Uncle Sam Meets Uncle Scrooge—The Temporary Regulations on Foreign Partner Withholding (Part 2)

"Mercy!" said Scrooge. "Dreadful apparition, why do you trouble me?" [1]

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Part 1 of this article in the October issue reviewed the final Regulations under Section 1446 of the Internal Revenue Code published by the IRS in the federal Register on May 18, 2005. [2] In this second part, we review the Temporary Regulations (also TD 9200) and Proposed Regulations (REG-108524-00, with cross-reference to TD 9200) issued at the same time and redeem our promise to offer some comments on the future of this tangled area of the law.

Background

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 implement this simple-sounding concept relentlessly and humorlessly.

In particular, the final Regulations interpret the statute to require that in computing the effectively connected taxable income (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. This rule essentially guarantees that the "1446 tax," as it is referred to in the Regulations, will almost always be greater than the foreign partner's actual tax—indeed in some cases the partnership will pay a substantial 1446 tax when no tax at all is due by the partner.

The authors could not think of a single significant withholding provision, in the international or domestic area, where an income recipient 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 Service, obtaining a ruling or determination, or entering into an agreement with the Service.

In the final Regulations, the Service declined to consider any form of withholding certificate procedure. What the Service 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 (see Temp. Reg. 1.1446-6T).

This article looks closely at the Temporary Regulations. The relief offered to partnerships and partners is modest, one might say timorous, and while Uncle Scrooge's crumbs are not to be swept under the table, we have to hope that when the Regulations are finalized, they can be made more useful to a broader group of taxpayers. And there seems little doubt that if the Service's timidity about using its authority to make sense of Section 1446 cannot be overcome, legislative change may be needed for this purpose.

Why should we care about this? Section 1446 in its current form is bad law but it has been bad law for 17 years (19, if you count the aborted earlier version enacted in 1986). During that period, the authors and others have complained about it but it has hardly inspired much fervent opposition. Instead, many tax advisors aware of Section 1446 have simply planned around it by advising their U.S. clients to require that foreign investors form U.S. corporations to act as partners in U.S. business partnerships, having those investors invest in debt instruments with equity kickers that qualify as interest, or having foreign investors invest directly in U.S. assets, with payments to U.S. joint venturers structured as management fees with profit-related bonuses. In these alternate structures, either no withholding is required or the withholding is relatively accurate. So, if we can structure around Section 1446, why keep tilting at this particular windmill?

The reasons are these: First, Section 1446 discriminates against the use of the partnership form and it is simply bad policy to have structuring of foreign investment driven by excessive withholding taxes. Second, Section 1446 acts as a method for compelling U.S. business partnerships to distribute cash to foreign partners and thereby interferes in business relationships of partnerships and partners—if withholding is necessary to protect the government, it should be reasonable and certainly not capable of yielding results that in extreme, but readily imaginable, cases are deeply unfair not just to foreign partners but also partnerships and their general partners and managers. Third, we ought not to have a withholding provision that gives the income recipients no way to avoid excessive withholding, especially on phantom income—and as seen below, the Temporary Regulations barely begin to address this problem.

Now that the authors' feelings on the subject are clear, we begin our examination of the Temporary Regulations.

Temp. Reg. 1.1446-6T: The Good-Driver Rule

The Temporary Regulations permit a foreign partner to certify annually to a partnership (but not a publicly traded partnership (PTP)) 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.

The Preamble and the Regulations make clear that this procedure is voluntary, so far as the partnership is concerned. Just because the foreign partner has provided a certificate does not mean that the partnership has to consider it. On the contrary, the partnership has no such obligation, understandably given the partnership's continuing exposure to payment of 1446 tax as well as interest, additions to tax, and most penalties in the event of numerous potential foot faults, not to mention the certificate actually being incorrect.

A foreign partner may provide the certification only if the partner is, in the idiom of the Preamble and, before that, the comments prepared by the authors and others and submitted through the ABA Section of Taxation, [3] a “good driver,” meaning that the partner has timely filed or will timely file a federal income tax return in each of the partner's preceding four tax years as well as the partner's tax 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. The Temporary Regulations set out detailed requirements regarding the contents and validity of good-driver certificates, as well as the timing for the delivery of certifications and updating and revocations of certificates.

The good-driver certificate can include deductions and losses (but not, it would seem, credits) 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 partnership ECI. The foreign partner generally must represent that such deductions and losses have been (or will be) reflected on a timely filed U.S. income tax return of the partner for a tax year that ends before the partnership tax year for which the certificate is considered. In other words, no anticipated deduction or loss with respect to the partner's current-year operations may be considered. There are several limitations on the scope of the certification, notably that a partnership may not consider a net operating loss (NOL) deduction in an amount greater than 90% of the partner's allocable share of ECTI.

We turn now to a detailed description of these requirements and then make some observations on what the good-driver certificate procedure does and does not accomplish. Let it be said at once, however, that if this or anything like it turns into the final word of Treasury and the Service on the subject, legislative change will be the only way to bring some rationality to this area of tax law.

Eligibility.

The basic requirement of Temp. Reg. 1.1446-6T(b) is that a foreign partner must have timely filed or will timely file a federal income tax return in each of the partner's preceding four tax years as well as the partner's tax year(s) during which the certificate is considered, and has timely paid (or will timely pay) all tax shown on such returns. In addition, the foreign partner must have provided the appropriate documentation to the partnership under Reg. 1.1446-1, which usually will be a Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding).

There is no requirement that the partnership have been in existence during this entire period or that the foreign partner have been a partner in the partnership at any time before the year in which the partner provides the certificate. The purpose of the good-driver certificate procedure is to identify compliant foreign taxpayers and this compliance does not need to have been demonstrated as a partner of the withholding partnership or any other partnership.

In a partnership (upper-tier partnership or UTP) that is a partner in another partnership (lower-tier partnership or LTP), good-driver certification is available to reduce 1446 tax due by the LTP with respect to a foreign partner of the UTP only to the extent that the look-through provisions of Reg. 1.1446-5 apply and the certificate is provided by such foreign partner to the UTP and, in turn, to the LTP. The look-through rules state that an LTP may but does not have to look through a foreign UTP to the UTP's partners in applying Section1446 and a domestic UTP may, with the LTP's agreement, in effect elect to transfer its 1446 responsibilities to the LTP. If the look-through provisions do not apply, the LTP cannot take account of a certificate from a partner in the UTP.

A partner that is a foreign estate is not permitted to give a good-driver certificate. It is not clear how many foreign estates that are partners in partnerships engaged in a U.S. trade or business

could take so long to administer that they might ever qualify as a good driver, but even less clear why the Service felt it had to exclude them (or even take time to consider excluding them). We think that the Service should include estates or explain why it does not.

Good-driver certification is also not permitted in non-grantor foreign trusts. Why such trusts might be unworthy of the Service's confidence is a bit of a mystery but we can guess that the Service was concerned about the administrability of the requirement because of the varying allocations of responsibility for tax between a trust and its beneficiaries, depending on the terms of the trust and its distribution patterns.

It is worth pausing a moment to see how Section 1446 applies to partners that are non-grantor foreign trusts. A simple trust (one that, under Sections 651(a) and 652(a), is required by its terms to distribute all of its income currently) is entitled to deduct all of such distributions under Section 651(a), subject to the usual limitation under Section 651(b) where the income required to be distributed exceeds distributable net income. In a complex trust, the same rule applies with respect to actual distributions of current income (seeSections 661(a) and 662(a)) but if the distribution is made out of accumulated income, the beneficiary must report the distribution and pay tax on it. [4] Fairly obviously, trust deductions of distributions to beneficiaries are partner-level deductions, and current-year deductions at that, and therefore they cannot be taken into account by the partnership.

The next question is whether withholding tax under Chapter 3, and Section 1446 in particular, is apportioned to beneficiaries. As explained in Part 1 of this article (in the section headed “Special Rules for Trusts and Estates”), the final Regulations require the trust to apportion 1446 tax between the trust and its beneficiaries. (Oddly, however, there appears to be no specific authority for this position in the Code, which contains specific provisions relating to the foreign tax credit and backup withholding tax; there is also a provision allowing the trust to elect to treat a portion of the estimated tax paid by the trust as allocated to a trust beneficiary. [5] But the Code apparently says nothing about apportioning other refundable credits, such as the credit under Section 33 for withholding taxes on nonresident aliens. [6]) If the tax is to be apportioned to beneficiaries, one could envision a look-through procedure that would appear very similar to the procedure for foreign partners that are LTPs and then permit a good-driver certification to be given by the beneficiaries. While the certification rules as they now stand do not explicitly prevent a trust beneficiary from giving a certificate, they also do not explain how the beneficiary could do this when he is not, by definition, a partner. And in the case of trust income from the partnership, a simple good-driver certification by the trust should be acceptable, accompanied perhaps by a certification that the related income will not be distributed or otherwise apportioned to the beneficiaries or deducted by the trust.

Scope.

The Regulations permit the foreign partner to certify deductions and losses from prior years. The foreign partner must reasonably expect the deductions and losses 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 is an odd choice of words, since the deductions and losses would not reduce the partner's tax liability if that liability were going to be zero irrespective of whether the deductions and losses were available. But we will assume that what is meant is that the deductions and losses are reasonably expected to be available to reduce the partner's taxable income that is effectively connected with a U.S. trade or business.

Temp. Regs. 1.1446-6T(c)(1)(i) and (ii) make clear that the deductions and losses may derive from the partnership, so long as those deductions and losses are or will be reflected on a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) for a prior partnership year, or from other sources. If the other sources include another partnership, the deductions and

losses must have been reflected on a Schedule K-1 issued or to be issued by that partnership. One key difference is that the partner can certify losses previously suspended under Section 704(d) (losses limited to partner's basis in the partnership) that it expects to be available but only to the partnership from which suspended losses were derived.

Apparently because of a concern about the alternative minimum tax limitation on NOLs, Temp. Reg. 1.1446-6T(c)(iii) provides that a partnership may not consider a partner's NOL deduction in an amount greater than 90% of the partner's allocable share of ECTI. [7] If that is the reason, and given that the AMT may be repealed in the future (at least for individuals), it would make sense for this provision to apply only if the partner could potentially be subject to the AMT. Presumably, the partnership should apply the 90% limitation cumulatively each time that the partnership has to pay 1446 tax so that if the partnership's annualized income declines during the year, the losses that can be applied will be reduced.

The Temporary Regulations contain a *de minimis* rule (Temp. Reg. 1.1446-6T(c)(1)(iv)). If a foreign partner can certify that it is a partner whose only source of ECI is a single partnership, and the partnership estimates that the annualized 1446 tax with respect to the partner will be less than $1,000, the partnership need not pay 1446 tax with respect to the partner.

The *de minimis* rule is a puzzle. It still requires a full certification that is therefore complex and costly to prepare, as well as having to contain an additional representation that the foreign partner will notify the partnership if circumstances change. It gives relief primarily to just the kind of portfolio investor whose noncompliance prompted the enactment of Section 1446. It is hard to know why the Service bothered but given that it did, we may hope that the final Regulations will simplify the certification requirements.

Contents.

The contents of the certificate are set out in the sidebar. Broadly stated, the certificate requires identification of the partner and the partnership, the amount, and, if relevant, the character of the losses and deductions. The certificate must also contain a lengthy series of representations concerning eligibility of the partner and of the losses and deductions, the filing of past returns, and the intention to timely file any unfiled returns. The representations must also state that the losses have not been disallowed as part of a proposed adjustment on examination.

A partner that has not yet filed a tax return required to be timely filed may represent that it will be timely filed. [8] However, the certificate must specify any tax year for which no return has been filed and the partner must update the certificate no later than ten days after the date that it files the return. If the foreign partner does not timely file the return, the partner must provide a status update under penalty of perjury to be received by the partnership at least ten days prior to the partnership's final installment payment date. [9]The status update must contain information regarding the filing due date of any U.S. income tax returns that have not been filed. If no status update is received, the partnership must disregard the certificate in connection with the fourth installment due date and when completing the annual Form 8804 (Annual Return for Partnership Withholding Tax). The partnership will still be considered to have reasonably relied on the certificate for the first three installment periods of the tax year. If a foreign partner submits a certificate and later determines that the deductions and losses reasonably expected to be available have decreased, or otherwise determines that the certificate is incorrect, the partner must provide an updated certificate to the partnership within ten days of making the determination. [10]

Not surprisingly, a representation must be included to the effect that the partner is not certifying the same losses and deductions to another partnership. However, this last requirement will

create practical problems in its implementation because it forces the foreign partner in more than one partnership to choose how to allocate its NOLs among the partnerships when it does not necessarily know ahead of time which partnerships will actually be able to use them. Make the wrong projection (read: guess) and deductions may go unused. A foreign partner will need to stay on top of the situation and file updated certificates from time to time allocating and reallocating losses and deductions among the various partnerships where they are needed.

One area where it is hoped that the Service will reconsider its requirements concerning contents relates to updated certificates, which are required in a variety of circumstances (see "Timing" below). The Temporary Regulations require that an updated certificate meet all of the requirements of an original certificate (superseded certificate) *and* include a copy of the certificate that is being updated, all of which seems a little heavy-handed when the changes may be quite minor. For example, an updated certificate will be required whenever the foreign partner has not filed a tax return for the immediately preceding year and the first certificate of the year therefore includes (as it is permitted to do) a representation that the return will be timely filed. The updated certificate may do nothing more than confirm that the return has indeed been filed. In fact, one would hope that the Service would make provision for a short-hand certificate that identifies the superseded certificate and simply states what has changed, signed under penalty of perjury. In addition to thinning the files of the partnership, it would avoid confusion caused by the need for the partnership to make a line-by-line comparison of the new and original certificates.

Timing.

The partnership may rely on the first certificate for the partnership tax year only if it receives it at least 30 days before the partnership installment due date or the annual Form 8804 filing date (without regard to extensions) for the partnership tax year for which the partner would like the certificate to be considered in computing the 1446 tax due with respect to the partner. [11] Updates may be considered only if received at least ten days before the partnership installment due date or the Form 8804 filing date (without regard to extensions). [12]

No explanation is given for these timing requirements. If the partnership is willing to rely on a certification submitted at the last moment, why should it not be permitted to do so, so long as it timely pays the installment or files the final return? And even more strangely, but absolutely intentionally, the Regulations instruct that a partnership is not permitted to rely on an updated certificate received within ten days of the due date, even where the partner has certified a reduced loss in the update. [13] This seems inconsistent with the rule that the partnership need not consider a certificate at all. It would make more sense to express the rule as follows: A partnership may rely on any certificate received prior to the making of a payment of 1446 tax or the filing of a return with respect to that tax but will not be penalized for failing to rely on a certificate received less than ten days before the due date for such payment or filing.

Effect.

The filing of a certificate with a partnership has no effect on the foreign partner's tax filing obligations. The foreign partner must continue to make estimated tax payments and to file a return after the close of the year. [14] It may take credit for tax actually withheld.

For the partnership, however, the effect of the certificate is that the partnership may reasonably rely on a certificate that meets all of the requirements as long as it has no actual knowledge or reason to know that the certificate is defective. Where reliance was reasonable, the partnership will not be subject to additions to tax under Section 6655 (Failure by corporation to pay

estimated income tax) (as applied through Reg. 1.1446-3), if the certificate is later updated or even if it turns out to be defective.

Where a partnership relies on a certificate, it must file all relevant forms and attach a copy of the certificate and a computation of the 1446 tax, even if the effect of relying on the certificate is that no 1446 tax or installment is due with respect to the partner in question. [15] It is hoped that the Service will consider modifying the requirement to provide the same certificate as many as five times a year. It should be sufficient that the form has a checkbox indicating that a prior form for the year included a certificate and that the certificate has not changed (except for a change involving confirmation that an unfiled return or payment of tax anticipated in an earlier certificate has now been filed or made).

The provision of a certificate does not relieve the partnership of liability for the actual 1446 tax, or applicable additions to tax, interest, and penalties if the IRS "in its sole discretion" determines the certificate to have been invalid or the foreign partner submits an updated certificate that increases the 1446 tax due with respect to the partner. Presumably, this refers to an increase in the tax that would have been due in the past if no certificate had been given or if the original certificate been accurate. The partnership is relieved of liability for the tax only if the foreign partner actually satisfies its tax liability by filing a return and paying tax due, as provided in Reg. 1.1446-3(e).

The Unsolved Problem of Overwithholding

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. In a prior issue of JOIT, one of the authors previously considered what might he called virtual withholding issues arising under Section 1441, but in most if not quite all of these cases, money had changed hands. [16] For example, withholding has been required (or penalties for failure to withhold imposed) where a payment was recharacterized from a payment for goods and services to a dividend. The final Regulations under Section 482 provide that a payment is considered made to the extent that income subject to withholding is allocated under Section 482. [17] Withholding has also been required where a withholding agent pays an amount due to a foreign person directly to the foreign person's creditor, who may in fact have a security interest in the amount due. [18]

But Section 1446 is concerned with allocations of income and this is no accident. After all, the original 1986 version of Section 1446 require the payment of tax on distributions. It caused serious overwithholding problems because partnership distributions are by definition not taxable in most cases and it was replaced by a regime intentionally based on income allocation. It is hardly surprising, although somewhat disappointing, that the Service took this broad principle and applied it in a manner that can victimize innocent withholding agents by requiring a tax to be paid on income that has no associated cash or other property that the withholding agent could call upon to meet the 1446 tax obligation.

There are four broad categories of potential overwithholding created by this legislative structure. First, the use of maximum rates ensures that too much tax will be collected. The Service is to be commended for allowing the use of maximum tax rates on long-term capital gains of individuals. It is also understandable that the Service felt unable to use some means of reducing 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 corporations have to pay.

Second, there is an overlap between Sections 1445 (FIRPTA[19] withholding) and 1446. As we argued in Part 1 of this article in the discussion of Reg. 1.1446-2, the Service could and should provide relief by giving priority to Section 1445 and thereby allowing an application to be made for a withholding certificate.

The third broad category concerns partner-level deductions. Without trying to identify every single way that this can happen, below is a list of partner-level deductions that cannot be taken into account by a partnership in determining 1446 tax:

- Loss carryovers (NOLs 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.
- Charitable contribution deductions, even where 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 or in bankruptcy.
- Tax credits allocated to the partnership's 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.

We simply believe that the Regulations are inadequate in this regard and we also have yet to hear any detailed cogent argument on this score. The Preamble describes various approaches suggested by commentators and states that "Treasury and the IRS believe that the Regulations set forth a procedure that will be administrable by partnerships, partners, and the IRS." This suggests that the concern about providing relief is primarily related to administrability rather than statutory authority—in fact, the only reference to authority in the Preamble simply restates Section 1446(d)'s grant of authority to alter the rules to accomplish the objectives of the section. That grant of authority is, we believe, quite wide enough. If administrability is indeed the issue, the public deserves a more detailed explanation of the issues that led to rejection of remedies, such as enlarging the scope and shortening the qualification period of partner certifications or an analog to the FIRPTA withholding certificate procedure.

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

The foreclosure problem: *Tufts* gain.[20] 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 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, as a result of which ABC has realized and recognized gain of $2 million, $1 million of which will be allocated to the foreign partners. ABC and the general partners will be responsible for 1446 tax on that amount except to the extent that the foreign partners can provide good-driver certificates.

The COD problem. 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, the bank forgives $1 million of the mortgage indebtedness. The result is ordinary income of $500,000 for the foreign partners and Section 1446withholding 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 (COD) income under Section 108. There is no obligation on the foreign partner to make a good-driver certification unless the partnership agreement explicitly so provides.

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

The "restricted access to cash" problem: the "lock box." 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.

Foreign partner fails to make required capital contribution. ABC tried to anticipate the potential need to fund 1446 tax by requiring in the partnership agreement a "call" by the general partner of any amounts necessary to fund the withholding tax. The foreign partners simply breach their agreement to timely meet their obligation to fund the withholding tax.

Section 1446 requires the general partner to withhold at the rate of 35% for individuals and 35% for corporations on the allocation of "effectively connected taxable income" (which the gain described above would be) to the foreign partners. In the ABC scenarios above, the general partner of ABC is required to withhold tax and remit this amount to the IRS even though the partnership did not receive any cash from which to withhold or that it could distribute to the foreign partners.

In short, the government rejected relief in these situations, except to the limited extent available under a good-driver certificate. The Preamble to the Regulations explains the government's position:

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 . . . Treasury and the IRS are issuing temporary and proposed regulations that permit a foreign partner, in certain circumstances, to certify to the partnership that it has deductions and losses it reasonably expects to be available to reduce the partner's U.S. income tax liability on the partner's allocable share of effectively connected income or gain from the partnership. This certification procedure may apply to reduce

the partnership's 1446 tax obligation with respect to COD income allocable to a foreign partner in appropriate circumstances.

Numerous comments had recommended varying forms of relief under Section 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 presently does not permit a current-year deduction to be included in the certificate. One government official commented that "It's not like we didn't think about that." [21] We do not for a moment doubt that the government did think about it long and hard. But it is, to say the least, somewhat frustrating that the government has given an explanation that is, to put it mildly, on the wrong side of terse and more an assertion than a reason: "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." [22] There is, in fact, little evidence for the second part of this sentence. The government is really asking the public to take it on trust that this is the right outcome without trusting the public enough to explain its reasoning.

Trouble for general partners.

In requiring overwithholding of tax, Section 1446, as implemented by the Regulations, creates a burden that goes well beyond creating a cash flow problem for the foreign partner. It places the burden of funding the overwithholding on the partnership and ultimately on general partners, managers, and other responsible persons.

Part 1 of this article noted that, under Section 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 Section 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 Section 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 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 one hand, and the foreign partners on the other. Specifically, Section 1446 acts to compel distributions to partners that otherwise might not be made under the terms of the partnership's governing documents. The Section 1441 Regulations do this too, but only where partnerships actually have cash or property that gave rise to the withholding obligation and where the tax is usually 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 to fund the transfer whenever cash is unavailable. While it is reasonable forSection 1446 to force the partnership to fund the foreign partners' actual tax liability, the Regulations should do everything possible to avoid overwithholding where the government is no longer securing tax for itself but simply acting as a conduit from the partnership to the foreign partners, with an interest-free loan to the U.S. government in the interim.

Even this result might be tolerable if there were some mechanism by which the partnership or the general partner could retrieve the tax once the determination of overwithholding had been made. But there is no statutory or regulatory mechanism (nor could one realistically imagine how

one could be created). And even the most artfully drafted partnership agreement, under which foreign partners are required to fund or refund to the partnership the 1446 tax, or at least the overwithheld portion of the 1446 tax, will not help in some circumstances, including the insolvency of the foreign partner or a dispute between the foreign partner and the partnership.

In the COD example above, withholding is required 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, the partnership's financial misfortunes could cause the foreign partners to become dissatisfied with the conduct of the partnership's business. One can well imagine a foreign partner that was eligible to file a good-driver certificate actually refusing to do so. Accurate drafting of partnership agreements could also require the foreign partners to file good-driver certificates but there plainly will be situations where the foreign partners cannot or will not do so or where the partnership might be reluctant to rely on a certificate.

In a panel at the ABA Tax Section Meeting in May 2005, one of the authors of this article asked the Treasury Department representative the following question: “What does the general partner do when a tax bill comes due and there's no money?” The Treasury official responded: “What does the general partner do when the light bill comes due and there's no money?” [23] The answer is that the general partner contracted the electricity company and voluntarily incurred the obligation to pay for power. The 1446 tax obligation can and routinely does arise even when there is no tax actually due by anyone or the tax required to be withheld is clearly excessive and, worse yet, any excess withholding will end up being refunded not to the partnership or the general partner but to the foreign partner. In these circumstances, Section 1446 becomes a vehicle for compelling a partnership, and especially an insolvent or poorly performing one, to make distributions to partners that it otherwise would not make and, in an extreme case, unjustly enriching a foreign partner or its creditors at the expense of the other partners.

A Critique of the Temporary Regulations

One has to admire the craftsmanship of the Temporary Regulations and especially the very helpful examples that explain how certificates work and what happens when they are updated or found to be defective. The requirements are cumbersome and there is scope for simplification but the rules are clear, if not concise.

Ultimately, however, the craftsmanship seems to have been placed in the service of the principle that if you build it, they will run a mile. The Temporary Regulations are narrow in scope and their requirement that a foreign partner have filed tax returns for at least four years is unduly restrictive. The four years should be reduced to two and, if nothing else, a foreign partner should be allowed to satisfy the requirement in, say, four of the preceding six years so long as the foreign partner had no filing requirements in any “gap” years.

The Temporary Regulations also provide little incentive to the partnership to accept a good-driver certificate. Certainly, the certificate offers a cash flow incentive but no relief from having to pay the tax or any interest, additions to tax, or penalties (other than estimated tax penalties) if something is or goes wrong with the certificate, including unanticipated changes in circumstances. Moreover, as we have demonstrated, some of the most acute overwithholding problems of Section 1446 remain unsolved. The question remains: What can be done?

As a starting point, the Section 1445 Regulations provide a template for handling overwithholding on phantom income. The differences between Section 1445 (which is concerned with the tax consequences of a single transaction and the requirement to withhold at the time of

the transaction) and Section 1446 (which is concerned with income over the course of an entire year that cannot be known with certainty until the year is over) are obvious. However, that does not mean that nothing can be learned from Section 1445, especially in the acute areas of cashless foreclosures and COD. Reg. 1.1445-2(d)(3)(i)(B) provides an exemption from the withholding requirements of Section 1445 in a foreclosure (or transfer of deed in lieu of foreclosure) where no cash is paid to the transferor of the property.

Notwithstanding the logical approach of the Regulations under Section 1445, withholding is still required by Section 1446. It is difficult to understand the rationale for the IRS's reluctance to grant relief under Section 1446 in an area where it grants relief under Section 1445. In fact, the final Regulations under Section 1446 do not require duplicate withholding under Section 1445 if there has been withholding under Section 1446, but if for some reason there is no withholding required by Section 1445, Section 1446 will apply. This is known as the "trumping rule." The IRS apparently feels that different considerations apply to an exemption under Section 1445 than under Section 1446, but when pressed to explain why, Treasury's response is: "There were concerns about compliance, there were all kinds of concerns in this area...the comprehensive final rules (T.D. 9200) under tax code Section 1446 are designed to balance the government's need for compliance with taxpayers' need for certainty. IRS made a significant effort to minimize withholding in cases where taxpayers do not have an underlying tax liability." [24]

Apart from the existence of the Section 1445 Regulations as a model, the Service really should consider allowing partnerships to take into account a broad range of partner-level deductions that arise during the current year, in particular deductions derived from the partnership itself and perhaps any other partnership with overlapping general partners or managers. The condition for allowing such partner-level deductions could include the foreign partner meeting the conditions for a good-driver certificate for a shorter period. The government should have a higher level of confidence in the partnership's knowledge of deductions for items incurred by the partnership than for deductions and losses incurred during the current year in other activities.

There is an overwhelming case, moreover, for allowing immediate relief for deductions under Section 199 (Income attributable to domestic production activities deductions). [25] Although Section 199 is dressed up as a deduction, it is in substance a rate cut. It is difficult to envisage a situation in which a Section 199 deduction generated by a profitable partnership would not be allowable to a foreign partner, and just because it is required to be computed at the partner level does not require that it be ignored in computing 1446 tax. The partnership has all of the information needed and the risk to the government appears minimal.

A strong case can be made for allowing relief for losses that were suspended at the partnership level or are being released at the partner level by reason of increases in the partner's basis. Once again, the partnership should have the data needed to determine the availability of the suspended losses.

The same can be said for deductions for state income taxes, especially when these are paid by the partnership on the foreign partner's behalf. If the state tax were excessive and the partner could apply to the state for a refund, the refund would not reduce the deduction but would be taxable directly to the partner. The Regulations could provide that only 90% of the deduction would be allowable, similar to the approach taken with the limitation on the use of NOLs in good-driver certificates, to provide an approximate offset for the fact that no withholding is required on state income tax refunds to partners.

Prospects for change.

It is not clear whether the government will be receptive to comments about solving the overwithholding problems described above beyond adjusting the good-driver certification procedure. The bulk of the overwithholding issues arise because of provisions in the final Regulations, and the government had certainly heard in detail from the private sector about overwithholding before it issued the Regulations. Nevertheless, because of the government's decision to offer relief in proposed form, there is one last opportunity for putting in place by Regulation a more moderate foreign partner withholding regime. In particular, while the government seems to be trying with the current rules to strike a balance between the interests of the government and foreign partners, it has given short or no shrift at all to the legitimate interests of the withholding agents. Under pressure from U.S. financial institutions, the government wrote and re-wrote the Section 1441 Regulations to get this balance right and it should be willing to do so in the case of partnerships even though they do not have the organization and clout of the financial institutions.

This article and comments and testimony that the authors are providing to Treasury and the Service, as well as the comments of others both before and after the issuance of the final and Temporary Regulations, represent an effort to make the case for substantial additional relief from the excesses of Section 1446. To the extent that the government is unable or unwilling to grant relief, the solution can only lie in legislative change. Section 1446 is, fairly obviously, not prominent on the legislative radar screen at present. It remains to be seen whether this might change once efforts to obtain regulatory relief have played out.

Conclusion

It may have come to the attention of readers of this article that the authors have some strong feelings about what has and should be done in this area. We nevertheless have tried to provide an accurate description of what has been done and to be clear when we are expressing our opinions. If the government chooses to make any significant changes, we will report on them in a future issue of JOIT.

Contents of a Foreign Partner “Good-Driver” Certificate (Temp. Reg. 1.1446-6T(c)(2)(ii))

No particular form is required for the partner's certificate of deductions and losses to the partnership but it must have a caption at the top of the page that reads: “CERTIFICATE OF PARTNER-LEVEL ITEMS UNDER TEMP. REG. 1.1446-6T TO REDUCE SECTION 1446WITHHOLDING.” Further, the certificate must include:

(1) Partner's name, address, taxpayer identification number (TIN), and date of certification.
(2) Partnership's name, address, and TIN.
(3) Partnership tax year for which the certificate is submitted.
(4) Amount of deductions and losses and, if applicable, their character (e.g., capital or ordinary), and any particular deductions and losses that are subject to limitation or otherwise warrant special consideration (e.g., suspended passive activity losses underSection 469, suspended losses under Section 704(d)) that the partner reasonably expects to be available to reduce the partner's U.S. income tax liability on the partner's allocable share of effectively connected income or gain from the partnership for the partner's tax year in which such income or gain is includable in gross income.
(5) A series of representations and statements that:

a. The partner is described in Temp. Reg. 1.1446-6T(b) and that deductions and losses in the certificate are described in Temp. Reg. 1.1446-6T(c)(1), i.e., the partner and the deductions and losses are eligible.

b. The deductions and losses have been reflected on a timely filed U.S. income tax return, consistent with Sections 874 and 882 and the Regulations thereunder (and such other provisions that impose requirements for the use of such deductions and losses).

c. The deductions and losses have not been included in a certificate provided to another partnership for the same tax year for the purpose of reducing withholding under this section.

d. The partner has timely filed (or will timely file) its U.S. federal income tax return for each of the preceding four tax years and the partner's tax year during which the certificate is considered, and has timely paid or will timely pay all tax shown on such returns. The partner must also specify any tax year for which a U.S. income tax return has not been filed as of the time of submission of the certificate, provide the filing due date for such return, and represent that the partner will comply with the provisions of Temp. Reg. 1.1446-6T(c) for furnishing an updated certificate or status update with respect to the filing of any such return.

e. All of the deductions and losses (other than losses suspended under Section 704(d)) are (or will be) reflected on an income tax return of the partner that is (or will be) filed with respect to a tax year of the partner that ends prior to the installment due date or Form 8804 filing due date (without regard to extensions) for the partnership tax year for which such certificate will be considered.

f. The deductions and losses have not been disallowed by the IRS as part of a proposed adjustment described in Reg. 601.103(b) (examination and determination of tax liability) or Reg. 601.105(b) (examination of returns).

(6) The following statement: "Consent is hereby given to disclosures of return and return information by the Internal Revenue Service pertaining to the validity of this certificate to the partnership or other withholding agent to which this certificate is submitted for the purpose of administering section 1446." If a representative of the partner signs and dates the certificate, a power of attorney specifically authorizing the agent to make this statement must be attached to the certificate.
(7) The signature of the partner, or its authorized representative, under penalties of perjury, and the date that the certificate was signed.
(8) For a partner that is a partner in only one partnership and making a certificate based on the expectation that the 1446 tax will be less than $1,000, a representation must be included confirming that the partner's only activity that gives rise to effectively connected income, gain, deduction, or loss is (and will be) during the partner's tax year the partner's investment in the partnership.

1

Charles Dickens, *A Christmas Carol*, chapter 1 (1843).

2

The Temporary Regulations (TD 9200) were released on May 13, 2005, but apply to tax years beginning after May 18, 2005, the date of publication in the Federal Register. Partnerships can elect immediate application to partnership tax years beginning after December 31, 2004, if they also apply the final Regulations (Reg. 1.1446-1 through -5) to partnership years beginning after that date. TD 9200 also included the final Regulations discussed in Part 1 of this article. The Proposed Regulations issued on the same day (REG-108524-00) were issued by cross-reference to TD 9200.

3

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 Section1446 on Effectively Connected Taxable Income Allocable to Foreign Partners" (January 27, 2004), page 8. See http://www.abanet.org/tax/pubpolicy/2004/0401ftt.pdf and Tax Notes Today, 2004 TNT 33-16 (February 19, 2004).

4

Section 662(a)(2). For domestic trusts, this rule has effectively been repealed by Section 665(c), enacted by the Taxpayer Relief Act of 1997 (P.L. 105-34), section 507(a)(1). But if the trust is foreign (bringing Section 1446 into play if the trust is a partner in a partnership engaged in a trade or business in the United States), Section 662(a) still applies.

5

Section 642(a) (foreign tax credit); Section 643(d) (back-up withholding); Section 643(g) (estimated taxes).

6

See Blattmachr and Michaelson, *Income Taxation of Trusts* (14th ed., Practicing Law Institute, looseleaf 1955-2005) at ¶ 2.6.1(C).

7

See Sections 56(a)(4) and (d).

8

Temp. Reg. 1.1446-6T(c)(2)(ii)(H).

9

Temp. Reg. 1.1446-6T(c)(2)(i)(B).

10

Temp. Reg. 1.1446-6T(c)(2)(i)(B).

11

Temp. Reg. 1.1446-6T(c)(2)(i)(A).

12

Temp. Reg. 1.1446-6T(c)(2)(i)(B)(4).

13

Temp. Reg. 1.1446-6T(e), Example 2(iii).

14

Temp. Reg. 1.1446-6T(d)(1).

15

Temp. Reg. 1.1446-6T(d)(1)(ii).

16

Karlin and Malocha, "'Virtual Withholding': Expanding the Observable Universe," 10 JOIT 8 (December 1999).

17

See FSA 199922034 (March 3, 1999).

18

See *Casa de la Jolla Park, Inc.*, 94 TC 384 .

19

Foreign Investment in Real Property Tax Act of 1980.

20

Tufts, 51 AFTR 2d 83-1132, 461 US 300, 75 L Ed 2d 863, 83-1 USTC ¶9328, 1983-1 CB 120 (partner who sold interest in partnership that operated apartment complex realized amount equal to outstanding balance of nonrecourse mortgage even though balance exceeded FMV of complex).

21

See "Additional Withholding Relief Unlikely for Insolvent Partnerships, Officials Say," BNA Daily Tax Report, May 27, 2005, page G-3.

22

And, it would seem, regardless of whether the foreign person actually will owe any tax.

23

Note 21, *supra*.

24

Note 21, *supra*.

25

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

Document Title: Uncle Sam Meets Uncle Scrooge--The Temporary Regulations on Foreign Partner Withholding (Part 2), Journal of International Taxation, Dec 2005
Checkpoint Source: Journal of International Taxation (WG&L)

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