary income is 35% for corporations and individuals and 15% for long-term capital gains of individuals.

The Partnership would compute rates as follows:

	CA	CA	CA	FL	FL
	Individual	Corporate	Individual	Individual	Corporate
	L-TCG	All	Ordinary	All	All
State rate (S)	10.30%	8.84%	10.30%	0.00%	5.50%
Federal rate (F)	15.00%	35.00%	35.00%	35.00%	35.00%
100 – S	89.70%	91.16%	89.70%	100.00%	94.50%
F × (100 – S)	13.46%	31.91%	31.40%	35.00%	33.08%
S + (F × (100 – S))	23.76%	<b>40.75%</b>	<b>41.70%</b>	35.00%	<b>38.58%</b>

If there are any 10% corporate Partners, the Effective Rate for California long-term capital gain would be 40.75% and for ordinary income would be 41.70%. and the rate for Florida income would be 38.58%. Note that it is the higher rate that is applied, even though this may result in individuals being entitled to distributions in amounts greater than their anticipated allocation of capital gains.]

(d) If the net income of the Partnership is taxable by more than one state, the computation of the Effective Rate and the taxable income shall be made state by state and the result aggregated to yield the assumed tax obligation. The computation shall be made for each state based on the allocation of income to that state under the state's rules concerning allocation and apportionment of income and without taking account of a Partner's residence or commercial domicile. If however the aggregate amount of income allocable to all of the states is more than the aggregate amount of Partnership income for federal income tax purposes ("federal income") due, for example but without limitation to differences in state law (such as methods of allocation and apportionment), the Partnership shall reduce the amount of income for each state in the respective proportions that the amounts of income for each state bears to such aggregate of federal income.

### **\_.3 Amounts Withheld**

(a) All amounts withheld pursuant to the Code or any provision of any Federal, state, local or foreign tax law with respect to any payment, distribution or allocation to the Partnership or the Partners shall be treated, for all purposes under this Agreement, as amounts distributed to the Partners with respect to which such amount was withheld pursuant to this Section \_3. The Partnership is authorized to withhold from payments and distributions, or with respect to allocations to the Partners, and to pay over to any federal, state and local government or any foreign government, any amounts required to be so withheld pursuant to the Code or any provisions of any other federal, state or local law or any foreign law and shall allocate any such amounts to the Partners with respect to which such amount was withheld.

(b) Every Partner shall provide to the Partnership from to time as provided by law a Internal Revenue Service Form W-8BEN or W-9 to establish the Partner's status as a domestic or foreign partner and to establish such Partner's tax classification as an individual or as corporation or other form of entity.

(c) The Partnership will accept and act on a valid and updated certificate from any Partner under Treasury Regulation §1.1446-6T. Every foreign Partner and Owner that is eligible to provide such a certificate shall do so and shall update such certificate as required by the regulation. Foreign Partners and Owners shall take all reasonable steps to become and remain eligible and, in particular, shall file their Federal income tax returns accurately and on a timely basis.

(d) Foreign Partners shall be responsible for causing their respective Owners (if any) to comply with paragraphs (b) and (c).

(e) Any amount withheld under Section \_3 with respect to any Partner shall be treated as being made on account of such Partner's entitlement to distributions first under Section \_2 and then under Section \_1. Any amount distributed under Section \_2 shall be treated as an advance on such Partner's entitlement to distributions under Section \_1.

## MEMORANDUM

### **\_\_4 Recontribution of Excess Distribution**

(a) If the amount withheld and treated as distributed under Section \_\_3 exceeds the amounts that would otherwise be distributed to the Partner under Section \_\_1 and \_\_2, the Partner to whom the excess distribution applies shall upon demand by the General Partner make a Capital Contribution to the Partnership equal to the excess, unless the General Partner elects, no later than April 10 in the year following the fiscal year to which the excess distribution relates to cause the Partnership to make a distribution to the other Partners that will result in the total distributions to all Partners being proportionate to their Percentage Interests, which distributions shall be treated as made on account of their entitlement to distributions under Section \_\_1.

(b) The Capital Contribution required under paragraph (a) shall be due and payable on April 15 in the year following the fiscal year in which the excess arose and until it shall have been made, the excess shall bear interest at the rate publicly announced by Bank of America NA as its "Prime Rate," compounded annually and may be funded by being deducted from or offset against any other amount due by the Partnership to the Partner in any capacity. If the General Partner reasonably projects that any payment of tax will result in an excess described in paragraph (a), it may require Partner to make the Capital Contribution at an earlier date not more than ten (10) days prior to the due date of the tax.

If within fifteen (15) days following the date on which an excess distribution shall have arisen, the General Partner shall fail to take action described in paragraphs (b) or (c), any Partner who could be entitled to a distribution under paragraph (b) may act on behalf of the Partnership in the General Partner's place.

### **\_\_5 Distributions Discretionary**

Subject to applicable law and the other provisions of this Section \_\_, the General Partner shall determine when Net Cash available for distribution shall be distributed to the Partners and the amount of such distributions. Notwithstanding any other provision of this Agreement, no distribution shall be made, if, after giving effect to such distribution:

(a) The Partnership would not be able to pay its debts as they became due in the usual course of business; or

(b) The Partnership's total assets would be less than the sum of its total liabilities, plus the amount that would be needed if the Partnership were to be dissolved at the time of distribution to satisfy the preferential rights of the other Partners, if any, upon dissolution that are superior to the rights of the Partner receiving the distribution.

### **\_\_6 Identity of Distributees**

Distribution shall be made only to persons who, according to the books and records of the Partnership, are the owners of record of Partnership Interests on the date to be determined by the General Partner. Neither the General Partner nor the Partnership shall incur any liability for making distributions in accordance with the preceding sentence, whether or not the General Partner has knowledge or notice of any transfer of ownership of any Partnership Interest.