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Living with the Final Partnership Withholding Regulations

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INTRODUCTION

During the course of the 1990s, a succession of lawyers at the office of Associate Chief Counsel (International) of the Internal Revenue Service led a wise and ultimately successful effort to modernize the regulations under §§1441 and 1442, dealing with the withholding of tax on investment income and services income from U.S. sources. [1] Sections 1441 and 1442 are short on detailed rules and guidance but they affect hundreds of billions of cross-border payments in a great variety of circumstances. During the course of the effort, the government listened attentively to the principal constituency among withholding agents — the banking and financial industry. Although the product of that deliberation and consultation, i.e., the final regulations that became effective on January 1, 2001 (delayed a year by what turned out to be misplaced fears about bank IT departments' ability to deal with both the new regulations and "Y2K" in the same year), was not at every turn a model of clarity and accessibility, it was a model of responsible and responsive regulation.

[1] Unless the context indicates otherwise, all section references are to the U.S. Internal Revenue Code of 1986, as amended ("the Code"), and to the regulations thereunder.

Over the same period, the government delayed addressing the need for regulations under §1446, dealing with the withholding of tax by partnerships engaged in a U.S. trade or business with respect to foreign partners' shares of partnership income. Section 1446 is a flawed and problematic statute. Interpreted literally and inflexibly, it will always result in overwithholding. This is, but only in part, because it calls for withholding at the highest rate applicable to the foreign partner's share of income effectively connected with a U.S. trade or business. Concerning this aspect of the law, the government did what it could by specifying that the highest rate in the case of individual foreign partners could take into account preferential rates such as the long-term capital gains rate. [2]

[2] §1(h)(1)-(6); Regs. §1.1446-3(a)(2)(ii).

However, the statute does not address the fact that many deductions properly allocable to a U.S. trade or business, including deductions for expenditures incurred or paid by the partnership itself, as well as credits, are allowable to partners only at the partner level. Similarly, the statute recognizes that it effectively mandates distributions (in the form of tax prepayments) for the benefit of foreign partners, irrespective of the partnership's financial condition, without regard for the terms of the partnership agreement and potentially at the expense of U.S. partners. It is silent on whether any form of regulatory relief should be provided to deal with the resulting problems.

Overwithholding is basically unfair to foreign partners and the partnerships in which they invest and it is undesirable as a matter of tax administration policy. Overwithholding in its most extreme forms, which occurs when a partnership or partners are insolvent, can be financially fatal and effect an unjust transfer of wealth from partnerships (and their domestic partners) to foreign partners with the participation of the government of the United States. But even for a partnership with a completely normal profile and a steady stream of profits, overwithholding can involve what amounts to a permanent interest-free loan to the government for the life of the partnership.

One would expect the government to look for ways to mitigate this problem. But when the government, its enlightened labors on §1441 concluded, turned its attention to §1446, wisdom and responsiveness were replaced, for no apparent reason, by rigidity and timidity. Throughout the process, one government representative after another excused or justified the lack of meaningful relief on the grounds that the statute did not provide authority. [3] Apparently the broad grant of regulatory authority in §1446(f) did not suffice. This is all the more remarkable when one considers that these same officials, with no grant of regulatory authority beyond §7805(a), crafted one special rule after another in the §1441 regulations.

[3] However, in providing that §1446 overrides §1445, the government representatives posited a belief about the intent of Congress for which there is no actual evidence at all in the legislative history or anywhere else in the public record (that we can determine) and proceeded effectively to repeal §1445(e)(1) by regulation.

The result is a set of tax regulations that leaves overwithholding largely uncured. What cure there is may be worse than the disease. Section 1446 did not have as its constituency a large body of powerful financial institutions. Instead, it mainly had persons like the authors, whose clout, unfortunately, did not match their enthusiasm. [4]

[4] The authors were the principal authors of the comments submitted by the Section of Taxation of the American Bar Association on the proposed regulations issued in September 2003 and the final, proposed, and temporary regulations issued in May 2005. Michael Karlin had submitted comments as early as 1996 on behalf of the Taxation Section of the State Bar of California and (appearing on his own behalf) was the only witness at the November 2005 hearing on the May 2005 regulations.

Venting aside, this article is concerned with planning in response to the regulations under §1446 in their now final form. We begin with a description of §1446, abbreviated because we have written at length, to the point of obsession, about earlier versions of §1446 and its regulations, vast tracts of which remain unchanged both in the details and in the parade of unsolved problems for partnerships and their partners. [5] We continue with a review of the changes made by the 2008 final regulations, most of which are concerned with the good driver certificate procedures under which foreign partners with a history of tax compliance can certify the availability of certain deductions to enable the partnership to withhold less than would otherwise be required. Next, we describe some practical issues raised by use of the moderate regulatory relief provided by the government, in particular the withholding certificate procedure set out in Regs. §1.1441-6. Finally, we will consider self-help — what, as a practical matter, partnerships with foreign partners should do to work with §1446 and the regulations and moderate their adverse impact on the partnership and partners, both U.S. and foreign.

[5] *See* Karlin and Appel, “Kissing the Blarney Stone — A Practical Guide to Structuring Partnership Agreements and Limited Liability Company Operating Agreements in Light of the §1446 Regulations,” 47 *Tax Mgmt. Memo.* 171 (5/1/06); Appel and Karlin, “At Long Last ... Final Regulations on Foreign Partner Withholding,” 16 *J. Int'l Tax'n* 10 (Oct. 2005) and “Uncle Sam Meets Uncle Scrooge — The Temporary Regulations on Foreign Partner Withholding,” 16 *J. Int'l Tax'n* 12 (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 §1446 on Effectively Connected Taxable Income Allocable to Foreign Partners” (1/27/04), reproduced at *http://www.abanet.org/tax/pubpolicy/2004/0401ftt.pdf*, 2004 *TNT* 33-16 (2/19/04) and “Comments Concerning Proposed Regulations Relating to the Obligation of a Partnership to Withhold Tax Under §1446 On Effectively Connected Taxable Income Allocable to Foreign Partners” (11/4/05), reproduced at *http://www.abanet.org/tax/pubpolicy/2005/051104sec1446.pdf*, 2005 *TNT* 215-11 (11/8/05).

SECTION 1446 BACKGROUND

History

Section 1446 was enacted by the Tax Reform Act of 1986. As first enacted, §1446 required withholding with respect to partnership distributions, but the original statute was so impractical that the IRS soon issued Rev. Proc. 88-21, [6] adopting a scheme of withholding based on allocations of effectively connected taxable income. Shortly afterward, in the Tax and Miscellaneous Revenue Act of 1988, Congress re-enacted §1446 in its present form, adopting the approach of Rev. Proc. 88-21. [7] Further minor changes were enacted in 1989. [8]

[6] 1988-1 C.B. 777, *obsoleted by* Rev. Proc. 89-31, 1989-1 C.B. 895.

[7] P.L. 100-647, commonly referred to as TAMRA, §1012(s)(1)(A).

[8] P.L. 101-239, §7811(i)(6).

On September 3, 2003, the IRS and the Treasury Department published proposed regulations (the “2003 proposed regulations”) providing guidance under §1446 and related sections. [9] On May 18, 2005, the IRS and the Treasury Department issued final regulations in relation to substantially all of the guidance proposed in 2003 (the “2005 final regulations”) and also published temporary and proposed regulations in Regs. §1.1446-6T and under subtitle F (Procedure and Administration) establishing a new procedure by which a partnership could consider certain partner-level deductions and losses when computing its §1446 tax. [10] The 2005 temporary regulations generally applied to partnership taxable years beginning after May 18, 2005, but a partnership could elect to apply the temporary regulations to partnership taxable years beginning after December 31, 2004, provided the partnership elected to apply the 2005 final regulations to partnership taxable years beginning after December 31, 2004.

[9] REG-108524-00, 2003-42 I.R.B. 869, 68 Fed. Reg. 52466 (9/3/03), corrected at 68 Fed. Reg. 62553 (11/5/03).

[10] T.D. 9200, 2005-1 C.B. 1158; 70 Fed. Reg. 28701 (5/18/05).

After considering written comments submitted in 2006 and comments made by one of the authors at a public hearing on November 16, 2005, the 2005 proposed regulations were adopted on April 29, 2008, as final, with a number of changes (the “2008 final regulations”), replacing the 2005 temporary regulations. [11] The 2008 final regulations also made a number of changes relating to the 2005 final regulations. Insofar as they relate to good driver certificates, the 2008 final regulations are effective for partnership taxable years beginning after December 31, 2007, except that, under a transitional rule, a certificate furnished on or before July 28, 2008, that complied with the 2005 temporary regulations remains valid. [12]

[11] T.D. 9394, I.R.B. 2008-21, 73 Fed. Reg. 23069 (4/29/08).

[12] Regs. §1.1446-6(f) and (g).

Overview

Withholding on ECTI

Section 1446 applies to a partnership, foreign or domestic, that is engaged in a trade or business in the United States and has one or more partners who are foreign persons. In any year in which the partnership has effectively connected income, the partnership must compute its effectively connected taxable income (ECTI) and pay tax at the highest applicable rate on the foreign partner's allocable share of ECTI. The tax, which the regulations refer to as the “1446 tax,” is payable in installments on the four dates a year applicable to corporate installments of estimated tax and the installments are required to be computed in the same manner as estimated tax payments. Following the end of the year, a true-up is required and the partnership must pay any balance due and is entitled to a refund of overwithheld tax.

ECTI is determined under the principles of §864, reduced by deductions properly allocable to the income under the principles of the §861 regulations. The foreign partner's allocable share is to be computed in accordance with the general rules of §704 and the regulations. As usual, the rules of

§703, which require certain items of income and their related deductions to be stated separately, will apply.

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

- Only income that is effectively connected income (ECI) in the hands of the partnership is taken into account, along with any status forms submitted by the foreign partner (the “income principle”); [13]

- Partner-level deductions and exclusions are not taken into account (the “deduction principle”); and

- Partner-level credits are not taken into account (the “credit principle”).

[13] For example, a partner may submit a form indicating that it wishes to treat net income from real property as ECI. Under §897(a), gain from the sale or exchange of U.S. real property interests are deemed to be ECI but rental income may or may not be and the taxpayer has an election under §871(d) or §882(d) and under many of our treaties to treat other real estate income as ECI. The reason to make this election is that, with the current U.S. rate structure, it is preferable for a foreign person to pay tax at 34% or 35% of net income rather than pay a 30% withholding tax on gross rental income with no deductions.

Under the deduction principle, with narrow exceptions, the partnership is not permitted to deduct or exclude items that arise at the partner level. These include, among others, net operating losses, charitable contribution deductions, deductions under §199, and cancellation of indebtedness income excluded under §108 on account of the partner's insolvency. Nor, under the credit principle, may the partnership offset 1446 tax with tax credits, even credits arising as a result of the partnership's own activity and even foreign tax credits payable on foreign-source income that is effectively connected under §864. [14]

[14] *See* Preamble to T.D. 9394, Explanation of Provisions, at para. I.E.4.

Rate of Withholding

The highest rate of tax for purposes of withholding is the rate of tax applicable to the income or gain in the hands of the foreign partner. At present, the highest rate is 35% for both foreign corporations and nonresident alien individuals. (No allowance is made for the fact that the vast majority of foreign corporations are actually not taxed at 35% but at the 34% rate applicable to corporations with taxable income of less than $10 million.) In the case of individuals, the 2005 final regulations confirmed that the partnership may apply the preferential rates applicable to long-term capital gains of individuals. In the case of an allocation to a partner whom the partnership knows not to be a corporation, the 1446 tax is computed using the highest capital gains rate (currently 15%), the highest rate of tax for collectibles gain (currently 28%) and the maximum tax rate for unrecaptured §1250 gain (currently 25%). [15]

[15] §1(h)(1)-(6); Regs. §1.1446-3(a)(2)(ii).

Section 1446 Withholding Equates to a Partnership Distribution

Section 1446(d) requires a foreign partner's share of any withholding tax paid by the partnership to be treated as a tax credit that is distributed to the partner on the earlier of the day on which such tax was paid by the partnership or the last day of the partnership's taxable year for which such tax was paid. The section permits the regulations to prescribe a different treatment, but the IRS declined to make use of this provision. If the deemed distribution exceeds the foreign partner's basis (it is not hard to come up with a scenario in which this could happen), §1446(d) can have the remarkable effect of causing a foreign partner to recognize gain on the deemed distribution even though the partnership agreement expressly prohibits the making of a distribution in excess of basis and requires the partner to repay any such distribution caused by the payment of 1446 tax.

Tiered Partnerships

The regulations provide various rules that apply to tiered partnerships. At the most basic level, where a partnership (a lower-tier partnership or “LTP”) has a partner that is itself a partnership (an upper-tier partnership or “UTP”), the LTP has no 1446 tax responsibilities, even if the UTP has foreign partners. The UTP will have that responsibility. [16]

[16] Regs. §§1.1446-1(c)(2)(ii)(A) and 1.1446-5(a) and (e).

However, an LTP that has received documentation and information from a partner that is a foreign UTP may (but is not required to) look through the UTP to the partners of the UTP when computing its 1446 tax obligation. The look-through regime is not an all-or-nothing proposition. To the extent that an LTP can reliably associate a portion of a UTP's allocable share of ECTI with a partner of the UTP, the LTP will look through when computing its 1446 tax or any installment.

A domestic UTP may, with the consent of the LTP, elect to have the look-through rules apply. If the LTP does not consent to the election, then the LTP treats the domestic UTP as a U.S. person for purposes of §1446, which means that it will have no withholding responsibility under §1446. Most LTPs in these circumstances will therefore have little or no incentive to consent and take on the responsibility to withhold when this can be left to the UTP.

Whether the UTP is a domestic or foreign partnership, and regardless of whether the LTP looks through the UTP in computing its withholding tax, the UTP remains obligated to report and pay tax under §1446. It may take credit for 1446 tax withheld by the LTP.

An LTP may not be able to reliably associate 100% of the UTP's allocable share of ECTI with the partners of the UTP. In such circumstances, the LTP must pay 1446 tax on the portion it cannot reliably associate with partners of the UTP at the higher of the rates in §1446(b). [17] Even though the UTP has provided documentation on its own behalf (e.g., Form W-8IMY), and the LTP therefore knows that the UTP is a noncorporate entity, the LTP may not consider any preferential rate when computing its 1446 tax due on the portion of the ECTI that the LTP cannot reliably associate with partners of the UTP.

[17] Regs. §1.1446-5(c)(2).

Publicly Traded Partnerships

A completely different approach to withholding is taken in the case of publicly traded partnerships (PTPs). Such partnerships are required to withhold tax on distributions rather than allocations. [18] One cannot but smile at the irony — problems with collecting tax from partners of PTPs were the reason for the enactment of §1446 and yet it is all the other partnerships and their partners, where there was much less evidence of, or at least concern about, noncompliance, that have been saddled with most of the hundreds of pages of regulation and institutionalized overwithholding.

[18] §1446(f)(1); Regs. §1.1446-4(a).

The look-through rules apply to a lower-tier PTP (or its nominees required to pay 1446 tax) if all the requirements of Regs. §1.1446-5 are met. In other words, if a lower-tier PTP has a foreign UTP, it may look through the foreign UTP and, if it has a partner that is a domestic UTP, the look-through election may be made with the lower-tier PTP's consent. On the other hand, look-through does not apply in the case of an upper-tier PTP.

Tax Computation and Compliance

Payment of Tax by Installments

Section 1446 applies, with modifications, the principles of §6655, the provision that sets out the estimated tax requirements applicable to corporations. [19] Section 6655 as applied by the §1446 regulations requires a partnership to pay four installments of tax during the year, with a true-up after the end of the year. The installments are due on the 15th day of the fourth, sixth, ninth, and twelfth months of the partnership's taxable year (April 15, June 15, September 15, and December 15 for a calendar year partnership). The final payment is due at the same time as the partnership's annual information return (Form 1065, whether the partnership is foreign or domestic).

[19] Regs. §1.1446-3(b).

The partnership may not reduce installments based on a foreign partner's estimated tax payments. [20] A foreign taxpayer faced with overwithholding might consider reducing its estimated tax payments with respect to its ECI from sources other than the partnership to take into account any overwithholding by the partnership. [21]

[20] Regs. §1.1446-3(b)(iii).

[21] *See* Regs. §1.1446-3(b)(iv) and (v), covering the situation of a partner whose interest terminates during the partnership taxable year and providing various technical exceptions to the rules of §6655 and necessary adaptations.

Under the principles of §6655, installments are the aggregate of each foreign partner's annualized share of ECTI multiplied by the applicable percentage based on the classification of the partner and the type of income. As a practical matter, the applicable percentage will usually be 35%, except where there is a preferential rate of some sort on gain allocable to a noncorporate partner. The partnership may also take into account the deductions certified to the partnership by a foreign partner that has satisfied the good driver requirements of Regs. §1.1446-6.

Section 6655 provides two safe harbors, under which a corporation is not liable for an underpayment addition to tax if the corporation pays 25% of either the preceding year's or the current year's tax liability in each quarterly installment. These safe harbors are often referred to as the “prior year safe harbor” and the “current year safe harbor.” [22] The final 2005 regulations provided that the §6655 current year safe harbor and a modified version of the prior year safe harbor could apply to a partnership subject to §1446. [23]

[22] §6655(d)(1)(B).

[23] Regs. §1.1446-3(b)(3).

Section 6655(f) provides that a corporation is not required to pay estimated tax when the amount of such tax is less than $500 for all of the foreign partners combined. This is, in the authors' judgment, too low a level for a de minimis rule and does not seem to reflect a reasonable balancing of the relative costs to partnerships and protection for the government, especially in light of presumed IRS processing costs.

Notifications to Partners

The 2005 final regulations require a partnership that pays 1446 tax on behalf of a foreign partner to notify the partner when a payment of tax has been made. The payment itself is made using a voucher prescribed as Form 8813. [24] Some exceptions apply here, notably in relation to partnerships with 500 or more partners.

[24] Form 8813, *Partnership Withholding Tax Payment Voucher (Section 1446)* (Feb. 2001).

Because the 1446 tax installment due dates are the 15th day of the 4th, 6th, 9th, and 12th months of the partnership's taxable year, a partnership must generally notify a foreign partner four times during the taxable year of the 1446 tax paid on the partner's behalf. No particular form is required for this notice. [25]

[25] Regs. §1.1446-3(d)(1)(i), which sets out the information required to be included in the notice.

After the close of the partnership taxable year, the partnership is required to file Forms 8804 and 8805 with the IRS and to provide a Form 8805 to each foreign partner. [26] The Form 8804 is an annual return of 1446 tax for the partnership as a whole. When completing its Form 8804 (as well as all Forms 8805), the partnership will use the actual results of the partnership's operations for the previous year. If the partnership determines that its 1446 tax is an amount greater than previously estimated, the partnership is required to pay any shortfall when filing the form.

[26] Regs. §1.1446-3(d)(1)(iii). Form 8804, *Annual Return for Partnership Withholding Tax*

(Section 1446) (annual; last updated for 2004); Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax* (annual; last updated for 2004).

Form 8805 sets out the 1446 tax paid on the foreign partner's behalf for the entire taxable year. Each foreign partner receiving a Form 8805 is generally permitted to claim a tax credit under §33 on its U.S. income tax return in the amount shown on the form as paid on the partner's behalf. For some reason, the form does not require the installments previously notified to the partner to be separately stated but simply the grand total for the year.

A partnership that considers a foreign partner's certificate under Regs. §1.1446-6 (relating to exemption from withholding if certain certification requirements are met) when computing its 1446 tax is required to furnish a Form 8805 to the partner and the IRS, even if the form submitted to the partner shows no payment of 1446 tax on behalf of the partner.

Forms 8804 and 8805 are separate from Form 1065 and are not to be filed together. In fact, irrespective of where the partnership files its information return, the Forms 8804 and 8805 are filed with the Internal Revenue Service Center in Ogden, Utah. A partnership must generally file Forms 8804 and 8805 on or before the due date for filing the partnership's Form 1065. [27] However, with respect to partnerships that keep their records and books of account outside the United States and Puerto Rico, Forms 8804 and 8805 are not due until the 15th day of the sixth month following the close of the partnership's taxable year. [28]

[27] *See* Regs. §1.6031(a)-1(c).

[28] *See* Regs. §1.6081-5(a)(1).

Coordination with Other Withholding Rules

The 2005 final regulations provide that when §1445 (FIRPTA withholding) and §1446 both technically apply, a partnership is required to pay withholding tax on behalf of its foreign partners in accordance with §1446. [29] This rule, referred to as the “trumping rule,” primarily relates to a domestic partnership's disposition of a U.S. real property interest, which is subject to withholding under §1445 (e)(1). Even in the case where §1445 would grant an exclusion from withholding tax, [30] §1446 withholding still applies.

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

[30] Regs. §1.1445-2(d)(3)(B)(ii).

2008 FINAL REGULATIONS

In the 2008 final regulations, the government adopted the temporary regulations with a number of modifications to the “good driver” certification procedures and made some minor changes to other parts of the 2005 final regulations.

The 2005 temporary regulations provided that no particular form was required for a foreign partner's certificate of deduction and losses to be presented to the partnership for purposes of claiming reduced withholding. The IRS has now published a form (Form 8804-C, *Certificate of Partner-Level Items to Reduce Section 1446 Withholding*) for this purpose and the final regulations prescribe the use of this form.

Deductions and Losses — Changes Made

The final regulations made a small number of changes to the computation of ECTI.

State Income Taxes

Most significantly, the 2008 final regulations allow a partnership to reduce a foreign partner's ECTI by 90% of the amount of any state and local taxes paid by the partnership on behalf of the partner with respect to the partner's allocable share of partnership ECTI. In fact, the partnership may consider these amounts regardless of whether the partner submits a certificate of deductions and losses and regardless of its de minimis status. [31]

[31] Regs. §1.1446-6(c)(1)(iii).

Net Operating Losses — 90% Limitation

The temporary regulations provide that a partnership may not consider a partner's net operating loss (NOL) deduction in an amount greater than 90% of the partner's allocable share of ECTI. In response to comments, the government agreed that the 90% requirement should be tied to the continuing applicability of the 90% alternative minimum tax (AMT) limitation on the use of NOL carryovers. [32] The regulations also now provide that the limitation should be applied on a cumulative basis for each installment period. Therefore, if the partnership's annualized income changes during the year, the NOL deduction that the partnership may take into account can increase or decrease accordingly.

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[32] §56(a)(4) and (d)(1).

Suspended Losses

The 2008 final regulations clarify that a foreign partner must identify any certified deductions and losses that are subject to special limitations at the partner level, such as the passive activity loss rules, and provide information to the partnership that will allow it to take into account such limitations.

The regulations continue not to permit the partnership to take account of prior losses that were previously suspended and that are released during the current year.

Deductions and Losses — Changes Not Made

Current Year Deductions

The 2008 final regulations confirm that a foreign partner can only certify prior year deductions and losses. The deductions and losses must be reflected on the partner's U.S. income tax return filed (or to be filed) for a taxable year ending prior to the installment due date or Form 8804 filing date (without regard to extensions) for the partnership taxable year for which the certificate is considered.

The Preamble to T.D. 9394 justifies this in these words: "[T]he IRS and the Treasury Department are concerned about the uncertainty associated with fluctuations in estimates of current-year activities and therefore have not adopted this suggestion."

We can perhaps understand this concern in relation to current-year activities of the foreign partner not related to the partnership. But it is harder to accept if the deductions are those that will be allocable by the partnership itself to the foreign partner and taken into account by the partner at the partner level. The whole structure of §1446 and the estimated tax provisions of §6655 on which it is built is founded on estimates that directly address "the uncertainty associated with fluctuations in estimates of current-year activities." And the government position is difficult to reconcile with its position on the estimates of current year earnings and profits for purposes of withholding tax on corporate distributions. [33]

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[33] Regs. §1.1441-3(c)(2).

It is understood that certain kinds of deductions are dealt with at the partner level because of a policy to allow those deductions based on the particular circumstances of the foreign partner. But in the majority of cases, that policy would not be impaired by allowing the partnership to take the deductions into account solely for purposes of what amounts to estimated taxes. Unlike in the case of withholding on FDAP income, the government generally has another opportunity to collect the taxes of partners engaged in a U.S. trade or business because such partners generally do file tax returns and indeed the only partners allowed to certify deductions are those who have already demonstrated a three-year record of compliance.

Moreover, the notion that limitations on deductions for partner-level deductions are a reason for not allowing them at all seems quite harsh. It turns §1446 into a vehicle for collecting tax from foreign partners on income that has nothing to do with the partnership. The legislative intent behind §1446 was to collect tax from foreign partners only with respect to their partnership income attributable to a U.S. trade or business. It was surely not conceived as a stealth method of collecting tax on other U.S. income.

Charitable Deductions

The final regulations do not allow a partner to certify charitable deductions "because of the difficulty a partnership would have in determining the amount of a charitable contribution deduction allowed to the foreign partner." The Preamble notes that §170 provides separate rules for corporations and individuals, the type of charity to which the contribution is made, and the type of property contributed to the charity, as well as separate rules applicable to the deduction amount in the case of charitable contribution carryovers.

Once again, we can understand this concern regarding charitable contributions made by the foreign partner. But most of these concerns are not applicable to contributions by the partnership itself. The partnership will know whether the partner is an individual or a corporation, will know (and must report to the partner) what kind of charity is involved, and will know what type of property it contributed and whether the amount of the contribution is limited to basis of contributed property or can be valued at fair market value.

Section 199 Deductions

On behalf of the Section of Taxation of the American Bar Association, the authors had suggested allowing a partnership to consider a partner's available deduction under §199 for qualified production activities in determining its 1446 tax. Section 199(d)(1)(A) requires the deduction to be computed at the partner level. The government rejected our suggestion because of the alleged difficulty in a partnership determining the §199 deduction of a partner. It pointed out, as we had done, that the §199 deduction is limited both by reference to the taxpayer's taxable income and to 50% of the Form W-2, *Wage and Tax Statement*, wages for the taxpayer for the taxable year.

However, the government did not address our point that there would be no risk if the partner's overall §199 deduction from both partnership and non-partnership activities were less than the amount of the deduction allocated to the partner. This could only occur if the foreign partner had losses from other activities that reduced the total amount of its income from domestic production activities. But those losses would also, presumably, reduce the amount of tax due by the foreign partner on income from the partnership.

Tax Credits

On behalf of the Section of Taxation, the authors had also suggested that a foreign partner should be able to certify credits to the partnership and that the partnership be able to consider current-year credits in determining the amount of its 1446 tax. In the Preamble, the government rejected this suggestion on the grounds that §1446 provides no authority for partnerships to consider credits in determining the amount of 1446 tax the partnership is required to pay.

The problem is that the Preamble mischaracterized our suggestion. What we actually suggested was that the partnership should be able take into account the partner's distributive share of the partnership's tax credits. We would argue that allowing consideration of credits arising out of the partnership's own activities would be a reasonable use of the authority granted by §1446(f).

Submission of Certificates

Time Lags for Submission of Certificates

The temporary regulations provided that the first certificate for a partnership taxable year could only be considered if it was received at least 30 days before the relevant due date for the partnership taxable year for which the partner would like the certificate to be considered. [34] Updated certificates could only be considered if received at least 10 days before the due date. In response to comments, the IRS removed these requirements. A certificate can now be relied on so long as it is received before the relevant due date.

[34] Basically, this is the due date of the installment in question or the due date (without regard to extensions) for the annual Form 8804 filing by the partnership.

Resubmission of Certificates

The temporary regulations required the partnership to attach a copy of any good driver certificate, and the related computation of 1446 tax, to both the Form 8813, *Partnership Withholding Tax Payment Voucher (§1446)*, and Form 8805, *Foreign Partner's Information Statement of §1446 Withholding Tax*, filed with the IRS for any period for which such certificate is considered. In response to a comment, the IRS agreed that a certificate submitted with Form 8813 should not be required to be submitted with subsequent filings of Form 8813 (unless an updated certificate is required) but would continue to require that it be submitted with Form 8805, in which case the most updated certificate for the year must be submitted.

The final regulations now provide that a partner's certificate need only be submitted for the first installment period for which it is considered. For subsequent installment periods, the partnership may instead attach a list of the name, taxpayer identification number, and the amount of certified deductions of each foreign partner whose certificate was previously considered and whose certificate was again considered in the subsequent installment period. The partnership would also indicate if it was relying on the state and local taxes withheld and remitted on behalf of the partner (see below). If the partnership were relying on the de minimis rule, the partnership would indicate that, instead of indicating the amount of certified deductions.

Denying Ability to Rely on Certificates

Under the temporary regulations, upon receipt of written notification from the IRS that a foreign partner's certificate is defective, the partnership could no longer rely on the defective certificate or any other certificate submitted by the partner until the IRS notified the partnership in writing. The final regulations confirm this and further provide that the IRS may also notify the partnership in writing if either a substantial portion of the certificates are defective or a substantial amount of the deductions and losses relied on by the partnership are reported on one or more defective certificates. Upon receiving such a notification, the partnership may not rely on any certificate submitted by any partner for the partnership taxable year in which such notification is received or any subsequent partnership taxable year, until the IRS revokes or modifies the original notice (in writing). [35]

[35] Regs. §1.1446-6(c)(5).

It is to be hoped that the IRS will use this new provision sparingly. In effect, it means that a defective certificate from one or more partners can result in the partnership being unable to rely on otherwise valid certificates submitted by other partners. In a large partnership, or a partnership with large amounts of ECTI allocable to foreign partners, this could effectively penalize a partnership and its compliant foreign partners for what may amount to no more than paperwork problems relating to other partners.

Procedural Matters

Filing Period Requirement: Number of Years

Under the 2005 temporary regulations, a foreign partner could not provide a good driver certification unless it had timely filed (or represented it would timely file) a U.S. income tax return for each of its preceding four taxable years and for the taxable year during which the certificate is provided. The partner was also required to have timely paid (or to represent that it would timely pay) all tax shown on such returns.

In response to comments, the IRS reduced the prior year filing requirement from four years to three years. However, the final regulations require that only returns that report ECI or deductions or losses properly allocated and apportioned to ECI will satisfy the tax return filing requirement. Accordingly, the partner may not fulfill the requirement with a U.S. income tax return that reports no such items. [36]

[36] Regs. §1.1446-6(b)(2)(iii).

The final regulations also relax requirements that all prior year tax returns have been filed timely in the case of a prior year return that had a due date (without extensions) before the beginning of the partnership taxable year for which the certificate is provided. The foreign partner can still provide a certificate if, before doing so, it had both filed such a prior year return and paid all taxes, interest, additions, and penalties shown on the return no more than a year after its original due date without extensions. This will provide relief for a foreign partner who missed a filing or payment deadline by a relatively short period of time. [37]

[37] Regs. §1.1446-6(b)(1)(ii) and (iii).

This relief does not apply to a missed date for a return in a year in which a certificate has been submitted to any partnership. Also, once a partner has submitted a certificate to a partnership, it must timely file all its subsequent years' returns (and timely pay all amounts due with the returns) to submit a certificate to a partnership in a later year.

Tiered Partnerships

As noted earlier, an LTP must withhold 1446 tax on ECTI allocable to a foreign UTP that is a partner in the LTP. However, if the foreign UTP provides sufficient information regarding its partners to the LTP, the LTP may withhold 1446 tax based on the partners in the UTP. These rules may also apply to domestic UTPs that have foreign partners. [38] Similarly, a UTP that receives certificates of deductions and losses from its foreign partners may provide the certificates to the lower-tier partnerships.

[38] *See* Regs. §1.1446-5.

The final regulations add several rules to ensure that deductions and losses certified to a UTP are not taken into account by both the UTP and an LTP or by more than one LTP. A new rule is also added requiring that sufficient information regarding a partner in the UTP submitting the certificate be provided to the LTP and then to the IRS so that the IRS can reliably associate the ECTI and the certificate with the partner in the UTP. [39]

[39] Regs. §1.1446-5(c)(2).

Trusts and Estates

The 2005 temporary regulations provided that a good driver certificate is not available to non-grantor foreign trusts or to foreign estates. The government declined to modify this in the final regulations. It also explicitly rejected our suggestion (moot in any event) that the compliance history of the decedent be taken into account in determining the estate's eligibility to provide a good driver certificate.

Effect on Reasonable Reliance on Certificates

The government rejected any change to the rules that require the partnership to be responsible for any underpayment of 1446 tax or for any applicable addition to the tax, interest, or penalties if a partner's certificate is defective or the partner submits an updated certificate that increases the 1446 tax due with respect to such partner. If a certificate is determined to be defective for a reason other than the amount or character of the deductions and losses set forth on such certificate (for example, the partner failed to timely file a U.S. income tax return), then the partnership is liable for the entire 1446 tax amount under §1461 (or any installment of such tax).

The one concession in the 2005 temporary regulations was that the partnership is not liable for the addition to tax under §6655 (as applied through Regs. §1.1446-3) for the period during which the partnership reasonably relied on the certificate. The government rejected a suggestion that reasonable reliance should protect a partnership against liability not only under §6655 but also for liability for the tax under §1461, interest on the tax under §6601, and various other penalty provisions. The Preamble points out that use of the certification procedures under Regs. §1.1446-6 is voluntary. The foreign partner is not required to submit a certificate and the partnership may consider all, none, or only a portion of the certified deductions and losses. It is hard to think of a clearer message that the partnership should think very long and hard before relying on a certificate.

This is as good a place as any to observe that in many cases it is the partnership, rather than the partner, that benefits from a reduced 1446 tax obligation but the certification procedures provide little incentive to foreign partners to certify their deductions and losses to the partnership. After all, one way of looking at withholding under §1446 is that it calls for a mandatory distribution to the foreign partner, courtesy of the U.S. government, irrespective of whether the partnership would otherwise have made a distribution to the partner. Add to this the unusual feature of the good driver certificate regulations, compared to almost all other withholding taxes where withholding agents are relieved of responsibility for reasonable reliance on payee certificates, certificates offer very little protection to the partnership. One has to wonder whether the government actually wants or expects anyone to make use of the procedure.

One welcome, if modest, concession is that the 2008 final regulations provide for a reasonable cause standard to be applied to determine whether a partnership that failed to attach the certificate and 1446 tax computation to the relevant filing is eligible for an extension of time to comply with this requirement. The partnership must show that the failure was due to reasonable cause and not willful neglect and must file an amended Form 8813 or Forms 8804 and 8805, with the necessary attachments. A written statement must include an explanation of the reasons for failure to comply. If the IRS fails to notify the partnership, within 120 days of the filing, of an adverse determination or of its need for more time, the partnership is considered to have demonstrated that the failure was due to reasonable cause and not willful neglect. The IRS determination is to be made based on all the facts and circumstances. [40] Presumably, we can hope that relief will normally be granted in the case of minor and short-term clerical errors.

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[40] Regs. §1.1446-6(d)(3).

Modifications to 2005 Final Regulations

The final regulations make several clarifying and conforming changes to the 2005 final regulations, including with respect to the calculation of installment payments of 1446 tax when a partnership considers a certificate received under Regs. §1.1446-6 and the information that an LTP must receive from a UTP when the LTP pays 1446 tax on behalf of the partners in the UTP. [41] Also, the prior-year safe-harbor provision in Regs. §1.1446-3 was conformed to §6655 to provide that, for partnership taxable years beginning after December 31, 2007, the partnership must compute its current year 1446 tax installments based on the total 1446 tax (without regard to Regs. §1.1446-6) as computed for the prior taxable year. [42]

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[41] Regs. §1.1446-3(b)(2)(i)(A).

[42] Regs. §1.1446-3(b)(2)(i)(B).

GOOD DRIVER CERTIFICATE

In this portion of the article we make some observations concerning the practical issues foreign partners and partnerships will face in providing good driver certificates on Form 8804-C.

Representations to Partnership

Form 8804-C requires the foreign partner to make a number of representations. Some of these representations may give rise to interesting practical problems, as noted below.

Line 1b — Trusts and Estates

In Line 1b, the partner must represent that the certificate is not being submitted by a partnership, estate, trust (other than certain grantor trusts described in the instructions), or beneficiary thereof. In fact, as we have seen, UTPs are permitted to submit certificates and this is made clear on page 2 of the Instructions. The reference to partnerships appears misleading.

The instructions also state, “The only type of trust that may submit a certificate to a partnership is a grantor trust. A grantor trust is any trust over which the grantor or other owner retains the power to control or direct the trust's income or assets. See sections 671 through 679.” This is in fact misleading. The only kind of grantor trust that would need to submit a certificate would be one with a foreign grantor — and a trust with such a grantor cannot be a grantor trust except in the limited circumstances provided by §672(f) or the transitional rules of the Small Business Job Protection Act. [43] A foreign grantor trust with a U.S. grantor does not need to certify deductions; it needs to provide a Form W-9 on behalf of the grantor so that it will not be subject to §1446 withholding at all. The Form should be revised to make all this clear, since §672(f) is not well-known.

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[43] The grantor trust rules do not apply to trusts with foreign grantors unless the trust is revocable or the only beneficiaries during the lifetime of the grantor are the grantor and/or the grantor's spouse. Under the transition rules applicable to trusts formed before February 7, 1995, the trust can also be a grantor trust to the extent income or capital can be distributed to the grantor or his or her spouse.

Line 2b — No Multiple Use of Same Losses and Deductions

This instruction requires the partner to certify that “I have not used (and will not use) the deductions and losses set forth in this certificate to reduce installment tax obligations under §6654 and 6655 on income, other than my allocable share of income from the partnership to which this certificate is provided.”

It is not quite clear what this representation means. The ambiguities are perhaps best demonstrated by an example:

José Fontanero, a nonresident alien, is a partner in domestic partnership McPlumbers LP, which is engaged in a business in Ohio that recently turned around after receiving extensive free media coverage. Fontanero also is directly engaged in a U.S. trade or business as a political consultant. Fontanero has net operating loss carryovers of $5,000 and is eligible to certify some or all of those losses to McPlumbers. On April 1, Fontanero certifies the losses to McPlumbers. On April 15, McPlumbers determines that Fontanero's allocable share of the profits of McPlumbers subject to 1446 tax in the absence of a certificate would be $500. It accordingly reduces the amount on which 1446 tax is calculated by $450 (remember the 90% limitation). In the meantime, Fontanero must pay his estimated tax on his other business. Assume that the other business would require tax to be paid on the basis of annualized income of $4,000.

This simple example illustrates the uncertainties. (The problems can get much more complicated if the foreign person is a partner in multiple partnerships.) Does the representation mean that Fontanero may not use *any* part of the NOL carryover against his other business in computing his estimated tax? Or does it mean that Fontanero may use the carryover to the extent that it is not used by McPlumbers LP? Or can Fontanero certify only a portion of the carryover to McPlumbers? If he can, should he? How will he or McPlumbers know how much it is going to use? What happens when the next quarter rolls around? Presumably Fontanero would have to submit an updated certificate if he has in fact used the part of the carryover that had previously been used by McPlumbers, because he underestimated what McPlumbers would use. Or would the prior certificate be invalidated?

The authors appreciate that the reader is reading this article in part to get answers. However, we have none on this particular point. We do believe that the representation or its instructions are in need of clarification.

Lines 3a and b — Tax Due Has Been Paid

Line 3a sets out representations for the first time a partnership certification is submitted to any partnership; line 3b sets out representations for any subsequent submission by a foreign partner, even if the partner has never previously submitted returns. These lines include representations that tax has been paid when due.

This is actually quite a problematic requirement. There is a difference between paying tax shown on a return and paying the tax actually due. Taxpayers cannot always pay the amount due because they may not know how much they owe if third parties, such as partnerships and trusts, or even employers, do not provide them with timely information. The IRS has taken some steps to alleviate this problem by limiting automatic extensions for partnerships and trusts to five months instead of six, but in many cases the foreign partner may have to make an estimate. But what if a foreign taxpayer underpays tax because a partnership or trust of which the taxpayer is a partner or beneficiary mischaracterizes or underreports income and later corrects this, too late for its partners and beneficiaries to have paid the amount of tax due? Foreign taxpayers are also required to pay tax if a withholding agent fails to withhold. But it is not always obvious to a taxpayer whether or not withholding has actually occurred or to what extent a foreign partner can rely on a notification from a partnership that 1446 tax has been paid.

In general, failure to pay tax in circumstances such as these constitutes acceptable behavior for taxpayers. They may have to pay additions to tax or interest but no one considers this to be culpable behavior. Nor should it bear upon whether the foreign taxpayer is a suitable person to file good driver certificates. Nevertheless, if we read the representations in lines 3a and b literally, it would seem that a foreign taxpayer would be disqualified forever if he just once underpays tax, even as a result of difficulties with third party withholding agents and information reporting. One wonders if this is what the IRS intends.

The IRS obviously recognizes that certificates may have to be updated because, for example, the amount or character of deductions may have changed (*see* line 5c) or other information given to the partnership has changed (*see* line 5e). However, if an update is caused by changes of any kind that would also have triggered an underpayment of tax, it would seem that the foreign partner can never again use the certificate procedure.

Updated Certificates

Line 5 requires an explanation of the reason for an updated certificate. The first two checkboxes simply inform the partnership that a return the partner previously stated had not yet been filed either has been filed (line 5(a)) or remains unfiled (line 5(b)). In the case of the filed return, the update is required within 10 days of the filing of the return. In the case of an unfiled return, the partner must indicate that a request for an extension has been filed; otherwise, one presumes, the original certificate is invalidated because the return was late.

The 10-day rule puts the onus on the foreign partner to be pretty organized and ensure that the filing of any return is also an occasion for reviewing requirements related to partner certificates. Still, one might wish for the deadline to be a little longer.

One might also wish for the language in line 5(b) to be a little clearer or perhaps split into two lines. The first line would then read: "I am submitting this updated certificate to the partnership prior to its final installment due date of 1446 tax (see instructions) to inform the partnership that an extension to file such return has been filed and that the new due date is ___. The second line would read: "I am submitting this updated certificate to the partnership prior to its final installment due date of 1446 tax (see instructions) to inform the partnership such return has not been timely filed and that it may no longer rely on any certificate provided by me/us."

The remaining three checkboxes deal with changes in the amount or character of deductions and losses previously listed or other changes in circumstances or information. While reasonably clearly expressed, it would be advisable if the foreign partner were required to state affirmatively whether or not, in consequences of these changes, the partner is no longer allowed to provide a certificate.

No Multiple Use of Deductions and Losses

Line 9 requires a certification that the deductions and losses will not be certified to another partnership. This certification, similar to the representation in line 2b discussed above, gives rise to the same problems.

The IRS's primary objective should be to avoid the multiple use of the same deductions and losses. But it should also seek to facilitate the use of deductions and losses in a flexible manner. We would therefore suggest two improvements to the form and to the representation in line 2b and the certification in line 9.

First, the instructions should clarify that a partner can certify to any one partnership fixed amounts of deductions and losses that are less than the full amount available to the partner. For example, a partner with a net operating loss carryover of $1,000 should be permitted to certify portions of the $1,000 to different partnerships, so long as the total certified to all partnerships does not exceed $1,000.

Second, the partner should be entitled to provide a single certificate to multiple partnerships, provided that: (1) the partnerships are under common management (that is, they have at least one managing general partner or managing member in common or, less flexibly, they share the same tax matters partner); (2) the partnerships are informed of the certification to multiple partnerships; and (3) the partner requires, or the partnerships agree on, an allocation of the certified amounts for purposes of §1446 according to a formula that cannot result in deductions and losses being used in excess of the total certified by the foreign partner. This would both reduce the number of certificates that the partner would have to submit and allow the deductions and losses to be used efficiently without jeopardizing the government's interests.

LIVING WITH §1446

In an article in 2006, we discussed in detail planning for partnerships and foreign partners in dealing with §1446. [44] It makes sense, nevertheless, to recapitulate the principal steps that we believe a partnership and its foreign partners can take to mitigate the effects of §1446.

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[44] *See* Karlin and Appel, "Kissing the Blarney Stone — A Practical Guide to Structuring Partnership Agreements and Limited Liability Company Operating Agreements in Light of the §1446 Regulations," 47 *Tax Mgmt. Memo.* 171 (5/1/06).

We believe that this planning is needed because of the clear and understandable preference of U.S. entrepreneurs and investors for pass-through forms of doing business in light of the continued double taxation of corporate earnings at corporate and shareholder levels. Because the S corporation is not an option for direct infusions of foreign equity capital, pass-through for these purposes means an entity that is classified as a partnership for U.S. income tax purposes. And that means confronting §1446 both as it affects the partnership and the partners, domestic as well as foreign.

FDAP Income Versus ECI

In some cases, partnerships can structure income to be FDAP income rather than ECI. In most cases, ECI is taxed more favorably than FDAP income because the nominal rates are comparable but the tax on ECI is a tax on net income and the tax on FDAP income is a tax on gross income, without deductions. However, in some cases, FDAP income is taxed more favorably, because of treaties or statutory exemptions. Partnerships can consider structuring activities so as to generate FDAP income rather than ECI if the rates make sense.

Allocation Provisions

ECI Versus Non-ECI

One approach to limiting the impact of §1446 would be to limit allocations to foreign partners of ECTI. 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, where the partnership has both ECTI and other forms of income, the allocation provision might provide for disproportionate allocations of ECTI to domestic partners and non-ECTI to the foreign partners. One situation in which this approach might have some appeal would be a service partnership where the foreign partner is not performing services within the United States. [45]

[45] *See* Rev. Rul. 2004-3, 2004-1 C.B. 486. For a review of this issue, see Blanchard, "The Unresolved Tax Status of Multinational Service Partnerships and Their Partners," 56 *Tax Law*. 779 (2003) (pre-dating the ruling); May, "Wrongs and Remedies: The U.S. Tax Treatment of Multinational Partnerships of Individuals," 103 *Tax Notes* 1509 (2004) (considering the ruling in depth).

Minimize Early-Year Allocations

A second way would be 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 three years with a catch-up provision coming into effect in the fourth year or on sale of the partnership's property. One reason for choosing three years is that it would give the foreign partner the three years needed to establish "good driver" status so that, when ECTI allocations begin, the partnership and the foreign partner could take advantage of certification of prior-year losses.

Another example would be where the partnership anticipated early-year losses likely to be offset by later-year profits. The partnership might choose to allocate these losses to the U.S. partners with offsetting income and gain allocations as soon as there are allocable profits. Otherwise, unless a good driver certificate were available, §1446 would require tax to be paid in the later year without regard to the earlier-year losses.

So long as such arrangements meet the substantiality requirements of the substantial economic effect test, the effect would be to minimize gain allocations to foreign partners before they have actual economic income from the partnership. Allocations of income that are transitory as to class or timing tend to be viewed with suspicion [46] but if 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.

[46] *See* Regs. §1.704-1(b)(2)(iii)(*c*).

Guaranteed Payments Versus ECI

Another 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 is not subject to §1446. Moreover, the partnership gets a deduction for guaranteed payments so that in the end no U.S. partner will be taxed on amounts paid as guaranteed payments. This approach lacks mathematical precision because a guaranteed payment is not dependent upon the income of the partnership. Rather, it is an estimate of what profits a partnership will have. [47] But it might, in appropriate circumstances, achieve the desired result.

[47] For further discussion of guaranteed payments, see May, "Wrongs and Remedies: The

U.S. Tax Treatment of Multinational Partnerships of Individuals," 103 *Tax Notes* 1509, at text accompanying notes 79 through 94 (2004).

Distribution Provisions

Coordinating Distribution Provisions with §1446 Requirements

Many, if not most, partnership agreements provide for the partnership to make minimum distributions to enable partners to pay their estimated taxes. The drafters of such provisions are, of course, free to take into account prior-year loss allocations and current-year partner-level deductions and so, in a partnership with no foreign partners, over-distribution is less of an issue.

At the very least, the agreement should require that the payment of 1446 tax will be treated as a distribution for the purposes of the minimum distribution provisions of the agreement. Beyond this, a foreign partner whose 1446 tax is greater than the distribution that the partner would otherwise have received can be 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 is due. This approach would be particularly appropriate in a case where the partnership does not wish to make any distributions at all.

Partnership Provisions Relating to Good Driver Certificates

Depending on the circumstances, §1446 can in some cases be a benefit to foreign partners. As noted more than once in this article, §1446 is, fundamentally, a provision requiring the partnership to make a distribution to its foreign partners. Even though the foreign partner may not actually get its hands on the distribution right away, it knows that the distribution is in the safe hands of the U.S. government. Moreover, if the foreign partner's capital account is negative or is rendered negative by the distribution, the distribution will have been funded, in effect, by the other partners. Given the current economic environment, this is going to become a common state of affairs until the economy recovers.

It follows that, even though a foreign partner could provide a good driver certificate, it will not always have an incentive to do so. From the perspective of the management of the partnership, the partnership agreement could require the foreign partner to qualify and maintain its qualification as a good driver and to submit a certificate if qualified and if it has more than a de minimis amount of available deductions and credits. Having said this, as we have pointed out before, such a requirement presents some difficulties. It would be hard to craft 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 sufficiently knowledgeable to be able to make declarations under penalties of perjury required to support a certificate. A partnership agreement provision that required such a declaration when the declaration could not lawfully be made might be unenforceable.

Avoid Foreign Partners

Restrictions on Transfer

Most partnership agreements contain provisions relating to the transfer of partnership interests. Drafters of partnership agreements may 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.

Co-Tenancy in Lieu of Partnerships

One structure, 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. There is considerable experience of this kind of structure in the world of like-kind exchanges, where taxpayers exchange their real property for co-tenancy interests (like-kind) rather than partnership interests (not like-kind).

Use of Blockers

Partnership Blocker

Foreign partners could be required to form their own domestic partnership to invest in a domestic partnership engaged in a U.S. trade or business. 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. [48] 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. [49]

[48] *See* Regs. §§1.1446-1(c)(2)(ii)(A) and 1.1446-5(a) and (e).

[49] 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).

Corporate Blocker

Foreign investors could be required by the partnership to invest through a domestic corporation. By such means, U.S. investors could still invest in a partnership vehicle but foreign investors would either invest separately through their own domestic corporation (which would hold investment assets directly) or would invest collectively in the partnership through a domestic corporation. These devices would all eliminate application of §1446.

The price for individual foreign investors would be double taxation of corporate earnings and loss of the capital gains preference on partnership profits. But for corporate foreign investors, a U.S. blocker not only eliminates application of §1446 but also moves the foreign corporation from the unpredictable and difficult to control branch-level-taxes regime of §884 to the relatively friendlier §1442 withholding tax regime on distributions. Any planning here must take account of a U.S. income tax treaty cutting or even eliminating the withholding tax on dividends and, in some cases, the branch-level taxes.

Example:

Sharpshooter PLC, a U.K. public company, plans to invest in Caribou LP, a domestic partnership engaged in the business of turning sows' ears into silk purses in Wasilla, Alaska. If Sharpshooter PLC became a partner of Caribou LP, the partnership would have to pay 1446 tax on its share of ECTI. Sharpshooter PLC would ultimately pay corporate tax at regular U.S. rates and receive a refund of any overwithheld 1446 tax.

If instead, Sharpshooter PLC forms Goshdarnit, Inc., a U.S. corporation, to invest in Caribou LP, Caribou LP would not have to withhold under §1446. Instead, Goshdarnit, Inc. would pay corporate tax at regular U.S. rates. Goshdarnit, Inc. would have to pay estimated taxes like any other U.S. corporation, that is, taking full account of all deductions, credits, and losses, whether at the partnership or partner level. No withholding would be required on dividends subsequently paid by Goshdarnit, Inc. to Sharpshooter PLC, based on Article 10 of the income tax treaty between the United Kingdom and the United States. (Sharpshooter PLC would be able to credit any tax paid by Goshdarnit, Inc. against its U.K. corporation tax or, alternatively, exclude dividends from Goshdarnit, Inc. from its taxable income for U.K. corporate tax purposes.)

It is hard to imagine why any U.K. or similarly-situated company would not employ a structure along these lines rather than have to deal with §1446.

Foreign Partners Segregated into Domestic UTP

One way to insulate the domestic members of a partnership with foreign investors is to require the foreign investors to become partners in a domestic UTP that would then invest in the partnership as an LTP. The LTP would have no obligation to withhold in this situation — all of the withholding would be required at the UTP level. While this would not eliminate the application of §1446 for the foreign partners, it would eliminate the exposure of the LTP and its domestic partners to the effects of §1446, including the obligation to pay 1446 tax in a situation where the LTP may have no cash.

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A few weeks before completing work on this article, the authors inquired of the Internal Revenue Service whether there were any statistics available concerning use of the good driver certificate procedures since they were introduced by the 2005 temporary regulations. The IRS declined to provide this information. The authors' pessimistic prediction has been that the procedure would be little used. We hope, rather than expect, that we are wrong, but the government has so far been unwilling to say.

In any case, we believe that the good driver certificate provisions are limited and problematic as a remedy for overwithholding. Their scope is too narrow, they leave far too many deductions, losses, and credits unacknowledged, the procedural requirements raise several practical problems and uncertainties, and the certificate, once obtained, does not provide a reasonable level of protection if it turns out to be wrong. Our conclusion, therefore, remains that U.S. business enterprises should stay outside the reach of §1446 where possible and should mitigate its impact where it cannot be fully avoided. There are, as this article has shown, a number of straightforward planning tools available to accomplish these objectives.

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