

**New York State Bar Association
Tax Section**

Report on Final and Temporary Section 1446 Regulations

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NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON FINAL AND TEMPORARY SECTION 1446 REGULATIONS

This report¹ provides comments on the final, temporary and proposed regulations under section 1446 issued on May 18, 2005.² Section 1446 requires a partnership engaged in a U.S. trade or business to withhold tax on the partnership's effectively connected taxable income ("ECTI") allocable to its foreign partners, generally at the highest applicable marginal rate. Foreign partners may credit the tax withheld by the partnership against the final tax otherwise owing when they file their own U.S. federal income tax returns.

The final regulations (the "Regulations")³ adopt, with certain modifications, regulations proposed in 2003 (the "Prior Proposed Regulations").⁴ The Regulations contain rules addressing how a partner's status as foreign or domestic and its allocable share of ECTI may be determined, and other procedures for calculating, paying and reporting section 1446 tax and quarterly installments of the tax. Additional rules address application of these procedures to tiered partnerships and publicly traded partnerships. In general, section 1446 requires tax to be withheld based on the partnership's ECTI allocable to a foreign partner without regard to other tax items of the foreign partner that may reduce the partner's ultimate tax liability. Temporary

¹ The report was drafted by Andrew Walker with substantial assistance from Diana Wollman. Helpful comments were received from Alan Appel, Kimberly Blanchard, David Hariton, Michael Schler and David Sicular. References in this report to "sections," unless otherwise stated, are to the Internal Revenue Code of 1986, as amended (the "Code").

² T.D. 9200, 70 Fed. Reg. 28,702 (May 18, 2005).

³ Treas. Reg. §§ 1.1446-1 through 1.1446-5, and 1.1446-7.

⁴ See 68 Fed. Reg. 52,466 (Sept. 3, 2003), corrected at 68 Fed. Reg. 62,553 (Nov. 5, 2003).

regulations,⁵ issued in proposed form at the same time⁶ (“Regulation -6T”) contain rules that, for the first time, allow partnerships to consider certain losses and deductions of a foreign partner when determining the amount to be withheld under section 1446.

We commend the Treasury and Internal Revenue Service (the “Service”) for responding to a number of concerns regarding the Prior Proposed Regulations expressed by commentators. Although we think some of the commentators’ suggestions that were not adopted have merit, in this report we raise only those remaining concerns with the Regulations we consider most important, and we then focus on Regulation -6T.

I. Summary of Recommendations

In summary, we have the following comments and recommendations:

- COD Income. A majority of our Executive Committee supports the Treasury’s and the Service’s decision not to adopt a special rule providing relief from withholding with respect to income from cancellation of indebtedness (“COD income”). However, we believe that applying section 1446 to COD income raises difficult issues that merit further consideration by the Treasury and the Service, and we discuss those issues in detail below.
- Section 1445/1446 Overlap. We recommend that the “trumping rule,” which requires application of section 1446 withholding when section 1446 overlaps with section 1445(e)(1), be reconsidered and that dispositions of U.S. real property interests by a partnership be subject to the withholding procedures of section 1445 rather than section 1446 when the real property interest is not held in connection with a U.S. trade or business. The Executive Committee was divided as to whether section 1445 should trump section 1446 in all cases involving dispositions of real property, but

⁵ Temp. Reg. § 1.1446-6T.

⁶ Prop. Reg. § 1.1446-6.

to further consistency and administrative simplicity, we think the Treasury and the Service should consider whether all dispositions of real property by a partnership should be subject to section 1445 rather than section 1446.

- Regulation -6T. Although we recognize it is a difficult issue, on balance a majority of the Executive Committee feels that a partnership that reasonably relies on a certificate under Regulation -6T should be protected from substantive liability for tax and interest thereon, not merely from the addition to tax under section 6655. Regardless of the scope of reliance permitted, however, we strongly recommend that the procedural requirements under section Regulation -6T be substantially simplified. We generally recommend substantial simplification of the Regulation -6T procedures. Specifically, we recommend that:

- The “good driver test” require tax return filings for the lesser of the 2 prior years and the number of years the partner has been a partner in the relevant partnership;

- Losses permitted to be certified to the partnership include the current year’s state taxes anticipated to be due on the partnership’s income and charitable deductions;

- A partnership be allowed to rely on a certificate (whether the initial certificate or an updated certificate) regardless of the number of days between the receipt of the certificate and the section 1446 tax due date;

- The rules for updating certificates be clarified; and

- The representations required and other formal requirements for a certificate be minimized.

II. Detailed Comments

A. COD income

1. Background

The Prior Proposed Regulations requested comments on the appropriate treatment of cancellation of indebtedness (“COD”) income recognized by a partnership. Although many commentators argued that COD income should be exempt from section 1446 withholding, the Regulations treat COD income no differently than any other income for purposes of determining the partnership’s section 1446 withholding obligations. This is the case even though COD income, by definition, will never correspond to the current receipt of cash by the partnership. A partnership that recognizes COD income therefore will need cash from another source to satisfy its obligation to withhold tax under section 1446. Many of the commentators addressed this cash-flow problem and the resulting shift of the ultimate economic burden of the tax from the relevant foreign partners to the lenders or the general partner (or other withholding agent). However, the Regulations’ drafters decided not to provide any special exception for COD income.

In explaining the decision not to provide a special exception, the preamble offers three justifications. First, it expresses a concern that the Treasury and the Service lack authority to adopt a special rule, because the statutory language is clear. Second, it suggests that the purpose of section 1446 is to collect taxes that the foreign partners otherwise might not pay and that this purpose mandates collection of taxes on taxable income allocable to foreign partners without regard to whether the partnership has custody or control over the income that is subject to withholding, whether the partnership

has access to cash that belongs to the relevant foreign partner and without regard to the partnership's financial capacity. Third, the preamble notes that new Regulation -6T permits a partnership to take into account partner level items available to shelter COD income, suggesting that this may provide relief in appropriate circumstances.⁷

2. Summary Position

A majority of the Executive Committee believes that the Treasury and the Service were correct in deciding not to extend any special relief from section 1446 applicable to withholding on COD income. The majority concurs with the judgment of the preamble that the literal language of section 1446 requires such withholding. Section 1446 is not a cash-flow based withholding regime. Section 1446 generally requires withholding in respect of a foreign partner's share of a partnership's ECTI rather than from cash distributions to the foreign partner.

The majority also believes that requiring withholding on COD income is justified with reference to the policy of section 1446. The statute is designed to insure that the government collects tax on a foreign partner's share of ECTI even if the foreign partner does not comply with its U.S. tax obligations. Section 1446 therefore may, in many circumstances, require withholding when cash would not otherwise have been distributed to the foreign partner, even when there may be no excess cash at the partnership level readily available for distribution to any partners.

A minority of the Executive Committee was not persuaded that section 1446 mandates collection of taxes on ECTI allocable to foreign partners without regard to

⁷ The preamble also rejects the view expressed by some commentators that, if the partnership is in bankruptcy, the withholding on COD income could in some circumstances be considered a preferential distribution by the partnership to a non-creditor in violation of the U.S. Bankruptcy Code. The preamble does not explain the basis for rejecting that view.

whether the partnership has custody or control over the income and without regard to the withholding agent's financial capacity, as the preamble suggests. The minority focused on section 1446(e), which provides that payment of withholding tax under the statute is required "at such time and in such manner as the Secretary shall prescribe."⁸ This statutory grant of authority could be interpreted as granting regulatory latitude to determine not only the procedures for payment but also how much and when the withholding tax must be paid. Indeed, the Treasury and the Service have crafted a regime for publicly-traded partnerships that requires withholding based on actual distributions to foreign partners.⁹ Although there was disagreement among our members as to whether the statute and its legislative history mandate reading the statute as imposing an absolute withholding requirement without regard to the partnership's ability to pay or whether the ultimate burden of the tax falls on persons other than the appropriate foreign partner, a majority of the Executive Committee felt that providing an exemption for COD income exceeded the "time and manner" discretionary authority granted the Service under the statute and would require legislative action.

⁸ The minority also viewed legislative history of section 1446 as somewhat instructive. The initial 1986 Act version of section 1446 required withholding on distributions. Tax Reform Act of 1986, section 1246(a). This was repealed prior to becoming effective in 1988 and replaced with a withholding regime based on the ECTI allocable to foreign partners. Technical and Miscellaneous Revenue Act of 1988, sections 1012(s)(1)(A) and (D). However, this was not out of concern that the original regime was insufficiently protective of the fisc. On the contrary, Congress was concerned that basing withholding on distributions could impose tax on amounts that included little or no income and therefore could result in overwithholding. See H.R. Rep. No. 795, 100th Cong., 2d Sess. 290 (1988), and S. Rep. No. 445, 100th Cong., 2d Sess. 304 (1988). On the other hand, Congress also believed that the 1988 amendments would "accomplish the objectives of the Act more accurately", *id.*, arguably supporting the majority view that the purpose of the Act was to collect tax on net income at the partnership level regardless of cash distributions to the partners. Likewise, the same legislative history gives, as examples of the Treasury's authority to prescribe regulations, purely procedural examples (such as avoiding double tax collections on tiered partnerships), with no mention of the Treasury's authority to provide substantive exceptions to the statutory rule.

⁹ See Treas. Reg. § 1.1446-4.

3. Policy Considerations

COD income is peculiar in that withholding with respect to COD income may result in an arguably inappropriate allocation of the economic burden of the tax.¹⁰ It is unclear whether the statute reflects a Congressional intention that withholding tax be collected even if the ultimate burden of that tax is not borne by the foreign partner to which it relates.¹¹ Given these concerns, we have included this discussion of what we believe to be the principal policy considerations relative to withholding on COD income. Notwithstanding our view that the regulations are correct not to adopt a special rule for COD income, the Treasury and the Service may wish to consider the issues in more detail, taking into account some of the alternatives described below, before reaching any final decision.

The majority of cases in which a partnership must fund withholding tax from sources other than cash at the partnership level present a temporary timing and liquidity problem. The problem arises when a partnership recognizes ECTI before receipt of the corresponding cash and cannot satisfy its withholding liability out of cash otherwise readily available for distribution to the relevant foreign partner. A partnership may fund the tax liability out of working capital or, if it is solvent, may borrow from third

¹⁰ Certain other comparable items, such as gain recognized upon foreclosure on real property by lenders whose debt exceeds the partnership's tax basis in the property, may raise essentially the same issue. However, since foreclosure gain may arise when the property securing nonrecourse debt is "under water" but the partnership as a whole remains solvent, the burden of the section 1446 tax may ultimately be appropriately borne by the foreign partners to which it relates.

¹¹ The extent to which COD income is U.S. source income or is properly treated as ECTI is unclear. We have provided comments on certain related sourcing issues in a prior report. See N.Y.S.B.A. Tax Section, Report No. 1070, "Report on Source, 'Effective Connection' of COD Income in Cross Border Financings" (Nov. 5, 2004), reprinted at 2004 TNT 217-23. For purposes of this report, we have simply assumed that the COD income of a partnership may be treated as ECTI.

parties who expect to be repaid in the ordinary course. Over the life of the partnership business, these types of timing mismatches will ordinarily be reversed and withholding tax can be recouped out of amounts that would otherwise have been distributed to the appropriate foreign partner. Stated differently, in most situations, the withholding liability does not exceed the value of the relevant foreign partner's equity in the partnership at the time tax must be withheld.

These types of temporary timing mismatches can be, and generally are, addressed contractually in advance in the partnership agreement. Typically, for example, a partnership agreement will provide that amounts that the partnership is legally required to withhold and that are attributable to a particular partner are treated as a deemed distribution to that partner for purposes of the agreement, which reduces the partner's capital account and therefore its entitlement to subsequent distributions. Alternatively, these withheld amounts may be treated as an advance to the affected partner that is automatically repaid out of distributions that would otherwise be paid to the foreign partner. In either case, because the value of the foreign partner's interest generally will exceed the section 1446 tax amount when withholding occurs, the partnership expects to recover the outlay eventually from assets that would otherwise be distributed to the appropriate foreign partner.¹²

COD income, unlike timing mismatches, is seldom anticipated when the partnership agreement is entered into or the borrowing is incurred. COD income also will not match up with a current or future receipt of cash by the partnership. Instead,

¹² In some cases the partnership agreement may deal with the cash-flow problem by requiring the foreign partner to contribute cash to the partnership to fund the tax payments. As discussed below, enforcing that obligation in a distress situation may be difficult for the partnership.

COD income is attributable to loan proceeds received by the partnership in an earlier tax year that will almost certainly already have been spent by the partnership. A lender is not likely to forgive any portion of the debt if the partnership has cash available to it or expects future cash flows sufficient to repay that debt.¹³ Typically, therefore, at the time a partnership recognizes COD income the relevant foreign partner is unlikely ever to be entitled to sufficient cash distributions from the partnership to “repay” the tax that the partnership or other withholding agent must withhold on the COD income.

To the extent that the partnership is insolvent, the withholding tax likely will not be borne economically by the other limited partners (we are presuming the foreign partner is a limited partner or that the partnership is an LLC). Instead, it will be borne economically either by the general partner (if any) or the managing member in its capacity as withholding agent or, indirectly, by the lenders, because the partnership will need to liquidate some of its remaining assets to fund the withholding obligation, thereby reducing assets available to satisfy the loan.¹⁴

¹³ While we are focusing on COD income generated in a situation where the lender accepts less than the amount due because the borrower simply is unable to pay the full amount, COD income can also be recognized by a borrower if interest rates have risen since the debt was incurred and the lender is willing to give the borrower a discount in exchange for an early redemption of the debt. Similarly, COD income may arise when the terms of debt are amended in a manner that qualifies as a “significant modification” under Treasury regulation section 1.1001-3, the issue price of the debt issued in the resulting deemed exchange is its fair market value under Treasury regulation section 1.1273-2 and that value is less than the debt’s face amount (either because of a rise in market interest rates or a decline in the issuer’s credit quality).

¹⁴ Under state partnership law, a general partner is liable for debts of the partnership, including an obligation to pay withholding tax. However, in those situations where the general partner would be able to satisfy the withholding obligation it would also likely be able to repay the lenders and therefore the lenders would presumably be less likely to be willing to forgive the debt. In the case of a limited liability company, the burden of the withholding tax on COD may fall on the LLC’s managing members, which, like limited partners would not generally be liable for debts of the partnership under state law, but may have direct liability for the withholding tax under U.S. federal tax law as a withholding agent. In either case, however, general partners and managing members are typically special purpose entities with limited capital at risk.

Based upon the specific factual situation, section 1446 withholding on COD income may lead to arguably inappropriate results. Consider a partnership that borrows and expends the borrowed funds on operations that generate deductible expenses or invests the funds in assets that generate losses. The associated deductions are allocated to the partners (including the foreign partner). The foreign partner may use the deductions to offset taxable ECTI from other sources; when the corresponding COD income is later recognized, the partner has no out-of-pocket tax cost because the withholding by the partnership satisfies the partner's U.S. tax obligation. Whoever has funded the payment of the withholding tax has provided a windfall to the foreign partner.

Alternatively, perhaps even more perversely, the foreign partner may have carried forward the prior years' deductions and may use them to offset the COD income allocable to it. In that case, the foreign partner's tax liability will be less than the section 1446 tax withheld and the foreign partner will be entitled to a refund of the tax paid on his behalf. In that case, the foreign partner walks away with money in its pocket – money that came out of the pockets of the general partner, the managing member or the lenders who have effectively funded the partnership's withholding obligation.

Ordinarily, the rule treating COD income as taxable income imposes the incidence of taxation on a person who benefited from the corresponding loss or deduction (*i.e.*, the loss or deduction resulting from the use of the borrowed funds) or tax-free receipt of borrowed funds. But in the section 1446 context, the benefit of the loss or deduction goes directly to the foreign partner whereas the ultimate burden of the tax on

Accordingly, unless the partnership assets are securing the loan under a lien that has priority over the tax claim, partnership assets would have to be used to satisfy the withholding obligation.

the COD income remains in the partnership or is borne by another withholding agent or the lender.

Of course, applying section 1446 to COD income will not necessarily raise these concerns in all contexts. COD income or comparable items may arise even if the partnership is not insolvent and the foreign partner's equity in the partnership has value. For example, as noted above, COD income may arise then a partnership repurchases its debt at a discount because the interest rate is below then prevailing market rates. Similarly, as noted above, COD income may arise because a negotiated amendment to the terms of debt results in a deemed exchange under Treasury regulation section 1.1001-3 at a time when the debt is worth less than face because of market interest rates or a temporary deterioration in the partnership's credit. Gain on foreclosure by nonrecourse lenders may arise when a particular asset is "under water" even if the partnership has other assets available to fund any section 1446 withholding tax. These factual scenarios do not necessarily mean that no relief from withholding on COD income should be available. However, they suggest that any rule providing relief may need to distinguish between those situations in which the partnership is unlikely to be able to recoup withholding from the appropriate foreign partner and those in which it can.

The majority of our Executive Committee felt that the policy concerns associated with shifting the incidence of tax is a matter for Congress if it wishes to change the statute, rather than a matter that Congress intended to delegate to the Treasury to resolve by regulations. In addition, the majority felt that absent a change in the statute, these issues could best be dealt with by the parties potentially affected thereby. We assume that the government's reluctance to provide a special rule for COD income may

be predicated on a belief that lenders to partnerships, as well as general partners, can protect themselves contractually. For example, it is fairly common practice for a partnership agreement to require foreign partners to indemnify the partnership for withholding taxes. We note, however, that a foreign partner whose partnership interest is worthless in many cases is aggrieved and probably has little incentive to make further payments to the partnership, which it will view as “throwing good money after bad.” While the partnership can sue to recover based on a repayment obligation in the partnership agreement, it faces precisely the types of practical and jurisdictional impediments the government faces in collecting taxes from the foreign person directly. For additional protection, the partnership could both impose the obligation and require the foreign partners to secure the obligation (for example through an escrow or letter of credit).

We recognize that, as a purely practical matter, many parties are unlikely at the outset of the venture fully to consider and appreciate the possible consequences of COD income or even to anticipate that there will ever be any COD income and, for those reasons alone, are unlikely to negotiate complex credit arrangements to deal with the situation. It may also be commercially difficult for a sponsor to insist on (or even suggest) arrangements to address this, since that may imply a lack of confidence in the business model upon which it is asking limited partners to invest. Nevertheless, most large partnerships with sophisticated investors and creditors and experienced and well-informed advisors should be able to address these concerns contractually.

Our agreement with Treasury’s and the Service’s decision on COD income is based in part on our recognition that a rule exempting COD income from

withholding could result in a failure to collect tax owing from foreign partners where the foreign partner has a tax liability from the COD income and fails to pay that liability directly. The minority's reservation is over whether Congress intended to preclude relief in these situations, and whether ensuring collection of the tax in this set of circumstances is appropriately achieved by a rule that may well shift the burden of the tax to persons other than the relevant foreign partner in other cases. The answer may depend on whether one expects partnerships and their lenders to protect themselves contractually, as discussed above, and on whether one believes that the government has the authority to write regulations to ameliorate the problem. In the event that the Treasury and the Service were to reconsider their decision not to grant relief, we have identified at least three possible approaches.

First, COD income could be exempted from section 1446 withholding only if the partnership is insolvent and/or the relevant foreign partner's equity in the partnership is worthless at the time withholding is required. This approach has the virtue of providing relief only when the burden of the section 1446 withholding tax will likely be shifted to persons other than the foreign partner but not in other circumstances. The disadvantage of this approach is that it would raise difficult questions involving valuation and proof and may be difficult to administer fairly.

A second approach would be to exempt all COD income from section 1446 withholding. This has the virtue of administrative simplicity but would undoubtedly result in a failure to collect tax owing in some situations where the partnership could have paid the tax and recouped the withholding out of the distributive share of the relevant foreign partner.

A third approach would be to require the partnership to withhold the section 1446 tax on COD income only out of actual distributions that would otherwise be made to the relevant foreign partner. This would ensure that any tax collected was in fact borne by the foreign partner. The disadvantages are that it offers taxpayers the opportunity to defer payment of the tax and (unless an interest charge is imputed) denies the fisc the time value of deferral and could become complicated. Rules would be required to deal with, among other things, sales of partnership interests by foreign partners to U.S. partners or other foreign partners while the section 1446 withholding is in the deferral stage, as well as intentional delaying of distributions (for example, the accumulation of earnings along the lines of what is targeted by the accumulated earnings tax).

Whether or not relief is provided more generally, we believe that a foreign partner that is itself insolvent and may therefore exclude COD income under section 108 should have the opportunity to certify under Regulation -6T that it is insolvent, and that the partnership should be able to take this into account in determining the appropriate rate of withholding given the nature of the income (i.e., COD income excludible under section 108). Despite the preamble's suggestion to the contrary, we read the current version of Regulation -6T as not permitting this.

In a similar vein, procedures under Regulation -6T, discussed at part C below, seem to us to offer little practical relief from withholding on COD income. Even if the foreign partner has not already used the associated losses or deductions and is eligible to certify the carried-forward deductions under new Regulation -6T, those new rules do not require the foreign partner to do so and the foreign partner has no incentive

to do so voluntarily. Although the partnership agreement could require such certification, the partnership cannot contractually ensure that these losses will be carried forward and, in light of the procedural complexities associated with certification discussed below, we question whether it would be possible to enforce such a contractual obligation any more than it would be to collect the cash from the foreign partner.

B. Section 1445/1446 Overlap

Section 897 treats gain and loss from the disposition of a U.S. real property interest (a “USRPI”) recognized by a foreign person “as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business” for purposes of imposing net income-based taxation under sections 871 and 882.¹⁵ When a foreign person disposes of a USRPI, section 1445 requires the transferee to withhold 10% of the total amount paid. A special rule, provided in section 1445(e)(1), applies when a domestic partnership with foreign partners disposes of a USRPI.¹⁶ Under section 1445(e)(1), the partnership is required to withhold tax equal to 35% of the gain realized and allocable to the foreign partners.¹⁷ If that gain allocable to the foreign partners is “deemed to be ECTI” pursuant to section 897 in the hands of the domestic partnership, then there is an overlap of two withholding regimes since the partnership will also be required to withhold on the deemed ECTI under section 1446. The Regulations ensure that no double-withholding is required by providing that, in the case of an overlap, only

¹⁵ Code § 897(a).

¹⁶ If a foreign partnership disposes of a USRPI, the general rule in section 1445(a) applies (pursuant to which the transferee withholds) because the transferor is a foreign person. See Treas. Regs. §§ 1.1445-1(b)(1) and (g)(3).

¹⁷ Code § 1445(e)(1); see also Treas. Reg. § 1.1445-5(c)(1)(i).

section 1446 shall apply.¹⁸ The preamble refers to this as the “trumping rule.” Issues arise, however, because the section 1445 regime provides exemptions from withholding that are not contained in the section 1446 regime.

For example, the Service has issued section 1445 regulations and a Revenue Procedure pursuant to which any transferor subject to section 1445 withholding, including a domestic partnership with foreign partners, may obtain a withholding certificate reducing or eliminating the section 1445 withholding obligation (based upon the transferor proving that the taxpayer’s maximum tax liability is less than the withholding otherwise required, or the transferor posting adequate security for the tax).¹⁹ The preamble to the Regulations explains that the Treasury and the Service decided not to institute any similar withholding certificate regime for section 1446 purposes.

The preamble goes on to explain that the “trumping rule” primarily relates to a domestic partnership’s disposition of a USRPI which triggers withholding under section 1445(e)(1), and that even in the case where section 1445 otherwise would grant an exemption from withholding tax, section 1446 withholding continues to apply. Thus, even if the partnership could avail itself of the section 1445 procedures to demonstrate that no tax is due, the full section 1446 withholding is still required. The preamble to the Regulations offers as the reason for this position that “Treasury and the IRS do not believe Congress intended for section 1445 to apply to the exclusion of section 1446

¹⁸ Treas. Reg. § 1.1446-3(c)(2)(i). In the case of a foreign partnership that has tax withheld by the transferee under section 1445(a), the Regulations permit the partnership a credit against its section 1446 liability. Treas. Reg. § 1.1446-3(c)(2)(ii). This is consistent with prior law. See Rev. Proc. 89-31, 1989-1 C.B. 895, §7.022(iii), as modified by Rev. Proc. 92-66, 1992-2 C.B. 428, §3.03.

¹⁹ Treas. Reg. § 1.1445-4; and Rev. Proc. 2000-35, 2000-2 C.B. 211.

where the sections overlap.” This explanation presupposes two things, both of which we question.

First, we believe that it is not clear whether Congress intended the specific rule in section 1445(e) or the general rules of section 1446 to have primacy. Notwithstanding the preamble’s statement of belief as to Congressional intent, we have found no legislative history directly indicating whether Congress intended section 1446 (which is the later enacted provision) to trump section 1445(e). One could certainly argue that as a matter of statutory interpretation, the later enacted provision should prevail. But, on the other hand, it is a well understood maximum of statutory interpretation that a more specific provision prevails over a more general rule in the case of inconsistency. The realistic, although unsatisfying, answer is that Congress simply may not have considered the possible inconsistency.

Second, this explanation and the Regulations’ interpretation of sections 897 and 1446 presupposes that there is *always* an overlap whenever a domestic partnership disposes of a USRPI. Specifically, the Regulations appear to assume that a disposition of a USRPI by a domestic partnership would always, pursuant to section 897, give rise to partnership-level ECTI that is subject to withholding under section 1446,²⁰ and they then specifically state that withholding must be made under the section 1446 regime and not under the 1445(e)(1) regime.²¹ As a matter of statutory construction, we question whether this interpretation of the section 897 “fiction” is correct.

²⁰ See Treas. Reg. § 1.1446-2(b)(2)(ii). The Service has taken this same position in Publication 515, “Withholding of Tax on Nonresident Aliens and Foreign Entities,” last updated January 2005.

²¹ See Treas. Reg. § 1.1446-3(c)(2).

First, this interpretation is troubling because it largely renders section 1445(e)(1) a nullity. If every disposition of a USRPI by a domestic partnership with foreign partners gives rise to ECTI to which section 1446 applies, then section 1445(e)(1) is unnecessary.²² If the combination of sections 897(a) and 1446 have this result, then section 1445(e)(1) should be repealed as deadwood. We are reluctant to adopt a statutory reading that has such an effect.

Perhaps even more significantly, this statutory reading does not appear to be supported by the text of the sections 897. Section 897 treats as deemed ECTI the gain or loss from the disposition of a USRPI by a foreign person, including a foreign partnership. It is not at all clear that the disposition by a *domestic* partnership technically results in recognition of ECTI at the partnership level under section 897, *such that* section 1446 would apply. Nothing in section 897, section 1445(e)(1) or any other provision of section 1445 characterizes the gain as ECTI. Section 1445(e)(1) merely requires withholding on gain from the disposition by a domestic partnership of a USRPI that is allocable to a foreign partner. In contrast, section 1446 provides that if “a partnership has effectively connected taxable income for any taxable year” (emphasis added), the partnership must withhold to the extent this partnership ECTI is allocable to a foreign partner. Accordingly, where a USRPI is not otherwise held in connection with a U.S. trade or business such that disposition gain would be “real ECTI” under section 864, it is

²² We recognize that section 1445(e)(1) would retain some limited role insofar as it addresses trusts and estates as well as partnerships, but if Congress had intended that section 1445(e)(1) be limited to trusts and estates, it would not have included the reference to partnerships.

not clear that its disposition technically gives rise to deemed ECTI in the hands of a domestic partnership such that withholding under section 1446 is triggered.²³

A contrary reading of the statute therefore supports treating gain from the disposition of a USRPI by a domestic partnership as subject to section 1446 withholding, in the first instance, only if the USRPI is owned in connection with activities that otherwise rise to the level of the conduct of a U.S. trade or business and thus ECTI under section 864. That would be the one case in which the two provisions overlap. In all other cases, only section 1445(e)(1) would apply.

We see three possible ways in which the coordination of the two provisions could be addressed in the case of a disposition of a USRPI by a domestic partnership with foreign partners: (1) all dispositions of USRPIs would be subject to section 1446 (this being the rule adopted in the Regulations); (2) any disposition of a USRPI that is “effectively connected” property to the partnership would be subject to section 1446 and any disposition of “non-effectively connected” USRPI would be subject to section 1445(e)(1); and (3) all dispositions of USRPIs would be subject to section 1445(e)(1) regardless of whether the USRPI is “effectively connected” property to the partnership. A USRPI should be treated as effectively connected where a partner has a section 871(d) or 882(d) election in effect.²⁴

²³ In addition, it is not at all clear from the Regulations and the preamble thereto whether it is intended that this “ECTI fiction” also apply where the partnership disposing of the USRPI is a foreign partnership such that section 1445(e)(1) is inapplicable and instead the transferee will be withholding under section 1445(a). In fact, the preamble suggests that the triggering of section 1446 occurs only where the partnership transferor is domestic, but this is not entirely clear. If a foreign partnership is still eligible to use the section 1445 withholding certificate procedures, that should be clarified.

²⁴ See Treas. Reg. § 1.871-10(d)(3).

The first alternative has the statutory interpretation defects that we discuss above. The second alternative avoids this problem but would require a determination in the case of each disposition of a USRPI by a partnership as to whether the USRPI was or was not effectively connected property. Avoiding such complex fact-based inquiries and inconsistent results in the case of USRPIs was one of the reasons, we believe, that sections 897 and 1445 were enacted. In addition, if this second alternative were adopted, a domestic partnership seeking a section 1445 certificate would first have to establish to the Service that the property was not effectively connected property. Thus, when a withholding certificate was issued the Service would be implicitly agreeing with that determination. As the Service has a “no-ruling” policy on such matters, it would seem that such a procedure would be problematic. Under current law, the issue does not arise for the Service because any foreign transferor of a USRPI is subject to section 1445 and eligible to seek a withholding certificate, regardless of whether or not the property is effectively connected. Thus, there are policy and administrative reasons in favor of the third alternative, which would result in all USRPI dispositions being treated consistently, regardless of whether or not the transferor happens to be a domestic partnership.

This third alternative would, however, result in a domestic partnership’s trade or business income being treated differently depending on whether it involved USRPI dispositions or not. This then raises the question whether it makes more sense to treat all trade or business income consistently (whether or not USRPIs are involved) (alternative two) or to treat all USRPI income consistently, whether not held in connection with a U.S. trade or business (alternatives one and three).

For the reasons above, the Executive Committee does not believe the statute supports applying section 1446 to a disposition of a USRPI when the USRPI is not held in connection with a U.S. trade or business and thus the gain is not “real ECTI” under section 864. We therefore recommend that the trumping rule not extend to the “deemed ECTI” situation. We were divided as to whether section 1446 was appropriate for “real ECTI” from USRPI dispositions or whether, for the reasons discussed above, section 1445 rather than section 1446 should prevail in the “real ECTI” situation as well.

C. Regulation -6T

Introduction

Regulation -6T permits a partnership, in computing its section 1446 withholding obligation with respect to a foreign partner, to take into account certain losses and deductions of the foreign partner arising in prior years and from sources other than the partnership. We commend the Treasury and the Service for issuing Regulation -6T as the regulations are likely to result in a closer match between the amount required to be withheld under section 1446 and the foreign partner’s actual tax liability. However, we ask that changes be considered with respect to certain aspects of the regulations, including the limitations on the types of foreign partners that may provide certificates and the type of losses that such partners may certify and the complex procedures and restrictions relating to when certificates may be relied upon by a partnership. Further, a majority of the Executive Committee believes that the regulations offer too limited protection against tax, interest and penalties to a partnership that relies upon a certificate which later turns out to have been incorrect.

In general, Regulation -6T allows (but does not require) a partnership to adjust its withholding based on a certificate from a foreign partner certifying to qualified losses and deductions that are available to reduce the foreign partner's U.S. federal income tax liability, provided that the partnership does not know or have reason to know the certificate is "defective." However, Regulation -6T is laden with limitations and restrictions and procedural requirements, which are discussed in detail below. These appear to be aimed at ensuring, primarily, that the United States in no event will fail to collect the total tax due by the foreign partner and, secondarily, that the partnership will have time to compute its withholding obligations correctly before the due dates for its withholding tax payments.

Most of these strict limitations and complex procedural requirements seem to us inappropriate given that the regulations (1) give a partnership the option whether or not to take into account all or any portion of any losses certified²⁵ and (2) provide a partnership that relies upon a certificate with very limited protection against penalties and interest.²⁶

First, a partnership is not required to take into account any losses or deductions of a partner, even if all the procedural requirements are satisfied and the foreign partner provides a non-defective certificate. Accordingly, if the partnership feels

²⁵ See Temp. Reg. § 1.1446-6T(d)(2)(i); and Regulation -6T preamble, Section G.3.

²⁶ As explained below, under Temporary regulations section 1.1446-6T(d)(2), if the partnership reasonably relies upon a partner's certification of losses that is later found to be defective or is later updated to reduce the amount of losses available, the partnership has no liability for the section 6655 additions to tax which would have accrued on the unpaid installments during the period of reasonable reliance. Temp. Reg. § 1.1446-6T(d)(2)(i). But, importantly, reasonable reliance does not relieve the partnership from the obligation (under section 1461) to have paid the full amount of tax due by the year-end annual return due date nor from being liable for interest that accrues from that year-end due date until the date the tax has been paid.

that a foreign partner's certification leaves the partnership insufficient time or contains insufficient detail to properly assess the partnership's withholding obligations, the partnership can simply refuse to consider the certificate. Alternatively, a partnership may take into account only a portion of the losses certified. Accordingly, a partnership does not need regulatory procedures to ensure that it has sufficient time or detail.

Second, even if the partnership has every reason to believe that the procedural requirements have been satisfied and does reduce its withholding tax payments in reasonable reliance on information provided by the foreign partner, as discussed below, the partnership receives only limited protection against taxes, interest and penalties if it turns out the foreign partner's certification was inaccurate. If the partnership may reduce section 1446 withholding only largely "at its own risk," then most of those procedural safeguards seem unnecessary. The partnership has every incentive to police the accuracy of the certification itself without burdensome procedural requirements imposed by regulations. If the procedural safeguards are to remain, a partnership should receive more comprehensive protection from liability if it has complied in good faith with all of these requirements.

Review of the Partnership's Withholding and Reporting Obligations

Before addressing these aspects of Regulation -6T in detail, we think it useful to review precisely what the partnership's withholding and reporting obligations are with respect to the section 1446 withholding tax and the tax, penalties and interest, additions to tax and penalties that may be imposed upon the partnership in the event of an underpayment of section 1446 tax. It is only with these clearly laid out that one can

understand how Regulation -6T works and its impact on the partnership and the foreign partner.

The section 1446 withholding and reporting obligations and the consequences of underpayments are as follows:

- The partnership must pay the section 1446 tax in four quarterly installments, due on the 15th day of the 4th, 6th, 9th and 12th month of the year (submitted on IRS Form 8813).²⁷
- The partnership must file a year-end annual return with respect to the section 1446 tax on the 15th day of the 4th month after close of the partnership's year and pay any additional section 1446 (in excess of the amounts paid in installments) with this return (IRS Form 8804).²⁸
- If the partnership fails to pay all or any portion of any quarterly installment, the partnership is liable for an "addition" to tax under section 6655 (which is essentially a proxy for an interest charge).²⁹ This addition is computed at the interest rate applicable to underpayments and it ceases to accrue on the date the year-end annual return (Form 8804) is due.³⁰
- The partnership is also liable directly for the section 1446 tax pursuant to section 1461.³¹ The tax under section 1461 is due with the year-end annual return (Form 8804). If the tax has not been paid by that due date, section 6601 interest starts to accrue on the section 1461 underpayment (at the rate generally applicable to underpayments).³²

²⁷ Treas. Reg. § 1.1446-3(a)(1).

²⁸ The partnership must attach to the Form 8804, an IRS Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax," for each foreign partner. These filings are in addition to the partnership's filing of a Form 1065 and Schedules K-1, which are due on the same date as the Forms 8804 and 8805.

²⁹ Treas. Reg. § 1.1446-3(b)(1). Interest under section 6601 does not apply with respect to an unpaid installment. See Code § 6601(h).

³⁰ Treas. Reg. §§ 1.1446-3(b)(2)(v)(C) and (e)(3).

³¹ Treas. Reg. § 1.1446-3(e)(1).

³² Treas. Reg. §§ 1.1446-3(e)(2) and (e)(3).

- If the partner pays its own taxes, the partnership is absolved of the section 1461 liability³³ (and the interest ceases to accrue under section 6601 on the date the partner pays the tax),³⁴ but this has no effect on the partnership's liability for the section 6655 "addition" penalty for having paid insufficient installments.³⁵
- The partner is separately required to pay its own taxes in quarterly installments, but the partner may claim a credit for the partnership's section 1446 installment payments.³⁶ If both the partnership and the partner fail to pay the installments, the partner is also subject to the "addition" under section 6654 (individual partner) or 6655 (corporate partner).³⁷
- The partnership is also potentially liable for other penalties (such as substantial understatement, fraud, failure to file a return, failure to pay tax shown as due on return, etc.), which are discussed in more detail below.
- If the partnership reasonably relies upon an IRS Form W-9 or other appropriate documentation to establish that the partner is not a "foreign person" or is a foreign grantor trust whose beneficial owners are U.S. persons, the partnership has no liability under sections 1446, 1461, 6655 or 6601.³⁸
- By contrast, under Regulation -6T, if the partnership reasonably relies upon a partner's certification of losses that is later found to be defective or incorrect, the partnership has no liability for the section 6655 additions which would have accrued on the unpaid installments during the period of reasonable reliance,³⁹ but remains fully liable for the section 1461 tax and section 6601 interest thereon.⁴⁰

³³ Treas. Reg. § 1.1446-3(e)(2). This "deemed payment by the partnership" rule is discussed in more detail below.

³⁴ Treas. Reg. § 1.1446-3(e)(2).

³⁵ Treas. Reg. § 1.1446-3(e)(3).

³⁶ Treas. Reg. § 1.1446-3(d)(1)(i).

³⁷ Perversely, the partnership's payments of the addition imposed on the partnership under section 6655 absolves the partner of having to pay the partner's section 6654 or 6655 addition, but the partner's payment does not absolve the partnership. Treas. Reg. § 1.1446-3(e)(3)(ii).

³⁸ Treas. Reg. § 1.1446-1(c)(2)(iii). This is the same standard used for withholding agents under sections 1441 and 1442. See Treas. Reg. §§ 1.1441-1(b)(7) and 1.1441-2.

³⁹ Temp. Reg. § 1.1446-6T(d)(2)(i).

⁴⁰ Temp. Reg. § 1.1446-6T(d)(2).

Discussion of Specific Aspects of Regulation -6T

We now turn to the specific aspects of Regulation -6T which we find problematic.

1. Limitations on the types of foreign partners that may provide certificates -- foreign partner must be a “good driver.” Regulation -6T provides that a certificate is valid only if provided by a foreign partner that meets certain requirements, which is referred to in the preamble as the “good driver” test. To qualify as a “good driver,” the foreign partner must, among other things, (i) have timely filed U.S. federal income tax returns “in” each of the partner’s preceding four taxable years,⁴¹ (ii) timely file returns for the partner’s current taxable year during which the certificate is taken into account by the partnership, and (iii) timely pay all taxes shown as due on those returns.⁴²

We understand that foreign partners with a meaningful prior return-filing history could be considered less likely to evade tax using the certification process. Certainly, a foreign person that has submitted itself to the U.S. federal tax system and the associated compliance burdens seems more likely to provide an accurate certificate than one that has not. It is therefore reasonable that this be a pre-condition to relief on the part of the foreign partner, although we believe that a period of less than four years should suffice for this purpose. We do not believe that four years of prior returns would provide

⁴¹ We understand this to mean (and the Examples confirm this) that returns must have been filed *with respect to* (or *for*) the four preceding taxable years, not that returns had to have been filed *during* each of the prior four years. See Temp. Reg. § 1.1446-6T(e), *Example 1(i)* and *(iv)* (referring to “returns for” the relevant years); see also Temp. Reg. § 1.1446-6T(c)(2)(ii)(H)(in certificate, partner must represent that returns “for each of the preceding four taxable years” have been filed). It would be helpful to clarify this, however, by changing, in Temp. Reg. § 1.1446-6T(b)(1), the word “in” to “for”.

⁴² Temp. Reg. § 1.1446-6T(b)(1). The foreign partner also may not be a foreign estate or a foreign trust (other than a grantor trust whose owner meets the various procedural requirements). Temp. Reg. §§ 1.1446-6T(b)(2)(ii) and (iii).

significantly more likelihood of accurate certificates than one or two years of returns. Particularly for partnership arrangements of limited contractual duration, a four-year test could largely preclude the use of Regulation -6T for much of the partnership's life.

In addition, a partnership that relies upon a certificate is required to file that certificate both with its quarterly installment payments (on Form 8813) and its final Form 8805 (Foreign Partner's Information Statement) for the relevant foreign partner.⁴³ Therefore, only a foreign partner that intends to be a scofflaw is likely to intentionally provide a false certificate and such a partner would also likely be willing to falsely claim that it satisfied the good driver test.

We suggest, therefore, a good driver requirement that requires the filing of returns for the two prior years or if, less, the years the partner has been a partner in this partnership.

The good driver requirement imposes a different type of concern for the partnership and the general partner/managing member. If the foreign partner is not, in fact, a good driver, the certificate is "defective". Nevertheless, the partnership and the general partner/managing member will have limited ability to confirm the filing of the prior years' returns. Even requiring the partner to provide a copy to the partnership would not ensure that the copy was accurate or was indeed filed, nor would the partnership necessarily be able to confirm the payment of taxes shown as due on those returns. If the partner truly has loss carryforwards from prior years, there will likely have been no tax shown as due on those returns, so requiring the partner to provide the partnership with a cancelled check for the taxes shown as due would often be irrelevant. More significantly, requiring the partner to provide the prior return information would

⁴³ Temp. Reg. § 1.1446-6T(d)(2)(ii).

conflict with the privacy principle that is a central tenant of our tax system and would strike most people as over-intrusive and objectionable.

In any event, the general partner and the partnership cannot possibly determine, even with diligence, that the partner will timely file the current year return or pay the tax shown as owing. The partnership therefore cannot know whether the certificate is being provided by a foreign partner that is or is not a “good driver” for this year. This means, as discussed below, that the partnership must rely upon the certificate without being certain that it is not technically “defective” because the partner is ineligible (that is, unless and until the Service notifies the partnership that the certificate is defective and the partner is not eligible).

We believe that having a “good driver” test makes sense, insofar as it provides a basis for the Service to notify the partnership and the partner that the partner is ineligible to certify losses (prospectively from the notice date forward). But the good driver test should not be used against the partnership-- that is, the partnership should be able to rely on the foreign partner’s representation that it is a “good driver” unless and until the partnership knows or has reason to know the representation is inaccurate.

2. Limitations on the types of losses that foreign partners may certify.

There are several limitations on the types of losses and deductions that may be certified.

First, in the case of losses or deductions attributable to the particular partnership, the losses or deductions must be reflected on a Schedule K-1 issued or to be issued by the partnership for a prior taxable year.⁴⁴ Losses reflected on a Schedule K-1, but not on a prior year return of the partner (because suspended under section 704(d)), may be certified only if from the particular partnership and not if from another

⁴⁴ Temp. Reg. § 1.1446-6T(c)(1)(i).

partnership.⁴⁵ In each case, the foreign partner must certify that the losses or deductions would reduce ECTI, or in the case of a corporate partner, are properly allocated and apportioned to ECTI.⁴⁶

Second, the losses and deductions must have been generated in years of the foreign partner ending prior to the partnership's section 1446 return filing date. In the case of the computation of the partnership's quarterly installments, this limitation applies with respect to the partner's years ending prior to the installment due date, and in the case of the partnership's final year-end Form 8804 filing, the limitation applies with respect to the partner's years ending prior to the due date (without regard to any extensions actually available to the partnership).⁴⁷ This generally means that no anticipated deductions or losses with respect to the partner's current year may be considered.

Similarly, no anticipated deductions for state taxes for the current year may be taken into account even if the partner or the partnership is certain that those state taxes will be due. Consider, for example, a foreign partner in a partnership that has generated ECTI that is subject to both U.S. federal and New York State income tax. The partner is certain that, to the extent there is a federal tax liability, there will be a state tax liability and that the state tax will be deductible in computing the partner's actual U.S. federal liability for the year. The partnership is not permitted to take into account the anticipated state tax deduction.

The limitation on certifying current year attributes has the effect of ensuring that withholding in excess of the actual tax liability of the foreign partner will continue to result even if foreign partners employ Regulation -6T and, in practice, will

⁴⁵ Temp. Reg. §§ 1.1446-6T(c)(1)(i) and (ii).

⁴⁶ *Id.*

⁴⁷ Temp. Reg. § 1.1446-6T(c)(1)(first paragraph).

limit the benefit of certification for many foreign partners. Administrative concern over allowing withholding based on mere estimates of anticipated deductions or losses, which may turn out to be inaccurate, is understandable. However, certain items like state taxes that arise from the withholding partnership's current year activities do not raise this concern to the same extent, because they will ordinarily be quite closely correlated to U.S. federal income tax liability. We therefore recommend that the final regulations permit foreign partners to certify current year state income and franchise taxes that arise from the activities of the withholding partnership.

There is a separate limitation on the use of net operating losses: a foreign partner may not certify net operating losses in excess of 90% of the partner's adjusted taxable income from the partnership for the current year.⁴⁸ We assume this is a proxy for the application of the alternative minimum tax, although it would be helpful to explain the rationale for this limitation.

Charitable deductions also may not be certified.⁴⁹ There is no explanation of this limitation. Perhaps it is because of a concern that charitable deductions are often falsified or an expectation that most charitable deductions would not be allocable to ECTI. Neither rationale seems a particularly good reason for prohibiting certification as neither concern is unique to charitable deductions – a foreign partner could easily falsify or misclassify other types of deductions. We believe that this exclusion is generally inconsistent with the policies behind the rules permitting the deduction of charitable contributions and suggest that it be removed.

⁴⁸ Temp. Reg. § 1.1446-6T(c)(1)(iii).

⁴⁹ Temp. Reg. § 1.1446-6T(c)(1)(first paragraph).

3. Procedural rules and restrictions -- time period requirements for delivery of the first certificate for the year. The partnership is not permitted to take into account the first certificate received with respect to a taxable year in computing the partnership's section 1446 installment obligation or year-end filing obligation unless the certificate was received by the partnership at least 30 days prior to the relevant due date (without extensions).⁵⁰ So, for example, if the partnership receives a certificate on March 17th, the partnership may not consider that certificate in computing the installment due April 15th, even if the partnership is willing and able to perform the computations within the 29-day period.

Mandating a lead time for receipt of the first certificate seems arbitrary and unnecessary. One could understand the regulations imposing a minimum time period requirement if the partnership was *required* to take into account deductions and losses reflected on a facially valid certificate from its foreign partners. However, under Regulation -6T, a partnership is not required to take a certificate into account, even if the certificate is valid and accurate. If a partnership is willing to process and rely on a certificate it receives less than 30 days before the next due date, it is unclear what purpose is served by precluding this. Accordingly, because reliance on the certificate is at the partnership's option, we suggest there be no required time frame for delivery of the initial certificate.

4. Procedural rules and restrictions -- updated certificates. There are detailed rules obligating the foreign partner to update the initial certificate for the year.⁵¹

⁵⁰ Temp. Reg. § 1.1446-6T(c)(2)(i)(A).

⁵¹ Temp. Reg. § 1.1446-6T(c)(2)(i)(B).

First, if any of the “good driver” test returns have not been filed by the partner when the initial certificate is provided, the partner must represent in that initial certificate that those returns will be filed and the taxes paid and the date that will occur; and an updated certificate must be provided within 10 days of the filing of those returns.⁵² If the update is not received by the partnership within 10 days of the specified filing date, the partnership may no longer rely upon the certificate. If a prior year return has not been filed by the end of the partnership’s year, the foreign partner must provide the partnership with a status update at least 10 days prior to the final section 1446 installment payment date. If the partner fails to provide this update, the partnership is precluded from taking into account the certificate for purposes of the final installment payment for that year and its filing of the year-end annual return.⁵³ Thus, the partnership is essentially obligated to “monitor” whether all the good driver returns have been filed.

We believe that it is inappropriate and unnecessary to impose this obligation upon the partnership. We believe that the partner should not be required to inform the partnership as to the anticipated filing date of any of its un-filed good driver returns or to provide updated certificates. As discussed above, the partnership will generally have no means of verifying the accuracy of the updated certificate, so we believe it serves little purpose and just adds a degree of complexity and administrative burden that is unwarranted.

Second, if the foreign partner determines that losses or deductions certified in a prior certificate were overstated or otherwise incorrect (*e.g.*, were capital

⁵² Temp. Reg. § 1.1446-6T(c)(2)(i)(B)(1).

⁵³ However, a foreign partner that fails to provide the required update in either situation appears not to be precluded from availing itself of the certification process in the following year *Id.*

rather than ordinary losses), the foreign partner must provide an updated certificate to the partnership within 10 days of making this determination.⁵⁴ Because a partnership that relies upon a certificate is protected from section 6655 penalties for so long as the partnership does not have reason to know the certificate is defective, it seems appropriate that a partnership not be charged with “knowledge” of an update that is not received well in advance of the installment due date and 10 days seems like an appropriate length of time for this.

What is problematic, however, is prohibiting a partnership from considering an updated certificate in determining the amount of any tax installment if the certificate is received less than 10 days prior to the installment due date.⁵⁵ Thus, a partnership that has received an updated certificate less than 10 days in advance of an installment payment appears, at first, to have two choices: consider the prior certificate (which the partnership now knows overstates the partner’s available deductions and will result in withholding that is less than the partner’s true tax liability) or consider neither certificate (which will amount to withholding in excess of the partner’s true tax liability). In fact, the partnership has a third choice: consider only part of the losses certified in the first certificate and thus, in substance, take into account the update even though doing so is technically prohibited⁵⁶

⁵⁴ Temp. Reg. § 1.1446-6T(c)(2)(i)(B)(2). Although the regulations say “must”, there appears to be no sanction applicable to the foreign partner who fails to do this. Of course, the partner remains liable for tax installments and the final tax payment for the year, and is subject to additions, interest and penalties for failure to pay these amounts when due. If, however, there is some sanction imposable upon a foreign partner who fails to notify the partnership of an error within the 10-day period, that should be made clearer in Regulations -6T.

⁵⁵ See Temp. Reg. § 1.1446-6T(d)(2).

⁵⁶ Of course, this third alternative does not help the partnership if the tardy update changes the character of the losses previously certified to.

As noted above, if the partnership chooses to rely on the initial certificate, the partnership is protected against section 6655 additions to tax for *this* installment – that is, the partnership is treated as if it does not know the certificate is defective for this installment.⁵⁷ But, for the next installment, the partnership is treated as knowing the initial certificate is defective and section 6655 additions would apply if the partnership relied on the initial certificate.⁵⁸

These rules seem to create perverse incentives for a partner to make last minute corrections, particularly because the time at which a foreign partner first “determined” the need for a correction is likely to be ambiguous as an evidentiary matter (in addition to the fact noted above that there appears to be no sanction for such misbehavior).

In the case of a certificate update increasing the available losses, we believe there is no need for a regulatory 10-day advance requirement for the same reasons as we state above with respect to initial certificates.

Accordingly, we recommend that a partnership be permitted to rely upon a certificate update (whether it increases, decreases or changes the character of the losses) without regard to when it was received, just as we are recommending with respect to initial certificates.

Imposing an obligation on the foreign partner to provide an update in the event that the amount of available losses is reduced or their character changes makes

⁵⁷ Temp. Reg. § 1.1446-6T(e) *Example 2(iii)*. It is not clear what would happen if the partnership knew the update was defective on account of the partner having discovered the error more than 10 days before providing the certificate, but that partnership still did not receive the update until less than 10 days before the installment due date. Such a partnership would likely choose to rely on neither certificate in face of this uncertainty in order to avoid section 6655 liability for underpaying installments.

⁵⁸ Temp. Reg. § 1.1446-6T(e) *Example 2(v)* and *(vi)*.

sense. We recommend, however, that it be clarified if there is a sanction imposed upon a foreign partner who fails to do so.

5. Procedural rules and restrictions -- form of certificates. Regulation -6T states that a certificate need not be in any particular form, but then goes on to provide that it must include all of the following:⁵⁹

- A caption at the top of the page that reads: “CERTIFICATE OF PARTNER-LEVEL ITEMS UNDER TEMP. REG. §1.1446-6T TO REDUCE SECTION 1446 WITHHOLDING”;
- The partner’s name, address, Taxpayer Identification Number (TIN), and the date of the certification;
- The partnership’s name, address, and TIN;
- The partnership taxable year for which the certificate is submitted;
- A representation that the partner meets the eligibility requirements to certify losses (including the good driver requirement) and that the deductions and losses set forth in the certificate are of the type permitted to be certified;
- The amount of the deductions and losses and, if applicable, the character of such deductions and losses (*e.g.*, capital or ordinary), as well as any particular deductions and losses that are subject to limitation or otherwise warrant special consideration (*e.g.*, suspended passive activity losses under section 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 ECTI from the partnership for the partner’s taxable year in which such income or gain is includible in gross income;
- A representation that the deductions and losses set forth in the certificate have been reflected on a timely filed U.S. income tax return, consistent with sections 874 and 882 of the Internal Revenue Code and the regulations thereunder (and

⁵⁹ See Temp. Reg. § 1.1446-6T(c)(2)(ii).

such other provisions that impose requirements for the use of such deductions and losses);

- A representation that the deductions and losses have not been set forth in a certificate provided to another partnership for the same taxable year for the purpose of reducing withholding under this section;
- A representation that the partner has timely filed, or will timely file its U.S. federal income tax return for each of the preceding four taxable years and the partner's taxable year during which the certificate is considered, and has timely paid (or will timely pay) all tax shown on such returns. The partner must specify any taxable year for which a U.S. federal income tax return has not been filed as of the time of submission of the certificate, set forth the filing due date for such return, and represent that the partner will comply with the provisions for providing an updated certificate or status update with respect to the filing of any such return;
- A representation that all of the deductions and losses (other than losses suspended under section 704(d)) and set forth in the certificate are (or will be) reflected on a U.S. federal income tax return of the partner that is filed (or will be filed) with respect to a taxable year of the partner that ends prior to the installment due date or year-end annual Form 8804 filing due date (without regard to extensions) for the partnership taxable year for which such certificate will be considered;
- A representation that such deductions and losses have not been disallowed by the Service as part of a proposed adjustment (relating to examination and determination of tax liability/examination of returns);
- 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 consent representation must be attached to the certificate; and

- The signature of the partner, or its authorized representative, under penalties of perjury, and the date that the certificate was signed.⁶⁰

We believe that requiring that these representations be made to the partnership is somewhat excessive, even though the certificate is required to be filed with the Service as an attachment to the Forms 8813 and 8805. It should suffice that the partner represents that it is qualified to certify to losses and that the losses qualify or, alternatively, that the certificate be acceptable to the partnership. As discussed above, if the partnership wants more information or representations before it is willing to rely, then it can demand that.

6. When a certificate is “defective” and consequences for partnership.

When a certificate is considered defective is important, because defectiveness of the certificate may preclude reliance by the partnership. A certificate is defective if (1) the foreign partner does not meet the “good driver” tests (*e.g.*, it subsequently fails to file the return for the current year or to pay taxes), (2) the deductions and losses described are not of a type permitted to be considered, (3) the timing requirements, including the timing requirements for updated certificates, are not met, (4) all the information required is not included, (5) any representation is incorrect, or (6) the foreign partner’s actual losses and deductions available to it are less than those certified to the partnership.

Partnerships can assess from the face of a certificate whether certified deductions and losses are of a type permitted to be certified and whether the required information is included. However, the other required items are generally beyond the

⁶⁰ Similar form requirements are stated for updated certificates.

partnership's knowledge or control. The partnership therefore cannot know whether a certificate is defective at the time it would be relying on the certificate. For example, the partnership cannot know definitively whether the foreign partner meets the "good driver" test, as it will not know until the subsequent year whether the foreign partner has filed the current year return. Whether an updated certificate it receives was provided within 10 days of the foreign partner "determining" the need for a correction is also practically impossible for the partnership to determine. Similarly, the partnership generally would not know with certainty whether the actual losses and deductions are less than those certified.

Regulation -6T states in paragraph (c)(3) that a partnership generally may rely on a certificate absent actual knowledge or reason to know that the certificate is "defective." Further, paragraph (d)(2) states that a partnership may reasonably rely, for purposes of section 6655, for any period during which it did not know or have reason to know the certificate was defective.⁶¹ Given the difficulties described above, this is a sensible standard for reliance. We doubt any partnership will make use of Regulation -6T unless it may rely on a facially valid certificate that it does not know or have reason to know is defective.

If the Service determines (in its sole discretion on audit or otherwise) that the certificate is "defective" or that the Service lacks adequate information to determine whether the certificate is defective and that the partnership may not rely on the certificate, the Service will notify the partnership in writing that the certificate is defective. Once the partnership receives this written notice, it cannot thereafter rely on the certificate even if it disagrees substantively with the Service's conclusion about defectiveness. We

⁶¹ See also Temp. Reg. §§ 1.1446-6T(e) *Example 2(v)*.

understand the regulations to mean that the partnership is still immune from section 6655 additions-to-tax for periods of reliance by the partnership prior to the date it received the Service's notification. This is confirmed by Example 3(v) and (vii) of Temp. Reg. § 1.1446-6T(e) but could be made clearer in paragraph (c)(3).

Thus, we agree with the standard for reliance by the partnership. Our concerns, as addressed in the next section, relate to the limited protections that a relying partnership receives.

7. Protection Afforded to a Partnership that Relies Upon a Certificate.

Assuming the partnership wishes to rely on a certificate that it may treat as non-defective, it must next consider the extent to which reasonable reliance will protect it. Many partnerships and their advisors will find it challenging to determine from the regulations the scope of the protection obtained by reasonable reliance. Central to this inquiry is an understanding of the liability rules under sections 1446 and 1461 and Treasury Regulation section 1.1446-3(e), including the "deemed payment" rule under paragraph (e)(2) (referred to above).

First, the partnership is required to pay the section 1446 tax in the four installments and the partnership is separately made liable for the section 1446 tax by section 1461 – with the section 1461 tax due on the 15th day of the 4th month after the end of the partnership's year. In the event of any underpayment on any installment, the "addition to tax" under section 6655 starts to accrue. That addition ceases to accrue only on the date the section 1461 tax is due, at which time interest under section 6601 starts to accrue (at the same rate as the section 6655 addition was accruing).⁶²

⁶² See Treas. Reg. §§ 1.1446-3(b)(2)(v) and -3(e)(3).

Under the deemed payment rule, once the foreign partner has paid the full amount of tax required to be paid by such partner, the partnership is “deemed” to have paid that amount for section 1461 purposes.⁶³ The date on which deemed payment by the partnership occurs is the later of the unextended due date for the section 1461 payment or the date the foreign partner is considered to have fully paid all tax required to be shown on its return. This means that if the partner pays the tax by the section 1461 due date, the partnership has no liability for tax or interest.

But the deemed payment rule is very limited: it applies only if the entire amount due from the partner on all its income (even income not from this partnership) is paid,⁶⁴ and it does not relieve the partnership from liability under section 6655 for the “addition to tax” in respect of underpayment of estimated tax installments.

It may be unclear from the regulatory language (although this uncertainty is resolved by examples) to what extent a partnership is relieved of section 6601 interest under the deemed payment rule. Regulation section 1.1446-3(e)(2) states that if the partnership proves that the foreign partner has fully satisfied its actual liability for the year, the partnership is deemed to have paid the section 1446 tax and that “the deemed payment rule. . . shall apply for purposes of section 1446, 1461 and 1463 and any

⁶³ Treas. Reg. §1.1446-3(e)(2).

⁶⁴ The partner must have paid the *entire* amount in order for the partnership to be deemed to have paid any of the section 1446 tax for section 1461 purposes. Treasury regulations sections 1.1446-3(e)(2) and (e)(4) *Example 1* illustrates this. In the example, the foreign partner pays only \$45 out of \$50 of tax due. Therefore, the partnership is not deemed to have paid any of the section 1446 taxes, even though the total section 1446 taxes were (by the example’s facts) only \$35. Moreover, even though the partner made all required installment payments when due, the partnership has full liability under section 6655 and, even though the partner’s underpayment was only \$5, the partnership is liable for interest under section 6601 on the entire \$35 of unpaid section 1446 withholdings until the date *the entire* \$35 is paid by the partnership or the additional \$5 is paid by the partner. Note that it appears that the partnership is required to pay the entire \$35 and thereafter the partner would be entitled to a credit or refund of \$30.

additions to the tax, interest or penalties potentially applicable to such partnership under section 1446, including sections 6601, 6651 and 6655.” But paragraph (e)(3) then states that, notwithstanding paragraph (e)(2), the partnership is not relieved from liability under section 6655 or for interest under section 6601, when applicable, and further that the interest on the section 1461 tax ceases to accrue only when the liability is satisfied (or deemed satisfied) under paragraph (e). We interpret this to mean that if the partner pays on a date after the section 1461 due date, the partnership is liable for section 6601 interest that accrues on the section 1461 tax until the date the foreign partner actually satisfies its liability. This reading is confirmed by the examples⁶⁵ but perhaps the regulatory language could be made clearer.

An additional source of concern for a partnership and other withholding agents (for example, a general partner) if they withhold based on a certificate that could prove defective is the litany of penalty provisions that might apply if the partnership fails to pay the appropriate amounts. The risk of such penalties will further encourage a partnership or general partner to police the accuracy of a foreign partner’s certification.

These penalties include:

- Section 6651, which imposes an addition to tax for failure to pay any tax that was required to be shown on any filed return after notice thereof, unless reasonable cause is demonstrated.
- Section 6672, which imposes liability for tax on any person (*i.e.*, responsible persons other than the partnership itself) required to collect, truthfully account for and pay over any tax or that willfully attempts to evade or defeat any tax.

⁶⁵ See Treas. Reg. § 1.1446-3(e)(4), *Example 3*.

- Section 7202, which imposes criminal liability of a fine or up to five years imprisonment on any person required to collect, truthfully account for and pay over any tax who willfully fails to do so.
- Section 6662, which imposes accuracy-related penalties for substantial understatements of tax.
- Section 6663, which imposes penalties for understatements due to fraud.
- Section 6721, which imposes a penalty for each failure to file correct information returns.
- Section 6722, which imposes a penalty for each failure to file correct payee statements.
- Section 6723, which imposes a penalty for each failure to comply with information reporting requirements.⁶⁶
- Section 7201, which imposes felony liability for willful attempts to defeat or evade tax.
- Section 7203, which imposes misdemeanor liability for willful failure to make returns or pay estimated tax.

Taking into account all of the foregoing rules, a partnership and its general partner appear to receive limited protection under Regulation -6T if they withhold based on a foreign partner's certificate even if the certificate is not apparently defective and reliance was reasonable. Such reasonable reliance avoids additions to tax under section 6655 only; it affords no protection from liability for the basic section 1446 tax and interest and penalties. Not only the partnership, but also the general partner and other persons that may be "withholding agents," would also be liable for the failure to withhold

⁶⁶ Section 6724 provides exceptions for liability under sections 6721 through 6723 if reasonable cause is demonstrated.

the correct amount of section 1446 tax (and may face exposure under section 6672 and the other sections listed above).

A partnership entertaining the notion of taking into account its foreign partners' tax losses based on a certificate therefore confronts three possible situations if it withholds based on a certificate that later proves defective:

First, if the foreign partner is acting in good faith, presumably that partner will ultimately pay all of the tax it owes on ECTI allocable to it. In that case, the partnership should escape liability for tax under section 6655 if it withholds in reasonable reliance on a certificate that it does not know to be defective, and should avoid liability for the section 1446 tax, which it will be deemed to have paid when full payment by the foreign partner is made. However, the partnership will incur interest under section 6601 from the due date of the section 1446 withholding tax through the date of deemed payment (meaning payment by the foreign partner of every penny it owes) if that date is after the section 1461 due date.

Alternatively, if the certificate was defective and reliance was not reasonable, but the foreign partner ultimately satisfies its tax obligations in full, the partnership is subject to additions to tax under section 6655 until the section 1461 due date and section 6601 interest from that date to the date of deemed payment, but not the section 1446 tax itself.

Alternatively, if the foreign partner is not acting in good faith and provides a certificate that is facially non-defective but false and does not ultimately satisfy the tax it owes, the partnership will remain liable for the section 1446 tax and section 6601 interest through the date on which the partnership satisfies the tax. In this case the

partnership may escape liability under section 6655 with respect to installments owing depending on whether its reliance on the certificate was reasonable and it had no reason to know of defectiveness. Presumably, the partnership in this situation escapes penalties for willful or fraudulent noncompliance, but its ability to demonstrate “reasonable cause” to escape other penalties may depend on the facts. To the extent the partnership itself does not or cannot pay the tax, other withholding agents and (responsible parties) may be at risk.

In summary, the partnership is at risk, at a minimum for interest even if it exercises reasonable diligence in reviewing the certificate and it assumes good faith on the part of the certifying foreign partner. Prudent partnerships and general partners may consider themselves at risk for even larger amounts.

We anticipate that the combination of complex and burdensome procedural requirements and risks to the partnership if under-withholding occurs will make the procedures under the Regulation -6T unpalatable for many partnerships and their general partners. Because a partnership is not required to adjust its withholding even if it receives a valid certification, many general partners may simply refuse to give effect to certifications from foreign partners.

Partnerships willing to withhold based on certificates presumably will do so only if they feel confident that they can police this risk. For example, in the case of a foreign partner that is a large, creditworthy institution, the partnership may be able to negotiate indemnities on which it can prudently rely as a precondition to withholding based on the partner’s certificate. However, this is not an approach likely to be practical for the smaller, less creditworthy partners. Alternatively, the general partner may feel

comfortable based on the nature of its business and the amount of partnership equity that the foreign partner has at risk that the partnership will be able to recoup its tax liability from subsequent distributions otherwise available to the foreign partner, provided the partnership agreement permits them to do so. Partnerships formed after the effective date of the regulations may be able to address these issues as a negotiated contractual matter in the partnership agreement. However, agreements of existing partnerships may leave general partners in a difficult position weighing pressure from certifying foreign partners to reduce withholding against the risk of action by noncertifying partners if they withhold based on certificates that, with hindsight, are defective.

We also do not believe any amount of procedural complexity can prevent a foreign partner determined to evade taxes from doing so. Nor does allowing foreign partners to certify losses create avoidance opportunities that do not presently exist. Avoidance by foreign persons willing to flout their legal obligations was possible under the pre-existing section 1446 regime. For example, a foreign partner determined to evade tax may invest in the underlying partnership through a domestic partnership that it controls, provide a Form W-9 to the underlying partnership and “manage” tax withholding for itself at the level of the higher-tier domestic partnership. The withholding regime for non-effectively connected income under section 1441 has the same infirmity. No withholding system that depends to any extent on taxpayer certifications of status can preclude tax evasion based on outright misrepresentation.

Accordingly, if the final version of Regulation -6T retains the approach of permitting partnerships to withhold largely at their own risk, we think the procedural simplifications we recommend above would be significant improvements. With

relatively minimal procedural requirements, the partnership could be permitted (but not required) to withhold based on a partner certificate it does not know or have reason to know is false because the partnership would have every incentive to police the certification themselves.

More importantly, a majority of the Executive Committee believes that reasonable reliance on a certificate (even with the procedural simplifications we recommend above) should protect a partnership against liability not only under section 6655, but also under sections 1461, 6601 and the various penalty provisions. This would be consistent with the rules for the partnership's determination as to whether the partner is or is not foreign (and with the treatment of withholding agents under sections 1441 and 1442 who may rely conclusively on facially valid certificates that they do not know or have reason to know are false).⁶⁷ A minority is of the view that full protection against tax and interest would undermine the purpose of the statute to collect tax, and may also be beyond Treasury's authority.

⁶⁷ As discussed above, if the partnership reasonably relies upon an IRS Form W-9 or other appropriate documentation to establish that the partner is not a "foreign person" or is a foreign grantor trust whose beneficial owners are U.S. persons, the partnership has no liability under sections 1446, 1461, 6655 or 6601. See Treas. Reg. § 1.1446-1(c)(2)(iii). The same standard applies to withholding agents under sections 1441 and 1442. See Treas. Reg. §§ 1.1441-1(b)(7) and 1.1441-2.